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THE 1969 ECONOMIC REPORT OF THE PRESIDENT

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

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THE 1969 ECONOMIC REPORT OF THE PRESIDENT

MONDAY, FEBRUARY 17, 1969

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Joint Economic Committee met, pursuant to notice, at 10 a.m., in room 318, Old Senate Office Building, Hon. Wright Patman (chairman of the joint committee) presiding.

Present: Representatives Patman, Reuss, Griffiths, Moorhead, Widnall, Brock, and Conable; and Senators Proxmire, Javits, Miller, Jordan, and Percy.

Also present: John R. Stark, executive director; James W. Knowles, director of research; and Douglas C. Frechtling, minority economist.

Chairman PATMAN. The Joint Economic Committee will please come to order.

Today we resume hearings on the state of the economy and the economic outlook. We have already heard from the outgoing Council of Economic Advisers and other officials of the previous administration on the 1969 Economic Report of the President.

Today we welcome the new Council. You are all known to us as highly competent and reputable economists, and you face a great challenge in your responsibility to recommend policies to carry out the objectives of the Employment Act, to promote maximum employment, production, and purchasing power.

I know that the members of this committee are eager to raise questions and discuss the economic policies of the Nation with you, Dr. McCracken, and your associates.

First, I would like to yield to the ranking minority member, Senator Javits, for a statement.

STATEMENT OF HON. JACOB K. JAVITS, RANKING MINORITY MEMBER OF THE JOINT ECONOMIC COMMITTEE

Senator JAVITS. Thank you very much, Mr. Chairman.

Mr. Chairman, I am making this statement on behalf of the Republican members of the Joint Economic Committee, speaking as a minority with one voice.

The minority members of the Joint Economic Committee welcome you here today for our hearings on the economic policies and programs of the new administration for the coming year. There are several major economic problems troubling our prosperity, left as a legacy of the previous administration. The Congress and the Nation will hope and expect to receive during these hearings your current analysis and evaluation of the economic issues facing this country and your proposals for solving these problems.

The major task for economic policy today is to halt inflation while maintaining a high level of employment. It is true that we are enjoying the lowest unemployment rates in 15 years, although the fact this has been achieved during time of war reduces the pride we can take in this feat. But, despite repeated warnings from the minority of this committee and others, the previous administration failed to take the necessary measures to prevent rapid increases in our price levels. Our consumer price level soared almost 5 percent last year, the highest rate of inflation in almost three decades. Aside from redistributing purchasing power capriciously, excessive demand and the inflation it produces has caused major distortions in our economy.

For one, interest rates have risen to levels seldom seen before. Recently, commercial banks lifted their prime lending rate to 7 percent, a historical high. And the U.S. Treasury was forced to issue a medium-term refinancing note as the highest Federal Government coupon rate since 1865. We will want to know your assessments of the effects of these high interest rates on financing business, housing, and public facilities, and what the new administration feels should be done to relieve these pressures.

Inflation must be brought under control, and it must be done so in a manner consistent with ample employment opportunities providing adequate incomes—there need be no "price" in the form of substantially increased unemployment paid by society for a more stable economy. We will be most anxious to hear how the new administration plans to deal with this problem.

Inflation has also contributed heavily to continuing balance-of-payments disequilibrium. In 1968, our trade surplus—for a long time a source of strength in our international accounts—declined to the lowest level in more than 30 years. Our overall balance of payments for 1968 appears to show a surplus for the first time in more than a dozen years. However, this is a "soft" surplus, purchased at the high price of controls on our foreign investment and accounting gimmicks in the form of "special transactions," which may not recur again. Moreover, abnormally high interest rates in this country have distorted normal international capital flows, providing us with an unusually large inflow of capital last year that will not continue. So, far from being able to take pride in our international payments position, we must now find ways to improve our international competitive position in a way which will allow us to remove controls and bring our balance of payments back into equilibrium.

After returning our price behavior and balance of payments to order, the most important task for economic policy is planning for the post-Vietnam war period. The transition from war to peace must be organized so as to produce the least disruption in the progress of our economy. We are pleased to hear that the administration has appointed a special interagency study group that will address itself to this issue. Further, what decisions are now being made to apportion the Vietnam peace dividend—the Federal financial resources that will be released by ending the war—among competing demands on the Government? How much of this dividend is available for civilian needs and not already committed to military programs?

Now is the time to plan how to best utilize these resources to meet urgent domestic needs, especially in our cities, which have too long been ignored by the demands of financing the war, and to insure that postwar readjustment is smooth and economic growth and stability continuous. Of course, the economic problems of farms and rural areas must also be attended to in any such plan for postwar reallocation of Federal resources.

Another important economic issue is Federal tax reform. We are gratified to hear that the new administration has placed this issue high on its agenda. The previous administration professed a dedication to tax reform that never materialized during its term in office. For too long, the Federal tax system has been looked upon as a device for economic stabilization, and the fact that the burden for this stabilization is not shared equitably has been ignored. We will want to know and carefully study what specific reforms the new administration intends to support to make our Nation's tax system more rational, equitable, and enforceable.

We also hope to hear representatives of the new administration address themselves to better coordination and implementation of fiscal and monetary policies. The great failure of economic policy in the 1960's was the delayed imposition of a substantial measure of real fiscal restraint. The inflationary predicament we face today is in great part due to the gross underestimation of the costs of the Vietnam war and the failure of the previous administration to face up to the unavoidable choice between guns and butter. The resulting fiscal stimulus of an already booming economy placed too much burden for restraint on monetary policy, which resulted in serious distortion of money and credit flows.

The ease in monetary policy after the enactment of the tax increase last year appears to have been another major economic policy mistake. The fear of fiscal overkill last year moved the Federal Reserve System to allow money and credit to expand at increased rates. Although the links between money and credit growth and economic activity are not entirely clear, it is fair to say that the failure of fiscal restraint to curb inflationary demand is due in no small part to mismanaged monetary policy. We will want to learn how the new administration proposes to better coordinate fiscal and monetary policies to achieve agreed-upon economic results.

Within the framework of a fiscal policy devoted to encouraging high employment without inflation, we will want to hear how the new administration intends to reorder priorities to meet pressing economic and social needs of the Nation. More specifically, how will this reordering be reflected in changes in the budget prepared and submitted by the previous administration?

In sum, the Congress and the Nation expect to learn how the new administration proposes to deal with the major economic problems inherited from the old administration. But while Government must show the way to economic stability and increased prosperity, it cannot achieve these goals by itself. This requires involvement of all sectors of the economy and a dedication to making sound economic policies and programs work.

We hope that these hearings will indicate the ways to improve our various economic policies and lead to the results which have thus far proved so elusive.

Thank you, Mr. Chairman.

Chairman PATMAN. Thank you, Senator Javits.

Senator Miller, would you like to say a word?

Senator MILLER. Thank you, Mr. Chairman.

Mr. Chairman, and my colleagues, it is a great pleasure to present to the committee the Chairman of the Council of Economic Advisers who, along with his colleagues, are scheduled to testify.

The chairman, Dr. Paul McCracken, is an Iowan. He was born and raised in Iowa and went to undergraduate college, William Penn, in Iowa before going on to Harvard for his advanced degrees. His parents and a brother still live in my State. He is no stranger before this committee because he has testified before us on many occasions especially while he was serving on the faculty at the University of Michigan. But I am sure that it is rare indeed for a Senator from Iowa to have the opportunity to present the top economist in our Federal Government, Dr. Paul McCracken.

Chairman PATMAN. Thank you, sir.

Mr. McCracken, you have a very comprehensive statement which we appreciate. All the members received this 2 or 3 days ago. They are familiar with it, and we would ask you to take about 20 minutes time, if that is sufficient; if not we will extend the time. Give us a résumé of your statement, then we will ask you questions. Each member will be allowed 10 minutes, and in that way we can probably cover the ground just a little bit better. So you may proceed in your own way with the understanding that your statement will be placed in the record at this point in full.

Senator JAVITS. Mr. Chairman, a parliamentary inquiry. Although I have not consulted them, I believe the minority entirely approve of the 10-minute rule, with the understanding that after the first round, members may have another succeeding round of 10 minutes.

Chairman PATMAN. That is part of the rules.

Senator JAVITS. Exactly. I thank the chairman.

Chairman PATMAN. Any member can ask any question he wants to if he stays here long enough and the witness stays here long enough.

All right, Mr. McCracken, we are delighted to have you, sir, and you may proceed in your own way.

STATEMENT OF HON. PAUL W. McCRACKEN, CHAIRMAN, ACCOMPANIED BY HON. HENDRIK S. HOUTHAKKER AND HON. HERBERT STEIN, MEMBERS, COUNCIL OF ECONOMIC ADVISERS

Mr. MCCRACKEN. Thank you very much, Mr. Chairman. On behalf of my colleagues, Dr. Stein and Dr. Houthakker, I want to express to you our very deep appreciation for this opportunity.

Your committee and our Council are the two bodies set up by the Congress and the President in discharging their responsibilities under the Employment Act of 1946. There is certainly much to be gained from cooperation between us. We want this morning to try to explain to you, and through you to the Congress as a whole, and to the American people the economic thinking that underlies the Administration as it shapes its programs and, at the same time, we hope and we are certain that we shall learn from you.

There has always been in principle a potential problem in the relationship between the Joint Economic Committee and the Council of Economic Advisers. The members of the Council are economists, and like other economists they are always prepared to talk. But they also have a position of confidence as advisers to the President, and there may be matters which must be kept confidential. In practice, however, as we observe the history, this problem has not prevented a quite full interchange between the Council and the committee.

We would propose, if you agree, to operate according to the procedure that has now been established. When you invite us to do so, we shall testify in public and on the record. If matters arise on which we are unable to speak, either in public or at all, we shall try to explain our inability. We hope in such circumstances that you will understand our problem. We would expect such circumstances to be extremely rare, however, if they occur at all.

Since the Council along with the rest of the administration has been in office only 4 weeks, we are not prepared to lay before you a comprehensive program covering the enormously wide range of the Government's economic activities. Neither are we prepared to analyze in detail all of the conditions and problems of the national economy. There is much that we do not know. This will always be true, but it is truer today than we hope it will be later. In fact, each of us would agree that in some respects he knows less today than he knew, or thought he knew, 5 weeks ago. Nevertheless, we think it important to report our current thoughts, however incomplete and tentative they may be.

Great problems beset the American economy, and our statement will concentrate on some of those problems. This is natural and proper, but it can also be misleading if the problems are not seen in their context. For the basic truth about the American economy is not that it has problems but that it is highly successful. The American economy generates the highest volume of output per capita the world has ever known. This output is far from equally distributed, but it has become more and more widely distributed. Most Americans enjoy, by any criteria, exceptionally high levels of living earned with exceptionally little physical toil. Moreover, Americans enjoy a high degree of freedom in choosing both their ways of living and their ways of working. Thirty years ago many thought there was a fatal flaw in the American economy—the problem of instability and unemployment, which gave rise to the establishment of your committee and our Council. Although instability remains a problem, at least potentially, and serious pockets of unemployment do exist, great progress has been made since the act was passed.

This successful performance did not just happen. It has required the abundance of our natural resources and a highly skilled people. But also, and even more importantly for our purposes, it has resulted from our economic and political system. This system defies simple description. The fact that it is so commonly called a mixed system only reveals that. But surely the distinctive feature of this system is the great freedom individuals have in the use of their labor, talents, and wealth, in associating with others for the organization of production, and in disposing of the resulting income. This freedom is disciplined by competition, but its restraint by tradition or the dictates of government has been remarkably light in comparison with other times and other places. The freedom of indviduals to use their own resources is a key factor in the success with which the American economy satisfies the needs of individuals.

The American economic system as it exists today did not spring full blown from the brow of some Scottish philosopher or Virginia gentleman 200 years ago. It has evolved over the decades. From time to time observers of our condition have claimed to see a radical turning point, with the system coming to be dominated either by monopoly capitalists or by overpowering government. They have proclaimed the advent of ominous new eras or new industrial states or roads to serfdom. These claims have always turned out to be exaggerated. The economy has changed in many respects, but its fundamental reliance on freedom disciplined by competition has remained. Corporations and labor unions are larger than they used to be, and the Federal Government is much larger than it used to be. But the economic and social environment within which we move has also greatly expanded. With the growth of incomes, knowledge and mobility the opportunities open to the average American in choosing his manner of living and working are broader than human beings have ever enjoyed before.

We believe that freedom with competition has been and remains a key element in the success of the American economy. This does not mean, obviously, that we see no problems requiring Government action. But it does mean that we should seek solutions to problems that rely upon and strengthen, or at least do not weaken, the free and competitive character of our system. The great success of economic policy in the last generation in dealing with large-scale unemployment shows the effectiveness of this approach. When the unemployment problem was at its most critical, in 1932 and 1933, there was a common belief in the United States, shared by conservatives and liberals, that solution of the problem would require radical change of the system in the direction of Government planning and control. This idea persisted, although with diminishing force, into the late 1940's. However, at the same time we were discovering that the solution of the problem lay in a different direction—in the use of fiscal and monetary policy to guide the growth of total demand. This solution required thought and action by the Government, but it did not require direct Government control of the activities of individuals and businesses. In approaching other problems there are similar opportunities for constructive Government action that leaves the market process free to work.

We are also impressed by the fact that all important economic policy decisions must be made in the face of great-uncertainty, about the future economic conditions in which policy will operate and about the effects of policy. This should not lead to paralysis or indecision. Still, it is a basic fact that must be given due weight in our decisions. We cannot act as if our most probable estimates are certain. We must ask ourselves not only what will be the best course if our estimates are correct but also what will be the safest course if the estimates turn out to be incorrect. There is a natural tendency for people to exaggerate the certainty of their own knowledge in offering policy advice. This leads to bad policy recommendations. Moreover, the exaggeration soon becomes clear, and it can lead to a general skepticism which undermines the deliberative process. In any case, we hope to recognize for ourselves and to reveal to you the uncertainties of information and analysis with which economic policymaking must contend.

EQUALITY AT THE STARTING LINE

We would like to concentrate here on two main problems—domestic economic stabilization and international economic relations. However, we must also say a few words about another problem which we regard as one of the most critical, perhaps the most critical, now facing us. That is the problem of bringing disadvantaged groups more fully into the mainstream of our economic life. We are unable to say much about this today because we, like others in the administration, are in the early stages of reviewing the efforts that have been initiated in recent years to deal with this problem.

At an early stage of history membership in a family or class was considered to be a proper criterion for access to material affluence. Then came a breakthrough as we insisted that every person should be able to go as far as his inclinations, energy, and ability could carry him, regardless of class or race or sex. Today we are in the midst of another breakthrough as we realize more fully the implications of the fact that people begin life's race unequally positioned around the starting line. Some begin so far back, through early cultural or educational handicaps, that latent ambition and ability never have the opportunity to flower and activate. The expectations of the poor and the conscience of the community as a whole, in short, will not be satisfied only to reap the gains for the poor yielded by continued economic progress and high employment.

We must, of course, always remember that American economic growth has been the most effective engine in history for eliminating poverty, and this continues to be the most basic requirement for progress here. And the maintenance of reasonably full employment will continue to contribute to the reduction of poverty. Especially in the short run, therefore, measures to increase the steadiness and productivity of employment can deal with only part of the problem. As poverty is now commonly measured, over half of the heads of poor households are unable to work, because of age or disability or because they are mothers of small children. In the longer run increasing employment and productivity will reduce the numbers of such people in poverty also. But for the present we must accept the fact that there are millions of poor for whom strong employment conditions generally will not be the answer.

For these people income support or income insurance is necessary. We do have systems for this, including social security and public assistance, through which large sums of money are paid. However, the public assistance, or welfare, system we have today does not measure up to the goals and capabilities of the American society. In many States the amount provided is grossly inadequate, and the terms on which support is given are often demeaning. Also, experiments are underway with procedures for making the determination of eligibility more objective and less objectionable. We look forward to rationalization and improvement of the income support system as a major objective for the Nation.

The ability to transfer money through the budget is not unlimited, of course, for economic as well as political reasons. If we now raise assistance for the poor in our scale of national priorities, as we should, we should be rigorous in trimming those budget flows which serve purposes now of lower priority. We think that a practical approach to the poverty problem will require great firmness in dealing with other expenditures and with tax reliefs and privileges not related to the antipoverty objective.

We would say one further word on this subject. The problems here are deeper than income alone. It is necessary for everyone to have an opportunity—not a certainty but a chance which individuals can improve by their own efforts—to do what is sometimes called making it. There needs to be an opportunity to attain greater independence and status. Our antipoverty efforts have not given sufficient emphasis to this.

THE GOALS: MAXIMUM EMPLOYMENT AND PRICE STABILITY

The Council of Economic Advisers was created by the Employment Act of 1946 to assist in carrying out the mandate of that act which calls the Government to use all of its capabilities to achieve and maintain maximum employment. We, of course, accept that mandate.

But even if there were no Employment Act, anyone who has lived through the past 40 years or knows its history must put maximum employment high on the list of national goals. Although we are a relatively affluent society, we cannot afford the loss of output that would result, and has resulted in the past, from persisting and large-scale unemployment. However, the main consequences of unemployment are not to be seen in the statistics of output. They are seen in the psychological injury to those individuals to whom the society seems to say, "We have no use for you."

Of course, we no longer conceive of the possibility of unemployment rates as high as 25 percent—the rate for 1933. It might seem that differences of a percentage point or two in the unemployment rate would not be a matter of major consequence. However, that is not the case. Unemployment is highly concentrated. In 1967, the average unemployment rate was 3.8 percent. During the year, however, 87 percent of the civilian labor force experienced no unemployment while 13 percent, or 11.6 million persons, did experience some unemployment. For most of these the period of unemployment was short. But there were 2.6 million persons, or 2.9 percent of the labor force who were unemployed for 15 weeks or more, of which 1 million persons—1.1 percent of the labor force—were unemployed for more than 26 weeks.

Unemployment is not randomly distributed across the labor force. Everyone does not have an equal risk of being unemployed. The likelihood of being unemployed is much greater for teenagers, for women, for the unskilled and for nonwhites than for the rest of the labor force. The likelihood of being unemployed for a considerable period in any year is especially great for the unskilled, for the nonwhite, and for the aging. The human and social implications of this are obvious.

A recent study by the Bureau of Labor Statistics reveals how important even a relatively small difference in the national average rate of unemployment may be for the disadvantaged. Between the fourth quarter of 1967 and the fourth quarter of 1968, when the seasonally unadjusted national average unemployment rate fell from 3.7 to 3.2 percent, the unemployment rate in urban poverty neighborhoods of the 100 largest metropolitan areas fell from 6.9 to 5.2 percent; and the unemployment rate of Negroes in these neighborhoods fell from 9 to 6.4 percent. Clearly we must try to reduce this concentration of unemployment. We interpret the mandate of the Employment Act, therefore, as having a qualitative as well as a quantitative dimension.

The Employment Act set other goals for us in addition to maximum employment. The most critical of these today is expressed in the term "maximum . . . purchasing power." This term has been commonly interpreted by the President and by the Joint Economic Committee to embrace price level stability and avoidance of inflation, and we see that if we examine the Economic Report and the Report of the Joint Economic Committee.

Thus, President Truman in his 1948 Economic Report said:

> "Our purchasing power objective for 1948 should be to effect the economic adjustments which are necessary to afford adequate protection against inflation."

A decade later in his Economic Report President Eisenhower declared:

> "A clear responsibility rests on Government to pursue policies that will help prevent inflation."

And in 1965 President Johnson said:

> "I regard the goal of *overall price stability* as fully implied in the language of the Employment Act of 1946."

There have been 29 annual and midyear Economic Reports of the President. Only three of these failed to express a concern about inflation and to affirm the national goal of price stability. Similarly, only three of the annual reports of the Joint Economic Committee failed to express concern over inflation. Each of the exceptions occurred during a recession.

Thus the President and the Congress have not only regarded price stability as an important national goal. They have also announced it as a goal and have given the American people every reason to think that it is the policy of the Government to avoid inflation. This is in itself a fact of much importance.

There are three main reasons for the continuing and almost universal concern with inflation. The first is the random, unjustified, and inequitable distribution of gains and losses that it causes. All of us—Government, businesses, and individuals—are constantly making commitments for the future in dollar terms. We agree to work or to hire labor for so many dollars an hour or year. We invest in life insurance or pension funds which entitle us to receive specified numbers of dollars at some time in the future. The Government undertakes to pay social security benefits, veterans pensions, and interest in the future in specified amounts of dollars. The Government sets tax rates whose height depends on income measured in dollars.

The real value and effect of all these commitments depends on the prices prevailing at the future time when the dollar payments are made. Obviously a person who bought a Government savings bond or put money in a savings deposit 3 years ago has lost 10 percent of the real value of his investment through inflation. After paying taxes on interest income, his "real" rate of return has been small, and for some it was negative.

When people enter into these commitments they have some expectation, more or less explicit, about what is going to happen to prices. Even if everyone were now to expect and to anticipate inflation, it would not make the present inflation harmless. People are now living with commitments to pay or to receive money which they had undertaken in the expectation of much less inflation than has recently been occurring. These people are being hurt. If we should now make the recent rate of inflation permanent, their injury would continue for years to come.

Just who gains and who loses from inflation is hard to calculate. The gains and losses are to individuals and tend to offset each other in statistics about groups. Thus measures of impact based on displacements of broad groups—wage earners, older people, farmers—obscure and underestimate the hardships.

There are, however, certain things that can reasonably be said. An inflationary environment creates more problems for the "little fellow" than for the sophisticated investor. It may well pose more intractable problems for the small businessman than the large corporation.

And one thing we can confidently say. Those who have taken at face value the Government's announced policy of avoiding inflation have lost in recent years. It is the Government's responsibility to provide good money—money whose value is predictable. To provide good money the Government must bring its actions about inflation into line with its declarations. Since it is hardly conceivable that the Government would declare a policy of inflation, honest treatment of its citizens requires action to prevent inflation.

A second reason for concern with inflation, in addition to the inequities it works upon individuals, is the distortion it causes in the pattern of production and in business and financial decisions. The calculus of investment and lending decisions tends to become less discriminating as people come to assume that inflation will bail out even poor decisions. Perhaps the most important, and certainly the most visible, of these adverse effects is on housing. In a period of actual and anticipated inflation the demand for credit from all quarters is high. Individuals and businesses are eager to borrow funds, which they expect to repay later in dollars of less value, and savers become less interested in fixed-dollar assets. Interest rates, therefore, rise sharply, and flows of funds into institutions particularly important in financing homes are curtailed. We see this today. When the new administration assumed its responsibilities, yield rates on new FHA mortgages had pushed to the 7½ percent zone. These high rates were a direct consequence of the inflation that had been allowed to gather momentum.

Because of the inflation a mortgage must now be larger to buy the same house. Because of the impact of inflation on interest rates, the monthly payments on a $20,000, 25-year mortgage must now be over 20 percent larger than three years earlier. Nor could these rates have been relieved by a more expansive Federal Reserve policy. This would have activated a further overheating of the economy, which would then have given another upward thrust to interest rates.

The third main reason for concern with inflation is its effect on the balance of payments and the international position of the dollar. While we shall discuss this in the later section of our statement, we must point out here that the serious deterioration in our trade balance largely reflects the flood of imports, which usually happens when demand becomes excessive and merchandise from abroad pours in to fill the gap.

We are the victims or beneficiaries of the past with respect to the choices that are open to us as we confront this difficult problem of inflation. But our successors will be the victims or beneficiaries of what we do.

We have in this difficult situation three principal alternatives:

1. We could cut back economic expansion severely enough to stop the inflation at once, and keep it at zero until the expectation of no inflation became firmly established. This would probably cause a period of substantial unemployment.

2. We could try to continue the policies of recent years that have produced substantial and accelerating inflation—as measured by the consumer price index, 2.8 percent in 1967, 4.2 percent in 1968, and at a 5 percent rate by the final quarter of 1968. Housing would be severely affected, further serious strains would be imposed on the international economic and financial system, and profound further changes would be apt to occur in the way savers would be willing to make their funds available.

3. Our third alternative would be to embark upon a course of gradually and persistently reducing the rate of inflation and thereby generating the expectation of diminishing rates of inflation in the future.

None of these courses is free of costs or risks. We have inherited a difficult situation. There is no point to pretending that we have a way to escape from this history. However, we believe that considering the national interest in high employment, price stability, and vigorous and on-going expansion, the strategy of moving steadily and gradually to reverse the inflationary trend is indicated.

What would this do to unemployment? This is an urgent question for all concerned Americans. So long as anyone wanting work is unable to find a job, we have unfinished business. These are, however, reasons for hope that the impact would not be large. It is significant that during the last 3 years we gained little on the unemployment front for the ground that we lost on the price level. The unemployment rate was the same in 1967 as in 1966 (3.8 percent), and it was 3.6 percent in 1968; thuogh it is true, of course, that by the end of the year it was 3.3 percent. At the same time no one can assure that the distortions from 3 years of economic overheating and price inflation can be corrected with no effect on unemployment.

THE INSTRUMENTS OF ECONOMIC POLICY

The principal way by which the Government can achieve its objectives for the economy is to influence the rate of growth of total spending for goods and services. This is true whether the chosen strategy is the one we have just suggested or some other. If the objective is to slow down the rate of inflation perceptibly but gradually so as to keep unemployment low, we shall need to slow down the rate of growth of total demand gradually as the means of achieving that objective.

From time to time, in the United States and elsewhere, attempts have been made to promote the achievement of expansion and price stability by recourse to "incomes policy." Essentially this means an attempt by education, persuasion, exhortation, threats, or other means short of mandatory and specific controls to induce businesses and labor organizations to hold price and wage increases below the amounts that would naturally occur in the prevailing market conditions, market conditions, by the way, it is worth repeating, which reflect the Government's basic fiscal and monetary policy. The United States has had recent experience with this kind of policy under the name of wage-price guideposts. We question whether these should play much of a role in the period ahead.

The concept of incomes policy has strong fascination for policymakers. It seems to promise the advantages of controls, which many people want, without the disadvantages, which almost no one wants. But in fact the benefits sought have been realized only to a minor degree, if at all, and never for very long, whereas the policy has brought many of the disadvantages of a controlled system and some of its own. This has been true in the United States as elsewhere. As a result the short life of incomes policy has become as predictable as the attempts to use it.

Probably the chief reason for the general ineffectiveness of incomes policy is that it can apply only to a limited segment of the economy. This is the segment of centralized national unions and large corporations. Even within that segment the distribution of the Government's influence is quite uneven. And those upon whom the influence is exerted become resentful and resistant, for understandable reasons. They have been singled out by no relevant criterion but only by vulnerability. They are asked to follow rules of behavior that are arbitrary and become more arbitrary as the policy is pushed harder. The rules have not been established by due process of law. They are sometimes enforced by the threat of using Government powers not given for that purpose. All of this undermines the moral basis on which the policy originally rested. For its part the Government has set up rules of voluntary behavior and is torn between seeing its rules violated and making the behavior less voluntary.

The President has the right and duty to use the moral leadership which goes with his office to achieve major national objectives. He cannot forswear such action. But he must use this leadership judiciously and not dissipate it by using it in circumstances where it is unlikely to be effective or where the moral basis is not clear.

There are, however, a number of areas where the necessary and legitimate activities of government affect labor or product markets and where these activities should take into account the national interest in price stability and high employment. This includes, for example, international trade policy, measures to promote competition, the Government's management of its own procurement, and those cases in which the Government sets minimum wage rates or maximum rates or prices. The Council of Economic Advisers is interested in the effects of all of these decisions on economic stability. We have not had an opportunity to bring ourselves abreast of policy in these areas, however, and will say nothing more about them here.

Our present main concern is with slowing down the rate of growth of aggregate demand in a way that will not cause an unacceptable increase in unemployment. And beyond that we are concerned with maintaining steady growth of aggregate demand at a rate that will be consistent with continued high employment and reasonable price stability. The main instruments for accomplishing these objectives will be fiscal, monetary, and debt management policies. The Joint Economic Committee has, of course, taken the lead in teaching the country about the instruments of economic stabilization, starting with the notable hearings conducted by the present chairman and by Senator Douglas almost 20 years ago. The country has now had a good deal of experience with the use of these instruments, and it is worthwhile to see what has been learned from that experience. We do not propose to review this history in detail but only to summarize what we think are its lessons.

The evidence strongly supports the view that fiscal and monetary policies taken together have a powerful influence on the rate of growth of total spending and on employment and prices. This influence has not always been exercised in the right direction and amount or at the right time to stabilize the economy. But the historical relationships between changes in fiscal and monetary conditions and changes in economic conditions, although by no means precise, are consistent with a priori expectations of the power of these policy instruments.

It is hard to separate and measure the distinct effects of fiscal actions and monetary actions. Nevertheless, we believe the most reasonable conclusion is that both are important and it would be imprudent to disregard the overall effects of either.

There is much disagreement about the channels through which monetary policy affects the economy and consequently about the best measures of the direction and degree of monetary action. Specifically, there is disagreement about whether monetary restraint or stimulus is exerted or measured by changes in the supply of money, which can be measured in various ways, by changes in the supply of bank credit or of total credit, or by changes in the general level of interest rates or in the relationships among interest rates, or in still other variables that could be mentioned. We are inclined to the position that the behavior of the supply of money is very important. However, we do not regard this question as settled and have no desire to be dogmatic about it.

We believe that fiscal policy would have been significantly more stabilizing than it was in the past 10 years if it had followed a steadier course, with smaller variations in the size of the surplus that would have been yielded at high employment. The rise in the high employment surplus between 1958 and 1960 and the rise in the deficit between 1965 and 1967 were excessive and contributed to instability. What now seem to have been the chief successes of fiscal policy from the standpoint of stability—the tax reduction of 1964 and the tax increase of 1968—were both corrections of previous departures from a steady path.

The parallel statement about monetary policy is less certain. Because of the existing disagreement about the best measure of the restrictiveness or ease of monetary policy, one cannot be confident of the effects that would have been yielded by a steadier policy in the past or about how to define a steadier policy for the future. However, if one accepts our opinion about the great importance of the supply of money, it is probably true that a steadier rate of growth of the supply of money would have contributed to economic stability.

Circumstances are possible when departures from the steady path for fiscal or monetary policy or both would be desirable. There may be fluctuations in the private economy too strong to be constrained within reasonable limits without extraordinary fiscal or monetary action. Moreover, once fiscal or monetary policy have strayed far from the reasonably steady path, measures of adjustment are needed to get back to it. Our point is that frequent adjustments of policy to correct dimly foreseen future departures from the desired path of the economy are on balance likely to be more unstabilizing than stabilizing.

To achieve a stabilizing fiscal policy, or at least avoid a destabilizing one, we need to learn how to separate decisions about the overall position of the budget from decisions about particular expenditure programs and questions of tax structure. On many occasions—notably, the long debate over the 1964 tax cut and the long debate over the 1968 tax increase—timely action was prevented because these issues became entangled.

We also believe that the conduct of anti-inflationary monetary policy is easier, and can be counted on more reliably, if the Federal Government is not a continuous large borrower during periods when restraint is needed. This obstacle to sound monetary policy is not insuperable. Nevertheless, it would be desirable to try to run a surplus in the budget at times of inflationary pressure and also to arrange the debt so that the proportion of it having to be refinanced every quarter or year is not so large as at present.

The fiscal and monetary requirements of domestic stabilization are often consistent with the requirements of balance-of-payments equilibrium. This is true, at least in direction, today. But often the domestic and international goals are not inconsistent and we need to find better ways to reconcile them.

Despite limitations of knowledge and conflicts of objectives, fiscal and monetary policy are capable of maintaining a high degree of economic stability—a higher degree than in the past decade. However, no one can promise precise adherence to the path of steady growth.

OUTLOOK AND POLICY FOR 1969

As we encounter the requirements of economic policy at the beginning of 1969, the basic fact we find is that the country has run out of the easy way of doing things.

1. Continuing rapid inflation has generated a strong inflationary psychology. This makes it highly dangerous to allow the inflation to continue. At the same time it makes the task of slowing down the inflation difficult, because it increases the risk of adverse effects on real output.

2. The credibility of the Government's repeatedly stated policy of stopping inflation has been weakened. New announcements of policy, however sincere, will not turn around the existing inflationary psychology. At least at first a new policy will have to work against, not with, the prevailing psychology.

3. The potentialities of slowing down inflation by appealing to the good behavior of business and labor have been weakened by overuse and misuse.

4. The budget, using the unified budget concept, has been brought barely into a projected balance by the imposition of a tax surcharge from last year's $25 billion deficit.

5. Many demands for Federal expenditure programs have been staved off by promises incorporated in legislative authorizations, without the provision of funds to meet them. The problem of establishing budget priorities has not been met but has been allowed to pile up.

6. The prudent structuring of the debt has had to be deferred as a result of the ceiling on interest rates for longer term securities. As a result the average maturity of the outstanding marketable debt has been allowed to decline to 4 years, from 5 years 4 months at the beginning of the Vietnam buildup. This presents an obstacle to anti-inflationary monetary policy. In its first refinancing the new administration did offer the longest maturities permitted by existing interest rate ceilings.

There is little room for choice among feasible and desirable courses for the economy in 1969. In general we agree with the picture for the year as a whole drawn by President Johnson and his Council of Economic Advisers in their January 1969 Economic Report. Gross national product for the year as a whole should be about $921 billion. Average unemployment for the year would be less than 4 percent. The year-to-year price increase, as measured by the GNP deflator, would be around 3½ percent. This would serve the imperative need to initiate a perceptible decline in the rate of inflation. This result should be achievable with the recommended budget and appropriate monetary policy.

We are, however, less confident about the feasibility or desirability of the pattern of developments expected through the year and about the policy by which this pattern is to be achieved. The economic reports are not entirely explicit about this but we believe that the picture can be fairly summarized as follows:

> The rate of expansion would slow down markedly in the first half of 1969. The fiscal restraint initiated in mid-1968 would have more of its expected impact and to this would be added the effects of the social security tax increase of January 1, 1969, and the tighter money that began in the latter part of 1968. In addition, there would probably be some decline in the rate of inventory accumulation. The slowdown would not be so great as to cause an actual reduction in output, but output would grow much less rapidly than in 1968 and unemployment would rise slightly. The most important effect would be a decline in the rate of inflation, which would continue to influence the trend of prices subsequently. After midyear, according to the report, the increase of output would quicken, but would remain at a rate below the growth of potential. The rate of inflation would continue to decline and the rate of unemployment would continue to rise, both slowly. The unemployment rate at the end of the year would still be below 4 percent. The rate of expansion foreseen in the second half of the year would require or permit some easing of monetary restraint after early 1969, especially since fiscal restraint would be continuing.

Our main concern with this projection of 1969 is that it may not bring us to the end of the year with the rate of inflation perceptibly declining, which we believe to be an important objective if economic stability is to be reestablished. We regard some slowing down of the rate of expansion in the first half of the year as probable, although the evidence is still uncertain. Much of the case for the slowdown rests on fiscal impacts which have proved in the past to be smaller, or at least slower, than was expected. The effects of the monetary restraints imposed in the latter part of 1968 may be felt only gradually in the first half of 1969. It is worth noting that the unemployment rate remained at the December level of 3.3 percent in January. The slowdown in the first half may, therefore, turn out to be smaller than the economic report assumes. Particularly, it seems unwise to count on the slowdown in the first half exerting such a cooling effect on the economy that the rate of inflation in the second half would continue to decline even though the rate of the economic advance generally would be accelerating.

The record of 1967 may be instructive. There was a bigger slowdown in the first half of 1967 and an upturn in the second half roughly comparable to that apparently implied in the last Council's projections for 1969. Still we find it significant and worrisome that by the end of 1967 the rate of inflation was again accelerating.

We think that the rate of expansion consistent with our economic goals in the second half of the year may be less than the economic reports imply. The goal should be to assure that the rate of inflation declines persistently throughout the year. This result would be consistent with President Johnson's estimate that the unemployment rate for the year would average less than 4 percent. It would also be consistent with a gross national product for 1969 which would differ from President Johnson's estimate of $921 billion by much less than the usual margin of error for such estimates. It would, however, mean a slower rate of expansion in the latter part of the year.

Our view of the outlook and goal for 1969 implies the need for continuation of a budget whose expenditures are at least matched by the revenues from the tax system—assuming reasonably full employment. Whether this will require extension of the tax surcharge depends on the outcome of the current review of expenditure programs. We are aware of the opinion held by some that fiscal actions in general, and the extension or expiration of the surcharge in particular, have little or no effect on total spending, prices, and employment. However, in the present state of our knowledge, and in the present state of inflationary psychology, it would be rash to act on the assumption that the return to a budgetary deficit would have negligible direct inflationary effects. Moreover, the reemergence of a large Federal deficit would create greater strains on the economy—particularly in financial sectors—in effectuating a stabilizing monetary policy. Aside from the inflationary effects, we would be concerned about the probable consequences of a renewed Federal deficit on the supply of funds for private investment, especially housing.

As you know, the administration is now engaged in a review of the budget for fiscal 1970 submitted by President Johnson, particularly in a search for opportunities to cut spending. The Director of the Bureau of the Budget will testify about this tomorrow. We want to make only two observations on this subject. First, we do not foresee probable changes from the budget submitted earlier that would have a major effect on the economic outlook for calendar 1969. Nevertheless, even relatively small immediate reductions would relieve the strain on private capital markets, and notably on the supply of funds for housing. Second, even though the immediate payoff in expenditure reductions may be small, a start on critical review of the budget is necessary to make room for tax reduction and expansion of high-priority expenditure programs later.

To achieve a continuous moderate reduction of the rate of inflation during 1969 will require an appropriate degree of monetary restraint. The last report of President Johnson's Council of Economic Advisers suggested that sometime in 1969 monetary policy might be able to "shift to a less restrictive stance." This seems to us unlikely unless the expansive forces in the private sector turn out to be significantly weaker than was indicated in the reports.

Management of stabilization policy would be assisted if the Treasury had a wider range of choice in selecting the terms of new securities to be issued. Under present law, the Treasury may not issue securities with a term in excess of 7 years with an interest rate of more than 4¼ percent, which has only meant that the Treasury could not sell long-term securities at all. It would be desirable for the administration to have a means of absorbing liquidity, by selling longer term securities. It would also be desirable to get the structure of the Federal debt into a longer average term, so that the operation of monetary policy was not inhibited by the constant presence of the Treasury in the capital markets as a borrower. In 1967 the Treasury asked Congress to raise the maximum term of securities exempt from the 4¼-percent ceiling, which was then 5 years, to 10 years. Congress would only agree to raise the exemption to 7 years. We believe that this whole subject deserves reconsideration.

We must recognize the possibility that events will not follow the path that we now regard as desirable and feasible. The intensity of the built-in forces for inflation in the economy are difficult to predict However, while the available instruments and knowledge do not allow us to control the upward path of the economy precisely, we are confident that a determined monetary policy and steady fiscal policy will hold variations in the course of the economy to reasonably narrow tolerances. There is, of course, the possibility that a slowing down of the economy might so puncture inflated expectations as to cause a decline which might for a time outrun the capability of economic policy to reverse it. We see no good reason for this to happen. The Government's intention to pursue a moderate and gradual course of cooling the inflation is clear. Although minor variations are inescapable, with orderly and steady management of economic policy the most reasonable expectation for real output and incomes at any time in the future is that they will be close to the path of normal growth. Still we must be prepared for the possible need to support the economy. The Government is sensitive to this possibility and ready to use the available fiscal and monetary instruments.

We must be prepared for the possibilities that will be opened up with the decline of spending for the Vietnam war when that comes. One of these would be a decline in economic activity. We do not believe that a decline is necessary and are confident that with proper advance planning the decline could be kept small and brief if it occurred at all. A program is now underway, under the direction of the Chairman of the Council of Economic Advisers, to continue studies begun under the previous administration to make sure that the needed plans are ready, and an interagency study group has been established to consider this matter.

1. What are reasonable projections of the course of Vietnam spending as this conflict starts to be resolved?
2. What will be the differential adjustment problems then posed for different areas, industries, and labor-force groups?
3. What policies and programs will contribute to a smooth transition for the economy and for these different parts of the economy?
4. How should the resulting room in the budget be divided among claimants?

We must never be satisfied with any level of unemployment, and this emphasizes the need to push on with specific measures to reduce the normal level of unemployment and its concentration. A great many programs to do this have been initiated, and they have apparently worked with different degrees of success. The administration is actively engaged in evaluating these and considering new possibilities. We at the Council regard this as a matter of great urgency, as the next great challenge flowing from the Employment Act in the present stage of development of fiscal and monetary policies. Since the Secretary of Labor will come before your committee later, we shall not pursue these matters in detail here.

We do, however, want to make one further comment. If something is deemed to be socially desirable, things will usually work out better if incentives are arranged so that this is also in the interest of the people themselves. As you know, the administration is intensely interested in the use of tax incentives to promote the training and employment of hard-to-place workers. Well-designed tax incentives could have the advantage of placing workers directly into the economic system—which is, of course, a powerful machine for training and employing people—rather than into Government programs, with all the problems of management they entail. We should be able to use tax incentives to promote objectives of highest present priority while clearing the tax structure of special privileges that no longer serve an important social objective.

The rapid flowering of new manpower training programs in recent years, mainly financed and planned from Washington but run locally, has created an unmanageable system. It is difficult to assure that the policies determined by Congress and the administration are being carried out, that all categories of needs are being met, and that duplication is being avoided. The Department of Labor, in consultation with other agencies affected, both Federal and State, is now making plans for improving the administration of the manpower programs.

The Secretary of Labor is also examining possible improvements of the unemployment compensation system, including ways to reduce the obstacle the system now places in some States to retraining the unemployed. Other related efforts are being directed to improvement of the employment service and to the development of statistics on job vacancies which can be used as a guide for national manpower policy.

What we have to report to you in this area is only a beginning, but we want you to know that we give the subject the highest priority, and we intend to pursue it actively.

THE UNITED STATES AND THE WORLD ECONOMY

In our international relations we seek to obtain the benefits of efficient use of our productive capabilities and capital through interchange with others in a system where others realize similar benefits, and to assist others—notably in the poor countries—to advance their own economic development. In some respects, especially in the aggregate flow of trade and investment, the performance of the international economic system has been highly successful. This has been a reflection of the growth of national economies in the industrialized countries, which has itself been promoted by favorable policies adopted around the end of World War II, and steps taken since.

Even where progress has been greatest, however, the potentialities of international economic relations are far from being fully realized, and there is danger of retrogression. In our own balance of payments and in the international monetary system as a whole we have been living with continuing problems which have been prevented from erupting into crisis by ad hoc measures, which provide no permanent solution. Our economic relations with the less developed countries, often a source of frustration on both sides, must also continue to be of special concern to us.

Some of our problems here are directly related to developments in our own economy. In the last 10 years the U.S. balance of merchandise trade—as reported in the balance-of-payments accounts—rose from an unusually small surplus of $0.1 billion in 1959 to a surplus of $6.6 billion in 1964, and then fell to a $0.1 billion surplus in 1968. During this period, exports grew at an average annual rate of 9.2 percent from 1959 through 1964, and 7.2 percent per year from 1964 through 1968. The change in the trade balance has come mainly from imports, which grew at an average annual rate of only 4 percent from 1959 through 1964, but surged to an average growth rate of 11.6 percent from 1964 through 1968.

While there were some specific structural factors affecting the trade balance, much of the improvement in the trade balance from 1959 to 1964, and its subsequent deterioration, can be traced to movements in U.S. income and prices relative to those of our major trading partners. Changes in domestic business activity and income affect imports fairly quickly through changes in demand, and more slowly through the lagged effect of price changes. As long as income grows steadily in line with the capacity of the economy, imports tend to grow fairly steadily along trend. The growth of exports is mainly determined by foreign demand conditions, unless hampered by a squeeze on domestic production capacity. When the growth of domestic demand for output overshoots capacity, shortages appear in some industries, delivery lines lengthen, domestic price increase, and imports tend to rise sharply. In 1967, for example, the demand for output in the United States rose by 5.6 percent, and 3.6 percent of the increase went for the purchase of merchandise imports. In 1968, gross national product increased 9 percent, and the rise in imports was 8.9 percent of the rise in gross national product. Thus, part of the explanation of the surge in imports since 1964 has been the high—indeed, inflationary—growth of domestic demand. It also appears, however, that since World War II our imports have tended to increase more rapidly than gross national product.

Another major factor behind the movement in the trade balance since 1959 has been U.S. price performance relative to the other industrial countries. From 1959 to 1964, prices in the United States were fairly stable, while prices in Europe, the United Kingdom, and Japan rose markedly. This relative price improvement, operating through a long and sometimes unpredictable lag process, contributed to the improvement in the balance of trade during those years.

Since 1965, however, U.S. prices, under the pressure of excess demand, have risen somewhat faster than in most industrial countries, contributing to the deterioration in our trade balance. From 1964 to 1968 the U.S. export unit value index has risen by 8.9 percent, while the import unit value index has gone up by only 3.8 percent. Even if the domestic demand for output is slowed in 1969 and 1970, the lagged effects of past and continuing price increases will continue to pose problems for us.

The growth in U.S. merchandise exports—9.2 percent in 1959–64 and 7.2 percent in 1964–68—covers a divergence between the growth rate of exports of manufactured goods, which rose in the latter period, and that of foodstuffs and crude materials, which fell sharply.

After growing at a rate of 10.2 percent per year from 1959 to 1964, the rate of growth for food exports began to fall in 1965 and 1966. These exports have actually declined in the last 2 years, falling by 1968 to about the 1964 level of $4.6 billion.

This abrupt halt in the growth of foodstuff exports, which were 18 percent of total exports in 1964, has slowed the total growth of exports even though the growth rate of manufactured goods exports has picked up. One of the factors is the increase in grain production in some of the less developed countries, which is welcome in itself. Of greater concern for our food exports in the coming years is agricultural policy in the European Economic Community (EEC), now again being discussed in Europe. The EEC system of high internal support prices, variable import levies, and export subsidies for agricultural products results in the retention of unneeded resources in farm production, increasing agricultural surpluses within the Community, and intensifying price competition in third-country markets. As long as the EEC continues this system, it is hard to visualize any major gain in U.S. agricultural exports, though the United States, with its highly efficient farming, has a strong comparative advantage in many important agricultural products.

A structural factor operating both on imports and exports is the United States-Canada Automotive Products Agreement which permits free trade in autos and parts across the United States-Canadian border. The rationalization of production that this agreement has encouraged has increased both exports and imports, but imports have so far shown the larger increase. The automobile manufacturers are still adjusting to the possibilities opened by the agreement, so its effects on exports and imports can be expected to continue for some time.

When we turn to U.S. earnings on investment abroad, we find a more reassuring picture. These earnings have shown steady and rapid growth throughout recent decades. During the 1960's, the average annual rate was about 12 percent. This is somewhat greater than the growth rate of U.S. direct investment abroad, which reached $59.3 billion at the end of 1967. The total foreign investment in the United States reached $2 billion at the end of 1967. Almost 60 percent of the total value of U.S. direct investment abroad at the end of 1967 was in Canada or in the less developed countries of Africa, Asia, and Latin America, including all the major oil-producing countries.

Beginning in 1965 it was judged necessary to discourage the outflows of investment funds which generate these important earnings, first through a voluntary and then through a mandatory control program. Much attention has been given to the "improvement" in the balance of payments under the 1968 mandatory program. To the extent these improvements were achieved by reduction in plannned investment, they may be transistory, involving reduced investment income in future years.

The outlook for our external payments during the coming year depends to a considerable measure on the buoyancy of domestic demand for output and on credit market conditions here relative to those abroad.

If we are successful in slowing down the rate of inflation, this should result in some reduction in the growth of imports and ultimately contribute to the competitiveness of U.S. exports. In addition, the adverse balance-of-payments effects of the steel and copper strikes of 1968 will not be repeated in 1969, though there may be some unfavorable effects of the prolonged dock strike. Some improvement in the merchandise balance may thus emerge during the coming year, possibly resulting in a small increase of the 1969 trade surplus over 1968.

At the same time, it would be imprudent to assume that the capital accounts, whose performance was exceptionally favorable in 1968, will be equally helpful in 1969.

Beyond measures to strengthen our external payments position generally we shall also need to give attention to trade policy. Here our basic objective must be to continue the progress made during the postwar period toward a more liberal and open international trading system, one from which we and our trading partners receive the mutual benefits of international specialization and exchange. Not only does trade make a direct contribution toward a more productive use of our resources and consequently toward a higher level of living, but it is also one of the strongest stimulants to healthy competitive behavior in the domestic economy. The restraining influence which world competition places on our domestic prices is of particular importance in inflationary periods such as this.

In the postwar period great strides have been made toward reducing tariff impediments to international trade. Much remains to be done in reducing the nontariff barriers such as quotas, taxes, unjustified health and sanitary regulations, and discriminatory government procurement policies which have limited the access of our exports, particularly of agricultural products, to foreign markets.

It is particularly important for its part that the United States not take actions which would prejudice our negotiations for a general liberalization of nontariff barriers, a liberalization which would benefit us, and we must be especially conscious of the effects that our remaining trade barriers have in denying less developed countries access to our markets and those of other advanced countries.

Economic growth and improved living standards in the world's poor countries are essential to a stable world order and an expanding world economy. There is much that the United States can do to assist this development effort. Reduction in trade barriers is one important approach but capital transfer and technical assistance are also essential.

The administration has been given a congressional directive to review U.S. foreign aid programs. In making recommendations for change, we must profit by experience under the existing program, preserving its good features, and developing new ways to increase the effectiveness of our foreign assistance efforts and gain them greater public support.

Among the new departures to be considered are proposals systematically to promote increased private investment in less-developed countries. Significant progress in this direction has been made by AID's Office of Private Resources, which assisted some 250 corporations and nonprofit groups in fiscal 1968. The book value of U.S. private direct investment in less-developed countries was about $17 billion in 1967, but 50 percent of this was in petroleum or in mining and smelting. Only 25 percent was in manufacturing. While this was a significant increase from the 15 percent share of manufacturing in 1960, even more should be done to increase the total flow of private investment funds and to direct these funds into nonextractive industries. Governmental programs of foreign aid will, of course, also continue to be desirable.

A quarter of a century ago an international conference convened at Bretton Woods, N.H., and agreed to set up a new system of world finance. With the trade and financial chaos and warfare of the 1930's fresh in their memories, the participants were determined to create a trading world that would be conducive to national growth and freer exchange among nations. Unlike the classical gold standard, which had been in operation for some decades prior to World War I, the Bretton Woods system sought to free countries from the necessity to correct external deficits by excessive internal deflation. The conferees also wanted to resurrect the climate of confidence and overall stability that had accompanied the classical gold standard in its heyday. Consequently, they wished to avoid the unpredictability of exchange rates which had exerted a debilitating effect on trade and capital movements, but they also recognized that orderly procedures for changes in rates were necessary to keep the system close to a durable equilibrium.

The system that was then established, after lengthy deliberations, has often been discussed before your committee, and therefore needs no further description. It is enough to say that it has served its purposes with an astonishing degree of success. International trade and investment has expanded rapidly. By and large international cooperation gained the upper hand over inward-looking nationalism. And there has been no postwar parallel to the economic warfare that had prevailed during the 1930's.

It is clear that a system which permitted these impressive achievements has great merit and strength. The system has actually proved to be capable of considerable adaptation to changing needs, especially to the increased need for reserves. The ever-growing need for liquidity is itself a result of the growth in international transactions under the Bretton Woods system, but it is also related to difficulties in the adjustment process. In the private sector the Eurodollar market continues to be an important source of liquidity. In the realm of official reserves the Special Drawing Rights facility should promptly be brought to the stage of activation on an adequate scale.

Less progress has been made in another important problem area, namely the adjustment process. To maintain an appropriate equilibrium in its foreign transactions, any country should look first of all to its domestic policies. If it runs an external deficit as a result of internal inflation, its first efforts should evidently be to cool down its economy; conversely a country with unemployment and a balance-of-payments surplus should stimulate the demand for output. In these cases there is no conflict between the goals of internal and external balance.

But the situation is not always so straightforward. Sometimes a country has both unemployment and a balance-of-payments deficit—this was our position in the early 1960's—or it has both high employment and a balance of payments surplus—this has been the case in certain foreign countries. At the moment, of course, there is no question that a reduction in our rate of inflation, which is necessary for domestic reasons, will also strengthen our balance of payments in the long run and help to maintain confidence in the dollar as a reserve currency.

It is nevertheless a serious misconception to believe that domestic measures aimed at full employment without inflation will always be sufficient automatically to assure external equilibrium. "Discipline" is necessary for good domestic policy, and usually helpful to the balance of payments, but it cannot always be relied upon to balance the international accounts. This was recognized in the Bretton Woods agreement, but its adjustment procedures have been rarely used, at least by the major countries. Nevertheless these procedures were intended to cope with a real problem and the virtual abandonment has left a gap in the arsenal of instruments for economic policy. In the absence of more suitable instruments, several countries—including the United States—have turned increasingly to direct controls, which detract from the benefits of free international exchange and rarely offer a durable solution. Yet a system that lacks appropriate devices for correcting disequilibria is clearly at the mercy of adverse developments—and of these there is no shortage, as the recent international monetary crises have shown. The search for improvements in the adjustment process must therefore be pursued with vigor. Some of the possibilities are discussed in the Council's 1969 Report, and the work of this committee has been valuable in focusing attention on new thinking in this entire area.

In our very understandable concern about improving the world trading and financial systems, however, we must keep squarely before us the central importance of good domestic economic policies. With a reasonably stable price level and orderly, vigorous growth of our domestic economy, this Nation can make its most basic contribution to world economic stability. If we cannot manage our own economic affairs in an orderly way, our advice about organizing the world economy is apt to receive the limited attention it would then deserve.

CONCLUSIONS

We are now in the early stages of an era whose economic potential is unusually bright. If it is to be an era of reasonably full employment, new jobs must be created at the rate of $1\frac{1}{2}$ million per year. Real incomes and output should rise 50 percent during the next decade, and the fruits of this progress will be diffused more broadly to all our people. Levels of living throughout the world will also be rising, not only for the "miracle" economies such as Japan or Taiwan, but also for the developing nations. With the more diversified patterns of output and demand that accompany economic progress, opportunities for enlarging world trade should continue to grow more rapidly than national incomes. This is the promise we face. It can be realized if we rise to the challenge and pursue economic policies that encourage orderly economic growth and reasonably full employment at home, and a more free and intergrated economy in the world at large.

Mr. Chairman, this concludes our statement.

Chairman PATMAN. Thank you, Dr. McCracken. You have given us a very thought-provoking statement. We appreciate it. You are always constructive. I know.

You have appeared before this committee many times and you have always been helpful to the committee in your statements.

I would like to ask you first about the "Quadriad." Did the President appoint the Quadriad this year or was he just accepting the Quadriad as set up? I am talking about monetary policies, and interest rates, and things in that area.

Mr. MCCRACKEN. Yes. The Quadriad, as I understand it, in recent years has been a somewhat informal institution for consultation among the Secretary of the Treasury, the Chairman of the Federal Reserve Board, the Director of the Budget, and the Chairman of the Council of Economic Advisers.

We have met once or twice. I would guess that we shall continue. I am not aware that there has been any directive or any procedure for formalizing this as an institution.

Chairman PATMAN. Now then, there is a committee appointed by the President as I understand it, a President's Committee on Economic Policy, as an overall group; is that correct?

Mr. MCCRACKEN. That is correct.

Chairman PATMAN. Mr. Burns is Chairman, Mr. Arthur Burns——

Mr. MCCRACKEN. The Chairman or the presiding officer of that Committee is the President.

Chairman PATMAN. The President is the presiding officer? Let me see if I have their names correctly.

Mr. MCCRACKEN. Yes.

Chairman PATMAN. The President is the presiding officer and Mr. Burns is next to him, I assume?

Mr. MCCRACKEN. Well, there are eight members in addition to the President. These would be the Vice President, Secretary of Treasury——

Chairman PATMAN. Secretary of Agriculture, Secretary of Commerce, Chairman of CEA; and Director of the Bureau of the Budget.

Why is it that Mr. Martin is not on that committee?

Mr. MCCRACKEN. The Cabinet Committee on Economic Policy is a committee within the administration.

Chairman PATMAN. I see.

Now, it is an overall committee, that means it will have priority over the Quadriad. In other words, if there is a difference of opinion between the Quadriad and this new Cabinet Committee on Economic Policy as an overall group, the overall groups' policy will prevail, is that correct?

Mr. McCRACKEN. The Cabinet Committee and the Quadriad will have somewhat different responsibilities and, of course, they are——

Chairman PATMAN. I know; but suppose there should be a difference between these groups, as it was with President Johnson in 1965 on December 6, and the Quadriad wanted to raise interest rates, and this overall group didn't want to raise interest rates. Who would have the decisionmaking power?

Mr. McCRACKEN. In other words, if there was a difference of opinion on monetary policy——

Chairman PATMAN. I am not talking about that so much. I am talking about who has the power now? Would the overall group have it or would the Quadriad have it?

Mr. McCRACKEN. The Cabinet Committee on Economic Policy is, of course, concerned with policy issues within the administration.

Chairman PATMAN. I am talking about interest rates now, and the supply of money—monetary policy. If that issue comes up now, who will have the decisionmaking power?

Mr. McCRACKEN. The Federal Reserve in this case.

Chairman PATMAN. The Federal Reserve. Why, the Federal Reserve is not even on the overall policy committee.

Mr. McCRACKEN. The Federal Reserve is the organization with the responsibilities for monetary policy.

Chairman PATMAN. Do you believe the Federal Reserve, without regard to the President in power, should fix monetary policy, including interest rates? They are not elected by the people, not one of them. Even a justice of the peace has to be elected. Of course, the President has been elected by the people, and the Congress has been elected by the people, and you are going to say that somebody who never has been elected, have 14-year lifetime terms, will pass upon these important questions like interest rates and supply of money, notwithstanding the objection of the administration in power.

Mr. McCRACKEN. Well, I think there are two questions here. One is the question given the way the Government is currently set up and given the authority which has been delegated to the Federal Reserve by the Congress——

Chairman PATMAN. May I respectfully dispute that. You can read the law, the Federal Reserve Act, you can read all the hearings before Congress at that time, House and Senate, and you will not find one reference to the fact that the Federal Reserve would be independent from the Government and act independently from them. You will not; will you?

Mr. McCRACKEN. No; not independent of the Government.

Chairman PATMAN. All right.

We are in accord with that. So there is nothing said in the legislative history of the Federal Reserve Act that it would be independent. It is not in the law that it is independent. It is just like any other law that is passed by Congress and the Constitution says shall be executed by the President. Wouldn't you agree with that?

Mr. McCRACKEN. Well, I can't speak in regard to the legal aspects of this.

Chairman PATMAN. Well, I will. Of course, the 10 minutes apply to the chairman as apply to the other members, which I will respect. I will have to make my comments a little briefer.

Do you consider, Dr. McCracken, that the interest, the aggregate interest, paid by the American people today in all respects and forms, such as the interest on the national debt, and the public and private debt—do you consider that the amount in the aggregate is too much?

Mr. McCRACKEN. Well, that—no.

Chairman PATMAN. Not necessarily?

Mr. McCRACKEN. It is a very difficult question to answer.

Chairman PATMAN. All right.

Mr. McCRACKEN. I think interest rates—I am unhappy that interest rates have risen to the levels they now have.

Chairman PATMAN. Now, of course, I can't discuss it too much, but I want to invite your attention to the fact that under the Federal Reserve we are paying our debts twice sometimes, and more. You take, for instance, the fact that the Federal Reserve didn't want to have to come to Congress for its appropriation to do business. All other agencies of the Government do. But out of the 100-and-some-odd agencies of the U.S. Government, the Federal Reserve agency does not. That agency found a way to get around it, and the way they do it is, they take the Bureau of Engraving and Printing money over here, which is also a Government obligation, and trade it for Government bonds that are outstanding and due in the future, interest bearing, which in effect cancels those bonds because it is one Government obligation paying for another Government obligation; and Mr. Martin, the Chairman, has admitted to me a number of times in public, in testimony, that that meant the debt was paid.

Now, of course, when it was a billion dollars or 3 or 4 billion, it didn't mean much, but now it has reached over $50 billion that we have paid for, I mean we have paid for once and we are paying interest on them at the rate of almost $2 billion a year just the same as if they had never been paid for.

Now, obviously, the object of doing that is that the Federal Reserve can take that interest and spend as much of it as they want to. They have got a $2 billion amount available to them every year to spend any way they want to and there is no accounting, not even an independent audit. The General Accounting Office has been refused permission to audit their books; no way to determine whether it is honestly done or not. All right. Out of that $2 billion they pay out about $250 million for the private banks, and for their own expenses, with no audit of these funds. We don't know exactly where it goes. But the rest of it goes into the Treasury, as it should go.

So my point is, don't you think there should be an audit of those books?

Mr. McCRACKEN. That is a matter on which I would not have an expert opinion.

Chairman PATMAN. I will not insist on it, but I will urge you to do this. You are in a very important position, representing the President of the United States. I don't know that the President could have found a better one; you stand mighty well with this committee. We have confidence in you. But I urge you to look into that and see if we can't cancel that $53 billion (that has been paid for once, save $2 billion a year, reduce our national debt by that much which would certainly help this inflationary situation. See if you can't come up with something, Dr. McCracken. Will you give it consideration?

Mr. McCRACKEN. We shall.

Chairman PATMAN. Talk to your colleagues about that. We would appreciate it.

Now, regarding the reference you made a while ago to the debt: that long-term debt should be eased; are you advocating taking off that 4½-, 4¼-percent ceiling that was passed over 40 years ago?

Mr. McCRACKEN. Yes; some modification of it.

Chairman PATMAN. Will you put in the record the modification that you have in mind?

Mr. McCRACKEN. I wouldn't have a specific proposal. I think it would be better for that to come from the Treasury.

My concern as an economist is that with this limitation the debt has been piling up at the short-term end, and this has complicated the problem of economic policy.

Chairman PATMAN. All right. Thank you very much, sir. My time is up.

Mr. Javits?

Senator JAVITS. Dr. McCracken, I would like to join the chairman in expressing our confidence in you and the satisfaction we have in your appearing today.

Now, do you bespeak the policy of the administration when you say in your statement, "However, we believe that considering the national interest in high employment, price stability, and vigorous and ongoing expansion, the strategy of moving steadily and gradually to reverse the inflationary trend is indicated"?

Mr. McCRACKEN. Yes; I think so.

Senator JAVITS. And does that mean that you have chosen the third alternative of your own paper, which says, "Our third alternative would be to embark upon a course of gradually and persistently reducing the rate of inflation and thereby generating the expectation of diminishing rates of inflation in the future."?

Mr. McCRACKEN. Yes; this would be our position.

Senator JAVITS. Do you believe that this will have a measurable effect of increasing unemployment above the figure of 3 to 4 percent at which it has generally hovered over the last year?

Mr. McCRACKEN. In our judgment, this policy can be pursued without pushing "unemployment," to use your term, substantially above that zone within which it has moved in recent years.

Senator JAVITS. Does the administration intend to pursue this policy even if it does result in increasing unemployment measurably above 4 percent, or will it undertake a change in direction if it sees it going out of that ball park, so to speak?

Mr. McCRACKEN. I am sure this administration will always be watching very closely the problem of unemployment as one of the major objectives of economic policy. We shall want to feel our way along here, and if policies seem to be producing an impact, then we would certainly want to take this into account.

Senator JAVITS. In order of priorities, will the administration follow this doctrine in economic policy wherever it leads or will the administration give the priority to keeping unemployment within reasonable levels?

Mr. McCRACKEN. I think I would put it this way. Our concern is to try to have the maximum employment and output in growth in the long run. It seems to us at this particular juncture we have to give some attention to the price level, but certainly the matter of high unemployment will continue to be a very major concern for the administration. Certainly we would not counsel watching the price level to the exclusion of any concern about unemployment.

Senator JAVITS. Pursuing that philosophy of gradualism, which is what it is, the implication is, given in your statement, that you would look with favor upon a continuance of the tax surcharge. I call your attention to the statement "Aside from the inflationary effects, we would be concerned about the probable consequences of a renewed Federal deficit on the supply of funds for private investment, especially in housing" and so on. "Moreover the re-emergence of the large Federal deficit would create greater strains on the economy—particularly in financial sectors—in effectuating a stabilizing monetary policy."

Do you contemplate, because this is very important in view of the President's pre-election position, the real possibility that in view of your, the administration's policy of gradualism in respect to fiscal policy, that we may have to continue the tax surcharge?

Mr. McCRACKEN. I think I would answer that question this way. In our judgment, it is quite important that we not allow another major deficit to emerge. The budget on the expenditure side is being reviewed by the Director of the Budget now. Whether we can maintain an essential balance without the surcharge or whether that must be continued, I suppose, will depend on the outcome of this review. But it is quite possible—it is quite possible that economic and budgetary conditions will require the continuance of this tax.

Senator JAVITS. Now, do you state the policy of the administration when you say: "Real incomes and output should rise 50 percent during the next decade, and the fruits of this progress will be diffused more broadly to all our people."

Mr. McCRACKEN. Yes; I think that would be a fair statement of what I understand the Administration's objective to be.

Senator JAVITS. That is their objective.

Now, moving to foreign economic policy: Do you agree with the recommendation of this committee which was made last year that there ought to be reforms in the international monetary system, and that one of these reforms is to negotiate a change in the present fixed exchange system that would permit wider fluctuations in exchange rates under the IMF different from the present one percent?

Mr. McCRACKEN. As we indicated in our statement we are impressed with the way the international economy has flourished under the present system, but we are also concerned about the growing trend toward controls here and abroad.

We consider that we would be derelict in our duty not to explore various modifications of this system which might be helpful.

As to which ones specifically will ultimately turn out to be the desired course that remains to be seen. It depends a great deal, of course, on developments and on sentiment around the world. We are not interested in unilateral action.

Senator JAVITS. Rather than not be interested in unilateral action, aren't we interested affirmatively in multilateral action?

Mr. McCracken. Correct.

Senator Javits. Isn't the objective of our policy going to be the endeavor to have the whole international community carry the burden of international credit for international trade?

Mr. McCracken. And to share the benefits, of course, too.

Senator Javits. And share the benefits, of course. But we certainly do not shut our minds, therefore, in this administration to a change in the Bretton Woods Agreements?

Mr. McCracken. We certainly want to explore any ideas that may turn out to be helpful.

Senator Javits. Now, on foreign trade policy, I have just one question. Do you feel that the efforts of the administration, announced as trying to obtain a voluntary agreement to restrict textile imports, will not inhibit the administration in resisting other protectionist pressures, whether in steel or other commodities?

Mr. McCracken. I am hopeful that that will not have this effect of inhibiting a general movement in that direction. I do think the interconnection between our domestic economy and our external payments here is a part of the problem.

Our domestic overheating has produced a substantial flood of imports, and this tends to create some of these pressures for protectionism. But the basic problem is, of course, to deal with our problem of domestic economic policy.

Senator Javits. Just one last question, if I may, Mr. Chairman. On the matter of U.S. private investment overseas, I am delighted that you have indicated the strong benefits of that to the United States. Will the administration examine very seriously and critically the recommendations for discontinuing or materially reducing the interest equalization tax and otherwise lifting restraints on U.S. overseas private investment?

Mr. McCracken. I think I can assure you that this whole range of problems is going to receive careful attention and study.

Senator Javits. Will you give for the record—and I ask unanimous consent that it be included at this point—a written reply as to the views of the Council of Economic Advisers on the recommendations of the U.S. Council of the International Chamber of Commerce on this question of lifting controls on overseas private investment? Could you give it to us later in writing?

Mr. McCracken. We will give it to you.

Chairman Patman. Without objection, it will be received and made part of the record.

(The following was subsequently supplied by the Council of Economic Advisers.)

We share the United States Council's dislike of investment restraints, and look forward to their relaxation and elimination at the earliest possible date. As their paper notes, "these measures were originally introduced for temporary periods." It is important that they not be allowed to drag on indefinitely.

While sharply criticizing the controls, the International Chamber of Commerce refrains from suggesting that they be abruptly eliminated. Rather, the Chamber stresses that, in working towards a relaxation of the controls, two objectives should be kept in mind. The risk of serious damage to the balance of payments should be limited, and the greatest possible gains in terms of simplification and flexibility should be sought. We share these two objectives.

The desirability of reducing the controls should be obvious to all. At the same time, an abrupt elimination of controls would raise a number of difficulties. Not only would there be the possibility of a marked adverse movement in the balance of payments, but there might also be very undesirable inhibitions on domestic policies. In particular, it is undesirable for the United States to be under strong pressures to keep interest rates high for international purposes. As we squeeze the inflationary psychology out of the economy, we may safely look forward to some decline in our interest rates. For domestic purposes, and in particular for the health of the housing industry, it is important that we maintain our option to have lower interest rates.

In terms of simplifying our investment control program, there is perhaps more to be gained by concentrating our efforts at relaxation on the foreign direct investment program rather than the interest equalization tax. At the same time, we would agree with the observation of the Chamber that the relative position of interest rates in the U.S. and abroad reduces the need for an interest equalization tax of 1¼ percent.

The capital control programs are currently under review as part of the Administration's balance of payments study, and it would be inappropriate to discuss the specific suggestions of the United States Council in greater detail at the present moment.

Senator JAVITS. I thank the chairman.

Chairman PATMAN. Senator Proxmire?

Senator PROXMIRE. Chairman McCracken, I want you to know I share with the chairman of this committee and the ranking Republican their pleasure at your appointment. This was a splendid appointment by President Nixon and I know you will do a great job.

In the President's Economic Report,* on page 94, the following is stated:

> It is doubtful whether acceptable levels of unemployment and reasonable price stability can both be achieved without the successful implementation of structural anti-inflationary measures and a voluntary cooperation in wage and price decisions.

Now, you just rejected quite emphatically in your statement two or three times, in fact, the notion that you should be involved in wage-price guidelines. Mr. Shultz yesterday on television was even more emphatic. President Nixon said the same thing in his first press conference so I think we are getting the message that you are not going to use wage-price guidelines in this administration.

At your confirmation hearings before the Senate Banking Committee, I think it was Mr. Houtthakker who stated that antitrust policy would not be an effective means of stemming inflation in the next 2 years. It might be in the long run you are for it but it wouldn't be helpful in the short run.

You are opposed to wage and price controls; you are opposed, I presume although you haven't explicitly said it, at the present time to credit controls.

Now, that leaves fiscal and monetary policy and our experience in relying on fiscal and monetary policy to control inflation in the past without wage-price guidelines and without any of these other measures has indicated we had to go to as high as 6 percent unemployment before we were able to turn down the rise in the cost of living.

What is there in the present economic situation that persuades you that we won't have to do that again?

Mr. MCCRACKEN. Let me begin, first of all, on the specific matter of our position on wage and price guidelines. I think we have arrived at that position simply because in reviewing the experience we are not

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*Economic Report of the President together with the Annual Report of the Council of Economic Advisers. H. Doc. 28. 91st Cong., first sess., January 1969. Available from the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C.

impressed that these can have a substantial and particularly a *continuing* effectiveness.

I do believe myself that the enunciation of the guidelines had some value. It certainly had some educational value. In the hearing this committee conducted commemorating the 20th anniversary of the Employment Act I stated in a paper——

Senator PROXMIRE. They had a great record of performance 1962 to 1966. We had reasonable price stability in a time of falling unemployment, and remarkable production gains.

Mr. McCRACKEN. And there was also slack in the economy. But the difficulty there is that once your price level comes unstuck, as it did after 1965, it becomes then extremely difficult to know what the operational rules of the game are. It is significant that in the Economic Reports the specific figures then were dropped out. There was a retreat to the more general language that people should take into——

Senator PROXMIRE. There is a new proposal to modify that perhaps with a 5 percent guideline.

Mr. McCRACKEN. Yes, to have wage agreements such that the national average would be a little less than 5 percent and a corresponding rule on the other side for pricing. But the difficulty there once again is that in pricing a specific commodity and in a specific wage negotiation it is very hard to know what is right for this specific price or wage to be consistent with the overall average.

Now, looking at this basic problem, I would approach it a little like this. I think we have here a parallel to discussions in the early 1960's as to whether unemployment was a structural problem or whether it was a deficiency of aggregate demand.

My view at that time was that I really didn't know what the proportions were, but it was perfectly clear that there was unemployment as a result of a deficiency of aggregate demand. And, therefore, one had to attack the problem from that point of view.

Now, at the current time our problem happens to be the reverse, and clearly a significant part of our problem in recent years has come about because we have had an excessively rapid rate of demand.

Senator PROXMIRE. Do you see anything in the situation now that is so different from the situation in the 1950's—will we be able to turn around inflation or slow it down without going to a high level of unemployment, 6 percent or so, as we did before, and if so what is it?

Mr. McCRACKEN. I think we have to feel our way along here. We have to deal with the basic fundamental always of an inflationary demand for output. This is the problem we must deal with first.

Senator PROXMIRE. Now, the Business Council is said to believe we might have to go to a level of 5½ or 6 percent of unemployment in order to secure a reasonable degree of price stability. If this estimate turned out to be true would you actively—in the councils of the President—oppose economic policies designed to achieve price stability at that cost in unemployment?

Mr. McCRACKEN. I would take into account both. In the determination of policy unemployment, price level developments, rate of growth in output, the unemployment problem—I would be concerned about all of them.

Senator PROXMIRE. I certainly hope so, because, Dr. McCracken, you are our hope on this score. We look at the Quadriad, they are wonderful people, I am sure they have big hearts and they are sympathetic but they are all bankers. The Budget Director is a banker, the Secretary of the Treasury is a banker—the same bank incidentally—Mr. Martin also in the Quadriad is a banker. You alone of the four members of the Quadriad are not a banker. The bankers are fine people, the bankers, I am sure want employment to be as full as possible, but they are especially concerned with the price level.

Mr. McCracken. If there is any generalized problem of unemployment these official would be greatly concerned about that, too.

Senator Proxmire. In your statement you say, "We do not foresee probable changes from the budget submitted earlier that would have a major effect on the economic outlook for calendar 1969." That translated to me means you don't expect to reduce the budget very much—the Johnson budget for 1970—maybe a billion, 2, or 3 here and there, but not the kind of big reduction that would enable us to have a surplus without extending the surtax?

I can't understand why this administration doesn't come down hard on the side of reducing spending. We have public works spending projected in this budget of over $10 billion and during the depression it was at a peak of a billion dollars a year. Then it was a matter of putting people to work who were unemployed. Now, it is inflationary. We have a space budget, which is just as big as it has been before although we have achieved our aims, or will this year. In any view we have a highly swollen military budget, and I think that is where the big expenditure cuts will have to come. The majority leader of the Senate has indicated he feels we will have to cut that military budget somewhat.

In your position as top administration advisers do you gentlemen feel that the spending will be at the same level as before? Is this your position or do I misconstrue your position?

Mr. McCracken. Yes. In our statement, we do, indicate our view. Certainly this administration is taking a very stern policy on expenditures.

On the other hand, there is enormous viscosity in the budgetary process. What we do say here is that even relatively small immediate reductions would relieve the strain in the capital market, and moreover this is a part of the process of beginning to accomplish the kinds of things that you are talking about.

So that——

Senator Proxmire. Very stern is a good word and I think we would all applaud it but very stern appears not to be the kind of action which is going to result in a $10 or $15 billion budget for you say in your statement that budget reduction is not going to have significant economic impact.

Mr. McCracken. In the current year.

Senator Proxmire. In the coming year, in the fiscal 1970 budget; I am talking about the fiscal 1970 budget.

Mr. McCracken. We were talking here about calendar 1969.

Senator Proxmire. It is half of the fiscal 1970 budget.

Mr. McCracken. The expenditures which we are going to see in the months ahead are going to be expenditures from decisions already made. This was the basis for our judgment that we weren't in the very near term going to affect a displacement of Federal expenditures which would warrant a major reevaluation of the economy.

Senator PROXMIRE. I do think you underestimate the attitude of the Congress and the American people. I have just been home for 10 days—many Members of Congress have—and I have never seen people so concerned about spending and high taxes, it is just uniform. They are against increasing on anything, even the things I favor, like education and so forth. They think they have had it up to here and this is a universal feeling I find everything, so I do hope you will consider this as a possibility and I know you are not locked in on anything but not to lock yourself in on the extension of the surtax.

You say—well, my time is up, I will come back.

Chairman PATMAN. Mr. Widnall?

Representative WIDNALL. Thank you, Mr. Chairman.

Mr. McCracken, I too would like to welcome you and your colleagues before the committee and I am sure that the Council is in good hands and I wish you well in your position.

Mr. McCRACKEN. Thank you.

Representative WIDNALL. You note that housing has been a major victim of inflation because of the increased cost of mortgages. With the deceleration of inflation which you indicate you anticipate, would you expect a significant increase in private investment in housing construction?

Mr. McCRACKEN. Yes, I think that would be a reasonable expectation. If we can cool off the inflation situation I would then expect more favorable interest rates, and financing conditions generally for housing.

Representative WIDNALL. Would you expect that increased investment in housing to go all the way through the housing industry or just pertain to commercial activity and multifamily housing?

Mr. McCRACKEN. I think that it would be fairly generally spread across the spectrum.

Representative WIDNALL. I am just hopeful that takes place. I hope it is not going to be again a complete reliance on Government guarantees and other such things, but that we have a program that seems to warrant action with some real investment, with the utilization of Government guarantees.

Several surveys last fall, both private and governmental, of business capital spending plans for 1969, indicate capital spending may rise 8 percent or more this year compared to a 4.7-percent increase last year. How can you account for those ambitious intentions in the face of a general economic climate that seems inauspicious for an expansive attitude toward new productive facilities?

Mr. McCRACKEN. That is a very good question, and it touches on some of the imbalances which a long, sustained inflationary situation can produce. For example, the question is raised as to whether this rate of expansion in investment, how long that will continue if the relatively flat trend of retail sales we have seen in recent months were to continue.

We see here a combination of a great many things. In the first place there are always many industries needing to expand their facilities. Secondly, there are those who because of the pressure on costs are having to replace equipment with more efficient productive machinery. One can't avoid facing the question as to the extent to which the expectation of continuing inflation has in some cases nudged investment decisions in the favorable direction even if capacity temporarily would be a little on the ample side.

Representative WIDNALL. It seems to me that Government is the one that should show the way in the reduction of this planned spending and hold the line or to decelerate the inflation that had been taking place, and I think that Senator Proxmire made some very valid comments in this connection, calling attention to the amount that was contemplated for public works by the Government.

Mr. MCCRACKEN. Yes.

Representative WIDNALL. The report of the Cabinet Coordinating Committee on Economic Planning for the end of Vietnam hostilities estimates that of the $29 billion currently being spent on Vietnam $10 billion would be required for other military uses in peacetime.

Is it true that one-third of the peace dividend has already been committed for military programs?

Mr. MCCRACKEN. This is a matter that we want to look into very carefully, and a subcommittee of the Cabinet Committee on Economic Policy has just been formed, as we indicated in our statement here, to review the planning which has already been done, and to carry it further. One of the claimants for the elbowroom that would be provided once the Vietnam conflict is resolved would be non-Vietnam defense spending. Just how it would fit in and what its priorities would be relative to the other claimants is something that we want to explore.

Representative WIDNALL. I heard some testimony not long ago which seemed rather valid that about $20 billion of the $29 billion has actually already been put in the pipeline in one way or another to take effect immediately. Part of that was by the military, and part by other agencies of the Government which have postponed action on programs where they did have authorizations. I hope that the American people have not been sold on the idea that with peace in Vietnam there is going to be a pot of gold just waiting there to be dipped into to carry out every conceivable kind of idea that people of good will have for the future of the United States.

Do you know what the military programs are that will be considered as necessary to continue military spending? I understand some of them would be in connection with naval vessels, airplanes, updating of various types of equipment, and that these programs are already in the wind, and downpayments have actually been made in many instances. Are you familiar with any of those as yet?

Mr. MCCRACKEN. Not in detail. This is an aspect of it which we shall want to be exploring carefully.

Representative WIDNALL. We have been through a period in which I feel the American people have been promised too much. We have had some great goals, sort of pie in the sky, and yet the performance has never measured up to the promise, and I am terribly worried that we might continue to do that and especially with the idea if we reach a peace in Vietnam all our troubles are over and we can then concentrate on many different directions to which we have applied no real large effective spending in order to cure our city problems, and other problems facing the country.

Which do you believe would be more effective in restraining an inflationary economy, increased Federal taxes or restraints on Federal spending?

Mr. McCRACKEN. What is necessary here is a broad-based approach. As between these two I would consider a dollar's worth of lower Federal expenditures to have a greater restraining effect than a dollar's worth of increased taxes. This would also carry with it certain implications for monetary policy.

Representative WIDNALL. As you know, within the last 2 years we had quite a fight between the Executive and the Congress as to the use of either increased taxes or decreased spending, and we finally came out with sort of a compromise. Do you feel that the two should work side by side, and the emphasis should still be on decreasing the amount of Federal spending but also increasing taxes, if necessary, in order to balance the budget?

Mr. McCRACKEN. We have to keep a budget where the revenues at reasonably high employment are going to cover outlays. The strategy has to be to examine very carefully the expenditure side of the budget. But given outlays, we have to have a flow of revenues which would reasonably cover them.

Representative WIDNALL. We have just had a statement issued covering the balance-of-payments situation that certainly is far more favorable than it has been in the past few years. Do you think that this can be continued or do you believe it is largely due to some unusual circumstance during the last year?

Mr. McCRACKEN. We are all, of course, grateful for good news here. I think one must say, however, that the fundamental improvement in our balance of payments is not anything like what might be implied by the swing in overall position from a large deficit to a small surplus in the liquidity balance.

The thing that must be a continuing source of concern is that we don't have strength in our balance of payments on current account.

Representative WIDNALL. Thank you, Mr. Chairman. My time is up.

Chairman PATMAN. Mr. Reuss?

Representative REUSS. Thank you, Mr. Chairman.

A splendid statement, Mr. McCracken. You are off to a fine start.

On wage-price guideposts, one of the parts of your presentation with which I do not agree, the majority of the Joint Economic Committee for some years has been urging the outgoing Council of Economic Advisers that in addition to sound anti-inflationary fiscal, monetary, and debt management policies, it should use the additional weapon of wage-price guideposts, and specifically we have said "have a rather specific guidepost, work it out initially with labor and management so that they have a proprietary interest in it, and thirdly, evolve some mechanism for focusing public attention on transactions which transcend those guideposts, particularly in the concentrated industries such as steel and automobiles." We got nowhere with that except on January 17, when the outgoing Council got out its report and, sure enough, our advice was all in there. We were delighted, but then on January 20 they went out of business and now you tell us, as I guess we expected, that you disagree.

I would have just one question in addition to what you told Senator Proxmire. In your statement, you set forth the mandate of the Employment Act of 1946 as one that "calls the Government to use all of its capabilities; to achieve and maintain maximum employment."

Well now, in fact, the mandate of the act of 1946 has the additional language "with the assistance and cooperation of industry and labor."

I know you are familiar with that, but doesn't that additional language give you at least a negative mandate not to throw out the window right at the beginning the possibility that wage-price guideposts, properly administered and cooperatively arrived at, can shave a fraction of a percentage point off of inflation?

Mr. McCracken. Yes. Indeed the language in section 2 of the Employment Act is, of course, quite flexible and quite general. It certainly does not exclude this kind of exploration.

We have had two or three concerns here. One of them is that as things have worked out there has been a somewhat erratic incidence. Certain areas that have been the targets. Others which actually have been a major part of the rise in the price level, as the Economic Report this year points out, have been largely outside the guidelines.

We don't, of course, foreswear doing our educational job here. We remain open-minded on this. As we indicated in our statement, after a month we are perhaps more impressed with what we don't know about many of these things than we were a month ago. And this may well be another item on this list.

Representative Reuss. On the matter of international monetary reform, I like what you said about the need to explore better methods of adjustment.

As you know, this committee has come out for an earnest exploration of somewhat more flexible exchange rates. I believe Dr. Houthakker, your colleague, wrote a very persuasive article in December, on the need for serious consideration of things like the crawling peg, achieving a little bit more flexibility in exchange rates.

Just in the last few days the Under Secretary of the Treasury was quoted as saying that this matter of more flexible exchange rates "is being considered by the academics, and that is where it should stay." Now if that is an accurate quotation I hope you would not agree with that.

Mr. McCracken. The Under Secretary, I think, has just now returned from Paris. I believe he will be before this committee.

But as I indicated in my statement, we consider that here and in many other problem areas is our responsibility to explore carefully the whole range of ideas—many of which, of course, we may conclude for a variety of reasons are not desirable or feasible, but we certainly will explore them.

Representative Reuss. In your paper you stress the need for economic development assistance to the poorer countries. Are you in favor of or opposed to the proposal to replenish the Internatinal Development Association and to put more money into the Asian Development Bank?

Mr. McCracken. I am not sure that I can be quite that specific as yet. We are impressed with the importance of finding channels by which these resources can be effectively utilized in the underdeveloped areas.

As we indicated here this whole area has been a source of concern and frustration both to the developed countries and to the underdeveloped countries.

Representative REUSS. In recommending that the $4\frac{1}{4}$ percent ceiling on Federal securities of over 7 years maturity be either abandoned or markedly limited, you have in mind, of course, the fact that today the Treasury can't market a long-term security at $4\frac{1}{4}$ percent, by a long shot, and it is your view that for reasons of monetary management it would be well to lengthen the debt.

Now, if the Congress did that, if it did repeal the almost half-century-old limitation, and the Treasury moved to use this new authority, this would put pressure on the long end of the credit market, the home mortgage, and the State and local borrowing end, which is now exhibiting the most distress, would it not?

Mr. MCCRACKEN. That, of course, is the dilemma. Any substantial amount of long-term financing presumably would create additional pressure. At the same time the scenario, it seems to me, requires that we take actions to try to cool the inflation and the inflation-mindedness which pervades the economy—because this is part of our high interest rate problem.

Representative REUSS. To cool it though without bringing additional agonies to home building, small business, and State and local government borrowing, I would hope.

Mr. MCCRACKEN. Yes.

Representative REUSS. What would you think of a congressional reaction to this proposal to remove the $4\frac{1}{4}$ percent ceiling, like the one we dreamed up 10 years ago when the last Republican administration asked for its removal? How about asking the Federal Reserve to cushion the impact of this by taking into its portfolio at least reasonable amounts of these new long-term Treasury securities so that the impact on the housing end of the spectrum is not disastrous?

In this connection, before you answer, it was interesting for me to note, as I looked at the Federal Reserve portfolio last night, that though for years this committee was urging the Fed to lengthen its $52 billion portfolio, and for years they told us that the world would come to an end if they did, nevertheless, in this last year whereas at the start of 1968 they had practically zero of long terms 5 years and up, now they hold more than $10 billion in the 5- to 10-year range. If they could do that without suffering the bends, it seems to me that they could accommodate future Treasury incursions into the long-term market.

What would you think about my proposition?

Mr. MCCRACKEN. This would help the strains in the market in which these long-term issues might be offered. At the same time it would correspondingly reduce the effect of offering these securities on the liquidity of the economy outside the Federal Reserve and the Treasury.

Representative REUSS. I thought, though, that your concern for having a greater mix of long terms was so that the Treasury didn't have to go to the money market every 5 minutes and thus require the Fed to temporarily forget its true function and go into the market supporting business.

Mr. MCCRACKEN. Yes——

Representative REUSS. If that is so, some Fed help on the long terms isn't going to interfere with that desired end?

Mr. MCCRACKEN. It is both. It is important that the Federal Reserve not have this problem of continuous refinancing to the same extent as now. Also presumably, if we could lengthen the average maturity of the debt held by the public, this would have an effect of reducing the liquidity in the hands of the public. There are two dimensions of this.

Representative REUSS. Thank you, my time is up, Mr. Chairman.

Chairman PATMAN. Senator Miller?

Senator MILLER. Thank you, Mr. Chairman.

Dr. McCracken, I appreciated the very fine statement submitted by you and your colleagues, Dr. Houthakker and Dr. Stein.

I was very interested in the point made wherein you state that during the last 3 years we have gained little on the unemployment front and we have lost considerably on the price front.

During those last 3 years, I am told, that there were 180,000 more Federal civilian employees added to the payroll, 657,000 more members added to our Armed Forces, and that upwards of 2 million are estimated to be working in defense industries because of the war.

Would it be fair to conclude that this war has had a considerable impact on that low unemployment rate as a result of those figures I have given you?

Mr. MCCRACKEN. Yes, I think it probably has. It has had the effect of removing from the normal civilian employment those people to whom you have alluded. There has been some direct employment provided by the defense industries.

The basic thing that has happened here, in the last few years, is simply the pressure of demand on our productive facilities which has kept employers also looking for labor, reexamining their skill requirements, and educational requirements.

Senator MILLER. Well, what concerns me is the thought that possibly, although we may be very euphoric about the low rate of unemployment over the last 3 years, because of the direct impact of the war on this low unemployment rate, we may not have really come to grips with the underlying causes of unemployment, at least to the point of being able to eliminate them, so that when the war in Vietnam is over, we will be able to meet the crisis in the unemployment that would arise.

Do you believe there are areas in this unemployment problem we really haven't come to any grips with?

Mr. MCCRACKEN. Oh, yes. As we have said in our statement we consider this to be one of the most critical problems facing this country.

Senator MILLER. Roughly, I understand the gross national product has increased around $3½ billion in the last 8 years, and there is a lot to be said about this dramatic increase. But I am also advised that according to the economic indicators that our total debt, Federal, State and local, and private, has gone up just about double that figure. One doesn't hear much about that side of the coin, but to me that is a troublesome side of the coin.

Do you think this is a healthy situation when the total debt of this country goes up about twice as fast as the gross national product?

Mr. MCCRACKEN. I think the ratio between total debt outstanding, public and private and gross national product has historically been a little—something like 1.8 or thereabouts. In other words, about $1.80 of debt outstanding per dollar of gross national product.

Senator MILLER. That may be the historical ratio, but is this a healthy ratio? It appears to me that we have had an awful lot of economic problems while this history is being made, especially in the form of inflation. I think it is worth noting that purchasing power of the dollar during that period in history has declined from a hundred cents in 1939 to 39 cents today. I just wonder if there might not be something wrong with this kind of a ratio, that we shouldn't try to do something about it.

Mr. MCCRACKEN. I think the major problem is the one to which you have just alluded. The excessive rate of credit expansion has been a part of the inflationary pressure which, in turn, then gives you the inflationary rise in gross national product which tends to validate the ratio.

There I think has been the nub of the problem.

Senator MILLER. Well, I agree. I am just wondering if the Council would look into this matter of the ratio, this historical ratio, to see whether it is a sacred cow or whether it really ought to be improved.

Mr. MCCRACKEN. Surely.

Senator MILLER. In your statement you say—

> But often the domestic and international goals are not inconsistent and we need to find better ways to reconcile them.

I do not quite understand the word "not" and I wonder if it should not read the international and domestic goals are inconsistent and we should find better ways to reconcile them. Should the "not" be in there?

Mr. MCCRACKEN. Are not consistent, yes, I think that is a typo there.

Senator MILLER. Thank you.

Then, a little further on No. 4, you pointed out that the unified budget concept shows that we have come pretty close to a balance, but, at the same time, I know that in President Johnson's Economic Report he estimated there would be an increase of \$6½ billion in the national debt. You will find that on page 494 of that document.

That would mean then that the administrative budget, as distinguished from the unified budget, would show a deficit of roughly \$6½ billion, would it not?

Mr. MCCRACKEN. I presume it would. I don't have those figures in mind though. This is on the basis of the new unified budget, yes.

Senator MILLER. Well, I am wondering if the Council is satisfied to pay attention only to the unified budget or if the Council is going to be concerned about the operating budget, the administrative budget, and if the Council will not be concerned about the fact that the operating budget shows a \$6½ billion deficit. Would not the Council be concerned about that?

Mr. MCCRACKEN. Dr. Stein is a distinguished student of budget policy, and I would like to ask him for his comments.

Mr. STEIN. Well, I think we have to look at the budget from the standpoint of several interests. From the standpoint of estimating the effects of the budget on the overall behavior of the economy the unified budget is probably superior. However, the condition you mention in which the unified budget is in balance whereas the administrative budget is not suggests that the general funds are in effect borrowing from the trust fund and this is a situation which has to be considered not with respect to its effects on the overall economy but whether we want to run a situation in which the contributors mainly to social security are making large advance payments, so to speak, to finance the rest of the Government.

Now this may be an unwise situation. But for the purposes of the analysis in which we are engaged, the analysis of the effects of the budget on inflation, unemployment, and so on, we do think that some more comprehensive view which takes into account the effects of the trust funds is essential.

Senator MILLER. Well, would it be fair to say that on operating budget deficit of $6½ billion would case concern to the Council over the inflationary potential this would lay a foundation for?

Mr. McCRACKEN. It is very difficult to take any single dimension of the budget as a measure of the inflationary impact on the economy. Certainly for many budgetary reasons we do want to look at the operating budget, and in our own budgetary analyses we look at all of these.

Senator MILLER. But there would be no particular difference between the administrative budget and the unified budget so far as the inflationary potential to deal with it is concerned.

Mr. McCRACKEN. Well, it seems to me that as a first measure of the impact of the budget on the whole economy, one has to examine the total outflow of expenditures on the one hand, and the total receipts of the Federal Government, on the other hand, regardless of the account. There are economists who will differ a little bit about this, by the way, because many of them would feel that the budget on a national income accounts basis would really be a better first approximation of the economic impact of the budget. This is a little different from the unified budget because the unified budget—well there are several differences.

I think, in my own view, the unified budget is probably the best rough measure if one is talking about the impact on the overall economy.

Senator MILLER. But on inflation.

Mr. McCRACKEN. Well, even possibly on inflation. It seems to me in the issue of the operating budget versus the unified budget, the major significance comes in this question of the desirability of having the social security contributions in effect financing the operating aspects of the budget.

Senator MILLER. Thank you. My time is up.

Chairman PATMAN. Mrs. Griffiths?

Representative GRIFFITHS. Thank you very much. I think it would be very unfair if I left the idea that you belong exclusively to Iowa. As a Representative of Michigan, I would like to point out that the University of Michigan has been happy to have two out of the last three Chairmen of the Council.

I never realized there was such a glamorous future until I saw a picture the other day of your ex-colleague, Gardner Ackley, dancing with Gina Lollobrigida in Rome. Probably the recruitment will pick up.

Is it fair to ask, is this budget based on the theory that Vietnam will not be in this year?

Mr. McCRACKEN. This is—incidentally, may I say I hope Dr. Ackley is establishing a tradition for ex-Chairmen. [Laughter.]

This is my understanding—that the projections in the budget do assume a continuation of the conflict.

Representative GRIFFITHS. Do you—I don't remember whether the bill is for a period of a year or we would have to renew it—but are you personally for the expiration of the controls over everseas investments?

Mr. McCRACKEN. I took the position as a private citizen when these were put into effect that I thought fundamentally we were going down the wrong road here, that it was another dimension of the world's moving toward direct controls in order to preserve the machinery of of the system. Indeed, in a paper of mine a year or so ago, I said that we have to countenance these only reluctantly. One of our basic long-run objectives here, as elsewhere, is to try to move toward a dismantling of these controls and toward a more liberal international system.

Representative GRIFFITHS. But wouldn't this be one of the wise things to permit to wait until Vietnam is over?

Mr. McCRACKEN. This is one of the questions which has to be looked at very carefully. Vietnam is itself a leakage in our external accounts.

Representative GRIFFITHS. I noticed that you mentioned also the problems of the EEC. Now, as a matter of fact, you need a renewal of authority to negotiate with the EEC. One of the problems last year in renewing that authority was the great danger that you would attach so much protectionist legislation to it. Do you see any real reason to believe that there is any less danger this year, than when that bill is opened up there will be additional protectionist legislation?

Mr. McCRACKEN. That is a very real problem. I see no diminution of protectionist sentiment. Quite possibly it is going the other way.

Representative GRIFFITHS. So that on any of these situations you are going to have increasing problems with balance of payments, and no matter which remedy you seek to impose, you are going to open up other great problems; is that not true?

Mr. McCRACKEN. I think that is true.

This focuses on the basic importance of cooling our domestic economy. We must attain a basic balance-of-payments position which is not causing the flows of imports that we have had in recent years—which, in turn, do create direct pressure for protection.

Representative GRIFFITHS. May I ask you specifically how you intend to get more money into the homebuilding market?

Mr. McCRACKEN. The most fundamental resolution of this problem has to be to deal with concern about the price level in order to get interest rates down to a somewhat more normal level. We must achieve a situation where people have more willingness to put their funds where they will flow into housing. This is a fundamental approach to this problem.

Until we do that, we have to reconcile ourselves to the fact that housing and construction are going to be adversely affected by our present conditions.

Representative GRIFFITHS. Do you intend absolutely to balance the budget, and if you do, which route are you going? Are you going to do it by cutting expenditures or by taxes or by a mix?

Mr. McCracken. In my judgment, economic conditions now do make a balanced budget mandatory.

Now, as to which route. The budget is, of course, being reviewed at the present time. The first line of attack has to be on the expenditure. If, given what apparently can be done there, the retention of the surtax or some part of it is necessary in order to avoid a deficit, then we shall have to continue the surcharge.

Representative Griffiths. So you are going to have some deficit even if you retain the 10-percent surcharge.

Mr. McCracken. I would not then expect a deficit. The budget as it has been projected shows a small surplus for this year and next, but the expenditure assumptions there are currently being reviewed.

Representative Griffiths. Thank you very much, Dr. McCracken; thank you, Mr. Chairman.

Chairman Patman. Mr. Brock?

Representative Brock. Thank you, Mr. Chairman. I have enjoyed your testimony. I particularly appreciate the emphasis you seem to place on the fundamental nature of our problems as opposed to the rather superficial laying on of additional patches of the quilt, legislatively.

You mentioned, I think you stated, "to achieve a continuous, moderate rate of inflation will require an appropriate degree of monetary restraint." That is sort of a nebulous phrase, "appropriate monetary restraint." I wonder if you can be a little more specific. What are we talking about? Are we talking about the continuous expansion of the money supply at a reduced rate or are we talking about a leveling off of the money supply, at least that part of it controlled by the Federal Reserve in its activities?

Mr. McCracken. I would interpret that to be a reduced rate of expansion.

Representative Brock. I think the reason I raised the point is because several members here have talked about home building. We had a rather dramatic experience with excessive monetary restraints back in 1966 when we used monetary policy simply because the Congress and the executive branch were unwilling politically to face the necessity for fiscal restraint. We had an out of balance policy.

You emphasize throughout here the necessity of a dual approach, and it seems to me the current interest rate level would indicate that we have just about exhausted the tool of monetary restraint and must place greater reliance on fiscal policy; is that a fair statement?

Dr. McCracken. If we can—certainly no one wants a repetition of what happened in 1966 when monetary restraint was pushed too far. Also to have a proper balance we do have to have a budget which is fundamentally in balance. This is essential in order to keep the pressures in money and capital markets from driving interest rates too high.

A part of the current high interest rate levels is the repercussion effect on interest rates from the inflation which began to develop about 3 years ago. So this is the fundamental thing which has to be attacked.

I would never counsel pushing so hard on the brake pedal that the wheel would be locked.

Representative Brock. I think it is a fair analogy.

Let's take it one step further then. We were unable to act politically for various reasons in 1966 to achieve fiscal restraint. We did put successive emphasis on monetary policy and it did create primary—dislocation primarily in home building, and I would hope that this, that your group would give a great deal of thought of recommending to the Congress whether or not we should allow the President some tax discretion, for example, a plus or minus adjustment of 5 percent in tax rates so that we could have a little more immediate effect on the fiscal end. It is very difficult because they have expenditures over a period of 4 or 5 years, money is in the pipeline and there is very little you can do about it. There is very little you can do about monetary policy without creating dislocation. It seems to me the only third and remaining tool has to be your tax policy, and I would hope that you would place some serious attention on this possibility of offering the executive the same latitude in discretionary tax adjustment within a range of 4 or 5 percent.

Let me add another thought or ask another question and verify 'my opinion of you on the matter of the ceiling of 4¼ percent on long-term debt.

I think the obvious reaction when you take off a ceiling is that that would cause interest rates to rise but it is not so if we took off the ceiling on long-term debt that the possible result could be a reduction in the rate of interest paid on total Federal debt.

Mr. McCRACKEN. Because of the peculiar shape of the yield curve at present. Yes, that is a possibility. The shape of the yield curve at the present time is that long-maturity interest rates are lower than they are for shorter term issues.

Representative BROCK. So the net effect there could be a reduction in our interest payments if we took off the interest ceiling or certainly it would ease the pressure of short term.

Thank you.

Chairman PATMAN. Mr. Moorhead?

Representative MOORHEAD. I would like to join my colleagues in thanking you for an excellent and far-ranging statement.

I would like to follow up on the statement by Mr. Brock about giving the President some discretionary tax flexibility. President Kennedy, of course, in 1962 requested the power to increase or decrease taxes as might be necessary. The Congress has refused to provide the President with this power because it is the prerogative of the Congress and, furthermore, an unscrupulous President could use this power just before an election to reduce taxes and which would certainly enhance his chances for reelection, or in an off year for the reelection of members of his party in the Congress.

I think that the Congress learned in 1964 that cutting taxes can be politically popular and effective economically.

One of my alternatives, and I would like to have your comments on it, is for the Congress to provide discretionary tax flexibility which would give the President the power only to raise taxes within a given range and subject to a congressional veto.

Mr. McCRACKEN. There is in some of my prose in previous years support for this position of giving the President some limited discretion for changing tax rates, subject to a veto by the Congress.

After our experience with this proposal in the early 1960's, I rather lost interest in it, but this would be a possibility.

I think if I were going to move in that direction my first inclination would be, however, to give some flexibility on both sides, both down and up. There is always the question of the extent to which the Congress would be willing to delegate the responsibility, but if I were going to go down that road my initial inclination would be to go both ways.

Representative MOORHEAD. The reality of politics is such that we might be persuaded to delegate the unpopular but we would not be so willing to delegate the opportunity to do the popular thing and there is, I believe, a good government aspect of this because there is a restraint on the President. He won't want to do the unpopular thing either and he would only raise taxes if it were really necessary.

Mr. MCCRACKEN. Yes.

Representative MOORHEAD. The other way there is no constraint.

Mr. MCCRACKEN. Yes; that is a good point.

Representative MOORHEAD. I would like to ask you gentlemen if you think that the fiscal policies adopted last year, and I refer particularly to the Revenue and Expenditure Control Act, have begun to make their effect felt. I cite particularly, that the rate of growth of the GNP—in instant dollars—dropped to 3.5 percent in the fourth quarter compared to a rate of 6.3 percent in the second quarter. Personal consumption dropped from a first quarter high of 10.3 percent to −.3 percent in the fourth quarter, retail sales dropped off significantly in the last quarter of the industrial production index of the Federal also indicates a cooling off.

Mr. MCCRACKEN. Yes. I think last year our views on this issue were swinging over entirely too wide a range. This seems to be the age of instant cereal and we also want instant fiscal policy. We passed a tax increase on June 28, and we apparently expected to be able to read about the effects in the next day's paper.

The fact of the matter is that these things do influence the economy with a substantial lag.

If you look underneath the basic current data, there are some indications that possibly we are seeing some effect here.

Retail sales increased, seasonally adjusted in January, but still were not above the level of the third quarter, and the rise in gross national product, as you indicate, was a little less in the third quarter. These are things which one would begin to expect to show up at about this stage, given substantial tax action in mid-year.

Representative MOORHEAD. Fine. Mr. Stein, would you or, Mr. Houthakker, have you any comments on that?

Mr. STEIN. I would agree with that.

Representative MOORHEAD. You point out that the present inflation in the economy can't be corrected without some adverse effect on employment. I am trying to determine your trade-off ratio. In your statement you said that a 2.5-percent rate of unemployment was unacceptable; however, I am not sure if I understand what rate short of 2.5 percent you think is acceptable as a trade-off for stability.

This, it seems to me, is a critical issue, especially considering the social problems that are bound up in this unemployment rate. I think I recall the statistics that if the unemployment rate increases from the present 3.3 percent to 4 percent that 300,000 to 500,000 people will be out of work. I think we all have a very good idea where this impact occurs. This is a high price to pay; however, I do agree that inflation is a cruel tax, but I'm not sure how cruel vis à vis unemployment.

The elderly and the poor do suffer, undoubtedly, from inflation, however, a recent study has shown that social security benefits have more than kept pace with inflation over the present expansion and the poor who are in debt and who are employed at the margin do reap some benefits from inflation. I do agree there is a trade-off here, but we should have a clear idea of the net social costs and benefits that surround the problem of controlling inflation before we bear down too hard.

Mr. McCracken. I wish I could be more confident myself about our technical information on the statistical nature of the trade-off here. We are hopeful that if we pursue a careful and gradual approach to this problem that the adverse effect on unemployment will not be large.

I cannot confidently say what rate of unemployment would be consistent with what rate of increase in the price level. I think these factors themselves change over time.

All I can say is that we shall certainly continue to be extremely sensitive and extremely concerned about the employment problem.

Representative Moorhead. Now, on the international monetary system, in your testimony you point out that for 20 of its 25 years this system has worked very well and it should be given respect.

But it seems to me that you have accorded it a little too much respect, because in a 12-month period, from the time of the pound devaluation through the March gold crisis to the November franc crisis, we have had three serious crises. Coupled with the fact that the system is 25 years old it may need more than just a few minor adjustments.

It seems to me that we should, as you say, pursue changes with vigor, but that was only one sentence out of the whole section, and I suggest to you, sir, we need more emphasis on the international monetary system than I believe your statement indicates that you are going to give it.

Mr. McCracken. Well, we certainly remain very much concerned about the kinds of problem that you allude to.

Representative Moorhead. In your testimony you state the importance of reducing the concentrations of unemployment. But I don't find in your statement any indication of the methods or programs that you are advocating for reducing these concentrations.

Mr. McCracken. We did not, of course, here outline in detail new programs. As a matter of fact, the Secretary of Labor will be before the committee later in this series of hearings.

However, in our statement we do allude to the kinds of approaches to this problem which would seem to be in order.

Representative Moorhead. Thank you, Mr. Chairman. My time has expired.

Chairman Patman. Senator Jordan?

Senator Jordan. Thank you, Mr. Chairman.

Mr. McCracken, I, too, want to welcome you before this committee in your capacity as Chairman of the Council of Economic Advisers and I want to commend you for the very fine statement you have given us.

In view of the fact that the two restraints for inflation, the monetary and fiscal, have different degrees of responsiveness in the time they can be applied due to the fact that monetary restraints can be applied almost instantaneously, and fiscal restraints are dragged out sometimes almost interminably, do you think there is a likelihood that we have over-compensated in monetary restraints in trying to control inflation in the past?

Mr. McCRACKEN. As one looks at the history of this in the last several years, there is some evidence that we have overconcentrated on the one instrument. This certainly would be a reasonable inference to draw from 1966.

Senator JORDAN. In other words, if we had had some fiscal restraint perhaps a year earlier it is quite possible we wouldn't have to go so high in monetary restraints, interest rates and so on, is that what you are saying?

Mr. McCRACKEN. Yes; if we could have had the tax increase a year earlier, we could have avoided that critical fiscal year 1968 $25 billion deficit which certainly played a role in drawing monetary policy itself off course.

Senator JORDAN. There would be an earlier solution to the inflation problem.

Mr. McCRACKEN. Yes. We would have had a more balanced approach.

Senator JORDAN. Doctor McCracken, do you believe that the two goals of zero inflation and full employment are possible?

Mr. McCRACKEN. I think looking at experience we would have to say that the technology of economic policy at the present time is not up to giving us those two goals simultaneously.

Naturally we want zero inflation and we want zero unemployment, but we don't yet know how to achieve them.

Senator JORDAN. So then it is going to be a judgment matter as to how we trade one off against the other to achieve the least inflation and the fullest employment.

Mr. McCRACKEN. Yes, and sometimes one is a more urgent and pressing matter than the other. Unemployment was a pressing matter in the early 1960's. The price level problem is urgent now.

Senator JORDAN. You made a good statement about the effects of inflation. You point out, and rightly so, that inflation hits the little fellow the hardest and the sophisticated investor is able to insulate himself against it more or less.

To what extent would you believe or would you think that inequities in our tax structure would contribute to this situation.

Mr. McCRACKEN. That is, contribute to——

Senator JORDAN. To the fact that the little fellow gets the worst of it in inflation, the sophisticated investor in this case is better able to take care of himself.

Mr. McCRACKEN. There are some aspects of our tax system which would tend to work in that direction. To the very small saver taking capital gains is not as valuable as to more affluent people. One could think of illustrations like that, yes.

Senator JORDAN. About 20 years ago the lower 20 percent of the people receiving incomes in the United States received less than 4 percent of the total income, and those in the upper 20 percent received about 46 percent of the total income. Those ratios haven't changed. With all of the fine tuning and with all of the effort that has been put in to try to equalize things, and I am not just talking about leveling everyone to a common denominator, but we haven't made too much progress along that line.

Do you have any idea how we can achieve a little better equity in this matter.

Mr. McCRACKEN. My guess is that if we had absolutely accurate and relevant statistics in regard to this, that the equalizing which has occurred is probably a little greater than the statistics themselves might imply.

I suspect prices of things the wealthy buy more of have probably increased a little more rapidly than others but that is just a judgment. The fundamental approaches here certainly have to be through education to make sure that each person entering the work force is going to be able to realize his full potential.

We have to recognize there are certain people for whom merely the provision of employment opportunities is not the full answer, and we indicate that in our own statement.

The general thrust of economic progress itself would tend to push us further in that direction. It is, of course, in the poor economies that you find the greatest extremes in the distribution of income and wealth. So it is a matter of economic progress generally and specific measures to make sure that there aren't disadvantaged people stranded.

Senator JORDAN. So it points up the need for concentrating on those hard-core situations that may require substantially more effort than the general level.

Mr. McCRACKEN. Yes. I would agree.

Senator JORDAN. I am glad to hear you say that because I am convinced this is where we have been falling down. We haven't put enough effort in the right places.

Dr. McCracken, we have about a 4½-percent inflation in 1968, is that correct? Is that the figure you use—about 4½ percent?

Mr. McCRACKEN. Yes, it is a little more than that with the Consumer Price Index——

Senator JORDAN. What is the normal annual increase in population in the United States?

Mr. McCRACKEN. The labor force is growing about 2 percent, close to 2 percent, per year now. The population growth is less than that, about one and a quarter percent.

Senator JORDAN. One and a half percent.

Then with a 7-percent increase in gross national product one must take into account that 4½ percent of it is inflation. We have a population increase of 1½ percent, you say, and we have got an increase in productivity of labor of that segment of the gross national product which is allocable to labor. Would you agree with me that a 7-percent gross national product increase under those conditions is no increase at all.

Mr. McCRACKEN. Well——

Senator JORDAN. In real terms.

Mr. McCRACKEN. A 7-percent increase in gross national product with, we will say, a 4-percent increase in prices, does leave about a 3-percent growth in total real output.

Senator JORDAN. Yes.

Mr. McCRACKEN. Then with a 1½-percent to a 1¼-percent rise in population we get 2¾-percent rise in output per capita.

Senator JORDAN. Yes.

Mr. McCRACKEN. Now we could if productivity is rising at about that amount, we could achieve that with roughly a constant labor force which is why, looking ahead, the ongoing longrun growth path that the economy should be on ought to be moving along something like about a 4-percent-per-year rate of growth in real terms.

Senator JORDAN. In real terms.

Mr. McCRACKEN. In real terms.

Senator JORDAN. Yes.

Thank you. My time is up.

Chairman PATMAN. May I ask you a question, sir. If we were to decide to not ask for a session this afternoon after we have two more members who would like to ask you questions, would it be all right for you to answer questions that any member of the committee submitted to you before you looked over your transcript, if you would answer the questions when you examine your transcript, would that be satisfactory?

Mr. McCRACKEN. We would try to be responsive.

Chairman PATMAN. Thank you, sir.

Senator Percy?

Senator PERCY. Thank you, Mr. Chairman.

Dr. McCracken, I would like to ask one or two questions of you and then see if we can't put your associates to work also this morning. I have a couple of questions in their area of interest.

Mr. McCRACKEN. Good.

Senator PERCY. I would like to first ask you about the budget. We will have, of course, a chance to go over that in detail tomorrow but I sense from the tone of your comments today that you would like to see us cut back the last Johnson administration budget even more.

How important would it be that we really put major emphasis on this as we did in the Congress last year to see if we can't really push the rate of Federal expenditures back significantly, not just in very minor shaded areas but in significant cutbacks? How important is it to the economy of the country that we try to undertake this jointly, the administration, Budget Bureau, the agencies and the Congress.

Mr. McCRACKEN. It is important that we start to make progress. The question is, of course, how do we make progress? The first requirement is that we get clear in our minds what the low priority items are that can give us the elbow room either to lower levels of total spending or for new programs which we consider high priority. This operation takes time and it can't be done instantly. But we do have to recognize that levels of expenditure at present are beyond the revenue producing capacity of our tax system unless we retain the surcharge.

So there is our overall problem unless we continue the surcharge in order to balance out the budget.

Senator PERCY. But at any rate, unless we are able to cut programs like public works, defense, possibly space, and other items that Senator Proxmire mentioned earlier, there is not much of a chance to increase expenditures in the humanitarian programs, such as social programs affecting the cities, rural poverty, hunger, and others.

Mr. MCCRACKEN. The elbowroom there is very limited. We have already a projected rather small surplus.

Senator PERCY. I understand while I was out of the room that you had commented there was increasing protectionist sentiment in 1969 as against last year. We can all feel it here, I think, in the Congress.

How important, in your judgment, would it be for us to resist opening a Pandora's box by having a little quota protection for one industry that might have a particularly articulate group of advocates in the Congress and in the country, and simply say that we can't afford to open this avenue now for greater protection on imports if we are to maintain a position of a great exporting country without retaliatory measures instantly being taken abroad against American products that we need to export abroad.

Mr. MCCRACKEN. I think we need to keep in mind our basic objective here, which is to work toward a freeing up of our international trading and financial system, rather than moving toward a system of growing controls. We all recognize that in this process there are specific problems that come up from time to time. We can't be unmindful of those problems. But I would hope in general that the basic thrust of our policies in the years ahead can be in the direction of opening up further opportunities for trade, and minimizing the impediments to trade that we have.

Senator PERCY. Do you, in your judgment, feel the textile industry has any unusual overriding factors involved in its situation that would cause it to be singled out as a specialized case to be treated separately from shoes, steel, fish nets, clothespins, and a multitude of other products, all of whose interests would like greater protection if they can get it?

Mr. MCCRACKEN. I really don't know. I haven't got, I haven't explored that that carefully. It is quite possible that there is a specific problem here. There probably is more exposure to displacements in this industry than in others and this is something that would have to be looked at very carefully. Employment here may well be concentrated in areas where alternating job opportunities are not readily available.

Senator PERCY. Dr. Houthakker, last week at the OECD meetings in Paris, I believe Dr. McCracken said that the only reason the U.S. balance of payments was as good as it was in 1968 was due to the foreign investments capital flow into the United States and the dropoff in capital flow out of the United States. What do you think will be the capital movement picture in 1969.

Mr. HOUTHAKKER. Well, Senator, I think that in 1968 there were three factors which helped to keep the capital account very favorable even though the trade account deteriorated.

One was our high interest rates relative to those abroad, in particular the fact that our interest rates structure had at last caught up with the European structure and this is still the case at the moment.

The second factor was the direct investment control program which is still under consideration. The third factor which made the accounts favorable was a large increase in special transactions. Those as you know are transactions in nonliquid investments with foreign governments and other official bodies. Now the exact nature of these special transactions is always somewhat obscure because to some extent foreign governments may have been more willing to buy those CD's and similar securities because of our high interest rates. So I would say that these are the main factors.

However, there is still another one which is perhaps even more uncertain; namely, the large purchases by foreigners of American equities, and in the case of equities we just do not have much knowledge on which to base any prediction as to what might happen in 1969 and the following years.

We know from the past records that equity purchases are quite volatile and I think that therefore we cannot be very sure that this kind of large movement will continue.

I think that also in the case of the other securities which contributed to the favorable capital account that there may have been something of a-once-and-for-all movement since our interest rates moved up rather suddenly in parity with European interest rates, approximate parity, this may have caused a-once-and-for-all move of purchasers and there again our knowledge is not—is very imperfect, and I think it is very difficult to predict our capital account movement.

Senator PERCY. Would you, Dr. Stein, or Dr. McCracken, state as to what our trade account balance of payments is likely to be in 1969?

Mr. HOUTHAKKER. There is, I think, not complete unanimity as to the outlook for the trade account. I think any slowdown in our rate of growth will have a favorable effect.

The increase of 23 percent in imports which we had in 1968 over 1967 is certainly an abnormal one and cannot be explained by any of the studies that I am aware of. In other words, 23 percent is much more than seems to be in line with previous experience. So we can certainly look forward to considerable reduction in the rate of growth of imports.

Now whether this reduction will be enough to bring the growth of imports in line with the growth of exports I think is not clear but I believe that a consensus on the trade accounts would be that there might be some small improvement.

Senator PERCY. Dr. Stein, would you want to comment on the question?

Mr. STEIN. Well, this is not a field of my activity but I agree in general with what Dr. Houthakker has said.

Senator PERCY. Thank you, Mr. Chairman.

Chairman PATMAN. Now, we have one other member who would like to interrogate, and we have some alternatives. If we proceed after that I think we will be obligated to have an afternoon session, if one can be arranged, and at which time other members will come back. Or since we have permission for any member to ask questions in writing to be answered in the record we could let that suffice; the third alternative would be if there should be a demand from the members to have you gentlemen back later, at some time that is mutually satisfactory, if it can be arranged?

Mr. McCracken. We shall certainly try to cooperate with the committee.

Chairman Patman. Thank you, sir. We have our newest member on the Joint Economic Committee, Representative Conable. Mr. Conable, we are glad to have you, sir. You may proceed.

Representative Conable. Dr. McCracken, it would be presumptuous for me to welcome you before this committee because my membership on this committee is shorter than your chairmanship of the President's Council. So my questions are necessarily modest, sir.

I am interested in the surtax, however. As I understand it, as an anti-inflationary device it has two major impacts. First of all, it reduces the deficit which is itself inflationary and, second, it tends to reduce the total demand for goods and services in the private sector.

Now you said, in answer to a question earlier, that you preferred the expenditure reduction route from an economic viewpoint, and I assume that was because it has a more immediate impact on the total demand for goods and services. Is that right, sir?

Mr. McCracken. My comment there was that I thought the anti-inflationary impact of reducing expenditures by a dollar would probably be somewhat greater than increasing taxes.

Representative Conable. Is that because of the very high level of savings at the present time? Do people tend to dip into their savings to pay increased taxes rather than reducing their demand for goods and services?

Mr. McCracken. Yes, that is a significant part.

Representative Conable. And is that one of the reasons why there has been a lag in the impact of the surtax on our economy generally?

Mr. McCracken. This, I think, has been a part of it, and the savings data show that.

Representative Conable. So we can anticipate, can we, a greater impact from the surtax, let's say in April, when people find out they are under-withheld, than there has been up to this point.

Mr. McCracken. I would expect there will be some unpleasant news there which will have an effect on consumer spending.

Representative Conable. What I am trying to decide in my own mind, sir, is whether the surtax then is likely to have a greater economic impact as we extend it, assuming that is necessary, than it did initially. Have we drawn down on savings to any extent or is the rate of saving continuing at this same high level that it was?

Mr. McCracken. The savings rate declined in the second half of 1968. It was, I think, a little, it was back within the normal spectrum, though still a little high by standards of the early 1960's.

I think the extension of the surtax would probably more or less continue the status quo. Research on consumer attitudes would suggest that anything which is "more of the same" is not apt to have a significant displacement effect.

Of course, if the surtax were to be reduced this might well be interpreted as good news which could produce quite a substantial rise in spending.

Representative Conable. I am wondering whether continuing the surtax at a reduced level would have the same economic impact in terms of inflation that putting it on at 10 percent last year had in light of last year's savings level.

Mr. McCRACKEN. Or in other words, what would be the effect of allowing part of it to expire.

Representative CONABLE. Yes. If there is a timelag in the impact of these things, and it is just beginning to catch up with us, does this mean that at a lower level we would have the same effect we had initially at the higher level or not?

Mr. McCRACKEN. The adjustment to that lower level would also take some time, just as the adjustments here has taken time.

Representative CONABLE. One other question in a different area, sir. What is the average interest on our national debt now, despite the 4¼ percent ceiling?

Mr. McCRACKEN. You mean the average rate——

Representative CONABLE. The average rate we are paying on the overall debt of $365 billion if that is approximately what it is.

Mr. McCRACKEN. I am not sure I have this figure.

Representative CONABLE. Well, I don't insist on having it right here, sir, if it can be supplied.

Chairman PATMAN. Would you supply it for the record?

Mr. McCRACKEN. Yes, sir; we will be glad to do that.

(The information requested and subsequently filed follows:)

The gross Federal debt at the end of the fiscal year 1969 is estimated to be $365 billion, not all of which is interest bearing. The latest figures from the Treasury Department indicate that the interest bearing portion of the debt was $357.6 billion as of January 31, 1969. The average interest rate at that time on the interest bearing portion of the debt was 4.684 percent. The rate at the end of fiscal year 1968 was 4.499 percent.

Representative CONABLE. Those are the only questions I have, Mr. Chairman. Thank you.

Chairman PATMAN. We will reserve the right to ask you gentlemen to come back if the committee should want you to come back at some time mutually convenient for the committee and for you. Will that be satisfactory, Mr. McCracken?

Mr. McCRACKEN. It will.

Chairman PATMAN. I believe then, that we can adjourn for the day.

Tomorrow morning we have the Director of the Bureau of the Budget, Mr. Mayo. I will be unable to be here because I will be a witness before the Ways and Means Committee, but the Vice Chairman, Senator Proxmire, has agreed to serve as chairman, which I appreciate very much.

So, the committee will stand in recess until 10 o'clock tomorrow morning.

(Whereupon, at 12:50 p.m., the committee was recessed, to reconvene at 10 a.m., Tuesday, February 18, 1969.)

(Appendix follows:)

APPENDIX

The following answers to later questions from Senator Javits were subsequently submitted for the record by the Council of Economic Advisers:

Question 1. It is generally agreed that the Federal Reserve prematurely eased monetary policy after the tax surcharge and expenditure ceilings were enacted last year. To what extent did this easing vitiate the restraining effects of the fiscal measures?

Do you believe this easier monetary policy the result of poor coordination between the Federal Reserve and the Administration?

What measures can be taken to reduce the possibility of fiscal and monetary policies working at cross purposes in the future?

Answer. The intention of the Federal Reserve to ease money conditions upon the enactment of the tax surcharge and expenditure ceilings in June 1968 is clear from the policy record of the Federal Open Market Committee. Thus, at its meeting of June 18, 1968, the Committee voted to maintain "generally firm but orderly conditions in the money market: provided, however, that if the proposed fiscal legislation is enacted operations shall accommodate tendencies for short-term interest rates to decline, . . ." In fact, interest rates did decline until about September, after which time they rose sharply. On the other hand, the money supply remained fairly constant from the time the surcharge was enacted until late October, when it began a rapid rise. Thus it is difficult to tell whether or not monetary influence in the few months after enactment of the surcharge was "easier." In any case, it seems unlikely that either the fiscal action at the middle of the year or the monetary action which followed it had much influence on the overall behavior of the economy in the second half of 1968. Their effects have only recently begun to be felt. Insofar as the second half of 1968 was influenced by policy it was the policy of earlier months, including the expansion of the money supply in the first half of the year.

We are not privy to the discussions that went on between the Federal Reserve and the Administration in 1968 and therefore cannot be sure whether there was a lack of coordination between them. As far as we can judge from the public record coordination was not lacking. The Administration and the Federal Reserve seem to have had a common view of the economic situation and of the appropriate policy. Although there may be a need for better coordination that is not the main lesson of 1968. The main lesson is the need for better understanding of the consequences of both fiscal and monetary policy.

Question 2. During the last two decades, the balance of employment has shifted dramatically from manufacturing industries to service industries. Whereas at the end of World War II, four out of every ten American workers were employed by service industries, now six out of ten work there. Even in manufacturing, the portion of employees in service-type jobs has doubled. Is it true as some maintain, that this change has increased general employment stability, since service-type jobs have proved relatively safe in economic slowdowns?

What does this mean for the so-called "trade-off" between unemployment and inflation?

Answer. In 1950 about 59 percent of nonagricultural employment was in the service-producing industries. Today the figure is 65 percent. Over the next decade, about 85 percent of the new jobs in the economy may well be created in this service sector. Employment is more stable in the service-producing industries than in goods-producing industries. During the four post-war recessions service employment rose, with the exception of a slight decline in 1957–58, while employment in goods-producing industries declined from 3 to 7 percent. The continued shift to service employment leads the Council to expect a corresponding increase in stability of total employment.

Since there is no fixed relationship or "trade-off" between unemployment and inflation, the Council cannot predict the effects on it of the increasing stability of the price level. While on the one hand, the growth of the service-producing sector should help reduce the incidence of unemployment, on the other hand, it may contribute an inflationary force in the economy. Productivity gains, as we measure them, are low in some of the service-producing industries, while wage gains are among the highest.

Question 3. The previous Council of Economic Advisers maintained in their last Annual Report that excessive demand was a "well balanced excess" in 1968, and not attributable to any one sector. Do you agree with this?

If so, doesn't this mean that any program placing the burden for restraint on one sector of the economy relative to others, such as repealing the investment tax credit, would be unfair and unwise?

Answer. We do not find the concept of a "well balanced excess" of demand helpful. It is true that the main components of demand increased more or less in proportion during the year, but this tells us little about whether one sector was leading and the others closely following. Neither does it tell us whether the division of total demand was well balanced in the sense of being sustainable or in the sense of conforming to national objectives. With respect to sustainability several points might be noted. The rate of inventory accumulation in the fourth quarter of the year was higher than is likely to be sustained for long. The rate of imports was probably unsustainably high relative to exports. The ratio of Federal spending to the gross national product was made sustainable only by a temporary tax surcharge. Whether the distribution of the total produce was well balanced with reference to national objectives is of course a matter of judgment. Certainly opinion could be found that it was not.

For the future it seems to us desirable to restrain demand in as general and neutral a manner as possible, allowing free market choices to determine the allocation of the restraint except where clear conflicts with national objectives are involved. We do not think that repealing the investment credit would be wise. If the repeal were permanent it would remove a stimulus to economic growth that the country can well use in the longrun. If the repeal were not permanent, there would be a temporary effect on investment spending; but its timing and amount would be hard to predict (with some evidence to suggest that it might have disappointing short-run results). We do not think that initiating such a disturbance would be consistent with the gradually decelerating course we should like to follow.

Question 4. In your statement, you note, "The rapid flowering of new manpower programs in recent years . . . has created an unmanageable system." What is your reaction to consolidating the many separate programs into a comprehensive Federal manpower program, administered and funded by a single Federal agency?

Answer. The Council supports the position that a comprehensive manpower program should be developed by the Department of Labor. It should be "designed to make centrally available to the unemployed and the underemployed a full range of Federal job-training and placement services. Toward this end, it is essential that the many Federal manpower programs be integrated and coordinated."

The following answers to later questions from Senator Miller were subsequently submitted for the record by the Council of Economic Advisers:

Question 1. Reference page 28 of testimony, line 15. Does this refer to the "unified budget"? If so, would it not be preferable to refer to the "operating budget"?

Answer. The relevant sentence in our statement is: "Our view of the outlook and goal for 1969 implies the need for continuation of a budget whose expenditures are at least matched by the revenues from the tax system (assuming reasonably full employment)." The reference is to the unified budget. We believe that for the subject there being discussed, namely the effect of Federal finances on the whole economy, the unified budget is the best single measure. The main difference between the unified budget and the operating (administrative) budget is that the former includes, while the latter excludes, social security contributions and benefit payments. These contributions and payments have effects on the level of business activity similar to the effects of many taxes and expenditures included in the operating budget. A better picture of the total effect of Federal finance is, therefore, obtained from the more comprehensive budget. This, of course, implies nothing about the wisdom of balancing the unified budget by running a deficit in the operating budget offset by a surplus in the trust funds.

Question 2. Reference page 36, last paragraph. Is it not true that, although over the last few years the rate of inflation in major competitor countries has been higher, the rate of inflation in the United States (applied to a higher wage base which has increased at least in an amount to reflect inflation) has diminished our competitive position in world trade?

Answer. Since 1965, our price level has risen more rapidly than in most industrial countries, and our competitive position has tended to deteriorate. Prior to 1964, our inflation was less rapid than in the industrial countries, and this tended to improve our competitive position.

Our high absolute wage rate does not in itself mean that wage increases will necessarily involve a decline in our competitive position. Even though our wages are higher than in other countries, an equivalent percentage increase in U.S. and foreign wages will not in itself cause a deterioration in the U.S. competitive position, provided that the rate of increase in productivity in the U.S. is as great as the increase abroad. Should the relationship between wage and productivity increases in the U.S. diverge from the relationships in foreign countries, there would be some tendency for price movements to differ among countries, with a consequent change in competitive relationships.

Competitive positions are, of course, affected by costs other than wages, and, at any rate, general price indexes do not give a very precise indication of changes in competitive positions. At this level of generality, however, it is true to say that changes in competitive positions occur, not because of the absolute level of wages as such, but because of changes in relative prices, behind which may be international differences in the percentage rise in wages, or in the percentage improvement in productivity, or both.

Question 3. Reference page 40, line 14. Would retaliation on our part against the EEC's recent proposal to tax our soybeans be regarded as "prejudicial" to such negotiations so that the Council would oppose such retaliation?

Answer. Any step which adds to the barriers to international trade, whether in the form of tariffs, quotas, or other nontariff barriers, raises the potential problem of retreat from the policy of trade liberalization which has been pursued by administrations of both political parties in recent decades. The danger exists whether the trade restriction is initiated with the objective of protecting a domestic industry, or whether it constitutes retaliation against objectionable foreign practices.

At the same time, a measured retaliation to foreign actions prejudicial to our exports may persuade foreign countries to modify these actions. Thus retaliation may, under certain circumstances, be instrumental in protecting our access to foreign markets, and contribute to the overall freedom of international trade. However, retaliation should not be undertaken lightly. It is most desirable, by international discussions and negotiations aimed at achieving mutually acceptable solutions, to avoid retaliation.

A number of European agricultural policies, both actual and proposed, involve obstacles to U.S. exports. This is conspicuously true of the proposed soybean tax. We consider it a matter of grave importance that the EEC, in their farm programs, make provision for U.S. agricultural exports.

THE 1969 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, FEBRUARY 18, 1969

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Joint Economic Committee met, pursuant to recess, at 10 a.m., in room 318, Old Senate Office Building, Hon. William Proxmire (vice chairman of the joint committee) presiding.

Present: Senators Proxmire, Miller, Jordan, and Percy; and Representatives Reuss, Moorhead, Widnall, Brock, and Conable.

Also present: John R. Stark, executive director; James W. Knowles, director of research; and Douglas C. Frechtling, minority economist.

Senator PROXMIRE. The committee will come to order.

Today we resume our hearings on the state of the economy, and the administration's economic policies.

I would like to welcome our witness, Mr. Robert P. Mayo, in his relatively new capacity of Budget Director. Mr. Mayo has been a witness before this committee in the past and has always impressed us with his competence and cooperativeness. We are glad to have you with us today.

It is obvious that the Federal budget occupies a crucial place in economic policy. Of our gross national product of $900 billion, almost $200 billion passes through the Federal Government in the form of tax receipts and expenditures. I am deeply impressed with the urgent need to reduce expenditures by asserting priorities. There are many low-priority items in the budget, and, in the aggregate, they total many billions of dollars. I intend, later on, to discuss the subject more specifically, Mr. Mayo.

I note that you have a fairly brief statement, which we welcome. After you have completed it, we will proceed to raise questions with you under our 10-minute rule.

You may proceed.

STATEMENT OF HON. ROBERT P. MAYO, DIRECTOR OF THE BUREAU OF THE BUDGET, ACCOMPANIED BY SAMUEL M. COHN, ASSISTANT DIRECTOR FOR BUDGET REVIEW

Mr. MAYO. Thank you, Mr. Chairman, and members of the Joint Economic Committee.

I welcome the opportunity to review with you the budget outlook for fiscal years 1969 and 1970. The Joint Economic Committee's contributions to better public understanding of economic policy issues have earned for it the respect and gratitude of the Nation. The increasing appreciation of the importance of economic policy in the United States is attributable in no small part to the efforts of this committee. I am pleased to join in your continuing discussion of this important subject.

Yesterday, the Chairman of the Council of Economic Advisers discussed with you the economic outlook for 1969. Tomorrow, the Secretary of the Treasury will discuss various aspects of economic policy. My testimony covers the budget outlook, an outlook which is now undergoing a thorough review; so it cannot today be as precisely defined as you and I might like.

We have learned much about how to conduct economic policy since the passage of the Employment Act of 1946. But the basic lesson, which led to adoption of the act, remains the same. Balanced economic growth at a pace consistent with optimum utilization of our resources does not just happen. We cannot merely wish away inflationary pressures, the rise in interest rates, or our balance of international payments problem. Nor will wishing lead to a healthy rate of economic growth and job creation. Our fiscal, monetary and other policies, working in harmony, must actively support basic economic objectives—while respecting and preserving the individual freedoms that are so essential to our economic progress.

For fiscal policy, this means that we should aim to provide restraint by achieving surpluses in the Federal budget in both the current and the coming fiscal year. Recognizing that action was required, this administration moved immediately to support the type of fiscal policy that emphasizes restraint—recognizing the need for both extension of the income tax surcharge and a diligent effort to reduce outlays.

In letters sent to the heads of executive departments and agencies almost 4 weeks ago, I stated the philosophy underlying this policy:

> In view of the critical role of fiscal policy restraint in today's inflationary economic outlook and our continuing heavy financial requirements for military operations in Southeast Asia, we—like our predecessors—must now plan for—
>
> extension of the income tax surcharge beyond its July 1, 1969, expiration date, and
>
> a budget surplus for 1969 and 1970.
>
> However, a prime objective of our administration is the removal or the tax surcharge as soon as economic conditions and defense needs will permit.

At the President's request, I also asked each agency head to make an intensive review of the budgetary consequences of all Federal programs under his jurisdiction. This review is now underway.

The review of the budget is urgent. This administration is now considering ways of reshaping the Government's programs in light of its own policies. We do not merely intend to pile new programs on top of old ones. We must, therefore, be in a position to achieve reductions or even elimination of lower priority programs. This will entail careful program evaluation on our part. We must examine the costs and the benefits of Government programs for only then will we have the data on which to make wise priority decisions. With the cooperation of the Congress, we hope to provide room—some in 1970, but particularly in the 1971 and later budgets—to introduce our own initiatives and proposals to meet the challenges of a constantly changing economy. Unless we act prudently now, our ability to move in these new directions will be severely limited by existing program and financial commitments.

Budget controllability always poses a problem. In the very short run, the President and his Budget Director have few choices. Flexibility, even in the 1970 fiscal year, is distinctly limited. It is only when we look farther down the road that significant room for maneuver appears. We must appraise our actions now in the context of that future—which will be upon us all too swiftly, and which will foreclose our options if we are not watchful now.

Federal department and agency heads have been asked to send the Bureau proposals for specific revisions of their budget estimates within the next week or so. The proposals will be reviewed by the Bureau, and, along with our recommendations, submitted to the President for decision. He will then transmit formal budget amendments to the Congress in accordance with law and established procedures. This is also in accordance with the expressed wishes of the chairman of the House Committee on Appropriations. I am optimistic that this review will produce *real* savings. I am realistic enough, however, to appreciate that overall savings are not likely to be dramatic either for the few remaining months of 1969 or for 1970.

Until this process is completed, I have no basis on which to provide complete overall revised budget figures. The following discussion of the budgetary outlook for fiscal years 1969 and 1970, therefore, deals with selected factors which have thus far emerged apart from the review.

FISCAL YEAR 1969

In January the outgoing administration presented a budget which showed estimated receipts of $186.1 billion in fiscal year 1969, outlays of $183.7 billion and a modest surplus of $2.4 billion. This is a tight budget, one born of restraint growing out of the expenditure ceiling enacted last June. Its comparison with the budget deficit of $25.2 billion a year ago shows dramatic improvement.

The need for a surplus—however modest—in fiscal 1969 is clear. But there are enough uncertainties in the estimates to suggest that the indicated surplus may turn out to be more modest than was indicated in January. Let's turn first to expenditures.

Outlays. Limitations established by the Revenue and Expenditure Control Act of 1968 (P.L. 90–364) cover about half of the total estimated 1969 outlays. The budget transmitted last month estimated that outlays for the covered programs would be $8.3 billion below the January 1968 estimate, which is $2.3 billion more than the reduction required by Public Law 90–364. Outlays for programs excepted from the limitations established by the act were estimated at $6 billion higher than those in the January 1968 budget.

The outlay estimate of $183.7 billion for the year was described as tight, given the programs it was intended to finance. It already appears to be overly tight in the sense that some of the expenditures, not all, but some of them, appear to be very conservatively estimated.

One reason why outlays are increasing is the unrelenting strong demand for credit. Interest rates are now higher than was assumed when the budget was prepared. Outlays for interest on the public debt, therefore, have risen significantly and will consume a part of the estimated 1969 surplus shown in the January budget. Moreover, as a result of the strong demand for credit, private banks may wish to hold a lower volume of farm price-support loans or they may require a higher discount rate on these loans than had been anticipated by the previous administration. In either event, Federal outlays would be higher than estimated. Also in the agricultural field, we are faced with $168 million of increased outlays on advanced payments under the feed-grain crop-diversion program. We have had to incur this unexpected expenditure because in our judgment the failure of the previous administration to announce this reduction publicly and well in advance imposed an unjust burden on those farmers who had been participating in the program.

Furthermore, past commitments may result in higher outlays this year, especially in such areas as highway construction. And also, receipts from offshore oil leasing—which are offsets against outlays—appear to be falling short of the Interior Department budget estimates.

We expect, of course, that outlays for some activities will fall short of the budget estimates. Revised estimates of the effect of removing Federal intermediate credit banks and banks for cooperatives from the budget when the Federal capital investment in them was retired indicate that the resulting reduction in outlays will be a little greater than estimated in the budget. In addition, lower than anticipated unemployment is likely to result in lower outlays for unemployment insurance.

I am confident that the budget review currently underway will produce other reductions in 1969, but I cannot define those at this time. Fiscal year 1969 is now nearly two-thirds over; so our ability to make substantial reductions in 1969 outlays is very limited. Nonetheless, we will not fail for want of trying. We are not looking for deferrals or stretchouts which would have to be made up later. Our goal is to build a sound base for future redirections of Federal programs.

Receipts. We are all quite aware that revenue estimates hold pitfalls for us, too. The modest budget surplus would be either doubled or wiped out if the receipts estimate were off by as little as 1½ percent. Our margin of error is thin indeed.

In any event, we already know of one specific reason to expect lower fiscal 1969 receipts than are shown in the budget. If—as appears likely—the tax surcharge is not extended by early April, receipts from corporation income taxes will be less than estimated, because quarterly payments that would be due on April 15 would not reflect the early extension of the surcharge that was assumed in the budget. Moreover, an additional deferral of receipts will occur if the extension does not occur in time to affect the following quarterly due date on June 15. Extension of the surcharge after June 15 will postpone $500 million of receipts from fiscal 1969 into 1970.

FISCAL YEAR 1970

In our prospective economic environment, a policy of continued fiscal restraint is certainly appropriate for the next fiscal year. The forces that threaten our economic health are still moving too consistently toward inflation. They are moving with too much momentum to be left unrestrained. We will be alert to changes in economic conditions that make changes in fiscal policy appropriate. In the absence of any significant change in our commitments in Southeast Asia and in the state of our economy, however, we continue to support extension of the surcharge as an appropriate and necessary fiscal policy in our efforts to stem the forces of inflation.

The January budget estimated a $3.4 billion surplus for fiscal 1970, the difference between receipts of $198.7 billion and outlays of $195.3 billion. The element of uncertainty is, of course, greater with respect to these estimates than for the 1969 estimates.

Outlays. The outlay estimates for fiscal year 1970 also appear to reflect considerable restraint and, again, some of the estimates seem to be at the lower end of a reasonable range, thus making budget reductions that much harder. Here again the intensive review of programs now underway should produce savings which can be used to finance our redirection of programs, and, hopefully, will add to the much-needed surplus. I would expect, of course, that the effect on the composition, if not the total, of 1970 outlays will be significantly greater than on 1969 outlays. We look forward to working closely with the Congress in this redirection of programs.

I should point out that the 1970 budget assumption that the personnel appointment limitations required by section 201 of the Revenue and Expenditure Control Act of 1968 would not be effective beyond June 30, 1969. This asssumption is being maintained for purposes of our current budget review. But I have asked for views of the department and agency heads on this point to aid the administration in developing its own position on this matter. I am expecting constructive suggestions from the agency heads about the personnel ceiling, not just negative expressions. The President is firm in his conviction that there must be strict control of personnel in the executive branch of the Government. I have so instructed the department and agency heads to do what they can to keep personnel under strict control.

As we look at 1970, we must also remember that achievement of the estimated surplus rests to a considerable extent on legislation proposed by the prior administration. Outlays will be over $1 billion higher if several major proposals are not enacted, specifically: $500 million in postal receipts—an offset against postal service costs. I refer specifically to the half billion dollars in postal receipts in the budget, which, of course, is an offset against postal service costs.

Three hundred million dollars in Farmers Home Administration outlays, which would be saved by shifting some of the direct farm operating loans to a proposed insured loan program.

Another $300 million in outlays for education, the saving to be achieved by adjusting entitlement for school assistance in areas affected by Federal activities.

And another $100 million in veterans benefits and services resulting from elimination of some duplicate burial benefits and compensation for arrested tuberculosis benefits and reduction of pension payments by the amount of railroad retirement income received.

These and other legislative proposals included in the 1970 budget totals are being studied as part of this administration's budget review preparatory to determining our position on them. We must also note that here again higher interest costs threaten to shrink the 1970 estimated surplus, and by a larger amount than in 1969 if present interest rates continue.

Receipts.—About $11.9 billion of the estimated $198.7 billion receipts in 1970 depends upon the passage of legislation. Of this—

$9.0 billion would come from extension of the 10-percent tax surcharge;

$500 million from extension of current excise tax rates;

$300 million from a shift to quarterly collections of unemployment taxes;

$1.7 billion from higher social security taxes; and

$0.4 billion in proposed user charges—airways, highways, and so forth.

Our administration's current position is to support the proposed extension of the surcharge and the excise taxes. The remaining proposed legislation, which would produce $2.4 billion, is currently being reviewed. The proposed social security and user charges legislation would also increase outlays by $1.7 billion, and those were not in the figures we were talking about before. Thus, $700 million of the estimated 1970 surplus of $3.4 billion is contingent on the passage of legislation affecting receipts from other than the surcharge and excises.

We call attention to the fact that these receipts are contingent on new legislation merely to emphasize the uncertainties associated with the 1970 receipts estimates. We do not mean to imply opposition to these proposals. The administration will develop its position on the proposed legislation during the course of its review of all the legislative proposals in the 1970 budget.

Your committee is well aware that budget receipts and expenditures are heavily dependent on the behavior of the economy. If the rate of economic expansion is slower than was forecast when the budget was submitted, receipts in fiscal 1970 would almost certainly be lower than was estimated at that time. The effects on expenditures would be mixed, but the net result is quite likely to be higher. On balance, there would almost certainly be a reduction in the surplus for fiscal 1970. Moreover, even aside from the problem of forecasting economic activity, as I have said before, there is always some uncertainty in the estimates of receipts.

We are just beginning our task of reviewing the financial condition of the world's biggest enterprise. It is an awesome task, combining challenges of organization, management, planning, and fiscal responsibility which are without parallel. We shall do our best, and we know you will help us in every way you can. That goes in both directions.

Senator Proxmire (presiding). Thank you very much, Mr. Mayo.

You say that if the tax surcharge is not extended by early April, there will be a postponement of about $500 million in receipts from fiscal 1969 to fiscal 1970. Now, do I take it from that that the administration may urge the enactment of the surtax shortly? After all, if we are going to act by April, it is going to take a position on the part of the administration within the next week or two, I would think.

Mr. Mayo. Well, two points on that. First of all, I am describing in that context the budget of the outgoing administration, which assumed that the surtax extension would occur before April 15. Some revenue will be lost to fiscal year 1969 if extension does not occur before April 15; an additional amount will be lost to fiscal 1969 unless the surcharge is extended before June 15. To realize the one-half billion claimed in the budget as revenue for fiscal year 1969, you would have to have enactment of the extension before April 15. To answer your question about this administration's plans, it is unlikely that we shall be prepared to ask for an extension of the surtax as early as the budget assumed. We will not have our budget review completed, sir, in time to permit necessary congressional action by April 15.

Senator PROXMIRE. Can you give us an idea roughly of when you would be prepared to let us know your position definitively on the surtax?

Mr. MAYO. That depends to a large extent, Mr. Chairman, on how we progress in the budget review that is underway right now.

Senator PROXMIRE. Have you made any estimate as to what the timing would have to be in order to assure that Congress would have time to hold hearings, the House and Senate both, to act so that you could have it certainly by July 1?

Mr. MAYO. We have not made an estimate in detail on that. And I would respect your point of view, Mr. Chairman. As a practical matter, I would think that we certainly would have to be up there in the neighborhood of late April or early May. It takes time for legislation to go through the Congress; we appreciate that. And we would want the extension, obviously, before the surtax expires on June 30.

Senator PROXMIRE. In the course of your remarks you indicate that this surplus of $2 or $3 billion could either be a little more than that, or even be a deficit. Does this imply that this is about what you anticipate? Do you feel that this is about right from an economic standpoint, to have a very small surplus, or do conditions require that, if possible, we should work on expenditure control and try to have a bigger surplus?

Mr. MAYO. I think that we are in the ball park here with the type of surplus that you are describing.

Senator PROXMIRE. Yesterday the Chairman of the Council of Economic Advisers indicated that because of the inflationary situation he expected that monetary policy would have to be tight, interest rates high, throughout this present year—something all of us deplore. Your statement here today apparently indicates that you are not going to take the fiscal action. And the administration has pretty well discarded the other instruments of inflationary control, in the short run at least, to do much about this.

Mr. MAYO. I wouldn't say we discarded them. We recognize that they have limitations, Mr. Chairman.

I would say that the achievement of a balance in the budget and the very modest surplus that we are describing here is, in conditions of the economic boom we find ourselves in, perhaps a neutral fiscal policy.

Senator PROXMIRE. It really isn't a restraining policy: it is a neutral policy. When you say it could be a little over or a little under a budget balance, it is going to be close to it. It might go a billion or two dollars either way.

Mr. MAYO. There is restraint in this budget, if only for the fact—again, may I observe—of moving from a $25 billion deficit to a small surplus.

Senator PROXMIRE. That is a very important point.

Mr. MAYO. I think that this movement can properly be called restraint, Mr. Chairman. In looking at it just by itself, without the dynamics for the moment, it might be called neutral. But, of course, the situation must be viewed dynamically, and to that extent it is a restraining budget.

Senator PROXMIRE. Of course, that restraint is being exercised right now, it wouldn't be exercised in 1970, that movement, because right now, as I understand it, we are operating at a level of give or take $1 billion or $2 billion surplus or deficit, that is, in——

Mr. MAYO. There are lags in the economic effect of this, as we all well know. It isn't a turn on and off sort of proposition.

Senator PROXMIRE. You described this as a tight budget, and perhaps an overly tight budget, which is surprising if not shocking to me, coming from your administration. What would happen if the Congress should do precisely what it did last year and use the same figures last year? In other words, supposing we should set a ceiling on expenditures at $183.7 billion, which was the expenditure of last year, I guess, or close to that, what would be, in your view, the difficulties that would develop if Congress should take that action?

Mr. MAYO. Well, two points. First of all, I was referring in the overly tight description—to the budget of fiscal year 1969 as we face it right now.

Senator PROXMIRE. What I am talking about is maintaining that level of spending for 1970, if Congress should do that.

Mr. MAYO. The question of maintaining a level of spending such as you suggest raises two problems in my mind. First—I don't want to sound like a broken record, because I think this has perhaps been overused—there is the problem of commitments and contracts and so forth that have already been made. The Congress could do a great deal on this through its appropriation mechanism to keep expenditures at a lower level next year. Second, we do have built-in increases which are rather significant, the pay increase, interest on the debt, and so forth. This raises the question as to how control over the budget should be exercised, whether it is primarily or almost entirely through the appropriation process, in terms of what is done on authority to spend, or whether we need additional restraint to be exercised through the debt limit, as we have had—sort of ex post—for many years, or through outlay controls such as were enacted last year.

Senator PROXMIRE. I am asking you, supposing we follow the Williams-Smathers amendment of last year, which many people seem to feel was quite effective. Secretary Barr of the Treasury, for example, has written a recommendation to the Congress that we follow this kind of line. He didn't recommend that we have the same level, of course, as last year, but he thinks that this is something that Congress can do which is effective. And there are a few things that we can do in this spending area which gives us a feeling that we are having a really definitive effect on the amount that is expended. That kind of action seemed to have considerable effect—giving the administration the discretion to spend within that ceiling, and perhaps for the moment laying aside the manpower limitations, which I understand that the President opposes quite strongly—at any rate, confining you strictly to the dollar amount with flexibility.

Mr. MAYO. Well, I might say again, the ceiling does exercise restraint. I believe I reflected that in this statement. One of the questions that I am still seeking the answer to is how the restraint can be handled so that it is not arbitrary with regard to programs that are pretty much fixed, where you can't do much, as against programs where you have more leeway.

Senator PROXMIRE. Let me ask you about another area. Some of us on this committee and in the Congress are very much concerned about military spending. We are also concerned about the failure of the Budget Bureau in the past to take the kind of sharp look at it that they seem to take at other areas of the spending. Mr. Zwick was quite frank in saying the Bureau doesn't go into the same detail for military spending as for civilian spending. And, of course, the amount involved is so great. This is an area where we can make sharp reductions if the policy choice persuades us that we should do it.

One of your senior staff members, Richard Stubbi, wrote a paper entitled "Improving the Acquisition Process for the High-Risk Military Electronics Systems." His conclusions were very shocking, as you may recall. He pointed out that the performance record of these multibillion-dollar procurements made by the Defense Department in the 1950's and 1960's were both bad, and in the 1960's they were so bad that six of the 11 major weapons procured reached a performance level of less than 25 percent of their specifications. He said that they cost on the average 200 to 300 percent more than the Pentagon expected and told Congress they would cost when they started. He said they were on the average 2 years late in delivery. He pointed out that the profits of these firms had not relationship to their performance; that in one case a firm which had failed to meet its specifications on five out of seven of its weapons systems had profits 40 percent higher than the rest of the industry, and 50 percent higher than nondefense industries in this country. That in another case you had a firm that failed on all—every one—of its procurements, and in this case their profits were higher than average.

Now, under these circumstances it seems to me that this is an area that certainly ought to be explored with considerable critical detail here. And I can't understand why a dollar spent in defense shouldn't be as carefully scrutinized as a dollar spent in nondefense areas.

Mr. MAYO. I share your concern, Mr. Chairman. I am quite aware of my predecessor's statement in this regard, and the statements of some of his predecessors. I feel that we have very competent analysts and program people on the defense budget within the Bureau of the Budget. I have been very impressed with their ability. I believe, however, that we need something a little more than that in terms——

Senator PROXMIRE. It is good to hear it.

Mr. MAYO (continuing). In terms of a separate, highly competent, highly skeptical look at the defense budget. And it was with this specifically in mind that I appointed about 2 weeks ago James Schlesinger, who was head of strategic studies for RAND, as an Assistant Director of the Bureau, with the specific purpose of having him advise me on this very subject. I think this is terribly important, to have a man of this competence separate from line responsibility people to actually dig into areas that I can't possibly do myself, either from the standpoint of time or technical competence, and to make an impact on the very problem that you are talking about. He has already started work in this direction.

Senator PROXMIRE. My time is up. But let me just say, it has been my impression, and an impression that I have confirmed by talking to a number of people that have been in the budget in the past, some in very high positions, that the Defense Department has had a peculiar relationship with Presidents in the past, that the Defense Department and the Presidents seem to work together on this, without the very useful discipline and the wholesome discipline of a forceful Budget Bureau, making the kind of independent critical analysis. After all, the Defense Department has its own interest and its own reason for wanting to fight for a higher budget, as every department does. So I am delighted to hear that you have made this appointment, and that you have this view that every dollar spent by the Defense should be as carefully scrutinized as nondefense dollars. And I do hope that you will have just as forceful an attitude toward waste in Defense as you have anywhere else.

Mr. MAYO. That is my intention, sir.

Senator PROXMIRE (presiding). Mr. Widnall?

Representative WIDNALL. Thank you, Mr. Chairman.

Mr. Mayo, I was really delighted by your answer to Senator Proxmire's last question. And I think it promises us a wholesome approach in the future toward military spending.

I have heard former Budget Bureau Director Charles Schultze speak on several occasions about projected spending for the military. And he has estimated that post-Vietnam military spending will rise to $70 billion for fiscal 1971, and $76 billion for fiscal year 1974. He characterized these projections as conservative, and said that they assume a significant stretchout and deferral of the number of existing weapon systems procurement programs. Do you agree with his projections?

Mr. MAYO. I haven't had the opportunity, Mr. Widnall, to look into those figures. I share the concern that I think is Mr. Schultze's message here, that there are built-in increases in Defense program costs. We have undertaken, as Mr. McCracken may have told you yesterday, a careful study of the post-Vietnam economy to consider not only transition within industries, and so forth, but also possible uses of what has been loosely called the peace dividend. This latter aspect of the study will be concerned with the choice between public expenditures and private sector tax reduction—not just the surcharge, but other possibilities as well. Careful attention must be given to the various claims that will be put on the so-called peace dividend—not only increased military spending, but also the needs of our cities, of science, and of other programs of the Government.

Representative WIDNALL. What is very interesting, of course, in the projections of Mr. Schultze, is that the Defense spending exclusive of Vietnam support in the current fiscal year is about $52 billion. And his estimates have gone to $70 billion for fiscal 1971 and $76 billion by fiscal year 1974, a very large increase.

Mr. MAYO. They are, sir, if I may observe, estimates that are based on weapons systems that were approved by the former administration. I have no knowledge at this point as to whether that context is still appropriate for us. These are all being reexamined, too, as you know.

Representative WIDNALL. Do you think that such a large increase in the next 2 to 5 years is inevitable?

Mr. MAYO. I do not think it is inevitable; no.

Representative WIDNALL. The small budget surpluses predicted for both fiscal 1969 and 1970 result from approximately $10 billion surplus in the trust fund account, primarily from social security. Since these trust funds are locked up and can be used for only one purpose, we, in fact, have a substantial deficit for both years; is that not true?

Mr. MAYO. There is a deficiency in what you might call Federal funds as opposed to trust funds; that is correct. We have taken the point of view expressed by the Commission on Budget Concepts, of which I happened to be Staff Director, that the unitary budget concept will be followed in this administration as it was in the last two budgets because it eliminated much of the confusion in the public eye, and if I may say so, in the eyes of the Congress and the administration, as to how to present the budget. In no way does the combining of trust funds with Federal funds affect the sanctity of the trust funds.

Representative WIDNALL. Do you foresee the time when we will have a balanced budget regardless of the trust fund balances?

Mr. MAYO. This would depend on so many conditions I wouldn't care to guess at it today, sir. I can't answer that.

Representative WIDNALL. Mr. Zwick, in his appearance before us a month ago, said the total fiscal 1969 outlays were then estimated at $183.7 billion, but that the information from the first 5 months indicated that outlays ran at an annual corrected rate of $181 billion. He said that we could have a rate of $187 billion for the rest of the year and still hit the estimate. Is it possible we might have even a larger surplus by spending at a lower rate than he suggested for the rest of the year?

Mr. MAYO. I would say that statement is a little on the optimistic side, Mr. Widnall. We have had some evidence already—one that comes to mind immediately is advance payments on feed grains programs that I mentioned in my statement, where there is $168 million to be spent—of higher spending than was estimated in the budget. There are other instances involving a great many programs where there may be a little more spending than was in that budget. Again, Mr. Zwick's statement was, I think, in the ball park, and was a proper statement when it was made. I would be a little less optimistic today, however, than Mr. Zwick was.

But let me ask Mr. Cohn, who is with me here today, whether he sees any other qualifications that he might like to make on those annual rates.

I am always a little afraid of annual rates, because of the way things jump around in Federal spending, Mr. Widnall.

Mr. COHN. Mr. Widnall, I share Mr. Mayo's pessimism about the outcome as Director Zwick laid it out on the basis of data he had through November. For one thing, the farm price support program has, through the great efficiency you get out of computerization, developed a new technique for paying bills. And the whole seasonal pattern has changed. And we have no experience as to what that seasonal pattern is. In an attempt to simplify the situation, Director Zwick made an assumption which gave him a seasonally corrected figure. The expenditures that we now see, based on December data, and the effect of the dock strike, which has tied up wheat shipments so that we are not able to sell abroad as much wheat as we had anticipated, Mr. Zwick did not foresee. As a result spending will be higher, I have no doubt.

for farm price supports than he thought it would in the second half of this fiscal year. I think we would be very lucky indeed to end the year with expenditures at the $183.7 billion level. The pressure seems to be a little bit in the other direction.

Mr. MAYO. This is all subject, of course, Mr. Widnall, to our review that we are undergoing right now. But as I said in my opening statement, I am hopeful, but I am also realistic. This narrow area of flexibility closes in on you very fast on the closing months of the fiscal year.

Representative WIDNALL. The Department of the Treasury publication indicates that the budget ran a deficit of more than $10 billion for the first half of fiscal 1969, and the Treasury borrowed about $10 billion from the public to finance it. However, the budget surplus of $2.4 billion is projected for all of fiscal 1969. Doesn't this mean that the Treasury will have to return about $12 billion to the money markets in the final 6 months of fiscal 1969?

Mr. MAYO. This wouldn't be a return to the money markets. As to whether the size of that swing will be as large as you suggest depends on several factors. One of them, of course, is the ultimate size of the surplus. But also, the swing must reflect other changes in the Treasury picture, such as changes in the cash balance, and securities, changes in nonmarketable securities, and so forth.

To come back to my opening sentence, there is a return flow here which should be encouraging to all of us as one factor at least working in the direction of a little lower interest rate. Whether it will be offset other places, I don't feel I am in a position to judge, but at least that is one factor working in the direction of lower rates.

Representative WIDNALL. My time is up. I would like to ask this one short question right now. Do you anticipate that the drastic Government turnaround from being a large net borrower to a large net supplier of funds will have at least a destabilizing effect on the money market in the economy?

Mr. MAYO. No, I do not. I think this can be controlled quite satisfactorily.

Representative WIDNALL. Thank you, Mr. Mayo.

Senator PROXMIRE (presiding). Mr. Reuss?

Representative REUSS. Thank you, Mr. Chairman. Welcome, Mr. Mayo.

As I understand your testimony, if Congress does not by early April extend the 10-percent surtax, there is a likelihood that about half a billion dollars of receipts will be taken from the fiscal 1969 budget and instead be deferred until the fiscal 1970 budget, the first Nixon budget.

Mr. MAYO. That is correct.

Representative REUSS. And thus will have the salubrious effect of making the first Nixon budget look better.

Mr. MAYO. Well——

Representative REUSS. I just wanted to assure you of my all-out support on that.

Mr. Mayo, is the gold budget your job, or the job of the Secretary of the Treasury—our foreign exchange balance-of-payments prediction?

Mr. MAYO. Well, I would say that this is something of concern to the Quadriad—the Troika plus Chairman Martin. We do basic figures in the Budget Bureau on the gold budget, that is true. We are not the source for the basic figures that are involved. We do a basic recasting of those.

Sam, am I saying that properly?

Mr. COHN. I think, just so we understand each other, Mr. Reuss, I ought to define "gold budget" the way I mean it, and the way we use the term in the Bureau of the Budget. The gold budget is the budget that describes the impact of the Federal Government's transactions abroad, its spending abroad, and the receipts it obtains from abroad. In that sense we in the Bureau of the Budget do a gold budget.

Prior to the time the Director and the President focuses on the annual budget, we run through the agency proposals in terms of what their impact would be on our balance of payments, just the Federal sector apart from all others. This is then woven into a much broader picture on the balance of payments and possible demand on gold. That broader survey is conducted, as Mr. Mayo said, by the Troika and the Quadriad, and involves the Secretary of Commerce, the Secretary of Agriculture, and others involved in balance-of-payments problems.

Representative REUSS. Couldn't this possibly be a case of what is everybody's business is nobody's business? I don't find anyone projecting our balance-of-payments situation for the coming year. Who is supposed to do this? You have had to get out, and your predecessors have had to get out, a very sharp pencil indeed on the domestic budget receipts and expenditures, as you have done this morning. Who does it with respect to our foreign position?

For example, we had hearings last month at which the Pentagon casually admitted that they were roughly 100-percent wrong on their predictions of the cost of our foreign military involvement, that instead of the $4½ billion figure that they have been putting down, it was closer to double that. But this all seemed very casual. And I wonder where in our Government responsibility is lodged for projecting our balance-of-payments position and deciding how we are going to manage it.

Mr. MAYO. I would say, first of all, the type of estimate that we are talking about here is more in the nature of an economic estimate than it is of a more precise budget estimate that has a basic accounting structure beneath it. Even the actuals are in some sense estimated. As you know, you have a great big discrepancy every year in this, because we are not quite that smart, even on the actuals on the whole balance-of-payments picture.

I say this merely to illustrate the point that the data we are talking about are economic forecasts, and the Federal Government is somewhat cautious about putting out official forecasts. True, the Government does put out projections of gross national product and corporate profits. You will not find, I believe, official administration estimates of pinpointed figures on unemployment, prices, or a great many of the other economic indicators involved. I submit that on balance of payments some of these same characteristics obtain.

But to come back to the responsibility angle, I would say that the basic responsibility for keeping on top of the balance-of-payments situation—and there certainly are estimates being made all of the time in a rough order of magnitude to help keep on top of this situation—falls, I would say, primarily on the Secretary of the Treasury. There are other parts of this that do affect the Department of Commerce. But if you had to have a single locus in mind for this responsibility, I would say that it does belong to Secretary Kennedy.

Representative REUSS. I am disturbed by the fact that I had to ask the question I did this morning. I also question whether the whole matter of balance-of-payments accounting is as amorphous as you suggest. Certainly, in the biggest single item, the military, if the military is capable of figuring up the domestic budgetary cost of our 210,000 troops in continental Europe, which comes to around $6 billion a year, I believe, it could also figure up the foreign exchange costs, which come to around a minimum of a billion and a half a year.

Mr. MAYO. Estimates could be made.

Representative REUSS. These figures are never projected in the foreign exchange field, yet if anything they are more critical than the domestic budgetary figures.

Mr. MAYO. I understand the problem.

Representative REUSS. We can get into an awful lot of trouble with a $4 billion balance-of-payments deficit, whereas frequently we can accept with equanimity a $4 billion domestic budget deficit.

I wanted to raise this because I think this committee and you, sir, have to think about it. I am not satisfied with our present method of projecting our balance-of-payments position.

I have one more question of, I suppose, a philosophical nature. There is much talk in the air among citizens and taxpayers about our national priorities. A great many people think that the swelling military spending, the supersonic transport plane, the space program, agricultural subsidies to large corporate farms, could well be reduced and more spent on such things as education, particularly in slum areas, manpower training, better air and water pollution control, for example. Under the Nixon administration, whose job is it to set these priorities?

Mr. MAYO. In the last analysis, this is the job—the biggest job in my book—that the President has himself. It is up to me to advise him on the figure side. On the program side, he has set up, as you know, the Urban Affairs Council. He has strengthened the National Security Council. He is working closely with his Science Adviser. There are three who would help him on the program side come to this basic decision of allocation of national resources.

There is no place short of the President where this can be completely focused. Perhaps my role is greater than that of any other single person. But this is a responsibility of the President himself.

Representative REUSS. Thank you.

Senator PROXMIRE (presiding). Mr. Brock?

Representative BROCK. Mr. Mayo, I have enjoyed your remarks. I sympathize with you. It is very difficult to respond to some of these questions in the very short time that you have had to analyze the budget. But where we can get some answers, it would be of some help to us.

Mr. MAYO. Of course.

Representative BROCK. I am concerned about this fiscal 1969 budget. I am concerned when I see the figures that we spent at the rate of, I think, $99 billion in the first 6 months, and have had receipts of somewhere around $90 billion. And it is a little hard for me to understand as a businessman how you can end up with the total figure of only $182 or $183 billion, which would mean 15 percent reduction over the level of spending in the first 6 months, and do it in the next 6 months.

Mr. MAYO. We do always have a seasonal factor in the way the budget deficit or surplus runs in this country, largely attributable to the receipts side, of course. Our receipts are a little on the lean side, in the period from July to December, and are more ample in January through June.

Representative BROCK. I am aware of that. But I am talking about expenditures.

Mr. MAYO. Well, on expenditures, again the figures for the first 6 months do not lead us to believe that any cutback would be necessary to achieve the total for the year. Now, we talked earlier about my predecessor's statement that we could run at a higher rate in the next 6 months, and balance off a lower rate in the first 6 months and still come out at the figure shown in the budget. Both Mr. Cohn and I express some reservation as to whether we would come out quite that well. But I do not think that there would be any reduction in the rate of spending implicit in the budget for the remainder of this year.

Sam, what were the figures for the 6 months, July-December?

Mr. COHN. The first 6 months were $93 billion out of the total of $183.7 billion that was projected in the budget. I might add that that $183 bilion includes a large sum for farm price supports which are normally high in the first 6 months, and especially with the new computerized system I talked about, would be higher than usual in the first 6 months.

The dock strike was a factor that we hadn't considered at the time that earlier estimate was made.

A second factor that Director Zwick brought out before the committee a month ago was that the first 6 months contain a seasonally higher spending rate for Federal construction programs such as the highway program and the Corps of Engineers. Construction spending is usually higher in the first 6 months of the fiscal year than later in the fiscal year. So that there is some seasonality on the expenditure side, not as marked as on the revenue side, but there is a small one on the expenditure side. Therefore, $93 billion in the first half of the year and $91 billion roughly in the second half wouldn't be far from normal.

Representative BROCK. Then the figure of $99 billion is incorrect?

Mr. COHN. I am looking at the monthly Treasury statement for December, and it comes to about $93 billion for the first 6 months.

Representative BROCK. Thank you.

Let's talk about the action that the Congress took last year, and relate it to Mr. Reuss' question about priorities.

We imposed a budget ceiling regardless of the appropriation process. It could have been $300 billion. We put a ceiling on total expenditures in an effort to reduce the impact of Federal spending. Is this over the long haul a rational approach? How do we balance the interest of the two directly related branches of the Government, the executive and the legislative, in terms of obtaining a sense of priorities and a sense of overall budget policy and its impact on the Nation's economy? Where does the primary responsibility lie in your mind? If it lies with the Congress, what specific areas can we attack in order to achieve a better balance of programing?

I don't think we have any such priorities at the present time. I don't think we have had any in the 6 years I have been in Congress. And I wonder if there isn't some way of obtaining a better sense of direction.

Mr. MAYO. We both have responsibilities in this regard. The administration has the responsibility in the first instance in preparing its budget to give its appraisal of relative priorities. That is what the budget is. It is a financial plan, it isn't just a collection of figures.

The Congress has a very important responsibility, too. The Congress decides upon the President's recommendations and molds those recommendations into specific program authorizations through the actual appropriation of funds. For many, many years we have taken the position that it is the appropriation process which is the ultimate arbiter of national goals and priorities.

Once the Congress has spoken, and the President has approved the bills in question then that establishes the dimensions of the spending process that have been established—although there may be differing spending patterns depending on what type of program you are talking about.

I think this is still the right way to approach it. The decision was taken last year to put in a further control. We have had experiments around the edges of this in the past, and really, the debt limit in a sense is an attempt at an overall budget review. But debt control is after the fact.

The attempt to impose outlay ceilings reflects a feeling of frustration, perhaps, in trying to get all of these things united together, because it is such a complex job.

Representative BROCK. Isn't it a little bit hypocritical for the Congress to impose a debt ceiling or to impose an expenditure ceiling and then go ahead and vote two or three times as much for appropriations? Isn't that having your cake and eating it too?

Mr. MAYO. It does create some difficulties. It is like the ad for the car that is now kind of out of date—bigger on the inside and smaller on the outside. You can only go so far. You can't have a negative wall on your car. And neither can you have an appropriation process that holds candy out to the baby and then proceeds to take it a little further away after many commitments have been made. Such a procedure tends to divert your spending restraint.

We all agree, there must be spending restraint. But a ceiling tends to divert restraint toward the things that are more easily cut off. And you are much harder put in many instances to take a big project that is part way along and incur the extra costs of having to postpone that. You have to make a judgment there. It may cost the Government many, many—depending on the projects—hundreds of thousands of dollars more to postpone and then to start it up again, or even more to just dump it and say, well, that has gotten too low a level of priority.

Representative BROCK. But I take it that the sense of your response is that you would be reluctant to advocate another similar ceiling?

Mr. MAYO. I would be reluctant. It doesn't mean necessarily that we may not find it necessary to agree with the Congress as to the need of such a ceiling, but I would like to rely more on the appropriation process in the first instance as the controller of the ultimate level of the Federal spending. It is easier to turn the faucet off at the boiler than it is to stick your finger in the spiggot at the end of the line. The pressure is kind of tough at that point.

Representative BROCK. I agree

Thank you very much.

Senator PROXMIRE (presiding). Mr. Moorhead?

Representative MOORHEAD. Thank you, Mr. Chairman.

Mr. Mayo, I appreciate very much your helpful and candid statements here.

I would like to follow along the line that Mr. Reuss was discussing with you, which was your function in helping the President set priorities among the various demands of the budget.

Mr. MAYO. Yes.

Representative MOORHEAD. In your statement you say "We must examine the costs and the benefits of government programs, for only then will we have the data on which to make wise priority decisions." Is it your belief that you can determine the relative net social benefits which accrue from a dollar spent on education versus a dollar spent on agricultural supports versus a dollar spent on public works?

Mr. MAYO. We are trying to work little by little in this direction. It is obviously still going to be a judgmental appraisal, regardless of how good the data base is, when you get down to the ultimate decision. But we find it helpful, and so does the Congress, to make a relative appraisal among, let us say, reclamation projects, or whatever it may be, one versus another.

Representative MOORHEAD. I can see how the analysis is relevant and meaningful concerning one reclamation project versus another. But what about reclamation projects versus education?

Mr. MAYO. Exactly. The next step is, how about reclamation prices versus agricultural price support? This gets a little tougher. And obviously, it gets even more difficult when you get to the stage of comparing defense and nondefense in the process of trying to decide what is required to make America strong. Well, we have an inadequate data base to make such an appraisal. And we probably always will have, because in the last analysis it will have to be the judgment of the President and the Congress as to what we mean by keeping America strong.

I would also suggest that we have quite a long way to go in getting toward this goal. We will never quite make it. But just as statistics have been helpful over the years in letting us learn an awful lot that we didn't know 30 or 40 years ago, so I think the process of program evaluation can make a real contribution when properly directed.

Representative MOORHEAD. Mr. Mayo, yesterday Dr. McCracken put a very high priority on moving disadvantaged people back into the economic mainstream of America. As you propose revisions to the budget, in what form do you see this priority taking—education, job training, improved health, a better functioning labor market?

Mr. MAYO. I have an open mind on this. I am quite conscious of the problem. I did work in the Chicago financial community within the past 6 or 8 months specifically on trying to get banking resources and talent diverted to helping the entrepreneur in the ghetto. I am also quite conscious of the President's serious concern about the way in which Federal programs are oriented toward our urban problem. However, this is part of the budget review and the program review that is going on right now, and I shall not prejudge it.

Representative MOORHEAD. As a budgetary matter, and in your role as the Director of the Bureau of the Budget—don't you foresee difficulties in being able to report as to the effectiveness and longrun wisdom of a tax incentive program for job training? Don't you fear that what is today socially desirable to put into the tax system may be the loophole of tomorrow, especially at a time when we are talking about meaningful tax reform?

It seems to me that as the Staff Director of the Budgets Concepts Commission and now the Budget Director, that it would be highly inconsistent to favor tax incentives rather than demanding that these expenditures be on the expenditure side of the budget so we can tell exactly how much this program is going to cost us.

Mr. MAYO. I understand the question that you are raising very well. And I think we must be watchful of it.

Representative MOORHEAD. I hope you are. Also, in your statement you suggest that $1 billion on the expenditure side and at least $0.7 billion on the revenue side of the budget are contingent upon the passage of certain legislation by the Congress.

Mr. MAYO. Yes.

Representative MOORHEAD. Has the administration taken a stand recommending this legislation, or will the administration take such a stand in the near future so that the budget will show a restraining surplus that the previous administration presented?

Mr. MAYO. This is part of the review that is going on right now, sir, as to what the administrations' position will be on each of these issues. The Postmaster General is looking at the problem of rate increases. The Department of Agriculture is looking at the Farmers Home Administration programs. And so forth. It is too early for administration policy positions to be taken on some of these issues yet.

Representative MOORHEAD. Will the budget surplus be dependent on the Congress acting on these measures by June?

Mr. MAYO. Well, I believe the assumption in the budget is that they would be enacted in this session of Congress—and I would assume before June 30. Certainly on something like postal receipts, an early date is rather critical if we are going to realize the figure that is in Mr. Johnson's budget.

Representative MOORHEAD. As the chairman pointed out, in the best of Congresses there is an administrative lag time between the time the proposals come up and hearings are held and action taken by the committees, and the two versions passed by both Houses are reconciled. And I just think that we need to discuss——

Mr. MAYO. It takes time.

Representative MOORHEAD. We want to cooperate with you, but we do have some institutional limitations here, as you know.

Mr. MAYO. Right. And we want to take enough time to study these matters. Many of us are new in many parts of this, although we have had experience that will be helpful.

So we are balancing the time factor here against the desire to wait until we are sure that we have the right answers. If one does the latter, he may wait forever, and be a complete failure.

So I think we want to get this neat balance, and we will do it as quickly as we can.

Representative MOORHEAD. Thank you, Mr. Mayo.

Thank you, Mr. Chairman.

Senator PROXMIRE (presiding). Senator Jordan?

Senator JORDAN. Thank you, Mr. Chairman.

Mr. Mayo, the previous administration has spoken of uncontrollable civilian budget outlays totaling more than $90 billion in 1969. In the limited time you have been Director of the Budget are you able to agree that this figure is high or low or about right?

Mr. MAYO. As an appraisal of uncontrollable——

Senator JORDAN. Of uncontrollable civilian.

Mr. MAYO. The figure itself—$98.8 billion is listed as relatively uncontrollable civilian outlays for fiscal 1970. This is the figure you have reference to?

Senator JORDAN. I asked for fiscal 1969.

Mr. MAYO. $90 billion in 1969.

Senator JORDAN. Do you agree that they——

Mr. MAYO. This is a tremendous figure, and it gives you great pause, as you look at the job of the Budget Director, to be perfectly candid about it. In other words, if this figure is correct it gives you a feeling of frustration right off the bat. Well, in truth this is a tabulation of items that are either what might be called fixed costs, which grow out of commitments, or costs which are firmly anchored in legislation, certainly as far as fiscal 1969 is concerned, I think you would probably agree with me, very little is going to be done to them in fiscal 1969. We are not going to turn over price support programs and say that they are going to terminate on March 31. I use the price support program case just to illustrate the uncontrollability of many of the items in the short run.

Now, the point that I tried to make in my statement, Senator Jordan, is this—that we have to look down the road a way to see controllability as a more manageable problem. I don't care whether we are talking about 1972, 1973, 1974, or 1975, it doesn't really make much difference. But the point is that as we look at our national priorities, and therefore at our budget outlook, 4 or 5 years down the road I think we have duty to make a real serious appraisal of our national priorities. As you look at the budget for 5 years hence, just to pick a figure again, you do have more flexibility there. You also have more flexibility for your programs if you can persuade the Congress that these are the right programs. But we do get boxed in by our art of compromise—or whatever you want to call the name of the game—as we make commitments and incur obligations which either legally or morally we must fulfill, but which produce a stream of "uncontrollable" outlays later.

The way I look at the job of Budget Director, more philosophically, is that if I can double from—just to pick figures—1 to 2 percent the amount of time I spend on the longer range issues, some successor of mine may not have to spend 98 or 99 percent of his time putting out fires, so to speak. My basic objective is to allocate my resources and the resources of my staff so as to make me more valuable to the President. If I can concentrate more on the point that you have raised here—it is a very valid point—of the frustrations of attempting to make significant changes through near-term budget revisions and the opportunity to make substantial achievements through real budget reappraisal and program reappraisal, the part of the time spent on longer range issues can be extended.

Senator JORDAN. I realize that the fiscal year 1969 is two-thirds over. But looking ahead, I think you make a good statement here when you say:

> The review of the budget is urgent. This administration is now considering ways of reshaping Government's programs in the light of its own policies.

And I hope that is true.

And, then, you add this sentence:

> We do not intend merely to pile new programs on top of old ones.

Congressman Roth has performed a great public service over in the House by identifying over 1,200 programs of Federal grants-in-aid, many of them overlapping and many of them competing, the agencies competing one with another, to see who can give away the most money. I would hope that you would, in your review of the reshaping of the Government programs, as a Budget Director, take that into account.

Mr. MAYO. We will.

Senator JORDAN. It is not altogether your responsibility. We share it with you.

But certainly I think that you could not turn your back on such a situation without giving it substantial attention.

Mr. MAYO. Yes, sir.

Senator JORDAN. Mr. Mayo, how much of the budget increases are built in? Have you identified those with respect to pay and interest and so on? Did you have a figure or a percentage in mind as to those built-in increases that cannot be avoided?

Mr. MAYO. We have figures that are available in the budget of the outgoing administration identifying specific built-in increases. The increase in pay is one of those, and I believe the figure is $2.8 billion.

We have other built-in increases that are less easily defined than that, relating to increase in workload in departments, increases in farm programs, increases that are related directly to a formula approach on public assistance, and grants-in-aid that we were just talking about, and, of course, the increase in people who are eligible to get social security benefits.

Those are what I would call built-in increases.

Sam, do we have a figure in the old budget?

It is the same table, really, that produced your $90 billion, Senator Jordan, and it gives the estimated costs of what we call open-end programs. I say "we". I did not have anything to do with the preparation of this, but I think it is a fairly clear presentation of what is required by existing law.

Senator JORDAN. Along with that, how about the built-in receipts? We all know that—because we have a graduated income tax structure—the rate of increase of Federal receipts is somewhat higher than the rate of increase of the gross national product. How does the built-in rate of increase in Federal receipts compare with the rate of built-in expenditures?

Mr. MAYO. Well, it is hard to make that comparison for any given year, because of the extraneous items that get into the picture. There is an increase of $8.6 billion from 1969 to 1970 in what is called relatively uncontrollable outlays. There is an increase of revenue, exclusive of the surtax, of a little over $10 billion. This is on page 61 of the budget of the outgoing administration.

Senator JORDAN. Thank you.

I just have one quick question, and, then, my time is up. How much of the 1969 budget goes for the ABM system, and how much of the 1970 budget goes for the ABM system?

Mr. MAYO. I do not think that there is any figure—at least, I have not found it yet, sir. I am still looking for figures in the budget.

Senator JORDAN. If you can get it, will you supply it?

Mr. MAYO. I will see if I can do it, sir.

(The reply from the Bureau of the Budget follows:)

Total obligational authority for the Sentinel ABM was estimated in the 1970 budget of the outgoing administration to be $962 million in fiscal year 1969 and $1,788 million in fiscal year 1970.

Senator JORDAN. Thank you.

Senator PROXMIRE, (presiding). Senator Percy?

Senator PERCY. Mr. Chairman, with your permission I would like to welcome our guest this morning. I know we look forward to having Dr. Mayo before us many times in the future.

We are very proud of him in Illinois. And we are very proud of the fact that both the Secretary of the Treasury and the Director of the Budget come from Illinois. We have a team that has worked together for many years, and I know they will work together ably and well here.

Dr. Mayo's personal history is well known to all the members of this committee. I was surprised to recall that he has served his Government for about 28 years now in the Federal area, coming to Washington the first time in 1941. He has also worked in the private sector and has always worked steadily to support the activities of the Government, especially in the Treasury Department.

He is known in Chicago as the man who budgets his own time. His colleagues claim that he squeezes 60 seconds of work out of every minute of activity. He organizes his activities well. He keeps his finger on top of everything. And, besides, he is enjoyable to work with.

I do not know whether you are going to enjoy working with this budget, Dr. Mayo. But I hope you will enjoy working with us, because we have a common purpose to better understand the economic impact of Federal spending on the economy and to try to better set priorities for the resources of this great Nation and to try to best utilize these resources.

I think this committee has contributed valuably to this understanding and especially my colleague before me, Senator Douglas who, I think, was probably one of the ablest and most active members.

I would like to ask, in the area of budget reduction—I know it has been only a short time that you have been looking at it but where do you see the possibility for reductions?

If we are going to reassess priorities, we have to perhaps emphasize some things more than others, and that means more money for certain projects rather than others. And new money has to come out of someplace. Do you see any possibility for it coming out of public works, defense, space, so that other budgets, say for the cities, can go up?

Mr. Mayo. Again, this is a question of national priorities, Senator Percy. And, again, I do not feel that I should prejudge the review that we are now undertaking.

In response to the chairman's suggestion earlier, I indicated that, as far as I was concerned, we were going to take just as careful look at the military budget as we do at the civilian side of the economy. Nothing is sacrosanct in our eyes as we undertake this review. Sure, we will look at space programs. We will look at all programs, including public works, with—I guess the Budget Director is supposed to have either a jaundiced eye or gimlet eye or a fishy eye. It is called all sorts of things, some of which are unprintable. In any event, we are going to look questioningly at everything that comes before us.

Now, I will not pretend to become an overnight wizard at interpreting all of these facts and opinions and judgments the first time around. But you can be sure that I will do my best to advise the President where I think cuts can be made as we try to redirect programs.

Senator Percy. As Director of the Budget, have you made your mind up whether you would like to see the President have discretionary authority to raise or lower taxes subject to certain limits placed by Congress?

Mr. Mayo. I have not made up my mind.

Senator Percy. Did you determine, or do you have any feeling as to whether the program that we used in the Housing Act of 1968 where, instead of large appropriations for public housing, we used interest subsidy measures which reduced the budget impact and brought forth huge amounts, hopefully, of private funds is a good approach? Have you determined whether or not the use of tax incentives for, say, areas such as job training, which, if we are going to do an adequate job, would require multibillion-dollar appropriations will do the job? Tax incentives would mean no appropriation required, but it would cut revenue. The impact to the Treasury would be felt only after the man had been trained and the tax deduction could be taken off the corporation income taxes. Have you determined yourself whether that is a feasible and desirable method of reallocating appropriations and revenues?

Mr. Mayo. All I can say at this time, Senator Percy, is that I think it is of sufficient merit that it is worthy of consideration.

Senator Percy. That leaves you lots of flexibility. You served on the President's Commission on Budget Concepts. Was there any discussion then, or have you determined whether or not it would be a good idea for the Government, like almost every corporation I know and universities and any major institution, to take a 5-year look ahead and try to see where you are going to go rather than always just dealing with a 12-minute period? Would it help to try to give us a broader picture? The administration will stay in certainly for 4, and I hope for 8 years. To take a 5-year period would give us a chance, then, to see where this administration intends to go? All of us, I think, would benefit from such a forecast.

Do you feel that would be a valuable contribution to our budgetary thoughts for the country?

Mr. Mayo. Well, we went through quite a bit of discussion on this, Senator Percy, in our Budget-Commission days.

I think all of us feel, as I indicated to Senator Jordan a few moments ago, that the only way we can get real control over the budget is through plans which, although they are subject to change will at least give us some idea of what we will be doing 3, 4, or 5 years in the future. This is the only way we will have a chance to make decisions—to avoid having them made for us by past commitments and obligations.

As to how formal such a presentation should be is a question that we never fully resolved in the budget commission discussions. There was unanimous agreement, if I remember correctly, that such estimates should be prepared for the major programs. As you well know, this is required on most public works projects now, before they are presented to the Congress.

Such estimates must be handled pretty carefully, again to keep your flexibility. For instance, the head of *x* program must not be given a feeling of great security that his program is there through that whole 5-year period by the fact that you put down some printed digits. It may be a program that, actually, you are hopeful of getting rid of before the 5-year period is up, and you have not fully made up your mind what would succeed, and so forth.

So, there is a question here of how formally you go about making and announcing 5-year projections.

There is also a question of the extent to which you want to put the President on the spot in terms of a set of numbers.

It was suggested in the Budget Commission's report that the need for long-term projections was very great, and if it could not really be done within the Government officially, that perhaps some responsible outside group could undertake such a project, possibly with help from the Budget Bureau staff.

These are some of the thoughts that have gone through my mind recently on this.

But I am terribly impressed with the need for keeping your flexibility as you go on out several years. Regardless of what we may say in criticism of the uncontrollable expenditures concept as being a defeatist or reflecting a defeatist point of view, we have to agree that there are some things that you just can't do anything about within a period of a month, or 2 months, or 4 months; there are more things you can do something about next year because Congress hasn't acted, and there are even more that can be changed in the year beyond that. But proponents of programs have a tendency to try to find ways to lock them in through formal arrangements such as formula grants and contractual commitments. Construction is probably a good example, because it is hard to turn it off once you get it started without being terribly inefficient in many cases. An administrator of a program that is susceptible of being locked in tries to get them locked in; and I suppose you can't blame them for trying.

That is a kind of long-winded answer.

Senator PERCY. Thank you, very much.

Senator PROXMIRE (presiding). Mr. Conable?

Representative CONABLE. Mr. Mayo, I think that we all sympathize with you at this point.

You are in a very specialized field, and you are dealing with a world you never made. You are reviewing someone else's budget.

Your position is politically a very sensitive one, sir, because you are the right arm of the President with respect to priorities, I do not believe you even had to be confirmed by the Senate; did you?

Mr. MAYO. That is correct.

Representative CONABLE. I am interested, without trying to embarrass you in any way: Are you bringing your own people into the Bureau of the Budget, or are you reviewing the budget largely with those who have drawn it up as your assistants?

Mr. MAYO. I have brought quite a few people into the Budget Bureau. I have also retained a number of people whom I have known personally over the years to be people with complete intellectual honesty and people who have been known as critics of the spending process and the way it is conducted. I have one of them at my right arm, Sam Cohn, who is Assistant Director for Budget Review. Another is my Deputy, Sam Hughes, who has been in the Budget Bureau since 1949, and is not just an elevated civil servant—he is much more than that; he is a real student of the process and a real spark plug. But let me add this: In adition to these two that I have mentioned, I have brought in new Assistant Directors—Dick Nathan on the human resources side, and Jim Schlesinger on the military and international side; Dwight Ink, in our office of executive management, and Maury Mann, who is behind me, from the Federal Reserve in Cleveland, who will be my man to handle economic matters. So, I have surrounded myself with a new team of four men as Assistant Directors, in addition to the two Sams.

Representative CONABLE. Of course, the real reason for my question is I want to be sure we are having a new look at this budget and not simply a review of it by those who originally formulated it.

Mr. MAYO. I understand that. And I submit that some of the Secretaries and the agency heads of the outgoing administration have suspected that many of the Budget Bureau people must be Republicans from way back.

Representative CONABLE. I am concerned about the oversight problem. I think, probably, your Bureau is performing more oversight than the Congress itself. We have a great tendency to pass things and never to hear from them again, and I think it is awfully important that we have independent people of judgment and loyalty to the administration who will be reviewing the various things that were done.

Mr. MAYO. I think you can count on us for that.

Representative CONABLE. I would like to ask you another question that has been around for a long time.

I am personally horrified to find us appropriating for the executive branch, the Departments, 3 and 4 months after the fiscal year has begun. This is no problem for Congress, but it must be a terrible problem for you. And I am wondering if there has been serious consideration of the possibility of going on a different basis, a calendar year basis for instance, where the appropriation process precedes the actual expenditure of the money by greater period of time in order to permit more orderly planning than must be possible in your office when we are on a fiscal year basis and have this very large degree of overlap? It is not unusual for us to be better than a quarter of the way through the fiscal year before you know what Congress is making available.

Mr. MAYO. I understand the problem very well. And as to the solution to the problem, I am much more uncertain, not just because I have been on the job for only a month, but much more fundamentally than that.

I have posed the problem—or philosophy, if I may—that maybe things do not get done until they just have to get done. And if you had a calendar year fiscal system, maybe the process would get postponed further, because of the attitude: "Oh, well, we do not have to quite make this deadline."

Representative CONABLE. We would have some self-limiting factors, however, in that respect, because of elections.

Mr. MAYO. Yes.

That raises another possibility that has been suggested, sir, that maybe you would put the budget on a biennial basis. Many States operate on that basis. And I have some personal reservations as to whether that would be going in the proper direction—at least, as I have observed it in certain State governments. But it is, at least, something that has been mentioned.

You could argue that that would substitute a more thorough review; but its timeliness, of course, would be affected in the process.

Representative CONABLE. Without respect to anything you may do between now and any given time in the future, what do you consider to be the most unstable part of the budget as a result of your cursory examination of it up to this point?

Do you feel, for instance, that defense is subject to the widest variation, or what areas are likely to cause you the most trouble, which require the closest attention and the quickest action if trouble starts developing?

Mr. MAYO. Well, this is a pretty hard judgment to form. Even after a period of time, I am not sure I could give you a satisfactory answer to your question. The Defense budget, being the largest and having certain elements of both volatility and inertia built into it, is probably the most difficult to get a handle on. And yet, the budget of any department or agency has challenges in it from the standpoint of your ability to achieve a technical competence to form your own judgment, not just make a reservation on someone else's judgment. I think this is part of the problem. And I do not think, certainly at this stage, that I have any fixed idea that one agency's budget is easy and another's is tough in terms of achieving control.

Representative CONABLE. That is all.

Senator PROXMIRE (presiding). Senator Miller?

Senator MILLER. Mr. Mayo, in your prepared statement, you said:

> For fiscal policy, this means that we should aim to provide restraint by achieving surpluses in the Federal budget in both the current and the coming fiscal year.

Yesterday, Dr. McCracken, in his statement, testified as follows:

> Our view of the outlook and goal for 1969 implies the need for continuation of a budget whose expenditures are at least matched by the revenues from the tax system—assuming at least full employment.

Reading these two pages together, it sounds to me as though you are shooting for surpluses, whereas he is more or less looking for a balance.

Mr. MAYO. I would not want to put words in his mouth, but I would interpret what you just said, Senator Miller, as indicative of a minimum requirement under these conditions. I certainly would consider it a minimum requirement.

Senator MILLER. What if that minimum is achieved, he would be happy, but, according to your statement, you would be much happier with the surpluses?

Mr. MAYO. Yes.

Senator MILLER. Now, with respect to fiscal 1969 and referring to the limitations of the Expenditure Control Act, a number of exceptions were made to that in the past.

Mr. MAYO. That is right.

Senator MILLER. And by the time Congress adjourned last fall, there were a good many of us that had the feeling that perhaps the exceptions were going to pretty much eat up the $6 billion expenditure reduction—such things as defense expenditures, increased spending on interest on the national debt, and the like.

Mr. MAYO. Yes.

Senator MILLER. Have you had a chance to analyze and see whether or not that $6 billion expenditure reduction has in fact been pretty well eaten up, or will by the end of this fiscal year be pretty well eaten up?

Mr. MAYO. Yes. I think your statement is a fair one, "pretty well eaten up." According to the figures in the budget of the outgoing administration, the expenditures under the ceiling were reduced, not by $6 billion, but by $8.3 billion. However, there is an estimated $6 billion increase in the expenditures exempt from the ceiling, not only those expenditures which were exempt in the first instance. As you will recall, the President had to come back to the Congress and was granted specific exceptions of up to $907 million for the Commodity Credit Corporation, and up to a specified amount of $560 million for public assistance. So, your point is well taken, with reference to eating up the $6 billion that the Congress had in mind in the first place. However, I would immediately say that that does not mean that the whole effort was not worth while from the standpoint of restraint of total expenditures, because it is hard to say what those figures would have looked like if there had not been the $6 billion ceiling. They could easily have been much, much higher.

Senator MILLER. As a supporter of that measure, I was not suggesting that we should not have passed it.

But the point I was trying to elicit from you was, because of these expenditures, because it is hard to say what those figures would have looked like if there had not been the $6 billion ceiling. They could easily have been much, much higher.

Mr. MAYO. I get your point.

Senator MILLER. Would you agree?

Mr. MAYO. Yes, I would agree.

Senator MILLER. Can you tell us whether or not you expect to present to the Congress any supplemental appropriation requests for the current fiscal year?

Mr. MAYO. There will be supplemental requests, yes; there is no question about that. We are in the process of reviewing proposed supplemental requests right now, those covering the items provided for in the budget. As we review them, we are sending them up. We do not want to hold up the process that Mr. Conable expressed concern about and cause even later appropriation action. We are reviewing the supplementals as quickly as we can.

There is also another supplemental in process involving authority for the Commodity Credit Corporation. It would shift an appropriation request of a billion dollars from 1970 to 1969. This is, if you want to call it that, bookkeeping between the 2 fiscal years. Budget authority has to be brought up more currently, because of the factors that we mentioned earlier—the effect of the dock strike and the advanced feed grains payment to farmers. This is a case in which funds are more available than is the authority to spend funds.

Senator MILLER. Does this imply that you are going to shift from the policy that I think has been followed for about 3 or 4 years of not covering the current years of losses in the CCC but to shift them into the following year and have them covered by appropriations?

Mr. MAYO. But there is still capital impairment of CCC from past years which has not been appropriated.

Senator MILLER. And you want to get the past years' impairments up to current——

Mr. MAYO. I want to get a billion dollars of this enacted this spring, yes. There is still further capital impairment to be restored in fiscal 1970. I believe it is $6.2 billion in total, including this bill. The proposed supplemental would merely reduce the request for capital impairment restoration next year from $6.2 billion to $5.2 billion, bringing forward the billion dollars.

Senator MILLER. Can you give me a rough figure on how much previous capital impairments of the Commodity Credit Corporation's capital account have not been covered up until now which you are going to have to cover?

Mr. MAYO. I believe that most of the $6.2 billion we are speaking of is in that category.

Senator MILLER. What this really amounts to is that if we are going to put a stop to inflation by coming out with a reasonably balanced budget, then there is over $6 billion of prior impairments that have to be restored before we can start thinking about some of these new programs that we would like to have; is that so?

Mr. MAYO. Let me put it this way: The expenditures for crop support have already been reflected, of course, in the budget. There is no question about that. This is the authority that now has to be restored. But this is one of the things that we have to get in order, yes.

Senator MILLER. I take it, from what you said, that your policy in the future will be to present a budget request or appropriation request which will restore impairments, certainly current impairments, during this administration; is that so?

Mr. MAYO. I am not yet to the point of making a judgment on that. As I said, this impairment restoration is to make up for most of the past impairment—restorations up to last June 30. I have not reflected yet on the question of how current we should become. But certainly that is an objective to keep in mind.

Senator MILLER. I have just two questions further, Mr. Chairman.

Senator PROXMIRE. Go right ahead.

Senator MILLER. On the anticipated supplemental appropriation request that will be coming in between now and the end of this fiscal year, you have alluded to a $1 billion item for Commodity Credit. Can you give us a rough idea of how much the supplementals would amount to?

Mr. MAYO. I really can't at this stage, because several of them are still under review—all of them except the very few that we made decisions on that are now in the process of going through.

Senator MILLER. I do not wish to tie you down to specifics, Mr. Mayo. But I was wondering if it might approach another billion dollars.

Mr. MAYO. No.

Senator MILLER. It would not be that much?

Mr. MAYO. Well, there is the pay increase itself.

Sam, would you like to speak on this?

Mr. COHN. Senator, the outgoing administration budget listed about $4.8 billion of supplementals that would be sent up this session for fiscal year 1969, and they were included in the budget figures. The two biggest were an amount for Vietnam—I do not remember the exact amount, it was for the Defense Department for Vietnam costs—and the pay raise that became effective last July 1. That pay raise was based on law and approved by the Congress. The pay raise amounts were not known at the time last year's budget was transmitted, and were not included in any of the appropriations enacted by the Congress last year. But the pay raise has been made effective and the salaries are being paid at the new rates. The total 1969 supplemental appropriations requested in the budget by the outgoing administration for that was $1.6 billion. As Mr. Mayo said, this is now being reviewed in an effort to see if we can cut down on that sum. But those supplementals will have to come forward this session.

Senator MILLER. In other words, the supplementals that were forecast by the recently presented budget for fiscal 1969 will remain roughly the same as far as this administration is concerned; is that right, talking in the neighborhood of $4 billion or might there be another billion dollars on top of that for the Commodity Credit Corporation?

Mr. MAYO. Well, the billion for the Commodity Credit is certainly in our submission at this point. On the reappraisal of the other, I really can't give you a judgment, because I have not tried to add up the few things that we do have. It is too early. But I would say that there are a number of instances where we are asking departments or agencies to evaluate their ability to absorb some of the pay increase, for instance. Whether these are minor or not, I can't give a judgment on at this point. But there is a push in that direction.

Senator MILLER. If you are stuck pretty much with that $4 billion, plus a billion dollars for CCC, that is going to come pretty close to eliminating the projected budget surplus for 1969, isn't it?

Mr. MAYO. Let's put it in two parts. First of all, on the CCC supplemental, that will not affect the budget surplus itself.

Now, the spending of the $168 million for advance payments on the feed grains program, yes, that does eat into the budget surplus. There may be some other expenditures in CCC—because of the dock strike—that eat into that budget surplus, but this will come nowhere near that bill on. But on the pay, and so forth, the expenditure effect, Senator, of the $4.8 billion that Mr. Cohn referred to here is already in the calculation of the $2.4 billion surplus. I do not think you need to be concerned about that.

Senator MILLER. I was just wondering how much additional you might be forced to ask for which would further reduce the already small surplus that is forecast.

Mr. MAYO. I think I can say this—Mr. Cohn can correct me if he thinks I am going too far on this: I think I can say that the supplemental we have in mind thus far—other than the CCC one, to the extent that it affects outlays—would not materially eat into the surplus.

Senator MILLER. Thank you.

One last question:

When you and Dr. McCracken—I presume, at least you can speak for yourself, but I assume you are together on this—when you refer to the Federal budget in those statements I quoted, are you talking about the unified budget?

Mr. MAYO. Yes, sir.

Senator MILLER. Is it your intention to present only a unified budget in your reports to the Congress, or do you expect also to give us an operating budget picture?

Mr. MAYO. It is our intention to concentrate on the presentation of the unified budget in the interest of having a focal point and a budget which should, complicated though it must be, at least give the reader of the budget a fighting chance to absorb one concept. This does not deny the need for separable figures on the trust funds and the aggregate of the trust funds, and those will continue to be presented to the budget.

Senator MILLER. I would hope that you might somewhere along the line give a synopsis of the trust fund accounts to compare, so that a person who is really interested in this could understand what the operating picture was. For example, the operating budget deficit for fiscal 1967 was in the neighborhood of $6½ billion. And, there are economists who feel that more accurately reflects the inflationary potential of the budget than merely a unified accounts approach.

Then, there is also this to be said, and that is: Taxpayers who pay into the trust funds may be a little unhappy about the fact that they are paying into the trust funds for the purpose of financing an otherwise deficit of the Government, and feel a little put upon.

So, if these points can be brought out somewhere in the budget statements, I think it would be a good way to keep the public informed. And this is one thing that I have found in the past few years they feel they are not informed about, and that is the impact on their own tax situations, and also the possible impact of inflation upon the budget.

Mr. MAYO. You may be aware already, Senator Miller, of special analysis B in the budget. I have it here in front of me, if you would like to take a look at it. Page 20 of the special analysis volume in the budget does have a table, table B–2, on Federal fund receipts and outlays, which I think answers precisely the point you have in mind. It shows, at the bottom of the page, an excess of outlays, excluding trust funds, of $6,962 million for the fiscal year 1969, and $6,848 million for 1970 as in effect deficits of the Federal funds.

We are not trying to satisfy all users of the budget—and I think I can speak in this regard for both the prior administration as well as this one, since the unified budget came out of a bipartisan commission appointed by President Johnson, chaired by the present Secretary of the Treasury, and including Mr. McCracken as a member and four of your associates in the Congress as members. I think I can say that they were looking for an appropriate measure that did not try to satisfy all users of the budget—this is impossible. They wanted to satisfy the vast majority of users by going to a concept which would include the net effect of the trust fund operations, because, from an economic standpoint, the taxes that are levied under social security do have an economic effect, different, of course, but an economic effect that is important to take into consideration.

We observed further—and I will continue to stress this point—that our decision to put a unified concept into effect in no way, in our mind, affected the sanctity of those trust funds. This is terribly important. And the Government securities held by these trust funds are just as legitimate investments as the investments by a private pension fund is in the stocks or bonds of an industrial corporation.

Senator MILLER. Be assured, I have no doubts about the integrity of the trust funds in your hands. However, I remember when the Secretary, the former Secretary, of the Treasury, testified before this committee around a year ago, in response to one of my questions, he recognized that Treasury borrowing is measured against the operating budget deficit.

Mr. MAYO. Borrowing from the public, yes.

Senator MILLER. That is right. Not the unified budget. And, therefore, to the extent the Treasury——

Mr. MAYO. I am sorry. I misspoke myself. The borrowing from the public concept plus the trust funds in the traditional sense is tied to the operating budget. You are quite correct.

Senator MILLER. Yes. And to the extent that such borrowing has an effect on inflation, then the operating budget deficit is very, very important. And because of the great amount of attention that the new administration has given to inflation, it would seem to me that something might be done about highlighting the operating budget deficit and the borrowing entailed and the inflationary possibilities that this would have.

Mr. MAYO. To pursue that one more step, however, Senator, I think, if you will go beyond that and look at the borrowings from the public, this is really the essential measurement of what the Treasury is able to do in debt management with the public, which is a very significant part of the whole inflationary environment. This is where the basic contribution is made. The basic contribution on the inflationary side that relates to trust funds is a contribution of an excess of those taxes over expenditures in the first instance. The issuance of the special obligations, therefore, is more neutral in the debt management concept, if I may disassociate the two.

I know this is getting a little esoteric, perhaps, but the point I am going back to is that, as an economist, I would pay even more attention to the analysis of the proper handling of the borrowing from the public as a good or bad indicator when I am analysing the inflationary problem.

Senator MILLER. Thank you very much.

Thank you, Mr. Chairman.

Senator PROXMIRE. Mr. Mayo, how many Budget Bureau personnel are assigned to Defense?

Mr. MAYO. Well, let me see. I do not have those figures in my head at this point. As a rough guess I would say, including the international programs that really go along with Defense, probably 50.

Senator PROXMIRE. Fifty. And how many people are there in the Budget Bureau?

Mr. MAYO. Well, there is a total of 500.

Senator PROXMIRE. How many of those are assigned to other work on other budgets?

Mr. MAYO. I did not bring my chart along with me that I rely on in such instances, Mr. Chairman. I should have. We have, of course, legislative reference; we have executive management; we have budget review, statistic standards, and a number of these operations that are terribly important which do not involve programs, per se.

Senator PROXMIRE. At any rate, about 10 percent of your personnel is assigned to Defense?

Mr. MAYO. Yes; 10 percent of total personnel.

Senator PROXMIRE. And Defense constitutes $81.5 billion in the new budget?

Mr. MAYO. Yes.

Senator PROXMIRE. And, as I understand it, relatively controllable civilian outlay is less than $20 billion in the new budget.

Mr. MAYO. Yes.

Senator PROXMIRE. And although the ratio is 4 to 1 in the Defense, they only get 10 percent of the Budget Bureau's attention.

Mr. MAYO. What I say is that although your ratios are overstated, your point is still in the right direction. I would say that the other expenditure programs are as much——

Senator PROXMIRE. Wouldn't it be fair to say that there is two to three times as much attention concentrated on the nondefense dollars as there is on the defense dollars, judging by the allocation of personnel today?

I am not holding you responsible; you are a new man.

Mr. MAYO. If you judge it strictly that way, I can't quarrel with your approach.

Senator PROXMIRE. Now, are you reviewing the anti-ballistic-missile system cost?

Mr. MAYO. That is being reviewed; yes.

Senator PROXMIRE. You are? How many people are on that?

Mr. MAYO. Well, I can't give you a guess on that. I just do not know. It has been reviewed with reference to our regular staff, our regular program people. And I have asked James Schlesinger to pay particular attention to this.

Senator PROXMIRE. Can you give us any idea when you would have a conclusion on this, a recommendation?

Mr. MAYO. No, I can't yet. This is part of the review which I am—I hope, understandably—reluctant to give terminal data on yet.

Senator PROXMIRE. I understand. But, at any rate, you will be in a position to make recommendations when the President decides whether or not to proceed with the ABM; is that correct?

Mr. MAYO. Yes.

Senator PROXMIRE. You say, in your statement:

> We must, therefore, be in a position to achieve reductions or even elimination of lower priority programs. This will entail careful program evaluation on our

part. We must examine the cost and the benefits of Government programs for only then will we have the data on which to make wise priority decisions.

I take it this refers to the PPB operations. Can you give us the Nixon position, the Nixon administration position, the plans of the new administration, for implementing and increasing the effectiveness of this new system?

Mr. MAYO. We feel that the idea of program evaluation, Mr. Chairman, is a sound one. I am not particularly wedded myself to the "PPB" as a term. I am, I think, skeptical of the arguments that have been made that PPB should be applied to areas that are still on the frontiers of analysis. It isn't that I am against progress, but I think we can devote our resources more appropriately to concentrating, at this stage of our progress, on the techniques and the concentration of many of those techniques, but not applying them to all of the Government's endeavors.

Senator PROXMIRE. Without getting into a discussion of the philosophy, or even some of the policy problems involved, as I understand it, the Presidents have used in the past a program memorandum which would summarize within a 20-page span, usually or maybe less, the policy alternatives that an agency is confronted with in making its expenditures, and I understand that there are possibly as many as 200 of these. And these indicate the cost-benefit relationship to the extent that they can on many of these programs.

Now, what I would like to ask in that connection is: How will the program memoranda and the analytical studies generated by the PPB system become a more integral of the decision process in the Bureau of the Budget?

And I take it from your first answer that you are not sure yet whether PPB itself should be given further scope or whether the limitations are such that perhaps it should not be.

Mr. MAYO. Well, I should clarify that a bit. I do believe strongly in the idea behind PPB, regardless of what we may end up calling it.

With this in mind, I have appointed a new assistant director for program evaluation, Jack Carlson. He is engaged now in trying to reorient our efforts to make the process not only more effective in our longer run look, which is one of its purposes, but also to see if we can integrate this a little better into the budget process. We want it to contribute more positively to the preparation of the budget, not just next fall when it may be a little too late to affect 1971, but starting even this spring to get a little more input into the budget process.

Senator PROXMIRE. We are very anxious—we, on this committee, and I have talked to a number of members—we are very anxious to have you, if you will, develop a set of proposals on making available to the Congress parts of the planning, programing, budgeting system, such as the program and financial plan, the program memoranda. This would be invaluable to us. I realize that some of this has to be confidential for the present, of course. But this kind of data has not been available, has not been used by the Congress to make our decisions on these priorities, and sometimes we have made decisions stupidly because we just did not know.

I do not see any reason why this could not be made available. It would be very helpful to us. It is prepared, anyway. And this committee is going to have hearings in the spring on this, and will go into detail on it, and I think that we would like to get additional information on the benefits and costs of the various public programs, including information on the characteristics of the beneficiaries of the outputs of these programs. This would be most helpful to us.

Mr. MAYO. I will be glad to work with you on this. I feel this is important.

Senator PROXMIRE. Now, in addition, I would like to ask you just a few more brief questions. Do you have a policy—have you worked out a policy on user charges? The advantages of user charges, it seems to me, are very considerable. They insure in the first place that the facilities will be used at an optimum level. They avoid congestion. And, No. 2, they tend to place the cost or burden of a public program on those who use them.

We have shifted to some extent in this area. Do you have any policy worked out as yet?

Mr. MAYO. No. This is part of our review again. As I mentioned in my statement, Mr. Chairman, on the user charges that were presented in the budget, we are taking a careful look at these.

Senator PROXMIRE. I hope you will let us know on this, because we are very interested in this.

And also Secretary Barr made a very, I thought, imaginative series of proposals to us just as he left office, and one of them was on what he called tax expenditures. You know the impact of tax credits, and so forth, on the budget. He said they represented a serious drain on revenues. And I wish you would do this: React to the proposal that a more comprehensive budget document be prepared which would display tax expenditures as well as regular Federal outlays, and the comment on the effect which the anticipated administration proposal on tax credits would have on the size of expenditures as defined by the U.S. Treasury report.

Mr. MAYO. We will take a look at that. I am aware of Mr. Barr's suggestion. I can see some possibilities in it. I can see some problems in it, too.

Senator PROXMIRE. If you could do that to some extent, summarize it perhaps when you are looking over your remarks, we would appreciate it, because we would like to get a reply from you just as soon as we possibly can.

Mr. MAYO. All right.

(The further reply from the Bureau of the Budget follows:)

Supplementary comments were requested on two subjects: (1) the proposal that a more comprehensive budget document be prepared which would display tax expenditures as well as regular Federal outlays, and (2) the effect which the anticipated Administration proposal on tax credits would have on the size of expenditures as defined by the U.S. Treasury report.

(1) The principal virtue of periodic estimates of tax expenditures is that, when related to regular budget outlays, they would afford a comprehensive measure of all calls upon budget resources—whether as direct outlays, loans, or revenue forgone. A fuller measure of the role of the Federal Government in allocating resources would thereby result. Moreover, since tax expenditures estimates measure the current cost, in terms of revenue forgone, of special tax provisions adopted in the past, they are essential to re-evaluations of these tax provisions.

The drawbacks associated with estimates of tax expenditures are both conceptual and practical in nature. Several conceptual limitations of tax expenditures estimates were noted in the Treasury Department study, "Tax Expenditures: Government Expenditures Made Through the Income Tax System," submitted to the Joint Economic Committee on January 17, 1969 by former Secretary Joseph W. Barr. Other limitations result from the fact that the revenue loss attributable to some special tax provisions has to be excluded from the estimates either because there is insufficient information regarding the magnitude of the revenue loss or because there are honest differences of opinion as to what constitutes a tax expenditure in specific cases.

Comparing tax expenditures with budget outlays often requires that tax expenditures be forced into classifications not appropriate for them; consequently, a substantial part of total tax expenditures falls into what is essentially a miscellaneous category. And adding tax expenditure estimates to the budget could pose a workload problem of major proportions.

When plans are made for the 1971 budget, the question of whether to include tax expenditure estimates in one of the budget documents will be considered. No decision on whether to include them will be made until full consideration can be given to the several relevant issues involved.

(2) The effect which the Administration's proposals on tax credits will have on the size of tax expenditures will depend upon the nature of the tax credits proposed. Estimates of their effect cannot be made until the tax credit proposals have been formulated.

Senator PROXMIRE. And you talked about flexibility and not tying yourself down in the future on the basis of policy judgments now. I would like to call your attention to one specific recommendation made by this administration in their closing days, the Trinity River project. The initial cost of this project would be $150,000. The ultimate cost or once we get committed is $750 million. It would provide a canal, in effect, from Fort Worth to the Gulf of Mexico. Some people say it would be easier to move Fort Worth to the Gulf of Mexico, and cheaper. At any rate, the benefit-cost ratio, with a 3¼-percent discount, is 1.5. If they used the new discount proposal which we will use after the 1970 budget, it goes down to 1.09. And the benefits there are very, very questionable, because the transportation benefits are measured on the reduced cost of those who will use the canal rather than the effect of the total reduced cost to the Nation as a whole. And it is a very risky project in the sense of the public investment actually paying out. And on the basis of the hearings we have had, I think that most economists, no matter how liberal they may be with the public money, would agree that this would be a serious misallocation of resources. So, I would hope that you would give that careful consideration.

Mr. MAYO. Well, I have seen the Trinity River——

Senator PROXMIRE. It is the kind of thing that we do so easily with pressure from powerful and influential and attractive Senators and Congressmen. It is just $150,000. And once we are in it, we never get out of it.

Mr. MAYO. This illustrates very well the problem of uncontrollability.

Senator PROXMIRE. If this were up for 1971, it would have a lot harder time, because we have adopted a new discount factor; instead of three and a quarter percent, we go to 4⅝, I think it is.

Now, finally, do you prepare budget estimates based on alternative levels of unemployment?

Mr. MAYO. Will I?

Senator PROXMIRE. Do you expect to?

Mr. MAYO. I have not gotten that far into it.

I don't expect to, in the light of what typically has been done here, but I am sure we will have in mind as we present our budget what might happen to these estimates under different levels of gross national product.

Senator PROXMIRE. There are two parts of it: one is technical, which it seems to me could be precisely the effect on unemployment compensation payments and the effect on the revenue side. Obviously, if you have a slowdown in personal income, you are going to have a serious drop in revenues. That is part of it.

Mr. MAYO. Yes.

Senator PROXMIRE. The other part of it, of course, refers to the part of the uncontrollable so-called expenses which are based on contracts, many of them, for public works for which we have made commitments, but which can be postponed with small penalty payments, and sometimes without penalty payments, deferred until a later date. And it would seem to me that it might be wise to the projections here, so that in the event of increased unemployment we would have some kind of a group of projects on the shelf, and so that also we could defer these inflationary expenditures.

Mr. MAYO. We are quite aware of the extent to which deferments have already been made and the type of thing you are talking about. I am not saying we have a list, but we are aware, project by project, what the status is and the extent to which projects can be speeded up if there were demand for that, if there were need for that.

Senator PROXMIRE. Thank you very much. You have been a very responsive witness.

Senator MILLER. Will the chairman yield at this point?

Senator PROXMIRE. Yes.

Senator MILLER. I think he raises a very interesting question, and that is the matter of the impact on employment or unemployment by some of these projects.

I can see that this could entail a very close analysis of the relationship between the end item and its stimulation of employment. For example, a certain project might, if it were postponed, only have an impact, say, on 500 jobs in construction of the project; but, on the other hand, this postponement could have a negative reaction in the failure to permit development of industrial plans that would provide 5,000 jobs. So, I just make that observation. While I agree with the desirability of having it, I would hope that the analysis of it would go beyond the direct employment on the project, taking into account the end results of the project itself.

Mr. MAYO. That is a very good point. There is a multiplier effect in all of these.

Senator PROXMIRE. Thank you very much. Before we adjourn, I accept for inclusion in the record at the close of today's proceedings answers from Budget Director Mayo to questions sent to him by any of our members individually.

The committee will resume its hearings tomorrow morning at 10 o'clock, in the auditorium of the New Senate Office Building, room G-308.

(Whereupon, at 12:25 p.m., an adjournment was taken until 10 a.m., Wednesday, February 19, 1969.)

APPENDIX

The following answers to Senator Javits' written questions were subsequently submitted by the Budget Director:

Question 1. The previous Administration's budget for fiscal 1970 anticipates that defense expenditures for Southeast Asia will drop almost $3.5 billion below their estimate for fiscal 1969. Is this reasonable, in your opinion?

What assumptions about military activity in Vietnam form the basis for this decline?

I note that the number of military personnel in that area will actually rise a bit, according to the budget; what other factors would lead to a reduction in defense spending there?

Answer. The entire defense budget, including expenditures for Southeast Asia, is currently under review. Until this review has been completed, this Administration will reserve judgment about the estimates contained in the budget of the outgoing Administration.

The previous Administration's estimate of outlays in support of Southeast Asia was based on the assumption that current force levels and activity rates would continue through fiscal year 1970.

The principal factors which the budget assumed would lead to the decline in defense spending in Southeast Asia are: reduced aircraft attrition, a significant reduction in the consumption of air ordnance and ground ammunition, and the completion of a large part of the Southeast Asia construction program.

Question 2. The Report of the Cabinet Coordinating Committee on Economic Planning for the End of Vietnam Hostilities estimates that of the $29 billion currently being spent on Vietnam, $10 billion would be required in other military uses in peacetime. Is it true that one-third of the "peace dividend" has already been committed for military programs? What are these military programs?

Answer. A special post-Vietnam study group within the President's Cabinet Committee on Economic Policy has been established to look into the whole range of post-Vietnam adjustment problems. This group will study, among other things, the magnitude and timing of the post-Vietnam peace dividend and the alternative uses of the total peace and growth dividend.

Until the study has been completed, the magnitude of the dividend will not be known, and its proposed allocation to specific uses will not be made.

Question 3. The excise tax cut of 1965 called for phasing out the Federal excises on automobiles and telephone services, but this has been continually postponed to help meet the Federal need for revenue. Is this Administration committed to eventually allowing these taxes to expire, as the previous Administration appeared to be?

Answer: It is this Administration's intention to allow these taxes to expire as soon as conditions permit.

THE 1969 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 19, 1969

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Joint Economic Committee met, pursuant to recess, at 10 a.m. in room G–308, New Senate Office Building, Hon. Wright Patman (chairman of the joint committee) presiding.

Present: Representatives Patman, Reuss, Moorhead, Widnall, and Conable; and Senators Proxmire, Sparkman, Javits, Miller, Jordan, and Percy.

Also present: John R. Stark, executive director; James W. Knowles, director of research; and Douglas C. Frechtling, minority economist.

Chairman PATMAN. The committee will please come to order.

Today we continue our hearings on the state of the economy and the economic program of the Administration.

Secretary Kennedy, we are glad to have you with us. We are also glad to have your associates, Mr. Walker and Mr. Volcker.

The Treasury occupies a central position in the fiscal and monetary affairs of this Nation, and I know the members will have a number of questions to ask you. So I will ask you each to proceed in your own way with your statement, after which we will ask questions under the 10-minute rule.

I am told Mr. Kennedy has a very important engagement involving a meeting of the National Security Council with the President at 11 o'clock this morning, and it will be necessary for us to release him at least 10 minutes before that time.

That is what you suggested, wasn't it, Mr. Kennedy?

Secretary KENNEDY. With your pleasure, please.

Chairman PATMAN. We will be very glad to do that.

So if you will summarize your statement, we will then interrogate you. Each member, of course, will be limited to 10 minutes, but we will respect the time that you want. And if it is necessary to have you back we will ask you to agree on some time that is mutually convenient for the committee and for yourself.

Is that satisfactory?

Secretary KENNEDY. That will be satisfactory.

Chairman PATMAN. And if we want to ask any of you gentlemen any questions in writing, I assume it will be satisfactory to do that. And then when you look over your transcript of the testimony of today's proceedings, you can answer those questions.

Will that be satisfactory?

Secretary KENNEDY. That will be satisfactory.

Chairman PATMAN. Then you may proceed, sir.

24–833—69—pt. 2——7

STATEMENT OF HON. DAVID M. KENNEDY, SECRETARY OF THE TREASURY, ACCOMPANIED BY CHARLS E. WALKER, UNDER SECRETARY, AND PAUL A. VOLCKER, UNDER SECRETARY FOR MONETARY AFFAIRS

Secretary KENNEDY. It gives me great pleasure to appear before your distinguished committee. I am accompanied on this occasion, as you have already stated, by Under Secretary Charls Walker, and Under Secretary for Monetary Affairs Paul Volcker. I understand that we are to concentrate mainly on domestic economic matters this morning. Your committee has already received testimony earlier this week from the Council of Economic Advisers and the Bureau of the Budget. Therefore, we will not attempt to review the economic and fiscal situations in great detail. Our prepared statements are fairly short. I will begin by giving you my own general appraisal of the current situation. The Under Secretaries will then comment briefly on specific issues in tax policy and debt management.

It is no secret that there are serious flaws in the economic picture. Strong inflationary pressures and an unsolved balance of payments problem require corrective action. But, there are also elements of great strength. American productive achievements in recent years have kept real income rising while also meeting the requirements of a rapidly expanding defense effort. Unemployment has been reduced to the lowest levels in nearly two decades. The dollar is strong and respected in the world in spite of recent inflationary trends and a deteriorating trade balance.

As a Nation, we are rich in material resources and responsive to the needs we see around us. Our conscience has been awakened to the existence of poverty amidst plenty and the need to make equality of opportunity a reality for all of our citizens. These heavy responsibilities must be met. To do so, the first priority must be to place the current expansion on a sounder and more sustainable basis. Otherwise, we run the risk of trying to do too much and end up by doing too little.

Any incoming administration encounters unsolved problems and we have our share. We have inherited a serious inflation. It is distorting the economy and weakening our international competitive position. If unchecked, this inflation will undercut the dollar at home and abroad. Already, rapidly rising prices have eroded the purchasing power of millions of Americans who counted on their government to provide sound money.

We recognize that there are risks in attempting to stop inflation too abruptly. If the economy were to be halted in its tracks, unemployment would rise prohibitively. Even though the inflationary psychology might be broken, the cost would be too high.

There are also risks in doing too little. Insufficient restraint would mean only a brief slowing down of the economy and no lasting reduction of inflationary pressures. Something very much like this occurred in 1967, when expansionary policies were pressed so vigorously as the economy slowed that the inflationary trend was never broken. As a result, inflation has built up a considerable momentum in recent years. The lesson is that the economy must be placed under firm restraint until there are unmistakable signs that we are headed back on a noninflationary path. There will, of course, have to be a continuing review of policies as the adjustment proceeds.

For the present, given the economic outlook as outlined to you by the Council of Economic Advisers, a combination of fiscal and monetary restraint is clearly required. The budget should be kept in surplus while the Federal Reserve pursues appropriate complementary policies. While the administration has reached no final decision with regard to extension of the 10 percent surcharge beyond this June 30, a budget surplus will continue to be needed if inflation is to be combated without extreme credit stringency. Unless fiscal 1970 Federal expenditures can be cut back appreciably from the levels now apparently in prospect, there will be no choice, in my opinion, but to continue the surcharge for another year.

Other matters for legislative consideration will be described by the Under Secretaries. As you know, President Nixon has emphasized that tax reform and equitable tax administration are to have a high priority. Hearings begin this month in the House Ways and Means Committee and in due course we will be submitting the administration's proposals.

The balance of payments continues to be a cause for concern. A small surplus was recorded last year on the liquidity basis of calculation. But this statistical improvement reflected a massive inflow of foreign capital—both private and official. Inflows are unlikely to continue on that scale. Meanwhile, our merchandise trade surplus dwindled to the vanishing point last year. A major reason for the steadily worsening trade position since 1965 is the sharp increases in imports caused by overexpansion of the domestic economy. A return to noninflationary growth is essential to the restoration of our trade surplus and the maintenance of confidence in the dollar.

In conclusion, I will only note that much the same economic policies are needed to promote internal and external equilibrium of the economy. Both the domestic economy and the balance of payments are badly in need of relief from inflationary strains and distortions.

Mr. Chairman, that completes my presentation.

Chairman PATMAN. Thank you, sir. You have made a splendid statement. In fact, I don't know of anything I disagree with. It sounds real good.

But, of course, Mr. Secretary, time is of the essence in your commitments. And I will get down to a point or two that I want to cover personally.

The conflict of interest is on the mind of practically everyone these days, as it should be. Many people believe that if our country ever falls as a Government run by the people, the conflict of interest will be the principal contributing cause. And that is not accusing you or any other person of a conflict of interest, I want that made plain. But I just bring it out to show the importance of it.

Of course, you are well known as a banker—a big banker and a fine banker. Nobody disputes that. And you have been appointed as Secretary of the Treasury. There are certain laws involving the Secretary of the Treasury that do not involve other people in the Government, because it is one of the most important positions. The Secretary of the Treasury has so much importance and authority. Therefore, Members of the Congress are certainly concerned about that.

And of course, it is reported that you held about 8,000 shares of bank stock in a big bank and other banking interests. Naturally, we would like to know how you disposed of that stock in order to become Secretary of the Treasury.

Secretary KENNEDY. Mr. Chairman, my estate was placed in trust with an independent trustee.

Chairman PATMAN. Who is the trustee?

Secretary KENNEDY. That is the Old Colony Trust Co. of Boston.

Chairman PATMAN. Is that a revokable trust?

Secretary KENNEDY. Nonrevokable during the period that I am in the service of my country.

Chairman PATMAN. Nonrevokable as long as you are Secretary of the Treasury?

Secretary KENNEDY. Precisely.

Chairman PATMAN. But you still own the bank stock?

Secretary KENNEDY. There will be divestiture of the bank stock in a matter of time, not complete, but to get a balance, a program of balance within the portfolio. I will not know what is in the trust at any time.

Chairman PATMAN. Of course a private trust, Mr. Kennedy, is not like a supervised trust. And this trust, being a private trust, would not have any Government supervision.

Secretary KENNEDY. We either believe in trusts, Mr. Chairman, or we don't believe in them. This has been gone over by the committee of the Senate that approved my confirmation. I agree with you, there is a problem. A way must be found where a man can serve, if he owns anything—unless you want a Secretary of the Treasury that owns nothing. And I have the feeling that this does take me out of any discretion with respect to my estate.

Chairman PATMAN. In other words, you are trying to arrange it so that you can still exercise independent judgment.

Secretary KENNEDY. Precisely. And I have indicated within the Treasury in a directive to all departments that on any matter where there would be any possibility of conflict, that I would not be involved, other than as Secretary.

Chairman PATMAN. I can give you a good illustration of what I mean. In this morning's paper, the Evans-Novak column has a heading, "Banks' Move To Open Old Loophole Will Provide Test of Tax Reform." That would be a good challenge to your independent judgment, being interested in banking. And you would have to act in favor of the bank if some wrong has been done to the banks. And of course, it is your duty to prevent wrong as well as anything else.

This discloses a question that is brought up before our committee oftentimes about the 2.4 provision for losses of banks. You know, that was agreed to. And the result was that the banks cut down on their loans; they didn't make venture loans so much, or risk loans, because they had that 2.4 that was guaranteed to them as a deduction. That was an incentive for them to be hard on their loans and not have any losses. Therefore, the banks have been making several hundred million dollars on this reserve.

I will ask, if there is no objection, that this article be placed in the record at this point.

(The article referred to follows:)

[Column from the Washington Post, Wednesday, Feb. 19, 1969]

BANKS' MOVE TO OPEN OLD LOOPHOLE WILL PROVIDE TEST OF TAX REFORM

(By Rowland Evans and Robert Novak)

The suddenly sprouting Congressional urge for tax reform will get an early test when the banking industry, which usually wins what it wants in Washington, attempts to pry open a recently closed tax loophole.

The closing came last fall in a quiet, clever maneuver by Stanley Surrey, winding up eight frustrating years as Assistant Secretary of the Treasury for tax policy. With a stroke of the pen, Surrey boosted by an estimated $100 million a year taxes paid by commercial banks.

As Surrey was well aware, both the outgoing Johnson team and the incoming Nixon team at the Treasury had ties to the banking industry which made it all but impossible to overrule his regulation. Thus, only Congress can restore the bankers' tax advantage—a preview of similar confrontations between tax reform sentiment and lobbying pressure in the coming tax reform struggle.

Like most big industries, the bankers enjoy a special tax privilege: A tax formula permitting them to take an automatic deduction equal to 2.4 percent of their outstanding loans as a so-called bad debt reserve.

Since *actual* bad debts are well under 1 per cent of loans, this formula amounts to a bountiful gift from Uncle Sam. This was precisely the view of Stan Surrey.

Surrey, an ardent tax reformer, had tasted more failure than success at the Treasury and last fall was chagrined when President Johnson suppressed his tax reform proposals. As a valedictory, therefore, Surrey began rewriting tax regulations in his closing days—including the one on bank taxation.

Instead of reducing the 2.4 per cent, Surrey ruled that the bad debt percentage could not be applied to absolutely safe loans—most notably loans to the U.S. Government. Nobody knows exactly how much that will cost the bankers in 1969, but $100 million is the educated guess. Accordingly, Surrey's stroke of the pen was an instant tax reform of major proportions.

Neither of Surrey's two superiors in the Johnson Treasury—Secretary Henry H. (Joe) Fowler or Under Secretary Joseph Barr—cared for the change. One report circulating among lobbyists is that Fowler was restrained from killing Surrey's rule change only when Surrey threatened to resign with a blast against the Johnson tax policy—a report confirmed by some and denied by others.

Adept at bureaucratic maneuvering, Surrey issued the change in regulations last October while Fowler was in Geneva for a monetary conference. Surrey's action could have been overruled in the Johnson Administration's closing days. But when Fowler resigned as Secretary in December, all hope expired for the bankers.

The reason: Barr, Fowler's successor as Secretary in these closing weeks, had accepted a post-Government job with a leading Washington bank—the American Security & Trust Co. Barr rightly felt constrained from interfering with Surrey's handiwork and so informed the banking industry.

That was particularly glum news for the bankers, because Barr's successor as Secretary in the Nixon Administration, David Kennedy, was coming to Washington from the Continental Illinois Bank in Chicago and was just as unwilling as Barr to bail out the banking industry at the risk of creating a conflict of interest.

The bankers' position became even bleaker when President-elect Nixon named as Under Secretary, No. 2 man in the department, the chief lobbyist of the banking industry: Charls Walker of the American Bankers Association. Walker, taking a surprisingly strong position for tax reform in nonbanking areas, must also avoid any seeming conflict-of-interest as an advocate of bankers' tax privileges.

Thus, bankers know their only hope is Congress. Legislation to overrule Surrey would take too long, but the Joint Committee on Internal Revenue could pass a resolution instructing that Surrey's regulation be revised.

However, leading House tax-writers are unsympathetic to the bankers' position. Indeed, there is some feeling in Congress that Surrey did not go far enough and should have limited the bad debt deduction to the actual amount of losses—running at less than 1 per cent—for an industry enjoying unprecedented profits. Whether that Congressional feeling persists should provide an accurate barometer for general tax reform.

Chairman PATMAN. The article states that an assistant to Mr. Fowler changed this to where it is going to cost the bank a hundred million dollars. Now Mr. Fowler was reluctant to change it because he was going out. And Mr. Barr, when he came in, he had already taken a position with the banks, and it would be embarrassing to him. And now it will be up to you. And if your judgment is that that should be changed, why that puts you in an embarrassing position if you are in the banking business.

Now, may I suggest that this is not new to me. Back in 1932—and I am not saying any of this as a threat, Mr. Kennedy, I have no personal feeling against you or any of your associates, and I am trying to act fairly on these matters—but I had a run-in with another Secretary of the Treasury one time in 1932, and I impeached him on the floor of the House, Mr. Andrew W. Mellon, and I gave my reasons for the impeachment charges. One of the major reasons was that he was extensively in the banking business, and in conflict with the law of our country, and therefore was ineligible.

Now, it is true, after 2 weeks hearings before the Judiciary Committee of the House—a number of them were executive sessions, but we had public sessions too—evidently somebody didn't want to let that committee pass on the impeachment charges. And for some unknown reason, like a flash out of the Heaven the word came out in big boxcar headlines, "Mellon Resigns, Appointed to the Court of St. James." And of course, that rendered moot those hearings. It was tantamount to a pardon in the middle of a trial.

So Mr. Mellon, I don't think, wanted to resign. But Mr. Hoover—now, I am telling you my personal knowledge of things that went on that were not always printed—Mr. Hoover was getting into a big campaign in 1932 with Franklin D. Roosevelt. And naturally, it wouldn't help his party for something like this to be hanging over him. He didn't necessarily want to get Mr. Mellon out, and Mr. Mellon didn't want to get out, I am sure he didn't. And he did one of the most courageous acts a President ever did. He accepted Mr. Mellon's resignation without it ever having been tendered. And so when Mr. Mellon was taking the oath, one of my friends in the newspaper fraternity was standing right next to him. He said, "Now, this is not a marriage ceremony, this is a divorce"—because he didn't want to leave the Secretary of the Treasury's office. But the sentiment was all the other way.

And of course he left, and the question became moot, and the committee decided not to pass on it further, although they could have. But many Members of Congress, like La Guardia of New York, Browning of Tennessee, and many others insisted on the hearings going on. But of course, the so-called wiser heads prevailed, and they decided that the question was moot, and he was not only out of office but he was out of the country, and they just let it go. And that is the way it happened.

But all these questions came up. And that is a terrific question in our country today, conflict of interest. And personally, I don't see how you can claim that you are not in the banking business if you just have your stock in trust. That is my personal opinion. Of course, the courts might not agree with me on this.

How much commercial bank stock have you placed in trust, Mr. Kennedy?

Secretary KENNEDY. It will be probably 38,000 shares.

Chairman PATMAN. How much would that aggregate in present-day value?

Secretary KENNEDY. A million two-hundred thousand, something like that.

Chairman PATMAN. A million two-hundred thousand. That would aggregate all of your commercial bank stock?

Secretary KENNEDY. But that stock will be diversified out of the trust within a reasonable time. So I don't think there will be any problem.

Mr. Chairman, if you are going to impeach me—

Chairman PATMAN. I didn't say I was going to impeach you.

Secretary KENNEDY. I know, but if that was what you are indicating, I would suggest you do it right away.

Chairman PATMAN. I didn't have that in mind, and I didn't want you to consider it a threat. It is not a threat. Of course, there are 435 Members of the House.

Secretary KENNEDY. As I have already indicated, I had a discussion before the Senate Finance Committee before I was confirmed. They went into this with great care. I recognized the problem. And it is up to the Congress to decide on conflict of interest. In my own conscience and heart there will be no conflict. I will use all my best efforts to see that the law of the land is maintained and there is complete equality of purpose, and everything else. But if it is the judgment at any time of the Congress that a conflict exists, they should so state and make it clear. I think that this trust arrangement does qualify. It is the only way I know to handle it. It seems to me the best solution.

Chairman PATMAN. I think you are on pretty solid ground to accept what the Senate did in confirming you. At the same time, that doesn't relieve the House of Representatives from taking action.

Now, when Mr. Mellon was appointed, many Members of the Senate felt that they made a mistake when they confirmed him. You know, we all want to confirm the Cabinet of the incoming President, we don't care who they are, just so they are eligible, and the Senate took it that way, I am sure. But now when Mr. Mellon was confirmed they tried several times to undo that. But they never could do it. He stayed in office 12 years.

Secretary KENNEDY. He was a great Secretary, Mr. Chairman.

Chairman PATMAN. To some people. A lot claim he was a great Secretary, some claim he was the greatest Secretary of the Treasury the country ever had. But there are some people who don't agree.

Secretary KENNEDY. That is right, there is always an honest difference of opinion.

Chairman PATMAN. When Mr. Harding sent his Cabinet to the Senate he didn't send Mr. Mellon's name up. And when Mr. Coolidge became President and he sent his Cabinet to the Senate, he didn't send Mr. Mellon's name up. Mr. Mellon was the only man in history who held the office without being confirmed except one time. And the Senate never could get a hold of it anymore. They would have liked to have done something about it, but they couldn't reach it. But that didn't keep the House from doing something about it, because under the Constitution, if an impeachment charge is made, it must be made not in the Senate but in the House. And if impeachment charges prevail in the House, then it comes to the Senate, of course, as you know, for a trial by the Senate. But the Senate never could get to it.

So it doesn't foreclose the question at all, Mr. Kennedy, because the Senate confirms you, not at all.

Now, I asked consent to file some pertinent information. Without objection I will do so, and then I will yield to the other members.

I have introduced a bill to prohibit certain conflicts of interests on the part of officers of the Government having responsibilities with respect to the banking and monetary system. And the provision here is:

> The Secretary of the Treasury and the Under Secretary of the Treasury shall be ineligible during the time they are in office for 2 years thereafter to hold office, position, or employment in any bank whose deposits are insured by the Federal Deposit Insurance Corporation. Neither the Secretary nor the Under Secretary of the Treasury shall be an officer or director of any such bank or Federal Reserve bank or hold stock in any such bank; and before entering upon their duties they shall certify under oath that they have complied with this requirement.

Now, the main point is that they cannot hold any office, position, or be employed in any such bank during the time they are in office or for 2 years thereafter.

A lot of people believe that a person shouldn't go out of office and go right into business that he has been exercising judgment over. How would you feel about a law like that, Mr. Kennedy?

Secretary KENNEDY. I haven't looked into the law that you propose. If that is the law, I will abide by it, of course. I have no idea of what will happen after I leave the Treasury. I have been chairman of a bank. I will surely not go back as chairman of a bank. I don't go back into past places as far as chairmanships are concerned. I don't know what I will do. I would like freedom of action.

Chairman PATMAN. Mr. Widnall?

Representative WIDNALL. I will pass.

Chairman PATMAN. Senator Proximire?

Senator PROXMIRE. Mr. Kennedy, following on the line which the chairman has opened up here, you and your two colleagues I think were excellent appointments. And I am specially aware of the remarkable job you did as Chairman of the Board of the Continental-Illinois Bank, one of the great banks in the country. And you were also head of the Commission on the new budget which we have adopted now and which you did such good work on.

Mr. Walker, too, has a fine record. I recall his appearing many times before our Senate Banking Committee, always knowing precisely what he is talking about and being a very, very helpful and intelligent witness.

Mr. Volcker has appeared before this committee. He has been a real expert not only in private life but also in the Treasury, I understand, in foreign international—I should say internation financial matters.

And yet you do raise an embarrassing problem, not in your confirmation—I was enthusiastically for all of you, as I said—but on getting disinterested objective advice from the Treasury on several matters: One, to which the chairman has alluded on this artificial write-off of 2½ percent on bad debt reserves; another on interest rate policy as it affects institutions; and the third, which concerns me very much, is in the one bank holding company legislation that is before us this year, probably the most important financial institution legislation we will have this year, and in which I feel the Treasury takes a position which will enable banks to get into other businesses, but will keep other businesses from getting into banking. It may be a sound position, but it is the kind of position you would expect from the banking fraternity. I have introduced another bill, as you may know, and of course the chairman has introduced a bill in this area.

So I do hope you are aware of the problem this raises. It has nothing to do with your character or your ability. You are all men of the highest character and ability. And yet there is this problem of your past associations which, it seems to me, are very, very hard to purge yourselves of.

Secretary KENNEDY. I wouldn't try, Senator. I think that we can be objective. We recognize the problem in each of the areas you mentioned. And we should be objective. We have come up with recommendations in each case. Your have our background.

You must bear in mind that each of us, I think, has spent as much time in the public sector as we have in the private sector. And so we do have balanced backgrounds. And I think that each of us, whether it is you or anyone of us here, is made up of our experiences and our training and character and everything else. I believe that the experience we have had in banking and related matters will be helpful rather than harmful in this effort.

Senator PROXMIRE. Now, let me ask a substantive question. You talk about serious inflation as one of the most troublesome legacies that you have. And I agree with you, it is troublesome. And yet you, and also the previous two witnesses we had, the Chairman of the Council of Economic Advisers and the Budget Director, all indicate that they anticipate a bare surplus. They don't anticipate reducing the Johnson budget significantly. In view of the obvious inflationary strain and also in view of the conclusions from this that Mr. McCracken properly drew, we will probably have tight credit and high interest rates all year. Do you also share this notion that it is unlikely that you can have a significant reduction in the 1970 budget?

Secretary KENNEDY. The 1970 budget reflects, as you well know, legislation that is already on the books, programs that the Congress has approved and that are going forward. It requires a careful examination item by item. I don't think that we are in the position yet to determine just what change or reduction can be made in that 1970 budget. In the present one I think it is clear that we can change very little, because the calendar is against us.

Senator PROXMIRE. Frequently in the past the Secretary of the Treasury has been the strong man of the Cabinet. You are a very able and strong personality. I do hope that you will be one of the ones that come down here to decide to keep spending down. I think in our area this committee in the past has recommended vigorously to the administration in a bipartisan way that they cut spending below what they have. And I earnestly hope that you will do that. Because, as you know, the alternative is a tight monetary policy which can devastate housing.

I am very disturbed in this area because Mr. Romney, who should be the champion of housing, and whom we confirmed with enthusiasm in the Senate Banking Committee, has indicated that he thinks the housing goals of the administration for low income and moderate housing are unrealistic, can't be achieved. They only provide for 233,000 units this year. And it seems to me to be a modest goal, modest in terms of the resources allocated, tough in view of the financial situation. But this is a problem that I hope you will help us solve.

Secretary KENNEDY. It is a very serious problem. And I am very much interested in the development of housing and in urban problems. I agree 100 percent that item by item and program by program we should have a careful look and see how much saving we can get out of the expenditure side of the budget. I believe that there would be areas for reduction—how much I am not prepared to say, because that is a review by each of the Departments, and by the Budget Director—but I am pushing to the extent of the power of my office to reduce as much as possible.

Senator PROXMIRE. One of the additional reasons why I am so concerned with this is the failure of the surtax to do what it was constructed to do. The economists, those who were frank about it, admit that they were wrong. They uniformly told this committee that it would have a rather direct and fairly prompt effect, not immediate, but fairly prompt effect on the economy. Since July 1, interest rates are up 10 to 15 percent, as you know, right along the line, all the Federal interest rates, municipals, corporates, and so forth. Consumer prices have gone up more rapidly since the surtax was passed. The balance of trade has deteriorated badly since the surtax was passed. We had a balance of trade in the first half of 1968 which was favorable. The balance of trade since then on the merchandise account has been unfavorable, distinctly unfavorable.

So that I think we can't rely just on higher taxes, or continuing high taxes to help us in this area. I don't see any alternative except to take a much harder, tougher look at keeping spending down more than we have.

Secretary KENNEDY. I agree that we have really got to push on the expenditure side, Senator.

Senator PROXMIRE. Now, on November 22, 1968, in an address you delivered at the Annual Civil Rights Conference at the University of Utah you said:

"There is no doubt that American industry, including the banks, has spent far too little of its energies and financial resources to relieve the strains of the inner city. That tide is now turning. We have a great deal to learn, including how best to communicate with the people who need our encouragement, but it will be done."

Specifically, how can we turn the tide, how can we get the banks more directly involved in this?

Secretary KENNEDY. I think in the last year or so the banks have been spending a lot of effort, time, and resources in this field. I spent at least a third of my time in the last year in this field.

Senator PROXMIRE. I know it has done a great job.

Secretary KENNEDY. Now, in the banking system they organized a national committee. Mr. Graham, of the Continental Illinois Bank, was chairman of that group. The committee discussed programs and policies that would be helpful in joining the banking system and the resources they have and the abilities they have to work within the community to develop programs that would help solve the inner city problems.

I am sure that in this field there has been not only an awakening, but also a recognition that this is all to the good. And it applies not only to banks, but it is moving over into the corporations generally. When you see the amount of time that the heads of corporations and the heads of banks and others are taking in this field—and that is what I was trying to indicate in that talk in Utah—you see that there is a change. And that is part of this administration's policy.

Senator PROXMIRE. That is very useful. But it seems to me that we have to see some concrete specific action. I am talking about what the insurance industry has done, which I think is most encouraging. They reported to the Banking Committee of the Senate that they were close to their commitment of $1 billion to be invested in the inner city areas. They invested over $700 million as of late last year. Now, what can the banks do? How can they get into the act? There is so much more money involved in the private financial institutions than the Federal Government has. Will guarantees do the best on the part of the Federal Government?

Secretary KENNEDY. Banks are doing it in several ways right now in this program. They are working on corporate joint enterprises to provide funds for not only loans, but also capital where it is needed. And they are making loan policies very liberal with respect to areas of need. If you add up the loans that are made, it is pretty hard to say whether they would have been made otherwise or not. We cannot pick a single number such as a billion dollars, but it will add up to a billion as you go along. And I think they can demonstrate statistically and in figures later to your satisfaction that effort is being directed in this vein.

Senator PROXMIRE. My time is up. What I want to know is what we can do as a Congress—there are guarantees, for example, which would not involve such a big budget commitment, in fact a rather modest one, but which would enable banks and other institutions to do a better job.

Secretary KENNEDY. That has to be on the Government side; this has to be a cooperative effort.

Chairman PATMAN. Ordinarily under the strict interpretation of the rules Senator Jordan would be the next member to interrogate the witness. But Mr. Widnall passed because he was not ready, and Senator Javits came in immediately thereafter. So unless there is an objection, the Chair will recognize Senator Javits under those circumstances.

Senator JAVITS. I thank the Chair very much. I hope there is no objection, I will try to be brief.

Chairman PATMAN. There is no objection.

Senator JAVITS. Mr. Secretary, just one question on your qualification to be Secretary of the Treasury, notwithstanding the fact that you are a banker, and will have some kind of interest, beneficial or not, directed to the extensive amount of bank stocks. What benefits does the United States get from the fact that you are one of the leading bankers in this country, perhaps in the world, from having you as Secretary of the Treasury?

Secretary KENNEDY. That is a very difficult question for me to answer. I do have from my experience in economics and financial matters a background that should be helpful. I would hope that it would be helpful. I do have a very large acquaintanceship abroad, not only among private bankers but among finance ministers and central bankers. I spent many years, as you know, in our Central Banking

System, the Federal Reserve. Those qualifications should be of value and help to our country. If I didn't think I had the qualifications—I am not boasting, I know the problems are very serious—I would not have accepted this assignment.

Senator JAVITS. Mr. Secretary, in a business where confidence counts for everything, isn't it fair to say that you ought to command the confidence of people who evaluate dollars and money and the probity of governments in the world?

Secretary KENNEDY. Banking is built on confidence. And I hope I have the confidence not only of the bankers but of the civic people with whom I work.

Senator JAVITS. So we ought to take you for your strengths, and if you have any weaknesses, we can always find other fellows that will give us different advice.

Secretary KENNEDY. I am sure I have weaknesses, sir.

Senator JAVITS. Just a few questions for you on a somewhat different line from that which is being pursued. It is a fact, is it not, that you have confidence that the dollar is strong and can be maintained? I notice with interest that you say, "The dollar is strong and respected in the world in spite of recent inflationary trends and a deteriorating trade balance."

Secretary KENNEDY. Precisely so, Senator. In the period that we have gone through just recently the dollar has stood up very well. And we hope that it will continue to do so.

Now, it will not, unless we can keep the balance necessary to control inflation in our economy.

Senator JAVITS. You talked about cutting expenditures, you talked about the necessity for perhaps continuing the tax surcharge, you can't get a budget surplus otherwise. Now, there are other things that can be done. One is to close tax loopholes, isn't that true?

Secretary KENNEDY. Precisely.

Senator JAVITS. Do you feel favorably disposed to the suggestion that the Treasury publish annually the cost in terms of tax revenues of those things which are complained about so much as tax loopholes, tax avoidances?

Secretary KENNEDY. In the Budget Commission studies that Senator Proxmire referred to we had considerable discussion on how you called these matters to public attention. And I think there should be and can be a way to do it. We are studying all of these areas and how we can best look at them.

Senator JAVITS. Just one other question along the same lines. You are going to refinance, we understand, some $12 billion in Government debt between March 12 and June 30. And a good deal of that is going to be returned to private capital, is that correct? The result of the refinancing, we understand, in that period will return a good deal of money to the money market.

Secretary KENNEDY. Yes, there is a paydown in that period, that is right, sir.

Senator JAVITS. What effect do you expect that should have on interest rates?

Secretary KENNEDY. It would tend to ease them slightly, offsetting other pressures.

Senator JAVITS. Can you think of anything else, aside from what we have been discussing, that would ease interest rates, bearing in mind all the results of the existing financial situation in which this country finds itself because incomes to a certain extent have kept pace with inflation, and those people hit hardest are those who have had to pay higher interest, and the effect on housing of higher interest rates? Is there any suggestion as to what should be done about it?

Secretary KENNEDY. In that connection, I don't think there is an indication that the Treasury's position will add very much one way or the other. We have a very heavy refunding program along with this paydown. And while our cash need will be down somewhat in this period, that is a market matter, and it will probably get in the short term area very quickly. It does have some ripple effect, but I don't think it would go to the heart of the problem you are trying to solve.

Senator JAVITS. Is there anything else that you have to suggest that we could do on the interest rates?

Secretary KENNEDY. We are pushing, as you know, to control inflation. And eventually—how long that would take I don't know—but hopefully that will reduce interest costs.

Senator JAVITS. That is your best prescription?

Secretary KENNEDY. That is the best prescription at this time.

Senator JAVITS. There is one other question I would like to ask, and then I will ask the committee's permission to yield to Senator Jordan. There is a lot of complaint and a lot of concern in my mind about Federal financing techniques as well as Federal bookkeeping. Now, let me lay that before you in a few words, and then I will ask you a question. The Federal bookkeeping is much objected to on the ground that they treat capital items as current expense, or we have no capital budget, that we are financing the Vietnam war on the pay-as-you-go basis, which is absolutely fantastic for wars, we have always financed them by debt. Those are two points. And thirdly, that we are failing to rationalize and develop interesting financial techniques. For example, in this very Banking and Currency Committee that Senator Proxmire talks about, we developed the techniques for financing college housing which took a budget drain of only the interest rate underwriting, that is all, the U.S. guarantee did the rest. We are beginning that same thing in hospitals, hospital modernization. I tried it last year and was unsuccessful. But I am confident we will get it this year. These make enormous differences.

For example, for hospital modernization you buy a billion dollars worth of modernization for budget exposure not in excess of $50 million. There is a big difference in appropriating a billion and 50 million. Now, is the Treasury going to study both these questions with a new and free outlook, not tied to the past, that is, whether the Federal accounts are really kept in such a way as to justify our position in the world? We say we are suffering from inflation and budget deficits. I don't think it is true in terms of the real strength of the currency and what it really means in production and integrity.

Secondly, the many ways in which an administration in which there is great financial confidence could adopt totally new financing techniques which will make very measurable budgetary differences.

Secretary KENNEDY. Senator, we are taking a look at some of those areas that you are talking about, and we will take a look at each of them. Because I agree that we ought to take a look at each of the areas rather than just be prejudiced by the past policy that doesn't mean that I agree in the various areas.

Senator JAVITS. Mr. Secretary, would it be taxing you too much to ask you to write to the committee—and I will ask unanimous consent to include it at this point in the record—as to the ideas and point of view of the Treasury and what it is going to look into, so that we have the whole thing before us as a kind of new approach to many of our problems? And it would be in a sense a self-dictated directive as to what you are really going to do. Would you mind doing that?

Secretary KENNEDY. I would be glad to do it.

Chairman PATMAN. Without objection it is so ordered.

(The information requested by Senator Javits and subsequently supplied follows:)

FEBRUARY 19, 1969.

Hon. DAVID KENNEDY,
Secretary of the Treasury,
Treasury Department,
Washington, D.C.

DEAR MR. SECRETARY: This is to confirm our discussion this morning at the Joint Economic Committee hearings concerning my suggestion that the Treasury consider the following: the question of setting up a capital budget within the Federal budget; the reasons why the Vietnam war is being financed out of current revenues rather than debt financing as in past wars; and new financial techniques such as interest subsidies to encourage the flow of private capital to modernize or construct hospitals, educational, and other facilities designed to alleviate certain basic social problems facing the country today.

In order that the record on our hearings may be clear on this, I would appreciate it if you would submit to the Joint Economic Committee a letter indicating that the Treasury Department plans to look into these questions.

May I congratulate you on your first appearance and excellent testimony before the Joint Economic Committee.

With best personal regards,

Sincerely,

JACOB K. JAVITS.

THE SECRETARY OF THE TREASURY,
Washington, D.C., March 4, 1969.

Hon. JACOB K. JAVITS,
U.S. Senate,
Washington, D.C.

DEAR SENATOR JAVITS: This is in reply to your letter of February 19, 1969 in which you confirm our discussion on that date at the Joint Economic Committee Hearings and request that I submit to the Joint Economic Committee a letter indicating that the Treasury Department plans to look into the following questions: "the question of setting up a capital budget within the federal budget; the reasons why the Vietnam war is being financed out of current revenues rather than debt financing as in past wars; and new financial techniques—such as interest subsidies to encourage the flow of private capital to modernize or construct hospitals, educational and other facilities—designed to alleviate certain basic social problems facing the country today."

These questions raise a number of broad budget and fiscal policy issues. While we have not yet developed our thinking fully on these matters, I would like at this point to make the following comments.

The capital budget question was explored in some detail in the October 1967 report of the President's Commission on Budget Concepts, which I chaired. The Commission strongly recommended against a capital budget which would provide separate financing of capital or investment expenditures on the one hand and current or operating expenditures on the other. The Commission felt that such a budget would seriously distort the budget as a decision making tool. Nevertheless, the Commission saw considerable merit in the continued publication and improvement of useful tabulations of capital items such as Special Analysis D in the budget document.

As to the question of financing the Vietnam war with debt rather than current revenues, I would like to note that in the fiscal year 1968 budget outlays for special Southeast Asia support were $26.5 billion, or only slightly more than the budget deficit of $25.2 billion. I believe it is now clear that such debt financing of the Vietnam war contributed greatly to the current inflation problem and that we must now make every effort to avoid budget deficits which would add further to this problem.

Your question on new financial techniques, such as interest subsidies on private borrowings, must be considered in the context of broader questions regarding the method of providing Federal credit assistance, the budgetary treatment of Federal credit programs, and the impact of these programs on money and credit markets and on the economy. These questions have been the subject of several private and public studies in recent years and were also studied by a special task force on Federal credit programs appointed by President-elect Nixon. In addition, the budgetary treatment of Federal credit programs was a very important part of the study by the President's Commission on Budget Concepts in 1967.

It is clear that maximum reliance must be placed on existing private financial institutions in meeting the credit needs of the economy. It is also clear that necessary Federal credit assistance to help meet these needs should be provided, where feasible, through existing institutions rather than through direct Federal loans. Such assistance can be provided through Federal loan guarantees and insurance as well as through interest and debt service subsidies on both guaranteed and nonguaranteed loans. These measures are feasible so long as private lenders are willing to participate in these programs on reasonable terms.

However, it should be emphasized that no matter what the financing techniques employed or budget accounting methods adopted, it is essential to provide for effective Executive and Congressional control over the volume of credit stimulated by Federal assistance programs. Also, in a full employment economy with excessive price increases, a Federal stimulus to high priority programs—for example in urban areas—should be offset by cutting back in areas of lower priority in order to avoid adding to inflationary pressures.

Thank you for your kind remarks regarding my testimony before the Joint Economic Committee. I assure you that we will be looking very carefully into the questions you raised and that we will be soon developing an overall approach to these problems based on our own careful review of them.

In keeping with your request, I am sending a copy of this letter to the Joint Economic Committee.

Sincerely yours,

David M. Kennedy.

Senator Javits. And I would like to yield to Senator Jordan.

Senator Jordan. Mr. Chairman, I am quite willing that we return to the regular order and go to the other side.

Chairman Patman. Thank you, sir.

Mr. Reuss.

Representative Reuss. Thank you, Mr. Chairman.

And welcome, Mr. Secretary, and your associates.

I note, Mr. Secretary, your strong emphasis—and here I quote—"that the economy must be placed under firm fiscal and monetary restraint." In the light of that, have you considered the effect of the 7-percent investment tax credit which in addition to costing the Treasury some $3 billion a year in revenues, produces an inflationary overheating of the capital equipment market in an area where the economy is under the most pressure? In the light of that, are you prepared to recommend the immediate repeal of the 7-percent investment tax credit?

Secretary Kennedy. I am not prepared to recommend immediate repeal, because we haven't looked into it carefully. Dr. Walker has been asked to take a look at all areas of taxation. That will be part of the analysis that we are going through. In fact, they are starting now to work on it.

Representative REUSS. You will, I hope, be willing, in view of the fact that the investment tax credit not only loses the revenue, of course, but in view of the fact that it has a very sharp inflationary potential—you will, I hope, put that near the top of your list.

Secretary KENNEDY. That will be very much on our list. We have already discussed it in general terms, but there is no indication that the actual effectiveness or ineffectiveness has been established.

Representative REUSS. Now, turning to the international field: this committee, as you know, has long opposed an American official increase in the price of gold. Among the reasons for our view is that to do so would hurt friends of the United States who have relied on the promises of three Presidents not to fool around with the price. It would help the speculators, it would help countries which by grabbing gold have succeeded in embarrassing us at various times. It would help the principal gold supplying countries, the Soviet Union, and the Union of South Africa. It could well lead to a worldwide inflationary situation by producing superabundant reserves. It could produce a destabilizing effect, because having once done it people might expect that it would be done again. And finally, of course, the power to change the price of gold lies, we believe, entirely in the Congress.

Would you agree with the position I have just outlined and with the reasons given, and comment on any of those reasons?

Secretary KENNEDY. I have had a few things to say on this myself, as you well know. And I would like to put it in the record, Mr. Chairman, the remarks which I made on this subject at the White House on January 22, 1969.

Chairman PATMAN. Without objection it is so ordered.

Secretary KENNEDY. Thank you.

(The statement referred to follows:)

We have inherited inflationary pressures that are seriously distorting the economy and financial markets. That inflation must, and will, be contained.

We are all conscious of the risks of abrupt and blunt action that could bring unnecessary unemployment. We mean to avoid that. But we are equally conscious of the risks of not moving decisively, because inflation is undermining both the foundation of our prosperity at home and our balance of payments position.

The indications of an over-all statistical balance in our international payments last year are welcome.

But no one should be deluded. Underneath the over-all result, our trade balance has sagged to the vanishing point under the pressure of inflation, and additional controls on American investment were imposed to achieve the balance. We do not plan to rely indefinitely on tight controls or statistical window dressing to disguise, but not cure, a basic deficit. Maintained too long, these devices can only be self-defeating.

It will be our purpose to maintain a strong dollar both at home and abroad. We will not seek an answer to our problems by a change in the monetary price of gold. We see no need or reason for such action.

Calm study in cooperation with our friends—not unilateral actions or disruptive changes in the vital role of the dollar and gold—must remain the foundation of real reform and progress in the international financial system.

Responsible budgeting and support for firm monetary policies are the core of the actions that must lie behind any successful attack on inflation and our balance of payments problems.

Representative REUSS. Did any of the points I have made disturb you in any way?

Secretary KENNEDY. I have considered all of those points, and they all have more or less validity. There are arguments on all sides of questions like this, as you well know. Our program, of course, is to keep the dollar strong by domestic policy, control of inflation, and build up our balance-of-payments strength, and then we are in a position really to maintain our dollar everywhere. That is the basis of our trust. Mr. Volcker will have more to say, of course, when he appears before you on this whole question.

Representative REUSS. This committee I know, based on past experience, will want to work very closely and cooperatively with you and your associates toward that end.

Secretary KENNEDY. And we shall be in touch.

Representative REUSS. Certainly if we can master our domestic economy, no reason appears to us, and I gather to you, Mr. Secretary, to change the price of gold.

Secretary KENNEDY. I have said that a change in the price of gold is not in the offing.

Representative REUSS. Thank you very much.

Secretary KENNEDY. Mr. Chairman, may I be excused?

Chairman PATMAN. You may be excused under our agreement. And we will ask you to come back at some time that is mutually satisfactory.

Thank you for your appearance.

Now, then, if it is satisfactory with the committee, if I hear no objection, we will just go ahead and recognize the members for 10 minutes. And that contemplates, of course, that you gentlemen file your statements, and we will just continue the questioning.

Mr. WALKER. Mr. Chairman, I respectfully suggest that we do have some substantive matters on debt policy and debt management in our statements.

Chairman PATMAN. You will be asked those questions. And at the close you may make a statement on your own. Will that be satisfactory?

Mr. WALKER. However the committee wants to proceed.

Senator SPARKMAN. Mr. Chairman, before we proceed, I want to make a suggestion with reference to committee procedure. If the committee knew that the Secretary was going to have to leave at a certain time, I think the time allowed for questioning of each member should have been cut down to such a point that all of us would have had an opportunity to ask him questions. I did have questions I wanted to propound to him. I would not, though, ask that he come back. I just mention that as a matter of procedure in the future.

Chairman PATMAN. I think you are exactly right. But of course, we did not know about this until 10 o'clock this morning, and we had to do the best we could.

Senator SPARKMAN. At the same time we could have cut the questioning time in two.

Chairman PATMAN. We overlooked your very wise suggestion and counsel, and I am sure if it had been brought up in time we would have.

Senator SPARKMAN. I hope you will not overlook it next time.

Chairman PATMAN. We will ask the Secretary to come back. I want him to come back anyhow.

Senator SPARKMAN. I don't.

Chairman PATMAN. Senator Miller?

Senator MILLER. I would not want to ask the Secretary to come back, although I have some questions. Could we have the same procedure that we have followed to date, that each member could have questions answered by him?

Chairman PATMAN. That has already been agreed on. And any member of this committee who desires to ask the Secretary or anyone of these gentlemen questions may do so. Ordinarily, we only have one statement anyway, Mr. Walker, from the Secretary, and the others; and if you want to ask any questions, you may proceed.

Mr. WALKER. I understand. And in this instance we very much shortened each statement so the total would be comparable to a regular statement.

Chairman PATMAN. With the understanding that if questions do not bring out the information you want to bring out you will be allowed to do so.

Mr. WALKER. Thank you.

(The prepared statement of Under Secretary Charls E. Walker, follows:)

STATEMENT OF THE HONORABLE CHARLS E. WALKER, UNDER SECRETARY OF THE TREASURY

Mr. WALKER. I am grateful for the opportunity of expressing to the committee the great interest of the Treasury Department in pressing forward with a program of tax reform and equitable tax administration. The President and the Secretary have emphasized both publicly and to me that these matters are to have a high priority in this administration, and the Treasury will bend every effort to attain these goals.

We have assured Representatives Wilbur D. Mills and John W. Byrnes, Chairman and ranking minority member of the Committee on Ways and Means, of our desire and intention to work closely with their committee in connection with the hearings on tax revision proposals that commenced yesterday. We are reviewing carefully the proposals developed at the Treasury Department under the previous administration which have recently been published. We are working on the development of proposals and plan to present them at the proper time to the Ways and Means Committee.

We hope to accomplish this as soon as possible consistent with the need for filling key vacancies in the Treasury Department staff and the desirability of developing and recommending a coordinated and orderly program of legislation.

Our first concern is with the equitable distribution of the income tax burden. The outgoing Secretary of the Treasury recently called attention to some of the problems involved on this score, and the agenda for the current Ways and Means Committee lists these and others. We regard the matter of tax revision to achieve equity as of fundamental importance, deserving of the most urgent attention in the administration and in the Congress. We shall strive to achieve also a good measure of simplification in this complex field. It may well be necessary to approach this task in stages, accomplishing first those changes that permit of ready solution and examining at greater length more fundamental revisions of the tax structure.

We are also devoting every attention to the use of tax incentive to help solve the problems of the cities and of our disadvantaged citizens. We are examining closely some of the more promising approaches recommended by the President's Task Force on Taxation. We hope that means will be developed to use the potency of tax incentives, along with other programs, to enlist private capital and business ingenuity in this urgent effort.

We intend also to bring the whole tax system—State and local as well as Federal—under careful and searching examination. The issues involved are long run in nature and involve the strength of our domestic economy, our international financial position, the capacity to generate revenues to meet national needs, the appropriate distribution of revenues among different levels of government in relation to their fiscal responsibilities, and many other factors.

Among these issues are those of the coordination of Federal, State, and local taxes, an exploration of the role of value-added taxes used by a number of Western European countries, and similar issues of fundamental significance. We believe these matters should be carefully examined and we plan to discuss approaches to these studies within the administration and with congressional leaders in the period ahead.

Mr. Chairman, this concludes my statement.

Chairman PATMAN. Thank you, Mr. Walker. We will proceed with the questioning.

Senator Miller?

Senator MILLER. Thank you, Mr. Chairman.

Mr. WALKER. May I make the point that we have a division of labor in the Treasury Department. The international, financial, and debt management question are Mr. Volcker's area. My area is tax policy and certain aspects of domestic economic policy.

Chairman PATMAN. That will be helpful to us. We will include Mr. Volcker's statement in the record at this point.

PREPARED STATEMENT OF THE HONORABLE PAUL A. VOLCKER

Mr. Chairman, I appreciate this opportunity to accompany Secretary Kennedy and Under Secretary Walker on our first appearance before your committee. As Under Secretary for Monetary Affairs, a good part of my own time will be devoted to the balance of payments and international finance. I understand that you plan to devote a later meeting exclusively to those matters. Consequently, my brief remarks this morning will be directed toward some problems of domestic financial policy related to my responsibilities for Treasury financing.

Virtually my first official act upon my return to the Treasury three weeks ago was to announce the terms by which the Treasury would refund some $14½ billion of maturing debt. By necessity, those terms included the highest rates of interest available on a Treasury note or bond since the Civil War. As it turned out, even those record rates—6.42 percent for an 15-month issue and 6.29 percent for a seven-year—failed to attract much enthusiasm among potential investors. More than a third of the maturing securities held by the general public had to be paid off in cash.

That experience reflects in a concrete way the strains pervading the domestic credit markets as we took office. You are, I am sure, familiar with other signs of pressure and imbalances: for example, the relative shortage and high cost of residential mortgage money, the sharp increases in interest expense for our state and local governments, and the growing tendency of some lenders to require an element of equity participation before committing loan funds.

My purpose today is not to elaborate these facts. Rather, I would like to suggest how, in managing the Treasury's finance and debt, we might contribute toward restoring better balance in financial markets.

The main responsibility, I should make plain, must lie elsewhere—in responsible budget and fiscal policy and in appropriate monetary policy. These are the principal policy tools for restoring sustainable, non-inflationary balance to the economy as a whole. This kind of balance in the economy generally is a prerequisite for any lasting reduction of tensions and interest rates in financial markets.

There are two ways in which debt management can and should play a supporting role in this effort to achieve better balance. In the first place, Treasury financing can at all times provide some positive support to restrictive fiscal and credit policies by absorbing funds that might otherise simply fuel excessive private demand. The precise means of achieving this result will always be dependent upon the particular set of economic and market circumstances prevailing at the time of financing. It would be an oversimplification to measure the economic impact of Treasury financing entirely by the maturity of the securities sold. Nevertheless, there can be no doubt that inability to offer longer-term securities eliminates one highly important option in debt management, and thereby sharply limits its potential effectiveness as a tool of general economic policy.

The second way in which debt management can support the aims of stabilization policy is at least as significant. In the best of circumstances, the necessitous nature of Treasury financing and the potential impact of these large borrowings on credit markets create difficult problems for the conduct of monetary policy. These problems can—and should—be minimized by orderly spacing of financing, by reducing the size of maturing issues, and by use of financing techniques that avoid undue reliance on sales to the commercial banking system or exposure to market fluctuations. Again, the maturity of the securities offered is not the only consideration. But it is a relevant and important variable.

These circumstances explain why we shall ask the Congress at an early date to review the 4¼ percent interest rate ceiling on Government bonds. This has been a contentious issue in the past, and I have no desire to open that debate prematurely this morning.

I will only observe that the average maturity of the privately-held debt has shortened steadily since mid-1965, when it stood at 5 years, 9 months. By the end of last month, it had declined to a post-war low of 4 years. This continuous shortening of the debt increased liquidity in the economy, and thus tended to add to the inflationary potential. And the net result has been to force the Treasury into the market for refunding in such large amounts as to immobilize monetary policy for extended periods. In 1965, for example, the average amount of privately-held, marketable Treasury debt maturing each quarter was $3 billion; the average amount maturing in each quarter of this year, $5½ billion, is very substantially larger.

I would also note, in this connection, that our savings bonds—solds to millions of individuals in relatively small amounts—are subject to a 4¼ percent ceiling. The savings bonds program has been a part of the Treasury's debt management effort since before World War II. In some ways, the value of this program is greatest precisely in an inflationary period like the present. Yet, we are all conscious that these same inflationary pressures that have so profoundly permeated other sectors of the credit market have, for the time being, reduced the relative attractiveness of savings bonds. This is also a matter that we will be reviewing urgently in coming weeks.

In conclusion, I can make no promise of immediate relief from the heavy pressures on domestic financial markets, or from high Treasury interest costs. That is certainly a part of our ultimate objective. Moreover, with fiscal and monetary policy both geared to a non-inflationary path, it seems to me a reasonable hope for the not-too-distant future. But to put low interest rates and better availability of money first on our list of priorities would be self-defeating. For the attempt could only add more fuel to the fire of inflation and, thus, to the distortions and strains in financial markets.

Senator MILLER. Whomever my question might fit, first of all, according to the proposed fiscal 1970 budget, which is now being reviewed and is possibly going to be revised, there is a $6¼ billion operating budget deficit, which is apparently the reason why there is an estimated increase in the national debt of $6½ billion. My question would be, how does Treasury propose, if we do indeed end up with an operating budget deficit of, say $6½ to $5 billion, how does it propose to finance that without aggravating the inflationary situation?

Mr. WALKER. Let me say one introductory thing, and then Mr. Volcker will comment on the financing techniques.

I understand that you are referring to the old administrative budget approach. I do want to point out that under the new concept adopted as a result of Mr. Kennedy's commission there is a projected surplus in the receipts versus expenditures, and also in net lending, giving an overall surplus. But Mr. Volcker can clarify why there is a financing operation.

Senator MILLER. May I say, I am very much aware of that. But the point is that in the budget document there is an estimate that the national debt subject to the debt ceiling limitation will be increased $6½ billion. And that is premised upon a $6½ billion operating budget deficit. My question is, after the revisions are made by the new administration, how will that budget deficit, if there is one, be financed without aggravating the inflationary situation?

Mr. VOLCKER. If I may try an answer to this one, Senator Miller, I think Under Secretary Walker's answer is the basic point so far as the inflationary aspect of this is concerned. What is happening here is that we have a deficit in what used to be called the administrative budget, and that deficit is more than offset by surpluses in the trust funds. To that extent the deficit in the administrative budget is self-financing. It is financed through issuing debt to the trust funds. And with the small overall surplus, the overall impact of the budget is neutral, at least. Our financing problems are not small. But in terms of increasing the debt, the significant part is the part held by the general public with respect to its impact on inflation. For the fiscal year as a whole, that is projected to decline slightly. We have the peculiar situation here where the debt subject to limit, as you pointed out, will rise, while the debt held by the public over the course of the fiscal year as a whole presumably will decline slightly. This will give us some debt ceiling problems that we are struggling with now. We have some work to do in that area. But the overall budget, so far as its financial implications are concerned with respect to the inflation problem, is in a position of essential neutrality.

Senator MILLER. If you finance this $6½ billion out of public securities issued to the general public, that would have a tendency to slow down inflation, would it not?

Mr. VOLCKER. To the extent that the trust funds have a surplus—and they have a very large surplus—it will not be financed through borrowing from the general public.

Senator MILLER. That is up to you, isn't it?

Mr. VOLCKER. I suppose it is up to us in the broadest sense. But we have a legal responsibility to keep the trust fund fully invested. They are limited to investment in Federal securities. So to fulfill that responsibility we must provide securities to meet the needs of the trust funds. In providing those securities our needs for financing with the public decline.

Senator MILLER. To that extent, then, is this not going to have an inflationary impact? As I understand it, if the deficit is financed by the general public, this has a definite tendency to curb inflation; it takes the purchasing power of the general public out of the economy, and therefore it tends to slow down expansion, whereas if you don't do it that way you tend to go into the other direction into the inflationary picture.

Mr. VOLCKER. This is a complicated process, as you are well aware, Senator. It depends on where you cut into the total picture. What is happening in the total budget, as reflected in the small surplus, is that money is being taken out, at least in a small amount, on balance from the private economy. This should have some deflationary effect in and of itself, apart from the way we do the financing. We also have a large number of maturing securities to roll over. We will have to do some seasonal financing. The way we conduct our financing operations will have a further effect on financial markets and on anti-inflationary policy. And I can assure you that we will try to arrange this financing, and we will have to do it in any even in very substantial volume, in a manner and to the degree that such financing is an appropriate tool to dampen inflationary pressures. That is the burden of my statement that I am submitting here today.

Senator MILLER. I am sure that you will do your best. And I understand that it is a very complicated problem, and ties in with the Federal Reserve and the monetization of the national debt and the monetary policy.

The thing I wanted to bring out, however, was that it appears that there may be less holdings in the general public sector rather than more holdings in the short range, and that this could cause an inflationary impact. Therefore, so you are going to have to do something else to try to offset that for your refinancing operation.

Mr. VOLCKER. As long as inflation is the major problem for the domestic economy, we will certainly try to conduct debt management operations so that there is no inflationary impact.

Senator MILLER. I have just one other question at this time. I take it that the position of the Treasury Department would be that it would prefer to take—that they would prefer to have our Federal Government take purchasing power away from the American people by taxation rather than by inflation.

Mr. VOLCKER. I certainly think that is true, where that choice presents itself.

Senator MILLER. Now, if that is so—and the suggestion is made that we change our structure, our bookkeeping so that we don't worry too much about capital investments even though they might amount to a debt, and even though we might have to finance that—would not that type of a bookkeeping change, with, you might say, a toleration of an addition of $10 or $20 or $30 billion a year in capital expenditures—which would have to be financed—would that not lay a foundation for inflation?

Mr. VOLCKER. I certainly think that whether the expenditure is on current account, so called, or on capital account so far as the budget is concerned, that we would have to be concerned about the potential inflationary impact in either event.

Senator MILLER. And the increase in the debt would lay the foundation for that problem, would it not?

Mr. VOLCKER. If we simply segregated capital expenditures and automatically financed them by an increase in debt, there may well be an inflationary impact, depending on the existing economic conditions. This would have to be taken into account. I don't think by any segregation of the Government accounts, whether or not that is desirable, conceptually, we get away from the necessity of maintaining an overall balance in the economy in balancing national output with productive capacity.

Senator MILLER. Will you be good enough to furnish the committee—and I would ask the chairman to have this placed in the record at this point—with an analysis of the budget deficit, let's say, the operating budget deficit situation, $6½ billion, and how the increase in the debt ceiling limitation that it would entail could be handled by some of these other mechanisms to which you referred to offset the inflationary impact that in itself might cause.

Mr. VOLCKER. We would be glad to do that.

Senator MILLER. Thank you.

Chairman PATMAN. Without objection, it will be so ordered.

(The subsequent submission in reference to the above follows:)

The budget for fiscal year 1970 estimates over-all surpluses in the unified budget of $2.391 billion in fiscal year 1969 and of $3.414 billion in fiscal year 1970. Special Analysis B indicates that these over-all surpluses reflect excesses of outlays of Federal funds over receipts of approximately $6.962 billion in fiscal year 1969 and $6.848 billion in fiscal year 1970. The trust funds in the same two fiscal years are estimated to have excesses of receipts over expenditures of $9.353 and $10.262 billion.

As a result of the over-all budget surpluses, earnings from seigniorage, and other adjustments in Federal accounts, $3.091 billion of Federal debt held by the public at the end of fiscal year 1968 will be repaid in fiscal year 1969 and $4.000 billion additionally will be repaid in fiscal year 1970, assuming unchanged cash balances.

Excesses of receipts over expenditures of trust funds are required by law to be invested promptly in Federal securities. Therefore, Government securities will be required to be issued to the trust funds in sufficient amounts to meet this legal requirement with respect to the trust fund surpluses projected in fiscal years 1969 and 1970. Thus, even with the reduction in debt held by the public, the estimated over-all increase in gross Federal debt (including special notes issued to the IMF) amounts to $5.135 billion in 1969 and $6.323 billion in 1970. After adjustments for changes in agency debt and in public debt not subject to the debt limit, the debt subject to the debt limit, according to the Budget, will increase by $3.747 billion in fiscal 1969 and by an additional $6.608 billion in fiscal 1970. The actual debt ceiling limitation will, in addition, also need to take account of the seasonal pattern in receipts and expenditures.

Senator Miller inquired about the inflationary effect of an increase in debt. At the present time, given an over-all surplus in the unified budget, there would normally be an equivalent—approximately equal—*reduction* in the debt held by the general public, which is defined to include the Federal Reserve System as well as private investors. This reduction in the publicly-held debt could be avoided by building up Treasury cash balances at commercial banks or Federal Reserves Banks. But any net deflationary effect of such a build-up in cash balances would need to be judged in the context of other monetary policy operations, which are the responsibility of the Federal Reserve System.

In general, while there are disagreements over the extent of the impact, a budgetary surplus is considered to have a deflationary impact on the economy by removing funds from the private spending stream. A reduction in privately-held Federal debt may release funds into the capital markets and thus facilitate borrowing by others. However, this influence may well be swamped by the general effects of monetary policy or other factors on conditions in the money and capital markets.

Chairman PATMAN. Senator Sparkman?

Senator SPARKMAN. Dr. Walker, Iwant to ask you about that investment credit that the Secretary had something to say about. As I understood him, he said that you were not ready to recommend yet that it be changed, or that it be repealed. Did I understand him correctly?

Mr. WALKER. I think I would recast that just a little. In referring to the words "recommend yet," I don't think that should prejudice any sort of action one way or another, or lead to an expectation that action may be coming. I think what he is saying is that we are reviewing all aspects of the tax laws just as efficiently and rapidly as we can. And that is one that we will look at. There are a number of arguments on both sides with respect to the investment credit, as you well know.

Senator SPARKMAN. I am glad to hear you say that, because I don't believe I agree with my friend, Henry Reuss, with reference to it, at least not all the way.

I would like to mention this——

Mr. WALKER. May I say just one more word on that?

Senator SPARKMAN. Yes.

Mr. WALKER. With respect to the investment credit it is quite clear that some economists believe appropriately timed removal or restoration of this to be an effective device to manipulate interest spending throughout the business cycle. Removal was attempted, somewhat abortively, in 1966, and credit had to be quickly restored. On the other side of the coin, the basic argument made by President Kennedy and Secretary of the Treasury Dillon in proposing the investment credit was that it was a fundamental type of tax reform that wouldn't be turned on and turned off too much—otherwise it tends to be diluted as a device to promote capital formation.

Senator SPARKMAN. I would certainly agree with you on that. I think it is well to keep in mind how the investment credit came into the law. I believe the first recommendation that was made by a congressional committee was made by the Senate Small Business Committee in the early part of 1953. It was the result of a study that had been made during 1951 and 1952. And it was proposed that an investment credit be allowed small businesses that were not able to replace their equipment as readily and easily as companies that had a good, strong capital background. And it was wrestled with for several years. Finally it was written into the law in the form that it is now, 7 percent across the board, without any distinction as to small businesses or big businesses. I certainly agree with you about turning it off and turning it on. I think it ought to be a steady policy whatever it is. And I hope that in consideration of it it may be kept in mind that it is something that means a great deal to small businesses. I don't know whether it would be feasible to make it applicable to small businesses alone or not. Certainly when it was finally agreed to it was not restricted to small businesses, but was made applicable across the board.

Now, another thing, I understand——

Mr. WALKER. May I make one more comment, Senator?

Senator SPARKMAN. Yes.

Mr. WALKER. I say we will review this, and I don't want to prejudge any conclusions. But I will say that I personally, ever since its introduction in 1961, supported the investment credit—to the objection of some of my employers at that time. It wasn't received well initially in the industrial, business, financial, or labor communities, as a matter of fact. But my own personal opinion is at this stage, subject to refutation on the evidence, that it has been a highly effective device to promote the longrun investment that really supports economic growth.

Senator SPARKMAN. I am glad to hear you say that, because I fully agree with you on it.

Furthermore, it seems to me—I may be wrong in this, but it seems to me that the repeal of the investment credit would run somewhat contrary to the proposal, which I understand will be a part of the administration's proposal, to use tax incentives for certain programs that we want.

Mr. WALKER. That is correct, sir. We are, at the direction of the President, hard at work studying two types of tax credits for incentive purposes. One would be in effect the application of a credit to promote what you might call human investment, on-the-job training, in other words. In the other area, we are taking a very hard and intensive look at those having to do specifically with investment in poverty areas. And I think that the apparent success of the initial investment credit leads some of us to be quite heartened about the possibilities of the success of other credits to solve some very pressing social problems.

Again, I am not prejudging. We will have our work on this area completed at the earliest possible date.

Senator SPARKMAN. Let me ask you about the debt limit. Are we going to be called upon to increase the debt limit?

Mr. VOLCKER. We have a very tight squeeze in that area in March and again even tighter in April, Senator Sparkman, and it does appear that action will be necessary to provide us with any kind of operating margin over that period. We will, in any event, have to take some kind of debt-ceiling action for the next fiscal year at some point along the line.

Senator SPARKMAN. Senator Proxmire addressed a question or made a statement to the Secretary regarding our housing goals. It seems to me every time we get into financial difficulty it is housing and small business that take the brunt of it first, and heaviest, and I certainly agree with his statement in which he expressed disappointment that Secretary Romney on several different occasions indicated that we would not be able to meet the goals.

Now, the goals have been set by law, and it seems to me that what we ought to be doing is steaming just as hard as we can at meeting those goals even if we are not able to do it in the long run and not start off by saying, we are simply not going to be able to meet the goals that have been set.

And I hope that you people in the financial world will help out with this housing program which I think will mean more to this country than almost anything that we have devised so far.

Mr. WALKER. Senator, let me say on housing—a subject you and I over the years have discussed rather intensively—that we particularly want to improve the functioning of the mortgage market and the long sought but still elusive goal of creating a secondary mortgage market that is active and viable. I would also point out that one of the major factors that economic policy should strive toward in containing inflation is avoiding erratic swings in fiscal and other policies. These swings have given us difficulty in recent years. We should avoid the type of credit crunch which by its nature hits hardest at institutions which traditionally make the largest volume of housing loans, partly by custom and partly by tax preferences, through such things as bad debt reserves and other measures which Congress has adopted in the public interest to promote loans for housing.

And I would like to make one more point: I have made this point privately before the savings and loan interests of the country, and I would like to make it before this committee. There is no question in my mind that in the long run there is going to be great difficulty in relying upon Government control of interest rates through Regulation Q to try to keep the housing credit flow up. This can be done in the short run, but in the long run it gets into all sorts of difficulty—it is a jerry-built proposition.

That is not saying that any recommendation with respect to the interest rate control bill is necessarily forthcoming or that it will take a particular form. But from the long-run standpoint of housing for the American people, there are many of us who are convinced—and I so told the U.S. Savings and Loan League—that the thrift industry has to be made more competitive vis-a-vis the commercial banking industry. The thrift industry has to be put in a viable position in terms of a more balanced portfolio so that when interest rates go up their interest income would also go up, and they could pay the rates to savers which are necessary to hold the savings funds and avoid this "disintermediation" which hit so hard in 1966. I called upon the savings and loan leadership to appoint a blue ribbon task force to work with us in the administration—and I have discussed this with Dr. McCracken—and to work with all other groups in an effort to make the thrift industry truly viable and more competitive vis-a-vis commercial banks. This is bound in the long run to help realize those housing goals which you referred to earlier.

Senator SPARKMAN. Thank you very much. My time is up.

Thank you, Mr. Chairman.

Chairman PATMAN. Senator Jordan?

Senator JORDAN. Thank you very much, Mr. Chairman.

One question I wanted to ask the Secretary, but he is not here, so I am going to ask it of either of you gentlemen.

I am curious to know why two sentences were stricken from page 4 of Mr. Kennedy's prepared statement, one of which says:

"In the financial area it will not be necessary to ask Congress for immediate action on the debt limit."

And you answered that, I think, in response to a question of Senator Sparkman.

Mr. WALKER. The answer is that Mr. Volcker in his statement was going to refer to some of those points that the Secretary initially had in his statement. But Mr. Volcker did not get to present his statement.

Mr. VOLCKER. I do not want to imply that the debt-ceiling decision has been made at this point. This is something we are looking at very intently at the moment, as we must, in view of the problems that lie ahead in terms of Senator Miller's concerns as well as the immediate problem.

Senator JORDAN. And the other sentence stricken from the Secretary's statement was "We also will be asking for congressional reconsideration of the 4½-percent interest rate ceiling on long-term Treasury issues * * *."

Do you want to address yourself to that?

Mr. VOLCKER. That sentence virtually duplicates a sentence which is in my prepared statement and is not stricken. I am sure you are well aware that with the current 4¼-percent ceiling for Treasury bonds, as a practical matter, it is impossible for the Treasury to issue any securities with a maturity of more than 7 years. This does pose some severe limitations on the flexibility with which we can conduct debt management operations during this very difficult period, and, certainly, on balance, it hampers the kind of job that we would like to do in terms of supporting the general effort to control inflation. We feel that this has become a problem of more critical importance through the passage of time and the very steady and severe decline in the average maturity of the debt.

At the time I left the Treasury in 1965, for instance, the average maturity of the privately held debt was about five and a half years. It has now slipped, as of the end of January, to something like 4 years, which is some indication of the increasing size and frequency of the refunding that has to be done to keep this very large amount of debt outstanding. The net result when the Treasury is in the market so frequently for such large amounts is to create some very real difficulties for the Federal Reserve in the conduct of their policies. It does also, as I indicated, hamper our own flexibility in conducting appropriate anti-inflationary policies in this situation. It is an area in which we have a great deal of concern. And we do have under consideration just what approach might be made to the Congress in this area.

Senator JORDAN. Not only that, but it puts the Federal Government competing with the State and local governments and the private sector for what money is available for loan purposes, does it not?

Mr. VOLCKER. There are very difficult problems in this area. The fact of the matter is that the securities markets in all areas are under very heavy pressure. I think this is basically a reflection of inflationary pressures in the economy generally. This has led to a very large demand for credit, and has led, too, on the other side, to a relative unwillingness on the part of the investor to put his money in fixed-income securities. I think the only real answer to that problem in the end is to restore balance to the economy and regain control over this inflation so that we have a more balanced picture in the financial markets and set the stage for the kind of decline in interest rates and easy availability of credit that we would all like to see.

Senator SPARKMAN. Will the Senator yield for just a suggestion?

Senator JORDAN. I yield.

Senator SPARKMAN. I wonder if it might be well to ask Mr. Volcker something about the interest rates on savings bonds. That is the only kind that the little fellow can participate in.

Senator JORDAN. I am coming to that.

Senator SPARKMAN. I thank you, Senator Jordan.

Senator JORDAN. You pretty well stated my point.

What incentive is there for this patriotic little fellow to buy savings bonds from the Federal Government at the rate that is available to him when the rate of interest he earns is less than the rate of inflation?

Mr. VOLCKER. We are anticipating each other.

Let me just read a paragraph that I did have in my prepared statement on this very point:

I would also note, in this connection—in connection with the interest rate ceiilng—that our savings bonds—sold to millions of individuals in relative small amounts—are subject to a 4¼ percent ceiling. The savings bonds program has been a part of the Treasury's debt management effort since before World War II. In some ways, the value of this program is greatest precisely in an inflationary period like the present. Yet, we are all conscious that these same inflationary pressures that have so profoundly permeated other sectors of the credit market have, for the time being, reduced the relative attractiveness of savings bonds. This is also a matter that we will be reviewing urgently in coming weeks.

We are very conscious of this problem, Senator.

Senator JORDAN. I have some questions for you, Mr. Walker.

I notice that you say that you intend to bring the whole tax system, State and local as well as Federal, under a careful and searching examination. Under what authority do you propose to study State and local taxation?

Mr. WALKER. That should be clarified, sir. As you well know, there are various proposals with respect to State and local revenue sharing with the Federal Government, as well as proposals for tax credits at the Federal level for income taxes paid to the States. We are not saying here that we are about to tell State and local governments what to do. But in order to reach decisions and make recommendations to the Congress as to the Federal tax structure, we must approach it as an integral whole.

Senator JORDAN. The State and local governments say that their sources of taxes have just about reached the point beyond which there is any more yield to be derived, and they intend to look to the Federal Government for tax sharing or perhaps vacating some areas of taxation to the States.

I hope you know that you will get into that.

Is that what you have in mind?

Mr. WALKER. Without endorsing any specific plan at this time that might have been advanced in this area, I think I can tell you that this administration is quite sympathetic to the problems which you so rightfully describe with respect to State and local taxation sources.

Senator JORDAN. On another point, among your studies will be the expiration of the role of value-added taxes used by a number of Western European countries. I have always felt that some countries used this device to operate against us in our balance of payments. Do you concur in that? And, if so, would you have any idea that you might recommend a value-added tax for this country?

Mr. WALKER. I will ask Mr. Volcker to comment on the balance-of-payments implications.

I am not at all sure that we can say that this is the whole purpose of the value-added tax in Western Europe. I will say that the value-added tax has important implications and perhaps great value for domestic purposes. And it has been recommended by certain responsible groups in this country as an appropriate approach to taxation in a major restructuring of the U.S. tax system.

This is a very, very complicated and difficult matter and, again, I do not want to prejudge. From a long-range standpoint, we think that this issue must be studied. And one aspect of it, of course, is the international implications which I will ask Mr. Volcker to comment on.

Mr. VOLCKER. This is a complex and contentious matter. But I personally share the feeling of a great many people that the way the value-added tax system operates in relation to the system of border tax adjustments used in Western Europe is such that the net result is to the disadvantage of our own trade position. This is an area in which we have a very considerable interest, whether or not the solution lies in a value-added tax in the United States, which is obviously dependent upon a great host of considerations apart from the balance-of-payments consideration.

We have the whole border tax question under intensive study. And there are various directions this could take.

This is something that we want to be discussing, I am sure, rather intensely, with some of our friends in Europe over the months ahead.

Senator JORDAN. I hope you do it, because I think at least an investigation of value-added taxation has real merit.

My time is up.

Chairman PATMAN. Dr. Walker, in the absence of the Secretary—you are Under Secretary; that is, you are next to the Secretary of the Treasury.

The Treasury Department, of course, markets the Government securities and it must be vitally concerned with the day-to-day operation of the monetary policy. Your Office has specific authority and responsibility in the area of monetary policy. It is your responsibility to develop a program to bring down the current high level of interest rates.

I call your attention to section 10, paragraph 6, of the Federal Reserve Act, 12 U.S.C. 246, which provides that—now, remember, Dr. Walker, that this is the law right now:

> Wherever any power vested by this Act in the Board of Governors of the Federal Reserve System or the Federal Reserve Agent appears to be in conflict with the powers of the Secretary of the Treasury, such powers shall be exercised subject to the supervision and control of the Secretary.

Is that your understanding of the law?

Mr. WALKER. It may be my understanding of that particular section, but I certainly would not interpret that, in view of my knowledge of the history and the record, as authorizing the Secretary of the Treasury to order the Federal Reserve Board to take certain steps in credit policy. Quite clearly, the Federal Reserve is a creature of Congress, and if those steps were to be desirable under the approach to central banking that has been followed in this country, then there should be congressional action, not executive action—in other words, through due action of the Banking and Currency Committees and the Congress of the United States.

Chairman PATMAN. It is my opinion—and I am sure you will agree with this point—that the Federal Reserve is exercising a lot of powers that are not specifically given to the Federal Reserve under the act. Don't you agree with that?

Mr. WALKER. No, sir, I do not think I agree with that. But if you want to bring up specifics, in terms of where you think the Secretary of the Treasury should attempt to prevent the Federal Reserve from exercising power and undertaking actions which they are performing illegally, I will discuss them one by one.

Chairman PATMAN. Very plainly and to the point, when the Federal Reserve fixes interest rates, that is, the rates that they are allowed to fix, at a rate that is against the public interest and the general welfare and detrimental to the public, the Secretary of the Treasury, under this provision I believe, has a right to take issue and decide that it will not be done.

Mr. WALKER. Mr. Chairman, although there will be differences of views with respect to what factors determine interest rates, the great preponderance of opinion among professional economists at the present time is that market factors are the prime determinants of interest rates, not whether the Federal Reserve tends to set a given discount rate level. The Federal Reserve obviously has an important direct effect with respect to the handling of open market operations, discount policy, and reserve requirements, but recent experience has contributed to the building up of opinions, to the effect that if the Fed attempts to use these instruments to get interest rates down below what the market forces would dictate in an overheated economy—and this has happened once or twice in the last few years—that the resulting upsurge in business activity and inflationary expectations actually results in higher rates than you would have had if they had not tried to bring the interest rates down by inflating the economy.

Chairman PATMAN. Now, may I answer that, Dr. Walker?

Mr. WALKER. Certainly.

Chairman PATMAN. I take issue with you that the market practice determines interest rates. I take issue with you that interest rates are determined by competitive market. When the national debt is huge and high, like it has been for a number of years, it gives a wonderful opportunity for the Federal Reserve, with the support and with the direction of the Secretary of the Treasury, to keep interest rates low on Government securities with the knowledge that the Government rate that is fixed on long-term Government securities will go clear across the board, because they dominate the market.

I have interrogated a lot of great men, in addition to yourself, on this subject——

Mr. WALKER. Thank you.

Chairman PATMAN. Like Mr. Eccles, who was Chairman of the Board for a long time, and also like many presidents of the bank, and also Mr. Martin, and I have never known any of them say that there is actually a competitive market in interest rates that fixes the interest rates when the national debt is large.

Now, they will almost say it, when you call their hand and ask: "Do you think that the competitive market fixes the rate on Government bonds?" They cannot honestly and truthfully say it, because the Federal Reserve has got a lot of special dealers around that have to do with this, and, of course, they control the dealers. And the open-market committee only deals with these dealers. That is correct, is it not?

Mr. WALKER. That is true, but the dealers are intermediaries for many thousands of holders of Government securities.

Chairman PATMAN. So, they fix the interest rates. They could have the interest rate on housing today at 4 percent or 4¼ if they wanted to.

Mr. WALKER. The dealers or the Federal Reserve sets them?

Chairman PATMAN. No, the Federal Reserve would fix those rates if they wanted to work in the public interest, like the Federal Reserve Board did for 14 years, from 1939 to 1953, when the Federal interest rate on Government bonds was fixed at not more than 2½ percent when the national debt was high. All during those 14 years, when we were in danger of depression, deflation, and inflation all the time, their rates were kept, always, under 2½ percent. Even after the Eisenhower administration came in, the first issue of bonds was 2⅜ percent long term; the next issue was at 2½, and then the Secretary of the Treasury, Mr. Humphrey, just arbitrarily asked for bids on bonds—I mean, asked for tenders on bonds—of 3 percent for the purpose of arbitrarily—without being required to—start the increased interest rates in this country. And in May it got so bad that year that they had to back up and start over again, because of a depression.

Between the two, I would rather flirt with an inflationary period than a deflationary period—that is, a depression—for the reason that there are known, provable ways of stopping inflation. You know what they are. It can be done. But there is no known, provable way of stopping a depression when it starts. Therefore, you are in great danger when you are flirting with a depression, and you are flirting with a depression today, because you will not exercise your power over interest rates.

Mr. WALKER. Mr. Chairman, we are both from the State of Texas. We have, over the years, discussed this issue many times, when I was Assistant to Secretary of the Treasury Anderson—another Texan. I enjoyed the exchanges, because I always learned something from them. I am especially pleased that you categorized me as among the "great men" that you have discussed this issue with, but I think you are overly flattering.

Chairman PATMAN. I am talking about reputation.

Mr. WALKER. Very good.

My substantive response to your points about the interest rate stability between 1939 and 1953 is this: I think you have got to realize that during that same period there was a very significant inflation and at the same time a decline in the value of a dollar. Now, obviously, a great deal of this was necessary and a result of World War II. But that should not obscure the fundamental economic force at work—which was the creation of money through monetary policy supporting the prices of these bonds. That is the only way to do it in the shortrun. But people learn.

In the situation today, this economic analysis I mentioned a few moments ago clearly leads toward the conclusion that any attempt to stabilize interest rates at levels lower than real economic factors justify is likely to be self-defeating and at the same time result in a significant amonut of price inflation exactly like we have had. Ultimately, if history teaches us anything, this leads to the very depression which you and I and this administration are determined to avoid.

Chairman PATMAN. My time has expired.

Mr. Widnall?

Representative WIDNALL. Thank you, Mr. Chairman.

Mr. Walker, the Secretary's statement spoke about "the balance of payments continues to be a cause for concern. A small surplus was recorded last year on the equity basis of calculation. But this statistical improvement reflects a massive inflow of foreign capital—both private and official."

How large an increase was there in total? Can you tell me that, Mr. Volcker?

Mr. VOLCKER. The figure that I recall offhand for the private inflow of capital was in the neighborhood of five and a half billion, which is an exceptional figure for the United States. There were two big components in this inflow. One was a very large inflow of funds, running up toward $2 billion, into American stocks. The other big component, also roughly $2 billion, was made up of bond offerings, either straight bond offerings or convertible bond offerings, by American companies who were financing their overseas investments through borrowings. These borrowings were primarily in dollar market, but either in the Eurodollar market or other markets abroad.

Representative WIDNALL. To what extent was that true?

You said it was largely made up of what type of funds? How large an amount?

Mr. VOLCKER. There are about $2 billion of issues that are identifiable for the latter purpose, American companies financing their operations abroad. This is, in good part, a response to the foreign direct investment program of the Department of Commerce, although, as it turned out, the relative market conditions in the United States and in the European market last year meant that this large volume of financing could be done in Europe at rates and on terms not all that much more costly than might have been done by the same company in the United States. There has been a major shift in relative conditions of the American market and the European market in this respect. Apart from the direct impetus of the Commerce program which certainly was the stimulus for this large amount of bond offerings in Europe, the basic market conditions themselves were more favorable toward this increased amount of foreign borrowing by large American companies.

Representative WIDNALL. How large was the official flow?

Mr. VOLCKER. The official flow referred to was made up by a variety of instruments held by foreign central banks or Governments—so-called, "Roosa" bonds, agency issues of various types, longer-term time deposits—which, in total, approximated something like $2½ billion last year. A portion of those transactions were directly related to the continuing military offset programs that we negotiate with our allies. They undertake on their part to offset at least a portion of the balance of payments' cost of our military expenditures through various kinds of neutralization procedures, some if which involve an inflow of foreign official capital to this country.

Representative WIDNALL. A lot of that inflow is attracted by the interest rates.

Mr. VOLCKER. There is no question that tight money in the United States has attracted a great deal of money to this country in recent months and the last year.

Representative WIDNALL. If that condition should change abruptly, how much of a problem would be posed almost overnight by a rapid outflow?

Mr. VOLCKER. Well, there is no question that the balance of payments position in general has been supported by the tightness of money in this country, and a change in that situation could well lead to a change in the volume of these capital flows. It is awfully hard to make any estimate, and I will not try, as to what the response might be under different conditions, because so much then depends, too, on what happens in European markets or other foreign markets at the same time. A lot of the money attracted here by the tightness of credit is short term funds initially lodged in the Eurodollar market. American banks are large buyers of that money now. But even if conditions eased in the United States, they would probably ease in the Eurodollar market as well. These funds would still be available for use somewhere, and I do not think it follows that the American banks lose all interest in this market with some easing of money in the United States, when that easing is paralleled by an easing of money in Europe.

But I think you have certainly put your finger on a potential problem, and it is related in a more general way to the fact that while we did have a surplus last year—and that is welcome—the structure of our balance of payments is not in a condition in which we would like to see it. The trade balance has declined. We have had to rely much more heavily on capital inflow, and I think we will be in a much more satisfactory long-term position when we begin building the trade balance back to at least its normal historical level than when we rely heavily in this kind of capital inflow. But I do not want to imply that all this capital inflow is temporary and transitory. We think there are some real factors behind it as well.

Representative WIDNALL. Are these investments pretty well divided, or do they reflect that one or two major central banks make the investments, or one or two private groups?

Mr. VOLCKER. I think they are very widely diversified in both the private and official areas, except to the extent of the military offset operations that were referred to earlier. The offsets naturally, are concentrated in those countries where we have some heavy military expenditures abroad.

But, in general, certainly the inflow of funds into stock market, as nearly as one can tell, comes from a wide variety of sources, mainly in Europe, but from a number of European countries.

Representative WIDNALL. To get back to the 4¼-percent interest rate being received on Government bonds, does the Treasury advocate changing the definition of Government bonds to include instruments up to 10 years?

Mr. VOLCKER. We have not reached a conclusion on that point, Mr. Widnall. I think the logic of the situation suggests that the ceiling under present conditions be removed but whether that is the best approach or not we just have not decided upon.

Representative WIDNALL. There is a choice of doing away with the ceiling altogether?

Mr. VOLCKER. I think that is the general logic of the situation, but I am not able to say whether we would propose that as the approach in this specific situation at this point or not.

Representative WIDNALL. There has been some discussion about doing away with the tax-free aspects of municipal bonds. Some have argued very seriously that this would impair local financing. Those favoring the elimination of the tax-free advantage have said that a program of federally supported loans as in the proposed Urban Development Bank would permit cities to obtain funds at a lower cost, since the municipals are now being floated at increasingly higher interest rates to attract buyers. Has the Treasury taken any position on abolishing tax-free bonds?

Mr. WALKER. No, sir, we have not. This is an issue that is under intensive study.

I will mention one or two of the situations that come into the picture.

It is quite clear that this is a highly prized and highly valued indirect subsidy that the State and local governments enjoy. And there are also, as you know, constitutional questions, and things of that type.

Representative WIDNALL. May I interrupt you?

Mr. WALKER. Yes.

Representative WIDNALL. And a considerable tax saving for a lot of people.

Mr. WALKER. That is correct, too. There are buyers and sellers, and all sorts of interests and all sorts of people involved here.

Now, I think the great preponderance of professional opinion is that the Federal Government loses more in taxes than the State and local governments get back through the tax-free subsidy. This is a very difficult thing to lay out in lay terms. But basically, it results from the fact that more and more State and local bonds are being issued. The tax brackets were reduced in 1964 although somewhat raised with the surcharge, and with the combination of an increase in volume, and fewer individuals who are interested in getting the tax exemption, you are tending more and more toward a saturation of the market.

Under the economic analysis, when you sell a block of bonds as an underwriter, you have to price those at a sufficiently high level in terms of interest rate, or low level in terms of price, to sell all of those bonds. This means you have got to make them attractive enough to pull in that last marginal buyer that the economists talk about.

Now, in this process it would be quite clear that if you had an alternative such as the Urban Development Bank that was proposed by the last administration and which we are studying at the present time—it is quite clear that there would be a theoretical possibility of the Federal Government or the Urban Development Bank borrowing through taxable issues and loaning funds to the State government at lower rates than they could have obtained through nontaxable issues.

But there is a great question as to whether you would want to substitute that approach for the tax exempt approach.

What has been discussed are alternatives to permit municipalities to take either approach, tax exemption if they like that, or the Urban Development Bank approach.

The question, as you well know, is not entirely an economic question. You get into major considerations with respect to the points that Senator Jordan raised as to relationships between State and local governments. Perhaps, Mr. Volcker in his—incidentally, you spoke of him as No. 2. We look upon ourselves as equal; at least we get paid the same amount of money and we work, more or less, the same amount of hours in the Treasury Department.

Mr. Volcker, both as an economist and in his responsibility as to debt management, might want to enlarge upon this point.

Mr. VOLCKER. I think you have covered it all.

Representative WIDNALL. Thank you.

My time is up.

Chairman PATMAN. Senator Proxmire?

Senator PROXMIRE. I want to congratulate you on that last answer, which is very helpful.

By giving the municipality an option, you would save money for the Treasury and for the municipality?

Our calculation is that it would mean a billion dollars in reduced cost to the municipality. But we could be wrong.

Nevertheless, I am very happy to hear your response, because it shows you thoroughly understand this.

Mr. WALKER. We are studying your bill very carefully, but I do not want to give the impression to all of our taxpayers and the Governors all over the country that we are going to come in with a recommendation. We are completely openminded.

Senator PROXMIRE. This bill would have to depend upon the support of the mayors, and so forth, around the country?

Chairman PATMAN. I hope you do not ignore my bill on that subject, too.

Mr. WALKER. You can bet your boots on that, Mr. Chairman—we will study all the bills.

Senator PROXMIRE. Gentlemen, I want to congratulate you, too. I must say that, generally, in these 3 days that we have had so far, I am disappointed that the officials of the Nixon administration have taken the President's inaugural warning to the country to heart the way they have. He cautioned them to speak in a low voice, and they have spoken in such low voices that sometimes we can't hear them. They are not all specific; they generalize. They say, "We do not know yet." "We may." "There is a possibility." There is a tendency not to answer in specific terms.

I understand your dilemma, but I do hope you can give me some answers on this. What I am concerned about is what we are going to do about, what Mr. Kennedy's predecessor, Joe Barr, said is a "taxpayers' revolt" in this country. He had reference in part to not only the heavy burden of taxes, but also to the loopholes in the tax laws, and the fact that a score of taxpayers with incomes over a million dollars last year paid no taxes; and the fact that well over a hundred with incomes over $200,000 paid no taxes. I wish you would write me, Mr. Walker, without giving the names, how the 155 taxpayers with very high income escaped taxes. I understand the Treasury did this in 1963 for a number of taxpayers without giving the names. The key items then were capital gains, oil, unlimited charitable deductions. But if you can make that available in the next few weeks, I would very much appreciate it.

Mr. WALKER. I think you should add to that list real estate depreciation.

Senator PROXMIRE. Yes. This is just suggestive; it is not all.

Mr. WALKER. Could I make a couple of comments?

Senator PROXMIRE. Yes; I wish you would.

Mr. WALKER. We regret that we cannot come forward with a broad array of policy recommendations at the present time. Just give us time to get organized, and I assure you that there will be many recommendations.

I think the press pointed out yesterday that one of the Republican leaders at the White House pointed out that there probably would be three Presidential messages this week. And there will be more in the future; there is no question about it. We are working in the area you referred to earlier with respect to the one-bank holding company problem, and we are close to having an administration bill on that particular issue.

Secondly, I do not think that there is a taxpayers' revolt, certainly not.

Senator PROXMIRE. You should have been with me in Wisconsin for the last 10 weeks; you might have had a different view.

Mr. WALKER. I know the problem; I know the mail that is being received on the Hill, and I know the mail that has been received in the Treasury Department. Mr. Barr said, I think, "We face now the possibility of a taxpayer revolt." And I share with all those millions of Americans who do pay a relatively large share of their income in taxes, as I have over the years, a repugnance toward that part of a system which does not provide for complete equity, and that repugnance is shared by the Secretary of the Treasury and the President of the United States.

Now, I hope that the people of the United States, instead of revolting in a manner that impairs this unique income tax system, with voluntary reporting, that we have in this country, will revolt in a much more effective way, and that is by making clear to the Members of Congress and the tax-writing committees that they insist upon measures to bring about an equitable tax system at the earliest possible date. And I assure you that the Treasury Department will come forth with positive recommendations in that area.

Senator PROXMIRE. Let me just suggest a few. First, as I understand it, the unlimited charitable deductions require the taxpayer to give away up to 90 percent of his taxable income in 8 out of 10 years. The gimmick here is that their taxable income is small, because people with investments, with capital gains and so forth, are in a position where much of their income is not taxable. Therefore, they are in a position where they can escape from taxation, or at least limit that taxation very, very greatly.

I understand that there is a recommendation that this be eliminated over a period of 10 years. There is a staff recommendation. The Treasury has taken no position on it. Do you feel that this is something that you can give your support to?

Mr. WALKER. Not at the present time. We have to look at all areas, and we have got to ask ourselves the question first, in approaching these various areas: Is the preference which was originally given—and I use the word "preference" instead of loophole—is the preference that was originally given, presumably for a given purpose, operative or significant in 1969 and the 1970's? I think it would be a mistake—and I am not talking too much about the charitable deductions; I am talking more about certain other areas here—it would be a mistake not to approach these areas directly and look at the preference itself rather than to say, initially, you are going around through the back door with some other approach.

Senator PROXMIRE. Let me ask you about two loopholes that the banks have: One is that a bank sells some of its securities, and there is a capital gain, and the maximum tax is 25 percent. But if it has a loss, it is treated as an ordinary loss. This is information I get from the staff of the Joint Internal Revenue Taxation Committee.

The other is the fact that banks are permitted to deduct two and a half per cent of their debt as a bad debt reserve——

Mr. WALKER. 2.4.

Senator PROXMIRE. Although the loss average is less than 2.4.

Why should the banks be given these two special tax advantages?

Mr. WALKER. You are referring to the banks with the 2.4 and not the savings and loans with 6 percent.

Mr. PROXMIRE. That is right.

Mr. WALKER. Take the second one first. The history of the commercial bank bad debt reserve grew out of the depression, when losses sustained by commercial banks were many times the 2.4—even based on just the banks that survived, the only reliable figures—and that does not take into consideration the thousands of banks that succumbed in which you had very large losses.

However, before any of us came to the Treasury the approach taken for taxation of commercial banks in this area recognized—and there was quite a bit of opinion to this effect at the end of World War II—that we might continue to have recessions and depressions and big losses such as we had in the 1930's. So, the procedure that was followed was to permit commercial banks, since they are in the business of dealing and operating in debts, to set aside a tax-free accretion to bad debt reserves each year in order to gird themselves for the sort of loan losses they could expect if their economy should——

Senator PROXMIRE. That is the historical. Why is it justified now? I understand the history of it, but why is it justified in 1969?

Mr. WALKER. I am not saying it is justified now. I am saying that this is on the agenda of the House Ways and Means Committee to be studied, and it is also on our agenda.

I thought you asked me to explain why it is in existence.

Senator PROXMIRE. You were the chief executive officer of the American Bankers Association, and I know you are very expert in this area, and I just wanted to know whether or not you now felt, as of now, 1969, there was any real justification for that 2.4 percent.

Mr. WALKER. I think the development of the percentage bears very significantly on whether that is or is not a justifiable percentage, and I am trying to explain how it came into existence.

Senator PROXMIRE. Now, how about the proposal that Senator Kennedy made shortly before he was assassinated, and since then a number of people have supported it, that at least 20 percent of a person's income over a certain level, fairly high level should be paid in taxes, that we should have a system of providing—I think he suggested 20 percent, and some have even suggested as high as 50 percent for those with very high incomes. In other words, just a blanket provision for taxation, so that nobody is in a position of having a big income and paying *no* taxes.

Mr. WALKER. That would get at certain people that have the tax-exempt securities and the charitable deduction approach, perhaps, and it certainly should be considered. At the same time it does not get into the area of such things as percentage depletion and rapid depreciation of apartment houses where they do not have the net income.

This is a tricky area, when you start thinking about it.

Senator PROXMIRE. I am glad to get that modification of it, but I think we should plug them where we can and find ways of perhaps bringing others in.

Let me ask you this: You say in your statement that you would like to provide tax incentives as a way of getting a private industry more active in our cities and for the disadvantaged. I think it is a very fine statement, but how would you feel about providing in the budget what Secretary Barr suggested, that is, having the cost of all of the tax concessions we have, including investment credit, and so forth, listed along with our expenditures so that we have some notion of how we are proceeding?

After all, from the viewpoint of the Congress, a tax concession is just as costly, from the viewpoint of balancing the budget, as expenditures are. And, by and large, they go to those with big incomes, and then trickle down.

Mr. WALKER. I think figures to indicate this sort of thing would be very, very useful, indeed. And you can bet your boots that when and if we go up to the taxwriting committees with these proposals, we are going to have to show what the initial revenue costs will be.

Senator PROXMIRE. It is a matter of submitting regular budgetary reports to the Congress, not just answering questions when you are asked, but so the country and the Congress would know what a burden those are.

Mr. WALKER. I want to point out that there is a substantial body of opinion that believes that some tax credits stimulate economic growth and, therefore, national income and corporate profits and bring back new revenue to the Treasury. Thus a tax credit may not in the long run cost any revenue but quite the contrary.

Senator PROXMIRE. You can say that about a lot of appropriations. I can say that about manpower training appropriations, that in the long run, in the short run in fact, it is a marvelous investment. They bring back returns many times.

But I think, to go from that to the notion that therefore it should not be reported——

Mr. WALKER. I did not mean to imply that at all. But I think Congress has got to look at the other side of the coin, if it is a productive credit or a productive subsidy, that you can't just look at the costs in 1969. You must also consider future benefits.

Senator PROXMIRE. I do not think you should necessarily eliminate these things. I think most of them are highly justified.

Mr. WALKER. I think Congress should have figures to the extent that they can be developed along these lines.

Senator PROXMIRE. My time is up, Mr. Chairman.

Chairman PATMAN. Senator Miller?

Senator MILLER. I would like to refer to this point of tax exemption on municipal bonds, Mr. Walker.

I agree that there are many taxpayers who are very concerned about reading in the newspapers that people with a lot of money invested and a substantial net income did not have to pay any taxes. I am also concerned about the ability of the local governments to finance their operations. Now, there are extremes. I think we are in one right now, where there is complete tax exemption. The other extreme is to do away with the tax exemption. I would hope that the Treasury would come out with a recommendation somewhere in the middle ground. One suggestion is that if a person shows $150,000 of taxable income on his income tax return and $100,000 of nontaxable income, he would have to pay tax on $50,000 because it exceeds by $50,000 the amount of the taxable income. Another possibility would be to use the percentage approach, say, 25 percent or 20 percent of the taxable income would be the amount that would be tax free, and the amount above that would be subject to tax. And, then, of course, there is the variation of a reduced tax rate on the amount of—I am sure you are aware of the various types of approaches to this problem, but I just wanted to let you know that I do hope that you use the middle ground approach rather than an extreme approach, and I hope you will come up with a recommendation, because this is an area of great frustration on the part of the taxpayers I have talked to.

Mr. WALKER. We will examine all avenues.

I want to reemphasize also that it is an area of great complexity. And if you had several "tax shelters," without identifying any that exist, to remove tax shelter A without doing something about tax shelter B will simply send that money and income into tax shelter B. That must be considered in all these cases.

Senator MILLER. The beauty of the approach that I have suggested to you is that it does not make any difference which tax shelter the income comes from, if it exceeds 20 percent of the taxable income, it is going to be caught; if it exceeds the amount of the taxable income, it is going to be caught regardless of what kind of a tax shelter it comes from.

Mr. WALKER. But some tax shelters show no taxable income. For example, apartment building depreciation, if that is a tax shelter—and I am not saying so—may not show any.

Senator MILLER. But it may ultimately be that depreciation turns out to be capital gains subject only to the 25 percent rates. So, you have got an area of nontaxable income here.

Mr. WALKER. You raise a good point, but the fact remains that many of these people pay no income taxes today.

Senator MILLER. I would hope to find an approach that would be as simple and understandable to the general public as possible.

I would like to ask Mr. Volcker this question:

And if this has been covered, please tell me.

Last year, on the in-flow of funds, we had, of course, as you pointed out, a substantial investment by overseas investors in the American securities market. Can you tell me how much of the in-flow of funds was attributable to acceleration of payments by other countries on contracts here in the United States?

Mr. VOLCKER. I can't give you that figure offhand.

Senator MILLER. Was it significant?

Mr. VOLCKER. I do not believe so, last year. There has been some of this in the past in connection with military payments in particular. I would have to look at the particular record for last year, before I could answer that question. I would be glad to do that for the record.

Senator MILLER. I wish you would. I remember that it was not very long ago when West Germany, for example, accelerated its payments on contracts for military equipment, and this had a palliative effect; it was certainly just a borrowing type of proposition.

Mr. VOLCKER. That is right. I would have to look it up.

Senator MILLER. What other types of borrowing mechanisms were used that showed up this last year in the form of an in-flow of funds?

Mr. VOLCKER. You are thinking of the official transactions?

Senator MILLER. Yes.

Mr. VOLCKER. I do not have the figures in front of me. There were sales of medium term securities denominated either in dollars or foreign currencies to foreign central banks upon a number of occasions either in——

Senator MILLER. Do you know how much that amounted to?

Mr. VOLCKER. I do not have any of these——

Senator MILLER. Could you furnish that?

Mr. VOLCKER. I certainly could, for the record. I could give you all of this for the record. There was some substantial volume of medium term deposits in American banks. There were special debt transactions that directly related to military offset.

Senator MILLER. Perhaps, I can shorten this by asking you if you would be good enough—if it is all right with the Chairman—to furnish for the record an isolated list of the amounts of these special transactions?

Chairman PATMAN. Without objection, it is so ordered.

You can prepare them for insertion at the time that you examine your transcript, if you will.

Mr. VOLCKER. I do find, Mr. Chairman, that these were published in the balance-of-payments release that was issued the other day. And I guess I do have some of these figures in front of me.

Chairman PATMAN. I assume Senator Miller wants them in this transcript here.

Senator MILLER. Yes.

Mr. VOLCKER. I can either read them off or supply them for the record.

Chairman PATMAN. Just insert them when you read the transcript.

Mr. VOLCKER. I will do that.

(The information subsequently filed follows:)

Net "special" financial transactions in the U.S. balance of payments, 1968

	Millions
Net sales of time deposits or certificates of deposits with an original maturity of 1 year or more	$594
Net sales of nonmarketable Government securities payable prior to maturity only under special conditions—	
To Canada	1,050
To others	960
Net sales of U.S. Government agency bonds to international and regional organizations	116
Nonscheduled repayments of U.S. Government credits	270
Special deposits in U.S. Treasury accounts	92
Other special financial transactions of Canada	—121
Transactions of the United Kingdom	—137
Total	2,824

Senator MILLER. One last question, Mr. Walker:

Yesterday, Mr. Mayo testified:

> If * * * the tax surcharge is not extended by early April, receipts from corporation income taxes will be less than estimated because quarterly payments that would be due on April 15 would not reflect the extended surcharge.

The question is whether or not the administration has any plans to make its position on this 10 percent known early enough so that the Congress could legislate to avoid that problem?

Mr. WALKER. It is highly doubtful that that timetable could be reached, given the budget review situation that is underway right now. For the revenue estimates we will want to look at the tax receipts in March or April, and we want to take a very close look at the economy and the extent of the inflationary pressures, and, of course, also the situation in Vietnam. All of these factors have to enter into the decision. It would be very difficult to move the timetable up as much as you indicate, even though highly desirable.

Senator MILLER. You do not think that you will be able to reach a decision on that 10 percent in time?

Mr. WALKER. It would be very difficult.

Senator MILLER. To avoid the problem of corporate quarterly receipts having to be postponed?

Mr. WALKER. It would be very difficult, sir.

Senator MILLER. Thank you.

No further questions.

Chairman PATMAN. Mr. Reuss?

Representative REUSS. Thank you, Mr. Chairman.

Mr. Volcker, in your paper you set forth two areas of the economy which are under acute pressure for long-term capital, and I read:

"The relative shortage and high cost of residential mortgage money, the sharp increases in interest expense for our State and local governments."

If Congress grants the Treasury's proposed request to issue long-term securities, longer than the 7-year practical limit now in the law, obviously, every billion dollars worth you issue is going to add a billion dollars worth of troubles to the credit market for homeowners, and State and local governments.

Would you spell precisely what this convenience of the Federal Reserve and convenience of the Treasury argument is which you apparently think supervenes the very obvious interest in not making the life of the homebuilder and the life of the local government trying to build a school any more difficult?

You just referred to difficulties, problems, and so on.

Well, before Congress votes to strike at the solar plexus of the housing industry and the local governments, we want to know a little more about it.

Mr. VOLCKER. Let me just make a couple of points about your premise, Mr. Reuss, if I may, before trying to answer the other part of the question.

I do not think this is a one-way street at all in terms of the maturity of the debt that is offered. Some of the most pronounced problems for homebuilding—and I am thinking particularly of the 1966 experience—were related to the problem of disintermediation. Certainly in some market circumstances this can be aggravated, I think, more by the Treasury piling excessive debt into the very short-term area than by a more orderly and longer term financing program, simply on the basis that people drawing money out of the savings institutions that may tend to buy mortgages may be more enticed by a very high rate on the short-term security than they may be enticed by taking the market risks that are involved in tying up their money for a long period of time. And you can, in fact, get market conditions to extend now when the short-term rates are higher than the long-term rates. The Treasury, by feeding that kind of rate situation, may turn out to aggravate the problems of the mortgage market in particular more than if they spaced out their financing over a period of time. This is particularly true with Treasury bonds in good part appealing to a somewhat different set of lenders than the lenders that are particularly heavy in the mortgage market.

I would also make one other point in this connection. I do not think the Treasury has any intention of going out and issuing a tremendous amount of long-term bonds without regard to its effect on the sectors of the economy that may already in some sense be under more relative pressure than other areas.

Representative REUSS. The less tremendous the amounts, the less the impact on these problems. What are they?

Mr. VOLCKER. I think there are, essentially, two problems here, Mr. Reuss. I will take them up in the reverse order that I mentioned in my statement.

The one is that the heavy schedule of Treasury borrowing operations, and perhaps most particularly the very large Treasury refunding operations that have been necessary in recent years to keep this short-term debt rolled over, means that the Treasury is in the market quite frequently, at least each quarter and sometimes oftener. If, during this period, the Federal Reserve finds that they need to take some action, it is circumscribed to some extent in terms of not being able to take action that might upset the whole structure of credit markets during the period of a Treasury offering of billions of dollars worth of securities, when those securities are hanging out, so to speak, in the market waiting for buyers.

Representative REUSS. I had thought that the Fed had emancipated itself from the Treasury in the historic and highly publicized accord of 1951. It turns out they are still chained to the old workbench?

Mr. VOLCKER. I think they have emancipated themselves, if that is the right word, from any direct support of Treasury financing, and I think that is entirely appropriate. They cannot emancipate themselves from the responsibility for maintaining viable money and credit markets in general. There is always a problem during these offerings The very mass of Treasury operations in the market is such that you could get adverse repercussions not only with respect to the success of that particular Treasury financing but spreading out and rippling through the credit market as a whole. You would create in the end the kind of disorderly conditions in the markets—the kind of discontinuity in markets—that would affect the prospects for all kinds of borrowers, including specifically State and local government borrowers and mortgage borrowers, if Treasury financing is not handled in a reasonably orderly manner.

Also they do, as part of their own responsibility, quite properly I think, feel some responsibility for maintaining not easy conditions but more or less steady conditions—on an "even keel"—during the period that the Treasury is in the market, I think what you find, in an attempt to do this, is that during a time of very heavy credit demand in all sectors of the economy, an even keel may provide something of an open door for that period to any borrower who comes into the market because his need, in effect, must be accommodated along with the Treasury's, or the purpose of the even-keel operation is defeated. I think you saw some elements of this kind of a situation perhaps more particularly last summer when the Treasury had to do a great deal of financing, despite the fact the surcharge had just been passed. The Federal Reserve was inhibited to a degree in maintaining its control of the money supply and bank credit during that period by the fact that the Treasury was in the market so frequently. I think, without probably any real intention on anyone's part, at least as I read the record from the outside at that point, you ended up at the end of the summer with a much larger expansion of credit and money than anyone had looked for. This has had continuing repercussions on the economy and on inflatioary developments since that time.

Representative REUSS. I intend to ask the Fed when they are up here, "Look, gentlemen, why don't you just relax the next time the Treasury tries a borrowing or refund and see what happens. I say that, because, really, what you are asking us to do is to assuredly hurt housing and State and local government. To the extent that the Treasury comes in with large bond issues, it is bound to tighten credit and raise interest rates on the long end. And whenever we do that, we want to be sure that we have a real evil that we are trying to work against.

I welcome your answer, and it is a straightforward one, and that has got to be considered, but first I want to hear what the Fed has to say.

Mr. WALKER. I am not sure what you want the Fed to do.

Do you want them to tighten or ease during the Treasury financing?

Representative REUSS. I want them to do that which they would otherwise do. I do not know why, particularly—up to 15 years, in my case, of hearing the Fed's reasons for the glories of the 1951 accord—I do not see why the Fed has to pervert itself. Granted, they are last, but there are other last ones.

Mr. VOLCKER. I think we should hear from them.

Representative REUSS. Avoid catastrophe, yes; and create a lot of excess money which you are then going to have to stop in a couple of weeks or risk Senator Proxmire's ire.

Mr. VOLCKER. The basic dilemma that we are in—and you will be interested in getting this directly from them—the basic dilemma that I am sure they sometimes feel themselves in is that if we have a large failure of a very important Treasury financing, they may end up with credit market conditions that will require an even larger injection of money in the end, to restore a tone of stability and balance to the markets, than if they conducted their own operations in such a way as to not aggravate that risk of failure which always exists anyway. It is a difficult problem. I do not want to prejudge this. But we are certainly going to be prepared—not only in this connection but in terms of our ability upon occasion and in judicious amounts make use of an authority to issue longer term securities in a way that will contribute to the overall aims of economic policy—to avoid undue effect upon any particular sector. I think in moderate amounts appropriately arranged, this is entirely possible through advance refunding techniques as well as through straight cash offerings or normal refunding.

Representative REUSS. I have a request for some information, which I make now to the Treasury.

On the 7 percent credit, investment credit, would you get me a breakdown of the types of business that received this credit, with particular reference to the Small Business Administration categories?

I say that, because it is my impression that Small Business really does not get very much out of the $2 billion annual Treasury loss as the result of the investment tax credit, and it would be very constructive to have that. And I would appreciate it, if that material would be available.

Mr. WALKER. Yes; we will do that.

(The information requested and later supplied follows:)

TABLE 1.—INVESTMENT CREDIT CLAIMED, 1964 AND 1965

Returns filed	Number			Amount		
	1964 (thousands)	1965 (thousands)	Percent increase	1964 (million dollars)	1965 (million dollars)	Percent increase
	(1)	(2)	(3)	(4)	(5)	(6)
Grand total	(1)	2,358.9		(1)	2,094.0	
Fiduciaries	(1)	10.5		(1)	1.9	
Total (less fiduciaries)	2,126.4	2,348.4	10.4	1,631.2	2,092.1	28.3
All individuals, total	1,797.5	1,980.7	10.2	312.7	375.8	20.2
Proprietors	1,304.7	1,447.3	10.9	227.5	284.7	25.1
Partners, small business corporation shareholders, others	492.8	533.4	8.2	85.2	91.1	6.9
Corporations	328.9	367.7	11.8	1,318.5	1,716.3	30.2

1 Not available.

Note: Amounts are rounded and may not add to totals.

TABLE 2.—ESTIMATED TAXES ATTRIBUTABLE TO INCOMES OF BUSINESSES, BY SIZE OF BUSINESS RECEIPTS AND FORM OF ORGANIZATION, 1965

[In millions of dollars]

Size of business receipts	Business income tax, by businesses organized as—				
	All returns	Sole proprietorship	Partnership	Electing small corporation	Corporation
Total, all sizes	$35,815	$2,951	$1,007	$195	$31,662
"Small" business, total	6,028	2,907	718	106	2,298
Under $5,000	1,046	114	7	(1)	97
$5,000 to $10,000		194	7	1	
$10,000 to $25,000		589	34	3	
$25,000 to $50,000	844	661	66	4	112
$50,000 to $100,000	998	676	125	6	192
$100,000 to $200,000	914	368	197	16	333
$200,000 to $500,000	1,200	241	188	45	726
$500,000 to $1,000,000	1,026	63	96	29	838
"Large" businesses (with receipts $1,000,000 or more)	29,786	44	289	90	29,364

1 Less than $500,000.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Feb. 20, 1969.

Note: Details may not add to totals because of rounding.

INVESTMENT CREDIT AND THE SMALL BUSINESS RETURNS

Table 1 indicates the amount of investment credit taken by corporations, partnerships, and sole proprietorships in 1964 and 1965, the latest years for which this information is available. Table 2 incidates the estimated taxes attributable to incomes of business by size of total business receipts. If one takes as a rough definition the characteristic of total receipts of less than $1 million as a "small business, Table 2 indicates the division of taxes between small and large businesses.

It will be seen that for sole proprietorships a very large proportion of the tax, about 99 percent, was paid by businesses that could be called small businesses. If one compares this with the statistic from Table 1 that the investment credit for proprietorships for 1965 was approximately $285 million, it follows that for sole proprietorships the investment credit was approximately 10 percent of the tax.

Corporations on the other hand were predominantly in the large business category, and it will be seen, by comparing Tables 1 and 2, that for corporations as a whole the investment credit in 1965 was approximately 5 percent of the tax, smaller than the credit-to-tax relationship for sole proprietorships. Part of this result follows from the fact that the effective tax rate on proprietorship income is in the neighborhood of 10 percent, while it is in the neighborhood of 40 percent for corporations. The credit is relatively larger for corporations in relation to their income but relatively smaller in relation to their tax.

For corporations we can also get a picture by comparing tax and credit by size of assets. Corporations with assets below $1 million (i.e., "small" businesses) received $189 million of investment credit in 1965 and paid corporate taxes of $3,077 million. The credit averaged about 6 percent of the tax. For all larger corporations the credit was $1,527 million and the tax was $28,585 million. Thus, the credit was slightly over 5 percent of the tax.

No data are available to make a direct comparison of tax credits and business size for partnerships and subchapter S corporations. This is because the data, as to the use of the tax credits against tax, would be reflected in the returns of the partners and the shareholders of subchapter S corporations, and those returns could not readily be associated with the size of the partnerships and the subchapter S corporations.

Chairman PATMAN. Mr. Moorhead?

Representative MOORHEAD. Thank you, Mr. Chairman. Mr. Volcker, while in Europe at the OECD meetings various statements were attributed to you, by the press, concerning your position on more flexible exchange rates as one alternative for meaningful international monetary reform.

Mr. VOLCKER. There is a multiplicity of particular kinds of proposals, as you know.

Representative MOORHEAD. At one point you were quoted as saying that the study of flexible exchange rates would be limited to "academic circles." However, other officials in the adminstration, notably in the CEA of the Treasury, said that they are indeed pursuing studies of flexible exchange rates. So I would like to give you this opportunity to set the record straight.

Mr. VOLCKER. That was not the connotation at all that I wanted to leave. And I want to correct any interpretation of the record that indicates that I consider academic life some sort of purgatory.

I think the fact is that with respect to these kinds of proposals— the wider band kind of thing to which you are referring—our position is—and I do not think there is any disagreement among any of us on this point—the same as it is toward a number of other proposals of like character. We want to look at these with an open mind. There are a lot of technical problems with that particular proposal, as there are with most, and I do not think any of us think there are any magic solutions in these areas—that we can seize upon any of these devices and our problems will somehow go away. I do not think that is possible at all.

But on the other hand, I think some of these proposals or some combination of them, may make a contribution toward a more effective functioning of the international financial system. I think they all need more study before we are going to be able to arrive at any position on any of them.

On the flexibility question we particularly found a notable lack of interest, I think, in European official circles at this point. So, I do not think that these ideas are right on the docket in terms of immediate moves in this kind of direction, and I do not want to give that kind of impression at all.

On the other hand, this is something that we will be looking at internally, obviously. And I would encourage others to look at it. And I, in fact, would be doing this in some of these academic circles myself had I not been sitting here. After a little longer period of gestation and the conclusions become clear as to where the interest of this country and other countries may lie, I think we will be in a position to reach some official conclusions on these matters. But we are definitely not there at the time.

Representative MOORHEAD. I can merely say that I encourage internal Treasury studies in addition to the academic studies on this important issue.

Chairman PATMAN. I would like to ask a question like I asked Secretary Kennedy. Do you, Mr. Walker or Mr. Volcker, own stock in commercial banks?

Mr. WALKER. I own no common stock in any business corporation.

Mr. VOLCKER. I own no stocks.

Chairman PATMAN. Now, if I understand correctly, there are four bankers in the Treasury Department now under the new administration: Mr. Kennedy; yourself, Dr. Walker; Mr. Volcker; and recently added was a man by the name of Jim Smith for Congressional Relations. Wasn't he your assistant in the American Bankers Association's public relations office?

Mr. WALKER. Mr. Smith was a long-time employee of the Senate and was assistant to Senator Mundt until he came to the American Bankers Association's Washington staff about 1961, 1962 or 1963. As for myself, I am not a banker. I never was a banker. I was a trade association executive.

Chairman PATMAN. If you represented the banks, I do not see how you could come here.

Mr. WALKER. I admit that you have got a point.

Chairman PATMAN. I mean as a career.

Now, I would like to ask another question. The President approves interest rates that are fixed on long-term Government bonds; isn't that correct?

Mr. WALKER. Anything over 1 year, any note or bond.

Chairman PATMAN. That has always been my understanding. I looked it up one time, and I was very clear that it was that way; but if it has been changed inadvertently or otherwise, I do not know it.

That means you keep talking about a 1951 accord. That was a meaningless so-called accord. That was under Mr. Truman. And Mr. Truman not only could not approve it; he denounced it. And how can you say there is an accord where he is the principal actor, since he has got to fix the interest rates on long-term Government bonds and he did not approve it?

He is one of the principal actors and, therefore, it could not be an accord.

I just submit that for your consideration.

Mr. WALKER. I am surprised. I would like to see the record. I did not know he denounced it. I wrote my doctoral dissertation on that episode, and I did not know it.

Chairman PATMAN. I happened to be around at the time, and I happened to be with Mr. Truman then, and I knew something about what was going on. He did denounce it. He thought it was terrible. But they finally agreed that they would not violate the understanding that the Board had with Mr. Truman, and that was that they keep the rates to 2½ percent except one issue, and 2¾ percent that were nonnegotiable and really not worth as much as 2½. And they kept those rates until the end of Mr. Truman's time. They did not violate that part.

Now, the other question I would like to ask you is:

You were with the Chase Manhattan Bank, were you not, Mr. Volcker:

Mr. VOLCKER. Yes.

Chairman PATMAN. And how long were you with them?

Mr. VOLCKER. I was with them for 3 years. I was with them earlier for a period of 4 years, too.

Chairman PATMAN. They are contributors to the American Bankers Association fund, aren't they?

Mr. VOLCKER. I assume so.

Chairman PATMAN. How much did they contribute in 1967 to the banking association fund, or anything that could be considered public relations in the 2 years of 1967 and 1968? Could you get those figures?

Mr. VOLCKER. I assume I can.

Chairman PATMAN. And will you put them in the record at this point?

Mr. VOLCKER. Yes.

(The information requested follows:)

THE UNDER SECRETARY OF THE TREASURY
FOR MONETARY AFFAIRS,
Washington, D.C., February 25, 1969.

Mr. MICHAEL CARLSON,
Secretary, Chase Manhattan Bank,
New York, N.Y.

DEAR MR. CARLSON: At the Joint Economic Committee hearings on February 19, 1969, Chairman Patman, after establishing my former connection with Chase Manhattan, asked two questions about the bank.

1. "They are contributors to the American Bankers Association fund, aren't they?"

My reply: "I assume so."

2. "How much did they contribute to the banking association fund, or anything that could be considered public relations in the two years of 1967 and 1968? Could you get these figures?"

My reply: "I assume I can."

Mr. Patman asked that the data be added to the record of the hearings.

If the information can be supplied, I would appreciate the bank sending it to the Committee directly. I plan to inform the Committee of this request to you.

Sincerely,

PAUL A. VOLCKER.

THE CHASE MANHATTAN BANK,
New York, N.Y., March 5, 1969.

Hon. WRIGHT PATMAN,
Chairman, House Banking and Currency Committee, Rayburn House Office Building, Washington, D.C.

DEAR MR. PATMAN: Paul A. Volcker, Under Secretary of the Treasury for Monetary Affairs, has informed us that at the Joint Economic Committee Hearings on February 19, 1969 you asked whether this Bank is a contributor to the American Bankers Association fund and how much this Bank contributed to the Bankers Association fund in the two years of 1967 and 1968. Since Mr. Volcker did not have the information requested, he has asked that we reply to you directly.

In each of the years this Bank paid membership dues to the American Bankers Association of $18,500, an amount calculated on the basis of assets. In each of the same years, this Bank contributed to the Foundation for Education in Economics $1,850, an amount computed in relation to the membership dues.

Yours very truly,

MICHAEL E. CARLSON,
Vice President and Secretary.

Chairman PATMAN. Now, then, Dr. Walker, do you have the information as to how much the bank distributed to the American Bankers Association fund during these 2 years?

Mr. WALKER. What years?

Chairman PATMAN. The calendar years of 1967 and 1968.

Mr. WALKER. Roughly, $8 million. The annual dues income at the time averaged around $4 million. So, it was roughly $8 million. Contributions by banks were matched by an equal amount that the American Bankers Association obtained primarily through its widespread educational programs, such as the American Institute of Banking.

Chairman PATMAN. How do you justify asking the Federal Reserve to contribute public money?

Mr. WALKER. Are you talking to me now as Under Secretary of the Treasury?

Chairman PATMAN. I am talking to you as a former representative of the American Bankers Association's lobby here on Capitol Hill—that you expended 600 percent during the time you were in there. In other words, you started out with one lobbyist and wound up with six.

Mr. WALKER. That is quite an expansion. I never thought of it in those terms.

First of all, I ought to say that I am not sure it is quite proper for an Under Secretary of the Treasury to comment upon the activities of a private trade association. I do know the answer that has been given to that question in the past is that the Federal Reserve banks had a reduced scale of dues vis-a-vis the commercial banks, and they had the privilege of participating in the educational programs of the American Bankers Association. They viewed this as particularly valuable in the training of their examiners and sending them to the bankers' graduate school at Rutgers. This participation helped toward giving their young people a college education. This was the major justification, as I recall, that the Federal Reserve banks made for participation in the ABA.

Chairman PATMAN. But they made direct donations over $1,000 a year, money that would have gone right straight into the Treasury and saved the taxpayers that much, but they elected to make a contribution to the people that they are supervising. So they were actually carrying members of the Federal Reserve System.

Mr. WALKER. I think the point is that they hoped to get a public interest return in terms of the educational system that the banking industry has organized.

Chairman PATMAN. Don't you think that the Federal Reserve can help the housing industry by fixing a low rate of interest, say at 4¼ per, and maintaining that rate for the construction loans of family-sized homes, and that is for families?

Mr. WALKER. For the reasons I went through earlier, I think it would be disastrous for the housing industry if the monetary authority created very large amounts of money, which in turn would force interest rates up, resulting in more disintermediation. This would be, I think, a highly self-defeating policy.

Chairman PATMAN. Can you see that we can continue to keep on paying the rate now and increasing it and survive?

Mr. WALKER. I think that interest rates are much too high. And that is why this administration is dedicated to ending the inflation which is the root cause of the high interest rates at the present time.

Chairman PATMAN. Don't you think higher interest rates cause inflation?

Mr. WALKER. No, sir. I think that inflation causes higher interest rates.

Chairman PATMAN. If you increase interest rates, say, to 10 percent, that is added on to the cost of all the goods on the shelves, added into every business in America, and that makes prices higher. High price is what causes inflation; isn't it?

Mr. WALKER. All economic analysts that I know of think that the impact of the growing money supply on the price level greatly swamps the cost effect of interest rate increases. I know of no reputable economic study that comes to any other conclusion.

Chairman PATMAN. You don't discriminate between necessary expansion or growth expansion?

Mr. WALKER. I would discriminate. I think I am on record with you, Mr. Patman—do you recall the letter I wrote you last summer with respect to the rate of monetary growth, commenting on the guidelines that came out of this committee, that I thought that a rate of monetary growth in a general range of 2 to 6 percent was not a bad idea, and that the Fed could properly be asked to explain aberrations from that rate, and they could under certain conditions—do you remember that I wrote you a letter on that subject?

Chairman PATMAN. I will look it up and read it carefully.

Now, before yielding to Senator Proxmire to ask some questions, before we close, I think we had better notify the Secretary of the Treasury that from the reports I have gotten from the other members, they would like to have him return at some suitable time in the future. So if you will keep that in mind I appreciate it.

Senator Proxmire?

Senator PROXMIRE. I would like to ask you whether the Treasury has had any chance to review Governor Rockefeller's suggestion that the surtax be kept over a period of time, and gradually be given to the States for educational purposes. Has the Treasury considered it already, or do you expect to give it consideration?

Mr. WALKER. I think we will probably take a look at it. We haven't considered it at this time. The sort of thing we would look at is whether it is desirable to tie down a substantial source of revenue. There are complications there. That is without prejudging the proposal. It should be looked at; yes.

Senator PROXMIRE. How about the possibility—someone suggested, that instead of permitting the surtax to expire, which many of us support, that we consider an alternative which would be more progressive, and which would result in about the same revenue loss, roughly, and that is to permit exemptions to rise from $600 to $1,000 per dependent?

Mr. WALKER. We have no objection to studying that one. I think the significant factor there would be the revenue implications of that particular action. I don't have the figures offhand.

Senator PROXMIRE. I understand it is just about the same as the surtax, around a $12 billion loss. The surtax is roughly in that area.

Mr. WALKER. That is certainly something that should be considered.

Senator PROXMIRE. There is a tremendous amount of interest in this in my State, and I think around the country. As I recall, the dependency deductions were at one time around a thousand dollars, and they lowered it during World War II. And of course with inflation the way it is, it is very hard to rationalize the notion that anybody can support a child on $600 a year. At any rate, such an increase would have a progressive impact. And I do hope that your mind would be open on that, and you would give it careful consideration.

Mr. WALKER. We certainly will.

Senator PROXMIRE. Thank you.

Chairman PATMAN. Thank you very much, Dr. Walker and Mr. Volcker. I think we have had some pretty spirited answers and replies. And there is nothing personal, I assure you.

Mr. WALKER. I think both of us look forward to 8 years of exchange with you, Mr. Patman.

Chairman PATMAN. Thank you very much, gentlemen. As usual, any questions submitted in writing to our witnesses and their subsequent answers will be included in the record at the end of today's proceedings.

Without objection, the committee stands in recess until 10 o'clock tomorrow morning.

(Whereupon, at 12:25 p.m., the committee adjourned, to reconvene at 10 a.m., Thursday, February 20, 1969.)

APPENDIX

The following material consists of questions raised by Senator Miller and submitted to Secretary Kennedy, and his subsequent answers:

Question 1. Reference first sentence, page 2, of your prepared statement. Is it not a fact that the low level of unemployment has been affected by the addition of 600,000 more Federal civilian employees over the last eight years, one million more men in the Armed Services, and employment of upwards of two million in industry because of the war?

Answer. The factors mentioned have certainly affected the distribution of employment between civilian and non-civilian pursuits and between defense and non-defense industries. There probably has also been some effect on unemployment rates as well, although this would be difficult, perhaps impossible, to estimate statistically with any precision. In recent years excessive demand came at a time when unemployment was already at relatively low levels and the main effect was to drive up costs and prices very sharply.

The question points to the necessity of insuring that a smooth economic transition is made when Vietnam expenditures can be reduced. President Nixon has requested a full review of this matter and studies are underway.

Question 2. Reference the next sentence. How do you reconcile your statement that "the dollar is strong" with the world market for gold? Also, since the dollar has fallen in value to 39 cents (compared to a 1939 dollar worth 100 cents), does this not show that the dollar has been growing weaker—rather than stronger?

Answer. In my statement I said: "The dollar is strong and respected in the world in spite of recent inflationary trends and a deteriorating trade balance." The dollar remains the most widely held currency and large balances are maintained in dollars both on private foreign account and by foreign monetary authorities in order to maintain the international value of their currencies in terms of dollars.

In short, the dollar remains the most convenient liquid asset on the international scene. Gold in the private market is not a real alternative to dollars for most persons. The gold market is thin and is affected by numerous special factors at this time.

This is not to say that the recent inflation in the United States may not have played some part in speculative pressure on the private gold market. We would, of course like to see the dollar even stronger than it is now, as my whole statement implies.

With respect to the second part of this question, the purchasing power of the dollar has fallen heavily as compared with the 1939 dollar. A substantial part of this decline in purchasing power took place during World War II and the immediate postwar period. Since 1963, however the cost of living had risen 16 percent as of November 1968. This is a result of the strong inflationary pressures to which I referred in my statement and which require corrective action.

As I said in my statement, "The economy must be placed under firm restraint until there are unmistakable signs that we are headed back on a non-inflationary path." This will strengthen the position of the dollar abroad as well as at home.

Question 3. You state that the budget should be kept in surplus (p. 3, last full sentence of statement), but the Council of Economic Advisers points to an objective of at least a "balance". How do you reconcile these two positions?

Answer. The two statements seem to amount to very much the same thing. Judging from its context, the statement by the Council of Economic Advisers was intended to emphasize that a budget deficit at this time might have direct inflationary effects and would create financial strains and expectations of continued inflation—hence the need for "at least" a balance. The Treasury statement simply stressed the desirability of keeping the budget in surplus rather than avoiding a deficit. As a practical matter, the budget surplus of $2.4 billion established in January for fiscal 1969 was relatively small (about 0.3 percent of GNP) and the estimate is subject to error. The current fiscal influence might well be described as relatively neutral although, taken together, fiscal and monetary policy are exerting restraint. In principle, a fairly sizable budget surplus may well be appropriate at a time when inflationary pressures are strong and the economy is somewhat beyond the point of reasonably full employment, as the term is usually defined.

Question 4. Page 5, second sentence of statement. Is not the sharp increase in imports due also to the inflation which has caused our wage rates to increase more (on an absolute basis) than those of countries exporting to us, thus causing imports to be more competitive with our domestic products?

Answer. There are two important ways that over-expansion of our domestic economy causes our imports to increase—and the reference made to such over-expansion as a major reason for our deteriorating trade position since 1965 was intended to encompass both of these effects.

The most visible, and initially most damaging, effect is that the inflated volume of our total demand for goods due to domestic over-expansion leads directly and immediately to more than proportionate increases in our demand for imported goods.

A second and different effect, which comes about more gradually but can also do more lasting damage to our trade position, is that excessive increases in our wages and other costs resulting from over-expansion of our economy will cause the prices of domestic goods to rise relative to foreign goods and thereby make it more difficult for our manufacturers to compete successfully against foreign-made products not only here at home but also in export markets.

THE 1969 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 20, 1969

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Joint Economic Committee met, pursuant to recess, at 10 a.m. in room G–308, New Senate Office Building, Hon. William Proxmire (vice chairman of the joint committee) presiding.

Present: Senators Proxmire, Javits, Miller, and Jordan; and Representatives Reuss, Widnall, and Brock.

Also present: John R. Stark, executive director; James W. Knowles, director of research; and Douglas C. Frechtling, minority economist.

Senator PROXMIRE (presiding). The Joint Economic Committee will come to order.

Welcome to these hearings, Mr. Secretary. Never before has an administration appointed to this Cabinet position a person with such depth in training, experience, and understanding relevant to the Nation's manpower problems. I understand you are the first Ph. D. in economics ever appointed Secretary of Labor. And that is also most desirable.

I understand furthermore that your predecessor, Mr. Wirtz, is not only a good friend but a great admirer of yours. And I consider Mr. Wirtz one of the most talented men who served in the last administration.

I am sure no one has to remind you, Dr. Schultz, that directing the Nation's manpower effort at such problems as poverty, inflationary skill shortages, and difficult collective-bargaining issues will not be easy. The programs which you direct have important bearing on the economic security of individuals and their families and on the effective functioning of the economy. Because of your background, it is quite likely that expectations for the effectiveness of manpower programs will rise sharply. It is also quite clear that the degree to which you can apply your talents to these pressing problems depends in no small part upon the support of this Congress. I think I may speak for all of the members of this committee, Mr. Secretary, in wishing you success, and to offer the assistance of a committee which, by virtue of its mandate in the Employment Act of 1946, has a special obligation to work toward solving the problems that you are centrally concerned with.

You may go ahead in your own way. You have an excellent statement. It was delivered to my house last night at 9:30. I stayed up late studying it.

Senator Javits?

Senator JAVITS. Mr. Chairman, I just want to welcome the Secretary. I came specially, though we have a Foreign Relations Committee hearing on the Nonproliferation Treaty to which I will have to go, because I think here is one of the most gifted men recruited by the new administration. And he has already emphasized his work in the statement, which I, too, have gone through. I am very grateful to the Chair for his fine introduction.

STATEMENT OF HON. GEORGE P. SHULTZ, SECRETARY OF LABOR

Secretary SHULTZ. Thank you, Mr. Chairman, and members of your committee. This is my first venture before your committee and, as an economist, I take pride in this appearance. But my awareness of the committee's expertise counsels humility, as does the range and the complexity of the problems before us.

Mr. Chairman, I appreciate your remarks and those of Senator Javits. I suppose in a sense, after your kind statements, I might quit while I am ahead. But in any case I would ask your permission to put the full statement that I have prepared into the record, along with the charts and tables that accompany it.

Senator PROXMIRE. Without objection that will be done. The charts and tables are also most helpful.

(The statement and attachments referred to follow:)

PREPARED STATEMENT OF SECRETARY OF LABOR GEORGE P. SHULTZ

This is my first venture before your committee. As an economist, I take pride in that appearance but my awareness of the Committee's expertise counsels humility as does the range and the complexity of the problems before us.

My role today is not of the economic forecaster. The Council of Economic Advisers has already performed this task, providing an analysis of the current economic scene together with their broad policy prescriptions for the coming year.

I will provide an assessment of certain aspects of the economic scene which are of particular concern to the Secretary of Labor: the job prospects facing American workers, developments in wages, prices, and labor relations affecting their welfare, and the programs of the Labor Department which have a direct bearing on general economic developments.

My remarks will be related to two questions both of which must be listed high on the agenda of anyone concerned with the future of this country:

1. What steps can help bring the current excessive rate of inflation under control without an appreciable rise in unemployment?
2. In what ways can this effort be related to a widening of economic opportunities and thereby contribute toward an end to poverty?

These two questions are closely connected. We cannot expect, on the one hand, to conquer poverty if advances in income are promptly offset by increases in the prices of goods and services the additional income was expected to buy. And, of course, the erosion of savings and of fixed incomes actually sets back the living levels of many who are only a step or two away from poverty.

On the other hand, a policy prescription that would halt inflation at the cost of producing a sharply rising level of unemployment would also prove disastrous for our efforts against poverty. For many families, the way out of poverty is more productive employment, and firms that are forced to reduce their operations are not apt to provide this opportunity.

Our sights must, therefore, be set on providing answers to both questions in a coordinated manner. We must work to check the current rate of inflation without an appreciable rise in unemployment as part of our program to provide greater economic opportunity for all. The solution will not come easily but the health of the Nation, both economic and social, depends on it. Our most important antipoverty program is a healthy economy.

HIGH EMPLOYMENT WITH A CHECK ON INFLATION

I believe there is substantial evidence to support the hope that inflation can be contained without sacrificing the high level of employment that is required if we are to attain a measurable degree of success in tackling the problem of poverty.

Three principal points lead me to this conclusion.

First, this Administration, as Dr. McCracken indicated Monday, will work to reduce inflationary pressures gradually, not abruptly. Our aim is not to achieve a zero price rise this year—this could not occur short of a sizeable recession. It is rather to halt the acceleration in the rate of price increase and then gradually—to bring the rate to a more acceptable level. In a sense, this operation involves turning the 1960-64 experience around. Then, a relatively stable price level was coupled with a gradual reduction in the unemployment rate. Now, we are aiming to maintain a relatively stable unemployment rate with a gradual reduction in the rate of increase in prices. To do more than this in a short time involves too great a risk. We must remember that inflationary expectations have been building for several years (See chart 1.) and they cannot immediately be dissipated. By starting now, and holding firmly and steadily to this objective, we can accomplish a worthwhile reduction in the rate of price increase this year, and set the stage for a further reduction next year. At the same time, an opportunity will be provided for the economy to create the expanding number of jobs that are required to keep employment in line with the growth in the labor force.

Second, a growing proportion of workers are now employed in industries that generally do not lay people off as soon as a slackening in demand occurs. For various reasons, employment in the so-called service producing industries (trade, transportation, utilities, finance, services, and government) is far more stable than in most manufacturing, mining or construction industries. This relatively stable sector has been growing much more rapidly than the economy as a whole, and it seems likely that this trend will continue.

In 1950, 59 out of every 100 jobs outside of agriculture were in the service producing industries. Ten years later, the proportion had risen to 62 out of 100 and today the figure is 65. By 1975, it is projected to rise to about 68 out of 100. A very large proportion—more than 85%—of the new jobs provided by the growing economy will be in the service sector.

Chart 2 shows how employment in the service producing industries held up during each of the four postwar recessions, when employment in the goods industries declined. In 1948–49, when employment in the goods industries dropped 6½ percent, service employment increased slightly. In 1953–54, goods employment dropped 6 percent, and again service employment rose slightly. In 1957–58, the decline in goods employment of 7 percent was accompanied by a very slight decline in service employment. In 1960–61, goods employment declined 3 percent, while service employment rose 1 percent. Since the last recession, in 1960–61, a large proportion of workers have obtained jobs in the service industries, and as I have said, the shift is expected to go farther still.

The hypothetical calculation at the bottom of the chart suggests that, as a result of this shift, we can anticipate greater stability in total employment should a slackening in demand occur. The effect of this shift in any one year is not large, but it is in a favorable direction and the cumulative impact of this development is of fundamental importance to our thinking and policy on economic stabilization and growth.

Third is the increased variety and growing quantitative importance of policy instruments available in addition to the traditional tools of fiscal and monetary policy. I concetrate, of course, on those policies in the manpower and labor market area, but I note the importance here of such matters as vigorous efforts in the anti-trust field and the further development of freedom in international trade.

These manpower policies are aimed at three specific targets: at individual groups within the population with markedly high rates of unemployment (e.g., disadvantaged teenagers working under the Neighborhood Youth Corps, ghetto residents newly placed through the JOBS program); at the development of greater supplies of labor where acute shortages exist oh can be foreseen (e.g., MDTA institutional and on-the-job training programs), and at the more efficient functioning of the labor market (e.g., upgrading and computerizing the work of the U.S. Employment Service).

It may be noted at the outset that the influence of these programs cannot be measured by a simple count of trainees in government programs. The constructive spirit of the JOBS program, for example, has proved quite contagious. The development by American business of realistic hiring, training, and upgrading programs for disadvantaged groups extends far beyond those firms that have been drawn into official contracts.

There are a number of ways in which manpower development and training programs ease the task of checking inflation without an appreciabile rise in unemployment. By focusing on the disadvantaged these programs concentrate upon the specific groups whose unemployment rates are the highest. By making available additional workers not otherwise employable, they help to ease tight labor market conditions. By training additional skilled workers or alternatively restructuring jobs requiring skilled workers so that these could be performed by individuals of lesser skill, they help improve the relation between supply and demand in the market for particular goods and services. By improving the functioning of the job market they cut the time between the loss of a job and the acquisition of a new job. I shall return to this subject to spell out in greater detail some possible emphases in manpower programs that should help specifically to meet the current situation.

I do not wish to exaggerate the role that the Department's manpower programs can play. Obviously they require a considerable period of time to become effective and alone they would prove powerless to curb inflation. But together with an effective use of fiscal and monetary policy, I think the manpower programs can help make possible a gradual transition to a significantly lower rate of price inflation while maintaining a high employment economy.

A Review of Some Recent Developments

I should like to now turn to a brief review of recent developments in employment and in wage-price-productivity relationships which are of special concern to the solution of the two question I posed at the start of my statement.

Employment and Unemployment

One of the dominant factors in the past few years has been the great change in the allocation of our resources: we have become involved in a very costly military operation, yet we have continued to expand our civilian economy with few of the direct restraints upon individuals or enterprises that have been resorted to in similar earlier periods. In the three years since mid-1965, using the GNP accounts, direct Federal outlays for goods and services (excluding such items as grants to States and transfer payments to individuals) rose more than 50 percent, while total output was expanding 26 percent. The great bulk of the increase was in defense. Expressed in terms of manpower, the increase is even more dramatic; about 2½ million more people are working in defense-related activities or in the armed forces than before the mid-1965 step-up in hostilities. These activities accounted for about 85 percent of the increase in male employment (including the armed forces) in these 3 years. This growth of employment added to the demand for civilian goods but did not contribute to their production.

Thus, we have had a major unanticipated shift in the economy's resources which created some scarcities and labor bottlenecks, and stimulated price and wage increases which otherwise would not have occurred. This development also, of course, highlights the importance of careful planning to avoid unnecessary unemployment when our defense needs are reduced.

A second important point in the manpower story is that the effects of recent monetary and fiscal measures are still scarcely visible in terms of the employment totals and the overall unemployment rate. For most primary workers in the economy—such as adult men or married men—unemployment rates are 2.0 percent or less, which many would call close to the minimum frictional level. Nevertheless, the work week for production and nonsupervisory workers on private payrolls, although still relatively strong, has eased somewhat in recent months. This may imply some leveling off in the demand for labor.

Another significant aspect of the current employment situation is that there has been a substantial reduction in the number of those who have lost their jobs. Some may think of the unemployed as consisting solely of those who, through no fault of their own, have lost their jobs, but this group actually consists of only about 40 percent of the unemployed. To these job losers, as a rule, unemployment is a more serious concern than to those who left their jobs voluntarily, or who never worked before, or who decided to re-enter the labor force, all of whom are rightly counted as unemployed. About 40 percent of the unemployed new entrants or re-entrants, for example, were seeking part-time work, nearly all of the adult women and teenagers.

These data make clear that some unemployment arises when the worker has freedom to quit in order to improve his position, freedom to seek part-time rather than full-time work, and freedom not to take the first job that is offered. One of the benefits of full employment is that it makes it easier to exercise these choices—to shift jobs and to be selective. Quit rates are usually high when the job market is tight, and low when it becomes less buoyant. Similarly, the number of new entrants or re-entrants may rise and fall with job opportunities. For these reasons, a reduction in demand produces some partial offsets to the rise in unemployment through layoffs.

The current low unemployment rate, of course, masks wide disparities. Thus, although nonwhite workers actually accounted for a larger than proportionate share of the total unemployment decline in 1968—reflecting the tight supply of labor as well as special efforts to reduce discrimination—their rate is still slightly more than double that for whites. This is approximately the same ratio as in 1961.

The unemployment rate for teenagers remains stubbornly high. The current teenage rate is significantly below the rates of the first half of this decade, but it has changed hardly at all in the last three years and has not shown the kind of improvement that has been experienced by adult workers.

The situation of the Negro teenager requires special mention. The jobless rate for Negro 16–19 year-olds was 25 percent in 1968, as against 11 percent for the white youngsters. Negro teenagers have remained virtually untouched by the recent unemployment reductions where as their white counterparts have experienced a substantial reduction in joblessness. As a result, the ratio of Negro-to-white teenage unemployment rates has risen substantially in recent years. In 1954, the teenage Negro-to-white ratio was a 1.4 to 1: by 1968 the ratio has risen to 2.3 to 1.

Negro girls have fared somewhat worse than boys. In 1968, their unemployment rate stood at 29 percent, as compared with 22 percent for Negro boys.

It is important also to note the absolute magnitude of the teenage situation. With the high rates, the total number of unemployed Negro teenagers averaged about 200,000 in 1968. Furthermore, over one-third were seeking only part-time work, mainly because they were still in school.

Another aspect of this diversity among rates of unemployment is highlighted by the findings of a new Department of Labor survey to measure unemployment and barriers to employment in a selected number of very low income areas in 6 large cities. This survey, known as the Urban Employment Survey, has two broad goals: first, to develop insights into the special social and economic characteristics of slums that affect employment conditions, including slum area residents' attitudes toward work, training, and other aspects of getting and holding a job; and second to evaluate the effect of various manpower programs.

This survey is being directed by the Bureau of Labor Statistics with the cooperation and financing of the Manpower Administration. The Bureau of the Census is conducting the survey in the Labor Department's Concentrated Employment Program areas of six cities—Atlanta, Chicago, Detroit, Houston, Los Angeles, and New York City. In addition to these low-income neighborhoods, the survey in Atlanta and Detroit will develop comparable information for the remainder of each of these cities in order to provide comparisons with the findings from the slum areas.

From this first report, being released today, I want to mention three findings.

1. High unemployment rates and low earnings characterize the employment situation of residents of these 6-slum areas, almost two-thirds of whom are Negro and another large proportion (18 percent) either Mexican-American or Puerto Rican. At 9.5 percent, the overall unemployment rate for workers in UES slum areas was more than two and one-half times the average for the total civilian labor force. About 15 percent of the full-time workers in these areas reported earnings less than $65 a week, about the equivalent of the current Federal minimum wage for a 40 hour week.

2. As expected, the jobless rate for Negro workers in these areas was higher than in other areas, 10.4 percent. The comparable unemployment rate for white workers was also very high, about two-thirds of the Negro rate, partly because the white rate is affected by the large proportion of Mexican-Americans and Puerto Ricans in several of the areas studied. In contrast, for the country as a whole, the white unemployment rate was less than half the rate for Negroes.

If supported in further surveys, this would reinforce the point of view that the difficulties shared by those living in these neighborhoods affect more than a single racial or ethnic group.

3. While low earnings characterize the residents of these areas, a sizeable proportion reported earnings well above the poverty level. Almost half of the men and one-fifth of the women earned $100 or more weekly for full-time work. Few women earned $150 a week at a full-time job, but about one-fifth of the men did. About 20 percent of the families with 4 persons or more reported incomes of less than $3,500 during the previous 12 months. On the other hand, nearly one-third of these families had incomes of $8,000 or more. This finding can be quite helpful in making clear that all slum residents are not mired in poverty but rather that many of them already have been able to raise themselves and their families to a decent level of living.

The current low national unemployment rates thus, while highly encouraging, do not permit complacency. Instead, they point to the necessity of a variety of manpower programs to create work opportunities, especially in an economy which might be growing at a less hectic pace than that of recent years.

Wage, Price and Productivity Changes

Turning first to wages and earnings, we see a picture with two sides—wages as a cost of production and wages as income from work. Looking first at the cost side—i.e., not taking into account the deterioration of purchasing power as a result of inflation—we find, as in the case of prices, a steady uptrend in the rate of increase. Average hourly compensation—including social security and various supplements—of all persons in the private economy rose 7.5 percent in 1968, compared with 6.1 percent the previous year and an average of about 5 percent annually between 1947 and 1966.

The 7.5 percent rate was the highest since 1950–51. It was the product not only of collective bargaining but also of decisions of employers in nonunion establishments to raise wages. Increases in statutory minimum wage rates and social security taxes also raised hourly labor costs.

The key determinant of how much of a wage increase gets into costs is, of course, productivity. In 1968, output per man-hour for all persons in the private economy rose 3.3 percent—returning to its long-term rate of advance. This was in sharp contrast to the previous year when productivity rose by only 1.6 percent. As production increased during the year, capital and labor resources tended to be utilized more efficiently with a resultant improvement in output per man-hour. Nevertheless, unit labor costs (i.e., compensation per unit of output) rose about 4 percent in the private economy. Although this was less than the rise for the previous year, it was the third consecutive year in which these costs have risen more than 3 percent. The yearly increment from 1947 to 1966 averaged 1.7 percent.

Compensation is income from employment as well as a cost of production. As such, the trend in compensation per man-hour, adjusted to reflect real purchasing power, can be compared with the trend in out-put per man-hour to determine whether increases in real earnings have kept pace with productivity gains. If this were the case then labor's share of total income would not change.

During the first 5 years of this decade (1960–65), real hourly compensation did not keep pace with the advances in productivity, so that labor's share of total product was reduced from 63 percent in 1960 to 61 percent in 1965. The uncommonly large increases in hourly compensation during the past three years have served to restore labor's share to approximately the 1960 level. It is important to note that over the postwar period real compensation per man-hour and productivity have kept up with each other.

Turning now to collective bargaining, a record number—about 6.1 million workers covered by major collective bargaining contracts—will receive deferred wage increases averaging 4.1 percent. In consequence, the average of *all* wage increases going into effect as a result of collective bargaining will be dampened as compared with 1968, though the pattern for new 1969 contracts has started at a high level.

Increases in the Consumer Price Index will have a limited direct impact on wages since most cost-of-living clauses have limits on the increases. Apart from this direct impact, however, there is an obvious influence of recent price increases upon this year's wage demands.

Prices of services, many of which have limited potential for productivity increases, are likely to continue on their rapidly rising trend. The Department of Agriculture anticipates an increase of 2 to 2½ percent in food prices in 1969 compared with a rise of 3½ percent from 1967 to 1968. While this will be a retarding influence on the rate of advance of the CPI as a whole, its magnitude is not great.

MANPOWER PROGRAMS AND ECONOMIC AND SOCIAL GOALS

The nation's manpower programs have been primarily directed at particular human problems rather than at their economic effects. They have been concerned with opening opportunity for persons disadvantaged by technological change, economic downturn or dislocation, poor and discriminatory educational preparation, and other barriers to self-supporting employment.

It has long been recognized that each of these programs has some economic effect. But their total economic impact has never been gauged, even though the manpower programs now run by the Department of Labor alone will total about $2 billion in fiscal 1969 and reach almost a million individuals. What has become clearer during the last decade is that the combined effect of these programs can be crucial in reaching broad national economic objectives. Historically, economists have given only a passing nod to the possibility that a better functioning labor market could contribute significantly to the overall functioning of the economy. This is no longer the case. The way we design and run our manpower programs will, I believe, be an important factor in answering the basic questions I posed at the outset of this testimony.

I should like to list four initial goals, or points of emphasis, that have important economic implications, and that are central to both immediate and longer-range manpower efforts.

First is the importance of being sure that our manpower programs are targeted to reach specific groups whose employment problems are sizeable and serious.

Negro youth unemployment has been the worst unemployment category in our Nation for more than a decade. In 1968, the nonwhite youth unemployment rates were 20.4 percent for 16–21 year olds and even higher—25 percent for 16–19 year olds taken separately. Almost ⅓ of a million 16 to 21 year old Negro youths are out of school and unemployed over the course of a year.

Virtually every one of our manpower programs is focused to some degree on this target group. Almost 200,000 out of school Negro youth are being reached by the JOBS, NYC, MDTA and CEP programs. With an effort of this magnitude focused on this target group, we should begin to see some effect on the group's unemployment rate. It is a matter of concern that the high unemployment rate has persisted, and we are now considering the types of program redirection that will be most effective.

For example, we are studying the possibility of a shift in program emphasis for the older out-of-school teenager from enrollment in the Neighborhood Youth Corps to enterprise employment, with better career and income possibilities.

In this connection, the expansion of the JOBS program to types of enterprises not now strongly represented would open opportunities for new, regular competitive jobs in the very sectors of the economy that are expanding the most or where personnel problems and skill shortages are severe—the non-profit hospitals, the publicly-owned utilities, the public transit companies, a variety of service and state and local civil service activities. In other words, there are many types of activity, and some growing kinds, that we have not yet adequately brought within the purview of our training and job programs and which offer special opportunities for youth.

Similarly, the expansion of the JOBS program beyond the present 50 cities, into other cities and areas of economic growth in the nation, would open many new development situations.

Beyond improving the targeting of our training programs, we need to give greater attention to means for bridging the gap from school to work. A good part of youth unemployment is the result of this gap, which incidentally, is far greater in the U.S. than in Japan and in European countries. Three-quarters of youth unemployment is accounted for by those who are newly entering or re-entering the labor force in search of work.

There are several things we can do to close this gap under authority of the MDTA, the Vocational Education Act, and the Wagner-Peyser Act. We should improve relations between the Employment Service and the schools so that youths receive timely job counseling and are helped to understand how they might best enter the job market. New opportunities for youth to bridge the gap can flow from expansion of cooperative education programs in the schools. About

200,000 secondary school students are now involved in cooperative arrangements with industry, working on jobs on a released time basis. These numbers can be expanded several fold.

Some part of the youth unemployment program will be influenced by what we do about the military draft. As new programs are developed to meet the nation's military manpower obligations, we should be able to find ways of removing the uncertainties which today make some employers reluctant to employ young people with future possible draft obligations hanging over their heads.

We are concerned also about high off-season unemployment rates in construction. Such unemployment wastes skilled manpower, raises unemployment compensation costs, impedes our national housing efforts, and contributes strongly to the environment that boosts construction wages and costs. Initial findings by the Departments of Labor and Commerce led last year to a Presidential memorandum directing government procurement agencies to develop positive anti-seasonal programs. The Congress has directed a further study of this subject. to be completed by the end of this year. We plan to work aggressively on this problem.

Second, is the importance of building skills that will increase the productive capacity of the economy and improve its ability to meet the heavy demand for goods and services which prosperity induces—a demand which can lead, unless offset by output, to price rises.

Medical service prices and construction prices have been responsible for a major share of the rise in living costs. Expansion of output to meet growing demand in both cases comes up against important shortages of trained manpower. Every projection of future manpower needs, at apprentice, technical and semi-professional levels, puts demand for manpower far beyond present and planned training activities.

In the medical field, needs far outrun projected manpower supply, and consideration must be given to programs which expand the supply of labor and improve manpower utilization practices, thus increasing the productivity especially of highly skilled medical manpower. Here also, the expansion of JOBS type program into the nonprofit field should aid in meeting the heavy manpower demands.

Programs for "upgrading" the work force would open new opportunities for those who come in at the bottom, as well as relieve the tensions increasingly associated in our society with routine, low-paying work. Our manpower programs thus far have hardly scratched the surface of the "upgrading" question.

The view has sometimes been expressed that skill development to meet production bottlenecks and add to the productivity of the economy means a different kind of manpower program, targeted at different people, than a program directed at the disadvantaged. This is true only in small degree. Getting a disadvantaged person into a real job means launching him on the path to a skill. Since skill training in American industry is very largely a matter of expanding skill opportunity on the job—in the "internal labor market"—the crucial action is to overcome the barriers to initial entry. Once that is done for a disadvantaged person, he is launched on the time worn path that has produced the great variety of skills that make up the American productive machine.

Third, is the improved efficiency of the labor market itself. Whatever the economic environment within which the labor market operates, workers will reap better results from the variety of job-and-people matching arrangements if these arrangements operate at peak efficiency.

The concept of a Job Bank has recently been put into practice in Baltimore. Maryland. The Job Bank is simply a running daily listing of all available job openings in a labor market area. This listing is furnished to the many public and non-profit agencies engaged in worker placement activities and has already shown good results in increasing and speeding worker placements.

A more sophisticated computerized job-matching system has recently been established covering the State of Utah. This system is only a beginning. The challenge is to develop appropriate descriptions of a worker's background and qualifications to feed into a machine and then match with a job which has also been appropriately described in machine language. Much developmental work is ahead of us, but is a most promising area and we are seeing the beginning here of a nationwide computerized system. While I wish to emphasize the positive on this subject, I should also add a note of caution. Arrangements on the part of an individual to take a job and of an employer to put someone to work involve personal and human considerations that are not subject to computerization and, indeed, that must be carefully preserved in a free and open labor market. We must never allow ourselves to forget that the employment process involves fundamentally a human relationship.

At any rate, these developments should speed up the reemployment of employable workers who now spend unnecessary weeks looking for new work opportunity. Cutting down unemployment time for the so-called "frictional" group, who are in fact going to be re-employed in fairly short order, will reduce the total amount of down time in the economy. If the computerization of the Employment Service can cut only one week's unemployment for those now unemployed about a month, for example, there would be a small, but noticeable, reduction in the overall unemployment rate.

Most of our unemployed, particularly those who come into the labor market for the first time, know little about the opportunities that exist, even in their own community. And it is within their own labor market that most opportunities are to be found, and that computerization would have its greatest effect.

Special types of assistance are sometimes useful where jobs are more available in locations other than the city or town of immediate residence, such as in the case of the young worker displaced from a technologically advancing rural area. Some experimentation has been done with aids to mobility, not to force or direct people, but to open new opportunities on a purely voluntary basis. Efforts of this kind, on a more regular scale—perhaps tying into the growing body of information at the Department of Commerce on the growth areas of the nation—would cut into the nation's unemployment down time.

A comprehensive system of job vacancy information would speed up the process by which workers and jobs come together, and enable us to focus more sharply on the targets for which training is needed.

It is of course of great importance to take the variety of actions necessary to end arbitrary discrimination, and to end hiring standards irrelevant to job performance, as more and more employers are doing, either on their own or with the aid or prodding of the Government.

Fourth is the importance of cushioning the human and economic losses that arise when workers lose their jobs through no fault of their own. One of the quickest and surest measures we have in our group of stabilizers is the unemployment insurance system. It begins to operate automatically, provides an important income cushion for laid-off workers, and counteracts the effects of sudden or too abrupt employment adjustments.

This system needs improvement if it is to play a fully effective role in combatting economic and human adversity.

* * *

Each of these four areas of emphasis involves many specific actions. Each action by itself is likely to have a small—often not easily measureable—effect on the overall unemployment rate, particularly the youth rate. But together they can have a sizeable impact, and can play an important part in efforts to combine high employment and a stable price level, while augmenting our drive to put an end to poverty.

An important companion step to action in each of these four areas is the improvement of the Government's ability to administer manpower programs effectively.

The current organization of the Manpower Administration in the Department of Labor is not satisfactory. There are too many lines to the field, and too little coordination of the planning and operating aspects of the programs. The states, cities and towns deserve a more understandable and responsive Federal partner. Major organizational improvements must be made at an early date. In order to remedy these deficiencies, alternative organizational structures are under consideration. Consultation is being initiated with interested groups to obtain their reactions and support.

Concurrently, a strong effort must be made to develop stronger relationships within the present or any proposed program content in the manpower field. As the President said in his Message to the Congress yesterday, "One of the priority aims of the new Administration is the development by the Department of Labor of a comprehensive manpower program, designed to make centrally available to the unemployed and the underemployed a full range of Federal job training and placement services. Toward this end, it is essential that the many Federal manpower programs be integrated and coordinated."

As we work toward these objectives, we do so with the knowledge that our manpower programs are coming of age. They have grown to a size and scope that gives them strategic significance in our economic as well as social policies.

This significance is enhanced under the current economic conditions. A strong job market makes it possible to move idle and under-utilized human resources into productive activity. The prospect that this current high level of job demand will be a stable and continuing one lends internal strength to the manpower efforts.

I welcome the growing attention of the Nation's policy makers and of this committee to the contribution that manpower programs can make, with the growing and proud realizaion that manpower matters are now too important to be left only to the manpower experts.

TABLE 1.—EMPLOYMENT STATUS OF PERSONS 16 YEARS AND OVER

[In thousands]

Employment status	January 1969 [1]	Annual averages 1968	1967	1960
Civilian labor force	79,874	78,737	77,347	69,628
Employed	77,229	75,920	74,372	65,778
Agriculture	3,752	3,817	3,844	5,458
Nonagricultural industries	73,477	72,103	70,527	60,318
Part time for economic reasons	1,605	1,716	1,913	2,560
Voluntary part time	8,834	8,452	8,048	5,815
Unemployed	2,645	2,817	2,975	3,852
Unemployment rate	3.3	3.6	3.8	5.5

[1] Seasonally adjusted.

TABLE 2.—EMPLOYMENT STATUS OF 16- TO 19-YEAR-OLDS BY FULL- AND PART-TIME STATUS, COLOR AND SEX, 1968 ANNUAL AVERAGES

[In thousands]

Characteristic	Civilian labor force	Employed	Unemployed	Unemployment rate
Full-time labor force	3,661	3,184	476	13.0
White	3,153	2,799	354	11.2
Male	1,727	1,560	167	9.7
Female	1,426	1,239	186	13.1
Nonwhite	508	385	123	24.2
Male	290	231	60	20.6
Female	217	155	63	28.9
Part-time labor force	2,958	2,595	362	12.3
White	2,686	2,396	290	10.8
Male	1,509	1,348	161	10.7
Female	1,177	1,047	129	11.0
Nonwhite	272	200	72	26.9
Male	154	116	38	24.9
Female	117	84	34	28.7

TABLE 3.—MAJOR UNEMPLOYMENT RATE INDICATORS

Characteristic	January 1969 [1]	Annual averages 1968	1967	1960
Total (all civilian workers)	3.3	3.6	3.8	5.5
Men 20 years and over	2.0	2.2	2.3	4.7
Women 20 years and over	3.5	3.8	4.2	5.1
Both sexes, 16–18 years	11.7	12.7	12.9	14.7
White workers	3.0	3.2	3.4	4.9
Nonwhite workers	6.0	6.7	7.4	10.2
Married men	1.4	1.6	1.8	3.7
Full-time workers	2.9	3.1	3.4	(2)
Unemployed 15 weeks or more	.4	.5	.6	1.4

[1] Seasonally adjusted.
[2] Not available.

TABLE 4.—WHOLESALE PRICE INDEXES FOR MAJOR COMMODITY GROUPS

Group	Percent change				
	December 1967 to December 1968	December 1966 to December 1967	December 1965 to December 1966	December 1964 to December 1965	December 1963 to December 1964
All commodities	2.8	0.8	1.7	3.4	0.4
Farm products, and processed foods and feeds	3.4	−1.8	.2	9.6	0
Farm products	4.4	−2.8	−1.2	11.1	−.6
Processed foods and feeds	2.9	−1.2	2.2	7.0	0
Industrial commodities	2.7	1.8	2.2	1.4	.6
Textile products and apparel	3.2	2.0	−.2	.5	.3
Hides, skins, leather, and related products	5.9	−1.1	2.4	8.7	2.3
Fuels and related products and power	−.4	.2	1.8	2.5	−1.2
Chemicals and allied products	−.7	.2	.6	.4	1.0
Rubber and rubber products	1.9	4.4	1.6	1.4	−1.7
Lumber and wood products	24.1	5.0	.6	2.5	.3
Pulp, paper, and allied products	.4	1.7	2.1	2.0	−.5
Metals and metal products	1.3	2.2	2.3	1.8	3.4
Machinery and equipment	3.1	2.3	4.7	1.6	.3
Furniture and household durables	2.8	1.7	2.2	−.2	.4
Nonmetallic mineral products	3.8	1.9	1.7	0	.3
Transportation equipment	(1)	(1)	(1)	(1)	(1)
Miscellaneous products	1.6	3.0	2.3	.8	.4

[1] Not available.

Source: U.S. Department of Labor, Bureau of Labor Statistics.

TABLE 5.—CONSUMER PRICE INDEX—U.S. CITY AVERAGE

[Percent changes for selected groups and subgroups, 1964–68]

Group	Percent changes: December 1967 to December 1968	December 1966 to December 1967	December 1965 to December 1966	December 1964 to December 1965	December 1963 to December 1964
All items	4.7	3.1	3.3	2.0	1.1
Food	4.3	1.2	3.8	3.5	1.4
Food at home	4.0	.3	3.4	3.6	1.4
Cereals and bakery products	1.4	−.3	5.9	1.1	1.8
Meats, poultry, and fish	2.9	.3	.7	11.2	−.2
Dairy products	3.8	1.4	9.8	.5	.6
Fruits and vegetables	5.7	4.6	3.0	−3.1	4.3
Other foods at home	6.1	−3.3	1.8	1.9	1.7
Food away from home	5.7	4.8	5.3	3.4	1.5
Housing	5.4	2.7	3.3	1.5	.8
Shelter	6.4	3.0	4.1	2.1	1.4
Rent	2.8	2.0	1.6	1.0	1.0
Homeownership	7.7	3.4	5.0	2.6	1.5
Fuel and utilities	2.0	.8	.3	.2	.3
Fuel oil and coal	2.7	2.6	1.5	2.6	0
Gas and electricity	1.2	.7	−.1	−.3	.2
Household furnishings and operation					
Apparel and upkeep	6.4	4.0	3.9	1.4	.5
Men's and boys'	7.3	3.7	3.0	2.1	.8
Women's and girls'	6.3	5.1	3.6	1.0	0
Footwear	6.6	4.1	6.3	3.5	.4
Transportation	2.0	3.6	2.0	1.0	1.5
Private	1.5	3.7	1.5	1.0	1.4
New cars	1.4	2.7	−.1	−2.9	−.5
Used cars	−4.9	9.3	−3.4	−4.4	2.8
Gasoline	1.6	1.3	3.4	4.0	0
Public	6.2	3.9	6.4	1.4	1.7
Health and recreation	4.9	4.6	3.8	2.0	1.4
Medical care	6.2	6.4	6.6	2.8	2.0
Personal care	5.3	3.1	3.4	0	1.1
Reading and recreation	4.9	3.2	2.6	.4	1.6
Other goods and services	3.5	4.7	2.2	2.8	.8
SPECIAL GROUPS					
All items less food	4.9	3.5	3.2	1.6	1.0
All items less medical care	4.6	2.7	3.2	2.9	1.0
Commodities	3.8	2.5	2.5	1.6	.8
Nondurables	4.4	2.3	3.3	2.7	.9
Nondurables less food	4.4	3.4	2.8	2.0	.4
Apparel commodities	6.7	4.2	3.7	1.3	.4
Durables	2.5	2.9	.7	−.1	.4
Household durables	3.9	1.4	1.7	−1.8	−1.0
Services	6.2	3.9	4.9	2.7	1.8
Services less rent	6.8	4.3	5.5	2.9	2.1
Insurance and finance	9.1	3.2	7.4	4.0	2.5
Utilities and public transportation	2.9	1.3	1.5	.1	.6
Housekeeping and home maintenance services	8.2	5.9	6.4	4.0	2.7
Medical care services	7.3	7.9	8.1	3.5	2.6

Source: U.S. Department of Labor, Bureau of Labor Statistics.

TABLE 6.—CONSUMER PRICE INDEX, EFFECT ON THE TOTAL INDEX. BY MAJOR CATEGORY

	December 1967 to December 1968	December 1966 to December 1967	December 1965 to December 1966	December 1964 to December 1965	December 1963 to December 1964
All items	4.7	3.1	3.3	2.0	1.1
Food	1.0	.3	.8	.8	.3
Nondurables less food	1.1	.8	.7	.5	.1
Durables	.4	.5	.1	−.2	.1
Services	2.2	1.5	1.7	.9	.6

Source: U.S. Department of Labor, Bureau of Labor Statistics, Washington, D.C., February 1969.

TABLE 7.—ANNUAL RATES OF CHANGE IN COMPENSATION AND EARNINGS

Measure	1965	1966	1967	1968
Compensation per hour, private nonfarm economy, all employees (4th to 4th quarter)	3.8	6.3	5.9	[1]7.5
Real compensation per hour, private nonfarm economy (4th to 4th quarter)	2.0	2.7	3.0	[1]2.7
Average hourly earnings, private nonfarm economy (December to December)	3.8	4.8	5.0	[1]7.3
Real average hourly earnings, private nonfarm economy (December to December)	1.4	1.8	1.8	[1]2.6
Real average weekly earnings, private nonfarm economy (December to December)	1.7	.1	.6	[1]2.0
Real spendable average weekly earnings (worker and 3 dependents) (December to December)	2.2	−1.0	([2])	[1].8

[1] Preliminary.
[2] Change of less than 0.05 percent.

TABLE 8.—ANNUAL RATE OF INCREASE IN WAGES AND WAGES AND BENEFITS UNDER MAJOR COLLECTIVE BARGAINING SETTLEMENTS, 1965 THROUGH 1968

Type of measure	Annual rate of increase (in percent) in settlements concluded during—			
	1965	1966	1957	1968
1st-year wage adjustment	3.8	4.8	5.6	7.5
Wage changes over life of contract	3.3	3.9	5.0	5.1
Wages and benefits (equal timing)[1]	3.3	4.1	5.2	6.0
Wages and benefits (actual timing)[1]	([2])	4.5	5.6	6.6

[1] Limited to settlements of 5,000 or more and, in 1965, 10,000 or more.
[2] Not available.

TABLE 9.—AVERAGE ANNUAL PERCENT CHANGE[1] IN OUTPUT PER MAN-HOUR AND RELATED DATA, 1947–68

Item	1947–66	1966–67	1967–68
Total private economy:			
Output per man-hour[2]	3.2	1.6	3.3
Output[2]	3.7	2.0	5.0
Employment	.9	1.7	2.2
Man-hours	.4	.4	1.6
Farm:			
Output per man-hour	5.9	12.3	.2
Output	1.4	8.6	−1.3
Employment	−3.6	−2.4	−1.0
Man-hours	−4.2	−3.3	−1.5
Nonfarm:			
Output per man-hour	2.7	1.0	3.3
Output	3.8	1.7	5.2
Employment	1.4	1.9	2.4
Man-hours	1.1	.7	1.9

[1] Computed from least squares trend of the logarithms of the indexes.
[2] Output refers to gross national product in 1958 dollars; man-hours based primarily on establishment reports.

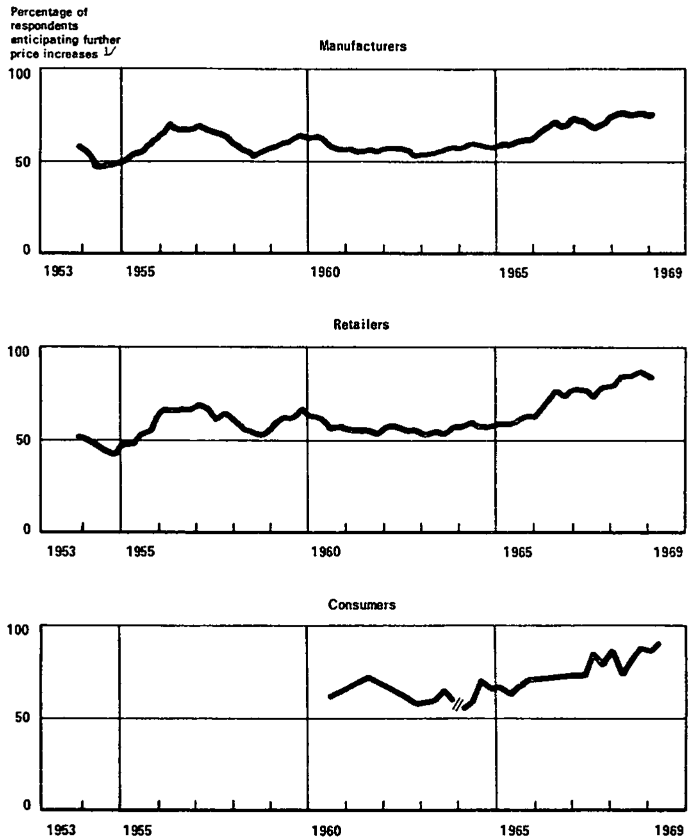
TABLE 10.—AVERAGE ANNUAL RATES OF CHANGE IN OUTPUT PER MAN-HOUR, HOURLY COMPENSATION, AND UNIT LABOR COSTS IN THE PRIVATE ECONOMY FOR SELECTED YEARS[1]

Item	1947–66	1966–67	1967–68
Unit labor costs	1.7	4.4	4.1
Output per man-hour	3.2	1.6	3.3
Compensation per man-hour	5.0	6.1	7.5
Real compensation per man-hour	3.2	3.2	3.2

[1] All rates computed from the least squares trend of the logarithms of the index numbers.

Chart 1.

Inflationary Expectations Have Been Building Up Since 1965



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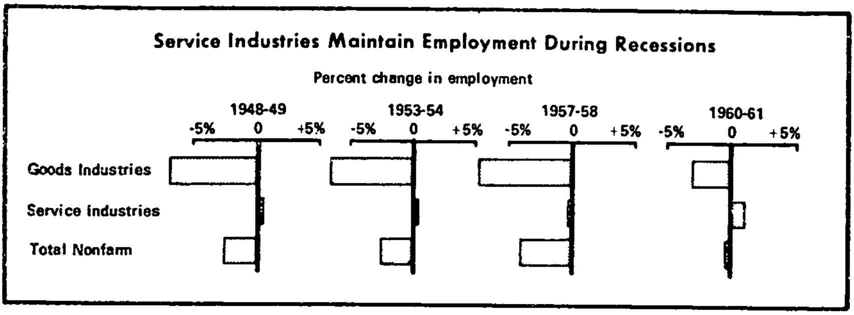
BUREAU OF LABOR STATISTICS

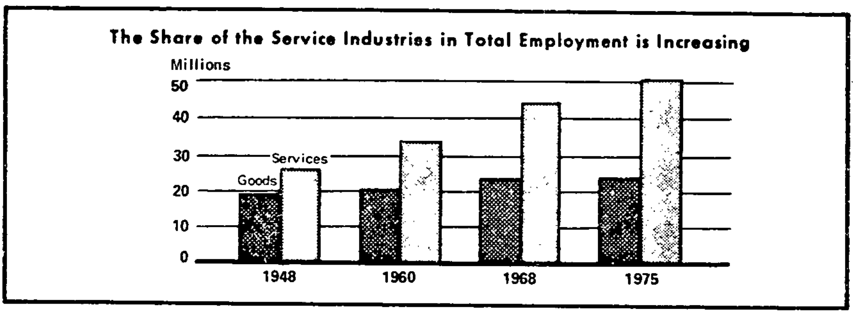
1/ Four-quarter span, plotted at final quarter.

Sources: Manufacturers and Retailers, copyright by Dun and Bradstreet. Used by permission. These series may not be reproduced without written permission from the source.
Consumers, University of Michigan Consumer Survey.

Chart 2.

The Role of Service Industries in Stabilizing Employment





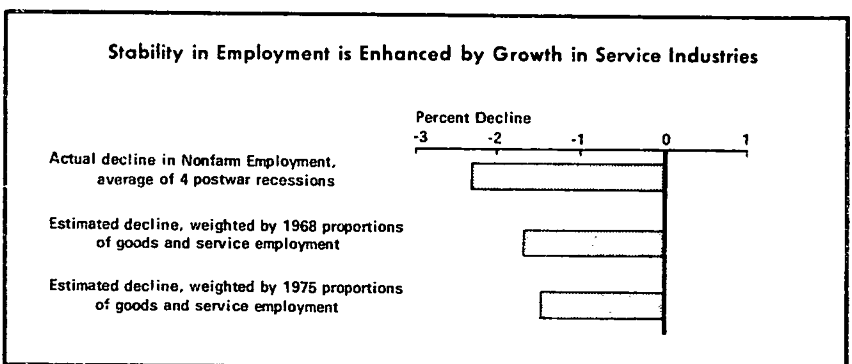


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Chart 3.

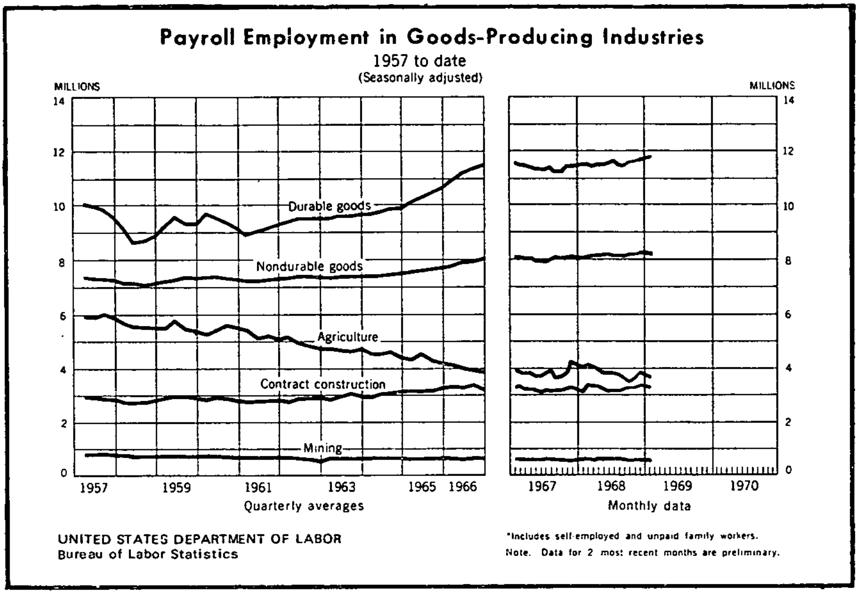


Chart 4.

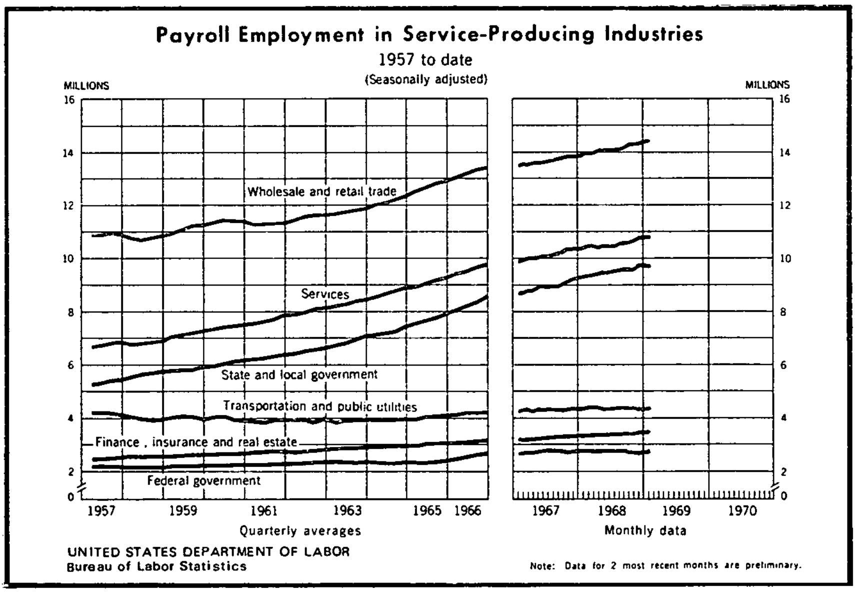
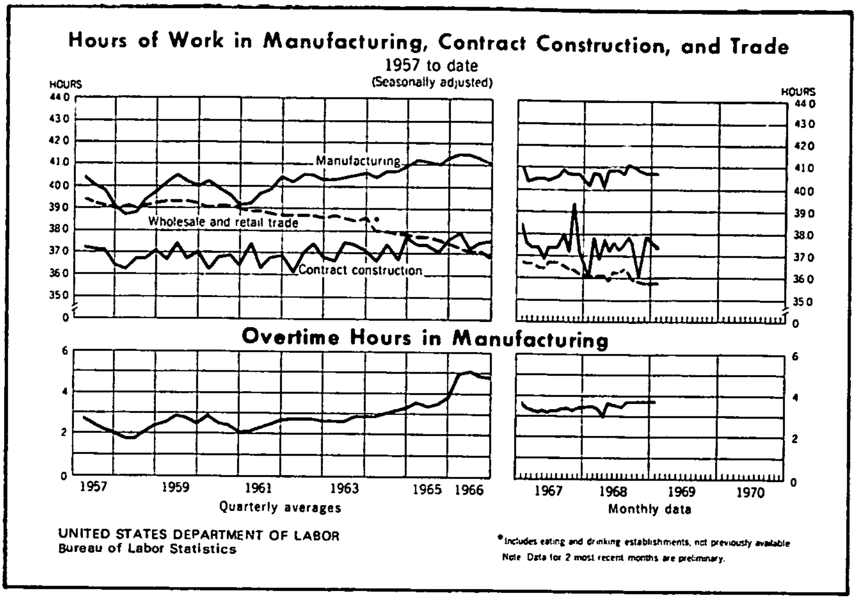


Chart 5.


Hours of Work in Manufacturing, Contract Construction, and Trade
1957 to date
(Seasonally adjusted)
HOURS
Manufacturing
Wholesale and retail trade
Contract construction
Overtime Hours in Manufacturing
1957
1959
1961
1963
1965
1966
Quarterly averages
1967
1968
1969
1970
Monthly data
UNITED STATES DEPARTMENT OF LABOR
Bureau of Labor Statistics
*Includes eating and drinking establishments, not previously available
Note: Data for 2 most recent months are preliminary.

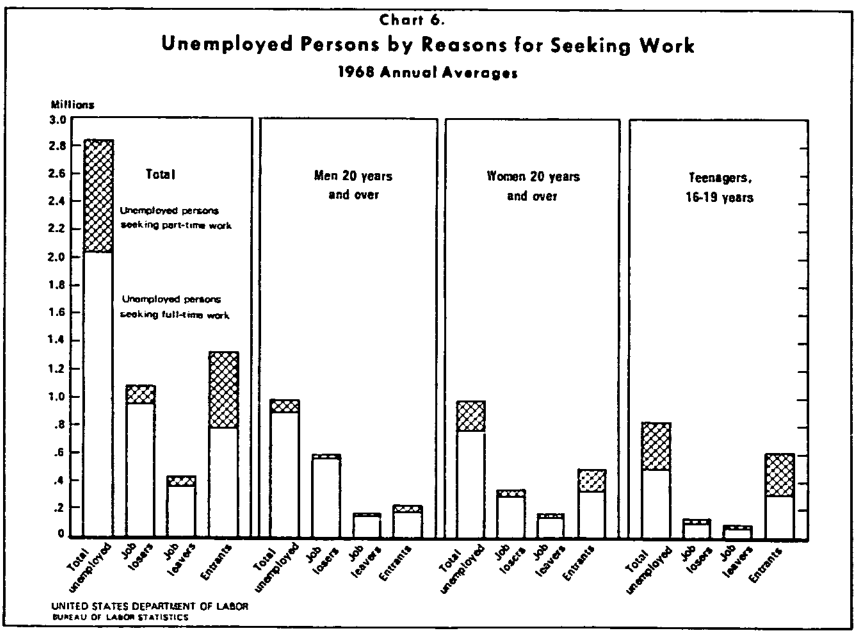


Chart 6.
Unemployed Persons by Reasons for Seeking Work
1968 Annual Averages
Millions
Total
Unemployed persons seeking part-time work
Unemployed persons seeking full-time work
Men 20 years and over
Women 20 years and over
Teenagers, 16-19 years
Total unemployed
Job losers
Job leavers
Entrants
UNITED STATES DEPARTMENT OF LABOR
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Chart 7.

Unemployment Rates for Teenagers by Color

(Seasonally adjusted quarterly averages)
1954 to date

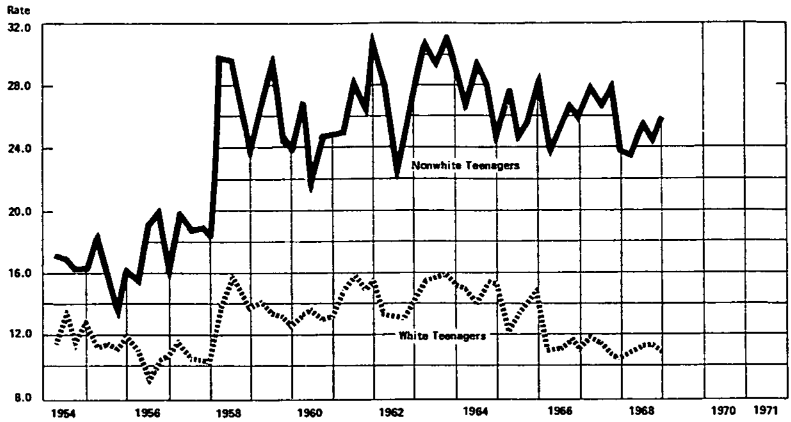

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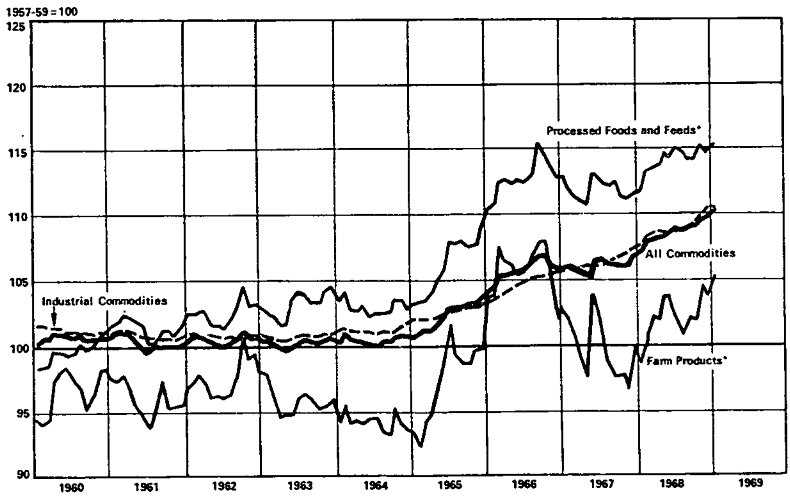
Chart 8.

Wholesale Price Indexes



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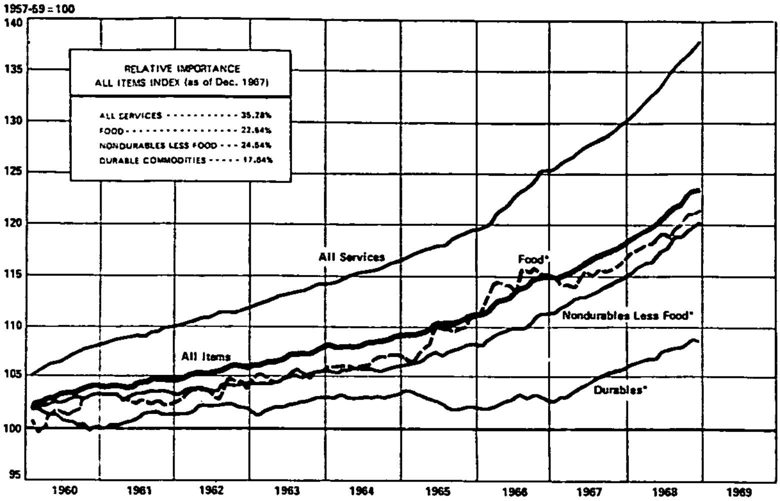
*Seasonally Adjusted
Latest Data: January 1969 (preliminary)

Chart 9.

Consumer Price Indexes: Commodities and Services



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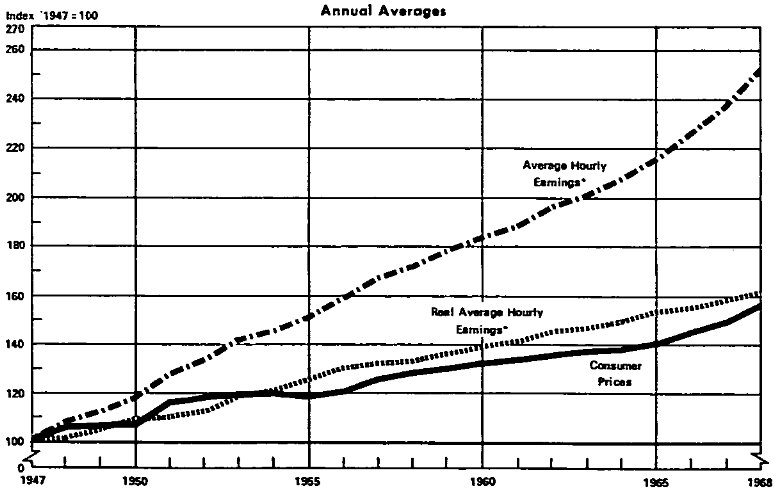
* Seasonally Adjusted
Latest Data: December 1968

Chart 10.

Indexes of Average Hourly Earnings, Real Average Hourly Earnings, and the Consumer Price Index-1957-59 Dollars

Annual Averages



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* Private nonfarm wage employees.

Chart 11.

Output Per Man-Hour, Total Private Economy, Farm and Nonfarm, 1947-68

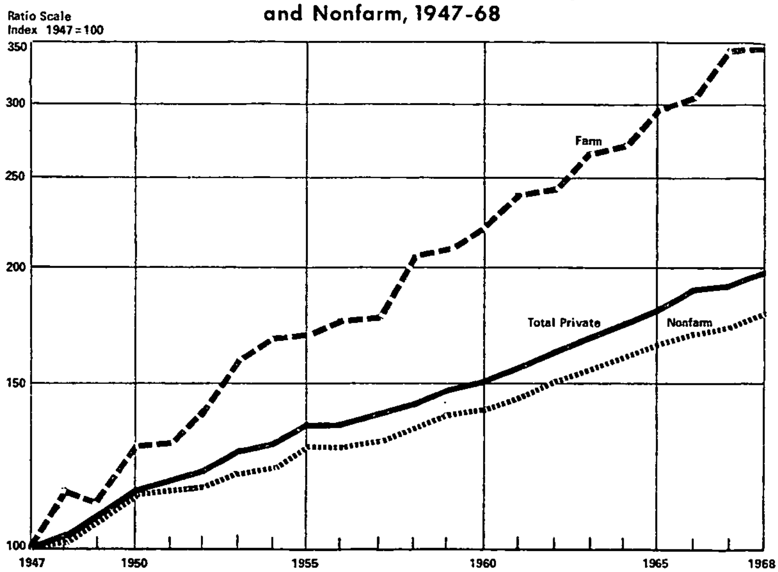

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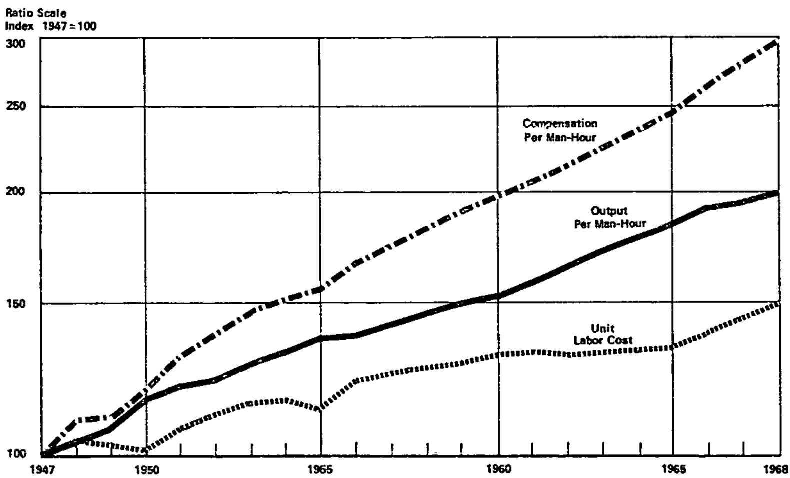
Chart 12.

Output Per Man-Hour, Compensation Per Man-Hour and Unit Labor Cost, Total Private Economy, 1947-68



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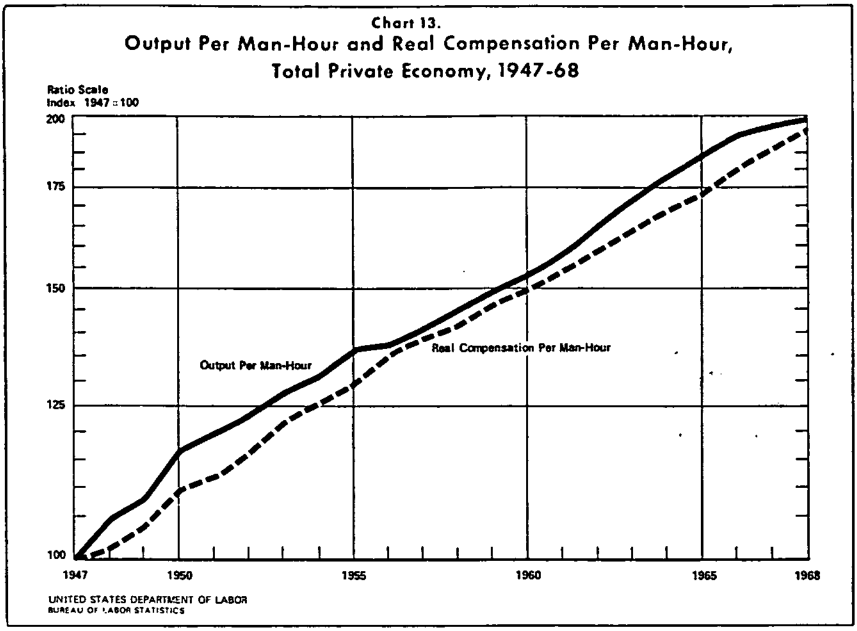

Secretary SHULTZ. You remarked on Secretary Wirtz and his nice comments about me. I would respond in kind. I consider him a good friend and very fine man. I hope to be a worthy successor. I thought I might go through the written testimony and paraphrase it and then respond to your questions.

I appreciate your comment about getting the statement late. It is practically a throwback, I guess for me anyway, to the typical academic professional meeting when you always get the paper too late to develop real comments on it. But I am reassured by the fact that you have gone through it, and I am very grateful to you for that.

My role is not that of economic forecaster today. That task has already been performed by Dr. McCracken of the Council of Economic Advisers. What I would like to do is examine the economic scene with a special view of those matters of particular concern to the Secretary of Labor, the questions of jobs and wages, labor relations, and manpower policies.

I would like to focus my comments on two questions that seem to me to be very important and necessarily high on anyone's agenda. The questions are:

What steps can help bring the current excessive rate of inflation under control without an appreciable rise in unemployment?

And second, in what ways can this effort be related to a widening of economic opportunities and thereby contribute toward an end to poverty?

Now, I view these two questions as closely connected. Inflation hurts the poor, and so does unemployment. So somehow in the axes of these two questions we need to develop an answer in a coordinated manner.

Let me address myself to the first question and say that I believe there is substantial evidence to support the hope that inflation can be contained without sacrificing the high level of employment that is required if we are to attain a measurable degree of success in attacking the problem of poverty. I might say that I recognize as an economist that that is a bold statement. But I believe there is a lot of evidence to support it.

And I rest for the moment on three principal points. The first one is that this administration, as Dr. McCracken indicated to you on Monday, will work to reduce inflationary pressures gradually, not abruptly.

It seems to me we can say that what we would like to do is turn the 1960 to 1964 period around. At that time, as you know, the effort was to bring unemployment down in a gradual manner while not having a sharp increase in prices. And that was achieved. Now we find ourselves with rapidly rising price level and low unemployment. It seems to me our approach should be to top out this rate of increase in prices and get it turned around and pointed down again, and at the same time try to maintain the low level of unemployment. And in a sense the earlier experience, I think, suggests that this approach of gradualism, mildness, but steadiness has some chance of working.

The second point is in a sense an analytical one about the nature of the economy and how it has developed. A growing proportion of workers are now employed in industries that generally do not lay people off as soon as a slackening in demand occurs. Here I point to the well-known fact that the so-called service producing sector—trade, transportation, utilities, finance, services, and government—is more stable insofar as employment is concerned than the goods producing sector—manufacturing, mining, and construction.

Thus, in 1950, 59 out of a hundred jobs outside of agriculture were in the service industries. Ten years later 62 out of a hundred, and today 65 out of a hundred. By 1975 it will be 68 out of a hundred. So a very large proportion of the new jobs as well as existing jobs are in this sector.

I think chart 2 brings out rather dramatically the meaning of this insofar as our chances of dampening inflation without having the rise in unemployment is concerned.

Secretary SHULTZ. You can see on the top line what has happened during four post-war recessions in the goods producing industries. In 1948–49 there was a decline in employment of around 7 percent there. Meanwhile the service industries actually grew a bit in employment. And you can follow that across the chart.

The second line on this chart or box is that a share of service industries in total employment—you can see how that is increasing.

Then there is a hypothetical calculation in the bottom box, in effect projecting the 1968 and then the 1975 proportions of services and goods industries into the average decline in employment for these four periods, showing the difference that it makes.

So as an analytical point we have a shift in composition of the economy toward more stability in the private sector. This stable base, I think, gives us some hope that the kind of outcome that we seek can be attained.

Third, I point to the increased variety and growing quantitative importance of policy instruments available, in addition to the traditional tools of fiscal and monetary policy.

I am going to concentrate in my remarks, as you would expect, on the labor market and manpower area. But I would like to take note of the fact in passing that there are a great number of other matters of direct economic policy that are important here. I mention particularly the antitrust field and the international trade field as important ones.

On the manpower side there are three particular things, it seems to me, to note as policy considerations in the solution of this problem. The first is that with the present unemployment, even though it is low, there are great disparities in the unemployment rate by groups of people. So one thing that manpower policy can do is work directly in those areas where you have exceedingly high unemployment. That is target No. 1.

Second, it is possible to direct these policies toward areas where we have special shortages and try to build up our supply of labor in these shortage areas to cool things down.

And third, we can direct our efforts toward improving the quality of performance of the labor market as a market, and thereby reduce somewhat the unemployment experience.

So these three things, I think, in the manpower area can be helpful as matters of general economic policy.

I might just note in passing that Government manpower policy, from my observation, has an influence that is not limited simply to what happens in Government programs. There seems to have been a kind of rippling effect in industry. We see a lot of companies, for example, doing things about the disadvantaged unemployed on their own. This reflects their own feeling, but it also represents, I believe, the influence of Government programs.

I don't wish to exaggerate the role that the Department manpower programs can play. Obviously, they require a considerable period of time to become effective, and alone they would prove powerless to curb inflation. But together with an effective use of fiscal and monetary policy, I think the manpower programs can help make possible a gradual transition to a significantly lower rate of price inflation, while maintaining a high employment economy.

Mr. Chairman, I would like to turn to a brief review of some recent developments. I am trying to refrain from a description of statistics here, and will pick out a few points that seem to me of special importance as we analyze the current situation and try to devise our policies to meet it.

First, I will turn to the area of employment and unemployment. The first point that I would make is that when you look at what has happened since mid-1965, a rather stunning fact emerges: the great impact of the military buildup. We estimate that nearly 2.5 million individuals since mid-1965 have been added to employment either in the Armed Forces or in defense-related activities in this period. That is 85 percent of the increase in male employment. So we have had a big buildup here.

Looking at it from the point of view of the inflation problem, we see that there has been a big increase of people in employment. They are receiving income from that employment and are able to demand civilian goods for that income. But the nature of their employment means that they aren't contributing anything to the production of civilian goods. So you see the impact of that in terms of the inflationary problem. Of course this fact points up for us the importance of post-Vietnam planning. This work, as you know, is under the leadership of Herb Stein of the Council of Economic Advisers.

A second point in the manpower story is that when you look at the employment picture you see very little impact of the fiscal restraint that has been introduced. Perhaps you can see some reduction in the workweek but I think you have to look pretty hard at these figures to see any impact.

Next, I think it is significant to notice the substantial reduction in the number of people who have lost their jobs. I think it is a mistake to think of the unemployed purely in these terms, but at any rate, we see a reduction of about 40 percent in people who are unemployed because they have lost their jobs, as distinct from people who quit their jobs voluntarily, and new entrants.

Chart 6 is an interesting one on this account since it shows unemployed persons by reason for seeking work. You can see on this chart the numbes of those who have lost their jobs as distinct from voluntary quits, and new entrants. This gives a picture of the composition of the unemployed.

These data make clear that some unemployment arises when the worker has freedom to quit in order to improve his position, freedom to seek part-time rather than full-time work, and freedom not to take the first job that is offered. One of the benefits then, of full employment—I think this is a benefit that shouldn't be underrated—is that it makes it easier to exercise these choices, to shift jobs and to be selective. Quit rates are usually high when the job market is tight and low when it becomes less buoyant. Similarly, the number of new entrants or reentrants may rise and fall with job opportunities.

The next point I would like to make is that the current low overall employment rate masks wide disparities. In some areas, especially the married male supporting a family, unemployment is very low; below 2 percent, and this is probably down to about the lowest fractional rate of unemployment. On the other hand there are areas where unemployment is quite high. And I think particularly the teenagers deserve attention here. The unemployment rate for teenagers remains stubbornly high. The current teenage rate is significantly below the rates for the first half of this decade. But it has hardly changed in the last 3 years; it has not shown the kind of improvement that has been experienced by adult workers.

The situation of the Negro teenager requires special mention. The jobless rates for Negroes 16 to 19 years old was 25 percent, as against 11 percent for white youngsters. I might say that unemployment rate for Negro teenagers has really not changed very much in a decade. It was high a long while ago, and it is still high. Negro teenagers have remained virtually untouched by the recent employment reductions, whereas their white counterparts have experienced a substantial reduction in joblessness. As a result, the ratio of Negro-to-white teenager unemployment rates has risen substantially in recent years. In 1954 the teenage Negro-to-white ratio was 1.4 to 1. By 1968 the ratio had risen to 2.3 to 1. And Negro girls have faired somewhat worse than boys.

I think in terms of perspective it is important to note the absolute magnitude that we are talking about. Even with the high rates the total number of unemployed Negro teenagers averaged about 200,000 in 1968. Furthermore, over one-third were seeking only part-time work, mainly because they are still in school.

There is another aspect of this diversity that is brought out in a new survey that is being conducted in the Department of Labor by the BLS, the Manpower Administration, and with the Census Bureau doing the data collection. This new survey is aimed at finding out more about what is happening in the slum areas and will be a useful addition to our flow of information about employment and unemployment. The first report is being released today and I want to call attention to three of its findings.

Senator PROXMIRE. I would like to interrupt for a moment, Mr. Secretary, to suggest that you are referring to the release of this morning, Thursday, February 20, on the "Employment Situation Surveyed in Slum Areas of Six Large Cities?"

Secretary SHULTZ. That is right, sir.

Senator PROXMIRE (presiding). I ask unanimous consent that that statement, which is brief, a little over four pages, be printed in the record right after your remarks. (See p. 453.)

Secretary SHULTZ. Fine. Thank you.

First, and I wouldn't say these findings are surprising, we see that high unemployment rates and low earnings characterize the employment situation of residents in these six slum areas.

Second, that the jobless rate for Negro workers in these areas is higher than in other areas, 10.4 percent. But it is interesting to note that it is also higher for other groups in those areas, such as Mexican-Americans and Puerto Ricans. This tends to reinforce the point of view that the difficulties shared by those living in these neighborhoods affect more than a single racial or ethnic group.

It is also an interesting fact that while low incomes characterize these residents, a sizable proportion reported earnings well above the poverty level. This suggests to us that there is success as well as problems in those areas. We want to ask ourselves, can we learn anything from the success that would be applicable to situations where we have more problems.

The current low national unemployment rates, while really encouraging, thus do not permit complacency. Instead they point to the need for a variety of manpower programs to create work opportunities, specially in an economy that might be growing at a slower pace than that of recent years.

I will skip through the material on wage, price, and productivity changes, noting, first, that the average hourly compensation of all persons in the private economy rose by 7.5 percent in 1968, compared to 6.1 percent the previous year, and an average from 1947 to 1966 of 5 percent. This is a measure of the inflation on the other side. I think it is important to note that this is not simply a collective bargaining development, but that you see this increase broadly in the economy in nonunion as well as union establishments. To put it another way, it is essentially a labor market phenomenon rather than a collective bargaining phenomenon.

Productivity in the economy as a whole rebounded last year to a rate of 3.3 from the low rate of 1.6 percent in the prior year. Nevertheless, unit labor costs rose by about 4 percent in the private economy.

If we put the productivity material together with the compensation and price material and look at real hourly compensation we see that in the first 5 years of this decade real compensation did not keep pace with the advances in productivity.

Thus, labor's share of the total product was reduced from 63 to 61 percent. But then the uncommonly large increases in hourly compensation during the past 3 years have restored labor's share to approximately the 1960 level.

When we look at collective bargaining, it is good sport to speculate on the future. We do have one fact about what is going to happen in 1969 that is of considerable importance. About 6.1 million workers covered by collective bargaining agreements will receive deferred wage increases this year averaging about 4.1 percent. Now, that is the largest number of people who are covered by deferred wage increases that we have had. It reflects the front-end loading in a number of the contract negotiations. And of course it will have a dampening influence on the average of collective bargaining wage increases, whatever the 1969 picture works out to be. It seems to me the 1969 contracts are starting out with pretty high pitch to them. But at any rate, there are these 6.1 million at the 4.1 percent level.

The cost-of-living clauses in contracts will result in some wage increases. But it is interesting to note that there are limits on most of them now. There has been an effort in collective bargaining to put a lid on these clauses.

The prices of services, many of which have limited potential for productivity increases, are likely to continue their rapidly rising trend. The Department of Agriculture anticipates an increase in prices of 2 to 2½ percent in food prices as compared to 3½ percent from 1967 to 1968. That will serve as a retarding influence on the rate of increase of the economy as a whole.

Let me turn now to the subject of manpower programs and their relation to economic and social goals. The Nation's manpower programs have been primarily directed at human problems while their economic effects got secondary consideration. They have been concerned with opening opportunities for persons disadvantaged by technological change, economic downturn, or dislocation, poor and discriminatory educational preparation, and other barriers to self-supporting employment. It has long been recognized that each of these programs has some economic effect. But their total economic impact has never been gaged, even though the manpower programs now run by the Department of Labor alone will total about $2 billion for fiscal 1969, and reach almost a million individuals. What has become clear during the last decade is that the combined effect of these programs can be crucial in reaching broad national economic objectives. Historically, economists have given only a passing nod to the possibility that a better functioning labor market could contribute significantly to the overall function of the economy.

This is no longer the case. The way we design and run our manpower programs will, I believe, be an important factor in answering the basic questions posed at the outset of this testimony.

I would like to point out four points of emphasis within the manpower area.

The first is the importance of being sure that our manpower programs are targeted to reach these groups whose employment problems are sizable and serious.

We talked about youth, particularly Negro youth. There is much emphasis now in the manpower programs in that direction. But the problem persists. And it is serious, somewhat baffling. And it calls sharp attention to itself.

But we are studying a variety of things that we think may be helpful here. There is a possibility of some shift in emphasis in the case of the older, out-of-school teenager from enrollment in NYC programs to enterprise employment training where they have better career income possibilities. I think there is some possibility in having a shift in emphasis a bit in the JOBS program run by the National Alliance of Businessmen, and an expansion in coverage of that program, which has worked very well.

It seems to me, also, we should be giving more attention to the whole problem of the transition from school to work. While I have not been one of those who has felt that you could look at the European countries—and Sweden particularly gets a lot of attention in this area—and transpose their programs to our much more complicated and larger environment, we, nevertheless, can learn some things. It is particularly interesting to note that the youth unemployment problems are greater in the United States than they are, say, in Japan, or in the European countries generally. It is also important to recognize that three-quarters of the unemployed youth are accounted for by those who are newly entering or reentering the labor force in search of work. This transition problem is an important and large one.

There are some things that we can do about that. We can improve the relations between the Employment Service and the schools. We can expand the cooperative education programs in the schools. We have an opportunity for a considerable expansion there.

Some part of the youth unemployment problem will be influenced by what we do about the military draft. As new programs are developed to meet the Nation's military manpower obligations, we should be able to find ways of removing the uncertainties which today make some employers reluctant to employ young people with future possible draft obligations hanging over their heads. This is an additional burden on youth.

We are concerned also about seasonal problems, particularly in construction. There are some things underway that should help us do something about that problem. This is an area where we want to work aggressively.

Second is the importance of building skills that will increase the productive capacity of the economy and improve its ability to meet the heavy demand for goods and services which prosperity induces—a demand which can lead, unless offset by output, to price rises.

The medical and construction areas are two that have severe shortages in them. The manpower programs need to be directed more into these areas.

We intend to put more emphasis on upgrading. This builds skills and can help in meeting labor shortages.

A third area that I want to comment on involves improved efficiency of the labor market itself. There are some interesting developments coming along in that field. One is the job bank that is now operating in Baltimore, Md. A daily list of job openings in the area is run through a computer and that list is made available to all the Employment Service offices. I am going to talk in a minute about national or regional labor markets, but most jobs, of course, are found in a local labor area. This important device should be some help.

In Utah we have the beginnings of a job-matching system that has just been put into place. We are watching its development and trying to learn from Utah's experience. I feel that it has national potential.

Now, I have been emphasizing the positive aspects of this subject. But I want to add a note of caution. Arrangements on the part of an individual to take a job and of an employer to put someone to work involve personal considerations that are not subject to computerization and, indeed, these must be carefully preserved in a free and open labor market. We must never allow ourselves to forget that the employment process fundamentally involves a human relationship, an intense human search which may be assisted by a computer process.

There have been some experiments with mobility benefits, not to direct people forcibly, but to open new opportunities on a voluntary basis. These experiments are worth following and continuing, and perhaps we can tie them into the growing body of information the Department of Commerce is developing on growth areas of the Nation.

We are also working on the job vacancy data and hope to develop a better system of job vacancies information.

I can't pass by this subject without taking note of the fact that discrimination in employment continues to exist. It is important to keep working on the elimination of arbitrary discrimination through hiring standards irrelevant to job performance. More and more employers recognize this. Employers have had the interesting experience of working with the hard core and being surprised at how well things have actually worked out. This has had quite some impact on their own thinking about what they do in the vestibule of employment in indoctrinating people and bringing them into the work force.

Fourth, I want to call attention to the importance of cushioning the human and economic losses that arise when workers lose their jobs through no fault of their own. I believe our unemployment insurance system is exceedingly important. We need to study it and improve it if it is to play a fully effective role in combating economic and human adversity.

Each of these four areas of emphasis involves many specific actions. Each action by itself is likely to have a small, often not easily measured effect on the overall unemployment rate, particularly the youth rate. But together they can have a sizable impact. They can play an important part in efforts to combine high employment and a stable price level while augmenting our drive to put an end to poverty.

I think in the manpower area an important thing for us to do and which we have been working on very hard, particularly Arnold Weber, Assistant Secretary of Labor for Manpower, is to see if we can't organize the management of this flow of funds better. And we are working, as I say, very hard on that. We think the States, cities, and towns deserve a more understandable and responsive Federal partner. We hope to make major organizational improvements at an early date.

Concurrently, a strong effort must be made to develop stronger relationships within the present or any proposed program content in the manpower field. As the President said in his message to Congress yesterday:

One of the priority aims in the new Administration is the development by the Department of Labor of a comprehensive manpower program, designed to make centrally available to the unemployed and the underemployed a full range of federal job training and placement services. Toward this and it is essential that the many federal manpower programs be integrated and coordinated.

I think this is a most important and serious responsibility.

As we work toward those objectives, we do so with the knowledge that our manpower programs are coming of age. They have grown to a size and scope that gives them strategic significance in our economics as well as social policies.

This significance is enhanced under current economic conditions. A strong job market makes it possible to move idle and underutilized human resources into productive activity. The prospect that this current high level of job demand will be a stable and continuing one lends internal strength to the manpower efforts.

I welcome the growing attention of the Nation's policymakers and of this committee to the contribution that manpower programs can make, with the growing and proud realization that manpower matters are now too important to be left only to the manpower experts.

(The news release referred to earlier follows:)

U.S. DEPARTMENT OF LABOR: OFFICE OF INFORMATION

EMPLOYMENT SITUATION SURVEYED IN SLUM AREAS OF SIX LARGE CITIES

—Workers living in slum areas have an unemployment rate 2½ times higher than the national average.

—Unemployment among teenagers is especially severe: 30 percent of slum youths are unemployed.

—Weekly earnings under $65 were reported by 1 out of 6 full-time workers.

These are the highlights of the first Urban Employment Survey, a new data collection program established by the Department of Labor to examine the employment situation, barriers to employment, attitudes and motivations of slum area residents. Included in the survey are the Concentrated Employment Program areas of Atlanta, Chicago, Detroit, Houston, Los Angeles, and New York City.[1]

The survey is being directed by the Bureau of Labor Statistics with the cooperation and financing of the Manpower Administration. The Bureau of the Census is collecting the information.

The first results of the Urban Employment Survey cover basic labor force information for all six slum areas combined for the 3-month period July–September 1968. Similar information covering a 6-month period for the 6 individual areas will be published later. Additional data for each area will become available later this year.

Here are additional findings of the Urban Employment Survey.

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[1] The survey area in New York City includes additional target neighborhoods outside the CEP designated areas. The balance of the cities of Atlanta and Detroit are also included in the survey.

Population

Approximately 825,000 men and women 16 years old and over resided in the selected slum areas of the six cities. Of the residents, 68 percent were Negro; the remainder were about equally divided between Spanish-American and other white persons.

Educational attainment

Workers living in the Urban Employment Survey areas had not completed as much schooling as their counterparts in the Nation as a whole. Slum area workers 18 years and over averaged 10.7 years of school completed, compared with 12.3 years for all the Nation's workers and 11.1 years for Negro workers in March 1968. Only 37 percent of the workers in these areas, compared to 60 percent of the workers in the Nation as a whole, had completed 4 years of high school or more. About the same proportion of Negro and white workers in the survey areas had completed high school.

Adult women workers (25 years and over) living in UES slum areas were better educated than men. The proportions who completed 4 years of high school or more were 39 percent for women and 30 percent for men. In the Nation as a whole, about three out of five of both adult men and women workers had completed at least 4 years of high school.

Labor force participation and employment

During the third quarter of 1968, 59 percent of the persons 16 years and over living in the UES slum areas were in the Labor force—working or looking for work. That was about the same as the national proportion. Adult women in the survey areas were more likely to be in the labor force than women in the Nation as a whole. In the case of adult men, the labor force participation rate was lower in the slum areas than nationally.

An unusually large proportion of the persons not in the labor force reported that they wanted work; 23 percent of the slum resident who were not in the labor force reported that they wanted a job "now," as compared to 8 percent of the nonparticipants nationally. More than half of those in slum areas who wanted a job indicated that they intended to look for work during the next 12 months; this compares with 78 percent in the Nation as a whole.

Nearly half of the men in the Urban Employment Survey areas who were not in the labor force but wanted a job, listed health problems as one of the reasons they were not looking for work. Health problems and family responsibilities were the main reasons given by women for nonparticipation.

About 80 percent of the employed persons at work in UES areas were working full time (35 hours or more weekly) during the third quarter of 1968, less than the national average (86 percent). Of those who were working part time, most did so voluntarily, although others wanted but couldn't find full-time jobs. About 1 out of every 5 slum area part-time workers was on short hours because of circumstances beyond his control, such as slack work, material shortages, and repairs to plant and equipment. That was about the same proportion as in the Nation as a whole.

Unemployment

At 9.5 percent, the unemployment rate for workers in the UES slum areas was more than two and one-half times the national average (3.6 percent) during the third quarter of 1968. The jobless rate for Negro workers in the UES slum areas was 10.4 percent compared with 6.8 percent for all Negro workers in the United States. White workers in the UES areas and in the Nation as a whole had unemployment rates of 7.2 and 3.2 percent, respectively.

Teenagers residing in these slum areas were particularly affected by unemployment. The teenage unemployment rate was 30 percent in the UES areas; this compares with 12.2 percent for all teenagers and 24.4 percent for Negro teenagers in the entire country. Jobless rates in these slum areas were 5.2 percent for adult men and 9.3 percent for adult women, compared to respective rates of 1.9 and 4.0 percent for all adult workers in the Nation. Heads of households had an unemployment of 4.2 percent for men and 8.0 percent for women, about three times the corresponding national averages.

Work experience

One of the best measures of the employment problems faced by residents of slum areas is their work experience over a full year. This contrasts with the labor force status information described earlier which relates to an individual's employment and unemployment experience during the calendar week immediately prior to the interview.

Nearly 110,000 persons living in the UES areas—about one out of every five who worked or looked for work—were unemployed at some time during the 12 months prior to the survey week. This contrasts with about one out of every eight in the Nation as a whole in 1967. Negro workers were more likely than white workers to be jobless at some time during the year. About one out of four slum residents who experienced unemployment did not work at all during the year; this was more than twice the proportion in the entire Nation.

Of the 110,000 persons with some unemployment during the year, one-fourth were out of work for a total of 15 or more weeks—about the same proportion as in the Nation as a whole. For men 20 to 64 years old who were heads of households, the proportion was much higher—38 percent. Another one-third of the unemployed experienced a total of 5 to 14 weeks of joblessness. Thus, well over half of those who experienced some unemployment during the previous 12 month period were out of work 5 weeks or more, slightly higher than the proportion in the entire Nation.

Earnings

About 1 out of 6 full-time workers from the UES areas reported earning less than $65 a week, or about the equivalent of the current Federal minimum wage for a 40-hour week. Women were four times more likely than men to be among the low earners. There was little variation in the proportion of Negro and white workers earning less than $65 weekly.

Although a large proportion of slum area workers received low earnings, many other UES residents had substantial weekly earnings; about one out of seven full-time workers earned $150 or more a week. Median weekly earnings for all full-time workers were $92, with men averaging $106 and women $74.

Median earnings for all workers in the UES areas (including both full- and part-time workers) were $85 a week in the third quarter of 1968. About 1 out of 4 earned less than $65 weekly, while more than one out of three workers earned more than $100 a week.

Family income

A disproportionate number of slum area residents are members of families with very low yearly incomes—which include earnings, welfare payments, rents, and money from all sources. About 20 percent of the UES area families with 4 persons or more reported incomes of less than $3,500 during the previous 12 months. This level of income approximates the "poverty line" developed by the Social Security Administration, which takes into account such factors as family size, number of children, and farm-nonfarm residence, as well as the amount of money income. On the other hand, nearly one-third of these families had incomes of $8,000 or more. There was little difference in the proportion of white and Negro UES area families with that level of income. The median annual income for all UES families was $5,400, compared to the 1967 U.S. average (median) of $8,000 for all families and $5,100 for all Negro families. Although median income levels were significantly lower than the U.S. average for families in the slum areas, about 1 out of 4 slum area families received $8,000 or more.

Unrelated individuals residing in the UES slums reported a median annual income of $2,500. Two-thirds of them received incomes of less than $3,500 during the 12 month period.

Future UES Reports

This preliminary release has furnished basic labor force information for the six poverty areas combined, although there are significant variations in the economic and social characteristics of persons residing in the separate UES areas. As the UES sample is accumulated to a satisfactory degree of statistical reliability, the data for each individual UES area will be published. Subsequent reports will also provide additional information on employment and unemployment as well as detailed data on job seeking methods, work history, job mobility, migration patterns, job skills, transportation problems, and attitudes towards work.

Senator PROXMIRE (presiding). Thank you, Mr. Secretary, for a thoughtful, intelligent, and I think most encouraging statement.

Mr. Secretary, do you envision your job as being the man to speak vigorously in the counsels of the administration for the migrant worker, the unemployed, or those on a minimum wage, the poor, is that part of your job?

Secretary SHULTZ. Yes, sir.

Senator PROXMIRE. This has always been a lonely job in every administration. And it seems to me that it is most important that a man in your high position, and with your intelligence and ability to articulate the position, should envision that very strongly.

As I see it, the way you spell this out, you say that you feel that stability in the service industries—which you point up very well, I don't know of anybody who has emphasized this as clearly and convincingly as you have this morning—better targeted manpower porgrams, better and more efficient labor markets, the use of something like the Baltimore and Utah job matching approach—these are the kinds of things that you feel would be helpful. Now, yesterday the Secretary of the Treasury said the administration would persist in economic restraint until there are unmistakable signs that inflation is under control, or at least inflation is no longer as serious a threat as it has been. And his was one of the most helpful statements we had indicating what the administration has in mind. He indicated that in 1967 there was a mistake on our part. In 1967 in the first half, growth slowed to about 1 percent in real terms. Unemployment went up at one point over 4 percent. Now, according to Mr. Kennedy, this would not be sufficient evidence of a slowdown in the economy to indicate that we should let up on restraint, we should still persist under those circumstances. This would mean that if we do that, unemployment for Negroes would exceed 10 percent, and it would mean, of course, that in the view of many people, including many Members of Congress, we would have a situation in which there was a stagnation in the economy. Now, would you concur with Mr. Kennedy, or would you counsel the President against such a price for continuing the fight on inflation?

Secretary SHULTZ. I believe, as I have said in my statement, that our initial objective should be to top out the rate of increase in prices; to get the rate of increase moving down from its current roughly 5 percent level; down to 4 percent, and so on. If we can top it out and get it moving downward, that is a major achievement. What we should be doing, is working toward that end while watching very carefully the employment situation.

Senator PROXMIRE. Of course, if we can do that we would all like it. It is very appealing the way you put it, the contrast with the early sixties, where we had a situation where we were able to keep stable prices and reduce unemployment. And you say we ought to keep stable levels of low unemployment and work on getting prices down. We haven't ever been able to do that before.

You reject one device which the administration seemed to think was a very useful one. John Sheehan made a study which I thought was a most impressive study, "Wage-Price Guidelines." We had hearing on it before this committee with four experts all agreeing that if you had the right kind of fiscal and monetary policy, that these are a useful adjunct, certainly not the whole show, but certainly useful. And you reject them out of hand, I take it. And, yet, you somehow feel somewhere, some way, we can maintain this low level of unemployment and overcome inflation. It seems to me that to rely on the very important but quite limited program you suggested isn't very encouraging.

Secretary SHULTZ. Well, I agree with you that the problem is a tough one, and that it hasn't really been resolved successfully anywhere. I believe that it is extremely important to keep your eye on this unemployment picture as well as on the inflation side of life.

Senator PROXMIRE. You say keep your eye on it, but you are going to be the man in the administration who under these circumstances is going to say, we simply shouldn't pay this price. This is something that we simply must not let unemployment do, rise significantly.

Secretary SHULTZ. I don't expect that my voice or my concern about unemployment will be the only one by any means. The President certainly is conscious of this. Mr. Kennedy is very conscious of it.

Senator PROXMIRE. But you are one of the most vigorous proponents of providing adequate growth in employment.

Secretary SHULTZ. Well, I expect to have equally vigorous colleagues.

Senator PROXMIRE. I don't want to put words in your mouth. I take it you do reject wage-price guidelines. I heard you on television say so. I just want to be sure that I am not speaking out of turn. Do you feel that wage-price guidelines are something that we should reject?

Secretary SHULTZ. Yes, I do.

Senator PROXMIRE. Would you go so far as to say that we shouldn't use President Kennedy and President Johnson's way, which many people feel is very effective, with the President speaking out vigorously when prices are increased, such as in the steel industry?

Secretary SHULTZ. I don't believe that the Presidential efforts have been all that effective.

Senator PROXMIRE. In other words, you don't think he should do it?

Secretary SHULTZ. I think as a practical matter the guideposts did not work in this country. They have been tried in one form or another in practically all of the democratic countries of the world and they haven't worked anywhere. I think that it is in some ways, sir, a deceiving kind of policy to follow. As you point out, what I have suggested as an approach to resolving this problem is certainly not sure fire, on the other hand, I think the experience of the guideposts and similar arrangements—income policies of various kinds—while they have not worked, they have led people to feel that they would, and thereby relax their attention on the monetary, fiscal, manpower, and other kinds of activities that are the fundamental ways to get at the problem.

Senator PROXMIRE. But do not the statistics show that in the period from 1962 through 1965, those 5 years, we had dropping unemployment and we did not have a sharp increase in the cost of living, and it was an unusual performance on the basis of historical experience? There may have been many reasons for it. But wage guidelines were one of the policies that the past administrations pursued that seemed to help. They feel so strongly about it that they recommend that we still try to proceed with it.

Secretary SHULTZ. My view on that, if I can just take a moment to develop it, is, first of all, to be dubious that the guideposts did play much if any part in what I agree with you was a good performance.

Second, I feel that the guideposts did quite a lot of damage when they blew up. They probably contributed to a higher level of wage settlements than we otherwise would have had, and greater strife on the collecting bargaining scene. The airlines example is a key one. I think the guideposts contributed there to a higher settlement than otherwise would have taken place, and to a longer strike.

In addition, the guidepost philosophy led the Government into what I would regard as a highly undesirable type of behavior, with the President, the Council of Economic Advisers, and various Cabinet officers calling people in from industries to discuss their pricing. We have an antitrust law that says that companies shouldn't get together and conspire about pricing. In the fact of that the Government calls people in and says, let's get together, boys, and have an agreement about prices. It seems to me that that is antithetical to the kind of competitive economy we want to promote. So my view is that the guideposts lead us into no end of trouble. Furthermore, they are discriminatory.

Senator PROXMIRE. You see, the difficulty is that in some major areas we don't have competition, and we know that Antitrust will take many years to get it. And we probably will never get it in steel, nobody can pretend that pricing in steel is competive. And nobody can pretend in some of these other areas—for example, in automobiles, where you have three companies that dominate—that pricing is as competitive as it is in many other areas. Under these circumstances there isn't any question that you have administrative decisions that have a profound effect on prices and on the price level. And of course, these are bellwether industries that do affect others.

I am sorry, if you want to proceed, go ahead, because of course you are the witness. But there are other things I want to get to. But I can do it later. But go right ahead.

Secretary SHULTZ. I wanted to follow along with your comments about steel and automobiles, because I think they are good selections from the administered price standpoint. But I point out that in both cases you have had quite an impact of competition. The picture of steel prices in the period since, say roughly 1960, is a very different one than the picture prior to that date. And I think the reason is perfectly clear.

Senator PROXMIRE. Imports.

Secretary SHULTZ. Imports is part of it, and competition from other materials is the other part. So it seems to me that the steel industry has been locked in a competitive vice, and that this competition has resulted in relative stability of steel prices compared with the earlier period: they have gone up, but not anywhere near like they had been. The reason for that was not presidential jaw-boning, not calling the companies in and giving them the word, but competition.

Now, in the automobile case I think that even there the imports of foreign cars as well as product type competition had an impact. It was well know some years ago that the Big Three auto makers didn't want to make small cars. But here they are making them. Why? Well, George Romney put them on the spot with the Rambler, as you well know.

Senator PROXMIRE. In Wisconsin.

Secretary SHULTZ. In Wisconsin. The foreign imports also put them on the spot, and competition forced them into the smaller cars, whether they liked it or not. So I think that competition and supply and demand factors are going to be the basic determinants.

Senator PROXMIRE (presiding). Senator Jordan?

Senator JORDAN. Thank you.

Mr. Secretary, I want to commend you for what I regard as a very fine statement.

First, I should like to ask a question that Senator Javits would have asked if he had not been called to another committee. There has been a great deal of interest recently in improving the Government's ability to deal with strikes in industries strategic to the economy. Do you have any proposals to deal with national emergency strikes, and does the administration contemplate any recommendation? Do you see any objection to congressional hearings on this subject?

Secretary SHULTZ. Let me take the second question first. I am very new to the Washington scene. But I sense that it would be out of place for me to comment on the appropriateness or the inappropriateness of congressional hearings about anything. That is Congress' business, and I will stay out of it.

But as far as the issue itself is concerned, the President, I think, has spoken publicly on that. We said that we are concerned about that area. And we are studying it. And we will bring recommendations to the Congress and state our views on that subject.

Since we are just beginning, I don't have a program to present to you at this time. But there are various kinds of things that might be considered. Most of these are very well known but it may be that we can think of something that hasn't been thought of before. At the same time, I think this is a question of what can you put together at this particular moment that will improve matters. And I think there are, myself, some things that can be done that would improve our ability to handle these emergency strike situations.

Senator JORDAN. Do you think the administration will have more to say about it at a later date?

Secretary SHULTZ. I am sure we will, sir.

Senator JORDAN. When the Council of Economic Advisers appeared before us on Monday, Mr. Secretary, they stated that the rapid flowering of new manpower programs in recent years has created an unmanageable system. You deal with that substantially in your statement. And you remarked that there was going to be a great effort to consolidate manpower training programs, and I commend you for that. I think it is a step in the right direction. What exact plans do you have, for instance, for assimilating the Job Corps into your Labor Department, and how will you change it if you do?

Secretary SHULTZ. First of all, sir, there is the problem of a strong administrative structure for managing the manpower programs now in the Department of Labor. And as I said in my statement, we are working on that very actively, developing our own ideas, and consulting with all of those we know who are interested and knowledgeable on this subject. We have ideas but we haven't firmed them up in our minds. We are engaging in genuine consultation. But I hope that by the end of the month we will have firmed these ideas up, and very soon we will have an organizational structure that we think will be simpler and more manageable. And we will concentrate our staff in a more effective way, and in general it will give us a stronger stance.

Now, so far as the Job Corps is concerned, this is something that will be coming into the operating sphere of the Department of Labor in July. Our intention at the moment—and of course, we are really just getting into this—but our intention is to bring the Job Corps into the Department as an operating entity, and to work with the current arrangement of the Job Corps and come to understand it. As we go along, then, we will try to see where we can add to the effectiveness of the Job Corps with resources in the Department, and at the same time add to the Department's effectiveness in its current programs by drawing on things going on in the Job Corps. We will see how this effort can fit together as part of a comprehensive manpower program with the other things we are doing.

The Job Corps has certainly had its share of criticism, and I expect some of it was deserved. At the same time I think it has had some things to be proud of. It has dealt with the difficult cases. And I think that that is something to be proud of and to keep your eye on.

The concept of the residential center is part of the whole picture of manpower program, and I think it is a good concept. We certainly want to keep that. They have done a good job in many cases involving the private sector in the operation of the Job Corps, and that aspect of it has been positive. At the same time I think there are ways in which we can help improve the operation of the Job Corps, particularly getting people on the job, and trying to get costs down.

So that this is our approach to it, sir.

Senator JORDAN. You will try to relate it more directly to placing those men after they have completed the course and making them employable and finding jobs for them in the private sector?

Secretary SHULTZ. That is the idea. And we think that that aspect of it will be improved.

Senator JORDAN. The statistics about unemployment are always confusing, Mr. Secretary. Even though we approach an average of about 3½ percent of unemployment, which is relatively good, yet as you so ably pointed out in your statement, there are many soft spots in this statistic, the fact that with respect to certain teenage groups the unemployment runs as high as 18 to 20 percent and higher, which indicates that we do have a real problem in this area.

And that brings up the question of dropouts and what we can do about it. Several years ago I was privileged to serve on the subcommittee of the Committee on Labor and Public Welfare which had to do with manpower problems. And at one time we had a panel of Swedes before that committee, a panel of three people, one representing government, one representing the labor unions, and one representing private sector. And I asked them, "What do you do in your country about the dropout problem?

And they said, "We don't have a dropout problem, we don't have any word for dropout. We keep these youngsters in school until they are employable."

Of course, I can appreciate that what they can do in Sweden might not work here. But it does point the way, it seems to me, toward a greater effort in that direction to try and keep these youngsters in school until they are employable. Do you have any comment on that?

Secretary SHULTZ. I think you are directing your attention to a very important point. I believe this whole subject of the transition from school to work is one we should concentrate a lot of our attention on.

I touched on a few things in my testimony about what we may do with the Employment Service, what we may do with the cooperative programs in which young people who are in school work on part-time jobs and gradually make that transition. I think the shifts that have been made in vocational education should help bring that area of activity into this field more effectively. There are a number of ways in which it seems to me we can work on this. And I agree with you that it is a very important thing to work on, and get people started in the labor market the right way. The fact that in Sweden and in most European countries, and Japan, they don't have this problem suggests that somehow or other it must be that there are things we can learn and do that will enable us to improve on our performance.

Senator JORDAN. I hope so, because that was a revelation to me. One country has apparently solved the problem. But they don't have the problems we do in that respect. But they certainly worked out their own solution for it. And I hope we can borrow some pages from their experience and maybe adopt them to our use here.

Secretary SHULTZ. I hope so. It is always interesting in international conferences on this that most country representatives go to the conference with questions, and before long the Swedes are always giving the answers.

Senator JORDAN. Thank you, Mr. Secretary.

Senator PROXMIRE (presiding). Mr. Reuss?

Representative REUSS. Thank you, Mr. Chairman.

And welcome, Mr. Shultz. And thank you for a very intelligent and humane statement.

I don't find anywhere in your statement an estimate of the number of people who will be unemployed by the end of this year as a result of the administration's demand killing programs. Did I overlook something? Do you have one in here?

Secretary SHULTZ. No, I don't.

Representative REUSS. Then I think we will have to look at what the chairman of the Council of Economic Advisers said the other day when he testified that unemployment in the first 6 months of this year will—and here I am reading from his statement—will rise slightly, and then in the second 6 months of this year it will continue to rise. And he says that unemployment at the end of the year would still be below 4 percent. But the implication is that it will not be very much below, let's say 3.9, it is now 3.3, that is 0.6 difference, which I translate into human terms at something between 300,000 and 500,000 people who by the end of the year will be walking the streets looking for work. Do you find anything erroneous in my arithmetic?

Secretary SHULTZ. I am sure your arithmetic is accurate.

I said in my statement that I was not here as a forecaster, and I guess I mean that in two senses. One is that I haven't tried to make this kind of forecast. The other is that I notice that people who are renowned in the forecasting business are often wrong. For example, the Washington economic community all felt last fall that we should be preparing for a real recession which they were predicting as a result of the surtax. You may remember the testimony that was given by the past Secretary of the Treasury and the Council of Economic Advisers about the surtax, and how important it was, and that somehow or other it was a life and death matter to the economy. It was going to change everything around, and so on. Well, that hasn't turned out to be right. So my approach to this is to say, well, let's use these fiscal and monetary tools. I am sure it is important to forecast and look at the implications, of what is going on and try to do that. But also let's keep our eyes very much on what is going on and what we see, and try to adjust ourselves to the situation as it emerges.

Representative REUSS. I don't criticize you for not forecasting. Let's you and I leave the forecasting to the Council of Economic Advisers, and stipulate that the blunt arithmetic seems to work out at 300,000 to 500,000 unemployed.

Your excellent study of unemployment in slum areas of six large cities furnishes a clue as to who the unemployed will be. And it wouldn't be white Anglo Saxon Protestants in any large number. So that I would envisage a very, very serious situation.

Which now brings me to my point. Is there any reason why you, as Secretary of Labor, cannot make an all-American try at finding jobs by structural methods for those 400,000 people who are going to be thrust out of work, by a combination of training and payment during the training period, if a job itself cannot be created in the private sector by getting the Nation some of the automobile mechanics and TV repairmen which it obviously needs, and in the public sector by providing the hospital orderlies, the park and recreational attendants, the municipal waste collection service employees that are so palpably needed? What is the hangup here? It seems to me solely money—which you could get by plugging a few tax loopholes. Why don't we get at this, why don't we say that we are not going to have any more unemployed than 3.3 percent, and that the Department of Labor will find jobs—or the equivalent in human and monetary value of jobs—for those people who step up to answer the call of the Council of Economic Advisers for 400,000 new unemployed?

Secretary SHULTZ. I don't think that is a fair way to put the Council's position.

Representative REUSS. That is the result, though, isn't it? I am not saying that there is anything wrong with the position that the demand method of making jobs has for the moment seemingly, particularly if you throw out wage price guideposts, run its course, and therefore we have to pursue it as a structural problem. And my question is, is there any reason why we can't solve it on a structural basis?

Secretary SHULTZ. The fact of the matter is that there has been very little decline in unemployment connected with the inflationary period that has gone on since 1965. There has been some. The last 2 months have showed this 3.3, but it has been running in the neighborhood of 3.5, 3.7, along in there. There was not much more mileage in the piling on of demands that we noted here.

Representative REUSS. True. But when we look at it the other way, sir, it seems to me that turning off the demand spigot will create unemployment. And my suggestion is not that we don't get a little tighter in money and fiscality, but that we pick up the unemployed in a humane way by some sort of concentrated public-private employment program in the appropriate centers—and you pinpointed them very well—because a man from Mars would have a terribly difficult time seeing why this country should sit still for 400,000 new unemployed.

Secretary SHULTZ. Well, I hope that the burden of my testimony has supported in a broad way the point that you are making, namely, that we should conceive of manpower policies as part of a coordinated set of economic policies. We should be using manpower policies, as we have discussed to reduce the unemployment rate of the Negro teenager, for example, where the unemployment rate is extraordinarily high. The impact of that on the average is to bring the unemployment rate down, whatever it is. If we are successful in reducing this very high rate to something lower, we will be using these manpower policies in a coordinated fashion as a matter of economic policy. I think it is only recently that the scale of manpower policies has approached the level at which it is realistically possible to conceive of it in this way. Maybe the scale isn't quite large enough, but it is quite large now. And if we can manage it properly we can probably make some important contributions in the overall economic policy area.

Representative REUSS. What I am saying, though, is that your administration comes in and tells us in effect that the scale of these manpower programs falls short, and that we are going to have to sit still for some 400,000 new unemployed. I see no need for this. I would think that the course of wise statemanship would be to augment the scale—if it costs a billion or two, find it overnight by plugging tax loopholes, or a number of other ways——

Secretary SHULTZ. What particular tax loopholes do you have in mind, sir?

Representative REUSS. See the Reuss 13-point program—oil depletion, the very inflationary 10-percent investment credit, hobby farms, accelerated depreciation of slum property—I think if you put your active mind on it you could improve my program and make it a 20-point program. But anyway, we are talking about just a fraction of the revenue that would raise. And I don't see why the job of the Secretary of Labor within the total team is not to be the standard bearer of a program which would take care of those 400,000 upcoming unemployed by an expansion of these excellent programs that we now have on the books, and which I am confident are in humane hands under your administration. As I said, I think the tone of this paper is fine. The only thing is, you leave out the arithmetic. But the Council's arithmetic says, as I read it, we are going to have 400,000 more unemployed by the year's end. Well, the unemployed are going to have great difficulty in figuring out why the Nation leaves them high and dry, why we couldn't have found a billion dollars or so, or whatever it would cost, to get jobs, or their equivalent, for them.

Secretary SHULTZ. As I read the Council's testimony, they did sort of throw the ball in part to manpower programs, and pointed this up. As I read the President's message yesterday, he also pointed up the importance of regarding the manpower area as one to be made more comprehensive, to be coordinated in a better manner, and in general to be made more useful in the way that you are suggesting.

Representative REUSS. The fact he is shifting the Job Corps from one agency to another. doesn't raise the level of jobs at all. What is needed, I think, is more money spent on manpower training and job programs. Mr. Moynihan's residual employer philosophy. And it seems to me that we ought at least to shoot at not creating any more unemployed than we now have. We have a very fragile social situation as it is. I think it is a very poor time to throw 400,000 people out of work.

My time is up. May I ask you to do this. Would you file at this point in the record, at my request, the dimensions of a Department of Labor program designed to sop up the unemployment caused by the slowing down of demand. We have quantified this as something like 300,000 or 400,000 people by the end of the year. What would be necessary in expenditures to have a concentrated public works program, a subprofessional employment program, a business-Government manpower training program? I am sure that it can be done. And I think it would be very helpful to the Congress if we knew how much it would cost. Would you be able to have your excellent people with the sharp pencils work out something like that for us?

Secretary SHULTZ. Yes; certainly, we will make an effort to provide that kind of information. I would say that it is not simply a matter of sharp pencils. I think it is a hard problem to grapple with in practical terms. It is easy to kind of conceptualize it and intellectualize it. I have lots of numbers here that I didn't include in my testimony that in part go to your question. But the reason I didn't use them is that they are difficult and uncertain to work with. You have to ask yourself, for example, how many slots, as the saying goes around Washington, do you need to create in order to, let's say, get one person out of unemployment? The figure that it takes has a great range of error in it, I find. I believe we need to study that more closely and get a better understanding of how well you can bring that number under some control.

So I don't think it is just a matter of going back to the toolroom and making a few calculations to come up with the figure that you are looking for. I think it is a rather difficult problem, but it is just the kind of problem that I feel we should be working on, and that is part of the process of thinking through the potential economic policy impact of the manpower area.

So I welcome the question. But I hope you won't expect an answer down tomorrow.

Representative REUSS. No. But with whatever methodological caveats you need, tell us what we need to do and how much it would cost—unless it is your conclusion that it is impossible by any stretch of statesmanship to employ the 400,000-odd people who will be thrown out of jobs. And I am sure you won't come up with that.

(The Labor Department subsequently supplied the following:)

The basic question, raised by Representative Reuss, was to file a statement indicating—

". . . the dimensions of a Department of Labor program designed to sop up the unemployment caused by the slowing down of demand. We have quantified this as something like 300 to 400,000 people by the end of the year. What would be necessary in expenditures to have a concentrated public works program, a subprofessional employment program, a business-government manpower training program?

At the outset it is important to indicate that we are not at all predicting that anything like this will occur. We hope that the combined efforts of the policies set in motion under our monetary and fiscal programs as well as those of manpower programs now authorized and a series of preventive actions and structural adaptations that permit a rise in employment without inflationary pressures will enable us to arrest the rise in prices and thereafter to diminish the rate of price rise, with a minimum of increase in unemployment. Under these circumstances, any calculation included in this reply is entirely hypothetical.

However, as I indicated during my testimony, the problem posed is nonetheless important because a carefully administered and pin-pointed manpower program can be very useful in keeping the unemployment rate from rising.

In my testimony I summarized the key ways in which a manpower program does this, as follows:

—First, by concentrating on groups with particularly high unemployment rates like youth, and by acting to deal with the special problems involved, e.g., by improving the transition from school to work which is a very important part of current youth joblessness.

—Second, by training people to improve the skills in our economy and by tackling specific situations in which there are skill shortages, through new upgrading efforts as well as by initial training.

—Third, by improving the operation of the labor market so that idle time between jobs is curtailed, and

—Fourth, by improving the operation of the unemployment insurance system.

These are more fully set forth in my testimony before the Committee.

The matter is not at all merely one of assuming a certain number of unemployed and calculating, on the basis of an assumed cost per job, the total cost to put them into a certain type of public or private employment to meet unmet needs. I recognize that there are long lists of unmet needs that would require manpower in our economy if goals of health, education, sanitation, etc., are to be met, but the meeting of these goals is a long-range matter that requires planning, training, and the allocation of resources of such magnitude as to require priority choices among them.

It is important at the outset, before engaging in any mechanical calculations, to recognize a number of factors that will affect both the size and the composition of the unemployed, if there were to be an increase in their numbers, and that therefore would affect the character of any special program to be developed.

First, it is important to recognize that the objective of the action taken against inflation is to top off the rate of increase in the price level, and gradually to obtain a lower, more acceptable rate of increase. It is not the intention of the Administration to precipitate a sizeable decline in prices or economic activity. The very slowness of the pace envisaged would make it possible to assess the size and design the necessary steps to meet needs that emerge.

Second, in a gradual slowing down of the type envisaged, a reduction in the work week, rather than a reduction of employment, is likely to be the initial reaction, and possibly the only reaction, of employers.

Third is the importance of recognizing the need to attack the unemployment problems of those who might be affected first if unemployment were to rise. Since the economy is strong and will continue strong even under the assumptions of the question posed, a rise in unemployment is not likely for the most part to take the form of sudden or sizeable lay-offs. As I indicated in my testimony, lay-offs are the cause of much less than half the total jobless at the present time. It is to be expected that new hires would be the first affected. The first effect would most likely fall on young people entering the labor market, on women re-entering—including secondary wage earners—and in both cases on reentrants without experience. It is also to be expected that there will be substantial hiring still taking place and that the job of improving the process of matching people coming into the labor force with existing vacancies will be of great importance. Our present plans already call for substantially increased programs along these lines.

Fourth is the question that arises, in the event hiring is affected rather than lay-offs, whether employers would not, in a slightly softer labor market, continue the positive hiring policies that they have begun with respect to the disadvantaged in the last several years. If they do not we would have additional problems with respect to young people and minority groups. If they do, we might continue to see further attacks upon the high unemployment rates of youth and Negroes regardless of what happens to the overall rate. I think it likely that U.S. employers are now committed to their new policies. I cannot make a numercial estimate of the extent to which employers would reassess their policies in the event of a *very* soft labor market, but I think that in the situation which would likely arise, under the circumstances posed, most employers would continue what they have begun. This is already indicated by the fact that the NAB program, for example, has had substantial success in cities of the country with unemployment rates up to and above 4%. In many cases, performance in these cities has been greater than performance in cities of low unemployment (below 3%) indicating that the commitment of employers and the institutional factors may be as important as the overall situation.

Fifth, since young entrants will be most heavily affected, it is important to realize that the volume of young people entering the labor market—which was unusually great during the first five years of this decade—is now beginning to stabilize and will in another two years slow down. At the same time, the proportion of young people moving on to higher education is increasing, so that the numbers of entrants that our economy has to absorb—particularly those who are untrained or uneducated or unprepared to cope with the problems of entry—will be increasingly smaller.

Sixth, the situation of young entrants will be very heavily affected by what we do in our Nation with respect to military service. As indicated in my testimony, there is at the present time some discrimination against young people who have not yet fulfilled their military obligation. I would expect that new policy respecting the draft—a matter now under consideration—will be of a kind which would diminish this discrimination.

It is readily apparent, when all of these factors are taken into account, that the matter of estimating the size of the program necessary to "sop up" the unemployment of a given size which might take place is not merely a matter of multiplying an assumed unemployment figure by some estimated average cost of a job spent in the public sector or the special cost of training and development of a job in the private sector.

Nonetheless, it is illuminating to indicate the range of detailed considerations which would have to be taken into account in making an estimate, assuming that none of the factors mentioned above would decrease the size of the group for whom the program was necessary—a completely unrealistic assumption, of course.

First is the relation of the unemployment rate to those who would be involved in the program—the size of the program needed to bring unemployment down by a certain amount, given the method by which unemployment is counted for statistical purposes. In this connection it is important to realize that the unemployment statistics collected by the Bureau of Census through the Current Population Survey for the BLS of the Department of Labor measures unemployment at a single point in time. Thus the people who are unemployed in one month will be, to a very considerable degree, different from those who are unemployed in other months; there is a great deal of short-term unemployment in the Nation. It makes a difference whether we aim a program at those who are unemployed no matter what the duration of their unemployment, or at those who are unemployed for a certain minimum period of time.

In general, there are approximately 2½ to 3 times as many people who experience some unemployment during the year as there are people who are unemployed during the weekly period of the single monthly count. To the extent that operating manpower programs draw from the entire population of the unemployed, they therefore would have to be aimed at a somewhat larger target in terms of numbers than the size of the one-time unemployed group, if it is to affect the statistical count. Moreover, a program will inevitably reach not only those who are unemployed at any time during the year but will also draw some who are now out of the labor force into the labor force, will draw new entrants who are only newly entering the labor force, and will even in some cases draw underemployed people, particularly those employed at very low wages. Thus, even assuming that none of the factors mentioned earlier would affect the situation, a program designed to offset a rise in unemployment rate by something like 400,000 might have to reach several times this number of people.

Some of the people to be reached, of course, can be handled by quick referral to jobs through normal operations of the Employment Service. Insofar as it was necessary to tackle a very large group, it would be necessary to assign a high priority to the improved operations of the Federal-State Employment Service so that it could handle with the greatest possible rapidity those who have the education or the training to get into the available jobs in short order. In this connection it is important to realize that probably half of our unemployment is normally of a short-term character, and that a reduction of only one week in the average duration of unemployment as a result of improved Employment Service operation—such as a development of Job Banks or other computerization of the Service—would have the effect of lowering the overall rate of unemployment by some sizeable portion of the 400,000 that is the concern of this discussion. Thus, improved Employment Service operation would clearly be a priority matter for any manpower program, as in fact it is at the present time in budget submission.

For some, training will be important as we develop an improved system of job vacancy reporting and are able to put people into job opportunities with additional preparation. For still others, the special costs of being supported while on the job will be important. In some cases such costs are now being met by employers or are reimbursed. It is to be expected that employers would continue to meet large portions of the costs, for example those that the JOBS program involves. But it is also conceivable that in an economic slow-down some employers, to maintain the policies that they have embarked upon under their own financing, will turn to Government financial resources that they have hitherto felt were unnecessary to support their operations.

In each of the situations above described there will be different costs associated with each of the different program elements and different ratios of success to total effort, just as there are in the broad range of manpower programs at present. When all of these factors are added and account taken of the great range of the costs that will occur, it will be apparent that the total cost of a program to deal with a potential use of 400,000 unemployed people could be as much as an amount equal in size to the present manpower efforts (almost $2 billion). The key point, however, is that the size will be affected very considerably by the character of the elements listed above.

Increased resources for manpower programs, such as those in the budgets which are now and will be before the Congress will permit increased capability of coping with the possibility of a rise in the unemployment rate such as that hypothesized by Representative Reuss. It will certainly permit quick attention to any unusual and particular problems that arise. Most important, it will permit the sound development of the Nation's manpower efforts to make manpower programs a significant tool that, with the proper mix of monetary and fiscal policy, and in coordination with them, can help us successfully deal with the problems that confront us.

Secretary SHULTZ. Could I make a further comment, Mr. Chairman, on the phraseology of 400,000 thrown out of jobs.

I think that unemployment does not occur that way.

Representative REUSS. Or otherwise unable to find jobs which they otherwise could find.

Secretary SHULTZ. There are an awful lot of intervening variables between the slowing down of demand somewhat and what happens to the layof rate. As you can see from some of these charts and tables, the number of people who have lost a job as a result of a layoff is, I think, around 40 percent of the total unemployed as we now see them. And that is a part of the way in which unemployment takes place. But I don't think that that is the sole way by any means.

Representative REUSS. To us a 22-year-old who has not been able to find a job, but would have been able to find a job otherwise, represents himself a social problem. And he has to be put into the program.

Secretary SHULTZ. I agree with that. I am just trying to pick up the phraseology of thrown out of jobs, because I do not think that anybody in this administration or any other administration is in favor of unemployment or is in favor of throwing people out of jobs, or wants to do anything except work in the other direction.

Senator PROXMIRE (presiding). Mr. Brock?

Representative BROCK. Mr. Secretary, I have enjoyed your very thoughtful presentation. And I think the last time I had an opportunity to talk to you it was a little less pressurized, in the intellectual calm of a university.

Secretary SHULTZ. We had a conference on race and unemployment.

Representative BROCK. Correct. And we had a lot of interesting discussions there. I delivered the same speech then.

I was very interested in the colloquy with the gentleman from Wisconsin. I can't help but react that I see no intellectual justification for the reaction that automatically the exercise of fiscal responsibility is going to create 400,000 jobseekers. I don't think that is necessarily so. And I don't believe the administration does either. It seems to me that the sensible testimony that we have had today is that the administration is trying very hard to enhance the job opportunities, and that we have an excellent prospect of doing so. Do you not agree with that?

Secretary SHULTZ. That is my reading of it; yes, sir.

Representative BROCK. In terms of these specific programs, I think some of them, from my own experience, have a great deal of concern in a couple of areas. First of all, in the area of coordination, we have such a proliferation of programs here coming out of the administrative process. I have seen efforts in these fields by HEW, HUD, OEO, Labor, and even Agriculture. And I am interested in the comment which you made that there is going to be a sincere effort for increased cooperation and coordination, bringing together the maximization and efficiency of related programs with coordinating them. I think that is very important. We have the situation in this country today that 99 percent of the American mayors don't know what is available. It isn't a matter of lack of resources being made available; it is a lack of knowledgeable resources on the part of the individual political and business leadership to maximize their utilization. And I appreciate your interest in the area. I wish you well.

Is there some effort, not just within your Department, but within the structure of the executive branch in total, to achieve greater cooperation? And if so, what can we expect?

Secretary SHULTZ. Well, I think the answer to your question is certainly yes. In its broadest sense it seems to me that this will be one of the objectives of the Urban Affairs Council that the President established as one of his principal Cabinet groups. Through the formal work of various subcommittees of that Council, and the Council as a whole, we hope to move constructively in this direction. I think also through the sort of informal relationships that develop that way at the Cabinet level and then through the supporting staff we will be able to develop a better working relationship in many of these areas. So I think that the administration is keenly conscious of this problem. We are certainly working at it. The creation of the Urban Affairs Council, one of the first things the President did, suggests the priority attached to it.

Representative BROCK. I appreciate your interest in the area. I sympathize with you as to the difficulty of completing it successfully, because I think the special interests are going to be very difficult to change.

I noticed the reaction of one of my colleagues in the House yesterday to the proposed change in OEO, which I considered minimum, which is almost Pavlovian in its nature. And I wish you well.

You mentioned this increased emphasis in the service area and its impact on employment. One of the concerns I have had and the one which I hope your Department will address itself to is the fact that we always talk about manufacturing in this country as the employer of America, and your own figures show that maybe one-third is manufacturing, and yet so many of our programs and efforts seem to be addressed to manufacturing. I wonder if I am being fair in that analysis. And if so, isn't it time that we shifted our emphasis somewhat to train people for jobs that don't exist, such as we dream up in the automobile industry.

Secretary SHULTZ. Yes, I think that is a very good comment. I think it would be fruitful to orient the manpower programs toward jobs in the expanding areas of the economy. There are a number of ways in which this can be done, assuming the people involved in this cooperative effort; namely, the business group, agree. We could redirect some of the emphasis in the JOBS programs of the National Alliance of Businessmen toward some of these growing areas and include in this conception of the program various types of industry.

Representative BROCK. The council mentioned in its testimony—I believe I have a direct quote—"Excessive and rapid general increase in minimum wage can hurt lower wage workers by curtailing their employment opportunities."

I agree with that, but I would like to have your particular comment to apply to minimum wage impact in terms of minorities and youth. We have had a good deal of discussion on readiness here, and the request for significant increases in minimum wage, following the rather large increases over the last 2 years. I ask you to comment first on the impact of the general increase in minimum wage at this time, and secondly, on whether or not we might consider some method—if you do think there is an impact—of protecting them, particularly from the adverse impact if it does occur.

Secretary SHULTZ. The subject of the impact of the minimum wage on employment has been studied a great deal. At the same time it is possible to say that more research is needed.

I guess it is always possible to make statements like that.

I don't feel that I have sufficiently mastered the research content of what is now available. I want to take a strong position on it. It does seem to me that we have had a fairly rapid increase in recent years, and that we ought to take a look this year and study what has happened as a result of this. I think one of the areas that is especially deserving of investigation is the question of the impact of the flat, rapidly rising, minimum wage on youth unemployment.

I am not here to say that I have an answer to that question. But I think it is a question that bears study.

It is true that one of the differences between the European economies, the Japanese economy, and our economy is that in these other countries you do have a concept of entry into the labor market at lower rates of pay for young people as they learn. Our concept is a flat minimum wage for everybody. I think it is a question that we all should be interested in, as to whether or not that difference is in part responsible for the high youth unemployment rates.

Now, I am not taking a position on that. I have heard lots of people's positions on it, but it is not an area that I have studied carefully at yet. But I plan to get into it, and try to work it out, at least in my own mind, and try to answer it.

Representative BROCK. In my own experience, the problems of young people are not that different from the problems of minorities in the sense that, due to some historical factors that we are well aware of, both groups are entering the labor market or attempting to enter the labor market with a reduced level of skill, reduced educational opportunity, which creates a problem.

Now, it doesn't matter whether black Americans 18 to 38 have not had the educational background and experience background and are no different from the 18-year-old white teenagers in the sense that they cannot compete. The fact is that the businessman simply wants to get value received as quickly as possible. I would hope that your study would include both groups, because I don't think there is that much disparity between the problem that faces each.

Secretary SHULTZ. Let me not leave the impression that I think all of the youth are hard to employ. That is not the case at all. In general, the youth coming into the stream of constructive work in this country are better educated and more strongly motivated and able to hold their own, more than hold their own.

But nevertheless there are problem areas.

Representative BROCK. I am not talking in general terms. I am thinking more of some of the areas I have seen personally—rural school systems which offer a rurally oriented education when there are no opportunities for rural jobs. When they go to the city it is an entirely different world. The dropouts that we mentioned earlier are the type of people that we are talking about, not the average high school graduate.

I have exhausted my time. And I thank you very much.

Senator PROXMIRE (presiding). Senator Miller?

Senator MILLER. Thank you, Mr. Chairman.

Mr. Secretary, I was interested that my colleague, Congressman Reuss, was seeking your assistance in furthering the 13-point Reuss bill. But before you get too far in that thicket I warn you that there are a few little controversial items in that bill, which is one of the reasons why he is still trying to lobby in favor of that bill.

Secretary SHULTZ. I had the impression that it was only the labor area that was controversial, and that those other things—such as taxes—were all handled by the experts.

Senator MILLER. I think his point, though, is that he is trying to find money. And I think most of us are. Most of us have tax bills. And I would like to talk about one.

I am not sure that this fits this structural unemployment problem. or whether we have a structural unemployment problem as such. I detect from your testimony that it is more in the matter of social strata, rather than the structural, as I understand it. But last year the Secretary of Agriculture testified before this committee that half the poor live in the rural areas. I am wondering if you wouldn't agree that it would be a good idea to have more industrial development in the rural areas to absorb these people into meaningful employment. rather than to let them drift away into the big cities and compound the unemployment problems in the big cities.

Secretary SHULTZ. Yes—although people seem to like reasonably good-sized aggregations somehow, I think general community services are what is drawing people to cities. It seems to me that the concept of growth points intermediate-sized cities in the rural areas is a pretty good concept. We should be pointing ourselves in that direction and not thinking always of growth in New York, Chicago, Los Angeles, and so on which, indeed, are places where the population has been leveling off.

Senator MILLER. A number of us are sponsors of a bill to provide tax incentives to industries to locate in the rural areas, following that concept. I won't ask you to commit yourself, but I hope that we might have your assistance on that, and at the same time you might see fit to support Mr. Reuss on one or two of his 13 points.

Secretary SHULTZ. Do I detect a spirit of bipartisanship here?

Senator MILLER. You have already, I understand, replied that you are studying the problem of strikes in the strategic industries, national emergency strikes, and things like that.

Secretary SHULTZ. Yes, sir.

Senator MILLER. I hope your studies and any proposal that you may furnish on that will also include what I call regional problems. What brought this to my attention was that transportation strike in your own city of Chicago, which caused great hardship to a region of the country and perhaps more hardship in total quantity than some national-type strikes. I hope you will consider the regional impact of these things in your proposals.

Secretary SHULTZ. If I may for just a moment, while I am not prepared to put forth a program, it is pretty apparent, at least to me, the sort of things that should be examined as a part of the development of a program.

One is the whole problem of how do you define an emergency dispute; how you recognize one when you see it.

Second—and this is what gets all the attention, but I think it is only part of the problem—what procedures you would like to see in the law in the event of an emergency.

Third, is the point that you made that there can be strikes that cause emergencies within a State, or in a region crossing State lines. These aren't national emergencies, but nevertheless they are extremely significant to the segment of the population in that area. That problem deserves attention.

And fourth, I would say that we need to examine whether or not we shouldn't include in our purview here the railroad and airline industries, which typically have been handled as a separate matter. We should ask ourselves if they aren't part of the general package.

Senator MILLER. I remember when I looked into this transportation strike in Chicago, I was advised by the Department of Justice that under the present law there was nothing the President of the United States could do, because it wasn't regarded as a national emergency. But it was certainly a tough one from the regional standpoint.

Now, in your testimony you indicate that upward of 2½ million people are in jobs related to the war effort, at least to the acceleration of the war effort, in the last few years. There are also 1 million more serving in the Armed Forces.

Secretary SHULTZ. It is actually 2.4 million by our estimates, including the people serving in the Armed Forces.

Senator MILLER. Then, could I imply from that that, if it were not for the war, we could have 2½ million people unemployed, in addition to what we have now?

Secretary SHULTZ. It could imply that. But I would hope that our economy would have been so managed that as these people came on the labor market they would have been employed in industries producing civilian goods and services rather than military, and that our economy is perfectly able to provide that kind of employment. And indeed, one of the things I was trying to point up in bringing this out was that because we have had this large flow of highly productive manpower into employment that doesn't produce anything as far as the civilian economy is concerned, yet adds to demand; that has been one of the reasons we have had the inflationary problem.

Senator MILLER. The thing that troubles me about that is that we have been operating under a deficit for a number of years. And if the money being spent for the war had gone somewhere else, we could have absorbed that 2½ million—implying that we would perhaps have to have a deficit anyhow. I trust that the new administration is going to seek to absorb these people when and if this war comes to an end without having to run up deficits all over again and aggravate the inflation condition. That is your objective; is it not?

Secretary SHULTZ. Certainly our objective is to use the tools of fiscal and monetary policy in a coordinated way that will yield us high employment, and we hope without excessive rates of increase in prices.

Senator MILLER. There is a limit to what fiscal and monetary policy can do. And we certainly have to rely upon private industry for the absorption of most of these problems; don't we?

Secretary SHULTZ. Yes, sir. What we are aiming at is the creation of a general environment through fiscal and monetary policy that brings about employment on private jobs, not just putting people on public jobs.

Senator MILLER. So your point is that the savings from the war costs, when those stop, would not necessarily be translated into hiring another 600,000 people on the Federal payroll or another 2 million on the Federal payroll, but to provide an environment for private industry to absorb these people?

Secretary SHULTZ. There are all sorts of ways to deal with the so-called fiscal dividend and the savings that would come if we can get ourselves into a more peaceful situation in the world. Among those ways is a reduction in taxes. Not all the ways involve additional spending.

Senator MILLER. Now, you testified that there has been a 7½-percent average hourly compensation increase; of that, 3.3 percent represents increased productivity, so that there is a differential of 4.2 percent. Now, I am troubled about the increasing amount of imports coming itno this country. Our exports have been going up a little bit, but the imports have been coming in here at a far faster rate.

I know that in some of the countries overseas that are trading partners there has been some inflation, in some years higher than our inflation. But because of the low-wage base they can better afford to increase their wage rates to keep pace with the higher rates of inflation in their country and be more competitive than we are, than we can be with increases to a high wage base to keep pace with a low rate of inflation. I have done a little calculating on this, and it looks like we have been slipping further and further behind in absolute increases of wages.

For example, in 1967 our wage rate went up 12 cents an hour to keep pace with a relatively low rate of inflation. In some of these European countries, on an absolute basis, wages only went up 4 or 6 cents an hour, although they had a higher rate of inflation than we did.

Now, does not this inflation have a serious impact on our relative competitive position, aggravating imports as far as our import situation is concerned?

Secretary SHULTZ. Yes; it does, especially in the short run, as the relative prices of goods among countries change against us. In a broad sense, of course, as trade balances itself off, you don't import more than you export—I am thinking of it in its broadest sense. But in shortrun terms the shift in relative prices can cause genuine problems in service industries, and it deserves attention.

Senator MILLER. I wonder, Mr. Chairman, if the Secretary would be able ot obtain it, if he could furnish for the record an analysis of the impact of the increased imports on unemployment over the last 2 years, 1967 and 1968.

Secretary SHULTZ. Yes; I certainly can do that.

Senator MILLER. And let's have a balanced picture, and show the increased jobs resulting from increased exports. But I would like to see the trade-off, and how we come out on the balance. My guess is that certainly in the last 2 years because of the horrible decline in favorable balance of trade, we lost jobs on net. If you have an analysis that you have prepared to show what the resulting picture has been, I think it would be helpful for the record.

Secretary SHULTZ. All right, sir; I shall see that that is prepared.

Senator MILLER. Thank you very much.

(The following material was later supplied by the Department of Labor:)

EMPLOYMENT AND FOREIGN TRADE

The Department of Labor now has underway a series of studies examining the relation between foreign trade, both exports and imports, and employment. This effort, of course, is extremely complex because of the difficulty of isolating the effect of foreign trade from the many other factors which affect job opportunities in the United States. Preliminary results are available which provide an indication of recent levels and changes in employment related to foreign trade.

Any examination of the influence of foreign trade on U.S. employment in the last few years must keep in mind the basic economic conditions prevailing during this period. Both 1967 and 1968 were years of high and increasing economic activity accompanied by strong inflationary pressures. Total employment rose by 3 million from 1966 to 1968, and the unemployment rate dropped from 3.8 percent to 3.6 percent of the civilian labor force. The strong inflationary pressures, along with the effect of certain supply shortages induced by existing or prospective strikes, stimulated the demand for imports, particularly in 1968. Without the increased imports which helped to meet the rising demand for goods, it is reasonable to assume that inflationary pressures on domestic markets would have been even stronger.

The number of jobs attributable to the export of goods from the U.S. is estimated by the Bureau of Labor Statistics to have increased from an estimated 2.5 million in 1966 to 2.6 million in 1968. The estimates of jobs include the direct employment necessary to produce the item exported and also the indirect labor necessary for all supplies, and materials and services incorporated in the exported item. Labor involved in the transportation and handling of the item is also included. In addition, about 750,000 jobs were involved in 1968 in export-related services such as those provided to foreign visitors and use by foreign nationals and companies of U.S. airlines and U.S. shipping firms.

It is far more difficult, both conceptually and statistically, to estimate the volume of employment related to imports. In relating employment to exports the task is to measure those jobs involved in producing and exporting the specific goods. On the other hand, there are no current jobs involved in producing imports; the task is rather to estimate employment that might take place, assuming other factors are constant, in the event that the value of these imports were produced in the U.S. Of course, since imports into the U.S. are the exports of other countries, the employment effect *in the exporting countries* of a reduction in our imports could indeed be estimated, provided the proper data were available, in the same way as we have estimated the employment effect of our own exports.

But the effect of a reduction in imports on employment *in the United States* is a different matter.

Another complicating factor is that not all of U.S. imports are of the same character. First, there is the fact that some of the things we import are not produced at all in the United States, e.g., coffee, chromite, tea, tin. Conceivably, with a sufficient expenditure of effort and resources we might be able to produce some of them, but surely the amount of employment thereby created is a speculative matter of no practical interest.

Next, there are imports of certain types of goods that are comparable to domestic materials but are in short supply in the U.S., such as asbestos, bauxite, newsprint, and sugar. To expand our production of these items sufficiently to replace our imports would again require a very large investment of capital and labor. It is not at all clear that the real costs of their production—in terms of the quantity and quality of labor and other resources—would be anything like their present real costs. If costs of expanding our production to replace such imports were higher, their prices would also be higher, and the utilization of such more costly materials might be substantially reduced. Hence the number of jobs which might theoretically be created in the U.S. by the reduction or elimination of such imports is not easy to estimate. Any estimate that simply assumes present costs to remain the same is certain to be seriously in error.

Finally, there are imports that are competitive with domestic goods, some of which have a minimal impact on U.S. markets, e.g., wood pulp and agricultural machinery, while others are relatively more significant, e.g., wool cloth, crude petroleum, and sheet glass. Conceivably the imports of these items could be replaced by domestic output. Prices would probably be somewhat higher, and utilizataion somewhat lower, but an assumption that costs, prices and utilization would be the same if such imports were eliminated would not be so unrealistic as in the two categories discussed above.

For purposes of these estimates, imports have been classified into the three categories mentioned. In 1966 the group of items not produced in the U.S. constituted 13 percent of total imports (by value), those produced in the U.S. but in short supply were another 13 percent, while those that are more nearly competitive with domestic products constituted 74 percent. This classification, however, represents only a rough approximation of the competitive characteristic of the commodities. For example, although most machinery is in the third category, a finer breakdown would disclose some items with unique qualities, features, etc., which are not made in the U.S.

Preliminary estimates, on the assumptions noted, indicate that about 1.8 million jobs in 1966 would have been required in the U.S. to produce the equivalent value of the items included in the third category. For 1968 the estimate would be about one-third higher—about 2.4 million. These estimates do not take into account the jobs which are dependent on imports, such as longshore activities in unloading imports, movement of imported goods on U.S. cargo vessels and processing of imports of crude materials. Since the elimination of these imports would eliminate these related jobs, the net effect on employment would be smaller than is indicated by the figures above. Estimates of the net effect are not yet available. Nor are estimates available for the number of jobs that would have been required to furnish the value of import-related services such as those provided to American visitors abroad or payments by Americans to foreign transport carriers.

It must be emphasized that these estimates, both on the export side and on the import side, are highly conjectural, for the reasons given. They do not represent the number of workers unemployed because of imports nor the number that would become unemployed if exports ceased. Moreover, the side effects caused by a reduction in exports or imports should be taken into account in any analysis. The fact that our imports provide other countries with the wherewithall to by buy our exports, and vice versa, is an example.

All this is not to say that for particular industries or for particular firms or groups of workers the impact of imports on the importance of exports may not be significant. For the most part, employment has increased during the last few years in industries which produce products similar to those imported. Some industries, however, have lost employment and in a few of these, according to preliminary indications, part of this loss may have been due to increased imports. The Department is now working to identify these industries and, as resources permit to analyze the effects of increased imports on employeemnt in individual industries.

If a judgment were to be made at this time it would have to be that, on balance, U.S. foreign trade is a favorable element in our economy as a whole and in our employment picture.

Senator PROXMIRE (presiding). Mr. Widnall?

Representative WIDNALL. Thank you, Mr. Chairman.

Mr. Shultz, the minority members of this committee have long recommended that a series of job vacancy statistics be developed and published by the Labor Department. We understand that the new administration sees this to be an important part of the employment program. How soon will the job vacancy statistics become operational?

Senator PROXMIRE. Would the Congressman yield at this point?

This has been the position of this Senator, and I think it has been the position of the whole committee, the very vigorous and forthright position that the Committee has taken.

Representative WIDNALL. I will enlarge my statement to say the members of the Joint Economic Committee.

But how soon will the job vacancy statistics become operational?

Secretary SHULTZ. I can't give you a precise answer in terms of a month of this year. But I can say that this is something that we are actively at work on. It is a matter that it is especially interesting to bring up, because Geoffrey Moore, the incoming Commissioner of Labor Statistics, has long been a leader in the area of developing this line of statistics, and has a great personal interest in it. I am sure that we will see this pursued vigorously and rapidly.

And we would expect to have onstream fairly soon much broader job vacancy statistics than now exist.

Representative WIDNALL. I think it has been rather discouraging in the past, when you are trying to analyze the employment in the United States, to realize that you have a lump sum given to you of maybe 3½ million unemployed, but you don't know at what they are unemployed. You just hazard a guess. And it seems to me that it will be invaluable for us to have these statistics available just as soon as possible.

Secretary SHULTZ. Yes. I think it should be realized that when you start a new statistical program, and you have the necessarily professional attitude that we have in the Bureau of Labor Statistics, and went to have in the Bureau of Labor Statistics, that they will want to see that whatever is put out is first tested and stabilized, so that when they put out a figure they can stand behind it and feel confident that it is a reliable figure and not just the first crack out of the barrel.

So when one does emerge you can be sure that it will be thought over and worked out carefully.

Representative WIDNALL. Do you believe that increases in the individual income tax such as the 10-percent surcharge enacted last year end to stimulate higher wage demands?

Secretary SHULTZ. I am sure that it is an argument presented at bargaining tables. The Union will use it as an argument for why there should be increase. My judgment is that people listen to the argument and then go out and bargain. I would guess that it isn't a big factor.

Representative WIDNALL. In that question, I had the thought in mind that whether or not that does vitiate fiscal policy, you engage in a game of ring-around-the-rosy in connection with it.

Secretary SHULTZ. No. If I am following your line of reasoning, perhaps I am not—the argument would be that the union would come to the bargaining table and say, "We now have a 10-percent surcharge on income, and in order to maintain real wages we have to increase the demands that we are making by the equivalent of that, and therefore, Mr. Employer, come across with higher wage than otherwise would be the case."

If that happened I suppose someone would argue that somehow the effect of the surcharge has been passed through to the employer. And I suppose there would be a presumption that he would pass it along in terms of prices, and thereby you would kind of wash the whole thing out. My response is in terms of saying that I am sure that demands or arguments of that kind were presented, but my guess is that they recede into a lot of other things, and it would be difficult to pick out any special influence there. I would doubt that it has a great deal of influence.

Senator MILLER. Will the Senator yield?

Representative WIDNALL. Yes.

Senator MILLER. On this point, are there escalator clauses in some of these contracts which not only provide for automatic increases based upon the CPI increases, but also upon an income tax increase?

Secretary SHULTZ. I don't know enough to state flatly that there aren't. But it isn't a widespread thing. My guess is that it is practically nonexistent.

Representative WIDNALL. Mr. Shultz, recently labor has shown a declining interest in the short-term contracts, 10 months or less, and an increasing interest in 3-year labor contracts. Whereas 30 percent of labor contracts involving the Federal mediation 4 years ago were long-term, now the average is about 60 percent. What are the implications of this shift as to wage and price stability of the general economy?

Secretary SHULTZ. Well, of course, it depends on what the long-term contracts contain. In general what seems to have happened is that you have, let's say, a 3-year contract, and you have so-called front-end loading, so that the first year cost is higher than the second or third year cost. That tends to have an impact, a special impact, in the years when there is a lot of bargaining involving lots of people. It has a counterpart in the subsequent years when the deferred increases are going into effect.

What that counterpart influence turns out to be depends upon what is going on in those subsequent years. In 1969, for example, the estimate is that a little over 6 million workers are covered by collective bargaining agreements that have a deferred wage increase built into them.

The deferred wage increase that will become due averages on the order of 4.1 percent, as I recall. I made comments about forecasting earlier but I believe one can say with some confidence that the average negotiated increase in 1969 will be higher than 4 percent. So I suppose one can say that in 1969 the deferred wage increases will have a bit of a dampening effect because of the large numbers involved. But it could work the other way around.

I think this happened in the steel industry, as a matter of fact, in the last days before competition from imports and other materials cut them down to size, and there were tremendous deferred wage increases built in. These were probably larger than might have been negotiated under the circumstances.

Representative WIDNALL. You spoke of this practice in the first year having the heaviest impact, and then subsequent 2- and 3-year contracts having a lesser amount as "front loading." Do you think this tendency to front load should be encouraged or discouraged?

Secretary SHULTZ. I don't really have a view on that, I guess. But in addition, I suspect the parties are going to do what looks right to them, whatever we urge. That is, you can see what goes on. If you want to get an agreement, people properly value immediate income above future income, and the union and the company may desire, in order to get an agreement, to take the cost and put some of it up front. That tends to dramatize what is available immediately and helps to secure acceptance of the contract. I think it is that sort of process that is going on. We can look at this as steely eyed economists, and that is one thing. But at the same time, there are a lot of practical labor relations problems to be considered. I personally tend to have the philosophy that the experts are the people immediately involved. They know more about what they want and how they want to arrange their affairs than we do, and we basically should respect their judgment.

Representative WIDNALL. Mr. Chairman, my time is up. I would like to ask one more question.

Senator PROXMIRE (presiding). Go ahead.

Representative WIDNALL. At the end of the current war I think, as we all recognize, that we may face some serious unemployment problems, and also the problems of dislocation where some industries may have to shut down and cut down material. What planning is now being done in this area by your department?

Secretary SHULTZ. We are participating in an effort led by Dr. Herbert Stein, a member of the Council of Economic Advisers, to tackle just this issue. And I might say that in having Herb Stein lead this effort the administration has, I think, undoubtedly the country's leading expert on this kind problem. It goes back to a prize-winning essay that he wrote about the readjustment from World War II. He has worked on this subject off and on since then, and has worked on it in connection with the current hostilities.

In my own view of economists who have worked in this area, I would have to put Herb down as the absolute No. 1 person.

So we not only are making an effort, but have been fortunate enough to have the effort led by a man of great knowledge and insight and depth of analysis in this area.

Representative WIDNALL. Thank you, Mr. Shultz.

Senator PROXMIRE. Mr. Secretary, it is my understanding that the President's Committee, or Cabinet committee, on Price Stability has been killed; is that right?

Secretary SHULTZ. I am not certain as to how these things work. I haven't gone to any meetings of such a committee, and I notice that the Secretary of Labor was on the original committee.

Senator PROXMIRE. There is quite a difference between the approach to inflation on the part of the Nixon administration and the preceding administration, in that you are going to concentrate exclusively, really, on monetary and fiscal policy. And of course we have these longer range factors of antitrust, which we agree with. And you recognize that there is some difference now in employment stability, but really you are going to concentrate on fiscal and monetary policy very largely as your anti-inflationary tools.

Secretary SHULTZ. I don't think that the relative committee structures have any particular implication of that kind.

Senator PROXMIRE. You are not going to use presidential jaw boning, or guidelines, or price controls, or anything of that sort. That doesn't leave much.

Secretary SHULTZ. I would say that the creation of the Cabinet Committee on Economic Policy—and certainly economic policy includes the problems of inflation, unemployment, and so forth—is a very positive step by the new administration to deal with these problems on a broad basis.

Senator PROXMIRE. You certainly have an interest in this committee in advising on inflation and anti-inflation policy. But you have many other responsibilities, as does this committee. But it is hard to say—it is hard to substitute that committee for a committee expressly and exclusively concerned with inflation, with price stability. It seems to me it is backing away from the institutional setup. Now, it may be right to do it. But all I am saying is that that seems to be a conclusion that I draw.

Secretary SHULTZ. I can't believe, from all the discussion that has taken place, in the light of the interest of this committee, and the people who have testified here, that there is any diminution of interest in this problem.

Senator PROXMIRE. No, but there is a concentration—and of course this is debatable as to whether this is why—there is a concentration on using particular policies, and the policies are fewer, the methods are fewer, than the methods before.

Secretary SHULTZ. I haven't tried in my testimony to outline a complete strategy for the administration, but I have concentrated on the manpower aspects of the program. I felt that was probably proper for me.

Senator PROXMIRE. About the manpower program, one definition of the target for these manpower programs, as I understand it, are those who have been employed for 15 weeks or more whose incomes are less than the poverty level. Do you have any data on how large a group this is?

Secretary SHULTZ. There are data on that, the so-called target group. And defining the group is a somewhat difficult problem.

Senator PROXMIRE. And how large a proportion of this group does the 1970 budget provide that the manpower program will meet?

Secretary SHULTZ. Well, that is something that we are digging into very hard to try to estimate.

Senator PROXMIRE. It is a small proportion, 15 or 20 percent?

Secretary SHULTZ. It is related to the question that Mr. Reuss asked me to report on earlier.

Senator PROXMIRE. At any rate, I understand it is a relatively small proportion. It certainly is not half, it is less than a quarter, it is a small part of the total problem.

Secretary SHULTZ. Yes.

Senator PROXMIRE. This brings me to the question of why you have, as I understand it, a flat opposition—if you do not let me know—to increasing the minimum wage. As I understand it, the minimum wage is designed to help bring more out of poverty those who have received the bare minimum wage, the $1.60, who would be on the fringe of poverty, depending on your definition, or very close to it.

What is your logic behind your taking this position, in view of the fact that we are not going to be able to help them through manpower policies, in the near future anyway?

Secretary SHULTZ. I support the general concept of the minimum wage. I think it has done some good things in our economy. The question, however, is whether or not it would be wise to raise the current minimum wage by some amount—and we talk about various amounts—this year. I think there is also a question that was raised about the impact of a flat minimum wage covering all people.

Senator PROXMIRE. It is always a bad time to raise the minimum wage, isn't it? When you have an unemployment situation you say that to raise the minimum wage is going to make the unemployment situation worse. We have had some very dramatic increase in the minimum wage, 15 cents up to 50, and 75 cents to a dollar, and then to $1.20, and now we are up to $1.60. And every time we were warned that this was going to increase unemployment and was going to be inflationary. And to the best of my knowledge, there is no data—and there has been plenty of opportunity to develop data—there has been no data to show that this is true.

You raise a very understandable question as to how this will affect teenagers. As I understand it, 20 to 25 percent of the labor force isn't covered by the minimum wage. And by and large—of course, there are many exceptions—but by and large teenagers are employed in areas that are not covered. So I think that without data it is hard to conclude that this would necessarily be restrictive on teenage employment.

Secretary SHULTZ. I do not believe that I made a flat statement of my view about the teenage employment problem.

Senator PROXMIRE. You did not, that it true. You raised that as a problem.

Secretary SHULTZ. I raised that as a problem, sir. And I do think that it is a legitimate problem and the contrast between our experience and the experience in other countries which handled this differently is quite striking.

The rise in teenage unemployment is much more of a problem now, relatively speaking, than it was, say, 10 years or so ago. It makes you wonder. Maybe it has some connection with the fairly rapid increases that have taken place, and the expansion of coverage. I am not ready to reach a conclusion on that either way. But I am certainly not going to sit here and say that I agree that the minimum wage has no impact on employment. I think it does.

But the question is whether or not, despite that, it can be desirable.

Senator PROXMIRE. You see, what this seems to spell out to some extent is that these policies of putting the whole burden of restraining inflation on monetary and fiscal policy—if you accept the Phillips concept of a trade-off between unemployment on the one hand and price stability on the other—and there seems to be a very logical argument in favor of that—it seems that the whole burden is put on the people with low income, the people who are likely to be out of work. And in a year in which Congress has increased its pay by 40 percent, it is pretty hard for us to go out and explain the logic of this to people in my State who have very low incomes.

Secretary SHULTZ. I think the question you have to face——

Senator PROXMIRE. How would you explain it? Suppose you were confronted by a group of people working in a low-income industry, and they want to know how you explain that our salaries were increased—I voted against it, but that is not my point—at any rate, our salaries are increased by a big margin, and we are telling them that we can't give them an increase in the minimum wage so that they can live.

Secretary SHULTZ. I think the question is, does an increase in the minimum wage produce an increase in income for the people who are the most disadvantaged insofar as their ability to produce on the job is concerned? If we were to find and could stipulate that the way to get all of the unemployed, poverty-stricken people of this country, a good income was to require employers to pay a $5 minimum wage, I would be all for it.

But what concerns me is that by raising the minimum wage to a level that is higher than the value that many people can produce on the job, we wind up with those people not having a job at the minimum wage or any other wage. So that really doesn't get them out of the problem.

Senator PROXMIRE. There has always been a question of the minimum wage. When we had sweatshops that were so conspicuous, and the people were paid less than 25 cents an hour, there was always the complaint, they are not worth more than 25 cents an hour. We found that this was not something that prevented the poor people from getting a better income, it was helpful. Wouldn't you conclude that minimum wage in the past has been a useful method of improving the income of low-income people?

Secretary SHULTZ. For some, I agree. And I agree that it can be a useful device in the future. The position I took was that this year, after the fairly substantial increases that we have seen very recently, it seemed to me that a pause was called for, and that we shouldn't push this too hard.

Senator PROXMIRE (presiding). My time is up. I want to come back. Senator Miller?

Senator MILLER. On this point, might it not be that—following the last round of minimum wage increases—a byproduct of unemployment, which, while normally resulting, did not take place because of the war, because of there being many more in the armed services, for example?

Secretary SHULTZ. I think it is quite clear from the employment figures presented that the armed services and the war-related industries were responsible for a great increase in male employment.

Senator MILLER. So that if it hadn't been for the war, this recent round of minimum wage increases might have shown up in the form of unemployment increases?

Secretary SHULTZ. It might have.

Senator MILLER. One other question. Do you have any plans to make any changes, substantial changes, in the CPI?

Secretary SHULTZ. This is a technical question. There is work going on to increase the usefulness of computer science as applied to the processing of the data. And that is underway. I believe that the results of the experience in terms of switching over to that method to a greater extent will bear fruit probably within the next 6 months. The CPI is periodically worked over from the standpoint of whether or not the weighting of particular goods and services is a true reflection of the market basket for various levels of income.

Preparations for the next comprehensive revision of the CPI are underway. There has also been continuing work—and I am not certain of the exact status of this now—continuing work and some concern about the problem of reflecting quality increases in the measurement process. For example, we say that medical costs are rising rapidly. And this is one of the big plus areas in the CPI.

It is certainly true that the daily price of a room in a hospital has been going up at a terrific clip. At the same time, one might ask what has happened to the cost of curing pneumonia, over a period of time? It may be that the cost of curing pneumonia has declined because of the advances in medical science. This means that the individual pneumonia patient does not remain as long in the hospital. However, the cost of curing pneumonia is a hard end product to get a handle on in a technical sense.

Now, I know there have been advances in price measurement techniques, and efforts are being made to continue these advances.

This is not a true technical response to your question.

If you would like a detailed one, I will see that you are supplied one.

Senator MILLER. For this time, that is all right. I am glad to know that you are very much aware of it, and you are working on it, and that computers will play a part in it.

On that point, however, is there any thought being given to possibly changing the area of sampling? As I understand it, the CPI is based upon sampling of wage earners in cities. And I have often wondered why we didn't take a broader look at this CPI to not only include wage earners in cities but wage earners in small communities, even retired people, so that we might have a little broader brush on what this looks like.

Maybe we might have to have two or three CPI's to reflect different segments of the social stratum. But do you know whether there is any thought being given to that?

Secretary SHULTZ. This involves sampling the varying market baskets that people in different communities have as distinct from the problem of pricing them out. The data come from surveys of individual consumers, rather than from the people who are selling the products. I am not prepared to answer that question completely.

Senator MILLER. I hope you will take a look at it and see what the possibilities are on that point, too.

Thank you, Mr. Secretary.

Senator PROXMIRE (presiding). It is my understanding that we have always legislated the minimum wage by steps, and we have always been moderate in doing so, and we have tried to tie it to some index of productivity, and so forth. And presumably we will do that in the future. I haven't heard anyone propose $5. I have heard some $2 proposals. And maybe that is too high. But what I am suggesting is that this is an instrument that we just shouldn't put aside and say we are not going to consider this this year, we are going to wait for a few years and see what has happened.

In the past we have had a lot of progressive systems for increasing the minimum wage. I don't say that we should increase it this year. We could act this year as we have to provide for step increases. Do you disagree that this can be another approach, and do you expect a moderate approach?

Secretary SHULTZ. I think a moderate approach to the subject is a desirable approach. And I would agree with you on that point.

Senator PROXMIRE. Now, as I understand it, you have stated that you favor the direct contract method for obtaining adequate public manpower programs as preferable to the tax-incentive approach, you have said so, I understand, in an interview. And you are also a member of the National Manpower Policy Task Force, which has cautioned against implementation of tax-incentive measures.

Is this a correct interpretation of your position?

Secretary SHULTZ. No, sir. The National Manpower Policy Task Force did put out a report. It took a very strong position on this question. I had left that task force before the report was prepared, and did not participate in the preparation of it, and didn't sign it, and had nothing to do with it.

I am not in any way derogating the report of that group, which I consider to be a very good group of people, and an able group of people, it is just that it isn't proper to infer any views of mine from this report.

Senator PROXMIRE. What is your position?

Secretary SHULTZ. My position is that the contracting approach as illustrated, I think, most prominently by the National Alliance of Businessmen JOBS Program, has worked quite well, and should be supported, and used aggressively. And we have plans to do so. I have referred to some of them in my testimony.

I think that the tax-incentive approach also has merit, and that the way we should conceive of this problem is not in terms of that approach or this approach, or some other approach. The way to go about this would be to realize that different ways will be useful in different segments of the economy, and that we need a kind of multidimensional approach to many of these problems.

So that I don't see that we can't have both of these things going on to some extent at the same time.

Now, so far as the use of tax-incentive is concerned in terms of specifics, I should think among other things that we ought to be conducting some efforts to learn by doing, and see if there aren't some areas where we could set up some experiments and see how well they work.

Senator PROXMIRE. What concerns me, and I think a lot of Members of Congress, is the erosion of the tax structure. Our rates are already very high, and we have already provided for many incentives such as the investment credit. And there are areas that we could do it in, in housing, and in so many areas. I am just concerned that this is going to give us a very awkward and unfortunate tax structure, even worse than it is now.

Secretary SHULTZ. I share the concern about the erosion of the tax base. And I think that when you talk about a tax incentive that there is a special burden of proof on the advocate because of the importance of preserving the integrity of the tax base. I agree with that.

Senator PROXMIRE. One other question in this connection. Isn't it true that every employer has to train the people he hires in most cases? This is a very big and important cost for an employer. Now, if you are going to start subsidizing that enormous cost—you have to do it in a very careful and discriminating way. You have to provide that he is going to be given a tax credit only for those who otherwise would not be employable for training programs. You have to limit it to those with a limited education or with some limited skill.

Isn't this going to be very hard to administer? Isn't it going to involve a degree of bureaucratic interference that would be quite substantial?

Secretary SHULTZ. I think the points that you make also must be made with respect to any contracting program. And it is certainly true enough that a tax incentive program in this field, unless you wanted to change the concept of it quite drastically, is not a sort of automatic, self-administering device.

Senator PROXMIRE. That is my point. You put it better. I am not saying that the contract employment doesn't also have these limitations. I am saying that the notion that you get away from bureaucracy by simply providing a tax credit and you take care of it in the private market is not valid, it will still have a very careful review by the Internal Revenue Service, and a good deal of governmental judgment.

Secretary SHULTZ. One of the problems with it, I think is that you might wind up with the Internal Revenue Service administering human relations problems. And with all due respect to them, I don't think that is at all desirable.

Senator PROXMIRE. Your friendly tax collector.

Secretary SHULTZ. Well, we used to train some in our business school.

But it probably is the case that a tax-incentive approach would lessen the amount of administrative detail that you would have to engage in. So it is a matter of degree.

Senator PROXMIRE. If it did, you would very likely have a lot of leakage.

Secretary SHULTZ. I think probably you would rely on stipulations of what people are doing, and also on the references from, say, the Employment Service to an employer of an individual what would qualify for this tax break. With these kinds of stipulations you could proceed, and if people violated the trust involved, they would be prosecuted.

That approach to the administration in this area has grown, and in general it is a good approach.

I might just say one other word. And it takes this problem back to the minimum wage discussion that we had. The contracting approach, the tax-incentive approach, any of these approaches to stimulating greater employment for the disadvantaged, are in the nature of special subsidies for their employment. The reason they are needed—and I support them—is that the person that you are talking about is not able to produce the value of his pay immediately.

So you have a method of, in effect, having the Government make up the difference. I think that it is a perfectly good method. But I think what it suggests is that there is a relationship between the amount of pay a person is required to get on a job and the decision about whether that person is employable at that pay. That just seems to me to be a pretty obvious proposition.

Senator PROXMIRE. Isn't one of the problems, too, the attitude of the supervisory personnel? These are the people who will weed out those who are inefficient and fire them. And that is one of the reasons that they are supervisory personnel, that is one of their jobs, they have to do that. But at the same time, unless they understand the problem here, and have the understanding of the requirement for patience and for seeing that these people do need particular help for a period of time, it is going to—the program isn't going to work well. Isn't it likely that this kind of approach is more sustainable with a contract method rather than with a tax-incentive method?

Secretary SHULTZ. No. I think the problem is the same in either case. But I agree with you that it is a central problem.

Senator PROXMIRE. Are you working on that aspect, too?

Secretary SHULTZ. It depends on the supervisor. But it is also the union steward and the work group in the particular place where the man or woman comes in to work that you have to work with. I think there have been some great and interesting strides taken by industry in this regard. And the Department of Labor programs support this effort.

But it is interesting that very explicit, special training programs for supervisors have emerged within industry on just this point. I think they have learned a few things of rather general interest to themselves as a result. They have learned that their hiring standards are not necessarily fitted to job requirements.

They have learned that by giving a lot of attention to the process by which a person comes into employment, they probably can have a considerable impact on the rate of turnover of people and keep them on the job longer. This is something not only applicable to the so-called disadvantaged person, but much more broadly.

So I think there is coming to be a little more emphasis on the so-called vestibule aspects of employment than there has been before.

Senator PROXMIRE. Just a couple more brief questions. Would you say that much of the inflationary pressure is caused by wage increases in the defense industry? Wage increases in the defense industry, I understand, were faster and more substantial than elsewhere. We have received a lot of evidence before this committee that the increase in expenditures in procurement have been just enormous, and that part of this is because of the rapid increases in wages to get labor to do a job, and do it in a hurry. Do you have any information on this?

Secretary SHULTZ. I don't have any special new information to contribute on that.

(The following letter was subsequently received from Secretary Shultz:)

U.S. DEPARTMENT OF LABOR,
OFFICE OF THE SECRETARY,
Washington, March 6, 1969.

HON. WILLIAM PROXMIRE,
U.S. Senate,
Washington, D.C.

DEAR SENATOR PROXMIRE: On February 20, in the course of my testimony before the Joint Economic Committee, you referred to high wage rates in the defense industry and their relation to high defense procurement costs. Although I commented only in part at that time, I have since had the opportunity to research this matter more fully.

Aerospace is predominant in defense procurement and aerospace wage averages do tend to be somewhere higher than general industry averages. The apparent explanation is not that the aerospace industry has experienced an escalating wage spiral but that the industry has a significantly greater percentage of higher paid professional workers—mainly engineers and scientists. Today only 59 percent of aerospace employees are blue collar in contrast to 73 percent for all other manufacturing industries. In the last several years there has been a shift within the aerospace industry from blue-collar to white-collar jobs. In 1959, for instance, 64 percent of aerospace employees were blue collar.

The average white-collar professional or technician earns $3,000 more per year than his blue-collar counterpart, so it is clear that this larger white-collar segment accounts for much of the differential in gross wages paid. In 1966, out of about 1 million employees in ordnance and aircraft, 143,000 were scientists and engineers and 54,000 were classified as technicians. In mnaufacturing as a whole, only about 3.5 percent were scientists and engineers and 2 percent technicians.

The foregoing doesn't fully depict differences between the pattern of job distribution in aerospace and other industries. Even within the aerospace blue-collar ranks, for example, an extensive shift of jobs from unskilled to skilled craft levels has occurred.

As I am sure you know this upward shift in job levels in aerospace has been caused by the rapidly advancing technological state of its products. Industry methods, materials, and designs have become increasingly sophisticated and complex. A heavy component of advanced electronics and instrumentation adds to this picture.

For further comparison purposes we examined wage rates of the machinist job, a representative job found in several industries, and noted the wages for that job in aerospace along with machinist's pay scales in three other major industries—steel, automotive, and shipbuilding. Aerospace machinists earned approximately $4 per hour as compared with $3.95 per hour average in the other industries.

Comparisons of this nature are always difficult to make. Variations in pay provisions, use of piece rates, recency of labor bargaining and region are all factors which complicate exact comparisons. However, on a job-for-job basis aerospace does not appear to differ greatly from other major industries.

I hope this information is more fully responsive to your question on this subject.

Sincerely,

GEORGE P. SHULTZ,
Secretary of Labor.

Senator PROXMIRE. It would be interesting to know this, because this is something that is to some extent within Government control. And it seems to me that we have done a poor job of limiting this kind of inflationary factor. It is a great big thing in the economy, $43 billion a year of Defense procurement.

One final question. And this relates to the very helpful statement that you make with regard to the need for training people in construction. I am delighted to see you emphasize that. Governor Romney, when he was before our Senate Banking Committee, pointed out that this was one of the bottlenecks that we have. I understand that there is a tough union problem here, and an understandable union problem.

What kind of progress do you anticipate you can make in this area?

Secretary SHULTZ. I think that part of the union problem is connected with the fears of job scarcity. So I keep emphasizing in my own mind and my own thinking the strategic importance for practically any questions you discuss of high employment.

Senator PROXMIRE. Especially in the housing industry, where they have this 10-year goal, that ought to help a lot.

Secretary SHULTZ. The efforts to estimate overall demand for labor in this industry, getting that known and understood well, are an important part here. The efforts to work at the seasonality problem seem to be an important aspect of reassurance to the union group. And I think that there have been successes, and I hope these will continue, in the use of various governmental programs, combining contract agreements with training, bringing in of apprentices, and so on.

So I agree that this is an important area, and there are various ways of working at it. It is not the easiest thing in the world to do, I am sure that is true, too.

Senator PROXMIRE (presiding). Senator Miller?

Senator MILLER. On this minimum wage again, at a time when you are concerned about inflation, would not the bumping effect of an increase in the minimum wage have a tendency to accelerate that inflationary problem?

Secretary SHULTZ. You mean, if you increase the minimum is there a pass through on up the line?

Senator MILLER. That is right.

Secretary SHULTZ. Yes, it would tend to have that impact.

Senator MILLER. But the tax-incentive or contract approach would not?

Secretary SHULTZ. I think I may have confused matters by bringing that in. I was trying to come back, I guess, to an analytical point in my discussion with the Chairman about whether or not there is any connection between the wage paid and the demand for labor of various kinds. The use of the contracting approach or tax approach—the distinction between the two is not important for this point—but the fact that contracting approach has worked to bring people who weren't otherwise there onto payrolls suggests that there is this connection.

One of the things that has happened in the contracting approach is filling this gap by the money that flows from the contract. That is what the contract is really all about. And this is one piece of evidence, I submit, on the question we were discussing. I will put it that way.

Senator MILLER. Finally, with this computer technology that is now becoming available to us, would it be feasible to have minimum wages according to regions around the country? What I am getting at is, a minimum wage of $1.50 in New York certainly would be very little. But in the State of Mississippi it would be very great.

I can see where it could cause a loss of industry in the State of Mississippi because of the economics involved. And what we want to do is, we want to keep industry and increase industry in some of these rural areas. And I am just wondering if this would be a feasible way of possibly modifying the aggravation of the migration of people by having a minimum wage on a reasonable basis according to the cost of living in the region.

Secretary SHULTZ. Well, wage differentials do exist between different regions in the country.

Senator MILLER. Not only minimum wage.

Secretary SHULTZ. And they do have the impact of stimulating the flow of economic developments. I suppose the concept of the statutory minimum wage covering all parts of the country at once would be that that is a minimum, and then States where there are very high wages can put up a higher minimum wage if they want. But at the same time you create some base that avoids competition among regions on the basis of, let's say, very low-wage labor.

And so I think that to a degree the approach you are suggesting takes place naturally in the economic workings of the economy. The fact that we have a minimum wage that covers the country as a whole means that in thinking about it, one does have to think about it in terms of the low-wage regions as well as the high-wage regions.

Senator MILLER. That is right. And that is why I am wondering if it might be feasible to go this route.

In any event, could you have that looked into as a possibility?

Secretary SHULTZ. Yes, sir.

Senator MILLER. Thank you.

Senator PROXMIRE. Thank you very much, Mr. Shultz. You have been a fine witness. And you talked about taking your orals again. Certainly, we are not as well qualified as you on any score, but if we were, we certainly would give you a high distinction in the job you did here this morning.

The committee will reconvene on Monday, February 24, at 10 a.m., to hear four distinguished professors, who will look in their crystal balls and tell us what is going to happen in the economic outlook. That hearing will be held in room 318, Old Senate Office Building.

(Whereupon, at 12:25 p.m., the committee recessed, to reconvene at 10 a.m., Monday, February 24, 1969.)

THE 1969 ECONOMIC REPORT OF THE PRESIDENT

MONDAY, FEBRUARY 24, 1969

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Joint Economic Committee met, pursuant to recess, at 10 a.m., in room 318, Old Senate Office Building, Hon. Wright Patman (chairman of the joint committee) presiding.

Present: Representatives Patman, Bolling, Brock, and Conable; and Senators Proxmire, Sparkman, Miller, and Percy.

Also present: John R. Stark, executive director; and Douglas C. Frechtling, minority economist.

Chairman PATMAN. The committee will please come to order.

This morning the Joint Economic Committee continues its hearings on the state of the economy and the administration's program.

Our leadoff witness last week was the new Chairman of the Council of Economic Advisers. He was followed by the Budget Director of the new administration, and the secretaries of the Treasury and Labor.

Today we are privileged to have a panel of four outstanding professors who are experts on the analysis of the economic situation in our country. We are delighted to welcome you, gentlemen, and we are grateful to you for your advice.

Our panel today consists of Prof. Lawrence R. Klein of the University of Pennsylvania; Prof. George L. Perry, University of Minnesota; Prof. Daniel B. Suits, University of Michigan; and Prof. Robert M. Williams, University of California at Los Angeles.

We hope that each of you can summarize your individual views within 10 minutes to permit us ample time for questions. You may always extend your remarks to include anything that is germane to your discussion that you would like to have included in the printed record.

After you have presented your views the committee will interrogate the panel under the 10-minute rule.

Professor Klein, we will begin with the discussion of your statement. You may start off in your own way.

STATEMENT OF LAWRENCE R. KLEIN, PROFESSOR OF ECONOMICS, UNIVERSITY OF PENNSYLVANIA

Mr. KLEIN. Thank you, Mr. Chairman.

Some of the main conclusions in the 1969 Economic Report of the President and the amended presentation of the new Council of Economic Advisers about the 1969 prognosis and the effects of recent fiscal and monetary policies are generally in line with the predictions made by the Econometric Forecasting Unit of the Wharton School of Finance and Commerce, University of Pennsylvania, but there are differences of detail that I would like to point out for the committee.

First, permit me to explain the method and background of my calculations on the present and projected state of the economy. The Wharton EFU predictions are made from a mathematical-statistical model of the U.S. economy consisting of some 70 simultaneous equations. This is a dynamic, nonlinear system of equations from which economic projections are computed every quarter for a period extending eight quarters into the future. Every quarter, data on the economy are assembled and updated for new projections. The Wharton EFU has been doing this since 1963 in cooperation with economists from many of the Nation's largest corporations. We meet regularly every quarter and assess the main assumptions of the projection solutions. This is not a mechanical, arithmetic process. Late information and judgment of all the participating members of our group are brought to bear on the final solutions used. The present calculations reached were decided upon at our regular quarterly meeting held February 14, 1969, in Los Angeles, Calif. They are made for a base case which reflects our best considered judgment on policy variables and unique events. We also make contingency calculations for policy alternatives or other events that may occur.

The principal assumptions that underlie our most recent calculations are:

1. The Federal income tax surcharge will be retained at a full 10-percent level for another year after July 1, 1969.

2. The war in Vietnam will continue at a slower tempo. This will enable national defense outlays to grow at their recent slow rate. Other Federal expenditures will grow at a restrained pace, but both sets of Federal outlays will re-reflect a pay increase in 1969.

3. State and local expenditures will continue to grow approximately as they have in recent quarters. I will read from my figures. The overall totals start out at 206.4 billion in 1969, first quarter, and increase to 210, 215, 219, 223, 227, 230, and 234 as of the eighth quarter the series gives the annual rate of Government expenditures, GNP account basis.

ANNUAL RATE

[In billions of dollars]

	1968	1969				1970			
	4	1	2	3	4	1	2	3	4
Defense	80.0	80.4	80.9	82.4	82.8	83.3	83.7	84.1	84.6
Other Federal	21.7	22.0	22.4	23.1	23.5	23.9	24.3	24.7	25.1
State and local	101.2	104.0	106.8	109.7	112.7	115.7	118.7	121.7	124.7
Total	203.0	206.4	210.1	215.2	219.0	222.9	226.7	230.5	234.4

The assumption No. 3 is that monetary policy will continue to be restrictive for the first three quarters of 1969 and will become somewhat easier. We are assuming a discount rate of 5.5 percent for three quarters and then a rate of 5 percent. We place net free reserves at minus $500 million for the next two quarters and then raise them gradually toward zero.

4. Farm prices and income decline slightly during 1969.
5. World trade continues its slow growth of recent months.
6. The dock strike in the first quarter of 1969, the increase in social security payments, and the payment of the retroactive portion of the surtax, are all accounted for in our calculations.

The model calculations with these assumptions yields slow growth in output during the first quarter of 1969. The quarterly increment in GNP is placed at $10–$11 billion in the present quarter, rising to about $12 billion in the next quarter, and slightly more than $12 billion in the third quarter, these are all annual rates.

For the remainder of the projection, quarterly growth is held to less than $14 billion.

In this slower economy, unemployment is expected to rise to levels as high as 4.5 percent and price inflation, measured by the GNP inflator, should be reduced by something between one-half and a whole percentage point. Wage rates are projected at approximately 7 percent per annum. Profits should recede from their present high levels and recover somewhat after mid-1969.

The slow performance indicated by the Wharton EFU model in early 1969 is below the rate implied by the Economic Report and the yearly average growth in total output is smaller. Our estimate of GNP for all 1969, given the reported value for 1968, is $916 billion. This is lower than the estimate of the Economic Report and of many other economic forecasters.

It is our opinion that the American economy changed its rate of expansion considerably in late 1968, as we had previously forecast, although our projections had been to low for the third quarter, that the pressures of restrictive measures are being felt more severely now, and will continue to be felt in the next quarter of 1969. We do not foresee a recission in this pattern of slowdown, but when the economy performs this slowly, unemployment should eventually increase because of normal labor force and productivity growth. A possible reason why we have not yet seen an effect of the slowdown in the unemployment rate is that there has been some labor hoarding. Hours worked per week have been falling for a few months, while the number of persons laid off has been kept small.

The turn-around of consumers under the pressures of higher taxes and social security payments is reflected in modest calculations of increases in consumer outlays of approximately $7 billion per quarter. This is much smaller than 1968 increments prior to the fourth quarter.

In the first quarter of 1969, we have built the effects of the dock strike into our solutions to yield a poor showing of net exports that is partially made up in the second quarter. We probably differ from the Economic Report in this respect. We also project modest rises in business fixed investment. The Economic Report is largely guided by the results of surveys on investment intentions. These have been unusually optimistic recently, while our equations for predicting investment show more modest rates of expansion.

A result of these differences in specific aspects of the economic outlook, together with our overall slower growth rate for GNP in 1969, produces a different budgetary assessment. Our projections of the deficit—NIA accounting basis; Federal, State, and local—are that it will be in surplus in the first two quarters of 1969 and then will turn negative, at increasing rates, again. The lower income base implied by our projections yields a smaller stream of receipts. Also, payments must be made for benefits at our projected higher rates of unemployment, and, of course, the higher interest rates are a big burden on interest payments by the Federal Government.

I have submitted some very late calculations that I wasn't able to include in my written statement, which is a table of the GNP account as it came off our computer output run. These are started in the left column as being the last quarter of 1968, and then projected ahead for the next 8 quarters. These figures have been slightly revised over the weekend but they are very close to the numbers that we are releasing for our first quarter forecast you can see in this table in line 17 the gross national product estimate in current prices. It starts at about $897 billion as an estimate for the present quarter and grows in smaller increments than we have recently seen during the next few quarters.

To explain the notation in the tabulation, line 4 is total consumer expenditures. Line 9 is investment in fixed plant and equipment. Line 10 is housing investment. Line 11 is inventory change. Line 15 is the net foreign balance. Line 16 is Government expenditures. Line 18 is GNP at constant prices. Line 19 is the GNP price deflator. Line 20 is corporate profits before tax. Line 21 is disposable income at current prices and line 22 is the unemployment rate.

You can see that we project an almost level pattern of output in the very near term and then a slight pickup. The unemployment rate is expected to grow slightly in the first quarter. The January figure is in but we would be projecting a higher figure for February and March in order to come out with the quarter's average that we have here.

Thank you.

(Tables follow:)

WHARTON ECONOMETRIC FORECAST, FEB. 24, 1969

	1968	1969				1970			
	4th quarter	1st quarter	2d quarter	3d quarter	4th quarter	1st quarter	2d quarter	3d quarter	4th quarter
Nondurables and services	$461.7000	$469.2329	$476.6960	$484.2117	$490.7451	$497.3452	$504.0398	$512.8838	$520.2512
Durables (excluding cars)	46.9000	46.7993	47.0460	47.7996	48.2767	48.3135	48.4366	50.7366	51.7045
Cars	38.2000	37.5540	37.7318	37.9980	38.1165	37.9175	37.9341	39.6634	40.4212
Consumption	$546.7998	$553.5862	$561.4736	$570.0090	$577.1382	$583.5759	$590.4104	$603.2837	$612.3767
Manufacturing investment	$28.1000	$28.8081	$29.0664	$29.4294	$29.8117	$29.9972	$29.9960	$29.7928	$29.9671
Regulated investment	$26.3000	$26.3808	$26.4596	$26.4868	$26.5341	$26.6975	$27.0337	$27.3614	$27.7210
Commercial investment	$33.7000	$33.7453	$33.2376	$32.8904	$32.8209	$32.6639	$32.3510	$32.0358	$33.2962
Farm investment	$6.8000	$7.1584	$7.2427	$6.9425	$6.7484	$6.8011	$6.8787	$6.9453	$6.9988
Fixed investment	$94.9000	$96.0926	$96.0064	$95.7490	$95.9151	$96.1597	$96.2594	$96.1352	$97.9831
Housing	$31.0000	$32.2922	$31.7559	$32.1415	$31.7955	$31.1618	$30.8769	$32.6609	$33.5632
Inventory change	$10.6000	$6.6630	$7.1036	$7.5625	$6.6412	$5.0380	$4.8224	$5.1040	$6.4919
Investment	$136.5000	$135.0477	$134.8659	$135.4530	$134.3517	$132.3595	$131.9588	$133.9001	$138.0382
Exports	$50.1000	$51.6607	$53.8961	$53.8481	$54.2116	$54.8007	$55.5358	$56.0649	$56.7549
Imports	$94.1000	$49.7845	$50.7065	$50.9665	$51.2717	$51.5596	$51.9278	$52.7155	$53.3356
Net foreign balance	$1.0000	$1.8762	$23.1896	$2.8816	$2.9399	$3.2411	$3.6080	$3.3494	$3.4193
Government expenditures	$203.0000	$206.4066	$210.0974	$215.2065	$219.0062	$222.8998	$226.6994	$230.4983	$234.3933
Gross national product	$887.3999	$896.9163	$909.6240	$923.5498	$933.4355	$942.0752	$952.6763	$971.0313	$988.2271
GNP (1958 dollars)	$718.3999	$719.1951	$722.2512	$726.0913	$727.5593	$728.7139	$730.6089	$739.5537	$746.9763
GNP deflator	1.2350.	1.2471	1.2594	1.2719	1.2830	1.2928	1.3040	1.3130	1.3220
Profits	$91.9000	$87.9647	$89.4088	$92.5178	$91.3145	$90.0724	$92.0135	$96.4537	$98.0372
Disposable income	$602.3999	$605.6900	$613.8730	$624.9172	$632.7712	$639.8342	$646.0117	$666.7300	$677.7019
Unemployment rate	3.4000	3.4808	3.6119	4.0076	4.0571	4.1775	4.3729	4.2998	3.9249

RECURSIVE SYSTEM 2—SUMMARY TABLE

1. CNS	$761.7000	$469.2329	$476.6960	$484.2117	$490.7451	$497.3452	$504.0398	$512.8838	$520.251
2. CNA	$46.9000	$46.7993	$47.0460	$47.996	$48.2767	$48.3135	$48.4366	$50.7366	$51.7045
3. CA	$38.2000	$37.5540	$37.7318	$37.9980	$38.1165	$37.9175	$37.9341	$39.6634	$40.4212
4. C	$546.7998	$553.5862	$561.4736	$570.0090	$577.1382	$583.5759	$590.4104	$603.2837	$612.3767
5. IFM	$28.1000	$28.8081	$29.0664	$29.4294	$29.8117	$29.9972	$29.9960	$29.7928	$29.9671
6. IPR	$26.3000	$26.3808	$26.4596	$26.4868	$26.5341	$26.6975	$27.0337	$27.3614	$27.7210
7. IPC	$33.7000	$33.7453	$33.2376	$32.8904	$32.8209	$32.6639	$32.3510	$32.0358	$33.2962
8. IFF	$6.8000	$7.1584	$7.2427	$6.9425	$6.7487	$6.8011	$6.8787	$6.9453	$6.9988
9. IP	$94.9000	$96.0926	$96.0064	$95.7490	$95.9151	$96.1597	$96.2594	$96.1352	$97.9831
10. IH	$31.0000	$32.2922	$31.7559	$32.1415	$31.7955	$31.1618	$30.8769	$32.6609	$33.5632
11. C–II	$10.6000	$6.6630	$7.1036	$7.5625	$6.6412	$5.0380	$4.8224	$5.1040	$6.4919
12. I	$136.5000	$135.0477	$134.8659	$135.4530	$134.3517	$132.3595	$131.9588	$133.9001	$138.0382
13. FE	$50.1000	$51.6607	$53.8961	$53.8481	$54.2116	$54.8007	$55.5358	$56.0649	$56.7549
14. FI	$49.1000	$49.7845	$50.7065	$50.9665	$51.2717	$51.5596	$51.9278	$52.7155	$53.3356
15. NFB	$1.0000	$1.8762	$3.1896	$2.8816	$2.9399	$3.2411	$3.6080	$3.3494	$3.4193
16. G	$203.0000	$206.4066	$210.0974	$215.2065	$219.0062	$222.8989	$226.6994	$230.4983	$234.3933
17. GNP	$887.3999	$896.9163	$909.6260	$923.5498	$933.4355	$942.0752	$982.6763	$971.0313	$988.2271
18. X	$718.3999	$719.1951	$722.2512	$726.0913	$727.5593	$728.7139	$730.6089	$739.5537	$746.9763
19. P	1.2350	1.2471	1.2594	1.2719	1.2830	1.2928	1.3040	1.3130	1.3230
20. PCB	$91.9000	$87.9647	$89.4088	$92.5178	$91.3145	$90.0724	$92.0135	$96.4537	$98.0372
21. DI	$602.3999	$605.6909	$613.8730	$624.9172	$632.7712	$639.8342	$646.0117	$666.7300	$677.7019
22. UN	3.4000	3.4808	3.6119	4.0076	4.0571	4.1775	4.3729	4.2998	3.9249
Number of iterations to converge		43	41	39	39	39	40	34	32

Chairman PATMAN. Thank you very much, sir.

Professor Perry, we will be very glad to hear from you, sir.

STATEMENT OF GEORGE L. PERRY, PROFESSOR OF ECONOMICS, UNIVERSITY OF MINNESOTA

Mr. PERRY. Thank you, Mr. Chairman.

In order to be brief, I shall limit this statement to a summary of my forecast for output, prices, employment, and the budget surplus, plus a couple of observations on some policy implications of this forecast.

I can fill in some more detail of the forecast if you would like during the question period.

The forecast assumes the surtax rates are extended and projects Federal expenditures at very near the levels estimated in the January budget. Also, in the forecast, interest rates do not rise significantly from present levels and are expected to ease, but only a little, as the year progresses. Under these conditions:

I expect the gross national product to increase by 7.2 percent or $62 billion, from $861 billion now indicated for 1968 to $923 billion this year.

I am not as optimistic as the Government in 1969 President's Economic Report about the likelihood of a substantial slowdown in prices this year. There should be some deceleration of prices as the year progresses. But more than half of my forecast GNP increase for 1969 is due to the rise of almost 4 percent that I expect in the GNP deflator. With real output increasing more slowly than the economy's potential, I expect the unemployment rate to average a little above last year's 3.6 percent and to approach 4 percent before the end of this year.

Consistent with outlook for GNP, I expect a 7½-percent growth in personal incomes and very little change in corporate profits in 1969.

I expect the Federal budget, on the national income accounts basis, will show a modest surplus for the year.

While the pattern of GNP advance in the forecast can be characterized as somewhat faster in the second half of the year than in the first, I do not expect a dramatic shift in the growth rate of real output. In particular, I would not characterize the year as another 1967 when a big change in the rate of inventory building resulted in a sharply different rate of advance between the first and second halves. This year, the modest pickup expected in the second half is due to the Government pay increase, which contributes to GNP but not directly to real output; and to other Government policy actions, both budgetary and monetary, which could well change from present projections.

Finally, if I had to project what now seem the most likely places where this forecast might go wrong, I would list the most policy-sensitive sectors of demand, particularly—

Residential construction, where I now forecast a 1.5 to 1.6 million rate of housing starts for the year, a figure that could prove too high if determinedly tighter monetary policy were pursued; and

Purchases by all levels of Government, where the decidedly larger increases I expect in the second half of the year compared to the first could be pared if present budget plans are revised.

I am old-fashioned enough in my economics to believe that fiscal policy has a large influence on the level of GNP. And, in particular, the surtax as well as the level of budget expenditures matter in today's outlook. In contrast to so many remarks we have been hearing, I believe the evidence since the passage of the surtax shows that it has been important in slowing the economy. The right place to look for surtax effects is in consumer spending. And over the last 5 or 6 months, retail sales have not moved up at all.

An early announcement that the surtax will be extended would be useful, not only through its possible effects on consumer demands, but through its desirable influence on inflationary expectations. It might help avoid a substantial disintermediation in financial markets which would once again seriously depress the residential construction industry. Generally, I favor flexibility and believe it is desirable to keep policy options open. But in this case. the probability that the Government will want to extend the surtax next summer seems high enough and the advantages to an early announcement significant enough, that a prompt call for full extension is warranted now.

With inflation recently accelerating, our foreign trade surplus virtually gone, and the average unemployment rate at 3.3 percent, economists today are as nearly unanimous as they will ever be in calling for some slowdown from recent rates of GNP growth. When it comes to how much of a slowdown will be needed to achieve any given improvement in the inflation record and how extended a slowdown policy should aim for, differences begin to appear.

The policy of trying to slow inflation gradually and over an extended period that was outlined in their testimony by the President's Council of Economic Advisers seems easily the best approach to take at this time. I am not an optimist on the inflation problem. I do not think it will slow down quickly, so I hope the Government is patient in pursuing its policy of gradual adjustment. And while we can improve on the most recent record, we may, in the end, still have to tolerate a noticeable degree of inflation if we are to maintain high employment in the longer run. This outcome is made more likely to the extent that the potential evils of something like the old guidepost policy are thought to outweigh its possible benefits—a conclusion that is hard either to verify or to refute—so that we take no new initiatives on these lines. Other policies that can help, particularly those directed at manpower training and labor market problems, have become less controversial. They seem to be limited mainly by our ability to agree on the details of implementing and administering them and, more fundamentally, by our willingness to pay for them on a large enough scale. Desirable as they may be, I doubt that they can fully reconcile low unemployment with price stability, and especially doubt that they can be counted on for much help in the near-term transition from present inflation rates.

While stabilization policy thus may have to take higher unemployment as the cure for today's inflation, steps can be taken to minimize the costs of taking the cure. Even a modest rise in unemployment has substantial costs for many individuals. As the Council showed in its testimony, when the average unemployment rate fell 14 percent during the past year, from a (seasonally unadjusted) rate of 3.7 to 3.2 percent between the fourth quarters of 1967 and 1968, the unemployment rate in urban poverty areas fell by 25 percent and the rate for blacks in these areas fell by nearly 30 percent.

By the fourth quarter of 1969, these changes may have been reversed, indeed will have been according to the kind of forecasts that are being made today. And before inflation is slowed much, unemployment is likely to be considerably higher in these groups. While this may be an inevitable result of a necessary slowdown, the amount of individual cost that has typically been involved in rising unemployment, especially to those in the high unemployment groups, is neither inevitable nor necessary. Anything that can be done to minimize this cost will make the anti-inflation program far more acceptable. This certainly justifies adequate access to programs with additional, longer run payoffs, such as education and training programs, for those unemployed who could benefit from them. In my opinion, it also calls for strengthening programs that openly transfer income to those who lose jobs and who do not get sufficient assistance in other ways—either because existing training or employment programs are inadequate, because they do not qualify for them, or because the existing system of unemployment compensation does not cover them or provides inadequtae coverage.

Chairman PATMAN. Thank you, Professor Perry.

Professor Suits, we should be very glad to hear from you, sir. You may proceed in your own way.

STATEMENT OF DANIEL B. SUITS, PROFESSOR OF ECONOMICS, UNIVERSITY OF MICHIGAN

Mr. SUITS. Mr. Chairman, the economic outlook that I shall present today was compiled by the research seminar in quantitative economics at the University of Michigan as part of a research project supported by the National Science Foundation. I wish, in particular, to thank my able colleague Prof. Saul H. Hymans for his contribution to its preparation.

BASIC FACTORS IN THE OUTLOOK

The outlook is predicated on the projections of several basic elements.

1. The 10-percent surcharge on personal and corporate income taxes is projected to be renewed and continued in effect.
2. Total Federal Government purchases of goods and services are projected to hold at the level of the last quarter 1968 until the beginning of the fiscal year 1970, when they will rise modestly in response to prospective pay increases.
3. State and local purchases of goods and services are projected to rise at a trend rate of $2.8 billion per quarter.
4. Monetary policy is projected at about the present level of tightness.
5. Projections of business fixed investment during the first two quarters are made consistent with investment intentions reported in recent surveys, and only small increases have been allowed for the last two quarters of the year.
6. Exports are projected to rise at a trend rate of $.8 billion per quarter.

Economy To Slow Down

The resulting economic outlook is presented in the accompanying table. Gross national project is forecast to rise from the $887.4 billion level of the fourth quarter of 1968, to reach $932.2 billion by the end of 1969. This would represent an average of $914.9 billion for the year as a whole compared to $860.7 billion for 1968.

ECONOMIC OUTLOOK FOR 1969

	1968, IV	1969 I	II	III	IV	Year
Gross national product	887.4	897.4	906.1	924.0	932.2	914.9
Consumption expenditure	546.8	552.8	558.2	568.5	573.0	563.1
Gross private domestic investment	136.5	137.3	137.3	138.9	139.1	138.2
Business fixed investment	94.3	96.2	97.6	98.6	99.6	98.0
Residential	31.6	32.2	32.4	32.4	32.8	32.5
Inventory accumulation	10.6	8.9	7.3	7.9	6.7	7.7
Net exports	1.0	1.4	1.8	1.8	2.2	1.8
Exports	50.1	50.9	51.7	52.5	53.3	52.1
Imports	49.1	49.5	49.9	50.7	51.1	50.3
Government purchases of goods and services	203.1	205.9	208.7	214.8	217.9	211.8
Federal	101.6	101.6	101.6	104.9	105.2	103.3
Defense	80.0	80.0	80.0	82.2	82.2	81.1
Other	21.6	21.6	21.6	22.7	23.0	22.2
State and local	101.5	104.3	107.1	109.9	112.7	108.6
Addenda:						
Unemployment rate (percent of civilian labor force)	3.4	3.4	4.0	4.1	4.5	4.0
Implicit deflator for GNP (1958=100)	123.5	124.5	125.5	126.9	127.8	126.2
Gross national product in 1958 prices	718.5	720.8	722.0	728.1	729.4	725.1

The quarterly pattern of the forecast reveals a very flat first half of the year followed by more rapid growth during the second half. This follows partly from the pattern of taxes. The forecast first half of the year is held down by the increase in social security taxes already in effect, and by the addition to final income tax settlements associated with the tax surcharge, but coupled with the $10 billion inventory accumulation during the last quarter of 1968. The greater buoyancy of the second half is partly the result of the termination of these final settlements, and the addition of the pay increase to Government purchases.

The components of total output do not grow uniformly. Consumer spending is forecast to rise almost 5 percent, but the growth in gross private domestic investment is only 2 percent, partly because of the slower rate of inventory accumulation at the end of the year. Net exports, on the other hand, are forecast to double as imports grow more slowly than the projected rise in exports. Government purchases of goods and services rise 9 percent.

Overall, the forecast represents a substantial reduction in the growth rate of the U.S. economy. In contrast to the gain of almost 10 percent registered during the year just past, the GNP forecast for the end of 1969 is only 5 percent above the fourth quarter of 1968. When adjusted for an expected 3.5-percent increase in prices, this amounts to a gain of less than 2 percent in physical volume of output, compared to 5.5 percent for the corresponding period last year.

Rising Unemployment But Price Increases To Continue

The forecast growth in gross national product is too slow to absorb the expected new entrants into the labor force and still compensate for rising productivity, and will be accompanied by rising unemployment that we expect to reach 4.5 percent of the labor force by the end of the year.

Despite slower growth and rising unemployment, however, prices will continue to rise at almost the same pace as during 1968. The reason for this is the backlog of undigested costs now in the economy. Producers cannot respond instantly to changed conditions, and there is necessarily a delay between the time a firm finds its costs rising and the time it can make appropriate price adjustments. Moreover, higher output prices of material producing firms represent higher input costs to their customers, and there is further delay before prices rise at the next stage of production. Our calculations indicate that it takes an average of 3 years before an initial increase in unit cost fully emerges in prices of final output, and for this reason any slowdown in the rate of economic growth has its first impact on jobs rather than on nonfarm prices.

Underlying Cost Pressures Reduced

Although the rate of price increase will be largely maintained through the year, underlying cost pressures will diminish and less inflationary steam will be generated beneath the surface than has been true in the recent past. Employee compensation per man-hour is forecast to rise only 5.5 percent this year, in contrast to recent rates of increase of almost 7 percent. With normal productivity increases, this implies a rise in unit labor cost of only 3.5 percent, a decline from rates of increase of 4 and 5 percent recently experienced. In other words, although rapid price increases can be expected to continue through this year, we are slowing the buildup of costs on which prices during 1970 and 1971 are going to depend. If slow growth in total output is maintained, the rate of inflation will be substantially abated by that time.

Direct Measures Are Needed To Change the Tradeoff Between Inflation and Unemployment

Although maintaining slow growth through 1970 can bring the rate of price increase back to something like 2 percent per year, our analysis indicates that this slow growth will be accompanied by rising unemployment which will take us back to the rates of joblessness in excess of 5 percent that characteristized the years from 1958 to 1964. During that period, prices as measured by the implicit deflator for the gross national product rose from their 1958 base of 100 to only 108.8, an average annual growth of only 1.4 percent. But this price stability was purchased at the cost of unemployment that never involved fewer than 5 percent of the labor force, and during 2 years averaged over 6 percent.

To put the matter another way, the present rate of price inflation is not the result of special economic "distortions" that can somehow be untangled to yield stable prices without loss of jobs. Rapid price inflation and low unemployment are ultimately tied together in our economy. We cannot eliminate one without ultimately losing the other.

This poses a serious policy dilemma that we have so far failed to face up to. Purely global policy measures—whether fiscal or monetary, and in whatever combination—merely buy price stability with high unemployment, or pay for more jobs with higher inflation rates. Either way, somebody gets hurt for the protection of somebody else. Either way the divisive social forces evident today are further irritated. The real policy question is not how to choose among the alternatives offered by the existing trade-off between unemployment and inflation, but how to change the terms of the tradeoff itself. This cannot be done by global action, but only by specific programs designed to increase the education, skill mobility, employment potential, and employment opportunity of the unemployed worker.

Chairman PATMAN. Thank you, Professor Suits.

Professor Williams, we are glad to have you, sir, and you may proceed in your own way.

STATEMENT OF ROBERT M. WILLIAMS, PROFESSOR, GRADUATE SCHOOL OF BUSINESS ADMINISTRATION, UNIVERSITY OF CALIFORNIA AT LOS ANGELES

Mr. WILLIAMS. Thank you, Mr. Chairman.

It is indeed an honor and a pleasure to appear before this committee. I have been asked to focus my testimony on the economic outlook. In carrying out this suggestion I shall present the UCLA business forecast for the Nation in 1969, which was the first presented on December 3, 1968, and recently was revised on the basis of more recent information, particularly data for the fourth quarter of 1968.[1]

Since 1952, a panel of economists at UCLA Graduate School of Business Administration has prepared an annual forecast of GNP and its components and other national economic series. More recently, when national forecasts became more common, we began to make additional forecasts for California and subregions of the State.

Our forecast presented today does not differ materially from our preliminary forecast for 1969 made last September, which in turn was much like that made in early December. I mention this to point out that we have believed for some time that the American economy would continue to expand through 1969, although at a slower rate than prevailed in 1968. We never subscribed to the concept of "fiscal overkill" feared by some following adoption last June of the Revenue and Expenditure Control Act of 1968.

Before discussing the details of our 1969 forecast, let me state two basic assumptions. First, we expect that war in Vietnam will gradually diminish in intensity. We believe, however, that total manpower commitments in Southeast Asia will not decline significantly this year, and that total defense expenditures will increase somewhat. The second assumption is that the 10-percent tax surcharge on personal and corporate income will be extended at least through 1969. Moreover, speaking

[1] See the UCLA Business Forecast for the Nation and California in 1969, Robert M. Williams, editor; contributors include: T. A. Andersen, F. E. Case, D. Eiteman, C. Ervin, W. A. Fogel, M. Granfield, C. Huizenga, E. C. Miller, F. G. Mittelbach, R. E. Moor, F. E. Norton, S. L. Rabin, D. Ratajczak, J. V. Schmidt, J. P. Shelton, P. L. Smith, J. F. Weston, and R. M. Williams.

for myself, I believe that the surtax should be extended to reduce upward pressures on demand and prices and to reduce or eliminate the Federal budget deficit, thereby making it possible for the Federal Reserve System to conduct a more flexible monetary policy.

A FORECAST OF 13 SELECTED ECONOMIC SERIES

Turning now to the details of our forecast, table 1 shows annual data for the last 5 years and the 1969 forecast for 13 selected economic series.

TABLE 1.—SELECTED ECONOMIC SERIES, 1964-1968 AND THE UCLA FORECAST FOR 1969

	1964	1965	1966	1967	1968	Forecast 1969
1. Gross national product (billion current dollars)	632	685	748	790	860.7	921.0
2. Federal Reserve Board Index of Industrial Products (1957-59=100)	132	143	156	158	165.3	170
3. Private housing starts (million)	1.53	1.47	1.16	1.29	1.50	1.60
4. Automobile production (million)	7.8	9.3	8.6	7.4	8.8	8.5
5. Wholesale Price Index (Bureau of Labor Statistics 1957-59=100)	100.5	102.5	105.9	106.1	108.7	111.0
6. Consumer Price Index (Bureau of Labor Statistics, 1957-59=100)	108.1	109.9	113.1	116.3	120.9	125.0
7. Civilian employment (million)	69.3	71.1	72.9	74.4	75.9	76.9
8. Unemployment as percent of civilian labor force	5.2	4.5	3.8	3.8	3.6	3.9
9. Average hourly earnings, manufacturing industries (dollars)	2.53	2.61	2.72	2.83	3.01	3.15
10. Interest rate on 3-month Treasury bills, percent	3.55	3.95	4.88	4.32	5.34	5.15
11. Corporate bond yield (Moody's Aaa) percent	4.40	4.49	5.13	5.51	6.18	6.15
12. Corporate profits before taxes (billion dollars) [1]	66.3	76.1	83.9	80.4	89.2	92.0
13. Dow-Jones average of 30 industrial stock prices:						
High	892	969	995	943	985	1,060
Low	766	841	744	786	825	900

[1] With inventory valuation adjustment.

The first is "Gross National Product," which is discussed in some detail later. Suffice to say here that, although our forecast of GNP of $921 billion is higher than that of some other private forecasts, it is the same as that presented in the 1969 Economic Report of the President and adopted by Dr. Paul McCracken, Chairman of the present Council of Economic Advisers, in his statement to this committee last week.

"Industrial Production," which includes output of manufacturing, mining, and utilities industries, is expected to increase by 4.7 points in the Federal Reserve Board Index in contrast to 7.2 points in 1968. This reduced rate of growth is about in proportion to that expected in "real" GNP.

"Residential Construction" is expected to continue the expansion which began in 1967, with the number of new private housing starts advancing to 1,600,000 in 1969 from 1,500,000 in 1968. In support of this optimistic forecast, the basic demand for housing in terms of existing vacancies is extremely strong, and we believe that the supply of mortgage credit, building materials, and skilled labor will be adequate to do the job.

"Automobile Production" is forecast to decline somewhat from the high level of 8.8 million reached in 1968 to 8.5 million in 1969.

"Wholesale Prices" are expected to increase by 2.3 index points or 2.1 percent in 1969, or slightly less than the 2.4-percent rise in 1968.

"Consumer Prices" are predicted to increase by 4.1 index points or 3.4 percent in 1969, or slightly less than the nearly 4.0-percent rise in 1968.

"Civilian Employment" is forecast to increase by 1 million in 1969 compared with 1,500,000 in 1968.

"Unemployment," as a percent of the civilian labor force, is expected to increase from the low level of 3.6 percent in 1968 to an average level of 3.9 percent in 1969.

"Average Hourly Earnings in Manufacturing Industries" are predicted to increase by 14 cents per hour in 1969 compared with 18 cents in 1968. This reduced rate of increase in wages in 1969 results from two factors. First, several important wage contracts made in 1968 provide for smaller increases this year than last. Second, premium payments for overtime worked will be lower in 1969 because of the shorter average work week expected.

"Short-term Interest Rates," as measured by the yield on 3-month Treasury bills, are expected to decline slightly from the high average level of 5.34 percent in 1968 to 5.15 in 1969. These rates are high now but are expected to decline in the second half of the year.

"Long-term Interest Rates," as measured by the yield on Moody's Aaa corporate bonds, are forecast to decline very slightly from 6.18 percent in 1968 to 6.15 percent in 1969.

"Corporate Profits," before taxes and adjusted for inventory valuation, increased by nearly $9 billion to a record level of $89.2 billion in 1968 and are expected to increase to $92 billion in 1969.

"Stock prices," as measured by the Dow-Jones Average of 30 industrial stocks, are expected to break 1,000 before the end of 1969. This barrier was approached early in 1966, when the DJIA reached 995, and again in November 1968, when the average reached 985. Early last week the stock market declined, allegedly in reaction to some of the testimony and discussions in this committee. At present, the DJIA is near the lower end of the range between 900 and 1,060 which we expect in 1969.

The Forecast of GNP in 1969

Table 2 shows the forecast of GNP and its major components for 1969. GNP stated in current dollars is expected to increase 60.3 billion or 7 percent in 1969, compared with an increase of $71 billion or 9 percent in 1968. In real terms, the expected increase is 3.4 percent in 1969 compared with 5 percent in 1968. The price increase in 1969, as reflected in the implicit price deflator for total GNP, is expected to be 3.5 percent, slightly less than the 3.8-percent increase recorded in 1968.

All components of GNP shown in table 2 are expected to increase except two, change in inventories—line 10—and net exports of goods and services—line 11—which are expected to decline slightly. Personal consumption expenditures are expected to increase $36.1 billion or 6.8 percent, gross private domestic investment by $8.5 billion or 6.7 percent, and total government purchases of goods and services by $16.1 billion or 8.2 percent.

TABLE 2.—GROSS NATIONAL PRODUCT 1965–68 AND THE UCLA FORECAST FOR 1969

[In billions of current dollars]

Line	Actual 1965	1966	1967	1968	Forecast, 1969
1 Personal consumption expenditures	432.8	465.5	492.2	533.7	569.8
2 Autos and parts	30.3	30.4	30.4	36.5	37.0
3 Other durable goods	36.0	40.1	42.2	46.0	49.5
4 Nondurable goods	191.1	206.7	215.8	230.2	245.0
5 Services	175.5	188.3	203.8	221.0	238.3
6 Gross private domestic investment	108.1	120.8	114.3	127.5	136.0
7 Residential construction	27.2	24.8	24.6	30.0	34.0
8 Other construction	25.5	28.5	27.9	29.2	31.0
9 Producers' durable equipment	45.8	52.8	55.7	60.8	65.0
10 Change in inventories	9.6	14.7	6.1	7.6	6.0
11 Net exports of goods and services	6.9	5.1	4.8	2.4	2.0
12 Government purchase of goods and services	137.0	156.2	178.4	197.1	213.2
13 Federal	66.9	77.4	90.6	100.0	106.8
14 (National defense)	(50.1)	(60.6)	(72.4)	(78.9)	(82.8)
15 (Other, including NASA)	(16.8)	(16.8)	(18.2)	(21.1)	(24.0)
16 State and local	70.1	78.8	87.8	97.1	106.4
17 Gross national product	684.9	747.6	789.7	860.7	921.0
18 Amount of increase	52.5	62.7	42.1	71.0	60.3
19 Percent increase	8.3	9.2	5.6	9.0	7.0
20 Percent "real" increase	6.3	6.4	2.4	5.0	3.4
21 Percent price increase	1.9	2.6	3.1	3.8	3.5

[Dollar amounts in billions]

	1968	1969	Percent increase
Personal income	$685.8	$730.0	6.4
Disposable personal income	589.0	626.0	6.3
Personal saving	40.8	41.2	1.0
Personal saving as a percent of disposable personal income	6.9	6.6	

Included in our forecast are the following changes in personal income and related variables.

As stated above, we expect a growth in real GNP of 3.4 percent in 1969. On the supply side, this assumes the following changes from 1968:

	Percent change
Productivity per man hour	[1] 2.2
Average hours worked per year	−0.45
Employment rate	−0.3
Labor force participation rate	0.05
Population 16 years of age and over	1.9

[1] This is down from 2.9 percent in 1968.

Table 3 shows the quarterly profile of GNP and its components for 1968 and 1969. Data through 1968, of course, are from published data now available. We forecast that GNP will increase by $11.2 billion in the first quarter of 1969, substantially less than in any quarter in 1968. GNP is expected to increase by $12.5 billion in the second quarter and by $17.5 billion and $15.5 billion in the third and fourth quarters, respectively.

TABLE 3.—THE QUARTERLY PROFILE IN GNP IN 1968 AND 1969

[In billions of current dollars at seasonally adjusted annual rates]

Line	Item	1968				1969			
		1	2	3	4	1	2	3	4
1	Personal consumption expenditures	519.4	527.9	541.1	546.3	555.5	564.5	574.5	584.5
2	Autos and parts	34.6	35.4	38.1	38.0	37.0	37.5	36.5	37.0
3	Other durable goods	44.4	45.6	47.0	46.8	48.0	49.0	50.0	51.0
4	Nondurable goods	226.5	228.2	232.7	233.5	238.0	242.0	247.5	252.5
5	Services	213.9	218.7	223.4	228.0	232.5	236.0	240.5	244.0
6	Gross private domestic investment	119.7	127.3	127.1	136.1	136.5	135.0	136.0	136.5
7	Residential construction	28.5	28.9	28.9	31.2	33.0	33.5	34.5	35.0
8	Other construction	29.6	28.5	28.8	29.8	30.5	30.5	31.0	32.0
9	Producers' durable equipment	59.0	58.5	61.3	64.4	65.5	65.0	65.0	64.5
10	Change in inventories	2.1	10.8	7.5	10.0	7.5	6.0	5.5	5.0
11	Net exports of goods and services	1.5	2.0	3.3	3.0	1.5	2.5	2.0	2.0
19	Government purchases of goods and services	19.50	195.7	199.6	202.5	205.5	209.5	216.5	221.5
13	Federal	97.1	100.0	101.2	101.6	102.5	104.5	109.0	111.5
14	(National defense)	(76.8)	(79.0)	(79.6)	(80.0)	(80.0)	(81.5)	(84.0)	(85.5)
15	(Other, including NASA)	(20.3)	(21.0)	(21.6)	(21.6)	(22.5)	(23.0)	(25.0)	(26.0)
16	State and local	93.4	95.6	98.4	100.8	103.0	105.0	107.5	110.0
17	Gross National product	832.1	852.9	871.0	887.8	899.0	911.5	929.0	944.5
18	Amount of increase	20.2	21.7	18.1	16.8	11.2	12.5	17.5	15.5
19	Implicit price deflator, 1958=100	120.0	121.2	122.3	123.5	124.5	125.5	126.7	127.6

Source: Survey of Current Business, January 1969, for data through 4th quarter, 1968

It should be pointed out that the accurate distribution of annual national output by quarters is difficult. We believe, however, that our forecast of GNP for the year is reasonable and that the second half of the year will see more rapid growth than the first half. If this prediction is accurate, then it is very important that the tax surcharge be returned through 1969. If the tax surcharge is not continued past June 30, 1969, we believe that prices and interest rates will be higher than we have predicted. Also, if the surcharge is not extended, total production, employment, and corporate profits will be somewhat higher but residential construction will be lower.

In conclusion, assuming that the tax surcharge is extended through 1969, we believe that the economy will grow at the respectable rate of 3.4 percent in real terms and that a start will be made toward reducing the rate of inflation. It is not possible in this brief statement to defend all the numbers presented in the three tables, so at the proper time I shall be glad to attempt to answer any questions you may have.

Thank you.

Chairman PATMAN. Thank you, Professor Williams. Senator Sparkman?

Senator SPARKMAN. Doctor, in your statement, just before you start on your conclusion, you inserted something there.

Mr. WILLIAMS. Yes, I did.

Senator SPARKMAN. Would you read it, please?

Mr. WILLIAMS. The sentence inserted was as follows:

Also if the surcharge is not extended total production, employment and corporate profits will be somewhat higher, but residential construction will be lower.

Senator SPARKMAN. Thank you.

Chairman PATMAN. I notice you said that "if the tax surcharge is not continued past June 30, 1969, we believe that interest rates will be higher than we have predicted."

Now, it has been amazing to a lot of people why housing starts have gone up in the recent past when interest rates and cost of closing loans generally have been very, very high.

The information I get from over the country is that it is based upon one argument to buyers or prospective homebuyers that if they don't buy now although interest rates are excessive you will have to pay more later.

Do you agree with that, Professor Klein?

Mr. KLEIN. I think the inflationary psychology has been with us, certainly, and very much of an issue in the last 6 months.

We have found, however, in the case of home buyers that when credit is available, even though rates are high, house purchasing still goes on.

The one instance in which we found high interest rates and a marked reaction downward in the housing market was in 1966 when the tight money conditions were associated with lack of funds for mortgage lending.

I think if we are in a situation where interest rates are high and construction costs are high but funds are still available for mortgage lending then we won't see such a strong reaction in the housing market as we did in 1966.

Chairman PATMAN. I believe the argument that if you don't buy now, it will cost you a lot more later is a very persuasive one, and I suspect it is the main argument that leads them into signing contracts to buy at such high rates of interest and such other real extortionate charges in addition to the high interest rates.

I would like to ask each of you gentlemen to respond to a question that concerns me.

Last week representatives of the administration told this committee that they favored continuation of the surtax plus a tight money policy, in order to achieve less inflationary pressure in the economy. They also conceded under questioning that this would increase unemployment.

Will you gentlemen please comment on this policy. Do you agree? Professor Williams, suppose we start with you first on that.

Mr. WILLIAMS. I think I can agree with that in general. However, it should be pointed out that if the surtax were not extended, and this was the point that I would like to make quite strong, the monetary policy would have to be tighter than otherwise. So it is a question of combining the surtax with a tight money policy or the lack of a surtax with a much tighter monetary policy, which I would not like to see.

I think there is a point at which housing might be affected adversely by tight money. I think that unlike 1966 housing will expand with the present high interest rates. As you indicated, money is available now, but I think the ceiling on the amount the savings and loan associations can pay, for example, at the present time would possibly lead to disintermediation with very high interest rates.

Chairman PATMAN. Professor Perry, do you believe you can stop inflation just by increasing interest rates?

Mr. PERRY. That would be only one indirect, initial result of a monetary policy aimed at slowing inflation. Certainly, too, today's higher interest rates partly reflect the existence of inflation and inflationary expectations.

Chairman PATMAN. I believe that the higher you put the interest the higher you put prices. Therefore, the higher the price is the more inflation, and I personally don't agree. I don't see where you can stop inflation that way.

Now, of course, there are ways of stopping inflation, and I will ask you gentlemen if you agree that these two ways of stopping inflation, No. 1, is to increase the reserve requirements of banks, in other words, to dry up to some extent the sources, the volume of funds. If it gets really ruinous and it looks like prices are going up through the roof, the next step is to siphon off the purchasing power, the excess purchasing power through taxes, siphon it off and pay it on the national debt.

In that way you would serve two purposes. You would stop the inflation and at the same time you would help the Government by reducing the cost of servicing the national debt, because cost of the national debt now is approximately about $16 billion, and if you will go back 14 years to the time we kept the interest rates low, and compare it with that, you will find we are paying $8 billion a year too much.

Do you believe we can stop inflation like I suggested, Mr. Suits?

Mr. SUITS. I think that there are a number of combinations of monetary policy and tax policy which could slow down the economy and stop inflation. If we are to operate on the global level without specific controls or specific programs, then one way or another we must reduce the aggregate amount of expenditure. We can do this by reducing the availability of loan funds, or we can reduce the availability of spendable income by removing income from individuals by taxation. Either way we operate on this global level, we are simply going to slow down the economy and buy reduced inflation with more unemployment.

Chairman PATMAN. Why do you say that is more effective than raising the reserve requirements of banks?

Mr. SUITS. Well, the raising the reserve requirements of banks is a mechanism whereby one——

Chairman PATMAN. Or reducing the reserve requirements of banks.

Mr. SUITS. Reducing the reserve requirements of banks would, of course, make the funds available, and would increase the rate of inflation.

Chairman PATMAN. I am talking about expanding 10 to 1 and have 8 to 1 or 6 to 1 or 4 to 1.

Mr. SUITS. Yes.

Chairman PATMAN. That is bound to reduce the volume of the money; isn't it?

Mr. SUITS. Yes, indeed.

Chairman PATMAN. And that would be an effective way, wouldn't it?

Mr. SUITS. Indeed it would.

Chairman PATMAN. The Federal Reserve Board has never seen fit to use that method. Probably the one time was in 1936, when we were paying out four and a half billion dollars to three and a half million veterans. They wanted to do something about what they considered to be run away inflation. They made it so difficult and hard that the country didn't get as much benefit from the payment of that money to every section of our Nation that I felt our country should have. But I have never known them to use it generally, have you?

Mr. SUITS. I am not an authority on the existence of Federal Reserve controls, Mr. Patman, as you no doubt are.

Chairman PATMAN. Well, I have been disappointed because, of course, that would take a little profit away from the banks if they did that. But why shouldn't the banks come in this and sacrifice to help stop inflation. That certainly would be an effective way.

Mr. SUITS. Indeed.

Chairman PATMAN. Don't you agree?

Mr. SUITS. Indeed.

Chairman PATMAN. Don't you agree, Dr. Klein?

Mr. KLEIN. I would say, Mr. Chairman, that we are called here this morning to talk about the economic outlook and we have put our assessments——

Chairman PATMAN. That is all right, I apologize for getting you off the track.

Mr. KLEIN. Well, we put our assessments in terms of the policies that are usually followed, and I think the discussion is very circumscribed. We think of interest policy and we think of tax policy, and I would say that the thinking is a bit unimaginative. Surely there are other ways to stop inflation than having a rise in the unemployment rate, and I think there is a good deal of merit in your suggestion about considering reserve requirements as well as traditional discount and open market policies.

And I would like to say, in addition, that there has been very little thinking about ways of stimulating private savings. If we can drive the economy at a high rate of production and simultaneously induce people to save a higher portion of their income I think we could have a chance of reducing the pressure on prices and, at the same time, keep employment at a high level.

Chairman PATMAN. Thank you, sir.

Mr. Brock?

Representative BROCK. Thank you very much, Mr. Chairman.

I am intrigued by your last comment, Professor Klein, and I would like to pursue it a bit.

What would be the impact on interest rates if you raised the reserve requirements?

Mr. KLEIN. Well, I think we could equate things like changes in the discount rate of a point, and an open market operation of a billion dollars and a change in reserve requirements probably of 1 or 2 percentage points, as equivalent impacts on supply of money. I think if we would consider changing the reserve requirements behind either time or demand deposits, by a full point from the present levels, that would be a step in the direction that we would want to consider. We are now considering discount rate moves of a half point or so and this would be in the same order of magnitude.

Representative BROCK. What you are saying is that you have to have a balanced program and, in effect, the balance would reallocate the monetary resources to some degree particularly in the area of residential construction. For example, if you did this you would make more money available to savings and loans and less available to banks.

Let's just take the first question I asked you. If, taken by itself, you raised the reserve requirements of banks would it not have an effect of increasing interest rates?

Mr. KLEIN. This would have an effect through the private money market. The traditional methods that we see through open market operations and discount operations have a direct effect on the Government bill markets and bond markets, but what is being suggested through a change in reserve requirements would percolate through the money market, through private transactions as well as through the Government transactions.

Representative BROCK. But the net effect would be higher interest rates.

Mr. KLEIN. I think this would be one effect.

Representative BROCK. When you reduce the supply of money in a tight money situation you have a higher price for money, isn't that a fair statement.

Mr. KLEIN. Yes, I would agree with that.

Representative BROCK. Let's pursue another area that I think virtually all of you have raised that is most intriguing to me. I think I gathered from the gist of your testimony almost unanimously that you feel that there has to be some alternative to this current trade-off between employment and inflation, and that there can be a policy change at this level which would allow us to change the terms of the trade-off.

Professor Suits, you directed yourself specifically to this question and Professor Perry raised it also.

But I am delighted that you brought our attention to this. I think there is a method of reducing the impact of less inflation or gradual increase in inflation, reducing that effect on employment. You mentioned specifically and particularly some more training in given areas.

I would like to put this question to you. We had testimony from Secretary Shultz last week to the effect that some two-thirds of our jobs now are service related as opposed to manufacturing, and this has an impact on unemployment because this tends to be the more stable kinds of employment. Would it not be a matter of concern to you if this Government should direct itself to expanding our training programs in this particular area, for example?

Mr. SUITS. Yes, I think so.

Representative BROCK. Is this what you are talking about, and would you elaborate?

Mr. SUITS. Well, let's ask ourselves why we have so much price inflation when we still have well over 3 percent of the labor force unemployed.

In some European countries the unemployment rate can go as low as 1 percent of the labor force before this kind of price increase is observed.

It seems to me that the reason for the difference is that so large a proportion of our unemployed 3 or so percent, consists of employees who are extremely expensive to hire. They are untrained, uneducated, immobile. They are not located where the jobs are. In effect, in other words, our unemployment rate, measured in terms of what is really available to the employer, is much below 3.3 percent.

I suggest, therefore, that we try to convert this unemployable or expensively employable component of the labor force into higher grade workers.

Now this is not an easy program. It is a long-term program to train even one man. I feel that if we start now realizing that this is the real problem, not whether to have a little more or a little less tax, then in 10 or 15 years we may have moved to a position where we can have, let's say, 2 percent unemployment, or whatever the rock-bottom rate is, and still have reasonably stable prices.

Representative BROCK. I appreciate you all bringing this up as a policy question related to our economy. It is very critical and I am very much delighted that you have said something about it.

Do you want to add something, Professor Perry?

Mr. PERRY. In response to your question, I am not very optimistic that you do a great deal through such measures to change this trade-off in any short period of time. What I tried to suggest in my remarks, is that the way the world is—and here I mean both the institutional structure of the labor market and what we are likely to do politically—you are faced with something like the present trade-off right. If you have to live with this and if you must pursue a policy of increased unemployment in the near future, it is useful to think separately about the need to pursue such a policy—the tradeoff we face—and the costs that go with such a policy. Costs which go with such a policy can be softened. You can pass bills which would simply make it much easier on those who are going to suffer the most in the process of increasing unemployment. I think that is a short-run question of great practical and immediate importance, as opposed to the long-run question of what we can do so that 5 or 10 years from now we can have less inflation with a low unemployment rate.

Representative BROCK. Thank you.

Let me just shift the subject briefly for a quick question. Professor Williams mentioned it, that he specifically endorsed continuation of the surcharge. You all included it in your projections. Is there any disagreement with the desirability of continuation of the surcharge?

Mr. PERRY. We are all in agreement.

Representative BROCK. If we continue the surcharge and accept that as our premise, I think the point was made, and I would concur and ask your concurrence, too, that we can have a considerably less restrictive monetary policy than we would have otherwise.

Now, the point I am getting at is this. I think Professor Klein mentioned the trade-off in terms of raising reserve requirements and, in turn, open market operations to put, say, another billion dollars into the economy. Can we assume that if this economy meets your projections which rank from a one and a half to a three and a half percent growth factor, which is not a terribly significant growth, if we assume these porjections, it is not conceivable that the Federal Reserve could have not just a tight money possibility—considerably eased monetary policy over what it is today within the next 6 months, could we not see a greater inflow of money into the economy through the open market operations, for example. Is it feasible, and if so, would it incur too high a rate of inflation or are you talking about increasing unemployment?

Mr. KLEIN. In the projections that I made, it was assumed that after midyear the degree of monetary restraint would ease, and we introduced this into our calculations through the traditional steps that have been taken recently, that is through open market operations and through discount policy.

But, of course, there is no reason why alternative methods could not be used. But I think that this easing of monetary policy later in 1969 concurrent with retaining the surcharge is quite a reasonable step and is not a strongly inflationary step, provided we get the slowdown that we are expecting in the next 6 months.

One other point in this connection is relevant, and that is that in all these considerations of economic policy I think it is much more sensible to consider a balanced policy and not pin everything on a surcharge, everything on tax policy or everything on monetary policy or everything on expenditure policy because when you have extreme moves of policy in one area there tend to be loopholes and distortions in the economy. It is much better to spread it around, and I think this is the reason why more instruments of policy should be sought after than are being considered at the moment.

Representative BROCK. Is there any other comment? My time has expired.

Chairman PATMAN. Senator Proxmire?

Senator PROXMIRE. I don't want to ask you questions on this but, first, I want to say I am surprised that none of you gentlemen seem to assume there is going to be any change in expenditure policy. You seem to make the assumption the surtax is based on a fixed given level of spending and that, therefore, whether we should have it or not depends on what happens in the economy and not what happens in expenditure policy. But it may be you can't cover everything.

I think these are helpful papers. It is so good to get the specification of precisely what you expect in various areas, and to have you pinpoint it by giving us the quantitative numbers. This is most useful because these general predictions—of course, it is easy to hedge and to make a prediction that can mean anything.

But having said that, I would like to say, I just wonder if this modern version of looking at the entrails of birds is really worth very much?

I don't see any crystal balls on your table but I just wonder if we have advanced very much in that kind of thing.

I say that because what I am referring to is a publication by Fels and Henshaw with which you may be familiar, put out by the National Bureau of Economic Research, it is part of a larger paper which questions the validity of short-term business forecasting, and this is pretty much what you are doing here.

Mr. Fels takes a series of publications and he says this:

> In my study—the eight principal publications in my study—one month before troughs and three months after peaks on the average was what they were able to determine.

In other words, they are able to tell the turndown 3 months after it occurred on the average. They weren't able to forecast it but 3 months after it occurred.

I wonder—if we were sitting here in 1929—and you gentlemen were asked to predict, if you would be likely to do what I suppose so many economists did then; that is, to state that the GNP is going to go up. Actually, it went down 30 years ago; by $20 billion, 10 percent.

In 1933 the tendency, I suppose, was to say it would go down. It went up. And in 1937 the temptation would be to say it was going to go up. It went down.

To predict in 1953 that it was going to go up, and in reality it went down, and so on.

My point is that it is easy, it is relatively easy and to be expected, to predict that a train moving in a certain direction is going to move in that direction, all things being equal; but really, the cutting edge is to tell when you are going to get the train to slow down or to maybe go in the reverse direction. And this study incidentally shows the Federal Open Market Committee had just about the same kind of feeble forecasting record.

The conclusion here is that out of 73 forecasts made on National Bureau of Economic Research reference peaks, there were 49 scores of zero for accuracy, that is 67 percent, and 40 scores of less than 50 percent for a degree of certainty. That is 55 percent.

That refers to the business publications. Then the Federal Open Market Committee—their comments on the business outlook in the vicinity of cyclical terms exhibits the same general pattern as found by Fels in the business publications, as time goes by becoming increasingly aware, first, of the *possibility*, then the *probability*, and then the *certainty* of a turning point, but it seems to come after the event has occurred, so that if we continue to have this 8-year prosperity, next year you gentlemen will be found to have been rather accurate.

But we don't know, and I don't know, if we know much more after listening to you about whether this is going to continue, or even the probabilities that it is likely to continue. Would any of you like to comment on that? Yes, sir; Mr. Perry?

Mr. PERRY. I am always appalled by how badly forecasts seem to have done when someone does a historical study of this sort. But then I am even more appalled as to why someone bothered to do that particular study. There aren't 73——

Senator PROXMIRE. I can understand why you would be.

Mr. PERRY. There aren't 73—or however many forecasts were surveyed—serious forecasts done at any one time. When you do something like this you have to evaluate particular forecasting models.

Senator PROXMIRE. These were 73 scores. I take it there are more than 73 scores you have given us today. You score not only on the GNP prediction, but what happens to prices, what happens to employment, and so forth.

Mr. PERRY. I took that to mean 73 forecasts that were somehow collected and sampled.

Senator PROXMIRE. No, these were scores of various kinds of forecasting by these eight publications.

Mr. PERRY. So that just eight were involved?

Senator PROXMIRE. Correct.

Mr. PERRY. The question is still whose forecasts are being evaluated and what period was involved.

Senator PROXMIRE. These are very able—this is the National Bureau of Economic Research. This is a responsible group, probably as fine a private organization as we have.

Mr. PERRY. NBER did the study, but it is still a question of what they had to sample.

Senator PROXMIRE. They selected the eight best publications they could find, and they picked the Open Market Committee. The Open

Market Committee, after all, is an agency that has to forecast and we presume they are able and competent economists who are making the forecasts.

Mr. PERRY. The other point I wanted to make is I think our ability to do this is a lot better than it was some years ago, certainly 1929 to 1933 that you cited, and quite a bit better than 10 or 15 years ago.

Senator PROXMIRE. These were within the last 15 years.

We don't know. We just had this upturn and everybody who got on the train has been right because they have been right in predicting the train is moving in the same direction.

Mr. PERRY. In this recent period, 1967 is the nearest thing to a downturn you had to worry about.

Senator PROXMIRE. We didn't even have a mini-recession, we didn't have two quarters in which the growth declined, so we didn't have a recession.

Mr. PERRY. You can be right in two directions. My point is, the good forecasts avoided calling a recession in 1967.

(In line with the foregoing colloquy, Professor Suits subsequently filed the following:)

EXTENSION OF REMARKS OF DANIEL B. SUITS

Senator Proxmire raised an interesting and important question about how accurately forecasters can, in fact, forecast. Each November for the past sixteen years the Research Seminar in Quantitative Economics has compiled and published an annual forecast for the coming calendar year. The complete record appears in the accompanying table.

During the entire period, the direction of economic movement was forecast correctly each year. The recessions of 1954 and 1958 were accurately forecast as well as the slowdowns of 1960–61 and 1963. Although the record shows substantial underestimation of the recoveries of 1955 and 1959, most of the forecasts show remarkable accuracy. In fact many of the forecasts appear to be more accurate than the measurement of the GNP itself.

TABLE 4.—REVIEW OF PAST GNP FORECASTS [1] (FIGURES REPRESENT CHANGES IN GNP OVER THE PRECEDING YEAR MEASURED IN BILLIONS OF 1954 DOLLARS, EXCEPT AS NOTED)

Outlook for year	November	Forecast	April	Observed
1953		13.0		15.5
1954		−4.5		−5.9
1955		4.4		29.6
1956		9.0		8.2
1957		9.1		7.7
1958		−2.9		−7.3
1959		9.0		27.3
1960		8.5		11.3
1961		7.4		7.8
1962		27.5		27.1
1963		14.1		15.9
1964		23.9		24.1
1965		15.8		30.8
1966 [2]	23.9		29.2	35.9
1967 [2]	28.0		24.5	16.0
1968 [2]	29.0			[3] 31.9

[1] Except the April modifications, each of these forecasts was presented before the conference on the economic outlook held in November of the year preceding the year forecast.
[2] 1958 prices.
[3] Preliminary as of November 1968.

Senator PROXMIRE. Let me ask you Dr. Klein, if you assume there will be an easing of credit tightness in the last quarter of 1969. I take it that you seem to be almost alone in that assumption. You base part of your estimates on GNP, and I assume other ingredients in it, putting housing starts in that. Last week the Secretary of the Treasury and Chairman of the Council of Economic Advisers testified they thought credit tightness would have to be pursued throughout the year. In fact, Secretary Kennedy specifically called the relaxation in tightness in 1967 a mistake.

Recently, in an interview in U.S. News & World Report, Governor Mitchell of the Fed said this, and I quote:

We mean business—

Speaking of the Federal Reserve Board—

in braking the inflationary psychology that has developed. It will probably take a reduction in real growth about two percent to get the kind of environment in which the present inflationary psychology will be halted. Economic growth will be retarded for a year or more before the needed change in climate takes place.

How then can you justify an assumption that the discount rate would be in the first quarter at 5 percent and the net free reserves would be continued at $500 million and then be allowed to raise to zero.

Mr. KLEIN. Let me comment on that. The public statement that the credit conditions will remain tight is just the kind of loose statement that you said we don't make. They are still fairly tight even at a 5-percent-discount rate. I am simply assuming there will be a change in the level but still at a very high level of tightness.

Now, as you also remarked in the previous commentary, that we hadn't considered expenditure policy, may I point out that due to the brevity in our presentation I didn't go into all the calculations that we have made. We have actually made alternative calculations.

Assuming, for example, that military expenditures, especially on sophisticated hardware systems, are somewhat higher and that the surcharge is continued not only through June 30, 1970, but even indefinitely, and that credit policy is kept severe for a longer period than through the first three quarters of 1969, then in those calculations we would find that the economy will perform at a somewhat better level on an overall basis. The unemployment rate will rise less, it will stay, according to my calculations, under 4 percent for almost all of 1970, but there is a considerable lag in the effects of monetary policy, and to maintain these very high rates of interest, and these very low levels of net free reserves at negative values, then we will find that by the end of 1970 there should be repressive—or there should be restrictive—signs in the economy, particularly in the areas of capital formation.

Senator PROXMIRE. Does this mean to you, first, that we will have a slowdown to perhaps a 2 percent level of real growth, 5 percent overall? You see, when Governor Mitchell—what he seemed to want was a 2 percent real growth and no more than a 3 percent deflator, in other words 3 percent rise in prices, so that together you wouldn't get a combination of more than a dollar increase of 5 percent at an annual rate in the GNP. Have you concluded a slowdown to that level by the end of this year?

Mr. KLEIN. Are you talking about the case in which interest rates are kept high, monetary policy is kept more restrictive, and expenditures are higher along with it: is that the case you want to present?

Senator PROXMIRE. Well, I am talking about what your assumptions are as to what is going to happen this year. I say that the Federal Reserve Board seems to be telling us that they are going to keep the brakes on the economy and try to make credit tight, keep reserves at a minus figure, and so forth, discount rate high until we slow down to a dollar increase GNP at an annual rate of 5 percent, real 2 percent.

Mr. KLEIN. I would say that we won't find that big a drop in the price level to three percent inflationary rate as a result of these more severe monetary policies. I would agree——

Senator PROXMIRE. But you think they are going to change their minds and let up a little bit on monetary policy anyway?

Mr. KLEIN. Well, I think they will be forced to, not by the movement of the price level but by the movement of overall income performance. There are many more indicators.

Senator PROXMIRE. Including employment.

Mr. KLEIN. Employment, yes.

I would agree very much with Professor Suits' notion that we are locked in for much of the price inflation in terms of the costs that we have incurred and the wage increases that we have had in the last 12 months. The techniques of slowing down the rate of economic expansion are going to show very modest results in terms of slowing down the inflationary pressure.

Senator PROXMIRE. My time is up, I will be back.

Chairman PATMAN. Senator Percy?

Senator PERCY. I would like to join our chairman and vice chairman in saying how valuable this testimony has been this morning.

Dr. Klein, you seem to be the most pessimistic in forecasting the lowest GNP increase, the highest unemployment level, and the highest wage increase estimates.

Dr. Shultz seems to be in general agreement with the AFL-CIO on the effect of an increase of the minimum wage. Do you agree that if the minimum wage were extended this year that we may have further unemployment problems? What effect would it have on the economy?

Mr. KLEIN. Well, the problem of the wage effect enters in more than one way. The minimum wage has its special effect, I think, on one of the problem areas of the economy; namely, teenage unemployment, especially in urban areas, and I think we should reconsider the whole question of minimum wage legislation until we have made much more headway in eliminating this big problem of unemployment of teenagers and especially of nonwhite teenagers.

As for the overall wage picture, I would say that the change in the minimum wage won't have a very big effect on the average hourly earnings or the average wage rate because that really is going to be dominated by the kinds of overall trade union agreements that have been negotiated in the last 2 or 3 years, especially those that have long-term contracts.

I think the most favorable thing we can say for the wage picture at the moment is that many of these 2- and 3-year contracts are now negotiated so that we can expect not as much pressure on the wage front in 1969 as we had in 1968 and toward the end of 1967.

Senator PERCY. Dr. Perry, Dr. Shultz testified that about 85 percent of all the gain in male employment since 1965 has been attributable to the war in Vietnam, that is two and a half million people in the

Armed Forces and defense-related activities. He attributes a good part of this current inflation to the growing demand on their part with no compensating civilian production. Do you think that is accurate?

Mr. PERRY. I wouldn't think very much of our inflation stems from the specific source of the increased demand. You could reach the same situation by increasing demands elsewhere. The fact that these demands came from war-related industries is of secondary importance.

Senator PERCY. Dr. Suits, last week Dr. McCracken laid out his plan for combating inflation—a gradual and persistent reduction of inflation with hopefully little impact on unemployment. Is this how you would approach the problem and do you assess it the same way? It would seem to be that from your testimony you see a much closer correlation between stopping inflation and resulting unemployment.

Mr. SUITS. I believe, Senator, that if we are to operate on the level of merely slowing the economy down by global controls whether by monetary policy, tighter money, or by tax policy, but on some overall level, then, as one businessman put it to me, you can't slow it down without slowing it down, and this means not only slower prices but it also means slower employment.

In my view, if we take a gradual approach to slowing the economy down, it will gradually slow down. We will gradually get less inflation, and we will gradually get more unemployment. This is a serious, and can be a tragic situation for us particularly at the present time, and I think it would behoove us to think very carefully about applying direct countermeasures to meet the problem of the people who are going to be affected sooner or later.

Now you mentioned the minimum wage. One step we might take—I am not necessarily advocating this as a policy measure but merely while we are discussing these questions, to suggest something that might be done—we could retain or even perhaps increase the minimum wage, and then counterbalance this effect by some kind of payment, recoupment, tax recovery or other device to firms in exchange for hiring and training these people.

Senator PERCY. In other words, give them a subsidy.

Mr. SUITS. Indeed.

Senator PERCY. And the subsidy would represent the difference between the actual productivity of the person and the minimum wage.

Mr. SUITS. Indeed.

Senator PERCY. And maybe the subsidy would be scaled down over a period of months as the worker's productivity increases?

Mr. SUITS. Indeed, exactly.

Senator PERCY. I couldn't agree with you more. It just so happens I put in a bill last year to do just that.

Dr. Williams, do you feel a steadier growth in the money supply over the past several years would have been a major contribution to economic stabilization?

Mr. WILLIAMS. Well, I think, with hindsight one might—if he had it to do over—not increase the money supply as fast as it was, perhaps at two stages, in 1967 and again in the summer and fall of 1968, when the fear of fiscal overkill was widely held, especially at the Fed, where recently they changed their minds completely.

But really, I would rather not focus on the money supply. I think that credit availability and interest rates are the important factors and I certainly would not advocate any rule for regularly increasing the money supply at a given percentage rate.

Senator PERCY. Would you care to comment however, on what the growth of money supply in 1969 should be taking into account your own forecasts?

Mr. WILLIAMS. I have not made any calculations on the increase of money supply. I just don't know what it would be.

Senator PERCY. You wouldn't want to comment on what you feel would be best for this year?

Mr. WILLIAMS. I think what would be best for this year would be the fiscal and monetary policies that I have outlined. Continuing the surtax so that a more flexible monetary policy could be continued, so that interest rates would not be any higher than they are now hopefully, and hopefully a little less. I think this is of particular importance in the housing industry. Again just what that means as to the level of money supply, I don't know.

Senator PERCY. Dr. Klein, I am sorry that I do not recall whether you forecast a surplus or a deficit in the budget with the figures that you are using.

Mr. KLEIN. On the national income accounts definition.

Senator PERCY. A deficit?

Mr. KLEIN. Yes.

Senator PERCY. Could I ask this question and then you can comment any way you want?

Mr. KLEIN. Yes.

Senator PERCY. How important do you think it would be psychologically, for us to have a small surplus as against a small deficit or a large deficit, of course, in combating the problem of inflation? In other words, based on your predictions would you say to the Director of the Budget "Do something to reduce the budget." Is that correct? How important would it be that we take action and cut some expenses or bring some new revenue in to give us the surplus that we are hopefully looking forward to?

Mr. KLEIN. Well, first, on just the passive prediction aspect, my calculation is for the national income accounts definition of the deficit or surplus. After midyear the figures that are to be in the national income accounts, that are seasonally adjusted at annual rates, will show a swing over to a deficit from the surplus that will come in the first 6 months and, as I stated in my opening remarks, the reasons for this are a somewhat slower income base and growth rate in my projections generating less revenue, the higher benefits that would have to be paid out of transfers in a slower economy, and the higher interest payments that will have to be made under the high interest rates.

Now, I think I would agree that you can never do harm by showing surplus in terms of combating inflationary psychology.

I think this would have a good effect. Here I think that we have a curious problem that we economists always face of having a trade-off. The question is whether you want t ohave good news from a surplus or whether you want to have the consequences on the economy that a surplus would entail.

In order to achieve the surplus with the current set of policies that we are considering this morning, we would have to change the structure of the economy considerably. We would have to have much higher revenues or if we had such low expenditures that we got to that level we would give up many more government services than most people are wanting to give up and we would slow down the economy through lower expenditure.

It seems to me that it is much better to take the surplus or deficit as it comes out and achieve—use it as a tool for achieving our objectives which are not to have a particular number on the budget account but to have a particular employment situation or to have a particular price level movement.

Senator PERCY. Thank you very much, Mr. Chairman.

Chairman PATMAN. Senator Sparkman?

Senator SPARKMAN. Thank you, Mr. Chairman.

I want to say that I think that has been a very fine discussion this morning. We are indebted to you gentlemen, all of you, for making this presentation.

There are several things that I want to ask you about, but not at any great length. By the way, I notice in the GNP something rather interesting, the highest prediction is $923 billion, the lowest prediction is $914.9 billion. If you average up the four of them it gives $918.7 billion. Who is going to be nearest right? I don't ask for any answer.

Now let me say something about the interest rates. I gather from you gentlemen that you rather expect interest rates to remain about the same as they are now throughout 1969.

Mr. SUITS. I think, Senator Sparkman, this depends on what the Federal Reserve Board does, and all we can do is look at the currents that are in the wind now. This is the posture which the Federal Reserve has taken, and I think that explains our belief that there will be a continued tight money policy.

Senator SPARKMAN. I have some rather interesting figures here on the mortgage debt. I would like to read them off for the last 5 years: 1963–64 it was $25.8 billion; 1964–65, $25.7 billion; 1965–66, $21.2 billion; 1966–67, $22.8 billion; and 1967–68, $26.8 billion.

It has been estimated that the rise in mortgage interest rates accounted for 10 percent of the increase in the mortgage debt.

Now, if the interest rate, if we assume that the present interest rate, continues and doesn't rise further that within itself will be somewhat of a brake no inflation, will it not, so far as the mortgage market is concerned?

Mr. SUITS. Yes, sir.

Senator SPARKMAN. In other words, it would be the increase that would have the inflationary pressure.

Mr. SUITS. That is right.

Senator SPARKMAN. I notice, Mr. Perry, that you estimate an increase in housing starts, an increase of a hundred thousand. Mr. Williams has the same projection. Mr. Klein, I believe yours is given in money rather than in units. I don't find where you mention the units.

Mr. KLEIN. It is on the calculation I handed out. It is somewhat higher in the fourth quarter.

Senator SPARKMAN. Somewhat higher than a hundred thousand?

Mr. KLEIN. It is $31 billion in the nonfarm sector. In the fourth quarter of 1968 and our average for the four quarters of 1969 are very close to $32 billion.

Senator SPARKMAN. What I am trying to get is a measurement as to these new starts. Would that be approximately the same?

Mr. KLEIN. About one and a half.

Senator SPARKMAN. Oh, yes, one and a half million.

Mr. KLEIN. Yes.

Senator SPARKMAN. It would be the same then in 1968—1968 had a million and a half didn't it?

Mr. KLEIN. Yes.

Senator SPARKMAN. Now, Mr. Suits, I don't believe I saw in your paper any estimate. Do you make an estimate?

Mr. SUITS. No, I only gave the money figure but this implies about the same rate of starts with somewhat higher prices.

Senator SPARKMAN. The same as 1968?

Mr. SUITS. Yes.

Senator SPARKMAN. So among the four of you, you say it would not be lower than the 1968, it might go as much as a hundred thousand above.

Mr. SUITS. Right, sir.

Senator SPARKMAN. I notice that recently, contrary to the thinking of most people, the number of starts has gone up, and I noticed in yesterday's Washington papers a rather interesting article about the sales of housing around here that sales are booming. Of course that may be explained by something the chairman has said, I believe it was the chairman, trying to buy before the rates go higher, before the costs go higher.

I just wonder if that might be taken as an indication of a greater interest in housing during 1969 than perhaps you have contemplated.

Mr. SUITS. Well, certainly if the January figure, which—I don't recall the starts figure but I remember it is very, very high——

Senator SPARKMAN. I don't remember them either.

Mr. SUITS. But it was very, very high.

Senator SPARKMAN. Yes.

Mr. SUITS. And certainly if this development continues our estimates on housing is far too low, if that unquestionably is so. The only question is whether it is a temporary phenomenon, as I am inclined to believe at the present time, or whether this is an indication of some further developments, later on.

Mr. PERRY. May I say one thing on that.

Senator SPARKMAN. Yes.

Mr. PERRY. I think we all probably feel the underlying demand for housing as shown by family formation and vacancy rates is very strong and probably consistent with the numbers we see this winter in housing starts. I suspect all of us who feel we are going to get a lower number do so entirely because of the restricted supply of mortgage funds that we foresee.

Senator SPARKMAN. Of course, the rather moderate weather we have had this winter has helped certainly in this area, has helped the housing program, at least it hasn't slowed it down as has been the case in the past.

We have housing goals for this year. Have you given any thought as to those goals, as to your idea as to whether or not we had the resources available in order to attain those goals. For instance, we have 300,000, I believe, is the number of—233,000, and we have a program of attaining a total of 26 million units over the next 10 years of all residential property.

Have you given thought to the question as to whether or not we have the resources to attain those goals?

Mr. WILLIAMS. I think I would like to comment on that in another connection, too.

Senator SPARKMAN. Please do.

Mr. WILLIAMS. I think we don't have the resources, and I think we would have trouble producing more than the 1.6 million houses I am talking about for 1969.

Senator SPARKMAN. You are measuring it by what, manpower?

Mr. WILLIAMS. Yes. I think skilled manpower is tight in housing, and I think that it is important to open up the construction trades to new entrants. I think it is very important to make these employment opportunities available to minority groups. This will help solve their unemployment problem and also will provide the human resources to construct these large numbers of housing units that you are talking about.

Senator SPARKMAN. I heard Secretary of Housing Romney on one of the national programs yesterday, in which he said that the thing we needed was organizing, organizing our resources in order that we could meet the goals that have been set. In the past he has made some rather pessimistic statements about not being able to reach those goals.

It seemed there was some modification in what he had to say yesterday, to the effect that we needed to—we had to organize quite efficiently in order to meet these goals.

Would you think that could be done with reference, for instance, to the manpower problem?

Mr. WILLIAMS. Referring to the manpower situation in housing, if you look at the data in my table 1, line 3, showing the number of private housing starts going back to 1964, you see that this is a very volatile industry. In 1966 housing starts declined to 1.16 million, and to some degree the supply of skilled labor——

Senator PROXMIRE. What line is that?

Mr. WILLIAMS. Line 3, table 1.

Senator SPARKMAN. Line 3, "private housing starts"?

Mr. WILLIAMS. Yes.

Senator SPARKMAN. Yes.

Mr. WILLIAMS. This is a very volatile series, and the supply of skilled labor, I think, has not increased very much. Construction workers tended to drift away into other pursuits, so that we do not have the resources of skilled labor to produce many more than the 1.5 to 1.6 million units that we are talking about, and to increase that number by another million would require development of many more skilled workers.

Senator SPARKMAN. My time is up but I just want to throw out this thought that maybe we can't do it, but we are going to have to do it if we are to provide homes for the new family formations and replace those that are destroyed, torn down, worn out in this country. So we have a job on our hands.

Mr. WILLIAMS. Yes.

Senator SPARKMAN. Thank you, Mr. Chairman.

Chairman PATMAN. On what Mr. Romney said, of course, organization is all right but don't you think allocation of credit is more important?

Senator SPARKMAN. I think we have a lot of things to do but my thought is we set the goal and we ought to aim for the attainment of it.

Chairman PATMAN. 26 million in 10 years.

Senator SPARKMAN. Yes, and whatever was set for this year.

Chairman PATMAN. All right.

Mr. Conable?

Representative CONABLE. Thank you, Mr. Chairman.

Gentlemen, I think it is generally conceded that the capital investment is going to be possibly as much as double this year what it was last year; isn't that right? Something like 4.7 percent last year, and close to 8 percent this year.

Mr. SUITS. Those were the early figures. In making my projection I have tempered that somewhat.

Representative CONABLE. It still is going to be substantially higher.

Mr. SUITS. Oh, yes.

Representative CONABLE. Is this largely the result of a banana-republic psychology? Really, this is not an auspicious time to increase our productive capacity, is it, generally?

Mr. SUITS. Oh, yes; I think it is.

Representative CONABLE. It is?

Mr. SUITS. This is one of the internally self-generating components of high prosperity, that when we get utilization rates on existing equipment very tight we simultaneously generate the need for additional facilities and, at the same time, provide a flow of funds in retained earnings.

Representative CONABLE. But doesn't a certain amount of this reflect the assumption that it is going to cost more to have capital expansion later?

Mr. SUITS. I am sure that some of it does, but how much I am not sure. One can point to the fact that when you have low rate of unemployment such as we have now, additional calls on industry for output have to be made through higher labor productivity, and this means capital investments. So while it would doubtless pay a firm to do it now rather than sometime later, I don't think that is the primary consideration.

Representative CONABLE. Have you considered at all whether anything should be done with the 7-percent increase in investment tax credit?

Mr. SUITS. No.

Representative CONABLE. Certainly the capital goods area is one of the so-called superheated areas in the economy generally. You don't consider this abnormally high and, therefore, you wouldn't consider any remedial action on the part of the Government in this respect?

Mr. SUITS. Not specifically, at this moment.

Representative CONABLE. I think you have something to add?

Mr. PERRY. I do have a somewhat different opinion. It seems to me that as you look at where we might restrict demands, the capital goods area is a good candidate for taking some of the burden this year. I don't know whether removing the investment tax credit is a feasible proposal at this time. But this is the kind of year, in my opinion, where restricting a surge in investment demands would make good economic sense.

Mr. KLEIN. May I say something?

Representative CONABLE. Yes, sir.

Mr. KLEIN. I think the investment tax credit definitely supports the high level of capital formation that we are having, but I have detected among business executives of this country a dissatisfaction with the idea of using something like that as a shortrun policy instrument.

Representative CONABLE. It certainly affects their plans rather adversely to have it frequently changed.

Mr. KLEIN. Yes.

Representative CONABLE. Businessmen's plans have to be made over a longer period of time.

Mr. KLEIN. That is precisely it.

Representative CONABLE. Too short a period of time was involved in manipulating it over the past few years. I understood there was a great deal of business dissatisfaction.

Mr. KLEIN. It is a longrun capital expansion.

Representative CONABLE. We were considering it a manipulative device in having taken it off and putting it back on immediately, and it is not desirable from a business point of view certainly. You think it is not desirable from an economic point of view also?

Mr. KLEIN. I think it didn't work in late 1966 because it was a shortrun measure designed to deal with a longrun issue, and it was ineffectual. Also it really represented at the time a kind of flip-flop in Government policy, something that was wanted in September was not wanted 3 or 4 months later. It isn't like an open market operation, and it isn't like a changing of current expenditure policy, current fiscal policy of the Government. It is a basic longrun consideration.

Representative CONABLE. Certainly quite apart from the effectiveness of such a device an on-again-off-again use of it does create very serious inequities in the business community.

Mr. PERRY. May I just say one thing. I don't see that you can both argue that it is ineffective in the sense that was just suggested and also that it is highly undesirable because it is so upsetting of plans. Also, if you are going to affect the capital goods area, however you do it will affect plans. If you did it by some very severe credit rationing and it had the same effect on capital goods producers I don't see that it would be more or less objectionable than if you did it via the tax credit.

Representative CONABLE. I realize you have to make a lot of assumptions in answering such a question but does an inflating economy have a greater impact on the reliability of information about interest rates, or capital investment, or inventory levels? In what areas are the variables the greatest here in the course of an inflating economy?

Mr. KLEIN. Well, let me say something about the present state of our national income account. We now carry along a figure in these numbers, which we all rely on so heavily, a statistical discrepancy between the income side and the expenditure side which is now as big as over $5 billion.

When we are dealing with these large numbers, inflated numbers, and making very strong corrections for inventory valuation adjustments and similar kinds of manipulations. We are having difficulty, and this is a very disturbing aspect to see that the range of disparity in our GNP forecasts at this table are about the same order of magnitude as the statistical discrepancy in the account, and it makes a lot of difference.

Of course, it is a question of the residual items in the account, and one of the things like inventory and inventory evaluation, and savings and profits, those numbers are very weak in this kind of situation.

Representative CONABLE. One last question. What do you think has had the greatest impact on housing starts lately, variations in the interest rate or variations in the cost of construction? I think we tend to overemphasize interest rates as a factor here, and to ignore the tremendous increases that have been occurring in the cost of construction services and materials. Isn't it true that these have had a substantial impact on housing starts? Which would be of the greater order of magnitude, in your view?

Mr. KLEIN. I would say that construction costs are a less flexible item in the house-purchase decisions because in the case of interest-rate variations there are other dimensions such as the length of the amortization period and the amount of the down payment; and the thing that many homeowners look at is the average payment they are going to have to make on the mortgage every month, and this is easy to move around in the case of financing by stretching out the amortization period or changing the down payment to compensate for movements in the interest rates.

It is less easy to do this in the case of the overall price of a house.

Therefore, I would attach a good deal more importance to the construction costs.

Representative CONABLE. The same psychological factors apply to car sales, of course.

Mr. KLEIN. Right.

Representative CONABLE. Psychology plays a very large element in the study you gentlemen made, I am sure, and this is one of the great problems. One doesn't know what the psychological climate is going to be regardless of what the long-term trend may be.

Thank you, that is all, Mr. Chairman.

Senator PROXMIRE (now presiding). Mr. Bolling?

Representative BOLLING. Thank you, Mr. Chairman.

I would like to comment very briefly on the colloquy—or not colloquy—between the chairman and the panel on forecasting. My own experience has been rather more satisfactory than apparently the chairman's has.

I have found that in the years that I have been on this committee that the forecasting by certain groups has become really very excellent. My own experience is that the independent economists, be they academic or members of the staff of the Joint Economic Committee, or other independent economists, tend to be a great deal more accurate than those who represent a particular interest. For some reason unknown to me the interest economists seem to project policy and the independent economists seem to project predictions based on economic facts, and I have had a very satisfactory experience in the last 18 years on forecasting. I think it has improved substantially and I think the performance of the economy of the last 8 or 9 years has indicated that the improvement is very substantial.

One thing that interests me about the study which I only had an opportunity to examine very quickly, is I can't find out what publications they researched. I should think that would be very pertinent.

I have a couple of questions.

All of you gentlemen have assumed that the surtax will be extended. What would you suggest would happen to interest rates if it weren't?

Mr. WILLIAMS. I think I addressed myself to that in some degree saying they would be higher.

Representative BOLLING. Would there be any disagreement with that?

Mr. KLEIN. I would say that would be true. We are trying to outguess what the Federal Reserve is trying to do, and we probably do agree that the Federal Reserve would have to be more restrictive on monetary policy if there was a weakening on the fiscal front.

Representative BOLLING. Right. So that, in other words, you would have a very substantial impact on interest and with so substantial an impact on interest at least in theory you could have the same kind of thing happen this year, despite the surprising experience with housing, that happened in 1966 on housing. You could have a crunch.

Mr. WILLIAMS. That is right.

Representative BOLLING. If you didn't have an extension of the surtax.

Mr. SUITS. There is one qualification that Professor Klein mentioned earlier, however, and that is the shift in the institutional arrangement. To the extent that that is different, the credit crunch has different implications.

Representative BOLLING. Right, right.

Now this is a question that I don't really expect anybody to give a definitive answer to, and I have a prejudice which I will make clear in the question. Who is hurt most by inflation? Is it not the old, the blacks, the poor, that being a redundant phrase, that last one, at least in part. Who is hurt most by inflation?

Mr. SUITS. Well, surely the old who are substantially supported by social security, which does not respond very rapidly. For the blacks and the poor one has to make a very careful study because, on the one hand, aid to dependent children allowances do not respond very rapidly and such children are, of course, punished badly by rising prices. On the other hand, as was pointed out earlier, employment rises most rapidly in precisely this same area, so it is very difficult to determine who is being hurt or how much. On the one hand we provide the breadwinner with a job. On the other hand we take purchasing power away from the family without a breadwinner.

Representative BOLLING. The point I was getting at was that it would seem to me there is a fair probability that the "least able to defend themselves" segments of the society face a year in which they can't win. If we have a significant increase in unemployment in order to stop inflation they are going to be hurt, and if we don't stop inflation they are going to be hurt. So they have got a no-win year except for the addition that I think you in your statement brought in and that is the direct aid to them in specialized kind of employment, if that is the way to put it. In other words, it is very clear there has to be some method to reach them beyond the classic methods we have been mostly talking about today or they are going to suffer or continue to suffer which, in turn has implications for the society as a whole that are too obvious to go into.

Mr. SUITS. That is correct.

Representative BOLLING. Now, isn't it possible, given the peculiarity—and I think it is a peculiarity—of the society today, that you have this, the easy way is to talk about affluence, you have this fabulous affluence with tremendous poverty, which we as a society are just beginning to realize the extent, the depth, and the degradation of. It is sort of interesting to find people catching on to the fact people are starving in the South. They have been doing it ever since I grew up there in the 1930's, as well as in other parts of the country, too.

But isn't it possible in this particular year, given the conditions of great affluence with pockets of poverty, wouldn't it be possible for demands to remain so high, despite a significant increase of, say, a half or a whole percent in unemployment, that inflation would continue at about the present rate, despite the substantial——

Mr. SUITS. I certainly think it will, at least through this year. I think this is reflected in all the forecasts that have been presented this morning.

Representative BOLLING. I thought it was, too, and I want to make it explicit because what we may be facing is getting inflation under control sometime next year, if we are lucky, and in the meantime everything that is going in the economy, regardless of which way you mix the policy is going to be, I don't want to use an inflammatory word, but more and more irritating to the social unrest that exists.

Mr. SUITS. I think that is correct.

Representative BOLLING. Thank you.

Senator PROXMIRE. Senator Miller?

Senator MILLER. Thank you, Mr. Chairman.

Gentlemen, the Employment Act of 1946, as you well know, set forth two basic goals—namely, full employment and a stable dollar—and repeatedly administrations have clung to those two objectives down through the years.

The act was overwhelmingly passed. I wasn't here at the time, but I am advised it was completely a bipartisan measure. Now I find according to the statements of Dr. Suits and Mr. Perry that they apparently don't think we can achieve those goals, and I am wondering why. And if you think we can't then why don't you recommend that we revise the Employment Act of 1946?

Mr. SUITS. I think we can. I think the problem is that we cannot easily. It is not an eay job.

Senator MILLER. I am aware of that.

Mr. SUITS. In those days——

Senator MILLER. Here is your statement wherein you say, "Rapid price inflation and low unemployment are ultimately tied together in our economy."

Mr. SUITS. Yes, and if I may just amend that statement, as it occurred to me when I was reading it, this should read in terms of using global controlled policy. In other words, we have to have a wider spectrum of things that we can do. If all we do is speed the economy up to make more jobs, or slow it down to hold prices in check, then we are always going to play this business of seesaw. One man is up and another man is down and that is the only game we are really playing.

We can indeed maintain both high employment and stable prices, but we cannot do it with global controls.

We must get very specific, as, for example, the question of subsidizing employment or training programs and so on.

Senator MILLER. I am glad to hear your explanation because you cover yourself by saying "*if* we do this"—and that is a very big "if." To me it would be a false assumption to assume that what is contained in the "if" is going to be there. Certainly it shouldn't be there.

I assume you want those objectives, and if you are not going to attain those objectives because of the "if," then you don't want the "if." I am glad that you state that you do think those objectives are attainable. If they are not attainable, then that would be a confession of defeat for the capitalistic economic system. Agreed?

Mr. SUITS. Agreed.

Senator MILLER. I would like to ask Dr. Klein why he takes such a dim view of my farmers' situation for 1969 when he says "farm prices and income will decline slightly in 1969." What is that assumption based on?

Mr. KLEIN. I will read you the numbers and you can—net farm income was $15.5 billion in the fourth quarter of 1968 at an annual rate. We have it hovering just under $15 billion during 1969 for the different quarters and farm prices on an index base of 100, well, 105, will go down to 104, 103.

Carryover stocks are in reasonably plentiful supply, livestock production is expanding, and the members of our forecasting group from the farm equipment sectors of the economy who conduct a very close watch over the farm economy have suggested that just a passive forecast of what they see happening, without doing anything about it, is that farm prices are going to ease somewhat over the next few months, and farm incomes will consequently be slightly lower.

Senator MILLER. Well now, as an offset against the easing of prices couldn't we have an easing of costs of production because of a slowing down in the rate of inflation?

Mr. KLEIN. Well, we could potentially but I think we are pretty well agreed that the things the farmers buy, the farm costs, are not coming down particularly because costs in the whole economy are not coming down very much.

Now, I think at this table we are talking about a national economy with something like a 4½-percent rate of inflation now, and some of us see it coming down to 3½ percent. Some of us seeing it coming down to 4 percent in the near term.

Hardly anyone here is going to predict stable prices or even a 2-percent rate of inflation.

Senator MILLER. I agree that Dr. McCracken stated as a goal of his Council having it come down to 3 percent for this calendar year.

Mr. KLEIN. I should say it is very optimistic.

Senator MILLER. Now if it did come down from 4½ this last year to 3 percent this year, in other words, if it dropped down 1½ percent, would that make enough difference in the costs of production to farmers so that you might change your assumptions?

Mr. KLEIN. That would be helpful to farm costs but I am very doubtful that that would be the crux of the matter for maintaining farm income.

Mr. SUITS. I think I would go so far as to say that the only feasible way that that result could be attained would be precisely by lower farm prices. That is where the flexibility in the price system lies in the very short term.

There is not much that can be done about manufacturing prices.

Senator MILLER. You mean the only way of cutting this down to 3 percent would be a reduction in farm prices?

Mr. SUITS. That is correct.

Senator MILLER. I am wondering if there was a reduction in farm prices, on the one hand, if that wouldn't be counterbalanced, on the other hand, by a reduction in costs of production, which would enable us to forecast at least a stable farm income in 1969 relative to 1968 rather than forecasting a drop.

Mr. SUITS. I think that the production costs in terms of fertilizer, equipment, and other prices of materials that farmers have to buy are not likely to come down; that is, there are undigested costs still pushing on the prices of those products.

Senator MILLER. Well, suppose you have an easing of interest rates. Farmers out here are borrowing for their cattle loans and paying 7 to 7½ percent. Suppose they end up paying 6. It would make a lot of difference in a livestock operator's income. So I wonder why you don't think that this would ease costs of production?

Mr. SUITS. Well to that extent, of course, it would. But if we look at the price side rather than the interest side, interest rates, of course, can be varied; but again, there is the question whether, given the posture of Federal Reserve, they will in fact be brought down.

Senator MILLER. Well, if we did have a reduction in the rate of inflation from 4½ to 4, don't you think there would be a correlative easing in interest rates?

Mr. SUITS. No, because I think that tight money is part of the force that is going to hold the expansion in place. We can't have it both ways.

Senator MILLER. Well, it seems to me that it is a correlative of inflation that you have high-interest rates. That just makes sense. If I borrow some money from you for a couple of years, and you forecast that the dollar is going to be less when I pay you back 2 years from now automatically you are going to charge me an intrest to make up for the difference regardless of the tightness of the market, and the tightness of the market is an added factor to that.

Mr. KLEIN. I think the timing is to be considered here, because we are talking about a year's income and even if interest rates are going to come down they are not going to come down for a few months. They are not going to come down very much if they do come down. They are not going to come down until well after midyear, and it is going to be very difficult for farm income in 1969 to benefit from these low-interest costs in our economy.

Senator MILLER. I have no further questions. I apologize for not being here for your statement.

Thank you, Mr. Chairman.

Senator PROXMIRE (presiding). Thank you, Senator Miller.

Gentlemen, I get the impression from you, and I am sure that individually you don't feel this way and I would like you to have a chance on the record to correct it, that we are kind of helpless in a sense; that is, that we can expect during the next year for unemployment to increase, No. 1. We can expect during the next year for the rise in the cost of living to go on at an unacceptable rate. We can expect also to have high-interest rates maybe not quite as high as at present but high, but maybe just as high as they are now, and I get it from you that, as Mr. Suits put it, there is nothing we can do about it in terms of global action.

Now, having said that, however, we look around the world, and we see Germany, quite a different economy, of course, but with better price performance in the last couple of years, far lower unemployment than we have, and there are a few other small countries that perhaps have—Sweden—that perhaps have a similar performance.

What is it that we can do to help solve this problem? Mr. Suits, you were the one who indicated that you can't do it globally. How can we do it?

Mr. SUITS. Well, first of all, when we look at the German case, there are some very special factors, as you know. They export part of their unemployment so their rate really isn't quite comparable to ours, but many of the other countries are——

Senator PROXMIRE. You might put it the other way, too, they are importing workers.

Mr. SUITS. That is right. So when they no longer have the total demand, they export them and their unemployment never shows up in the records. That is a very special problem with respect to Germany, but it wouldn't be the same thing, let's say, for the Netherlands or for Sweden.

What they have their is a much more homogeneous, much more highly trained, much more mobile labor force than we have.

Senator PROXMIRE. We have to make our labor force better trained, we have to make them more mobile, we have to break down the terrible racial barriers we have had, we are making progress in those directions, but I take it as we do this we can begin to have greater price stability with a lower level of unemployment; is that right?

Mr. SUITS. Exactly, exactly.

Senator PROXMIRE. Now, how about the wage guidelines, they have been battered and beaten and kicked out by this administration. They don't seem to feel they want it yet. We have a statement by Arthur Okun, just a couple of days ago, saying if the administration is going to dismiss the guidelines, that they had better find some way of bringing some consideration in the private area, in unions and in management, of the policy effects of their price decision. Do you share Mr. Okun's position? Is there another way, are guidelines this ineffective under present circumstances?

Mr. SUITS. I see no real mechanism for making wage-price guidelines effective other than some form of legal price-wage control.

Senator PROXMIRE. Well now, how about the administration's proposals before they went out of office that you compromise them? In other words, you provide for a guideline of around 5 percent which would be somewhat more than the expected increase in the cost of living, and take into account some of the productivity increase. I should say all the productivity increase and some of the increase in the cost of living. In addition to that they would ask the management, in the administered price areas, to absorb the first 1-percent increase in costs. Is this a practical formula?

Mr. SUITS. I question its practicality merely on the grounds that, in our economy, we have found ourselves unsuccessful in depending on good will for economic motivation. Good guys always lose. If I decide, in the interests of preserving the price level, to apply my own wage-price guideposts and not to ask for higher wages next year, or not to get higher prices for my services, this doesn't guarantee that everybody else will go along.

Senator PROXMIRE. Well maybe.

Mr. Perry, you, as I understand it, made some study of this, and you found, as I recall, that the wage-price guidelines perhaps reduced inflation by eight-tenths of a percent, which is a very significant contribution if we can verify it, and I have the feeling that the good guys, at least those who abide by it, were big steel companies, big automobile companies, big steel unions, and big automobile unions, and none of them were exactly hurt. They aren't certainly at the bottom in any case of the economic spectrum. How about it?

Mr. PERRY. That is correct, as you described it. But I think someone would point out, if he wanted to argue the other side, that the real spendable income of workers in these areas hasn't gone anywhere for a few years now. I don't know where you come out. I believe guidelines were working; a lot of my colleagues aren't quite so sure.

Senator PROXMIRE. Are they beyond revival? Would you say that the Johnson administration's proposals in this area cannot be practically enforced or go into effect?

Mr. PERRY. I see no reason why, if the administration wanted to get into this business, they couldn't go back to approximately the same kind of applications as were being made in 1965. They would have to use different numbers.

Senator PROXMIRE. You think it might have some effect, at least, a significant effect, in keeping down the rise in prices and perhaps move the Phillips curve over a little bit so the trade-off between inflation and unemployment wouldn't be quite so bad?

Mr. PERRY. I think it would have such an effect. There are people who would point out that it would have effects they don't like and you have to weigh the two. But it could have an effect, yes, sir.

Senator PROXMIRE. How about the policies that have been followed ever since Franklin Roosevelt—and I guess, more or less by Presidents of the United States—of speaking out publicly and emphatically when a big industry with pricing power, price leadership power, increases its prices, or a union has demands which seem unreasonable? Is this a useful action? Should the new President follow this policy, in your view?

Mr. PERRY. Yes. I certainly think it is useful and something that a President is right in doing. It becomes hard to know when you have a clear case when you have quite a generalized inflation as we do today, as compared to taking that sort of position when you don't have generalized inflation.

Senator PROXMIRE. Well, of course, President Nixon hasn't, to my knowledge, indicated that he is rejecting that but certainly administration spokesmen before this committee have made it pretty emphatic they don't think it very wise. For example, Mr. Shultz, the Secretary of Labor, said he would counsel the President in effect not to do it. He feels that the President's prestige shouldn't be put on this line that way. You disagree with that?

Mr. PERRY. Yes, I see no reason why the President shouldn't do that if he has a good case.

Senator PROXMIRE. How about you other gentlemen, would you agree with Perry or with Shultz?

Mr. KLEIN. I think while we can agree on a lot of things, like academic economists we have our disagreements, and we probably get different votes. I am dead set against the guidelines and I think I would agree with Professor Suits that they——

Senator PROXMIRE. I didn't say "Suits," I said "Shultz."

Mr. KLEIN. Well, they are both against.

Senator PROXMIRE. Yes.

Mr. KLEIN. And they are for a theoretical economy and not for the real facts of life.

I think I would agree with Professor Perry's calculations for 1961, 1962, and 1963, but I think you can attribute much of the present inflationary pressure to a great effort on the part of companies to make up for all the ground they lose in that period. There was restraint, and now they have boiled over. I would say overall, to take a long view, that it didn't do any good.

Senator PROXMIRE. Mr. Williams, what would be your position?

Mr. WILLIAMS. I think I am closer to Dr. Okun in his position.

Senator PROXMIRE. To Okun and Perry?

Mr. WILLIAMS. Yes, Okun and Perry. I think the guidelines approach might be useful again in particular situations: maybe not very useful, but I certainly wouldn't throw them away. I think the administration and the President have great moral power to bring to certain wage and price situations, and use of this power certainly has to be selective; but I think they may return to some such system in the future.

I might say while I am speaking that other things might be done to help with the inflation problem. I mentioned reducing restrictions on entry into certain trades. In addition I think Dr. McCracken mentioned that antitrust policy could be useful and should be enforced vigorously to the end of maintaining more stable prices.

Senator PROXMIRE. Houthakker, McCracken, and Stein, the three members of the Council of Economic Advisers, appeared before our Senate Banking Committee for confirmation. Houthakker said he thought antitrust policy would help in the long run, but he was talking about 10 years, he felt the antitrust action instituted this year, you have to win a court case or two or three to set a pattern and that takes a long time in their view.

Mr. WILLIAMS. In any case I think it is important to the long run.

Senator PROXMIRE. And it may well be in its psychological effect. If business knows that there is a stern, meaningful antitrust policy they are more likely perhaps to make their decisions within the public interest in stabilizing prices.

Mr. WILLIAMS. Right.

That is absolutely correct.

Finally, I would say that tariff policy gives us some opportunity to get more competition into industries which are in a position to control their prices. I would consider lowering tariff rates where this would have a beneficial effect, and I would certainly look very closely at demands for import quotas in industries where they might have an unfavorable effect on domestic prices.

Senator PROXMIRE. Along this same line, Dr. Perry, as I understand it, you advance the thesis that profits are one of the variables in prices, in the price-unemployment setoff, I should say. In other words, if I understand it correctly, we can have lower unemployment and a lower rate of inflation if profits aren't as high. We have had a tremendous increase in profits between 1960 and 1968. One of the most dramatic changes, I suppose, of all of the economic indicators has been the very sharp increase in profits, both corrected for inflation and after taxes and so forth. How about that?

Mr. PERRY. As to the effect of profits on this whole situation, I think that it probably in relevant only in the highly concentrated, highly unionized industries, where very high profits rates can serve as a target for large wage demands. I don't know that, economywide, it has a great deal of relevance.

Today, profit rates are probably at not unexpected levels. But if we measure them from 1961, we are measuring from a recession period when, of course, you expect profits to be low.

Senator PROXMIRE. That is a big part of the explanation, I would agree.

Mr. PERRY. Today, if one looks at rate of return on equity, I think it is probably about where you expect it to be, not extraordinarily high by historical standards for a period of high economic activity. Profits are, of course, highly volatile, and as you move to low unemployment rates, rates of return typically rise and if you have a slowdown profits will suffer disproportionately.

May I just make one last statement on your earlier question? Whether the administration, the President, is prepared to make a public statement, it seems to me, must depend on whether that statement is very well founded. Even today, a year when in manufacturing there were many large settlements, you couldn't single out manufacturing as being ahead of the rest of the parade.

If you have a situation such as a very large wage increase when wages elsewhere are not increasing rapidly, or a price increase warranted by shortages or by a former wage increase, then it is easier to advocate guidepost actions and Executive pressures may be justified.

If you couldn't on the basis of recent facts, single out prominent manufacturing industries and say that they are leading the parade, that they are causing the inflation. And this is what makes guideposts quite a different matter today and this is why the guideposts were abandoned in the first place.

Senator PROXMIRE. You said, Mr. Perry, that the surtax was effective and the best evidence of it is what has happened to retail sales.

Mr. PERRY. Yes.

Senator PROXMIRE. But you know we adopted the surtax for several purposes, No. 1, to hold down the increase in the cost of living, No. 2, to try to do something about the high interest rates and, No. 3, to help us on imports so that our balance of payments would be corrected. We failed dismally in every single one of them. As you know, since the surtax went into effect the rise in the cost of living has been sharper than before; the rise in interest rates has been much sharper than before; and, also, since it went into effect, we have converted a trade surplus into a trade deficit, a big trade deficit in the last quarter. How long do we have to wait on this? After all, part of economic policy is the timing effect.

It would seem to me that you could make a good argument that the surtax to date has been a real failure.

Mr. PERRY. Well, Senator, I guess I don't have to tell you that we don't forecast perfectly. You have to make a statement about whether these things that you have listed would be worse if we hadn't had the surtax, and the only statement I can make is that they would have been worse.

Senator PROXMIRE. Yes.

Let me reply to that again to get back to the argument that—you fellows zeroed in on the tax angle rather than the spending angle. In my view, we would be a lot better off if we cut $10 to $12 to $15 billion out of the budget, especially out of the military budget, but also out of space and public works. Public works are now over $10 billion, 10 times as high as they were in the depression when we had to have them for a work force 20 percent or so out of work. Of course, the value of the dollar has dropped a lot but not that much.

Under the circumstances, it seems to me we should take a good healthy look at spending policy and we can make a strong case for doing some of these things much more effectively especially in controlling inflation and also interest rates by a policy of reducing spending instead of reliance on higher taxes.

Mr. SUITS. Senator, in our calculations, dollar for dollar, a tax dollar in terms of ability to hold the economy in check is only worth about 75 cents compared to an expenditure dollar. That is to say, the checking power of a dollar increase on my taxes is only three-fourths of the checking power of a dollar decrease in military.

Senator PROXMIRE. That is a fascinating statistic. I have not heard that before. Can you also say something about the timing of this? In other words, if you reduce spending, Federal spending, does that have a quicker or a slower effect on the economy than an increase in taxes would have in most cases?

Mr. SUITS. I doubt that there is very much material difference.

Senator PROXMIRE. Why wouldn't there be a lag since people tend to adjust their spending patterns over time?

Mr. SUITS. That might be very true, I hadn't thought about it, yes.

Senator PROXMIRE. Certainly you have the experience lately. It took them a while to reduce their spending proportionately to the tax increase.

Mr. SUITS. Yes, that is very true.

Senator PROXMIRE. So in both cases in the first place you would have a bigger impact and, in the second place, you might have a swifter effect.

Mr. SUITS. Yes, true.

Let me add this is, of course, a policy question on an entirely different level. I would be very happy to see $10 or $15 billion come out of our military budget purely as a policy measure even if we transferred that expenditure to some other programs that I consider to be much more essential.

Senator PROXMIRE. I think this is a very real prospect. After all you have the majority leader of the U.S. Senate, Mike Mansfield saying we should cut the budget, and cut it very sharply. We cut it before; we cut it last year by several billion dollars. I think this year there is far more sentiment in favor of that and certainly we can make a very strong case in terms of waste.

The Congressional Quarterly, as you may know, had a very interesting study in which they indicated they thought we could cut it by $10.8 billion and have a stronger combat force after than before because of the fact that we have a guest excess of service and support troops, and then in cutting expenditures in space, but in terms of its economic impact you feel it would be at least as good and perhaps better.

Mr. SUITS. I think a $10 billion cut in military spending would have a definite and immediate impact on the economy, so much so that I would certainly recommend that a cut in military spending not be taken out of the Federal budget, but be transferred to a number of other programs that desperately need funding.

Senator PROXMIRE. Well, I certainly would disagree with that at the present time. I think it is very hard to transfer any of that kind of money efficiently to some of our other programs. Maybe you can, but I wonder. For example, in the housing area Senator Sparkman and I talked about—he is chairman of the housing subcommittee and I am ranking member—here is an area in which we can have a great deal more activity than we have but I doubt if it would take billions of Federal expenditures to achieve this. It would some in the private sector, and that is why I was so startled that you gentlemen are so pessimistic about housing; you are being realistic, of course, and I am not criticizing your judgment of what is going to happen. I just say it is appalling we can't do better. In 1950 we spent 5.3 percent of our GNP in housing; this year the goals provide if we meet the goals we put 3.4 percent of our resources for housing, about 60 percent as much. Obviously, we can do better. It may very well take some kind of a crash program in training people, it may take a better effort in terms of financing.

We have a housing act now that provides for a subsidy to 1 percent of effective interest rate for low- and medium-income housing. I can't see why we can't do a better job.

I would like to ask Mr. Perry one other question, and I have a couple of other questions for you other gentlemen. Doesn't the transfer of income to ameliorate unemployment result in more inflation? This is one Senator Sparkman is interested in, too. In other words, you indicate that transfer payments of some kind, maybe a guaranteed income or something of that kind would help to ease the burden of unemployment for these people.

What I am saying is if they have an income without producing anything you increase demand because they have more to spend, you don't increase supply because they don't produce anything.

Mr PERRY. The reason I introduced the thought was that we talk about the need to decide between unemployment and inflation and how much we are going to have. There is the other side of the picture which ought to be considered—whether you can do something about the amount of hurt that is involved in whatever policy choice you make. If you make a policy choice for a lot of inflation you can certainly do something to compensate some of the people affected there. If you make a policy choice for more unemployment it seems to me you ought to concern yourself in that direction: whether you worsen the inflation in the process would depend on whether you reduce someone else's income in the process.

If you were to make these transfers, they should be legitimate transfers, transfers from others to those who are becoming unemployed. If you increase total income—that is, make it an addition rather than just a shifting around—then your point is very well taken. You will generate more demand. So I think you do have to think of it as a real transfer, you have to consider simply whether the people you are going to unemploy are going to bear all of that burden whether you are going to shift some of it around.

Senator PROXMIRE. So you would have a trade-off? It would be a washout as far as the effect on the economy is concerned; you said you would have to increase taxes in order to compensate for it?

Mr. PERRY. Increase taxes or spend less money in some other area. If you wanted to increase transfer programs to these people, and say $2 billion are involved, if you take $2 billion out of some other area you accomplish this. I am not suggesting that this is the best way to do it. But if you are faced with a policy that is gradually going to increase unemployment, one should at least consider taking such steps.

Now, I think there are better steps. The Government, as an employer of last resort, in whatever fashion such a scheme were implemented, would be far more desirable. I am not suggesting that you do away with the wrongs of unemployment simply by some transfer device. Only that it is a minimum you should do if you plan to pursue this kind of policy. But I would prefer a policy which was much more active, which in fact found employment, found training programs, found something constructive to do. These transfers are not constructive in this sense. They are just a way of easing the pain.

Senator PROXMIRE. Now, Mr. Suits, I would like to ask you to tell me what effect this would have on housing and the economy? As you know we have regulation Q, which limits the amount that savings banks can pay so we don't have the disintermediation that we had in 1966, and I am for it. I think we have to have it although any kind of control like that is not desirable.

Now, a different kind of credit control for the same purpose would be to recognize the enormous amount that we are pouring into this credit economy of ours into consumer credit. It has expanded from $5 billion in 1946 to $110 billion today, 22 times in 22 years, just phenomenal, and it is a big element in our spending and in the movement of our economy.

Supposing we had another regulation W, which would have an effect of limiting or rather requiring a certain size down payment, say for an automobile one-third, one-fourth, or one-fifth, whatever seemed desirable, an amortization period of 18 months or 24 months or something of that kind. Wouldn't this have the effect in the first place of limiting the requirement for borrowed money and tend to slow down the rise in interest rates and make funds more available, perhaps, for housing?

Mr. SUITS. I think it certainly would, Senator.

The consumer stands at the head of the line when they are passing out credit. He is the least sensitive of all the borrowers in the economy. The typical automobile borrower, for example, hasn't the faintest idea really of how much interest he is paying, and the way the interest rate is commonly stated to him, even is not ordinarily of much help, that is if he is paying——

Senator PROXMIRE. My bill on "Truth in Lending," which will begin to take effect on July 1, is going to have some effect on it.

Mr. SUITS. It will indeed. It will an effect on what he sees. It is a question of whether it will have any effect on what he does. As somebody else pointed out earlier, what he usually looks at is the size of the downpayment and how many months to pay, and those are the things that will affect whether he can buy a car or not, or a television set or a new refrigerator or whatever it may be.

So surely if we want to ration credit in such fashion as to leave more of its available for houses or for business purposes, it must be directly diverted from the consumer. It cannot be restricted by merely letting interest rates rise because the consumer is not sensitive to those.

Senator PROXMIRE. Thank you very much.

I just have a couple of questions, I think, for Mr. Williams.

Mr. Williams, in your statement about housing you said nothing in your optimistic estimate—you call it optimistic—of 1,600,000 housing starts; would you give a figure or a money amount?

Mr. WILLIAMS. I gave both. I gave a figure of 1.6 million housing starts, up 100,000 from 1968. The dollar figures for residential construction are shown in table 2, line 7.

Senator PROXMIRE. You don't come down hard at all or didn't seem to give any allowance for the level of interest rates or availability of credit. Did you think this was because it was established policy by the Federal Reserve and we couldn't do much about it?

Mr. WILLIAMS. Well, I said that we believe there will be ample mortgage credit available. You might recall that I had the most optimistic forecast in terms of the number of units of any of the four members of this panel. I think one other has a range of 1.5 to 1.6 in his forecast.

Senator PROXMIRE. Don't you think it makes a big difference in housing that credit will be available at a particular interest price?

Mr. WILLIAMS. Well, I have a feeling that today people are more concerned about the availability than they are the price.

Senator PROXMIRE. That may well be but the market would broaden a lot, wouldn't it, if you could get that cost, that rate down. It is there for low- and moderate-income housing. We have the 1968 housing bill and we can peg the interest rate down but that is a relatively small segment of the 1,600,000 or 2 million.

Mr. WILLIAMS. Other constraints may come into play which would limit it to 1.6 million, perhaps the availability of skilled labor.

Senator PROXMIRE. But doesn't the actual payment by somebody who has to pay 8 percent for his mortgage, the actual monthly payment as compared to one who has to pay 6 or 6½ percent, isn't there a substantial difference when you are buying a $25,000 or $30,000 home?

Mr. WILLIAMS. Yes, it is substantial, but I would say that today the vacancy rate is so low and the basic demand for housing space is such that I think this price will be paid.

Now there may be——

Senator PROXMIRE. It is an interesting position. I don't recall anybody else stating that. It may be the proportion and it may be perfectly correct. But your feeling is as far as this year is concerned, that it doesn't matter a lot if we have interest rates at 8 percent on mortgages or 7 percent or even a little bit lower, the important thing is the availability of houses, that is the vacancy, family formations and things like that or people are going to have to economize elsewhere but they are going to get that house.

Mr. WILLIAMS. I think that is basic.

Senator PROXMIRE. You don't think the market is elastic enough to make that much difference?

Mr. WILLIAMS. Well, I feel if we do have the extension of the surtax that interest rates in the housing area will not be much higher than they are today, and I see them today as no limiting factor.

Senator PROXMIRE. Right now they are 7½——

Mr. WILLIAMS. That is right.

Senator PROXMIRE. Do you gentlemen share this, that the credit cost is not very important compared to these other elements in terms of what is going to happen to housing this year?

Mr. KLEIN. As long as the supply of funds doesn't dry up.

Senator PROXMIRE. Mr. Perry?

Mr. PERRY. Well, very roughly, it seems to me that the statement that we are making is that present credit costs are consistent with the rate of housing starts in the neighborhood of last year's. I don't feel that the credit costs are unimportant. I think that they make a substantial difference in the amount of homebuilding activity you have in a particular year. And I don't know that you can get very far in trying to hold down some rates so long as the total funds available in the mortgage market are limited. For instance the need to raise the VA, and FHA——

Senator PROXMIRE. I would agree with that. You can't put a ceiling on that makes any sense where the market is so far above it you just have point payments or rationing of money. I am talking about the prospects of trying to achieve this perhaps by fiscal policy, by spending policy as well as tax policy and so on. There you think if the interest rates did come down you would perhaps have a better market.

Mr. PERRY. Yes, I think housing is responsive to the changes.

Senator PROXMIRE. Mr. Suits?

Mr. SUITS. I think this is an open question. Certainly the primary element is how much is really available to the housing market, and this has to do with what mortgage rates are compared to other alternative investments, and with the distribution of loanable funds among institutions.

Senator PROXMIRE. I have one more question. Mr. Williams, you have a startling divergence in your predictions of GNP. In the first quarter of the year you expect a $9.2 billion increase in GNP; second quarter $14 billion; and the third quarter $19 billion; and the fourth quarter it will tail off to $15 billion. Why the big increase, sudden increase, of economic activity in the third quarter of the year, and then a cooling off?

Mr. WILLIAMS. Unfortunately, Senator, you have an old copy.

Senator PROXMIRE. Is that a typographical error?

Mr. WILLIAMS. No, it has been revised. Would it be possible to get a——

Senator PROXMIRE. What I have is $897, $911, $930, and $945 billion.

Mr. WILLIAMS. The revised——

Senator PROXMIRE. Four quarters of 1969.

Mr. WILLIAMS. My revised statement which I brought in at 10 o'clock this morning reduces variations in quarterly growth rate over the year. Annual total GNP hasn't been changed, but the quarterly increases in 1969 are: $11.2, $12.5, $17.5 and $15.5 billion.

Senator PROXMIRE. You still have the big increase in the fourth quarter, not quite as much but it is still a big one. Why is the third quarter expected to be so bullish?

Mr. WILLIAMS. I think most of us had this greater increase in the second half. In the third quarter you have a pay increase in the Federal sector.

Senator PROXMIRE. The pay increase is an element but you know everything we have heard from everybody who has testified here in the last week was that they are determined to slow the economy down, and it should be cumulative and we shouldn't have a period 6 months from now, after applying restraint over a period of time, which goes up higher.

Mr. WILLIAMS. Well, this overall increase that I have called for of 3.4 percent in real terms is a substantial slowing down in the economy.

Senator PROXMIRE. Well, except there is no slowing down between the second and third quarters.

Mr. WILLIAMS. That is true.

Senator PROXMIRE. There is a speedup.

Mr. WILLIAMS. Yes.

And that is due to a steady increase in Government spending, augmented by the pay increase in the third quarter. I don't see——

Senator PROXMIRE. That is when the credit is likely to get tight, the Federal Reserve is likely to have the brakes pretty firm during that period I would think.

Mr. WILLIAMS. If they wish to prevent this, that is what they will do, yes.

Senator PROXMIRE. Well, gentlemen, I have detained you and imposed on you long after other members have gone, but you were so interesting and so responsive and competent that I just couldn't resist. I very much appreciate a splendid job. Thank you very much.

The committee will have its next hearing tomorrow morning in room 1202, New Senate Office Building, when we will hear four experts on fiscal and monetary policy. The meeting stands in recess until then.

(Whereupon at 12:40 p.m., the hearing was recessed, to reconvene, Tuesday, February 25, 1969, at 10 a.m.)