439

THE 1969 ECONOMIC REPORT OF THE PRESIDENT

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

NINETY-FIRST CONGRESS

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INVITED COMMENTS

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ORGANIZATIONS RESPONDING

THE 1969 ECONOMIC REPORT OF THE PRESIDENT

The letter appearing below was sent to the following organizations: American Bankers Association, American Farm Bureau Federation, American Life Convention, Committee for Economic Development, Communications Workers of America, Conference on Economic Progress, Consumers Union of the U.S., Inc., Cooperative League of the U.S.A., CUNA International, Inc., Federal Statistical Users' Conference, Independent Bankers Association, Life Insurance Association of America, Machinery and Allied Products Institute, National Association of Mutual Savings Banks, National Consumers' League, National Farmers Organization, the National Farmers Union, National Federation of Independent Business, Inc., National Federation of Independent Unions, the National Grange, National League of Insured Savings Associations, National Planning Association, Railway Labor Executive Association, United Automobile, Aerospace and Agricultural Implement Workers of America (UAW), United Mine Workers of America, United States Savings and Loan League. These organizations were invited to submit their views or comments on the text and recommendations contained in the 1969 Economic Report of the President. Fourteen organizations submitted statements and their views were considered by the Joint Economic Committee in the preparation of its report on the President's Economic Report.

FEBRUARY —, 1969.

DEAR ————: Under the Employment Act of 1946 the Joint Economic Committee has the responsibility of filing each year a report containing its findings and conclusions with respect to the recommendations made by the President in his Economic Report. Because of the limited number of days available for hearings, the committee is requesting a number of leaders of banking, business, labor, agriculture, and consumer organizations to submit statements on the economic problems facing the Nation. These statements will be made a part of our hearings on the Economic Report in a printed volume containing such invited statements.

We invite your comments on the economic issues which concern the Nation and your own organization. Under separate cover we are sending you a copy of the 1969 Economic Report of the President, filed January 16 by President Johnson. Also, we will send you the testimony of the Chairman of the Council of Economic Advisers under the new Administration when the Council appears before the Committee later this month.

We would like to distribute copies of your statement to the members of the Committee and the staff, and would therefore appreciate your sending 30 copies, by March 1, 1969, to Mr. Hamilton D. Gewehr, Administrative Clerk, Room G-133, New Senate Office Building, Washington, D.C. 20510.

With kindest regards and best wishes, I am

Sincerely yours,

WRIGHT PATMAN, *Chairman.*

AMERICAN BANKERS ASSOCIATION

The American Bankers Association is pleased to submit a statement in connection with the annual hearings of the Joint Economic Committee on the state of the economy. The committee request asked for "comments on the economic issues which concern the Nation and your own organization." We have, therefore, selected for comment a number of specific issues upon which we feel the banking industry has special competence to express itself. Largely these concern either credit matters themselves or public policy that will ultimately affect the demand and supply of credit. The issues raised, however, are of such importance they transcend concern by the banking industry alone.

I

Periods of high employment such prevailed in 1968 and presumably will prevail in 1969 put major strains on all financial institutions. While the real growth of the economy from the previous year as measured by gross national product was only 5 percent in 1968 and price increases added 4 percent to the growth in total GNP, the aggregate volume of credit increased some 20 percent last year. The growth in credit demand is the result of a combination of circumstances; high aggregate demand as a result of strong business and consumer incomes, the fact that rising prices makes future investment and production appear abnormally profitable and attempts by businesses and consumer to anticipate future price and interest rate increases and shortages. That these conditions are occurring is, of course, the consequence of unduly expansionary monetary and fiscal policy in 1967 and 1968.

The strain on financial institutions may take several forms. While the traditional channels utilizing financial institutions under ordinary circumstances are adequate to move a sufficient volume of savings into investment, in periods of high employment demands for credit frequently exceed the amount that can be provided by these institutions. For example, the volume of mortgages or corporate bonds in particular years may substantially exceed the amount normally purchased by institutions buying assets of this type. The increased supply of these instruments pushes their interest rates higher. Some leading institutions may then shift their purchases from types of obligation that they customarily find attractive to the particular asset that happens to be in strong supply, or the borrower, because of the increased cost of funds and the inability to attract sufficient buyers for these particular assets, may switch to other types of instruments. Businesses which would ordinarily finance in the bond market, for instance, may move to bank loans or commercial paper as a source of funds.

The role of commercial banks is complex. In addition to servicing their customers' normal short-term needs, banks tend to be the major residual supplier of funds for the economy in periods when credit demands and interest rates rise sharply. Such periods of high demand for bank funds, however, are not without concern to commercial banks. Under these circumstances banks frequently must sell securities from their portfolios at substantial losses in order to meet their formal and informal commitments to valued customers. If there are heavy Treasury demands for credit at such times the problem of financial institutions is further compounded. When banks respond within the free market mechanism by rationing credit on the basis of price (interest rate) rather than by arbitrary decisions, they frequently incur unjustified criticism for raising rates charged to customers.[1] Yet when the banks, whose ability to meet expanded borrowing demands of their customers requires them to be able to attract funds, succeed in increasing their time and savings accounts, they are sometimes said to be "obtaining more than their fair share of the savings market."

It should be recognized that the disruptive strains upon our financial system are not caused by commercial banks nor by specialized financial institutions. Rather, they arise from the fact the economy can generate more uses of credit under an outlook for relatively full employment than it is possible to supply at current interest rate levels. The problem is compounded by inflation which both increases the demand for funds and reduces the motives to save. To the extent that monetary policy is successful in holding down price increases, the measure of its success may be the shortage of credit itself. To the extent that price increases occur, credit demands that are satisfied compound inflation. The administration and Congress have often been sympathetic but at times they have added to public misunderstanding of the role commercial banks play in supplying credit by viewing dimly either interest rate increases made necessary by market pressures or by suggesting that banks are obtaining greater than their arbitrarily assumed share of the "market for savings."

The American Bankers Association recommends that the administration and Congress bear in mind the strains placed upon financial institutions in times of excess demand. To this end an active policy should be pursued to cut back Treasury and Federal agency demands for funds when the economy achieves rapid growth of demand and high employment as a result of a strong private sector. Furthermore, recognition is essential that monetary policy should appropriately be concerned with both interest rates and the volume of bank credit. Finally, attention may well be directed toward determining whether the present structure of financial institutions is appropriate to provide the optimal flow of credit needed for a high employment economy in the long run.

II

The statement of the incoming Council of Economic Advisers presented to the Joint Economic Committee on February 17, indicates the priority given to the problem of inflation by the present administration. The statement rejected the economic projection of the retired Council and instead indicated that a greater attempt would be made

[1] In 1966 the American Bankers Association published and distributed to all of its members a brochure entitled *The Banker's Role in Reinforcing Monetary Policy* which pointed out procedures the bankers could use in determining loan priorities. This publication pointed out the beneficial effects that could be produced by responsible bank management decisions which would obviate both the need for Government guidelines and ever higher interest rates. Consideration is now being given to reissuing this publication.

to bring inflation to a halt than merely relying upon an assumed slowdown in the first half of 1969 as a result of the surcharge instituted last year. At the same time the Council indicated the administration is well aware of the consequences of increased unemployment that could result from too severe use of fiscal and monetary policy in order to break inflationary expectations. Wisely, the Council has suggested the use of appropriate monetary and fiscal policy to bring about expectations of diminishing rates of inflation in the future.

We regard as positive the Council's apparent realization that the relation between price increases and unemployment is sufficiently flexible to permit many things to be done to decrease the degree of inflation without raising unemployment. The Council's emphasis on moderating rather than crushing the growth of aggregate demand will permit steady progress toward improved price performance without sacrificing low levels of unemployment.

Our particular concern is that the damping of inflationary expectations may not be as smooth as the Council implies. At some point as the rate of growth of prices decelerates, there may be cumulative abandonment of investment plans, restrictive inventory policy and consumer postponement of purchases. At such times, those who guide both fiscal and monetary policy may feel that they face a dilemma between immediate reaction to the new conditions and a "steady hand on the tiller" approach.

It should be the intention of the administration with the help of Congress to pursue many policies—consistent with maintenance of the free market mechanism—aimed at decreasing inflation in addition to the principal ones using monetary and fiscal measures. While the aim of Federal action against inflation is nearly always thought to be the concentration on the reduction of excess demand, possible action to improve supply can also be in order. The Federal Government can well occupy itself in the elimination of any conditions that limit the working of the price and free market mechanism and thus tend to raise both prices and wages. Both labor and management should be made aware of the beneficial effect of measures to increase productivity and steps should be taken to see that practices that conflict with maximum productivity growth are eliminated or reduced whether they originate with Government, labor, or business. Finally, a thorough review is required of all those areas of public policy aimed at pegging prices and wages. It is appropriate to question whether the minimum wage law plays a useful role at the present time; it may only lead to greater unemployment of marginally productive workers. In any case, while wage and price supports may be appropriate in periods of underutilization of resources, in periods of high employment of fully productive workers, there is little excuse for them, and they add significantly to inflationary pressures.

In the end, however, the fight against inflation will be largely won or lost by monetary and fiscal policy. If the past decade is any indication, the greatest single determinant will be the volume of Government spending. Indeed, Korea, the space and missile race, and Vietnam essentially determined Government spending. But Federal revenues were adjusted only slowly, and monetary policy did not fully compensate. Thus pressure was placed upon scarce resources in the name of national policies endorsed by a sizable percentage of the American public. The American Bankers Association believes that in recent years the Federal Government has been the major perpetrator of inflation, because it did not give adequate consideration to the overall impact of major policies.

At some point, the judgment must be made as to whether to err on the side of a more or less restrictive policy despite all the good wishes of the current administration in avoiding that problem. In the recent past, this decision has generally been against that of sufficient restriction and instead policy has fostered more inflation. We feel strongly that undesirable as even a small rise in unemployment would be, the administration must be prepared to accept some rise in the number of jobless and must not weaken its actions against inflation for fear of such consequences. The association is firmly convinced, moreover, that inflation has seriously intensified the problems faced by large segments of our population who have low incomes, whose incomes are fixed, or who are on some form of public assistance. While we are mindful of the beneficial effect of a highly expansionary policy in employing marginal and submarginal workers, we feel the Federal Government has, in pursing a "Guns and Butter" policy, achieved a high rate of employment through over-stimulative policies at a cost of lowered purchasing power for families who are only one short step up the economic ladder from low-skilled workers who are also a prime object of Federal concern. A realistic cost benefits analysis might well dictate other ways of solving the problem of putting the least employable workers into jobs.

III

The commercial banking industry is obviously concerned that the pursuit of monetary policy be practiced with maximum efficiency. In the last year despite three separate and distinct Federal Reserve policy phases, monetary growth overall was much too high for a year of rapid inflation. The money supply defined as demand deposits and currency grew at a nearly steady rate while the money supply plus time deposits actually accelerated in its growth rate as the year progressed. Viewed in this light the basic decisions of monetary policy seem clearly to have been in error. Monetary policy, on the other hand, becomes more understandable if its goal was conceived as largely that of trying to affect interest rates. During the moderately restrictive policy period up to late spring interest rates particularly in short-term securities rose. Following passage of the surtax and agreement on the spending slowdown when policy shifted because of fear of "overkill," rates fell only to turn up again barely 2 months later when the economic expansion proved stronger than anticipated. Of course, Treasury requirements in 1968 unduly limited the hands of the monetary authorities. Nevertheless, whether interest rates or the growth in the money supply was the guiding policy principle, the total effect of last year's actions was obviously inappropriate for a period of inflation.

During the past year the Joint Economic Committee suggested the Federal Reserve Board specify regularly its goal in terms of growth of the money supply and explain reasons for policy changes that produced divergences from a steady rate of growth. While viewed as a victory for those who advocate fairly steady growth in the money supply, in a larger sense its chief contribution probably was that of putting the Federal Reserve on notice that fewer, rather than more, frequent shifts in policy would be desirable and that interest rates are less important than previously thought in creating an effective monetary policy.

In contrast to the apparent willingness of those who hold this viewpoint to focus greater, if not complete, attention upon money supply growth, the annual report of the retiring Council of Economic Advisers went out of its way to point out the undesirable effects of a simple rigid rule related to the growth of the money supply by pointing out the undesirable effects upon the interest rates that could be produced under certain situations.

The American Bankers Association has no wish to endorse a particular viewpoint in monetary theory. We do see definite advantages to the cause of economic stabilization in a less volatile monetary policy and therefore less precise concern over interest rates levels per se. Such a course, however, requires reducing the institutional rigidities imposed by various interest rate ceilings incoroprated by law and regulation in many parts of the financial system. Ceilings on interest rates paid to savers at various institutions, rate ceilings on Treasury bonds, maximum lending rates on insured and guaranteed mortgages, student loans and small business loans, and imposed ceiling rates on consumer loans as well as mere tradition or convention all tend to make interest rates unusually important in the present financial system. Since a high employment economy is likely to produce interest rates near or even above legally imposed ceilings or ceilings fixed by lack of timely administration, it is likely that until many of these restrictions are removed monetary policy will have to be cognizant of sharp and irregular effects set off by slight changes in interest rates. Therefore, it would seem entirely appropriate for the committee to bear in mind the inconsistency of advocating policies favoring relatively stable monetary growth but continuing to favor the institutional rigidities imposed by legal interest rate ceiling on various types of instruments.

As a case in point, the banking industry should point out that the hoped-for gentle attack against inflation may be turned into a serious credit crunch by failure to take appropriate action to increase the ceiling rate on large certificates of deposit issued by commercial banks. Certainly the current course of interest rates suggests that instruments other than bank certificates are more attractive to sophisticated large investors and wholesale "disintermediation" could well spread as it did in 1966. Immediate action should be devoted to removing, placing on a standby basis, or raising this sensitive rate ceiling. Such a move would not lessen the anti-inflationary stance but would reduce the threat of another serious credit crunch emanating from serious "disintermediation."

IV

Recent years have seen a considerable atmosphere of innovation in banking practices, questioning of existing operating and regulating procedure, and the invention of new methods of organization. In such areas as savings instruments, underwriting of revenue bonds, capital instruments, credit cards, provision of Federal Reserve discount facilities. Loan production offices, provision of noncredit services by banks, and limits on loans of particular types such as mortgages, the commercial banking industry has become restive with previous arrangements. In the past year the diversification movement in the commercial banking industry, generally taking the form of financial congenerics, has garnered considerable attention from the public, the administration, and Congress.

There is often a temptation to regard these developments in isolation and see them as the mere result of oversight in drafting previous legislation or regulation, the discovery of ingenious legal arrangement, or nefarious intent on the part of bank managements. Yet, all of these developments and many more that could be mentioned are undoubtedly only the external manifestation of major changes that are taking place in the American economy and the financial system's attempt to adapt to them.

Without attempting to exhaust the list of fundamental changes in the economy leading to changed financial practices it is possible to point out a few obvious ones. First, the rising scale of industry has meant demands for financing and other financial services are much larger than before. Technical developments have increased capital requirements of customers; they have also changed the practice of banking. Sharp shifts have occurred in the cost curves of the commercial banking industry in particular operations and as the payments system rapidly becomes automated, as now appears likely in the next decade, the economics of the industry will be changing rapidly. Bank managements have incerased their professional character and highly skilled personnel are required to service customers. On the consumer level, demands for deposit and credit services have changed appreciably. Indeed, the very output of the economy has changed appreciably from material things to services of various types and this development affects the functions of financial institutions.

The American Bankers Association is, of course, seeking to represent the commercial banking industry in dealing with the Congress and the banking agencies as legislation and regulations are developed to take account of necessary changes. We urge that the Joint Economic Committee as well as other congressional committees dealing with banks attempt to view the financial structure as a whole rather than on a piecemeal basis as it reviews the need for specific changes. Generally, the American banking system over the years has been able to adapt prudently and efficiently to broad economic and social changes and the nation has benefited from this flexibility. To continue this favorable record requires a depth of vision and willingness to innovate on the part of legislators and regulatory agencies unwilling to be satisfied with the status quo. In their future dealings with the banking industry we hope the flexibility of approach contained in the principle of dual regulatory authority will be preserved.

V

The announced intention of the new administration to contain inflation by a policy of gradual reduction of expenditures growth will have a wholesome effect on the U.S. balance of payments. It is fairly obvious that only inflow of capital from Western Europe and a willingness by U.S. firms to go beyond what was asked of them in limiting capital outflows abroad enabled the U.S. payments balance to show up as well as it did in 1968. The poor showing of the United States on trade account last year is a foreboding sign that the threat of a large-scale deterioration in the balance of payments still hangs over the Nation.

For 1969 we urge that major efforts be made to expand U.S. exports. Such efforts should include a thorough examination of the types of incentives that could be used to encourage American industry to expand exports. Joint efforts with our trading partners should be aimed at a thorough review of unilateral changes of indirect taxes which tend to distort trade patterns among nations. Negotiations to remove nontariff barriers should also be pressed, so that the advantages of free international markets can be made more fully available by all nations.

The Joint Economic Committee in its deliberations on the U.S. balance of payments may well benefit from examination of *The Cost of World Leadership*, an analysis of the problems and solutions of the problem recently completed as a staff study of the American Bankers Association.

AMERICAN FARM BUREAU FEDERATION

We appreciate the opportunity to comment on the Economic Report of the President for 1969.

Farm Bureau members are interested in the Economic Report because it deals with matters which determine the economic climate in which farmers must try to make a living.

Our members also have an interest, as taxpayers, in the many sections of the Economic Report which call for continued, or increased, Government expenditures.

At the present time the economic climate is dominated by strong inflationary pressures. This is recognized at several places in the Economic Report. For example, on page 33 [1] the Council of Economic Advisers notes that "The pressures of excessive demand pushed up the price level at the unacceptable rate of nearly 4 percent" (in 1968). This apparently refers to the Consumer Price Index.

As an industry that suffers from overproduction—some of which has been induced by Government programs—agriculture is seriously hurt by inflation because farm costs rise faster than farm prices. This is well illustrated by the chart on page 48 which shows that farm prices have consistently lagged behind other wholesale prices since 1963 except for a brief period in 1966 when farm prices were boosted by an unwarranted hysteria over the world food situation.

From December 1962 to December 1968 the Wholesale Price Index for all commodities, including farm products, rose 9.4 percent, but the wholesale price of farm products rose only 6.2 percent.

We certainly agree with former President Johnson's statement (p. 9) that, "The immediate task in 1969 is to make a decisive step toward price stability."

We strongly urge the Congress to pursue inflation control with greater vigor in 1969. In achieving this, major emphasis should be on cutting Federal expenditures in order to obtain a balanced budget for fiscal 1970. Reductions in expenditures should have priority over continuation of the surtax for an additional year.

We are well aware of the argument that reducing Government expenditures might increase unemployment. We do not, however, believe that inflationary policies are a sound approach to the desirable objective of maintaining a high level of employment. The unemployment problem is concentrated in groups that have very little to offer the job market. The major impact of inflation on employment is to increase the demand for—and consequently the money income of—the better qualified workers who already find it relatively easy to obtain employment.

The problem of finding employment for the disadvantaged can best be approached through efforts to upgrade their skills in order to

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[1] Economic Report of the President, transmitted to the Congress, January 1969, together with the Annual Report of the Council of Economic Advisers: U.S. Government Printing Office, Washington, D.C.

qualify them for the type of work that is available in a technologically advanced society. In some cases such efforts could be materially assisted by exemptions from the minimum wage law for handicapped and beginning workers.

While the Council of Economic Advisers indicates that a price level rise of 4 percent per year is "unacceptable," we do not think the Council has placed sufficient emphasis on the long-run dangers of inflationary policies. There is real danger that efforts to increase employment by inflating the economy may lead to an economic bust which would increase rather than reduce unemployment.

It has often been argued in the past that an easy money policy is necessary to hold down interest rates in order to stimulate the housing industry. Recent experience suggests that an inflationary expansion of the money supply leads to high, not low, interest rates. If lenders are convinced that they will be repaid in cheaper dollars it is only natural that they should demand higher interest rates to offset the potential loss in the purchasing power of loan funds. If prices are advancing at a rate of 4 percent per year, interest rates must exceed 4 percent if lenders are to receive any real return for the use of their money.

We agree with former President Johnson's statement (page 10) that, "the vital guiding mechanism of a free economy is lost when the Government fixes prices and wages." We do not, however, agree with the Council of Economic Adviser's statement (page 59) that, "business and labor should undertake a pattern of voluntary restraint" based on Government-suggested guidelines.

Government guidelines are an interference with the operation of the market system that is only a step removed from price and wage controls. The proper role of the Government in inflation control is to create an economic climate that is conducive to a stable price level—not to inflate the economy and then ask business and labor to refrain from responding to inflationary pressures.

We do not agree with former President Johnson's suggestion that Congress "give the President discretionary authority to initiate limited changes in tax rates, subject to congressional veto" (page 13). The record indicates that the Congress can act quickly on tax changes when a majority of its Members are convinced that proposed changes are required by the national interest.

Enactment of the present surtax was delayed because many Members of Congress—reflecting the views of their constituents—felt that an increase in taxes should be accompanied by a reduction in Government expenditures. We do not think it would be wise for the Congress to surrender its right to originate changes in tax rates, to decide the amount of such changes, and to decide whether increases should be accompanied by cuts in expenditures.

Agriculture

We agree with former President Johnson's statement (page 16) that, "Agriculture has been the stepchild of trade negotiations, and deserves prompt and proper attention."

The most notable agricultural result of the Kennedy round was an International Grains Arrangement which has resulted in an inverse subsidy, or export tax, on U.S. wheat exports. We do not see how anyone could expect to expand wheat exports by taxing them. It is not surprising that wheat exports have declined since the International

Grains Arrangement went into effect, although we recognize that other factors may have contributed to this decline.

The United States should seek to have the wheat provisions of the International Grains Arrangement suspended or materially modified at the earliest possible date.

The new administration should give a high priority to efforts to increase farm exports. Our immediate goal should be to increase farm exports from $6.3 billion in fiscal 1968 to $10 billion per year. This would improve our balance of payments as well as strengthen our farm economy.

In order to achieve this goal, it will be necessary to resist the current pressures for new restrictions on imports. It will also be necessary to eliminate the direct payment features of domestic farm programs. Direct payments to farmers on commodities which are produced for export are a disguised form of export subsidy, and are recognized as such by other countries. We cannot expect to persuade other countries to reduce trade barriers such as the Common Market's variable fees as long as we are subsidizing exports through direct payments.

We appreciate the Economic Council's recognition (page 116) of the need for "a restructuring of farm programs"; however, we do not agree with the Council's inference that direct payments should be continued.

New farm legislation should be enacted during 1969 so that farmers will have time to prepare for the changes that should be made in existing farm programs. Further delay in coming to a decision on this issue would only make the problem of adjustment more difficult for farmers.

In developing new farm legislation it should be recognized that the problems of agriculture can be divided generally into two categories: First, the problems of commercial farmers and second, the problems of other farmers.

Farm Bureau supports a transitional program to deal with the problems of noncommercial farmers. This could take the form of whole farm cropland retirement, permanent retirement of allotments, adjustment and retraining assistance, or other means.

For the commercial farmer we recommend a program which would move as rapidly as possible to the market system by phasing out acreage bases, acreage allotments, marketing quotas, and compensatory payments with no limitations on payments to individuals during the phaseout.

The objective should be to create conditions which will make it possible for farmers to get their income in the marketplace rather than being dependent on congressional appropriations. A few farmers should not be penalized because they are larger than others.

The phaseout of acreage controls should be accompanied by an expansion of the voluntary cropland adjustment program (authorized by the Food and Agriculture Act of 1965) with emphasis on whole farms. We are pleased to note that the Economic Report favors an expansion of this program (page 116). As a first step toward getting agriculture on to a sounder footing, funds for new cropland adjustment contracts should be included in the Agricultural Appropriation Act for 1970. This would enable the Secretary of Agriculture to begin to move in the direction of the adjustments that are needed by offering farmers new cropland adjustment contracts in the fall of 1969, a year before the act of 1965 is scheduled to expire.

AMERICAN LIFE CONVENTION
and the
LIFE INSURANCE ASSOCIATION OF AMERICA

This statement is submitted on behalf of the American Life Convention and the Life Insurance Association of America, two trade associations with a combined membership of 360 life insurance companies which account for 92 percent of the legal reserve life insurance in force in the United States. The total assets of the life insurance business today aggregate more than $187 billion, which represents the savings that have been entrusted to us by millions of policyholders. The protection of the economic value of these savings is of vital concern to our business. We appreciate the invitation of the Joint Economic Committee to express our views on the materials and recommendations contained in the "Economic Report of the President Together with the Annual Report of the Council of Economic Advisers" and we hope that these comments will prove helpful to the committee.

Prospects for the Economy in 1969

In our view, the No. 1 problem facing our domestic economy in 1969 is the threat of continuing strong inflation and the deepening of the inflationary psychology that has spread widely through the economy in recent months. During 1968, the inflationary forces that were permitted to develop led to a 4.8-percent increase in the consumer price level and a 3.9-percent rise in the GNP price deflator for the entire economy. Inflation was no longer merely a threat—it became a reality.

The inflationary trends of 1968 have already exacted a toll from the American public in terms of higher prices for everyday living expenses, rising costs of housing, and decreased value of their savings and fixed incomes. But another difficulty with a major inflationary surge is the change in public attitudes that it carries with it. Once the public becomes convinced that prices are going up further, there is a natural urge to anticipate price increases by purchasing in advance of needs, even if it means borrowing to do so. In such circumstances, rising interest costs become a minor deterrent to borrowing when compared with the rising prices that are projected in an inflationary climate. Thus an inflationary psychology can seriously distort the spending and borrowing decisions of consumers and businesses alike. As living costs advance, pressures for higher wages also build up and persist in later labor negotiations. Moreover, inflation carries with it a forward momentum that can be checked only by appropriate economic policies applied with determination and persistence.

It is our opinion that the primary objective of economic policy measures in 1969 must be the reduction of the rate of inflation. In its *Annual Report*, the Council of Economic Advisers projects that gross

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national product will rise in 1969 by about $60 billion to a total of around $921 billion for the year, and this estimate is in accord with that of many private forecasters. An increase of about 6 percent is foreseen between the final quarter of 1968 and the fourth quarter of 1969, with a projected rise of less than 3 percent in real output and an increase of a little more than 3 percent in overall prices. This estimate implies a diminution in the rate of inflation during the coming year as compared with the price advance of recent quarters. While we would regard this degree of reduction in the inflation rate as a desirable objective, we also believe that this goal may prove difficult to attain unless gradual but persistent restraint is applied through checks on Federal spending, extension of the 10-percent income tax surcharge, continued restraint in monetary policy, and programs to improve productivity.

POLICY FOR RESTRAINT OF INFLATION

Effective action to break the grip of inflation and counter the threat from a deepening inflationary psychology requires a policy of simultaneous restraint in four major areas, as outlined below.

1. *Federal spending* should be kept in check to avoid greater pressures on aggregate demand and to permit a balance or surplus in the Federal budget. The ability of the Congress and the executive branch to curb the growth of spending programs has been demonstrated by the Revenue and Expenditure Control Act of 1968. It is clear that the pressure of inflation during the present fiscal year would have been even greater in the absence of this measure, but the need for continued holdbacks in Federal expenditures is no less pressing today than a year ago.

In our view, the $3.4 billion Federal budgetary surplus that is projected for fiscal year 1970 in the Economic Report and in the Budget Message operates in the proper direction of fiscal restraint. But this planned surplus could be easily jeopardized or even reversed if the Congress relaxes its careful scrutiny of spending programs in both the civilian and military areas. Previous budget analyses have demonstrated how sizable are the budget outlays which are "relatively uncontrollable" as a result of commitments under Federal programs adopted in earlier years or enlarged by previous legislation. Accordingly, the need for close review of new proposals or expanded programs is heightened by the narrowing of congressional discretion over current spending.

2. *Extension of the 10 percent tax surcharge* is essential in the present budgetary situation to achieve the budget surplus needed to maintain fiscal restraint in an inflationary economy. The life insurance business urged the imposition of an income tax surcharge on both individuals and corporations in August 1967, and we now favor extension of the 10 percent surcharge for the fiscal year ending July 1, 1969, as proposed in the Budget Message and the Economic Report. Failure to renew the surcharge beyond its June 30 expiration would lead to a Federal deficit in fiscal 1970 of about $5½ billion—a fiscal position which would be wholly inappropriate to the present economic outlook of excessive demand and continuing inflation.

Past experience has shown that unexpected developments in military requirements, budgetary trends, or economic conditions sometimes call for rapid adjustments in Federal tax policies. But prompt changes in tax rates, either up or down, are typically difficult to obtain under present procedures. In order to permit more rapid adjustments in tax levels, we would urge that consideration be given to some flexible mechanism to permit removal of the renewed 10 percent surcharge by the President before the end of the 1970 fiscal year, if changing circumstances warrant such action. The precise form of such a mechanism would be a question for discussion between the Congress and the new administration. While we do not presently visualize the emergence of conditions that would call for early removal of the surcharge, we feel that this type of flexibility would represent a potential improvement in our fiscal controls.

3. *Monetary restraint* is vitally needed to hold down the growth rate of money and credit, perhaps for a considerable period ahead. Beginning last December with an increase in the discount rate, the Federal Reserve authorities have moved in the direction of more restrictive monetary policy which has slowed the growth rate of money supply and brought greater pressure on member bank reserve positions in recent weeks. We believe that monetary restraint should be applied in a gradual fashion, in order to avoid the violent disruptions of a "credit crunch" but should be presistently maintained for a sufficient period to break the inflationary psychology which has gripped the financial markets in recent months.

As noted earlier, the upsurge of inflation during 1968 has quickened the desires of consumers, homebuyers and corporations to purchase goods in anticipation of rising prices, and to borrow to finance such purchases. The rise in interest costs of recent months has been outweighed in the minds of many borrowers by the expectation of higher prices for goods if the purchase were delayed. At the same time, lenders have become increasingly aware that they must obtain a higher return on fixed-debt obligations if they are to be repaid in dollars that have been cheapened by inflation. While precise measurement is difficult, it appears that these attitudes have produced an "inflation premium" on fixed-dollar investment, which has been an important force working toward higher interest rates in recent months.

The Annual Report of the CEA expresses the hope that as fiscal restraint is continued through fiscal 1970, monetary policy may gradually be able to shift to a less restrictive stance and that a decline in interest rates may take place. In our opinion there is a grave danger that premature easing of monetary policy, at the first signs of economic slowdown or rising unemployment, would revive inflationary expectations among savers and lenders and lead to higher interest rates rather than lower rates. The prospect of continuing inflation under these circumstances would impel the public to borrow more, while lenders would shun fixed-dollar investments or build in an "inflation premium" in their fixed-debt lending rates. For these reasons, we believe it is imperative to maintain a restraining monetary policy until present inflationary psychology has disappeared from the financial markets. This may require a considerable period to accomplish against the background of recent developments.

4. *Other policies for price stability* can also contribute to the objective of reducing the inflation rate, in addition to the aggregative effects from fiscal and monetary restraint. Chapter 3 of the Annual Report of the CEA contains a discussion of the effect on price levels of wage rates, labor efficiency and mobility, utilization rates of plant capacity, and competitive pricing policies. We endorse the perceptive analysis of the Council in that discussion, and feel that the suggestions put forward by the Council deserve the careful consideration of business and labor groups as well as the Congress. Improvements in the areas described in that chapter should also be pursued in the search for price stability consistent with high levels of employment of manpower and utilization of productive capacity.

THE QUESTION OF UNEMPLOYMENT

The Economic Report expresses the fear that "an overdose of fiscal and monetary restraint" might bring on a recession with rising unemployment and growing social unrest. The life insurance business shares the concern over the economic waste and the damage to family stability and individual dignity that would result from deliberate policies to increase unemployment as a means of halting price inflation. It is for these reasons that we urge gradual and persistent policies of restraint that will permit adjustments in production and labor markets without the violent disruptions that an economic downturn would bring.

Recent discussion of these questions has centered on the "trade-off" or choice between inflation and unemployment. According to this argument, in the short run, unemployment can be reduced to nominal levels if demand is allowed to expand rapidly, at the cost of upward pressure on wages and prices; conversely, if demand is restrained to curb inflation, unemployment may increase. In our view, this argument overlooks the fact that unsustainable growth rates lead to distortions in the economy which can bring on extremely painful downward adjustments with a steep rise in the unemployment rate. In a longer run analysis, an overheated economy that produces inflation will lead to higher unemployment in the subsequent economic downturn which follows as a corrective aftermath of unsustainable growth.

The present 3.3 percent unemployment rate represents the lowest level in recent years. However, the social consequences of even this degree of unemployment should not be ignored. A great part of the present joblessness reflects the problem of "unemployables" who lack skills or training, as well as pockets of structural unemployment in certain urban or rural poverty areas. However, this type of unemployment does not respond readily to variations in aggregate demands. The social and economic problem of the "unemployables" should be attacked through redoubled efforts to bring this group into the labor force through programs of job training and relocation. Similarly, hard-core unemployment among minority groups in urban ghetto areas should be approached not through pressing harder on total demand but through direct programs for providing new skills and new job opportunities for these workers.

It should also be recognized that inflation exacts a heavy toll on the meager living standards of the jobless and the low-income family through higher costs of food, shelter and clothing. Efforts to develop low-income housing are stymied by rising construction costs. Welfare payments and unemployment benefits provide less help when the prices of essential goods continue to mount. Those who are socially and economically disadvantaged could be benefited most through a combination of broad policies to curb inflation together with manpower programs to bring them into the labor force and provide them with needed job skills. Efforts should also be made to improve Government employment services and to develop a data bank on job vacancies in order to identify job opportunities and increase labor mobility.

Balance of Payments Problems

The year 1968 produced the first surplus in our balance of payments since 1957, but there was little cause for elation in view of the continued weakening of our merchandise trade balance from a $3½ billion surplus in each of the years 1966 and 1967 to less than $500 million last year. A heavy inflow of foreign capital was primarily responsible for converting the deficits of earlier years into a narrow surplus in 1968. However, there is little or no assurance that these offsetting capital inflows will continue in the future, since they arose to a considerable degree from political disturbances in Europe rather than from basic economic relationships.

Inflation and excess demand have doubtless played an important role in the deterioration of our trade balance this past year, by attracting an increased flow of imported goods while making our exports more expensive to many foreign buyers. If we are to maintain our competitive position in world markets, it is essential that we regain control over inflation to prevent rising export prices.

The Economic Report recommends that controls over foreign lending and direct investment be maintained and that the interest equalization tax be renewed. While these measures may be unavoidable under present circumstances, we should not lose sight of the desirability of removing these restrictions on international capital flows as quickly as circumstances permit. The persistence of this type of "temporary" capital control illustrates the need to achieve domestic price stability and to restore a viable balance in our international trading position.

Management of Domestic Monetary Affairs

The Economic Report offers proposals to modify the organization of policy formation within the Federal Reserve System with a view to enhancing its effectiveness. If any modifications are to be made, however, we believe it is highly important to maintain the independence of Federal Reserve policy from political supervision or direct control by either the executive or legislative branch. This independence permits monetary policy to respond to changing economic conditions with a speed and flexibility which would be sacrificed if the System operated under fixed political directives.

In a related field, greater flexibility is also desirable in the management of the public debt and Treasury borrowing operations. For the past three years, the Treasury has been unable to market securities with a maturity beyond 7 years, because of the 4¼ percent interest rate ceiling on bond issues. As a result, the average maturity of the public debt has been steadily decreasing.

In our view, the Congress should consider changes that would provide Treasury access to the longer term capital market as a regular part of its debt management function. One method would be to raise or remove the 4¼ percent bond ceiling; another would be to extend the maximum maturity of note issues beyond the present 7-year limit. Regardless of the method, the ability of the Treasury to lengthen the maturity of the debt would help not only to improve the debt structure but also to reduce the frequency and size of Treasury financing operations in the money and capital markets.

In conclusion, we believe that the foremost objective of economic policies in 1969 must be a reduction in the rate of inflation. Anti-inflation policies should be applied in a gradual fashion, to avoid a downturn in economic activity or sharply increased unemployment. But the campaign against inflation must be pursued with persistence, to rid the economy of the inflationary psychology which threatens to distort the spending, lending, and borrowing decisions of the public.

The economy has enjoyed a prolonged period of rapid growth and prosperity over the past several years. Employment, production and incomes have advanced to record high levels. But the pressure of excessive demand has outrun our capacity to produce, leading to an unhealthy and continuing rise in wages, costs, and prices. If we are to return to the path of sustainable economic growth with high employment and price stability, it is essential that we achieve a significant reduction in the rate of inflation in the months ahead.

COMMITTEE FOR ECONOMIC DEVELOPMENT

By Emilio G. Collado, Chairman, Research and Policy Committee

We are especially pleased at this opportunity to comment on the Economic Report of the President and the annual report of the Council of Economic Advisers, because the subject matter of these important documents relates to many of the issues discussed in a January 1969 statement of CED's Research and Policy Committee, "Fiscal and Monetary Policies for Steady Economic Growth." *

This statement, prepared by a subcommittee headed by Douglas Dillon, was the result of intensive analysis of the opportunities and problems facing the U.S. economy now and in the years ahead. It represents a modernization and restatement of our analysis and recommendations for maintaining a steady rate of noninflationary growth, and is the latest in a series which began with our first stabilization statement in 1947. Since our analysis and comments on the Economic Report of the President and the annual report of the Council of Economic Advisers will draw heavily on the positions taken in this recent CED document, it is useful to briefly outline its contents and recommendations.

In "Fiscal and Monetary Policies for Steady Economic Growth," the CED Research and Policy Committee asserts that the four basic economic objectives of the country are a high level of employment, general price stability, economic growth, and balance-of-payments equilibrium.

In defining "high employment," the report notes that for many years an unemployment level of 4 percent of the labor force has been widely used to represent a high-employment situation. However, there is little economic justification for setting a target for high employment in terms of a constant fraction of the labor force. Rather, the ultimate objective requires the maintenance of a level of demand for labor which will provide a number of jobs equal to the number of workers looking for employment at wages which the marketplaces are willing to pay for their capabilities; that is, their productivity.

With this employment objective, additional measures may be necessary to increase the productivity of those workers whose productivity is insufficient to earn a decent standard of living. Before shifting away from the familiar measure of unemployment as a percent of the labor force, it will be necessary to compile and utilize data on unfilled job vacancies, and on unemployment, by both location and skill. Until this is done, we shall have to use the present measure of unemployment, keeping in mind that a satisfactory level of employment will imply lower levels of unemployment as the adjustment of workers to job opportunities improves.

*Copy in committee files.

In a section of our policy statement whose implications we regard as most important, the Committee concludes that there is little reason to be concerned with the necessity of trading off some rate of price inflation to obtain tolerable levels of unemployment. Put in yet another way, there is no necessity for accepting a substantial permanent rise in unemployment to attain relative price stability. The analysis in the statement suggests that expanding demand from levels well below the country's potential to produce at stable prices does reduce unemployment. However, as unemployment expands, the economy begins to approach the position where increases in employment become harder and harder to achieve by simply expanding money demand. Potential workers are in the wrong location, have mismatched skills, or skills not particularly relevant to any of the existing demands for labor. Under such conditions, further increases in money demand become increasingly inefficient ways to reduce unemployment and result primarily in increases in the price level. Lasting expansion of employment beyond this "normal" level of unemployment requires specific steps to improve the efficiency of labor markets and cannot be obtained by continued expansion of demand. At the point where expanding demand leads to inflation, further increases in demand have little, if any, lasting effect on employment. Thus, there is little, if any, trade-off between inflation and employment because expanding demand to a level generating inflation brings no lasting rise in employment.

In dealing with the need for price stability, the committee states that the adverse effects of inflation on domestic economic growth, on the distribution of income and wealth, on resource allocations, and on the Nation's competitive position in the world economy are now fully evident. If policy is to be directed at price stability, it is essential that a reliable measure of price movements be the basis for measuring whether this objective is met. The Consumer Price Index is the single most reliable of the major indexes for measuring price stability, and the economy ought to aim for stability in the Consumer Price Index after allowing for inability of this index fully to reflect quality changes in goods and services produced.

The third objective, economic growth, is regarded as a prerequisite for the attainment not only of economic, but of other fundamental goals as well. With increasing levels of output, the standards of living and opportunity of the great majority of Americans rise. At the same time, an expanding economy provides the means to meet the minimum economic needs of all citizens, and to ease the stresses of a variety of current technological, social, and economic changes. For the postwar years, the measured trend rate of increase in productivity per man-hour for the private and public sectors combined has been just over 2.5 percent annually. Adding the growth trend of 1.5 percent in total man-hours worked, the annual rate of exapnsion of potential output has been about 4 percent. The Nation's economic growth objectives should be to maintain a rate of growth in productivity per man-hour at least equal to the 2.5-percent trend, and continuing attempts should be made to improve this performance.

In defining the final objective, equilibrium in the Nation's balance of payments, the committee notes that in nearly every year of the last decade the United States has experienced an annual deficit in the balance of payments. In settling these deficits, our gold reserve has declined and our liabilities to foreigners have increased substantially. However, the acquisition of dollar balances by foreigners has also served a useful purpose. Private foreigners have voluntarily increased their dollar holdings to finance world trade and international business. Because of the dollar's important role as an international reserve asset, foreign official institutions may also want to add further to their liquid dollar assets.

Equilibrium in our international payments is attained when, on average, the deficits in our international accounts are equal to the additional dollars the rest of the world voluntarily wishes to add to its holdings at the existing exchange rates when there are no direct or indirect government controls over international trade or capital transactions imposed for balance-of-payments reasons. The United States is not likely to achieve longrun payments equilibrium unless the economy reaches its other objectives of high employment, stable prices, and steady growth.

The statement then specifies the role the Government plays in affecting the economy as being composed of two conceptually separate sets of forces: those which affect the level of output that the economy has the *potential* to produce at stable prices and those forces which affect the *actual* level of demand at any time. The Government's impact on the *economic potential* of the economy arises from its influence on the size of the labor force as well as its impact on the productivity of this labor force. While the factors affecting productivity are many and diverse, Government expenditures on health, education, urban development, research and development and the like have direct impact on the motivation and ability of the work force and thus affect the potential. Expenditures and tax programs designed to induce innovation and investment also provide significant stimuli to increase productivity. However, to the extent we spend publicly to achieve these objectives when the economy is at high employment, less resources are available to be used in the private sector. Thus, we conclude

> Our longrun objective for economic growth requires that the Federal Government manage its spending, taxing, lending and borrowing programs in ways which assure that the resources of the whole economy are used as efficiently as possible. This means that the productivity of Federal spending and lending programs should be weighed against the productivity of private spending and that the tax system be one which fosters or least deters initiative, effort, and investment. These objectives can best be served if the Federal Government manages its spending and taxing so as to yield approximate balance in the overall budget *when the economy is at a high level of employment and experiencing stable prices.*

The Federal Government through its taxing, borrowing, spending, and lending decisions exerts a significant influence on the actual level of the economic activity in the economy. Monetary policy similarly exerts a substantial impact on the level of demand, employment, and prices. Our recommendations for public policy with respect to the objective of achieving high employment at stable prices are that if, with proposed Federal spending and the existing tax rates, total demands exceed or fall short of the country's capacity to produce at stable prices, the Congress should enact legislation affecting either spending or taxes or both so as to bring the total of public and private demands within these bounds. The method of temporary income tax change selected by Congress to stabilize the economy should be easy to initiate, easy to understand, and easy to administer, and it should not substantially alter the tax structure.

Experience with the use of tax changes for economic stabilization purposes demonstrates that such action often needs to be taken more expeditiously than the usual congressional procedures have permitted. There should, therefore, be a consensus not only about the form of the tax change and the economy's need for it, but also a mechanism for obtaining timely action.

The basic role of monetary policy in a broad program of economic stabilization should be to create and preserve an environment in which expectations of monetary developments are themselves stable. This requires a close coordination in the use of monetary and fiscal policies. Major failures in fiscal policy cannot be successfully offset by monetary measures. Experience has demonstrated that fiscal and monetary measures cannot be effective when used in substantially conflicting ways. This philosophy implies a restrained use of the basic monetary instruments consistent with long-run objectives, avoiding drastic short-run changes in monetary postures.

Given this general introduction to our policy statement it should be clear that there are many parts of the Report of the Council of Economic Advisers with which we heartily agree. The report's emphasis on the need to restrain inflation and the necessity of both fiscal and monetary restraint are most appropriate. We especially agree that some more efficient procedures must be established within the Congress as well as within the executive to assure that the level of Federal expenditures and tax rates are such as to keep the levels of demand within the country's potential to produce at stable prices. We agree with the report that this requires congressional review of the proposed budget as a whole as well as the need for a prompt mechanism to enable the executive to propose and the Congress to enact tax changes.

Aggregate Demand, Employment, and Inflation

We are pleased to concur with the report's conclusion that excessive levels of demand leading to inflation produce little permanent decline in unemployment. As is suggested by the behavior of unemployment in the 1961–1965 period, when output was below our capacity to produce, raising demand resulted in a marked decline in unemployment. Further increases in demand and unanticipated increases in prices brought some temporary further increase in employment and output. As the acceleration in prices became more obvious, however, the increases in employment became much less pronounced and the wage rates demanded by workers accelerated.

We now find ourselves in the position where business and labor feel inflation is likely to persist and are making price and wage decisions in this anticipation. The task before the country is to slow down the growth in total demand so that the rate of price increase gradually diminishes and anticipations of inflation are adjusted downward. We agree with the report that this must be a gradual process. Given these existing inflationary anticipations, if aggregate demand were substantially reduced in an attempt to eradicate the inflationary anticipations quickly, unemployment is likely to jump substantially. Excessive slowing of the growth in demand and a sharp reduction in prices will generate unnecessary temporary unemployment until price expectations are gradually brought into line with the new reality of relative price stability. A more gradual reduction in the growth in demand and a more gradual reduction in the rate of price increase is consistent with little increase in unemployment.

We would like to accentuate more than does the Council's Report, however, our belief that the elimination of the inflationary expectations must be persistent and complete as well as gradual. If gradual action means that inflationary expectations are not reduced sufficiently by the end of calendar 1969, then aggregate demand policy in 1970 must be consistent with a continued reduction in such expectations to the point of elimination.

In this regard we are concerned about two features of the report. First, while the report is not precise about the pattern of economic activity throughout calendar 1969, it does suggest that real output will be accelerating toward the end of the year. It also suggests that the price level will still be increasing at a rate inconsistent with reasonable price stability. Should an acceleration of the economy arrest the decline in the rate of price increase before something close to relative price stability is achieved, we shall not have achieved the primary objective of eliminating the inflationary anticipations. To embark on a path of gradual reduction in the rate of price increase is better than pursuing a policy of sharp deceleration of demands *only if* the policy of gradually reducing demand is pursued long enough to achieve its objective. There is no assurance that a gradual reduction in the rate of price inflation in 1969 followed by an increase in price inflation in 1970 would be more in our interests than a substantial reduction in the rate of growth of demand in 1969. If we are to achieve our objectives for price stability we must take positive action to assure aggregate demands in the years 1969 *and* 1970 are consistent with decelerating prices.

Given this need for persistent and complete elimination of the inflation and inflationary expectations, we agree with the report's conclusion that the proper fiscal policy for fiscal year 1970 would be one that would yield a surplus in the Federal budget. It is mandatory, therefore, that planned Federal expenditures be reviewed closely in a search for opportunities to cut spending. Unless ways are found to reduce planned expenditures by a sufficient amount, it will be necessary, as the report recommends, to extend the income tax surcharge through fiscal year 1970 if a budget surplus is to be achieved.

Second, the report suggests that business and labor must make *sacrifices* in their price and wage decisions to assist the economy in achieving price stability. We think this is an ineffective approach to price stability. If the Government pursues actions to bring about price deceleration and if credit policies lead business and labor to anticipate a reduction in the rate of inflation they will in their own self-interest set prices and wages consistent with this deceleration; in this sense there need be *no* sacrifices. Wages and prices will have been set in the expectation of decelerating prices and such a deceleration will have occurred. There will only be sacrifices if business and labor make decisions in the belief prices will decelerate and the Government does not take action to bring this deceleration about. Business and labor make their decisions, in part at least, on their expectations with respect to the future. If these decisions are to reflect a belief in diminishing inflation the Government will gain little by exhorting business and labor to make sacrifices. It can affect wage and price decisions only if it shows *performance* in actually reducing inflation.

Thus the major emphasis in a policy to decelerate the rate of price increase and restrain inflation must be on controlling Government expenditures and taxes as well as on a stabilizing monetary policy, so that the economy exposes itself to very little chance that demands are excessive. A policy which places heavy reliance on attempts to administer prices and wages while at the same time managing fiscal and monetary policies so as to expand aggregate demand at dangerously high rates would be an inappropriate and highly inefficient plan.

Policies To Reduce the Frictional Level of Unemployment

Unemployment can arise in a variety of ways. Total demands may be less than the country's capacity to produce at stable prices. With the economy operating at or close to its potential, temporary variations in unemployment can arise because business and labor are unable fully to anticipate short-term business variations. In addition, a more permanent or persistent cause of unemployment arises from the seasonal character of some work, the difficulties of matching job skills and job locations, the faulty information about job prospects or labor skills, from the effects of discrimination by employers and unions, and from restrictive labor practices.

We agree with the council's report that there are several steps which can and must be taken to reduce the amount of unemployment arising from these sources. Such action must be taken for two reasons. The employment and income these workers could generate would provide the support they and their families need. In addition, however, programs to improve the competitive character and efficiency of labor markets will increase the productivity of those now working as well as enhance the productivity of the unemployed.

Thus, beyond its beneficial impact on the life and well-being of the unemployed and underemployed, programs which affect labor productivity affect all of us in the sense that they change the potential output in which we all have a share. Indeed, it has been estimated that as we continue to incorporate minority groups into our labor force more efficiently, this step alone will raise the rate of growth of our economic potential from about 4 percent to almost 4½ percent per annum. With the level of output in 1969 close to $900 billion, this implies that this more efficient use of our resources will produce an annual increase in our real output of almost $5 billion. If such a program were to have this impact over 5 years, output in the 5th year would be almost $30 billion higher than if we had not engaged in such programs. This social benefit is greater than the private benefit these families obtain from becoming more productive members of society.

Fiscal and Monetary Policy and Aggregate Demand

The Council's report deals at length with the specific impact of past fiscal policy actions on the economy. It leads one to the belief that we possess a knowledge of the impact of fiscal policy in rather sophisticated detail. On the other hand, it suggests that the impact of monetary policy is less clear. The exact mechanisms through which monetary policy works and the exact impact and timing are said to be unclear. The report concludes that it is likely to be unwise to attempt to use monetary policy with the hope of very closely controlling aggregate demand, that monetary policy should be flexible and not tied to any specific rule. We agree with these comments about monetary policy, but we think many of the arguments the council poses against attempts to use monetary policy to "fine-tune" the economy apply to fiscal policy as well. Just as it is unclear how different definitions of money supply affect spending decisions, there is at least some uncertainty about the effects on spending by the private sector of Federal spending as opposed to Federal lending, of Federal spending as opposed to Federal taxes, or direct Federal expenditures as opposed to transfer of payments, or of corporate income taxes as opposed to personal income taxes. The report itself attests to the difficulties of making very precise predictions of the savings behavior of individuals and the determinants of business investment and inventory accumulation. The report reflects the uncertainty in most minds about the exact impact of fiscal or monetary policy on interest rates and thus on savings flows to mortgage lending institutions and thereby to expenditures on construction.

We are not suggesting that we do not know enough about how monetary and fiscal policy affect the economy to enable us to use these tools to help us meet our economic objectives. However, we do not know enough about the precise effects of either monetary or fiscal policy to try to use them to contain the economy within very precise limits.

Economic Policy in 1969 and 1970

This difficulty in using either of these policies in very exact ways has substantial implications for economic policy in 1969 and 1970. The major problem facing the United States in the years immediately ahead is to eliminate the inflationary expectations which have been built up over the past 3½ years. The elimination of inflationary expectations requires that we expose our economy to very little risk of excessive demands—that we do not pursue fiscal and monetary policies which might lead to an acceleration of prices before the middle or end of 1970. Given our inability to predict exactly how fiscal and monetary policy work, we must take a fiscal and monetary policy position such that if we are wrong and if consumers and business expenditures as well as Government expenditures move differently than we expect, the economy does not accelerate too rapidly toward the end of 1969. Such a policy necessarily exposes us to some risk that the economy will grow too slowly and that unemployment will temporarily increase. Given our unwillingness to take sufficient action to control the inflation in the past 3½ years, however, the price we may now have to pay is this exposure to the risk of a temporary rise in unemployment. To be sure, we must stand ready to minimize the effects of this risk by being prepared to take steps to expand demand should it become clear it is growing more slowly than the return to relative price stability requires. In addition serious attention should be given to making existing manpower and training programs more effective in order to minimize any temporary rise in unemployment. However, since we are not able to use monetary and fiscal policies to control exactly the level of the economy and since the eradication of the inflationary expectations is our paramount problem, we must assure ourselves that aggregate demand does not accelerate too rapidly. From our current position, therefore, we must be more willing to bear the risk of a temporary rise in unemployment than to bear the risk of a reescalation of price increases.

The second major economic problem facing the United States is the necessity for improving the productivity and expanding the economic potential of a large fraction of our unemployed and underemployed workers. While a part of the poverty problem is not directly associated with this productivity problem, a very large part is. According to the report, two-thirds of the poor, nonelderly households are headed by able-bodied working-age men. The poverty of these families arises from an inability of these men to find jobs where their productivity enables them to earn a level of income high enough to raise their families above the poverty level. Vigorous efforts must be made to develop in these people the skills and motivation to be more productive and by working with business and labor to expand the job opportunities open to them. The Council of Economic Advisers has provided enlightening documentation of location and demographic factors associated with those families and persons experiencing low levels of income in the United States. It defines the "poverty gap" as the amount by which the income of these families and individuals falls below minimum income standards. In line with the concern for the productivity of many of these people, an alternate definition would be the shortfall of output they and the economy suffer because many of them have such low levels of productivity. Their individual and collective inability to produce efficiently generates serious social and personal problems as do their low incomes. Social action should concentrate attention on improving productivity and output of many of these persons rather than concentrate attention on income supplements.

The Overall Design of Government Programs To Influence the Economy

There is little doubt but that society collectively, with the Government as its agent, has a substantial responsibility and opportunity to affect the economy. We feel it should be a guiding principle of such action that the Government should enact positive programs which create the environment of competition and efficiency and which make the economy more adaptive and self-reliant rather than design a wide variety of specific programs to alleviate specific problems with little concern for their cumulative impact on the character of economic life.

On the basis of this point of view, there are at least two examples of such misplaced emphasis in the report. One is the role suggested for the Wage-Price Cabinet Committee. It is suggested that there exists a number of product and labor markets in which "discretionary" power exists—power which presumably does not exist in competitive markets. To deal with this problem the report suggests that the Cabinet Committee might evaluate the wage or price decisions made in these specific markets, publicize any supposed deficiencies, and attempt to obtain the cooperation of labor and business in reaching decisions which in the eyes of the Cabinet Committee were more in the public interest. Besides being an invitation to arbitrary and discriminatory practice on the part of such a committee and inviting a kind of collusion among producers and labor unions to "play the system," such a proposal is unlikely to achieve its objectives.

To the extent there exist restrictive practices in labor markets or product markets, the Labor and Justice Departments have the direct responsibility to deal with such illegal practices using their legislative or judicial authority, with due process. To establish a Cabinet committee with no such legislative or judicial authority is only to blunt the interest and activity of those who have authority to deal with the issues involved.

In another area society's attempts to assure adequate living standards for those living in poverty should concentrate as much as possible on assuring these people the opportunity of becoming productive rather than simply attempting to funnel income to them from the more productive members of society. Social welfare programs clearly require more than attempts to improve productivity. Some people and families will need income beyond what their productivity can earn and society will necessarily choose to provide this income to them. However, the major emphasis of the war on poverty ought to be a positive program directed toward improving productivity and output and the personal and social dignity which comes from being a productive member of society. Throughout this program and other Federal programs, the driving emphasis ought to be on creating mechanisms which have the effect of improving productivity and efficiency, of freeing markets and persons from dependence on Government action and programs, and of making the economy conform as closely as possible to the pressures of competition.

Toward International Equilibrium

In its examination of the international economy, the Council's report reviews the progress that has been made in the growth of international trade and capital movements since the end of World War II. We share many of the views expressed in this section. The contribution of the present IMF system, the importance of stable exchange rates, the need for continuing progress on the problems of liquidity, confidence, and adjustment, and the need for freer trade including reduction of nontariff barriers are subjects which we have studied and on which we have taken firm position in recent years. While we share many of the positions expressed in the report on the necessity of restoring equilibrium in the U.S. balance of payments, there are some differences between our veiws that also should be highlighted.

The basic objective of our international trade and financial policy should be to achieve the full benefits of international exchange for ourselves and others by reducing restrictions on international trade and investment. A primary requirement for the effective functioning of the international payments system is that the United States achieve equilibrium in its balance of payments and thereby eliminate a major source of instability which has impaired the effectiveness of that system in recent years.

As we indicated in our most recent policy statement, equilibrium in our international accounts does not require the elimination of the deficit. Rather its size should be reduced to a level compatible with the willingness of the rest of the world to voluntarily maintain or to increase their dollar holdings in line with the need for world liquidity. The reduction in our balance-of-payments deficit by means of restrictions on international trade and capital movements is inconsistent with our objective of securing benefits of greater trade and investment.

Despite some improvement in the underlying balance-of-payments position in 1968 compared to 1967, the underlying 1968 deficit (which excludes special transactions which our Government has persuaded other governments to undertake in order to make the recorded result look better) was still on the order of $2.7 billion on a liquidity basis. One encouraging aspect of the 1968 result is the large foreign purchases of U.S. stocks and there is some reason to believe that this trend will continue. However, there was also an unusually large inflow of foreign capital influenced by high interest rates in the United States and by reduction of outstanding foreign loans by U.S. banks. We cannot rely on these factors to provide lasting relief to our balance of payments.

The most disturbing aspect of the 1968 result was the virtual disappearance of our traditionally large merchandise trade surplus from a level of $3.5 billion in 1967. Clearly this reversal is critical. It results in large measure from a surge of imports induced by the inflationary growth of demand to which we have referred earlier. It is interesting to note that the growth rate in exports in 1968 was 9.5 percent, substantially above the rate in 1967.

We do not share the views expressed in the report that restrictions imposed by the United States for balance-of-payments reasons have been helpful. While they may have afforded temporary relief, by now it is evident that the controls have not restored equilibrium in our international accounts. Further, what started as a few, temporary controls have now become a network of apparenly more permanent controls which are wasteful, inefficient, and undermine our avowed objectives of encouraging international trade and investment.

While the report does stress the need for a domestic stabilization program to assist in the achievement of balance-of-payments equilibrium, we believe that this is *the critical need.* A stabilization program to achieve high employment and stable prices would serve to improve the trade surplus and to insure maintenance of sufficient dollar holdings by foreigners to reduce the need for controls.

The Council report notes a number of proposals which have been advanced for changes in the present exchange rate adjustment mechanism. While a review of the adjustment mechanism may be useful, we share the Council's view that intensive study would be required before serious consideration could be given to the adoption of any of the proposals which have been put forward. Such intensive study should focus on the practical effects on trade and investment flows of any changes from the present system.

COMMUNICATIONS WORKERS OF AMERICA

In both the statements of President Johnson's Council of Economic Advisers and the new Council for President Nixon, there are references to the necessity, under the existing economic circumstances, for *qualitative* adjustments in fiscal and monetary policies for 1969. In both statements there is a preoccupation with the problem of stifling inflationary pressures in the presence of persistence of some continuing troublesome residue of unemployment. This is expressed in an oft-repeated caution that it may be impossible to have full employment without some inflation. The policy considerations are concerned with the possibility that this problem is increasingly qualitative in nature, and that "doses" of ant-*in*flationary or anti-*de*flationary fiscal and monetary policy are not quite suitable as the remedy. The apparent requirement is alternatively expressed as a "fine mix" or "fine tuning."

As has been the case with the development of general fiscal-monetary policy, direction for the more refined problem must be looked for in the behavior of the economy. The lessons simply are a little more difficult to work out. The behavior of the economy in the last 2 years does appear to offer, however, some viable possibilities if they are carefully examined.

A central characteristic of the behavior of the economy over the last 2 years, despite inflationary pressuers and the pressures of the Veitnam war, has been a certain basic balance. Consumer expenditures have been an important expansionary force in the economy for the last 3 years, although slightly less so in 1967. In 1968, consumer expenditures rose by $42 billion, while the increases in the previous 3 years had been in the neighborhood of $32 billion, although only $25 billion in 1967. More importantly, however, as a percentage of disposable income, while consumer expenditures had declined for the preceding 4 years from 92.7 percent to 90.1 percent in 1967, they returned to 90.6 percent in 1968. Savings, on the other hand, which reached an unusual peak of 7.4 percent in 1967—in spite of some inflation—from 6.4 percent in 1966, held to 6.9 percent in 1968. Included in the increase in consumer expenditures was a strong $10 billion increase in durable goods purchases.

By contrast, business investment declined slightly as a proportion of the total national product, and business fixed investment declined by approximately the same amount in contrast to its usual tendency to rise in an expansionary year.

The main point is that investment, which used to be regarded as the prime mover in the economy and has been regarded as a primary target for monetary and fiscal policy, may new be less the volatile lever among economic variables in the economy. It is expected, as a matter of fact, that the first half of 1969 will see a strong *resurgence* of business fixed investment on the basis of the experience in 1968.

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It is somewhat startling to compare these changes with a number of other changes that took place during the last 2 years. During 1967, while the Government's 3.5-percent estimated productivity end of the wage-price guidelines was being effectively cracked, real average hourly compensation increased 3.2 percent, while productivity in output per man-hour increased 1.6 percent. The year saw a 6.1-percent increase in money earnings. During 1968, following effective "abandonment" of wage-price guidelines, money earnings increased 7.4 percent; real average hourly compensation increased 3.3 percent in spite of inflation; and it was supported by a 3.3-percent increase in output per man-hour. Unit labor costs, which rose 4.4 percent in 1967, only rose 3.9 percent in 1968.

Nevertheless, in spite of all this, corporate profits rose to an astronomical $92.3 billion from $81.6 billion in 1967, to continue what has been described as a profit inflation. This amounted to a 14.3-percent increase over 1967, although there had been a decline in 1967 from 1966. The fact is that the President's Council in 1967 viewed with alarm a development which suggested that the proportion of national income going to profits was increasing at the expense of a slightly decreasing proportion of income going to all wages and salaries. The Council wondered if the strong increase in the level of consumer expenditures for both 1965 and 1966 would hold up in 1967. It did not! What actually has happened to these shares is apparent in the record below:

[In percent]

Year	Share of national income		
	Profits	Wages (including supplements)	Other
1968	12.95	72.0	15.1
1967	12.5	71.7	15.8
1966	13.8	70.2	16.0
1965	13.8	69.8	16.4
1964	12.9	70.6	16.5

The figures for 1968 appear to indicate some evening up of economic shares in 1968, in the face of an inflation which might otherwise have produced opposite effects, as well as aggravation of inequalities which seem to have a fairly direct bearing on the behavior of consumer expenditures. The record for 1968 might be taken to indicate that reasonable distribution of productivity in 1968 enabled the economy, apparently still capable of real expansion, to push ahead in spite of the pressures on cost from inflation.

Of course, the growth in the second half of the year was dampened by the new surtax, while inflation slackened slightly. But this is a better adjustment to inflationary pressures than declines in production and employment. Clearly, also, profits have hardly suffered. While wages and salaries in 1968 finally reached 72 percent of the national income (from 71.7 percent in 1967), this was largely at the expense of interest, rent, and independent incomes, as profits moved up to 12.95 percent from 12.5 percent in 1967.

We think that these kinds of factors, involving a fine balance in the flow of goods and incomes in the economy, will have to become a focal point in the "fine tuning" of fiscal and monetary policy.

For example, a considerable portion of the high profits for 1968 are going to go back into investment, adding additional fuel to an already overheated economy. We noted earlier that the old Council contemplates a considerable increase in business fixed investment for 1969. A substantial portion of such investment will be in response to 1968's notable increase in purchases of consumer durables—which were not very strong in 1967, and may not be again in 1969. Indeed, some of the buying of durables in 1968 may well have been in response to anticipated price increases during 1969.

Increasingly, the economy is becoming consumer oriented—as might be expected in an affluent society. An additional measure of this may be found in the increase in the percentage of consumer expenditures which go for the purchase of services—which was around 37½ percent of disposable personal income in 1967 and 1968, 37 percent on the average from 1959 to 1966, and only 34 percent on the average over the period 1956 to 1958. In addition, new investment in plant and equipment has an increasing tendency to be capital saving, as well as laborsaving, and its increased productivity is going to have to be thoroughly distributed, or the time will come when all the products will not be purchased back.

These shifts in our economic situation appear to dictate some of the elements of a policy which may be pursued in an effort that may be called fine tuning.

In the past, economists have said that the major problem in achieving full employment without inflation was to balance aggregate monetary demand and aggregate supply. A critical factor is held to be the balancing of decisions to invest with decisions to save. This is because investment has always been regarded as the volatile element in aggregate demand. Indeed, if the proportion of consumer savings from the national income had not been inordinately large in 1967, we might have had more inflation that year.

Generally, Government policy to influence investment has been direct monetary policy or indirect fiscal policy. That is to say, Government has sought to influence investment decisions through the monetary mechanism and interest rates, directly. Indirectly, it has sought to influence investment decisions by increasing or decreasing spendable incomes through fiscal policy.

The difficulty with the latter policy, in the present circumstances, is that fiscal policy is a general onslaught against all spending. The requirements of "fine tuning" do not seem to permit this. Consumer expenditures are increasingly critical to stability in the economy. It is increasingly clear that high profits heavily outweigh the influence of interest rates in investment decisions. While consumer expenditures as a proportion of the GNP have fluctuated from something over 64 percent to something under, gross private domestic investment has fluctuated from 13.83 percent in 1961 to 16.56 percent in 1966—and suffered for it somewhat in 1967.

As the basis of a high proportion of incomes, consumer expenditures are heavily dependent upon wages and salaries, in order that goods and services for profit can be "cleared from the shelves" without inordinate, unanticipated increases in inventories. At the same time as purchasing power is maintained, it should not, of course, find a shortage of goods and thus produce inflation. If more purchasing power is channeled into time-consuming investment than is going to be provided from current savings, inflation will be the result. This condition has been the situation now for some years. Investment has proceeded apace in response to perhaps the wildest profit boom in our history.

It is in this context that we have never been able to accept the veracity of a voluntary "incomes policy" comprehended in wage-price guideposts. A sacrificial wage policy will not keep profits up, if consumer expenditures fall below the level anticipated as necessary to "clear the market," if the low-wage increases merely leave incorrect anticipations of higher profits. We think the wage policies of unions have helped sustain an expanding market by preserving the proportion of the national income going to wage and salary compensation.

The old Council urges labor to accept wage increases (money) of no greater than 5 percent, and businesses to accept profit margins no higher than the average achieved in 1967–68—probably as high as they have been in recent years—and asks that they absorb increases in unit labor costs up to 1 percent.

The profit margins of 1968 required a 2.6-percent increase in industrial prices. The corresponding increase in the Consumer Price Index was 4.2 percent. If these increases are approached in 1969, it does not appear that an increase in money average earnings of 5 percent would increase real average earnings sufficiently to maintain the present distribution, as between wages and profits, from the national income, unless there were less than a 3.3-percent increase in productivity—in which case the profit margin would not be retained anyway.

We find it gratifying that the new Council of Economic Advisers has abandoned the idea of wage-price guidelines as a mechanism for maintenance of distributive shares. Since, as the Wall Street Journal recently acknowledged, it is *prices* which lead *wages* upward, a guidelines policy is poorly designed for its job—because it always leaves wages behind. While wages and salaries have gone up by 40.5 percent since 1960, profits have gone up 85.7 percent.

We think profit margins are already too high, and offer too high an incentive for further investment. We note a recent release from the Internal Revenue Service indicating that, for the fiscal year ending in June 1968, while individual income tax collections increased by $8.7 billion over the previous year, corporate income tax payments declined by $5 billion. Note that this period covered the higher rate of expansion in the first half of calendar 1968.

The current additional "dosage" of indirect fiscal policy contained in the 10-percent surtax, though probably necessary to curb a runaway inflation incident to heavy governmental expenditures, does not appear to be depressing investment aspirations as much as it affects consumer expenditures, if the last half of 1968 is any indication. We suspect that this is partially the effect of high returns from investment in industries with a heavy concentration of Government contracts.

We think it is time to attack inflation on a discriminating basis, by a frontal attack on the proportion of national income going to profits as compared to wages and salary compensation, in order to stabilize consumer expenditures without inflation. Consumer expenditures have been quite stable as a proportion of the national product—but only with inflation. We think the problem of maintaining consumer purchasing power for increased consumer goods and services without inflation is directly related to the issue of tax reform.

In addition, in the midst of inflation, we continue to have "pockets" of hard-core unemployment and serious "pockets" of poverty amid affluence. Continuing unemployment is always a waste in any form. We think the new Council has correctly made a decision that a discriminating expenditure policy is required here, too, as compared with some "dosage" of fiscal policy. Both the unemployment and the poverty problems are also related, in our mind, to tax reform.

The present revenue level from individual income taxation can be retained with considerable shifting in the progressivity of the individual rates. We feel that this should be done on a basis which would allow negative income taxation at poverty levels, exemption from income taxation on family incomes between $3,000 and $5,000 a year, the imposition of a minimum tax on all income above a reasonable level, and the application of higher marginal rates at high-income levels.

We think the corporate income tax should be overhauled as well. For one matter, the existing rates are considerably overstated on the basis of current depreciation and depletion guidelines. These were a part of an earlier tax reduction and recession-induced expansion program, and are contributing to the present inflation. In particular, the continuation of the oil depletion allowance is scandalous and an affront to the poverty ridden, not only of the United States, but of the world.

Higher corporate income tax rates will reduce the level of investment expenditures and induce more careful use of resources. If higher individual income tax rates on higher incomes are to be put into effect, some partial exemption from a higher corporate tax rate schedule could be given to distributed corporate profits (dividends). The latter measure might alleviate a number of the current pressures in the money market. However, if the latter effect is not forthcoming, we feel there is an urgent need for Federal subsidization to lower interest charges on housing and residential construction. Investment in these areas has been drained by high profits elsewhere.

While we agree that tax credit for investment in training and education of the unemployed through private enterprise is a nice idea, we feel that this would become a very unwieldy mechanism, and we are in serious doubt as to the interest of private enterprise in this particular problem. On the other hand, direct cooperation between Government and private enterprise will be a necessary base for solutions to the problems of the hard-core unemployed.

We would hope that movements in these directions could be a substantial step toward dealing with some of our more vexing domestic problems.

Finally, we offer some comments on the balance-of-payments problem. It seems clear that the various measures undertaken during 1968, including direct controls on foreign investment, the cessation of gold shipments for private markets among the gold pool nations, and the ending of the gold-backing requirement for U.S. currency, have temporarily allayed any immediate balance-of-payments crisis.

We cannot help noting, however, the necessity of Government controls on direct foreign investment as an interesting commentary on the haste of American profits to seek an ever-higher rate of return, in the midst of developing inflation at home. Actually, it now begins to appear that this program has less resistance as a result of investment abroad, perhaps having run most of its course before the restrictions were imposed. In contrast, the net balance on foreign investment income now has attained a level such that it has given considerable improvement in the balance-of-payments problem. Although it may be true that we cannot assume the same improvement increments in future years, there does not seem to be any reason to believe that this factor will recede very quickly.

The overriding issue in the balance-of-payments problem lies in the fact that, presumably, we have been importing too much. Ironically, a larger factor in this has been the importing of I O U's—"exports" of capital which have given others claims on us. In a free market for international exchange, this should have meant that there was a growing demand for foreign claims in order to pay for foreign debts, and a consequent premium for exporters who provide the major source of such foreign claims. Of course, when it becomes too expensive to liquidate debts through the exchange system, there are, as there have been, gold payments.

This increasing pressure has suggested that a freeze on gold and "freely fluctuating exchange rates" would correct the import situation. We now have, for practical purposes, the gold freeze. The objections to a proposal for freely fluctuating exchange rates center around problems of uncertainty, disturbance to trade and investment relationships, and requirements of shifts of resources among industries which export and those which compete with imports. Most of these arguments are invalid from an economic point of view. The only ultimate remedy in a world economy in which gold no longer is an adequate medium of exchange is freely floating exchange rates.

However, inasmuch as our international trade still only amounts to 5.3 percent of GNP, other international considerations may be regarded as more pressing. Under freely flexible exchange rates, much importing would likely be cut off. The present domestic inflation, as a matter of fact, receives some relief from imports. On the other hand, we feel some approach to flexible exchange rates will have to be made in the not-too-distant future.

Summary

In summary, it is our view that the "fine tuning" which is called for under a gradualistic approach to deflation ought to concentrate on the profit-push phenomenon, and its insidious ally, the new boom in corporate investment. Coupled with such an approach must be a serious and searching restructuring of the entire Federal tax-levying mechanism, with a view to long-range revision of the distributive shares of our national income.

CONFERENCE ON ECONOMIC PROGRESS

By Leon H. Keyserling,* President

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* Former Chairman, Council of Economic Advisers; consulting economist, and attorney.

CHARTS

(Appearing at end of statement)

INTRODUCTION

Once again, as in previous years, I deeply appreciate the opportunity accorded to me by the Joint Economic Committee to set forth my analysis and conclusions related to the Economic Report of the President and the Annual Report of the Council of Economic Advisers.

Reasons for main concentration upon CEA Report

In the very nature of things, there must be almost absolute consistency between these two documents. It is fair to state, without any implication of criticism, that the President's Economic Report tends to become virtually a summary of the Annual Report of the Council of Economic Advisers. This Annual Report contains, entirely appropriately, the detailed economic analysis and other statistical appraisals, as well as the economic forecast, upon which the President's Report is based. For these reasons, it would appear to be most helpful to the Joint Economic Committee for me to concentrate upon the CEA Report, and this I shall do in accord with my practice during recent years.

Need for a long-term perspective

The 1969 CEA Report brings to a close a clearly distinguishable era in the development and application of national economic policies, extending from January 1961 through December 1968. Those who have been basically responsible for these policies have given them the appealing appellation of the "New Economics." It was reasonably to be expected, and in fact it has so developed, that the final CEA Report of the "New Economists" should be, in substantial measure, an explanation, defense, and praise of the policies, accomplishments, and economic philosophy of the "New Economics."

It would therefore seem most fitting, and I hope most helpful to the Joint Economic Committee, that I focus mainly, not upon what has happened during the past year or so, but instead focus in broad perspective upon what has happened during the past 8 years, and in this larger view appraise the "New Economics" of the recent CEA members.

This course seems particularly desirable at this time, for at least three reasons:

First, it has long been my view that economists in general, including conspicuously the "new economists," have devoted relatively too much attention to short-range trends and policies, and far too little attention to long-range trends and policies. In the main during the most recent years, the "fine tuning" attempts to adjust policies and programs to short-range trends have in some important respects been unsuccessful, not primarily because of detailed errors in judgment, but rather because of failure to invoke sufficiently a longer term perspective. So-called fine tuning has fallen short, not primarily because of the nature of the instruments, but primarily because the listening apparatus has been far too circumscribed and insulated. It is my view that the greatest single improvement in national economic policies would be to turn more sytematically and comprehensively to longer range analysis and programs. Indeed, I believe this to have been the core intent of the Employment Act of 1946.

A second reason why this appears to me to be a very appropriate time to evaluate the "new economics" in the full perspective of 8 years is this: It is the very nature of our political system that the recent change in the national administration should be expected to bring forth a fundamental reexamination of national economic policies and programs, and some considerable changes in them. It is my hope that the type of analysis which I shall bring forward may be helpful toward changes in proper directions.

In the third place, the fundamental approach I am undertaking would seem desirable, because we now stand at what appears to be a clear and important transition in the economy. Despite the current stress upon curbing inflationary forces, which has come to amount to almost a sole preoccupation, the even more important challenge now confronting us is the threat of a serious retardment in the rate of real economic growth, a serious rise in unemployment, and in consequence an increasing inability—at least in the context of general attitudes—to meet adequately the great priorities of our domestic and international needs.

Plus marks for the "New Economics"

There can be no doubt that the "new economics" has accomplished much, even though these accomplishments have unfortunately been accompanied by an unusual degree of public self-praise which has impeded critical evaluation. For the 8 years as a whole, a high, though not entirely satisfactory, rate of economic growth has been maintained. Unemployment has been reduced greatly, even though not sufficiently. For the 8-year period as a whole, in terms of the realities rather than the ideal, a fair measure of average price stability has been maintained. Established programs, devoted to the well-being of the people, have been greatly expended. Many innovative social programs have been initiated, some of them successfully. The conscience of America has been aroused to the problem of poverty, even though the measures forged to deal with it have thus far been inadequate and disappointing. The responsibility of national fiscal and monetary policies to contribute to economic stability and growth has fortunately become increasingly recognized, even though the equal or even greater responsibility of these and other national policies to improve income distribution and enlarge social justice has been grievously neglected. The level of economic literacy and interest has been greatly elevated, largely through national leadership, and an enlarged consensus on many important matters has been achieved, perhaps enduringly.

But many problems have remained unsolved, some vital problems have been seriously neglected, and economic analysis and policy-making have been guilty of many serious errors of commission and omission.

Minus marks for the "New Economics"

The above critical comments would not seem excessive. Despite policies put forward to achieve stable and optimum economic growth, the real growth rate for the 8-year period as a whole has been somewhat on the low side, the 2-year period 1966–68 averaged a palpably and seriously deficient real rate of economic growth, and the short-term outlook can hardly be called favorable. Meanwhile, instead of seeking to reverse this low-growth-rate trend, policies and exhortations seem directed toward carrying it further. Dspite programs and policies put forth to curb inflation and improve the balance-of-payments situation, the 2 most recent years, and especially the past year, have evidenced the highest rate of price inflation since one short period during the Korean war, and the end is not yet. The international financial situation remains parlous, and fundamental remedies have been avoided. Despite the long-avowed promise to get unemployment down to levels consistent with maximum employment, the rate of unemployment among some vulnerable groups remains tragically high, and is contributory to political, civil, and social unrest, notoriously in our urban areas. Despite the promise to move toward a Great Society, which in proper context clearly means a good society, some of the greatest and most pressing priorities of our domestic public needs remain sorely neglected. And there have not thus far emerged, either in the pronouncements of the "new economists" or in the declared intentions of the new administration, any substantial and specific programs and policies offering reasonable prospects of overcoming these manifold difficulties.

Significance of my earlier studies

I approach the task of specifying my reasons for the foregoing conclusions with mixed feelings. On the one hand, I regret that more and better have not been done, and this is my primary sentiment. On the other hand, I feel justified, rather than prideful, in calling to the attention of the Joint Economic Committee and others that, year by year for many years, my presentation of matters to the Joint Economic Committee and to the public at large have identified fairly consistently what was going wrong, and have to a high degree been vindicated by where we now stand. I take no particular satisfaction in this, except that I feel duty bound to point out that there is a lesson to be learned, that is, that the extent to which I have turned out to be correct may be explained mainly by my attempt to work in a long-range perspective.

Thus, it might be profitable and in the public interest for economists in the public service, and others, to examine more carefully than they have thus far done what I have made available to the Joint Economic Committee practically year by year during the past 8 years.

Outline of my presentation

I shall deal specifically with the following:

I. The problem of optimum economic growth.
II. The problem of economic equilibrium or balance.
III. The problem of social equilibrium, or plain justice.
IV. Fiscal policy.
V. The problem of inflation.
VI. Problems of monetary policy.
VII. The international economy.
VIII. The Economic Report of the President.
IX. Summary of my own recommendations.

In dealing with the first seven of these nine topics, I shall in each instance state first my own analyses and conclusions (responsive, naturally, to my examination of the CEA annual report), and then discuss those portions of the CEA report which seem to me most relevant.

I. The Problem of Optimum Economic Growth

The growth record and the growth need in detail

During 1960–68, the average annual rate of U.S. economic growth was 4.8 percent in real terms, a marvelous record when compared with the 2.4-percent average rate during 1953–60. Nonetheless, the evidence is strong that this performance was somewhat short of the optimum, particularly when one considers the historic record; the identity of optimum economic growth with optimum resource use; the current level of unemployment, and more essentially its distribution; the imperative nature of our unmet domestic needs; and the scope and weight of our international obligations.

Turning first to historical review: Our average annual rate of real economic growth was 4.7 percent during 1922–29, 4.5 percent during 1947–50, 5.1 percent during 1950–53, 5.1 percent during 1960–66, 4.8 percent during 1960–68, and 5 percent from 1967 to 1968. I should mention at this point, although I will deal with the inflationary problem in detail later on, that the periods 1922–29 and 1960–66 were characterized by a quite satisfactory degree of price stability, and that the price inflation during a portion of the period 1950–53 was mainly a speculative reaction to the Chinese intervention in the Korean war, and was not due to an excessive rate of economic growth. All this appears to support my conclusion that the 4.8-percent average annual rate of real economic growth during 1960–68 was somewhat on the low side. In view of technological trends, the unsolved unemployment problem, and the pressures of our domestic and international needs, I believe that we should aim toward a real rate of economic growth averaging at least 5 percent annually from 1970 to 1977, and averaging about 6 percent during 1968–70, toward restoration of optimum resource use.

The "longest upward movement on record," and the economic outlook

More important still, the 4.8 percent average annual rate of real economic growth during 1960–68 is not indicative of the most recent trends, nor of the economic outlook. From 1966 to 1967, the real rate of economic growth fell to only 2.5 percent, and the average for the 2 years 1966–68 was only 3.7 percent. Taking into account current informed forecasts, and the purpose of recent and current economic policies to "slow down" the economy further, there is strong evidence that we may be reverting to the recurrent periods of economic stagnation, if not absolute recession, to which I commenced to call attention so insistently from 1953 forward. It is remarkable and indicative that this possibility has thus far received so little attention.[1]

Actually, the insistent chorus about "the longest upward movement on record," from early 1961 to date, has been both misleading and overly prideful. The recovery movement from early 1961 until circa the massive tax reductions of 1964 was not the result of important positive changes in national economic policies. It was more or less a normal or autonomous recovery after the mini-recession of late 1960, early 1961, and continuation of the recovery from the substantial recession of 1957–58. This movement from 1961 forward was hardly more impressive than the upward movements which had followed the periods of stagnation and then recession during the years 1953–60, and it was recognition of this lack of impressiveness that finally prompted the massive tax reduction in 1964.

These massive tax reductions provided a very strong stimulus to the economy for less than 2 years, but even that amount of money thrown into the streets and scrambled for would have done that. Because these tax actions represented a basically erroneous analysis of the entire problem of economic equilibrium or balance (as I insisted at the time of their enactment, and as I shall discuss further when I come to the matter of fiscal policy), the real rate of economic growth turned very sharply downward early in 1966 and has averaged far too low during 1966–68. Moreover, I believe the developments during 1966–68 would have been far more unfavorable, and might well have carried us into an absolute recession, but for the unexpected acceleration of defense spending due to the Vietnam war and some other factors. After all, measured in current dollars, national defense spending rose from $50.0 billion in 1964 and $50.1 billion in 1965 to $60.6 billion in 1966, $72.4 billion in 1967, and $78.9 billion in 1968 (calendar years). There is no particular trick in maintaining an upward movement, albeit at a declining real rate of growth, in the presence of these kinds of jumps in defense spending. Those who are still chuckling about their role in promoting "the longest upward movement on record" should have it recalled to their attention that we have also had "the longest war on record."

Regardless of the merits or demerits of that war, these most recent developments appear to have justified my earlier findings that a more rapid expansion of Federal spending than earlier had been projected

[1] See chart 1, following text.

would be essential to maintenance of an adequate rate of real economic growth. The lesson to be learned from this, which has not yet been learned, is that we should contemplate large increases in domestic spending for priority needs during the years immediately ahead, and further that these increases should be much greater than any reductions which may result from a change in the international situation, or from our reactions to it.

Productivity trends, and their significance

Careful examination of productivity trends more than support my findings as to the needed rate of real economic growth, in order to absorb the annual increments in our productive capabilities under conditions of reasonably full resource use. Over the decades, under the impact of advancing technology, inventiveness and innovation, rising labor skills, improved management, and more effective public policies, the average annual rate of productivity growth in the U.S. private economy has tended to accelerate greatly, except when inhibited by the repressive influence of inadequate demand and low real economic growth. Thus, the average annual rate of productivity growth in the U.S. private economy was 0.4 percent during 1910–20, 2.3–2.4 percent during 1920–40, and 3.2 percent during 1940–55. (It was 4.0 percent during 1947–53). It fell to a 2.4 percent during 1955–60, when the real rate of economic growth was very low and punctuated by two absolute recessions. But during 1960–66, the average annual rate of productivity growth rose to 3.7 percent. And it averaged 3.5 percent during the full 8-year period 1960–68, even though it averaged only 2.4 percent during 1966–68, when the real rate of economic growth averaged the unacceptably low level of only 3.7 percent. The only reason why the very low economic growth rate during 1966–68 did not increase unemployment was that underutilization in the plant, resulting in much lower productivity, was preferred to more overt unemployment. These two dismal alternatives are not acceptable, nor could they be available enduringly even if acceptable. This leads me to the conclusion that the productivity growth-rate potential in the U.S. private economy during the years ahead cannot possibly be less than in the neighborhood of 4.0 percent and may be considerbaly higher, under conditions of optimum resource use. Even allowing for a lower productivity growth rate in the public sector (not yet subjected to enough analysis to verify this common assumption), it appears that the productivity growth rate potential in the total U.S. economy for the years ahead must be in the neighborhood of 3.5 percent, or even higher. Adding to this the projected growth in the civilian labor force under conditions of maximum employment, about 1.5 percent, the optimum overall U.S. economic growth rate during the years ahead cannot be less than 5 percent, after restoration of reasonably full resource use, and might even be considerably higher.[2]

Bearing of rate of economic growth upon employment and unemployment

There are even more important reasons for striving to restore and maintain optimum economic growth than those set forth above. Never during recent years have we come close to reasonably full utilization

[2] See chart 2, following text.

of our basic productive capacities. In 1968 and on into 1969, many if not a majority of our key industries were operating at capacity levels well below the optimum.

Although officially recorded unemployment averaged only 3.6 percent in 1968 (not far from the 3.8 percent in both 1966 and 1967), the true level of unemployment in 1968 (taking into account the full-time equivalent of part-time unemployment, and the concealed unemployment resulting from those not participating in the civilian labor force because of scarcity of job opportunity and therefore not counted as unemployed) was in the neighborhood, as I estimated it, of 4.2 percent or higher. Moreover, as we all know, unemployment has tended to be two to three times as high among teenagers and Negroes as the nationwide average, and has remained as high as 30–40 percent in some critical sectors of some urban areas. We simply cannot afford to tolerate the urban consequences already revealed, nor those in the offing, which stem so largely from this amount of unemployment.

One of the most striking illustrations of poor economic analysis is the viewpoint expressed by many economists, and at least intimated by the CEA, that the average level of unemployment is not now too high (or may even be too low from the viewpoint of combating inflation), and that the excessively high level of employment among vulnerable groups is a "structural" problem rather than a problem of aggregate demand or overall economic growth. They therefore conclude (as does the CEA 1969 report) that this structural problem should be dealt with by measures which do not aim at a more rapid expansion of aggregate demand or a more rapid rate of economic growth.

The use of the word "structural" may be valid in explaining that the unemployed are unemployed because of an improper fit between them and existing jobs, and that programs of training and other forms of adaptation are needed (even though that explanation is seriously overworked). Be that as it may, how can the level of excessive unemployment among the vulnerable groups be reduced, without reducing the nationwide average level of unemployment, unless the reduction of unemployment among the vulnerable groups is to be accomplished by more unemployment among others? Further, whatever may be the reasons why an unemployed person is unemployed, and even if it were to be assumed that there is a "job vacancy" awaiting for him if he were more fit, it still remains true that a job vacancy is not a job. A job vacancy involves no expenditure, while the putting of an unemployed person into a job involves an expenditure sometimes estimated in the nature of $15,000.

It follows that putting a million people (I take this figure arbitrarily, merely by way of example) who are now unemployed into jobs would involve additional outlays in the neighborhood of $15 billion, which means an increase of that size in aggregate demand, and correspondingly means a considerably higher rate of economic growth in real terms. There is absolutely no merit in the proposition that unemployment can be reduced to acceptable levels, without expediting the rate of real economic growth. Those who ignore this fact are curiously inconsistent when they argue that slowing down the rate of real economic growth to combat inflation would result in more unemployment.

Targeting economic growth through 1967, and its significance

The vital importance of an optimum rate of economic growth is indicated by estimating, for the 10-year period 1968–77 inclusive, the difference between an optimum rate of real economic growth (somewhere in the neighborhood of 5.3 percent as an annual average, and a 3.5 percent average annual rate of economic growth (cf. the rate of 3.7 percent during 1966–68). The difference, measured in fiscal year 1969 dollars (as estimated in January 1969, and for the purpose of approximating the current price level) comes to $1,255 billion over the 10-year period, or an average of about $125 billion a year, and comes to $226 billion in 1977 alone. Surely, we cannot afford to forfeit these amounts in terms of real goods and services, or anything even approximating them, when we consider the tasks that confront us, and how far we are from doing more than scratching the surface with respect to many of them.[3]

My next two charts depict in more detail my optimum high and low economic growth projections through 1967, and also indicate how well they maintain the traditional balance between private and public responsibilities.[4]

The erroneous views of the CEA on economic growth

I turn now to what the 1969 CEA report says on the subject of economic growth, bearing in mind that what it now says is quite consistent with the position it has been taking in earlier years. What the CEA now says indicates why I have felt it necessaary to develop this phase of my analysis so extensively, and perhaps may convince many others as to the validity of my conclusions.

The 1969 CEA report states that the increase in the U.S. growth rate potential was at an average annual rate of about 3.5 percent from the mid-1950's to the early 1960's; that for the last few years it is estimated at 4 percent a year; that it was 4 percent from fourth quarter 1967 to second quarter 1968; and that it was 4 percent at the end of 1968. The CEA therefore concludes that this is the growth potential for the years shortly ahead (pp. 40, 45, 64, 66).

The CEA bases this finding upon the observation that, since 1950, the annual growth rate of productivity in the private economy was 3 percent, and for the entire economy 2.5 percent, and that adding to this a 1.5 percent annual growth in the civilian labor force results in the 4 percent figure (p. 66).

I find it utterly impossible to find any justification for this CEA finding, in view of the productivity trends which I have depicted (consistent with data appearing in CEA reports). The CEA *average* of productivity trends since 1950 is the result of very different productivity trends during periods of rewarding economic growth, economic stagnation, and economic recession. Such an average figure would be acceptable only if the goals for the future were to contemplate recurrence of these same three types of periods. Such an average has nothing whatsoever to do with the growth potential, nor with sustained maximum production and employment under the mandate of the Employment Act of 1946. And such a finding by the CEA appears even more outlandish, when the CEA itself admits that only a serious departure

[3] See chart 3, following text.
[4] See charts 4 and 5, following text.

from optimum growth reduces the productivity performance to levels consistent with the 3-percent average in the long run. Thus, the Council finds: "In early 1967 the diminishing pace of the expansion was reflected in a slowing of productivity growth rather than a sharp rise in unemployment" (p. 34).

The CEA does even worse than this. It does not set a target for real economic growth during 1969 even at this improperly low 4-percent figure. Whether interpreted as a goal or as a *welcome* forecast, the CEA says: "The rise in real output during the four quarters of 1969 should be less than 3 percent," consistent with a 6-percent rise in price terms (p. 56).

Why does the CEA want us to move in this direction? Its answer is made clear: "Although economic expansion is expected to moderate during the first half of 1969, a continuing policy of restraints is essential to curb inflationary pressures and to strengthen our international trade performance" (p. 53). My comments as to the quality of the finding that we should further reduce the rate of economic growth as a "promising" way of containing inflation will come later. My other comment comes now: It is, in my view, frightening that we should be willing to forfeit what will be forfeited by bringing the real rate of economic growth so low, risk the unemployment which will result, risk the recession which may result, and starve our domestic priorities to the extent built into the achievement of this objective, meanwhile regarding the problematical strengthening of our international trade performance as a gain comparable to this forfeiture.

II. The Problem of Economic Equilibrium or Balance

Essentials of economic equilibrium or balance

No economist of substance would deny that maintaining an optimum rate of economic growth, and maintaining optimum employment consistent with minimal or frictional unemplyoment, depend essentially upon an economic equilibrium or balance in the allocation of the current or functioning GNP between (a) the investment which adds to our capabilities to produce and (b) ultimate consumption in the form of private consumer spending and public outlays combined. Yet there has never been a time when the "New Economists" or the CEA reports have offered tangible and substantial quantitative evidence of coming to grips with this analytical problem, or of adjusting policies and programs accordingly. This has been an oversight so glaring that I have been unable to offer a rational explanation for it.

The closest that the CEA has come to any such attempt was when it suggested, some years back, that optimum economic growth depended upon a much higher permanent ratio of investment in plant and equipment to GNP. However, as I have frequently pointed out, (a) a *sustainable* ratio of such investment to GNP depends upon the productivity of capital (which is advancing), not upon the overall growth rate targeted, and (b) the record since 1952 has uniformly shown a strong tendency toward relative overinvestment of this type, corrected only when "overcapacity" leads to sharp cutbacks in such investment, with unfavorable consequences throughout the economy.

The empirical evidence, detailed in my repeated public studies from 1953 forward, has made it very clear that the transition from moderately adequate though not optimum economic growth to stagnation and then recession occurred when the failure of ultimate demand as I have defined it (or, even more pertinently, the private incomes and public spending which underlie ultimate demand) to keep up with the investment in plant equipment which is primarily responsible for our increasing capabilities to produce became abundantly visible.

From the time of the advent of the "New Economics" in early 1961, I continued my studies along these same lines. Well before 1966, I pointed out that the same type of disequilibrium augured the very sharply reduced average annual rate of real economic growth during 1966–68. In fact, my opposition to the massive tax reductions of 1964 and some subsequent tax concessions was based upon the proposition that, while these would stimulate the economy for a time, they were in the longer-run so enormously misdirected that they would bring on another period of serious economic stagnation, and *increase inflationary manifestations to boot.*

It is true that the "New Economists" and the CEA reports at times, but almost entirely as a matter of hindsight, observed that investment in plan and equipment was advancing relatively too rapidly to be sustainable, and advocated such measures as the suspension of the investment tax credit. But later on they advocated its reinstitution, and I could never understand why, because this contributed further to the economic disequilibrium. I shall deal further in detail with these tax or fiscal policies later on in my statement.

Factual anatomy of the economic disequilibrium

An examination of relative trends in various key sectors of the economy illustrates rather dramatically how the economic disequilibrium made itself manifest, and indeed was aggravated by key policies and programs. From 1961 to 1968, measured in constant dollars, total national production grew 42.2 percent, private consumer spending grew 39.6 percent, and government outlays for goods and services at all levels grew 50.1 percent.

Private business investment (including net foreign) grew 42.3 percent, but this reflected home construction on the average far below our priority needs. Private investment in plant and equipment, and this is the indicative figure, grew 65.7 percent. The disequilibrium in income flows was roughly compatible. Wages and salaries grew 45.5 percent, total labor income including fringe benefits grew 51.2 percent, and farm proprietor net income grew only 3.1 percent, while corporate profits and investory value adjustment grew 55.4 percent, personal dividend income grew 58 percent, and personal interest income grew 84.9 percent.

The rampant profit inflation

It is equally important to look at the trends during 1967–68 alone. First, of all, the disparities indicated in the previous paragraph were even greater during 1961–67, but were "corrected" somewhat by what happened from 1967 to 1968. But what were the nature of these corrections? The main correction was that private investment in plant and equipment shrunk to an annual growth rate of only 1.0 percent. That is far too low. However, this happened just because of the disequilibrium created by the relatively excessive advance of this type of investment for a number of years. This is one of the most striking illustrations of the entire equilibrium thesis which I have set forth for so many years, and restated in earlier portions of my discussion above.

Moreover, and again in substantiation of my basic thesis, this private investment in plant and equipment did not turn down so sharply during 1967–68 because of any general inadequacy of profits or other investment funds. It turned down because relatively excessive profits in earlier years contributed powerfully to the various disequilibrium which brought about the sharp investment reaction during 1967–68.

Equally or even more seriously, the relatively excessive and disequilibrating profit binge continued on into 1968, and so did the price increases which fed them, despite the ominous warning signal in the sharp downturn in private investment in plant and equipment. During 1967–68, measured in constant dollars, while wages and salaries grew only 5.6 percent, labor income only 6.5 percent, and farm proprietors' income only 1.4 percent, corporate profits and inventory adjustment grew 7.1 percent, or considerably more rapidly than the average annual rate of advance (allowing for compounding) during the 7-year period 1961–68 as a whole.[5]

In short, the disturbing inflationary trends during 1967 and 1968 have been very clear demonstrations of profit inflation. This is one of the most dangerous and disequilibrating kinds of inflation. One must be deeply concerned that this whole matter has been so completely disregarded in the 1969 CEA report, and equally so in the whole range of policies which emerge from the highly defective CEA analysis. Instead, the CEA urges that real hourly wage rate increases be held to 2.0 percent during 1969.

To reinforce this profit point by returning to the 1961–68 analysis in another aspect: From 1960 to 1968 (measured in current dollars, which is satisfactory for the purpose), prices in total manufacturing rose 7.5 percent, contributing to an advance of 111.6 percent in profits after taxes. Reflecting in part the profit yield, investment in plant and equipment grew 84.9 percent, but wage rates grew only 33.1 percent. In motor vehicles and equipment, prices rose 3.8 percent, profits after taxes 89.4 percent, investment in plant and equipment 71.9 percent, and wage rates only 34.4 percent. In three other key industries shown on the same chart, the respective trends told essentially the same story. My utilization of wage rates rather than aggregate wage payments in this exercise appears to me to be justified for a variety of technical reasons which I shall not cover at this point, although much light is shed upon this problem by my subsequent discussion of the comparative trends in productivity and hourly wage rates.[6]

CEA neglect of economic equilibrium problem

The poverty of economic analysis displayed by the CEA throughout the years, with respect to the whole issue of economic equilibrium, is genuinely distressing. Considering the resources available to the Council and the importance of the problem, and the rich experience made manifest in the performance of the American economy under widely different sets of circumstances, one would have thought that by now the CEA would have developed and made available a thorough

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[5] See chart 6, following text.
[6] See chart 7, following text.

and discerning study of this whole problem of economic equilibrium. My own view is that, by now, they should have had a 50-page chapter in one of their annual reports on this subject.

But only pages 70 to 74 are devoted to the "Problem of Economic Fluctuations" in the 1969 CEA report. The quality and depth of what is said is revealing indeed. We learn this:

"Sudden changes in Federal spending have, on occasion, seriously disrupted the stability of the economy" (p. 71).

"Consumer outlays normally follow the path of household incomes fairly closely" (p. 71). This statement is so bland that it masks some of the most serious problems in the whole area of economic equilibrium. Variations in the rate of saving, at any given level of aggregate consumer incomes after taxes, are profoundly important. Why and how have these variations occurred? The ratio of aggregate personal saving to aggregate personal income after taxes is profoundly affected by income distribution. What is the significance of this, in the actual context of what has been happening to the economy during the past 8 years?

"But fluctuations in capital spending have often been important sources of instability. For example, real investment (constant prices) rose by 42 percent between 1963 and 1966, contributing to a strong expansion of aggregate demand, but this leveled out in 1967" (p. 71). This is true, but what conclusion does the CEA draw from it? I pointed out in 1963 (not in 1969) that the proposed tax reductions would have just this unfortunate result by way of disturbing further the economic equilibrium. Is the CEA now prepared to reappraise its fiscal policies, or does it continue to extoll them, except to the extent of claiming that the Congress prevented action as promptly as it otherwise would have been undertaken?

III. The Problem of Social Equilibrium, or Plain Justice

Identity of economic and social objectives in the United States

Even if the policies and programs of the "new economics" in general, and of the CEA in particular, had not been erroneous during the past 8 years with respect to the restoration and maintenance of economic equilibrium or balance, they were certainly highly vulnerable from the viewpoint of social equilibrium, or plain justice.

It is conceivable, in some economies, that social justice must temporarily be sacrificed in the short run, in the interest of economic development and growth, narrowly conceived. That may be true of an underdeveloped country, such as India. But it is not true of an economy so highly developed and richly endowed as our own. If called for, even some sacrifice of optimum economic growth would be justified in the cause of social equilibrium, in that we are a wealthy enough economy to afford to do justice and—as we have recently learned at great cost—too sensitive a body politic to afford to do without it.

But the case is even stronger than this. In line with the economic analysis set forth above, the failure to achieve or maintain economic equilibrium at optimum resource use and optimum economic growth has been inextricably interwoven with the failure to achieve an improved allocation of income flows and human employments in terms of the criteria of social equilibrium, or plain justice. It is one of our essential assets as a nation and a people, and we should exploit it to the hilt, that economic progress and social progress call essentially for the same policies and programs.

More consumption relative to investment would have been, and still would be, more conducive to both types of equilibrium. Better income distribution would enlarge the propensity to consume. Lifting the poor to at least minimum-decency standards of consumption and living would open up additional markets for the products of our factories and our farms. More rapid expansion of public-priority services in the fields of health, education, and housing, and some others, would not only serve the cause of social justice and make deep inroads upon poverty, but would also improve productivity, open up new job opportunities, and augment a more healthful and sustainable rate of economic growth than we have recently experienced. All of these propositions are so close to universally accepted, and so explicit even in the pronouncements at times of the "New Economics" and of the CEA, that the question naturally arises as to why these pronouncements have not been translated into more effective action.

Poverty and income maldistribution

The pertinent facts are brutally clear. In 1967, 5.3 million American multiple-person families and 4.9 million unattached individuals lived in absolute and dismal poverty, even according to the low poverty-income ceilings officially set by the Social Security Administration in the Department of Health, Education, and Welfare. The total number of people living in abject poverty in 1967 aggregated somewhere in the neighborhood of 26 million people, or about 13.5 percent of the total population in that year.

In addition, about 11.0 million families and about 2.4 million unattached individuals, coming to about 35.4 million people lived above the officially established poverty-income ceilings, but in deprivation nevertheless. Therefore, in the neighborhood of 61.4 million people, or not very far from one-third of the Nation in 1967, lived either in poverty or deprivation. It is noteworthy, in this connection, that the Bureau of Labor Statistics in the U.S. Department of Labor indicated in 1967 that somewhere in the neighborhood of $9,000 for a four-person family and about $3,400 for an unattached individual would be required to maintain a *moderate* standard of living in metropolitan areas.[7]

Even though all empirical evidence proves conclusively that optimum economic growth and reasonably full employment are by far the most important avenues toward the liquidation of poverty, it hardly seems conceivable that substantial redistribution programs are not also essential. They would be essential in any event, because the concept of poverty is and should be in part a relative concept, which cannot be blind to the state of the industrial arts and the general income situation throughout the Nation. It is thus of high import that we have thus far made very little progress toward improved income distribution since World War II. Among multiple-person families in 1947, the top income fifth enjoyed 43 percent of the total money income of families, while the lowest fifth obtained only 5 percent, the lowest two-fifths only 17 percent, and the lower three-fifths only 34 percent. In 1966, the top fifth enjoyed 41 percent, while the lowest

[7] See chart 8, following text.

fifth obtained only 5 percent, the lowest two-fifths only 17 percent, and the lower three-fifths only 35 percent. Among unattached individuals in 1947, the highest fifth enjoyed 59 percent, while the lowest fifth obtained only three percent, the lowest two-fifths only 8 percent, and the lower three-fifths only 20 percent. in 1966, the respective figures were 52 percent, 3 percent, 11 percent, and 24 percent.[8]

Social equilibrium involves the public sector

Adequate programs in the public sector are equally relevant to any meaningful war against poverty, and indeed to the life and living of the preponderant portion of the total population. And it is here that the trends in public expenditures at the Federal level become so disturbing. During the fiscal years 1947–1953, Federal spending for all domestic programs came to 6.92 percent of GNP (despite the Korean war during 3 years of this period), while during the fiscal years 1954–1968, these domestic programs came to only 5.64 percent of GNP. The figure of 6.10 percent in fiscal 1968 compared with 8.17 percent in fiscal 1947 and 6.13 percent as late as fiscal 1959. There is no legitimate explanation of these domestic-spending trends in trends in defense and other international spending, for total Federal spending declined from 16.52 percent of GNP during fiscal 1947–1953 to 16.23 percent during fiscal 1954–1968.

With respect to fiscal 1969, the President's Budget initially projected total domestic spending at 10.91 percent of GNP. But this figure cannot validly be contrasted with the ratios for the earlier years. Beginning with fiscal 1969, the Federal Budget included immense trust funds, which in the main are not supported by Federal outlays (for example, the payroll taxes under the social security program).

The relative starvation of the public sector must also be taken into account, toward realization that a meaningful definition of poverty in America must go far beyond the 13 percent or less of the people of the United States who are below poverty-income ceilings as of now in 1969. At least one-sixth of our people are ill-housed. At least one-third cannot afford adequate and modern medical care. Perhaps 90 percent of the children in our public schools go to schools where the teachers and para-professionals are grossly inadequate in number and still grossly underpaid; and perhaps a majority are in overcrowded classrooms, a large portion of which are either fire-traps or in other respects unsafe. As the public schools are increasingly becoming the habitation of the poor and deprived, a very large portion of those who go to these schools—are drop out—go home to parents who live in slums, do not enjoy an American minimum decency standard of income, suffer excessively high unemployment, and altogether too frequently are alienated and restive, if not rebellious. Many of our transportation systems are obsolete. Air and water remains poisoned, with at least the air getting worse. Our central cities are deteriorating if not already decayed, and are increasingly unable to meet the rising costs of education, police and fire protection, and other essential public services.

In its most recent issue, Fortune magazine, a distinguished business publication, contained a vivid article reiterating what so many other individuals, research organizations, and special commissions have been

[8] See chart 9, following text.

saying now for so many years—that we can afford to rescue and restore the public sector, and cannot dare to do less.

CEA position on poverty: talk versus action

The current CEA report sets forth succinctly a quite good outline of approach to the problem of poverty. It sets forth a strategy including sustained high employment and economic growth; education, training, medical assistance, and access to well-paying jobs; some form of income maintenance for those not within the employment stream; and attacks upon poverty pockets in the ghettos and certain rural areas. The CEA further states that "the number of poor in poverty pockets can be reduced by promoting public and private relocation assistance to those with employment opportunities elsewhere" (p. 155).

Elsewhere in the same chapter, the CEA points out that a small redistribution of the benefits of growth would greatly speed reduction of poverty (p. 160); that the tax system itself redistributes income away from the poor (p. 160); that minimum welfare benefits should be established, financed wholly by the Federal Government (p. 167); and that there should be guaranteed work programs (p. 171).

All this sounds fine, but where are the quantified and specific programs needed to carry forward along these lines? How can benefits of growth be redistributed in favor of the poor by the tax policies and interest-rate policies during recent years, advocated or approved by the CEA, which have redistributed income in a very regressive direction? How can guaranteed work, which implies full employment by direct Government action if that is the only way to achieve it, be squared with reluctant insistence that perhaps the current level of employment needs to be increased somewhat to fight inflation?

How can the degree of population relocation which may be required be undertaken, without penetrated quantitative analysis of what kind of relocation should take place, how people are going to get there, and who is going to finance the costs of such relocation, including not only the transportation costs and the housing costs, but also the needed shifts in industry? How can this new awakening to the problem of relocation be squared with farm policies and other policies which, during the past 8 years, have "relocated" millions of farm families to urban areas, where they have contributed so mightily to relief costs, unemployment, urban decay, and urban unrest?

The sad fact of the matter is that CEA has not come to realization that the achievement of social equilibrium through a full-scale war against poverty is not a side issue to be treated superficially in one chapter of a CEA report. It must instead interpenetrate with the whole process of the development of a long-range social and economic budget for the Nation, and the adjustment of *all* basic economic policies thereto, something which the CEA has never attempted.

The inclusion within the current document of the report to the President from the Cabinet Coordinating Committee on Economic Planning for the End of Vietnam Hostilities (pp. 181–220) underscores two shortcomings. The first is failure to recognize that planning must be a continuing process, and that the work and the responsibility of the CEA with respect to so vast an issue cannot be done separately and apart from the work of a Cabinet Coordinating Committee. The second defect is failure to recognize that we will not move suddenly from a state of high defense expenditures to a state of low defense expenditures, but instead will move very gradually.

The problems of poverty and social disequilibrium, inseparably connected, as well as the problem of economic disequilibrium, cannot wait until the Vietnam hostilities are over, or even beyond that to the time when a truly peaceful world assures a lower level of total defense outlays. Even now, there is some prospect of an antimissile defense system, of incalcuable but huge costs. The war against poverty and social disequilibrium should have started long ago, it should start now, and it should be at the very heart of the study programs and recommendations of the CEA, because it is at the very heart of our total economic problem—not a year or 10 years from now, but *now*.

IV. Fiscal Policy

Misdirection of tax cuts to date

In all the plethora of detailed examination of national fiscal policy during recent years, we have in large measure ignored examination of the purposes and consequences of the fiscal policies, actually put into motion. Consequently, the recent and current debate and concern on the subject has arrived at a condition for which the term "immaturity" would be a charitable description.

By the test of economic equilibrium, for reasons already discussed, the massive tax cuts of 1962–65, accompanied by earlier tax concessions from 1962 forward, were fundamentally misdirected. Viewing tax cuts having a total original value estimated at $19.2 billion—having a very much higher value now, because of the great expanded tax base—$8.6 billion were allocated, according to my analysis, to investment purposes, and only $10.6 billion were allocated to consumption purposes. This was in no degree responsive to the economic developments between 1953 and 1962 or 1965 which gave rise to this veritable orgy of tax cutting. Even if we were determined—as we should not have been—to attempt the major stimulus to the economy in the form of tax cuts, an entirely different composition would have been much more conducive to economic equilibrium and optimum economic growth in the long run, as well as to the restraint of inflation, than the tax cuts accordingly engineered. To illustrate, a very large portion of the tax cuts should have been devoted to lifting the personal exemptions from $600 to $1,200, or preferably to $1,800.[9]

Because of the importance of enlarging the propensity to consume, the composition of the tax cuts was also highly undesirable from the viewpoint of long-range economic equilibrium, not to mention the even more important issue of social equilibrium and economic justice. The 1964 personal tax cuts added only 2 percent to the after-tax income of the four-person family with $3,000 income; only 1.6 percent in the case of $5,000 income; and only 2.1 percent in the case of $7,500 income. But the same tax cuts added 3.8 percent in the case of $25,000 income; 6.2 percent in the case of $50,000 income; 8.3 percent in the case of $100,000 income; and 16 percent in the case of the $200,000 income. These comparisons are even more shocking when we take account of the fact that they are based upon established tax rates, and take in-

[9] See chart 10, following text.

adequate account of evasions and loopholes available to so many people in the high-income brackets.[10]

Narrow view of scope of the total tax burden

But this is only the beginning of the travesty. Among all the "new economists" including the CEA membership who appeared before the Joint Economic Committee to urge and applaud the changes in the Federal tax structure which have actually occurred, hardly a one of them had the breadth of perspective to focus upon the *entire* tax structure throughout the Nation, rather than exclusively upon the Federal tax structure. Yet a first year course in economics should have encouraged them to do just that.

In 1966, looking at all persons in all the income classes shown, those with incomes under $3,000 paid only 3.7 percent of their incomes in the form of Federal income taxes, and this percentage moved upward to 14 percent in the case of those with incomes from $15,000 to $19,999, and to 33.6 percent in the case of those with incomes at $50,000 and over. This gives the appearance of a quite progressive tax structure, although again ignoring the fact that these comparisons are based upon tax rates without adequate allowance for evasion, avoidance, and loopholes. But looking at *total* taxes paid, including all Federal income taxes, social security taxes, State and local income taxes, sales and gasoline taxes, and personal property and real estate taxes, how different the true picture is. Those with incomes under $3,000 paid 14.1 percent of their incomes in total taxes. Those with incomes of $3,000 to $3,999 paid 19.3 percent. But those with incomes of $5,000 to $9,999 paid only 17.5 to 17.6 percent. Those with incomes of $15,000 to $19,999 paid 19.8 percent, or very little more (ratio concept) than those with incomes of $3,000 to $3,999. Those with incomes of $20,000 to $49,999 paid 24.2 percent, and those with incomes of $50,000 and over paid 38.8 percent, again looking only at the tax rates on the books. In the main, this represents a horribly unjust and inequitable nationwide system of taxation.[11]

The situation is worse now than it was in 1966, although comprehensive data are not available to me for the most recent years. The regressive State and local taxes, and the sales taxes, have continued to mount. And when the time came for the Federal Government to lift taxes in order, avowedly, "to fight inflation," the sound decision was not made to lift taxes in accord with the same pattern which had governed their previous reduction. Instead, a 10-percent across-the-board "temporary" surcharge tax was imposed, which manifestly adds to the regressive nature of the entire nationwide tax burden, or at least is certainly not progressive.

The issue of "tax reform"

There is now a great deal of discussion about "reform" in the Federal tax structure. Such discussion concentrates mainly upon plugging loopholes which enable large numbers of very wealthy taxholders to pay no taxes at all, or to pay only token taxes, or to pay distressingly low taxes relative to those very much lower down in the income structure. Sometimes this proposal is coupled with the idea that there shall

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[10] See chart 11, following text.
[11] See chart 12 following text.

be a ceiling upon the taxes that anybody shall pay, relative to income—say, 50 percent.

There is much merit in some aspects of these proposals, but nobody has yet made clear whether the net impact of them would be to make the total tax structure more or less progressive. Related to those who really pay the tax rates as written on the books, instead of engaging in avoidance or evasion, it would be a very good bargain for many to consent magnanimously to the proposition that they should pay *some* taxes in exchange for being assured that under no conceivable set of conditions would they have to pay more than 50 percent of their income in taxes.

As a matter of stark fact, I believe that the whole issue of tax reform becomes confusing and misleading, when it is not recognized that the major job of tax reform is to remedy the gross distortions in the Federal tax structure, both on economic equilibrium and social equilibrium grounds, which have resulted solely from the misguided and massive tax reductions during recent years, aggravated by the 10-percent surcharge.

I submit that the most useful reform which could be made in the Federal tax structure would be to lift the exemptions greatly, and to restore the rates, at least in the high-income portions of the structures, a good part of the way to where they were before 1964. The argument that this paralyzed investment and initiative was mereticious from the outset. The argument that the high marginal tax rates caused people to try to evade taxes, by legitimate methods, was foolish from the outset. Those who hired expensive lawyers and accountants to get their taxes as low as possible when the marginal rate was 92 percent did not stop doing so when the marginal rate was reduced by about 30 points.

Neglect of core purpose of the Federal budget

All of what I have thus far said only touches the outskirts of why the massive tax reductions were so wrong, at least from the viewpoint of social equilibrium and plain social justice. The "new economists" have claimed and propaganded that they have done a great service in the improved use of national fiscal policy to stabilize the economy and promote its real growth. But they have entirely forgotten the real purpose of the Federal budget and of national economic policy, as made manifest by the Federal budget. The main purpose of the Federal budget is neither to stabilize nor promote the growth of the economy, although this would be a very useful byproduct if the policies are more correctly devised than they have been thus far. The main purpose of the Federal budget is to allocate to the public sector enough expenditures to meet the great priorities of those public needs which cannot be served, or cannot be served so well, in any other way. If the only or main purpose were stabilization, we could simplify matters greatly by having 10 or 15 billion dollars' worth of Federal spending and no Federal taxation when we were threatened with deflationary forces, and the reverse when we were threatened with inflationary forces. But this would be forgetting what the Federal budget is really for.

Appropriate fiscal policies

The appropriate coures is to determine what portion of our resources, through Federal spending, should be allocated to public purposes, both domestic and international. This should be done on a long-range basis. We should then allocate to these purposes, through the Federal budget, such percentage of our potential total national product, estimated at optimum resource use. If, in fact, this leads, in conjunction with all other spending, to inflationary pressures in the form of excessive aggregate demand, we should then not cut back on these priorities, but instead increase taxes to curtail the extravagant, wasteful, or at least expendable, instead of sacrificing the essential. Curtailment of Federal spending to combat inflation negates the priority purposes of Federal spending. If, on the other hand, the determined levels of public spending plus all over spending do not generate sufficient aggregate demand to avoid deflationary trends, we should certainly not cut Federal spending on the ground that the revenues yielded by a deficiently performing economy are not sufficient to cover this Federal spending. Instead, we should obviously reduce taxes. In short, all taxes are burdensome, and practically no taxes have intrinsic value in themselves. It is the tax, rather than the spending side of the Federal Budget, which should serve the purposes of stabilization.

All this is so elementary that it is almost inconceivable that the "new economists" and the CEA could have forgotten it. But they did forget it, almost entirely, and so did their allies and protagonists in the academic world. In 1964, they arrived at the miraculous conclusion that a lot of people would rather have their taxes reduced than to witness increased Federal spending. An equal amount of action in either direction would have had the same deficit impact upon the Federal budget in the short run, although in the long run the spending route would have increased revenues faster than an equivalent amount of tax reduction because the former approach would have been sounder from the viewpoint of economic equilibrium and growth. But having arrived at the miraculous conclusion that tax reduction was "easier," these economists drew upon their full intellectual and propagandist resources to argue that it really made no difference to the Nation and the people which of the two routes were taken, or what blend of the two routes were chosen, because the impact upon the economy would be the same at any given dollar level of net action.

Never before in my recollection was there such forgetfulness of the purpose for which a responsible Central Government exists, nor of the purpose for which a responsible CEA should exist. To be sure, it was not foreseeable how much expenditures would increase for the Vietnam war. But it was manifestly foreseeable that our international burdens would remain immensely heavy, and perhaps even grow, for as far ahead as we could foresee. It was not only foreseeable, but currently apparent, that our great domestic priorities had been starved at least since the beginning of the great depression, and that, at least since the launching of the first sputnik in 1957, the urgency of the need to allocate much larger absolute amounts of resources to the public sector, if not larger relative amounts, had been recognized by almost all responsible people and organizations everywhere.

To cap the climax of this farrago of national fiscal policy, the "new economists" and the CEA were hoisted on their own petard from 1967 forward. Having argued that it made no great difference whether we reduced taxes or increased expenditures when the economy needed stimulation, they were led to argue that it made no great difference whether we reduced expenditures or increased taxes when it was felt that the economy needed restraint. They even came to the point where they were supinely accepting some of both medicine, which was almost equivalent to the preposterous proposition that a tax increase would be more acceptable if spending were reduced and the pressures on the economy accordingly reduced than if spending were not reduced.

It will take us many years, at best, to work our way slowly and painfully out of this hole into which the "New Economics" has so proudly put us.

Increasing fiscal responsibilities of Federal Government

I have only one additional point to make in this phase of my discussion, but it is one that cannot be overlooked. Another reason why the recent fiscal policies have been so inadequate is that they have failed to recognize the inescapable increasing responsibility of the Federal Government to meet a larger share of the burden of the cost of rescuing our urban areas and making war against poverty. I can never understand how my friend Walter Heller, so ardent an advocate of massive Federal tax-sharing with the States, thus evidencing the recognition of what I have just stated, could have gone all out for the kind of incontinent tax reduction which was sure to make the Federal Government have so much less to share.

From 1947 to 1967 (fiscal years), Federal spending increased at an average annual rate of 6.1 percent, while State spending increased at an average annual rate of 9.1 percent, and local spending at an average annual rate of 8.9 percent. During 1953–61, the respective average annual rates of advance were 3.4 percent, 9 percent, and 9.1 percent. From 1961 to 1967 the respective average annual rates of advance were 8 percent, 8.2 percent, and 6.5 percent.

From 1947 to 1967, the average annual increase in the public debt was 1.1 percent for the Federal Government, 12.6 percent for State governments, and 9.1 percent for local governments. From 1961 to 1967, the respective average annual rates of advance were 2 percent, 8.4 percent, and 6.9 percent.[12]

Coupling these trends with the extremely regressive nature of State and local taxation, and the relatively greater impact of tight money and rising interest rates upon the State and local governments in view of the immensely greater percentage increases in their necessary borrowings than in the case of the Federal Government, the full consequence of recent Federal fiscal policies are clearly revealed.

A model Federal Budget, responsive to needs and capabilities

At an earlier stage in my discussion, I set forth projections for gross national product and its components running ahead to 1977. A Federal budget showing trends compatible with its responsibility for economic and social equilibrium is an indispensible element toward achieving these goals. My next chart sets forth a model for such a Federal budget. It indicates that outlays for all domestic programs should rise from 10.91 percent of GNP, as estimated for fiscal year

[12] See chart 13, following text.

1969, to 13.32 percent in calendar 1977; that expenditures for the economic opportunity program or its equivalent should rise from 0.23 percent to 0.39 percent of GNP and from $9.86 on a nationwide per capita basis to $24.04 (measured in fiscal year 1969 dollars); that outlays for housing and community development should rise from 0.32 percent to 0.64 percent of GNP and from $13.72 to $39.34 on a per capita basis; that outlays for education should rise from 0.53 percent to 2.36 percent of GNP, and from $23.16 to $143.79 on a per capita basis; that outlays for health services and research should rise from 1.21 percent to 1.43 percent of GNP, and from $52.51 to $87.41 on a per capita basis; that outlays for public assistance and labor manpower and other welfare services should rise from 0.69 percent to 1.08 percent of GNP and from $30.95 to $66.00 on a per capita basis; and that outlays for agriculture and natural resources should rise from 0.91 percent to 1.11 percent of GNP, and from $39.91 to $67.75 on a per capita basis. These goals include Federal contributions of $1 billion in 1970 and more than $2 billion in 1977 to the OASDHI to help increase benefit payments to the aged. This tableau provides, if it should be needed, an increase from $89.5 billion to $94 billion for national defense, space technology, and all international, but this would involve a decrease from 10.11 percent to 6.73 percent of GNP, and from $441.18 to $410.84 on a per capita basis. Yet, in an adequately expanding economy, all Federal budget outlays, while increasing from $917.01 to $1,223.77 on a per capita basis, would actually decline from 21.02 percent to 20.06 percent of GNP.[13]

With this feasible degree of dedication to do what we ought to do and cannot afford to do without, we could by 1977 virtually liquidate poverty in the United States;[14] provide a decent home for every American family (which we have promised since 1939); achieve minimum standards of uniform excellence in our public schools throughout the Nation; and bring adequate health services, at costs within their means, to all of our people. The projections for all domestic programs cover also our transportation needs. The projections for agriculture and natural resources contemplate that we reverse the trend—a trend against which I have been protesting for 16 years or longer—toward the impoverishment of our farm population and the abysmal neglect of rural life and living standards, toward malnutrition and hunger among millions of our people despite indescribably abundant agricultural production, and toward the forced movement of millions of farm families toward our great urban areas, where they have contributed, and contributed disproportionately, to unemployment, relief costs, overcrowded housing, urban decay, and urban unrest.

In fact, the failure of the CEA, in its preoccupation with fiscal policy, and erroneous fiscal policy at that, to give adequate attention as mandated by the Employment Act of 1946 to the other great areas of major economic policy, such as farm policy, social security policy, housing policy, and internationally economic policies, has been a signal aspect of the CEA failure to view our economy in a sufficiently broad and long-range perspective, and to develop an integrated policy and program in lieu of a spawling proliferation of policies and programs

[13] See chart 14, following text.
[14] See again chart 8, following text.

which already have become almost too numerous to count and too complex to harmonize.

CEA views on fiscal policy

The current CEA report reaches the conclusion that fiscal policy on the whole during the past 8 years has been both wise and effective, and that "most of the shortcomings of the period were errors of omission rather than commission" (p. 77). It then makes clear that most of the errors of omission were due to tardiness, and could be cured in part by better forecasting, but in the main by conferring upon the President the discretionary power to make certain kinds of tax changes (see discussion pp. 78–85).

The conclusions which I have set forth above are very diffierent.

A revealing portion of the CEA discussion says: "The experience of 1961–65 demonstrated that an effective fiscal policy to stimulate the economy could be carried out without adding unnecessarily to the size of the Federal budget. Since the aims of stabilization be implemented either through tax changes or expenditure changes, decisions regarding Federal expenditures can be properly based on the desired allocation of resources between the public and private sectors" (pp. 77–78).

My objections are as follows: The period 1961–65 is too short to make a full evaluation of fiscal policies during the past 8 years; the actual policies during that period fell far short, for reasons which I have already stated, and while a proper principle is stated for the desired allocation of resources between the private and public sectors, such allocation was not undertaken, and such allocation is of profound significance with respect to economic equilibrium as well as with respect to social equilibrium.

Even more broadly, the emphasis upon fiscal policy in this chapter and throughout the report ignores the fact that fiscal policy—and to a degree monetary policy—are but segments of a wide variety of national economic policies, including those related to social security, agriculture, housing, and international economic policy. There can be no sound and sufficiently comprehensive nor integrated development of economic and social policy for the Federal Government, as intended by the Employment Act, until these other profoundly important policies become as important portions of the economic report of the CEA report as fiscal policies have been to date. This process is also essential to the correction of fiscal policy itself.

A striking demonstration of this shortcoming is revealed by the fact that the treatment of agriculture is confined in the CEA report mainly to pages 115 to 116 thereof. Yet the problems of agriculture and other aspects of rural life are among the most urgent and important that we face.

V. The Problem of Inflation

Three main errors in approach to problem of inflation

The "new economists" and the CEA during the past 8 years have committed three serious errors in dealing with the problem of inflation: *First*, they have grossly exaggerated the problem in the United States, and gross exaggeration is always undesirable because it distorts the evolution and disturbs the balance of economic policies and programs; *second*, they have offered no serious analysis of whether the amount of inflation we have had in the United States during these 8 years has on net balance done more good or harm, and whether alternative policies which might have been devised to restrain inflation further would on net balance have done more good or harm than has resulted from avoidance of such policies. It is no answer to this criticism to say that it is difficult to make this kind of analysis, for there are many types of economic analysis which are difficult, but which nonetheless must be undertaken instead of following a course without such analysis; and *third*, they have completely misjudged the causes of recent and current inflation, and, therefore, the policies they have adopted to deal with it have both aggravated the inflation and caused other damage far more costly than the inflation itself.

It is highly desirable to consider the problem of inflation in a long-term perspective, rather than to focus excessively upon the admittedly high rate of price inflation during 1967, and especially 1968. In a matter of this kind, short of a runaway inflation which we have not had even during the past 2 years, the longer term averages are in my view far more significant and a better guide to policies addressed to the future than rather extreme aberrations from these longrun averages during a year or two. It is noteworthy that 1967 and 1968 are by no means the first time when such aberrations appeared, nor the first time when the reaction to them was excessive.

Moreover, it would be very unfair for the CEA to claim—and I do not assert that it has claimed—that its large attention to the problem of inflation arose during the past 2 years. Even during 1961–66, when we experienced unusual relative price stability, there were constant alarms about the problem of inflation, especially on the ground that it was a basic cause of our unfavorable balance-of-payments position, in that it put us at a competitive disadvantage in the international exchange of goods and services. Yet the fact of the matter was that we maintained a quite favorable balance in these categories, and our unfavorable balance was due to causes which had very little to do with the American price level, such as our international spending abroad, the flow of American capital to other countries, the withdrawal of foreign capital from the United States, and so forth. Further, some of these unfavorable developments were due to some competitive disadvantage exhibited in the overall performance of the American economy, which in turn was due to some of the repressive measures adopted for the alleged purpose of restraining inflation.

Evaluation of magnitudes of inflationary trends

The average annual increase in consumer prices in the United States was 1.7 percent during 1918–68, 1.8 percent during 1928–68, 3.1 percent during 1938–68 (affected greatly by the reflation after the Great Depression and the World War II era), 1.9 percent during 1948–68, and 1.9 percent during 1958–68. Even during 1960–68, the average annual increase in consumer prices was only 2.0 percent, and during 1960–66 it was much less than that. During 1966–68, the average annual rate was 3.5 percent, and from 1967 to 1968, it was 4.2 percent. My next chart, depicting these trends, also depicts the trends with respect to wholesale prices and industrial prices, but I am not discussing these in detail, because the conclusions I would draw from such discussion would be essentially the same as those I draw from discussion of the trends in consumer prices.[15]

Viewing this performance sensibly, I do not see how we can conclude that our economy has been threatened or will be threatened in future by anything approximately a "runaway" or even unusual amount of price inflation in any fair perspective. This fair perspective is further reinforced by comparisons with other countries. During the 5-year period 1962–67 (1968 not comprehensively available to me), compared with the 2.6-percent average annual increase in consumer prices in the United States during the 5-year period 1963–68 (and only 2.0 percent during 1962–67), the average annual increase in consumer prices was 3.3 percent in the United Kingdom, 3.2 percent in France, 2.7 percent in Germany, 4.7 percent in Italy, 2.7 percent in Canada, and 5.4 percent in Japan. Comparisons of the wholesale price trends in these countries with those in the United States would lead broadly to the same conclusions.[16]

CEA has not probed deeply into actual consequences of rising prices

Coming to the second phase of this aspect of my analysis, at no time during the past 8 years has the CEA undertaken anything approximating a definitive nor even substantial analysis of the economic or social consequences of price trends in the United States during this period. Nor has CEA attempted to evaluate what the alternative consequences of more restrictive price policies would have been. A mere regurgitation of the word "inflation" as a horror signal, or of the charge that inflation is "the cruelest tax of all" provides no substitute for such empirical analysis, especially when in the long run the American experience indicates strongly that periods of rising prices (with rare exceptions) have been periods where production, employment, and income distribution have behaved more satisfactorily than during other periods.

The CEA has gravely misjudged the causes of inflation

Coming to the third phase of this aspect of my analysis, which is the most important of all, the CEA's entire approach to the problem of inflation throughout has been based entirely upon the rather prevalent assumption that a more rapid rate of real economic growth is more conducive to price inflation than a lower rate, and/or that a lower level of unemployment is more conducive to price inflation than a higher rate of unemployment, and/or that an economy operating close to reasonably full or optimum resource use is more prone to inflation than an economy with a larger amount of economic slack.

The empirical evidence irrefutably refutes these unalloyed assumptions, even more though it may not conclusively prove the contrary.

During 1952–55, the average annual rate of consumer price inflation was only 0.3 percent, when the average annual rate of real economic growth was 3.5 percent, and unemployment as officially counted averaged 4 percent. During 1955–58, the average annual increase in consumer prices was 2.6 percent, although the average annual rate of real economic growth was only 0.8 percent, and unemployment averaged 4.9 percent. During 1956–58, the average annual increase in consumer prices was 3.1 percent, while the average annual rate of real economic

[15] See charts 15 and 16, following text.
[16] See again chart 15, following text.

growth was only 0.2 percent, and unemployment averaged 5.1 percent. During 1958–60, the average annual rate of consumer price inflation fell back to 1.2 percent, while the average annual rate of real economic growth was 4.3 percent, and unemployment averaged 6 percent. During 1960–68, the average annual rate of real economic growth rose to 4.8 percent, and the average annual increase in consumer prices was only 2 percent. Unemployment averaged 4.9 percent, but was reduced greatly to 2.6 percent by 1968. During 1960–66, the average annual increase in consumer prices was only 1.6 percent, while the real rate of economic growth averaged 5.1 percent. Unemployment averaged 5.3 percent, but was reduced to 3.8 percent by 1966. During 1966–68, the average annual rate of increase in consumer prices was 3.7 percent, although the average annual rate of real economic growth fell to 3.5 percent. Unemployment averaged 3.7 percent, or almost the same as the 1966 level. The trends in wholesale prices and industrial prices are shown on the same chart, but I do not analyze them in detail because they tell basically the same story.

Certainly, these trends in the main indicate an inverse or negative rather than a positive correlation between the rate of real economic growth and the rate of price inflation. Nor do they indicate in the main that a movement toward reduction in unemployment promotes an increase in price inflation.

But it may be argued that, while a higher rate of real economic growth or a lower level of unemployment does not in itself promote inflationary tendencies, inflation is nonetheless promoted by an economy *moving to reasonably full or optimum resource use.* However, this thesis is also discredited by the trends depicted above. For example, during 1956–58, with unemployment averaging 5.1 percent, and with the sharpest recession since 1952 occurring within that period, the average annual rate of consumer price inflation of 3.1 percent was about twice as fast as the 1.6-percent average during 1960–66 when unemployment averaged 5.3 percent, or about the same. From 1966 to 1967, the price inflation was 2.8 percent, and unemployment stood at 3.8 percent.

The analysis could be further complicated, and my conclusions might be somewhat modified, by the introduction of time-lag factors and some others. But I submit that my analysis and conclusions are in the main sustainable, and most assuredly do not justify the unalloyed position of the CEA which is at times deliberately sought to generate excessive deviations from optimum real economic growth, and at least to tolerate excessive unemployment, in the pursuit of a nonsustainable proposition bearing upon the relationship between price trends and these other factors.[17]

My thesis with respect to recent and current inflation

My own explanation of inflationary trends—which I commenced to set forth in the mid-1950's before future experience lent much further support to my position—runs as follows: In an economy characterized so largely by administered prices, and inadequate volume of real economic activity and insufficient employment, or even the clear prospect of these, tend to generate protective efforts to compensate for these

[17] See again chart 16, following text.

deficiencies through the managerial price-making process. This thesis is perhaps most clearly borne out by the resumption of a relatively high rate of price inflation from early 1966 forward, when the signs became large and unmistakable that the economy was entering a period of severely reduced real economic growth, and when recession talk was in the air.

In some other areas, such as medical care and housing, and at times in the area of farm prices, rising costs or prices have been due to entirely different factors. In the medical field, there have been shortages of facilities and personnel relative to the real need, engendered by long neglect of adequate public spending for these purposes, such neglect being fomented by the avowed desire to fight inflation. In the area of housing, rising costs have not been due to excessive aggregate demand for housing relative to the Nation's needs, but instead have been due in large measure to the fantastically rising interest rates, again allegedly designed to fight inflation.

The thesis that excessive aggregate demand (which in fact we have not had any time in recent years, when measured against the demand required to sustain optimum economic growth and bring unemployment low enough) explains the inflations during recent years, and particularly during 1967–1968, breaks down at all points. It is further corroded by the special industry studies which I have made from 1952 forward, indicating even more clearly the propensity to increase prices more rapidly during periods of relatively high unused capacity and relatively high unemployment than during periods of relatively less unused capacity and relatively less unemployment.

Analysis of cost-push inflation

Frequently, it is argued that the inflation has been of the cost-push variety, occasioned by wage costs per man-hour rising faster than productivity. Repeatedly and systematically, the CEA has taken this position. But it is completely torpedoed by the empirical evidence.

During 1960–1968, in the total private nonfarm economy, measured appropriately in constant dollars, productivity rose at an average annual rate of 3.1 percent, while hourly wages and salaries rose at an average annual rate of 2.9 percent. It is even more revealing to break this period into two parts. During 1960–1966, productivity rose at an average annual rate of 3.4 percent, while wages and salaries rose at an average annual rate of only 2.7 percent. This was a period when the average annual rate of real economic growth was 5.1 percent. But during 1966–1968, when the average annual rate of real economic growth declined to 3.7 percent, productivity rose at an average annual rate of only 2.2 percent, and wages and salaries at an average annual rate of 3.2 percent.

The trends in manufacturing tell the same story, only more so. During 1960–68, the figures were 3.2 percent for productivity, and 2.2 percent for wages and salaries. During 1960–66, the figures were 3.7 percent for productivity, and 1.9 percent for wages and salaries. During 1966–68, the figures were 1.7 percent for productivity, and 2.9 percent for wages and salaries.

This leads to the implication that the relative trends during 1966–68 exerted cost-push inflation, and thus explained the rapidly accelerating inflationary trends (it should be noted that the "New Economists" and the CEA talked a great deal about cost-push inflation, and developed the unworkable and unfair price-wage guidelines accordingly, long before 1966, when the rate of real advance in wages and salaries was lagging far behind the rate of productivity gains). I cannot accept the CEA position, implied if not made explicit, that the relative trends in wages and salaries and productivity during 1966–68 justified in any sense the accelerated price inflation during this period, particularly in view of profit margins and aggregate profits, which the CEA appears extremely anxious to avoid discussing in its 1969 report, and handled very gingerly in previous reports. Consumption, supported so substantially by wages, had certainly not been excessive, but rather has been deficient, during the past 2 years, by economic equilibrium tests which the CEA never brings forth.

But let us assume for the moment—contrary to my own view—that the relative trends in wages and salaries and productivity during 1966–68 "caused" or even "justified" the accelerated price inflation. In that event, this happened, not because the rate of advance in real wages and salaries was too high in terms of any equilibrium model for reasonably full use of our potentials, but rather because the rate of productivity growth dropped abysmally. And this happened precisely because of the abysmal decline in the real rate of economic growth, coupled with the election (desirable in itself) to translate this into less efficient utilization of the employed labor force rather than into more overt unemployment. Of course, such inefficient utilization is a form of concealed unemployment, although the CEA has not yet come to think that way.[18]

Under these circumstances, how wrong and upsidedown it is to try to stop this kind of cost-push inflation by further repressive measures, designed to reduce still further a seriously inadequate rate of real economic growth.

Further, my basic position is that policies designed effectively to achieve a stable and optimum economic growth would in the long run yield less net price inflation than result from erratic ups and downs in the real economy, rapidly changing labor and business expectations, and general uncertainty. The evidence to date on this seems fairly clear. But even if the evidence were less conclusive or more arguable on rational grounds, we should choose the certain benefits of steady and optimum economic growth and minimal unemployment, instead of committing ourselves to a theory as to the cause of inflation which cannot be squared with what has been happening.

In the foregoing discussion of wage and salary trends, the data are based upon hourly rates of pay, and do not include other so-called labor compensation in the form of fringe benefits, while the CEA does include fringe benefits in its analysis of this problem. I am convinced that my approach is preferable, because fringe benefits in general do not enter currently into the disposable income of wage and salary earners, and it is this disposable income which must keep up with productivity trends in order to maintain a reasonable balance between growth in output and growth in consumer demand. From the viewpoint of total labor costs including fringe benefits, there is no evidence that the trends in total labor costs have militated against adequate

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[18] See chart 17, following text.

profit margins. To the contrary, the evidence is that profit margins have in many cases been far too high, and that this has contributed powerfully to the recurrent tendency of the rate of growth in investment in plant and equipment to exceed the rate of growth in consumption, particularly in view of the increasing productivity of capital. But even if it were to be conceded that fringe benefits should be included in the comparisons between hourly wage and salary trends and productivity, the picture which I have set forth above would not be changed materially in its fundamental import. The picture would still show that real labor compensation lagged seriously behind productivity trends, until the advent of a seriously retarded rate of real economic growth.

Finally, in this phase of the discussion, I have used the trends in real hourly wages and salaries, while the CEA consistently has compared the current dollar trends in wages and salaries (or in total wage costs) with productivity trends. This posture on the part of the Council is completely indefensible. Productivity is a real output concept, and the core problem of maintaining a balanced relationship between productivity trends and hourly wage and salary trends must involve the concept of the real purchasing power of wages. And from the viewpoint of business costs, there has been absolutely no evidence that the adjustment of real rather than current dollar wage and salary trends to productivity trends impair profit margins. This is true in part because, when the price level is generally rising or under conditions of reasonably full prosperity even with a relatively stable price level, the price makers are in at least as good a position to protect their profit margins as other income earners are to protect themselves.

Shortcomings in CEA treatment of inflation

With respect to 1968, the CEA report says that "The pressures of excessive demand pushed up the price level at the unacceptable rate of nearly 4 percent," and insists that "Total demand must be brought into better balance with the Nation's productive capacity" (p. 33).

I have stated above my disagreement with this position. Further, and in accord with my own basic position, the CEA says that erratic ups and downs in the economic performance "would probably involve a more serious danger of inflation than would steadier movement that remained close to the path of potential output" (p. 54). So why, acquiesce in, or even promote, such erratic movements? Yet, the CEA's entire fiscal-policy position, including extension of the 10-percent surcharge tax for another year, and the extension at present levels of excise taxes on automobiles and telephone services, has moved in just that direction (p. 54–55).

Then, the CEA report states that "In a slack economy, rising prices are hardly a problem," and attempts to support this as follows (p. 94):

> The difficulties of combining price stability and high employment in the past 15 years are evident . . . In 1956–1967 and from 1966 to 1968, when the unemployment rate was between 3.6 and 4.3 percent, price increases ranged between 3.1 percent and 4.1 percent. In contrast, between 1958 and 1964 the unemployment rate consistently exceeded 5 percent, and price increases were uniformly less than 2 percent.

I submit most earnestly that this fragmentary and highly selective use of figures will not stand comparison with my more complete analysis of relative trends in prices and economic performance, as set forth above.

Further, the CEA report says this (p. 97):

> But historically, unemployment rates of 4 percent or below have been associated with a price performance that most Americans considered unsatisfactory * * * price increases at the rate recently experienced clearly impair our international trade performance, cause a haphazard redistribution of income and wealth, and may jeopardize sustained prosperity. * * * The first line of defense against inflation must be fiscal and monetary policies that avoid excessive pressure on a productive capacity.

My criticisms of the foregoing statement are explicit in all that I have said. They combine an incorrect analysis of the causes of recent and current price inflation with a very curious set of values as to the relative importance of the balance-of-payments problem and the problem of unemployment, inadequate economic growth, and social disequilibrium at home. It is incredible to propose, or even accept, the proposition that the unemployed should be asked to protect the affluent from paying the allegedly higher prices which more jobs might cause. As for impact upon income distribution, the CEA has not examined that at all.

In line with its analysis, the CEA urges, as a measure against inflation, an "increase in money wage rates a little better than 5 percent" for 1968 (p. 59), which would mean an increase of about 2 percent in real terms. I suggest that no economist could meet the challenge of developing a responsible economic equilibrium model based upon an increase in the hourly-earned purchasing power of wage earners of only 2 percent a year, less taxes paid.

In consequence of these deficiencies in its entire analysis of the inflationary problem, the programs to deal with inflation which the CEA sets forth are in the main a medley of relatively minor and traditional approaches, for example, increased mobility, training, promotion of competition, antitrust activity, etc. (pp. 99–122).

VI. Problems of Monetary Policy

General considerations

My views with respect to the prevalent monetary policy during the past 15 years or longer have been diametrically opposed to those of the CEA and of most of the "New Economists."

Generally speaking, their view is that tight money and rising interest rates help to contain inflation. My view is that tight money and rising interest rates exacerbate inflation, and are in themselves highly inflationary.

My view is that tight money and rising interest rates powerfully inhibit optimum real economic growth and contribute to economic instability (for the reasons stated above, these consequences are in themselves inflationary). Their view on this subject is not made explicit, and is certainly not advanced in the in the 1968 CEA Report, because it seems to be worried about the fantasy of too high a rate of real economic growth and too much employment rather than about the ominous reality of too low a rate of real economic growth and too much unemployment.

My view is that tight money and rising interest rates have been monstrously inequitable and adverse to social equilibrium and plain justice; they appear entirely impervious to this aspect of the problem.

My view is that we need a much more selective monetary policy, because an aggregate or blunderbuss monetary policy represses what ought to be accelerated, and has little or no impact upon what ought to be restrained, and feeds the fat while starving the lean. The 1969 CEA Report appears impervious to this problem, although it does make some very slight obeisance to the damage earlier done to housing by the prevalent monetary policy.

My view is that one of our largest problems is to integrate the policies of the Federal Reserve System with the policies of the Federal Government, and indeed to make monetary policy the servant of the objectives of the Employment Act of 1946, and of the governmental policies designed to achieve these objectives. The CEA has never come to grips with this problem, and its friendly commentaries about the prevalent monetary policy in its 1969 report ignores this problem.

Tight money and rising interest rates work against economic equilibrium

Let me now become more specific about the very foundation of the prevalent monetary policy during the past 15 years or longer—the entirely erroneous proposition that tight money and rising interest rates serve admirably to help contain inflation. This erroneous idea is essentially allied with the erroneous idea (discussed above) that policies inimical to optimum economic growth and conducive to excessive unemployment help to contain inflation. Consequently, the analysis which I present immediately below is essentially similar in method to that which I used in discussing the inflationary problem generally.

During the period 1955–68 viewed as a whole, the average annual growth in the nonfederally held money supply was only 2.5 percent, and the average annual real growth rate in total national production was at the deficient rate of 3.8 percent. I believe that there was a strong relationship between the deficient growth in the money supply and the inadequate economic performance, but I will not elaborate upon this particular point, especially because I believe that too much weight has been attached to monetary policy in the aggregate in this particular connection. Theoretically, and perhaps practically also, a more or less rapid growth in the money supply might affect the level of prices considerably, but should not affect the real trends in production and employment if economic equilibrium were maintained in the fundamental allocation of resource and in income distribution, which can be achieved either at a more or less rapid growth in the nonfederally held money supply.

Nonetheless, what I have just said does not apply to extreme cases. It seems perfectly clear that the extremely low growth rate in the money supply during 1955–57, and again during 1958–60, was intimately associated with the recession of 1957–58 and the minirecession in late 1960 and early 1961. It also seems abundantly clear that the extraordinarily low growth rate in the money supply during 1955–66 was an important factor in initiating the extremely low real economic growth rate during 1956–67 and the unsatisfactory average annual rate during 1966–68. The relatively more rapid rate of growth in the money supply during 1957–58 and during 1960–61, and again during 1962–65, appears to have been conducive to more favorable trends in the real rate of economic growth. The rapid expansion of the money supply during 1966–68 seems clearly to have helped prevent the very serious deterioration rate of economic growth during 1966–67 from being continued over a longer period of time. On net balance, in a long term perspective, it seems quite clear that the monetary policy has been much too tight, and that a relatively liberal monetary policy is highly conducive to satisfactory economic growth.

More seriously, the monetary policy has worked powerfully against economic equilibrium, because it has helped to reallocate resources in directions bearing no relationship to economic equilibrium, and in many cases quite destructive of it. The tightening of the money supply has had practically no effect upon the relatively excessive investment booms in plant and equipment, because those indulging in these booms are not greatly affected either by general shortages of credit or by rising interest costs; they finance mainly out of retained earnings and out of the price structure. On the other hand, a better rate of economic credit nor by rising interest costs; they finance mainly out of retained earnings and out of the price structure. On the other hand, a better rate of economic expansion in other important sectors, or, more generally, a relatively larger ultimate demand composed of both private consumption and public demand, would have been much more conducive to economic equilibrium at steady and optimum growth, and these developments have been very harshly impeded by both tight money and rising interest rates.

Tight money and rising interest rates are in themselves inflationary

Most important of all, in the context of the argument that tight money and rising interest rates restrain inflation, let us look at the empirical evidence. The extraordinarily contraction in the growth rate of the money supply during 1955–57, while it impacted severely upon the real rate of economic growth, was accompanied by a 3.5 percent average annual rise in consumer prices from 1956 to 1957. The greatly expanded growth rate in the money supply during 1957–58 was accompanied by a reduction in the rate of consumer price inflation to 2.8 percent. During 1958–61, there was throughout an inverse or negative correlation between the trends in the money supply and the rate of consumer price inflation. During 1962–65, a sustained and relatively rapid expansion of the money supply was accompanied by remarkable price stability. During 1955–66, a very sharp contraction in the rate of growth of the money supply was accompanied by a very rapid acceleration of the rate of price inflation. During 1966–67, the money supply expanded about three times as fast as during 1966–67, but the rate of consumer price inflation was slightly lower. During 1967–68, the rate of expansion of the money supply was the same as during 1966–67, but the rate of consumer price inflation was tremendously higher.[19]

Viewing these relative trends in an adequate time perspective, it appears to be clear that excessive restraints upon the growth of the money supply worked toward more price inflation in the long-run for practically the same reasons that excessive restraints upon real economic growth and employment expansion worked in the long run toward more net price inflation.

Beyond all this, the almost unbelievably erratic changes in the rate of growth of the money supply over the years represents an attempt at "fine tuning" which is utterly impractical, and really indicative of

[19] See chart 18, following text.

a wayward and thoughtless long-range monetary policy, and general economic policy as well.

Tight money and rising interest rates are appallingly unequitable

In this connection, I set forth the following:

(1) From 1952 to 1967, the interest rates on new Treasury borrowings rose 144.7 percent for 3-month bills, 167.4 percent for 9- to 12-month issues, 138 percent for 3- to 5-year issues, and 81 percent for long-term bonds. The computed average interest rate on the Federal public debt rose from 2.33 percent in 1952 to 4.15 percent in 1967, an increase of 78.3 percent. For the 15-year period as a whole, the rising interest costs to the Federal Government alone aggregated $35.1 billion, and stood at about $5 billion in 1967 alone. The annual cost to the Treasury now in 1969 is close to $8 billion. These rising costs to our Federal Government have in part been paid for by taxes imposed upon the people, but in the main these rising interest costs have added to the Federal deficit. Those who claim that Federal deficits are inflationary per se will thus be hard put to explain how rising interest rates can contribute to the war against inflation.

(2) During the same 15-year period 1952–67, the rising interest costs have imposed an additional burden of $5.2 billion upon State and local governments. This additional cost burden stood at $1 billion in 1967 alone, and is very much higher than that now in 1969.

(3) During the same 15-year period, the computed average interest rate on the total interest-bearing private debt rose from 4.97 to 6.24 percent, a rise of 25.6 percent. Thus, the aggregate burden imposed upon private borrowers during the period as a whole was $66.4 billion, and stood at about $11 billion in 1967 alone. This increased burden is at an annual rate of between $12 and $13 billion now in 1969.

(4) Looking at all types of borrowings, both private and public, the computed average interest rate rose from 3.5 percent in 1952 to 5.4 percent in 1967, a rise of 54.3 percent. This imposed in the aggregate an additional interest burden of $106.6 billion, and $17.7 billion in 1967 alone. The additional interest burden in 1967 alone was about two and a half times as high as the average annual additional interest burden during the 15-year period. Now, in 1969, the annual rate of the excess interest burden is considerably above $20 billion.[20]

(5) If the trend toward rising interest rates continues, I estimate conservatively—and my estimates made many years ago have turned out to be conservative to date—that the additional or excessive interest burden might well rise to $25 billion in 1977 alone, averaging annually well above $20 billion during 1969–77 inclusive, and aggregating well above $180 billion over the 9-year period.

(6) The additional interest burden aggregating $106.6 billion during the 15-year period I have reviewed equates with an excess interest cost per capita for the entire U.S. population of $88.90 in 1967 alone, and $591.89 for the period as a whole. Thus, the additional or excessive interest costs for a family of four came to $355.60 in 1967 alone, and $2,367 for the period as a whole.

(7) Upon whom, in the main, has this unconscionable interest burden fallen? It has fallen upon the small businessman and the farmer; the person who buys a car on time to get to work; the family who buys

[20] See chart 19, following text.

on time a refrigerator or television set or other consumer durables; the family who borrows money to pay the hospital bills when there is a long illness; the family who borrows money to put a child through college; the States and localities borrowing money to have enough policemen and firemen and teachers, and trying to pay them adequately compared with other occupations. The rising interest rates enter into the cost of living, and yet the workingman is told that cost-of-living adjustments in his wages are "inflationary." The average family with an income of $8,000 before taxes, buying or renting a $16,000 home, will pay out over the life of the mortagage about $8,000 more in interest rates alone than if interest rates had stayed where they were in 1952.

(8) We are committed to making an effective war against poverty. The additional interest burden today, at an annual rate, is about 65 percent higher than the amount by which the incomes of all the poor people in the United States would need to be raised to lift them above the poverty-income level as defined by the Government.

In the entire history of American economic policy, I submit that there has been nothing more wrongful, more injurious to the public interest, and more in contrast with our most cherished principles of equity and fairplay, than the long and tremendous rise in interest rates which has already occurred. The efforts now, on so many fronts, to push interest rates still higher needs to be stopped in its tracks.

CEA comments on monetary policy

The CEA appears to be very complacent, and even cheerful, about the prevalent monetary policy. It refers to a "dramatic demonstration of the effectiveness of monetary policy," and adds that "the record of the past 8 years demonstrates that flexible, discretionary monetary policy can make an effective contribution to economic stabilization" (p. 85).

Most of the CEA discussion of monetary policy is extremely theoretical and of the textbook variety, with little or practically no attempt to develop a quantitative empirical analysis of just what monetary policy has done during the past 8 years, and what we can learn from the varied experience. There is no mention of the iniquitous effects of rapidly rising interest rates. There is no adequate integration of monetary policy with treatment of all other basic national economic policies such treatment actually omitted, as I have already pointed out).

What the CEA has to say about housing is most extraordinary (p. 86):

Although the demand for housing—and for mortgage credit—does not appear to be especially responsive to mortgage interest rates, the supply of mortgage funds is quite sensitive to several interest rate relationships.

This comment is hardly short of ignorance. Has the CEA forgotten the vast and salutary changes in homeownership and financing brought about by the tremendous reduction in interest rates on housing, in response to the great depression? Why does the CEA ignore the entire market current situation with respect to housing, demonstrating so clearly that a mass market for decent housing for low- and lower-middle income people requires above all low financing charges? How can the CEA reconcile its commentary with the very nature of the long-range housing program proposed by the President and enacted by the Congress not so long ago, the very heart of which is recognition that a full-scale housing program, adequately directed toward the slums and poverty, requires a very wide range of charges to the user? Whether the charges to the user are reduced by lower interest rates, or by subsidies covering the cost of higher interest rates, has no bearing upon the erroneous nature of the CEA commentary.

Indeed, this CEA commentary about housing reinforces, possibly more than anything else in the CEA report, my conviction that the CEA has not assumed the responsibility to develop that expert and comprehensive treatment of all basic national economic and social policies which alone can fulfill its responsibilities under the Employment Act of 1946.

VII. The International Economy

The treatment of the international economy in the 1969 CEA report is expert and informative, but excessively conventional, complacent, and nonenterprising in view of the unsettled state of international economic arrangements and the recurrent crises during recent years.

I would have been more impressed if the CEA had dealt positively and firmly with these issues, which I deem to be of central and pressing importance:

(1) Some nations must run an unfavorable balance of payments, as that term is conventionally defined, and should not the United States be one of them? Our preeminence in economic and financial terms, and many other factors, have led me to the conclusion that, for a number of years ahead, we should be huge net investors in overseas areas, especially in underdeveloped areas. If we are to pursue such a policy, we must run a large unfavorable balance of payments for some time to come, measured short term.

(2) Does the customary method of recording international accounts correctly reflect our true international position, or is it highly misleading? As in the case of the Federal Budget, especially until the most recent year or so, the commingling of all types of outflows and receipts in our international accounts presents an entirely unrealistic and excessively alarming picture. For example, defense outlays overseas do not have the same economic nor financial significance as loans or investments overseas. There is also failure to distinguish realistically between short-range and long-range positions.

(3) Viewing our unfavorable balance of payments in ratio to our GNP during recent years and currently, have we not made a mountain out of a molehill, to the extent that we have allowed efforts to solve this problem—substantially unsuccessfully, at that—to militate against adoption of infinitely more important programs and policies directed toward the optimum advancement of economic and social equilibrium, optimum economic growth, and minimum unemployment at home?

(4) Can we really determine optimum international economic policies without setting them in the broader perspective of total economic analysis and programs, which I have stressed throughout this discussion, and which the CEA has not yet brought forth?

(5) Do we not need to move more vigorously and rapidly toward the gradual abandonment of the gold anachronism?

(6) Instead of temporizing and extemporizing, should we not move more positively and broadly to improve the international mechanisms of exchange, so as to make them fully contemporary, rather than substantially obsolete or at least inadequate to the times?

VIII. The Economic Report of the President

As I said at the outset, it would be both burdensome and cumbersome for me to attempt a detailed examination of the Economic Report of the President, in that the foregoing analysis of the council's annual report makes clear my views.

Succinctly, the President's report recommends a tight budget policy; extension of the 10 percent tax surcharge for another year; Presidential discretion in the matter of tax policy; voluntary cooperation and increased productivity, toward price stability; and promotion of world trade by reducing trade barriers. The President's report also concludes that "our monetary institutions are working well" (p. 13).

The mere listing of these proposals, combined with what I have said about the CEA report, indicates fully my attitude toward most of them. They appear to me to represent, in the main, excessive satisfaction with policies already adopted and now in being; a negative attitude toward the imperative need for profound correction of some of the most important of these policies; and a generally quiescent attitude, when the country's needs are crying out for a great program of action.

There are only two items on the list which would seem to call for further comment.

I am opposed to the vesting of discretionary tax authority in the President. This proposal places relatively too much emphasis upon fine-tuning and quick and frequent changes in tax policy, when we need a fairly long-range and stable fiscal and economic policy, geared to a long-range and continuous pro-prosperity program, rather than anti or counteracting measures of a maginot line nature. Moreover, the fact that the administration then in office took from early 1961 to early 1963 to recommend a vigorous fiscal policy, despite the promises made during the 1960 campaign and the urgency of the need throughout, plus the fact that it took the Congress only 1 year to enact the recommended program (with some modifications), indicate to me the impropriety of blaming delay excessively upon the legislative branch. Further still, and perhaps most fundamental of all, I do not believe that something as close to the lives and livelihoods of the people should be removed from direct consideration and approval by the people's representatives in the Congress. I think we would lose far more than we would gain by any such change, and I am heartened by the fact that the Congress to date has felt the same way.

I am not against voluntary methods of improving price-wage-profit and other adjustments in the private economy, and I think them to be a preferable alternative to direct controls under current and foreseeable circumstances. But meaningful progress in this direction will require institutional changes toward improved and more continuous consultation among industry, labor, and Government. The first requirement for this will be recognition by CEA of its responsibility to provide a broader perspective for such consultation, in the form of the kind of long-range, comprehensive, and integrated economic and social analysis which thus far has been so sorely lacking.

The President's report also recommends some improvement in disability insurance, an average 13-percent increase in social security benefits, and improved unemployment insurance, with special federally financed benefits for long-time unemployment. These proposals are all in the right direction, although they do not go far enough. Short-time unemployment is bad enough, and I believe that the federally financed benefits should be applied to it also. Maintenance of income among the short-term unemployed would also help to reduce the translation of short-term unemployment into long-term unemployment.

IX. My Own Recommendations

My own recommendations are so explicit in what I have already said, that unnecessary duplication would result if I set them forth again comprehensively. However, some of the highlights are these:

(1) The CEA should develop and include in each annual report a long-range and carefully quantified program and policy for economic and social equilibrium at sustained optimum resource use. This should set quantified goals for employment, GNP, and its major components, with explicit regard for the problems of both economic and social equilibrium. I have at times called this an "economic performance budget." Without this, all short-range policies tend to be improperly oriented, and are frequently at cross-purposes. Economic and social policies and programs are so inseparable that I do not favor the proposal—although it has considerable appeal—that a separate Council of Social Advisers be established;

(2) Maximum employment, with unemployment as conventionally defined held down to not more than 2½ percent of a broadly defined civilian labor force, should be an unalterable must. Placing upon the unemployed the burden of protecting the employed and the affluent against inflation is utterly indefensible. The concept of the civilian labor force should be expanded to include, not only those customarily in it, but to all those for whom gainful employment would be better for them, and for the Nation at large, than economic disutilization. As a last resort, if all else falls short, there should be federally guaranteed employment;

(3) The long-range economic and social budget referred to above should include, in proper balance, every policy and program of the Federal Government which is economic and financial in the sense that it utilizes and allocates substantial portions of our economic resources. It should include the Federal budget, which is but one aspect of basic economic policy;

(4) Even though in the long run we should be able to accomplish our social imperatives with the ratio of Federal spending to GNP no higher in 1977 than it is now, nonetheless in the years more immediately ahead we should shift much more resources to the public sector, and lift Federal spending accordingly. We should reject without equivocation the proposition that spending and taxation are available alternatives, even toward stability and growth, much less toward social equilibrium. The needed level of Federal spending should be determined first, and variations in tax rates should be utilized to combat inflation or deflation as the case may be. We urgently need a very much more progressive tax policy than we have, and this should

commence with lifting the exemptions plus elevating some of the rates, from somewhat above the middle-income levels upward, such elevation retracing the pattern of the personal income tax reduction of 1964. Corporate taxes should be increased, possibly along the lines of the 1964 reductions, but preferably on a more progressive basis. Some Federal deficit should be run, until optimum resource use is restored;

(5) The monetary policy has been and still is atrocious. We need a much more stable and a much more liberal monetary policy, a much more selective monetary policy, and insistence upon the proposition that the Federal Reserve System and all its works must be subordinated to the requirements of the Nation and its people, through subordination to the general economic policies and programs of the Federal Government itself. This probably requires legislation. Monetary policy should be nationalized, within the Economic Reports of the President;

(6) We need to reexamine thoroughly the causes and consequences of inflation, thus transmuting the treatment of this important economic and social problems from unrealism to reality, and from slogan to substance. We should establish new institutional devices for concerted consultation on this subject among industry, labor, and Government. This consultation should be integrated with consultation regarding the overall development of the CEA Annual Report and of the long-range economic and social budget which should be contained therein;

(7) We need to accelerate greatly the war against poverty, to streamline its efforts, to integrate it with general economic and financial policy, so that the striking force of a unified national policy may be brought to bear upon the liquidation of poverty in America within decade;

(8) We need, as part and parcel of the war against poverty, and for many other reasons, to achieve wtihin a decade decent homes, adequate educational opportunity, and good medical care for all our people. These, fully quantified and supported by implementary policies, should be essential elements in the long-range goals within the CEA Annual Reports;

(9) We need to dispel the dangerous and diverse dichotomy or competition between our domestic requirements and our international requirements, and recognize that we have the resources to meet both adequately, if need be, by willingness to limit the nonessential;

(10) We need to concentrate far more than we have upon reversing the persistent degradation of farm life and incomes and the disparities in our rural areas, and start building the people who live in these areas, instead of driving them elsewhere, as we have done by the millions during recent years. We need, in this connection, to budget and fulfill the duty to provide a balanced and nutritious diet for every American. These goals, also, should be essential elements in the CEA Annual Reports;

(11) We need to guarantee, not only sustained full employment, but also at least minimum-decency incomes, through a unified nationwide program initiated and supported mainly or entirely by the Federal Government, for all those *who cannot be brought within the employment stream.* This should not compete with a full-employment policy,

nor minimum-wage legislation, designed to prevent substandard wages for those employed;

(12) We need not only to talk about housing and urban renewal (and not only to enact plenary authorizing legislation without the funds to carry it fully forward), but also to recognize that an adequate housing program for the appropriate income groups is absolutely essential to the problems of liquidating poverty, achieving and sustaining optimum economic growth and full employment, advancing social justice, and restoring and maintaining civil order;

(13) We need to stop frightening ourselves by talking about what America "cannot afford," and start encouraging ourselves by just recognition of what our resources will permit, and what our problems require that we do;

(14) It goes without saying that what I have set forth above, with respect to the content and purposes of the CEA Annual Reports, must carry over naturally—in properly abbreviated form—to the content and purposes of the Economic Reports of the President.

Chart 1

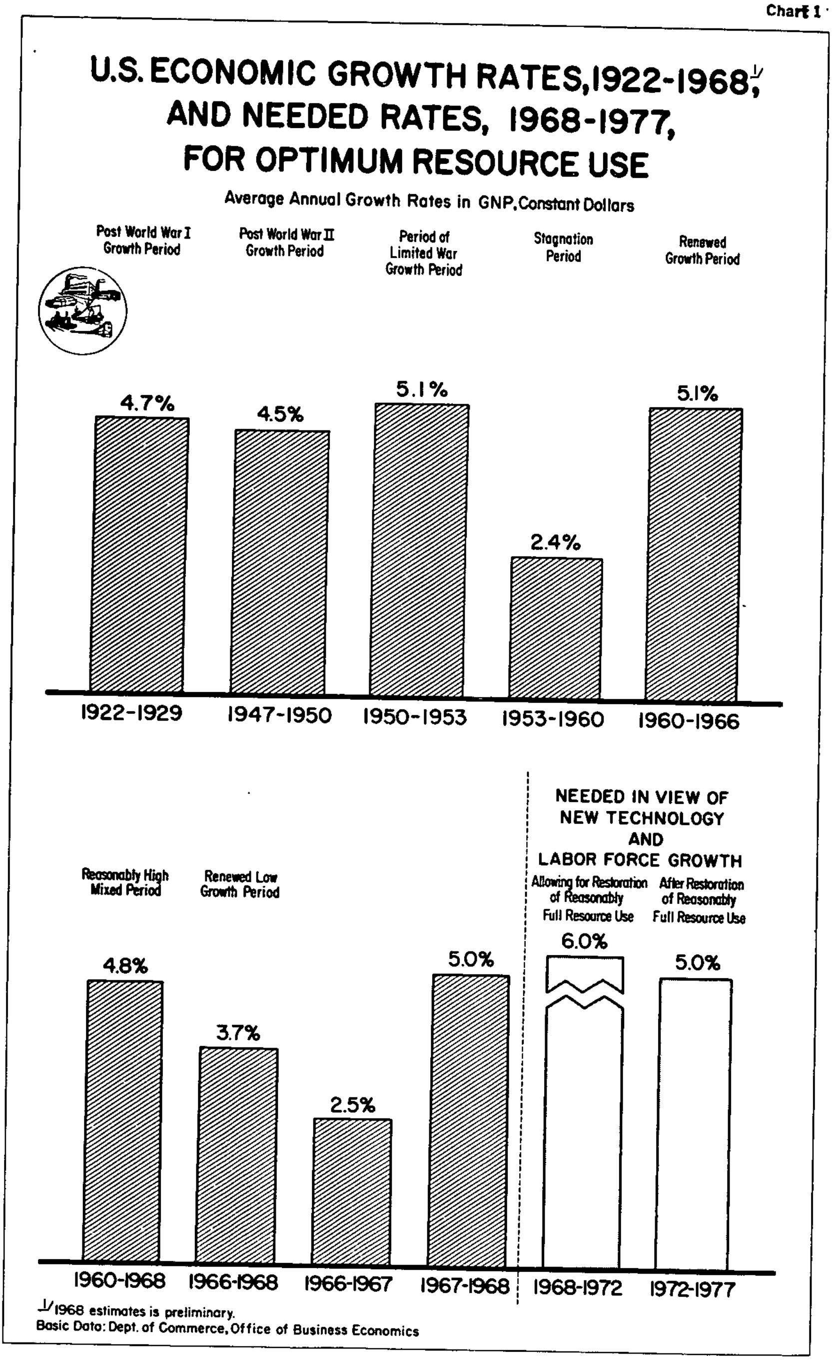

U.S. ECONOMIC GROWTH RATES, 1922-1968,[1]
AND NEEDED RATES, 1968-1977,
FOR OPTIMUM RESOURCE USE
Average Annual Growth Rates in GNP, Constant Dollars
Post World War I Growth Period
Post World War II Growth Period
Period of Limited War Growth Period
Stagnation Period
Renewed Growth Period
4.7%
4.5%
5.1%
2.4%
5.1%
1922-1929
1947-1950
1950-1953
1953-1960
1960-1966
NEEDED IN VIEW OF NEW TECHNOLOGY AND LABOR FORCE GROWTH
Reasonably High Mixed Period
Renewed Low Growth Period
Allowing for Restoration of Reasonably Full Resource Use
After Restoration of Reasonably Full Resource Use
4.8%
3.7%
2.5%
5.0%
6.0%
5.0%
1960-1968
1966-1968
1966-1967
1967-1968
1968-1972
1972-1977
[1] 1968 estimates is preliminary.
Basic Data: Dept. of Commerce, Office of Business Economics

Chart 2

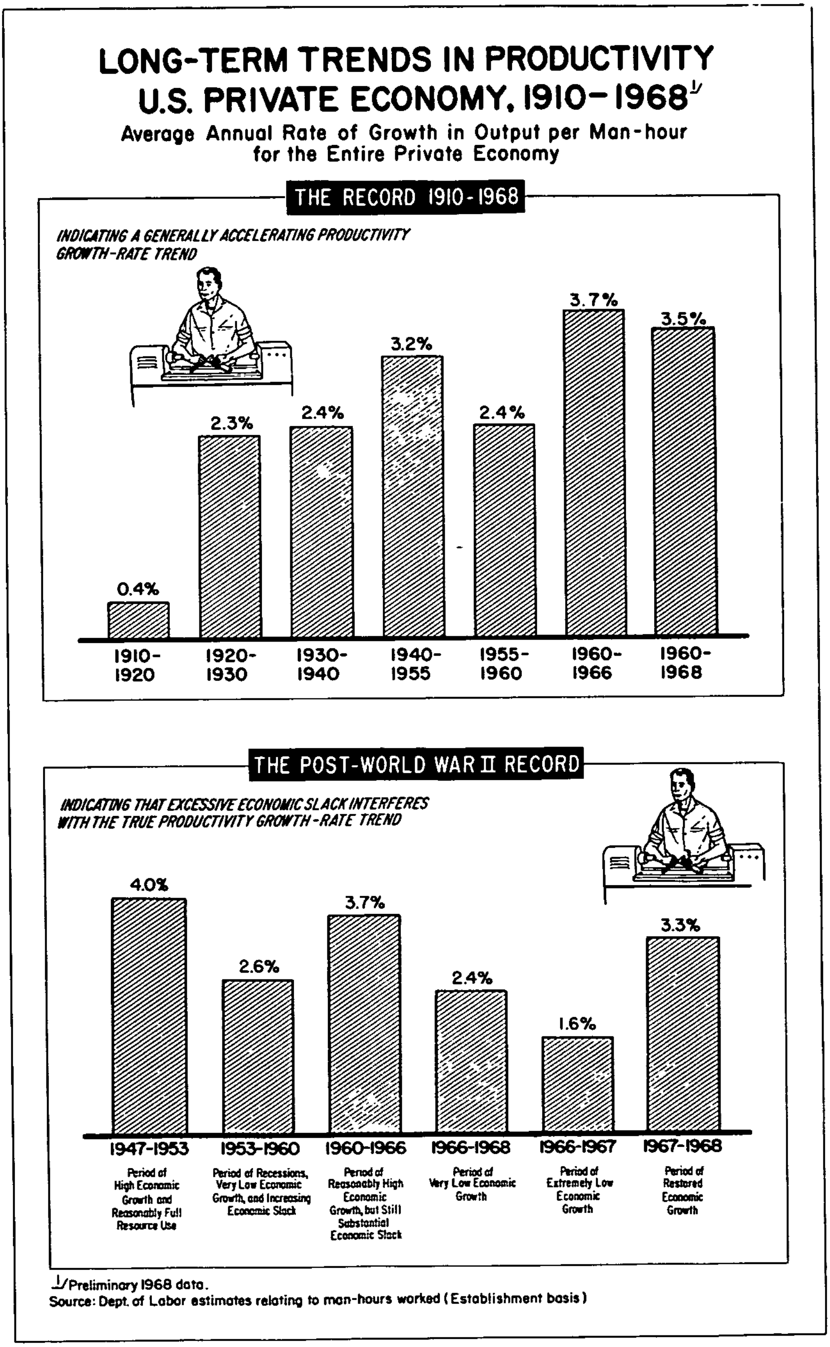

LONG-TERM TRENDS IN PRODUCTIVITY
U.S. PRIVATE ECONOMY, 1910–1968[1]
Average Annual Rate of Growth in Output per Man-hour for the Entire Private Economy
THE RECORD 1910-1968
INDICATING A GENERALLY ACCELERATING PRODUCTIVITY GROWTH-RATE TREND
0.4%
2.3%
2.4%
3.2%
2.4%
3.7%
3.5%
1910-1920
1920-1930
1930-1940
1940-1955
1955-1960
1960-1966
1960-1968
THE POST-WORLD WAR II RECORD
INDICATING THAT EXCESSIVE ECONOMIC SLACK INTERFERES WITH THE TRUE PRODUCTIVITY GROWTH-RATE TREND
4.0%
2.6%
3.7%
2.4%
1.6%
3.3%
1947-1953
Period of High Economic Growth and Reasonably Full Resource Use
1953-1960
Period of Recessions, Very Low Economic Growth, and Increasing Economic Slack
1960-1966
Period of Reasonably High Economic Growth, but Still Substantial Economic Slack
1966-1968
Period of Very Low Economic Growth
1966-1967
Period of Extremely Low Economic Growth
1967-1968
Period of Restored Economic Growth
[1]/Preliminary 1968 data.
Source: Dept. of Labor estimates relating to man-hours worked (Establishment basis)

Chart 3

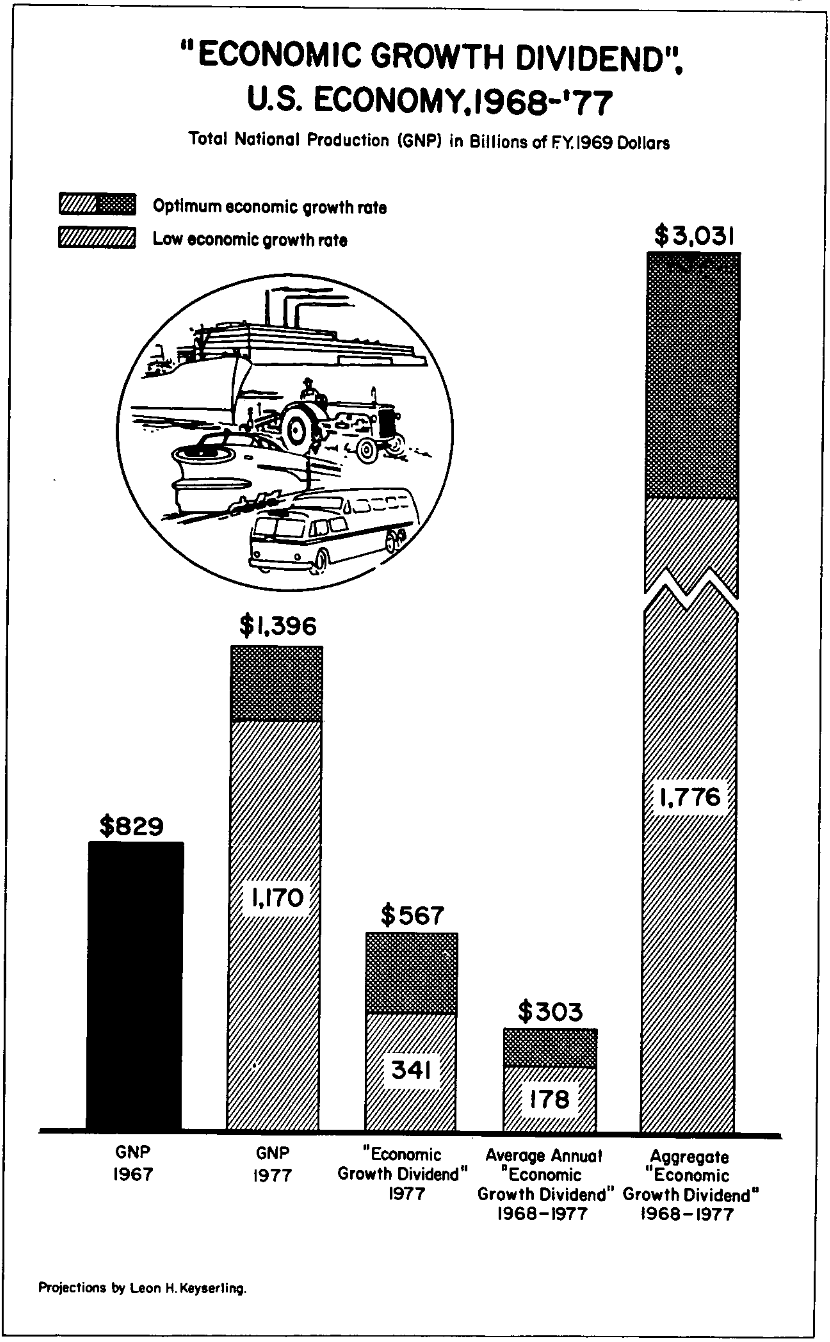
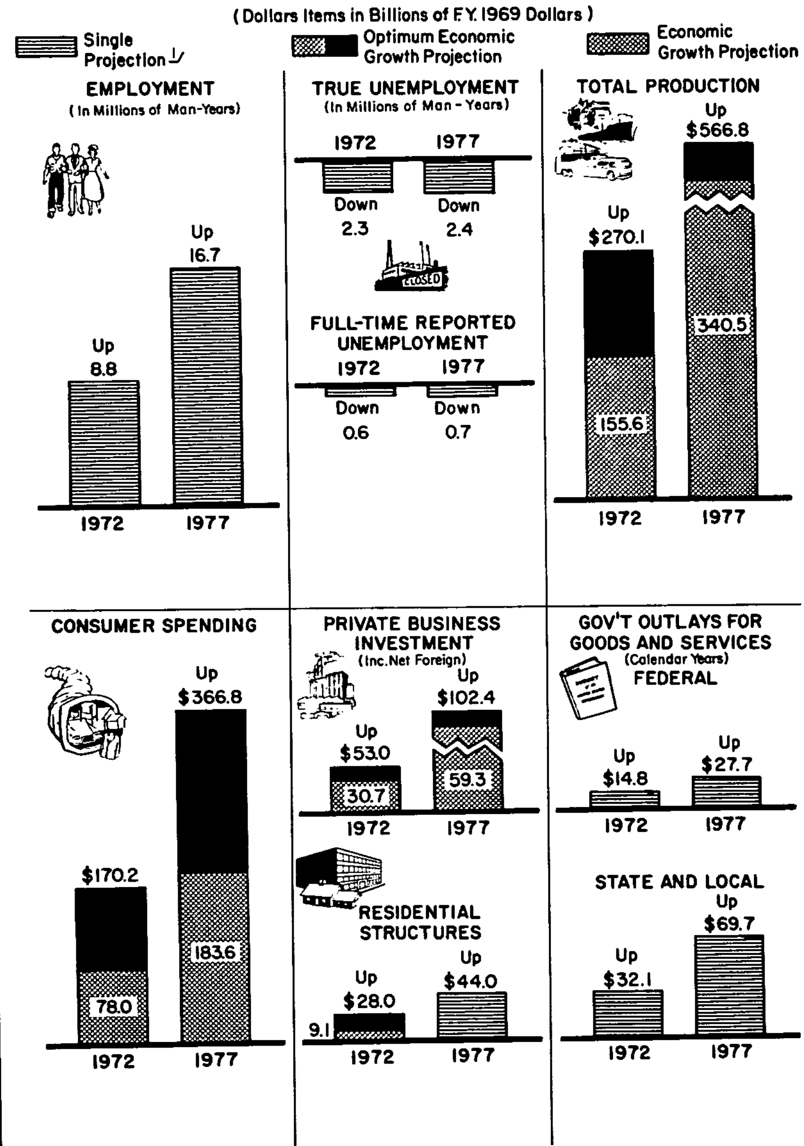

"ECONOMIC GROWTH DIVIDEND",
U.S. ECONOMY, 1968-'77
Total National Production (GNP) in Billions of F.Y. 1969 Dollars
Optimum economic growth rate
Low economic growth rate
$3,031
$1,396
$829
1,170
$567
$303
341
178
1,776
GNP 1967
GNP 1977
"Economic Growth Dividend" 1977
Average Annual "Economic Growth Dividend" 1968-1977
Aggregate "Economic Growth Dividend" 1968-1977
Projections by Leon H. Keyserling.

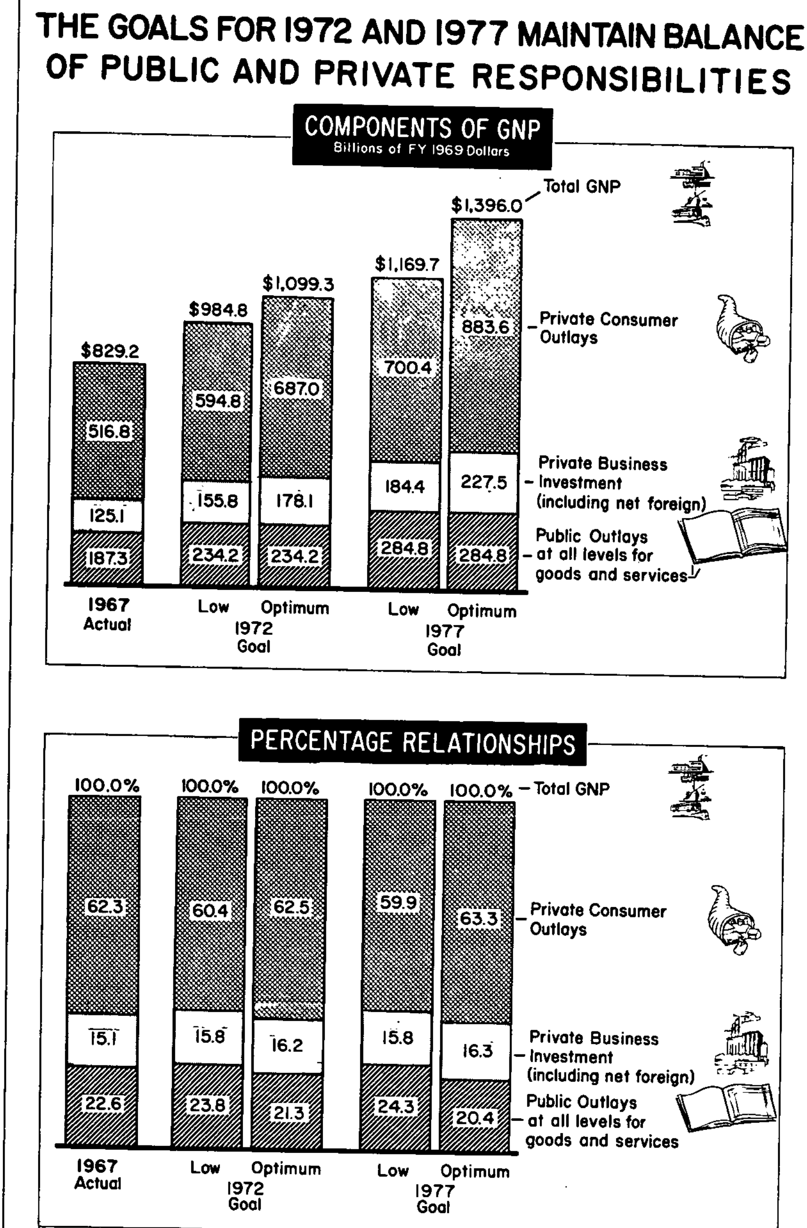
Chart 4

GOALS FOR THE U.S. ECONOMY, 1972 & 1977 PROJECTED FROM LEVELS IN 1967



1/ The single projections relate to goals of such high priority that they should not be reduced even if only the lower goals for GNP are attained. In that event, lower priority objectives should be modified accordingly.

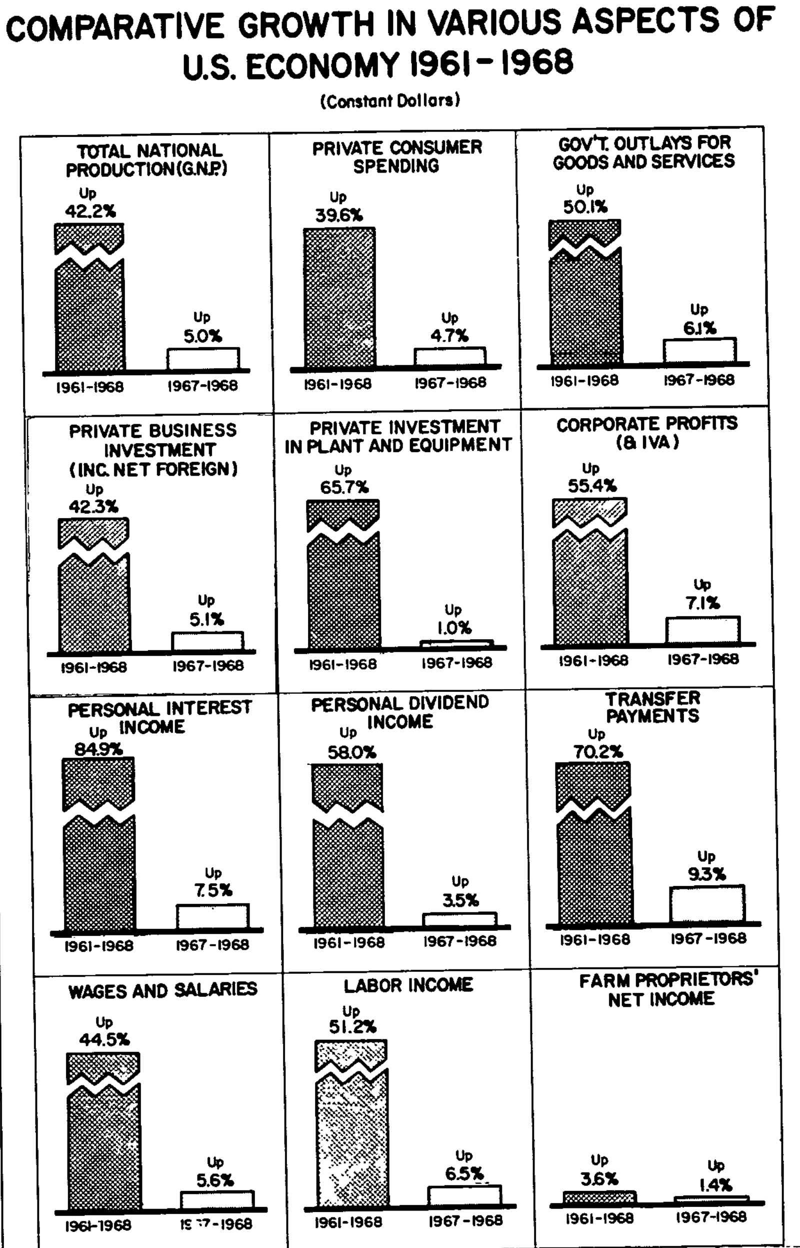
Chart 5



1/ Public outlays are of such high priority that they are projected identically for the lower and higher GNP goals, with modifications of other goals accordingly.

Projections by Leon H. Keyserling.

Chart 6

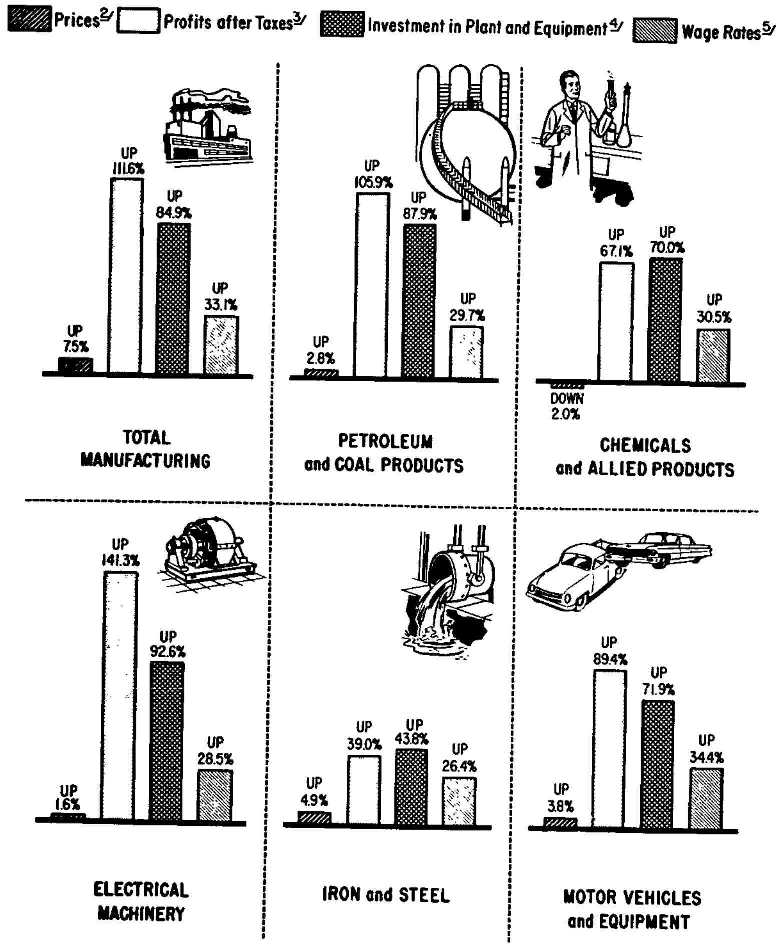


Source: Dept. of Commerce, Office of Business Economics and CEP.

Chart 7

PRICE, PROFIT, INVESTMENT, AND WAGE TRENDS DURING 1960-1968[1]

Percentage Change, 1960-1968



1/ All 1968 data preliminary.

2/ Data: U.S. Dept. of Labor, wholesale commodity price indexes.

3/ Data: Federal Trade Commission-Securities and Exchange Commission.

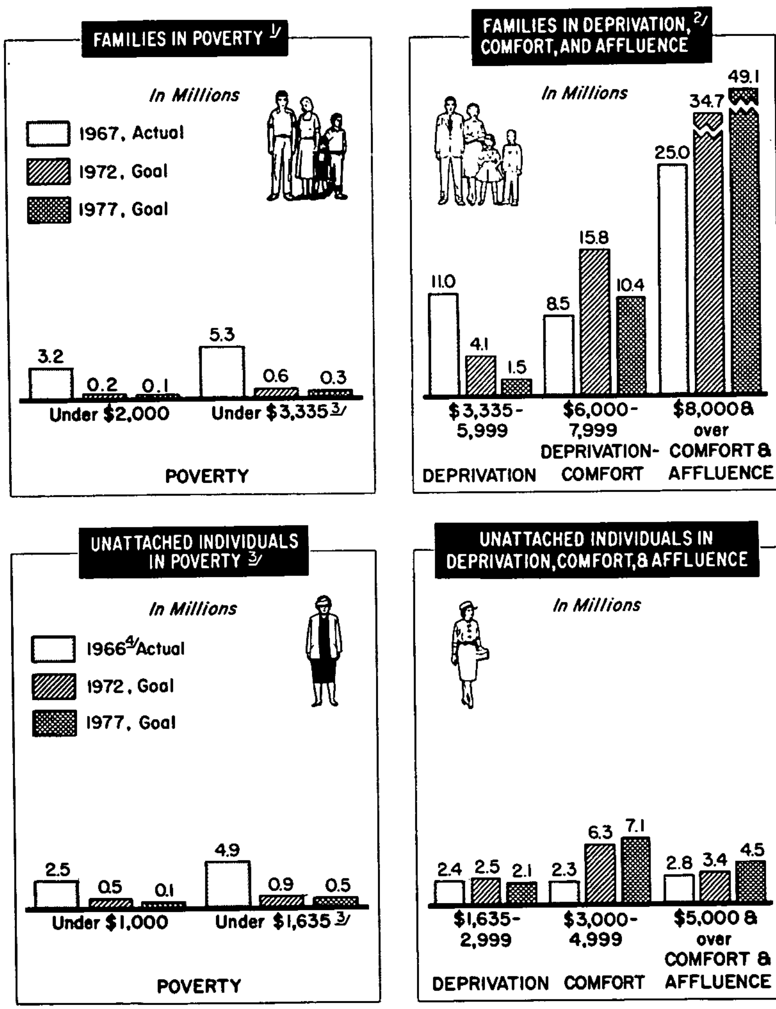
4/ Data: U.S. Dept. of Commerce and Securities and Exchange Commission.

5/ Data: U.S. Dept. of Labor, Bureau of Labor Statistics; Average hourly earnings of production workers.

Chart 8

NUMBER IN U.S. LIVING IN POVERTY, DEPRIVATION, COMFORT, AND AFFLUENCE, 1967, AND GOALS FOR 1972 AND 1977

Annual Money Incomes, Before Taxes, in 1967 Dollars



1/ Poverty-income ceilings vary by size of family. The figure of $3,335 applies to a family of four, according to the estimates of the Social Security Administration, Dept. of H.E.W. The average size of families in poverty being four, 5.27 million families involve about 21.1 million people.

2/ The average size of families living in deprivation is about 3.0, coming to about 33 million people.

3/ The poverty-income ceiling of $1,635 accords with the estimates of the Social Security Administration, Dept. of H.E.W.

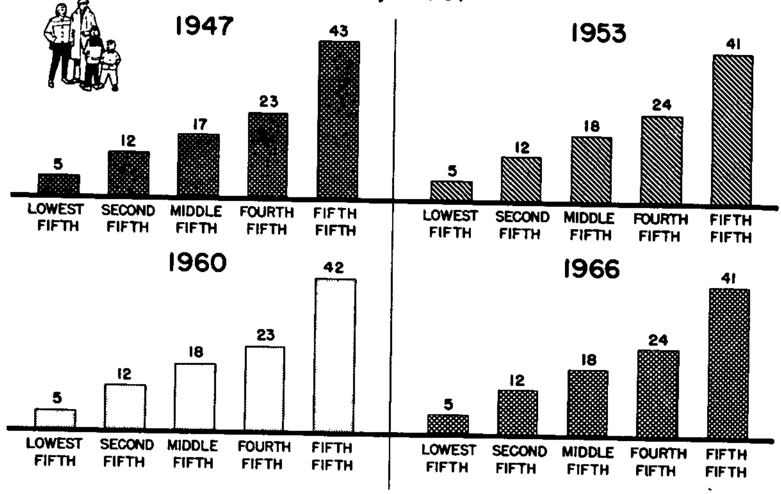
4/ 1967 not available. All projections, however, in 1967 dollars.

Basic Data: 1966, 1967: Social Security Administration, Dept. of H.E.W.; Bureau of the Census, Dept. of Commerce.

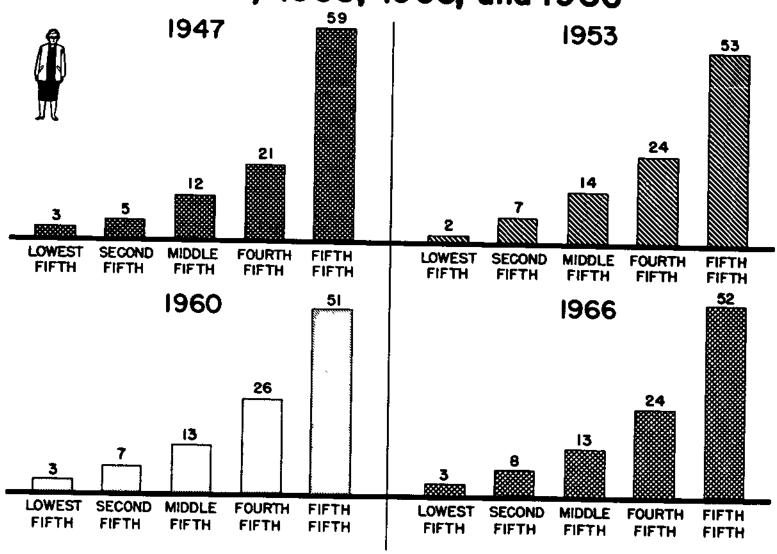
Chart 9

SHARE OF FAMILIES IN TOTAL FAMILY INCOME BY QUINTILES, 1947, 1953, 1960, and 1966

(Money Income)



SHARE OF UNATTACHED INDIVIDUALS IN TOTAL INCOME OF UNATTACHED INDIV., BY QUINTILES, 1947, 1953, 1960, and 1966

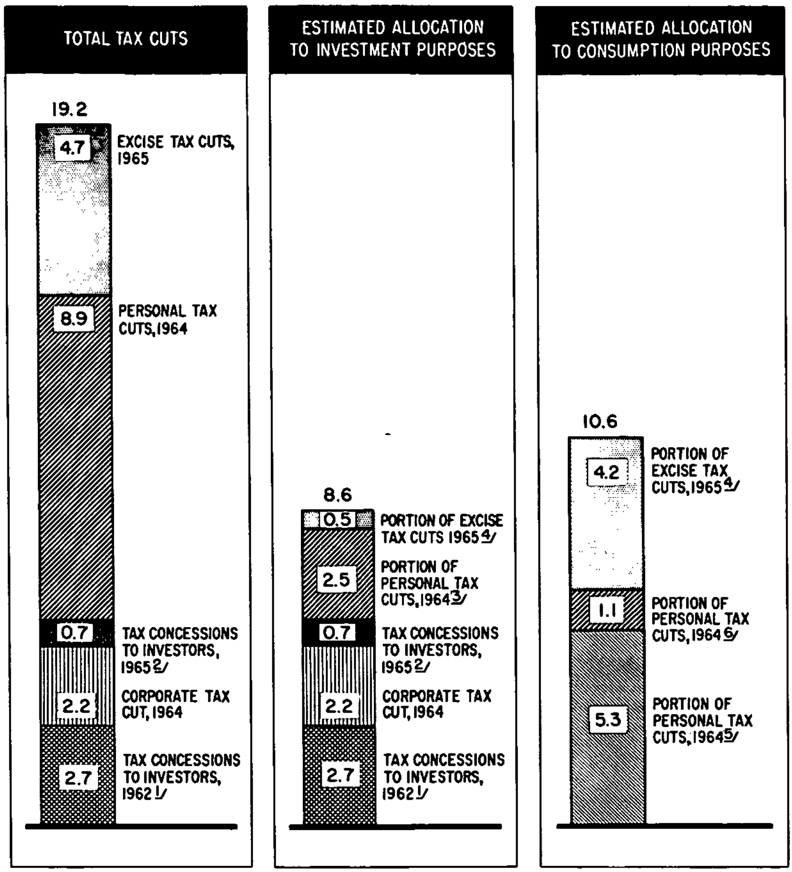


Data: Bureau of the Census.

Chart 16

ALLOCATION OF TAX CUTS, 1962-1965: INVESTMENT AND CONSUMPTION PURPOSES

(Billions of Dollars)



1/ Through Congressional & Executive Action

2/ Through Executive Action

3/ Estimated portion of personal tax cut, for those with incomes of $10,000 and over, which they would save for investment purposes.

4/ Based on estimates of excise tax cuts passed on to consumers through price cuts.

5/ Personal tax cuts for those with incomes under $10,000.

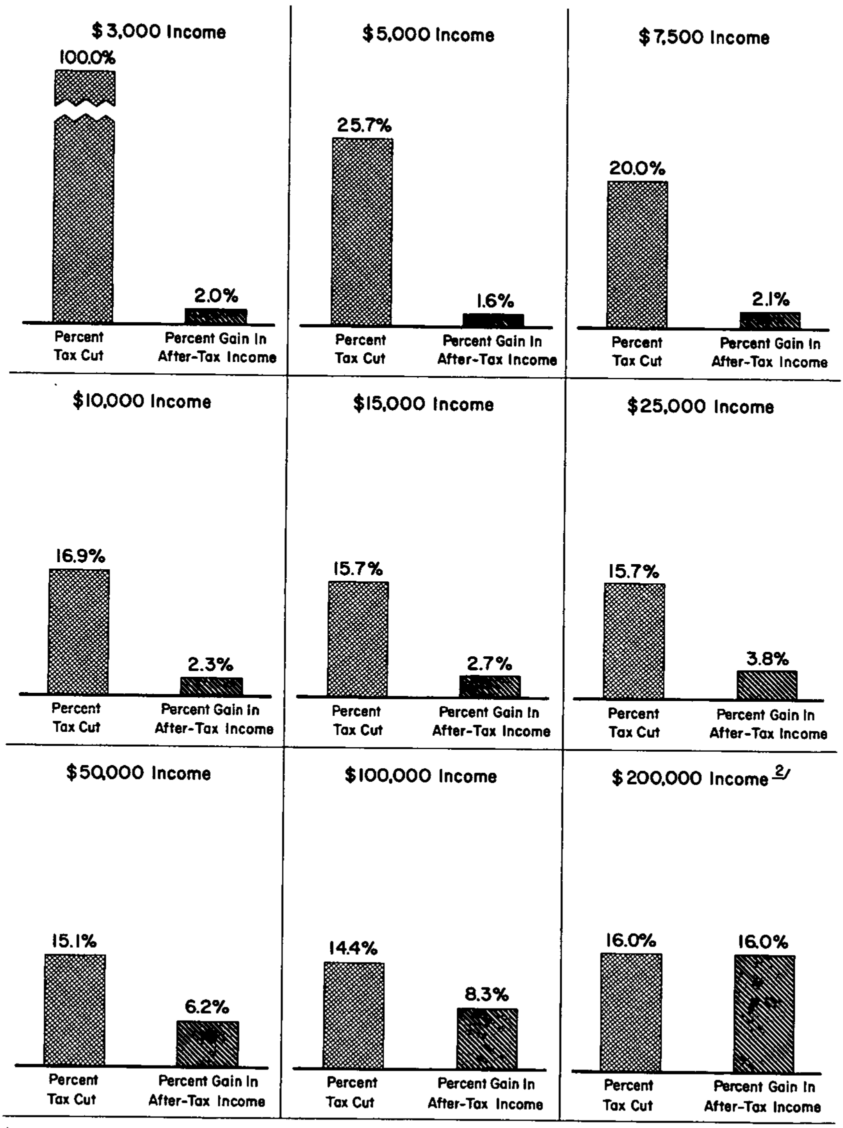
6/ Estimated portion of personal tax cuts for those with incomes of $10,000 and over, which they would spend for consumption.

Note: Estimates of excise tax reduction allocation by C.E.P. (amount might be passed on to consumers by price reductions.) However, a large portion of this did not go to low income consumers.

Chart 11

1964 TAX ACT, PERSONAL TAX CUTS

Percent Tax Cut And Percent Gain In After-Tax Income
Married Couple With Two Children At Various Income Levels [1]

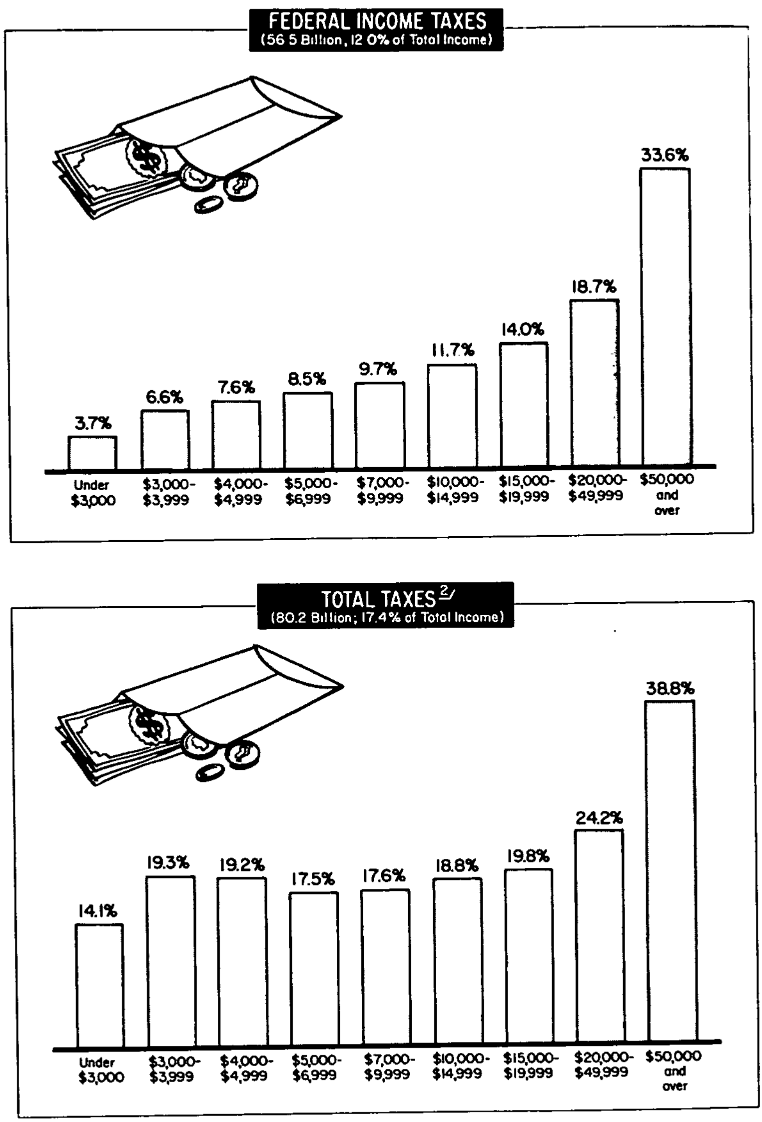


1/ Adjusted gross income levels. 2/ Estimated

Note: Standard deductions for $ 3,000 income level. Typical itemized deductions for other income levels.

Chart 12

TAXES PAID AS % OF INCOME, U.S. 1966[1]



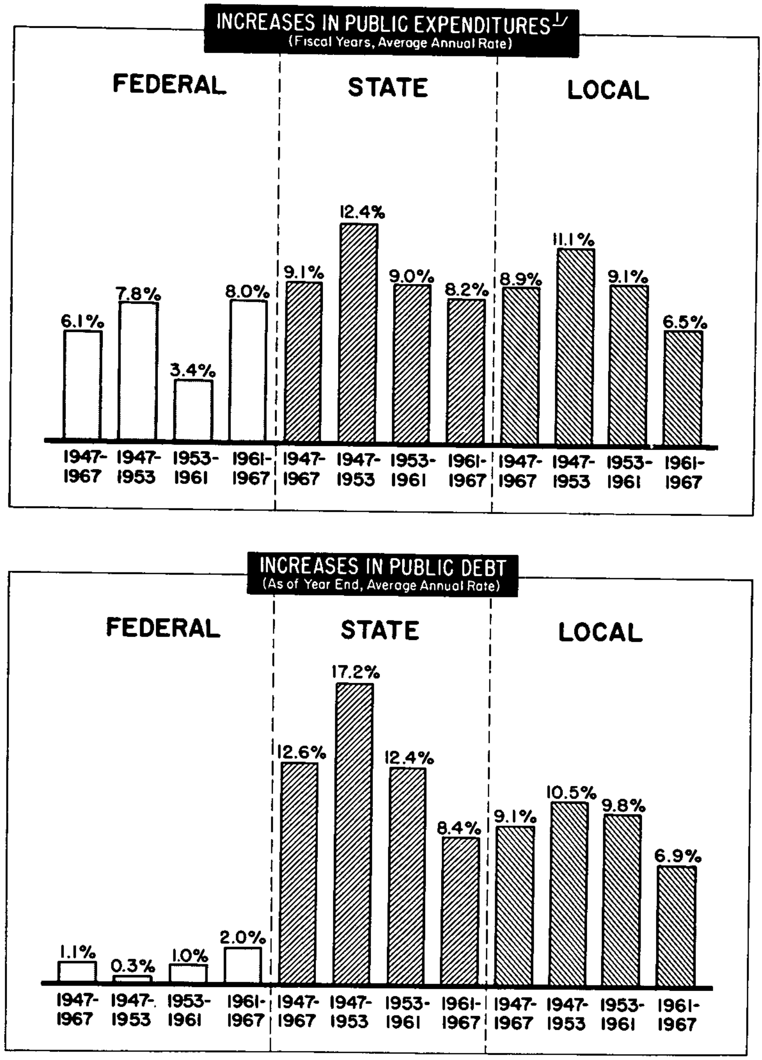
[1] Income relates to "Total Gross Adjusted Income" of all persons in the income classes shown.

[2] Includes Federal Income taxes; social security taxes; State and local income, sales and gasoline taxes; and personal property and real estate taxes.

Basic Data: Internal Revenue Service and Brookings Institution

Chart 13

RESOURCES OF STATE AND LOCAL GOVERNMENTS MORE STRAINED THAN THOSE OF FEDERAL GOVT. RELATIVE TRENDS, 1947-1967



1/ Expenditures classified by source of financing, i.e., intergovernmental transactions treated in terms of originating level of government, rather than recipient government.

Basic Data: Department of Commerce

Chart 14

GOALS FOR A FEDERAL BUDGET, 1972 AND 1977, GEARED TO ECONOMIC GROWTH & PRIORITY NEEDS

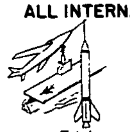
1969, fiscal year; goals for 1972 and 1977, calendar years

All figures in fiscal 1969 dollars[1]

ALL FEDERAL OUTLAYS

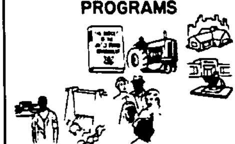
Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969[2]	186.062	917.01	21.02
1972	226.500	1,068.90	20.61
1977	280.000	1,223.77	20.06

NATIONAL DEFENSE, SPACE TECHNOLOGY, & ALL INTERNATIONAL



Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969[2]	89.515	441.18	10.11
1972	90.000	424.73	8.19
1977	94.000	410.84	6.73

ALL DOMESTIC PROGRAMS



Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969[2]	96.547	475.84	10.91
1972	136.500	644.17	12.42
1977	186.000	812.93	13.32

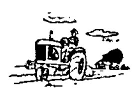
ECONOMIC OPPORTUNITY PROGRAM

Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969[2]	2.000	9.86	0.23
1972	3.800	17.93	0.35
1977	5.500	24.04	0.39

HOUSING AND COMMUNITY DEVELOPMENT

Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969[2]	2.784	13.72	0.31
1972	5.500	25.96	0.50
1977	9.000	39.34	0.64

AGRICULTURE; AND NATURAL RESOURCES



Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969[2]	8.099	39.91	0.91
1972	12.000	56.63	1.09
1977	15.500	67.75	1.11

EDUCATION

Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969[2]	4.699	23.16	0.53
1972	16.200	76.45	1.47
1977	32.900	143.79	2.36

HEALTH SERVICES AND RESEARCH

Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969[2]	10.655	52.51	1.21
1972	14.000	66.07	1.27
1977	20.000	87.41	1.43

PUBLIC ASSISTANCE; LABOR, MANPOWER, AND OTHER WELFARE SERVICES

Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969[2]	6.280	30.95	0.69
1972	9.500	44.83	0.86
1977	15.100	66.00	1.08

1/ Dollars of purchasing power apparently assumed in President's fiscal 1969 Budget.

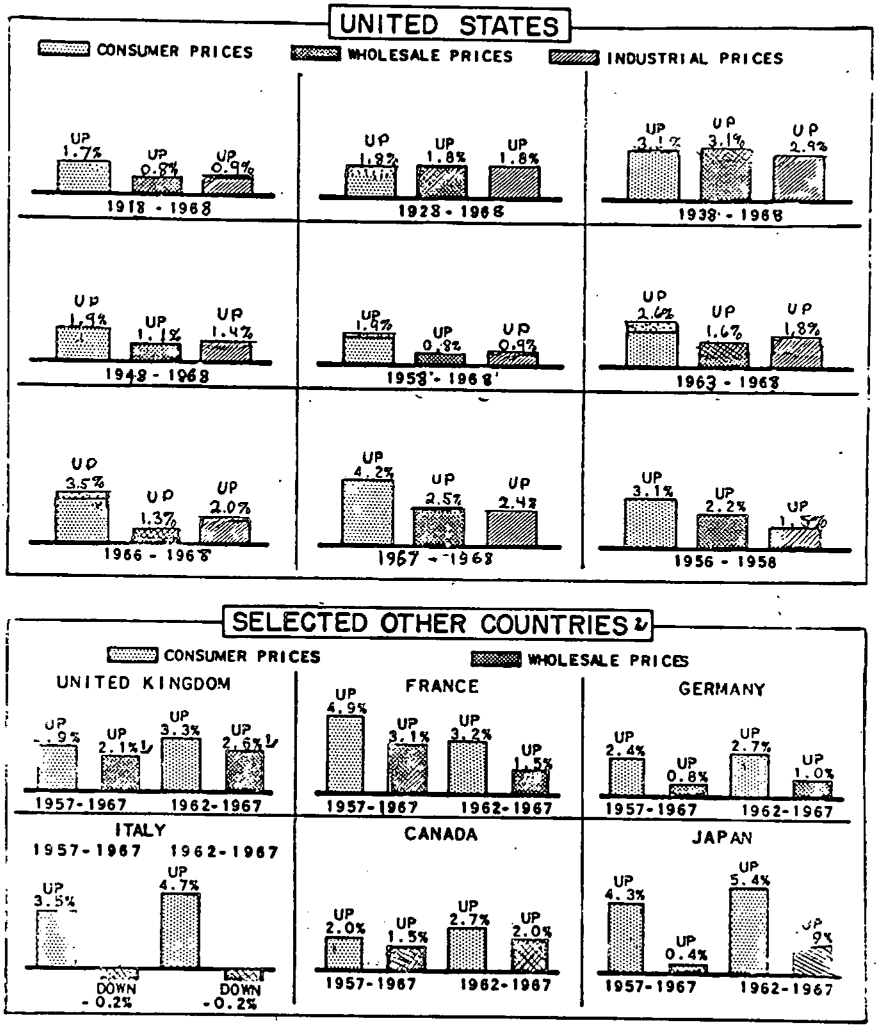
2/ Administration's Proposed Budget as of Jan. 29, 1968. Beginning with fiscal 1969, the Budget includes the immense trust funds, net lending, and other relatively minor new items. Note: Goals include Federal contributions of one billion in 1970, and more than two billion in 1977, to the OASDHI to help increase benefit payments to the aged.

Projections by Leon H. Keyserling.

Chart 15

SELECTED PRICE TRENDS, 1918-1968
U.S. AND SELECTED OTHER COUNTRIES

AVERAGE ANNUAL RATES OF CHANGE



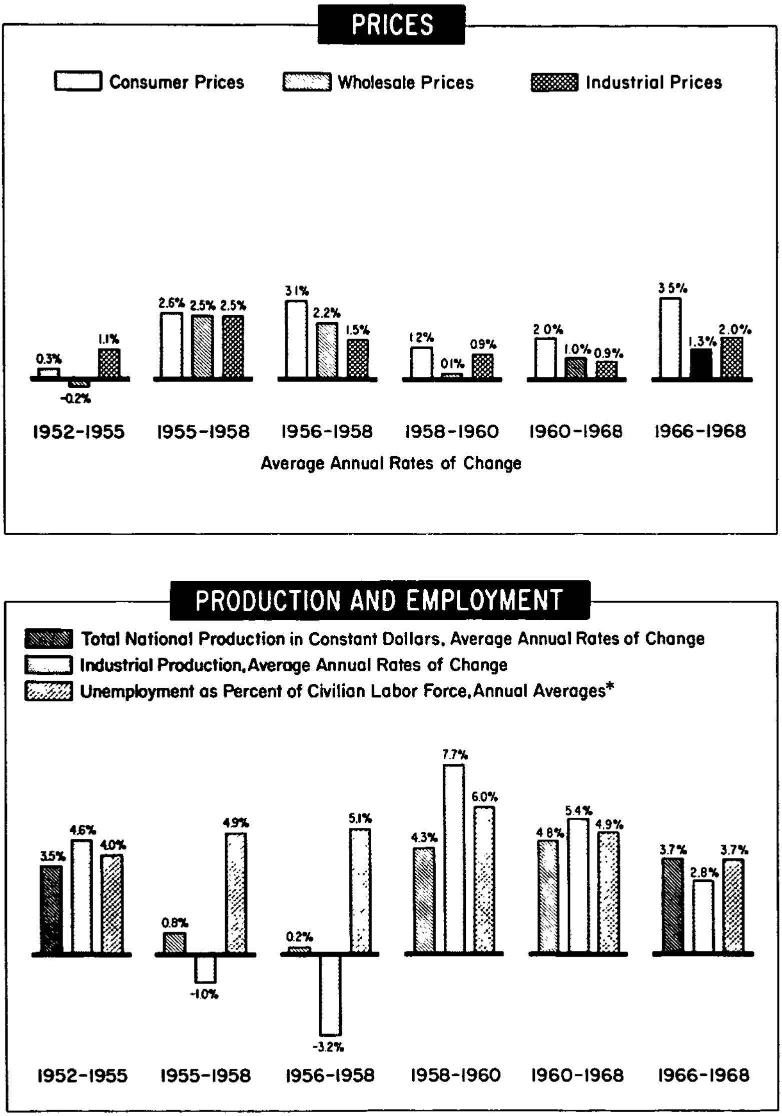
1/ WHOLESALE PRICES OF FINISHED GOODS (WHOLESALE PRICES OF BASIC MATERIALS INCREASED 0.1% A YEAR DURING 1957-'67 AND 1.6% A YEAR DURING 1962-'67).

2/ 1967 DATA ARE PRELIMINARY ESTIMATES BASED UPON FIRST NINE TO ELEVEN MONTHS.

SOURCE: BUREAU OF LABOR STATISTICS; OFFICE OF BUSINESS ECONOMICS; AND THE UNITED NATIONS; DEPT. OF LABOR; AND ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT.

Chart 16

RELATIVE TRENDS IN ECONOMIC GROWTH UNEMPLOYMENT, & PRICES, 1952-1968[1]

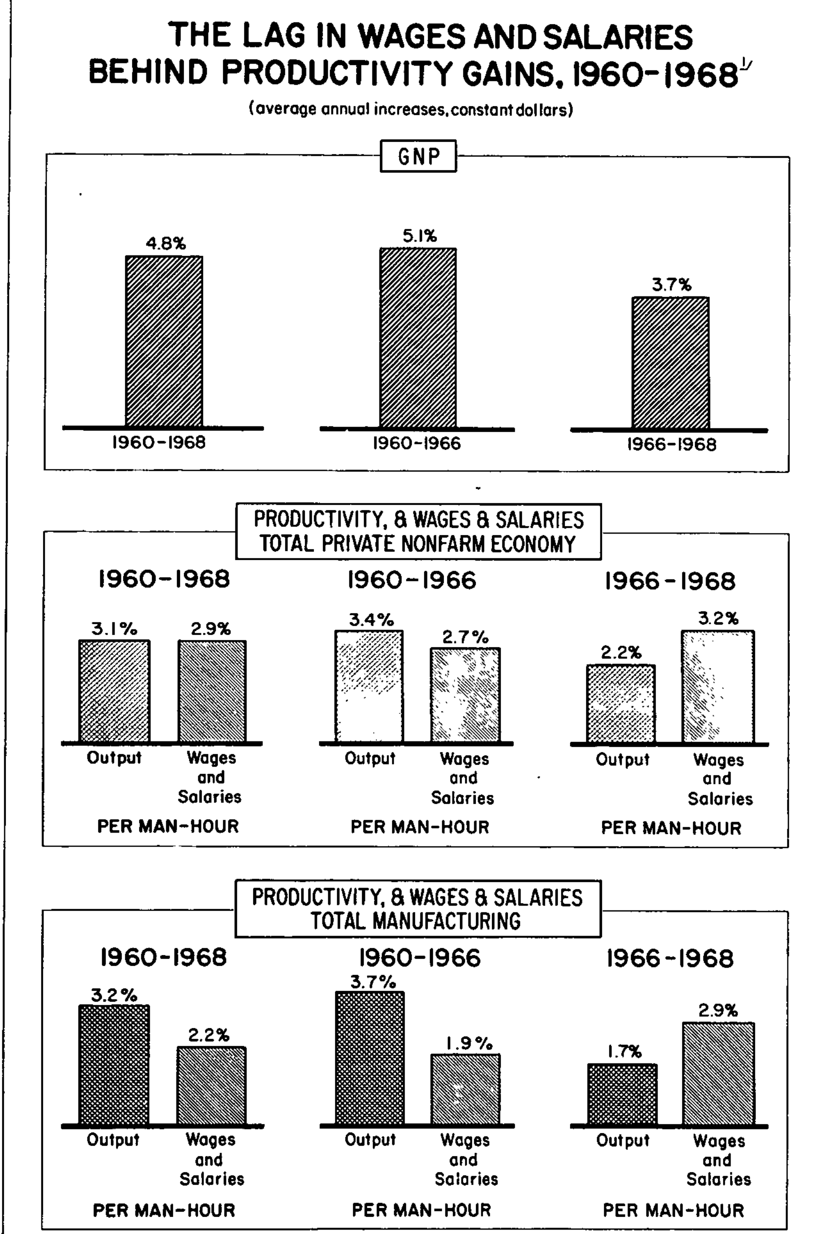


[1] Preliminary 1968 data.

*These annual averages (as differentiated from the annual rates of change) are based on full-time officially reported unemployment measured against the officially reported Civilian Labor Force.

Source: Dept. of Labor, Dept. of Commerce, & Federal Reserve System.

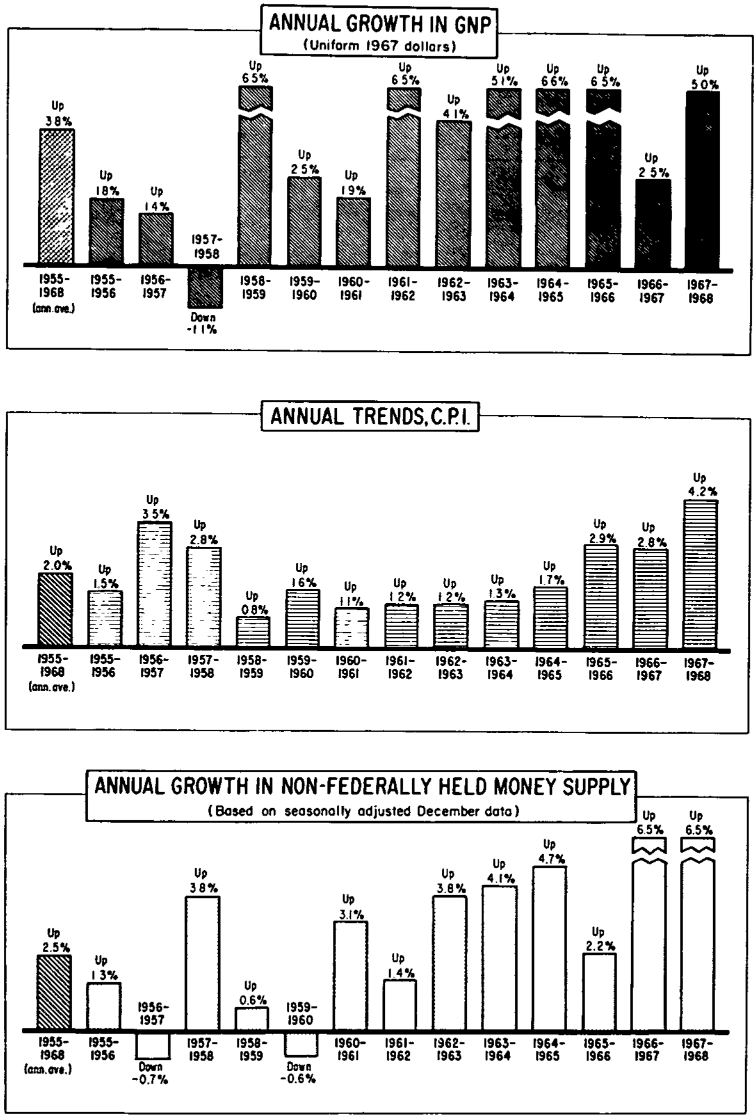
Chart 17



[1] All 1968 data preliminary.
Basic Data: Dept. of Commerce; Dept. of Labor

Chart 18

COMPARATIVE TRENDS IN GNP, PRICES, AND NON-FEDERALLY HELD MONEY SUPPLY, 1955-1968[1]



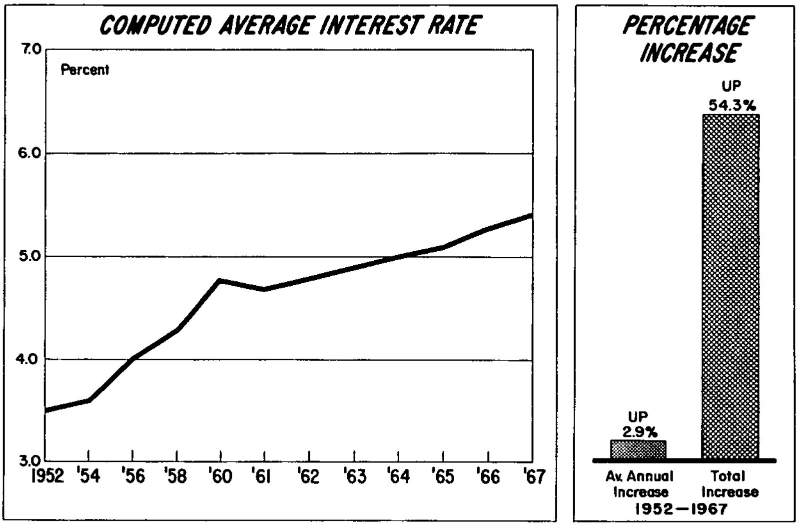
[1] All 1968 data preliminary.

Data: Economic Report of the President

Chart 19

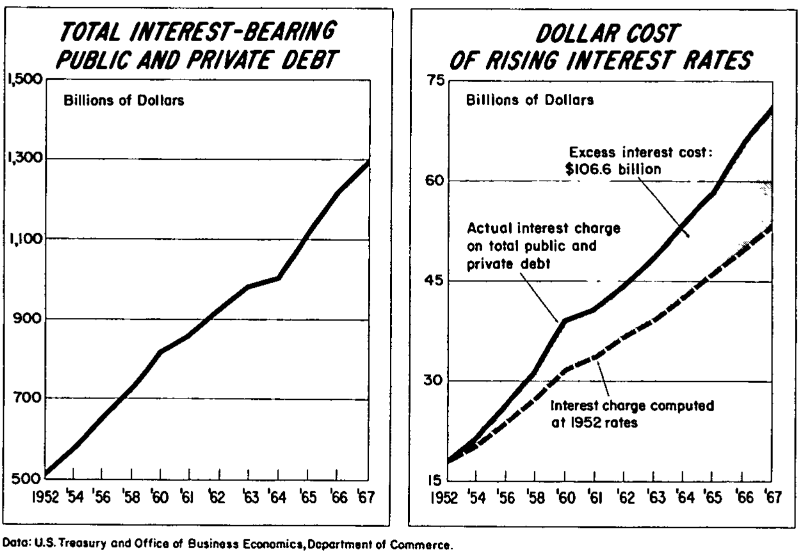
AVERAGE INTEREST RATES ON TOTAL PUBLIC AND PRIVATE DEBT, 1952-1967

Calendar Years



TOTAL PUBLIC AND PRIVATE COST OF RISING INTEREST RATES, 1953-1967

Calendar Years



Data: U.S. Treasury and Office of Business Economics, Department of Commerce.

CUNA INTERNATIONAL, INC.

By J. Orrin Shipe, Managing Director

This statement is submitted on behalf of CUNA International representing credit unions in every State of the Union, District of Columbia, and Puerto Rico. Over 20 million Americans belong to credit unions at the beginning of 1969.

CUNA International appreciates the opportunity to express its views concerning certain aspects of the Economic Report of the President transmitted to Congress, January 1969.

General Economic Position

Nineteen hundred and sixty-eight turned out to be a much better year than expected. The economic boom in business continued through the entire year; the policy of the Government to moderate inflationary forces through the imposition of a surcharge was approved by the Congress; peace talks had started on the war in Vietnam; inflation, however, continued to undermine the value of savings in credit unions and other financial institutions. As President Johnson has stated in this report, "The immediate task in 1969 is to make a decisive step toward price stability."

The Credit Union Member

More than a million persons voluntarily joined credit unions in 1968. This credit union family generally has stable employment; a mortgage on their home; makes an average of over $7,500 a year; has very little in readily available liquid assets. Two-thirds of the credit union families are forced to borrow for consumer installment needs. The average savings of these credit union families are low. Most of these members have steady employment. Therefore, they have the problems of maintaining a rising standard of living while paying increasingly heavier local, State, and Federal taxes; at the same time paying off the mortgage on their homes, their installment debt, and, saving funds to educate their children and for future needs.

The continued rise of prices in 1967 and 1968 provided them with a serious challenge. They saw the value of their savings in the credit union and in other financial institutions being reduced by an inflationary trend.

The heart of the credit union is the member. The credit union is created to serve the needs of the member. Anything that harms the member is of interest to the credit union. An inflationary trend that eats away the value of the savings of credit union members and other Americans can only harm these individuals. As President Johnson has stated, "The first line of defense of the dollar is the strength of the American economy." The need for some price stability with economic growth is primordial to our comments. The distortions that inflation brings about in the structure of the economy and the pressures it generates in financial markets, inevitably results in economic dislocation to those on fixed incomes.

The reduction of income in the hands of the public together with a sound Government budgetary program may bring price stability in 1969. The estimated surplus of $3.4 billion should reduce the inflationary trend. An institution as a credit union that only accepts savings that can be withdrawn on a moment's notice, would have difficulty protecting the works that it undertakes if a constant inflationary trend reduces the value of the savings that our members have placed with us.

If it is necessary to maintain the surcharge on income taxes as suggested by President Johnson in order to produce greater price stability, we believe that this should be viewed along with other measures of tax reform in order to lessen some of the burdens of taxes on the lower and middle income families.

While credit unions are interested in price stability, we recognize that the bulk of our members live in the large urban complexes. Therefore, many of the nonmilitary Government programs that will aid the living conditions in urban centers are in the best interest of the credit union families and the Nation. CUNA believes that there should not be a reduction in Government programs that aid the poor, the aged, and those that live in urban centers. Programs for additional training, education, and health should be supported.

Balance of Payments Problem

As credit unions continue to expand overseas, CUNA International becomes more and more involved with the problems of the balance of payments. The 1968 U.S. foreign trade surplus dropped to the lowest level in 30 years. A surplus on merchandise trade of only $725 million was a distinct change from the high level surpluses of preceding years. We recognize the necessity of need for freer trade between nations. The United States will be unable to change its current balance-of-payments problems if prices continue to rise domestically. All of the schemes to increase international liquidity will fail if we cannot sell U.S. goods abroad at a competitive price.

Summary

The credit union movement through CUNA is intensely interested in programs that will increase the strength of our Nation and our members. We recognize that our members are facing problems of increased inflation in 1967 and 1968.

Unchecked inflation can only drive up the prices of all commodities including money. We urge positive programs to protect the Nation and our members from the hardships of inflation.

We urge that domestic programs to aid those living in urban centers be continued and strengthened.

FEDERAL STATISTICS USERS' CONFERENCE

This statement is submitted on behalf of the Federal Statistics Users' Conference whose membership is composed of organizations from all sectors of the economy. Our members have a common interest in the development of adequate, reliable, and timely statistics from Federal sources.

The Conference appreciates the opportunity to express its views regarding certain statistical materials which provide much of the information upon which the President's Economic Report and the Report of his Council of Economic Advisers is based. This vast storehouse of information is used by private as well as public planners and policymakers in making important decisions that affect the course of the economy. It is important for all of us that our actions and policy decisions are based upon the best measures of the economy that it is possible to obtain.

We consider these two documents and the Federal Budget of such importance to our members, and others, that for 3 consecutive years we have sponsored 1-day conferences at which these documents were discussed by the chairman, or a member, of the Council of Economic Advisers, and by the Director, or Assistant Director, of the Bureau of the Budget. We plan to hold a fourth annual conference in April or May of this year. Our purpose is to help raise the level of understanding of the public policy issues involved in these documents and to assist users of them in making more effective use of the information they contain.

This year, neither the President's Budget Message nor his Economic Report gave even passing mention to the need for improved economic statistics. This is in contrast to last year when President Johnson, in his Budget Message, identified five "long-standing goals" one of which was: "Providing improved statistics to aid business, labor and government in sustaining economic growth." In his Economic Report last year the President said: "Accurate, comprehensive and timely statistics are essential to the development of sound economic policies by government, business and labor. Our economic statistics are the best and most comprehensive in the world, but they can be and need to be further improved. The costs will be exceedingly small relative to the benefits." The passing of 1 year has not diminished the accuracy of that statement, nor the necessity for continued emphasis upon improvement of our economic statistics. We urge that the Joint Economic Committee, in its 1969 Report, not overlook stressing these needs.

Last year's Report of the Council of Economic Advisers directed specific attention to improvement in economic statistics and outlined a program for improvements in such statistics. That report carefully spelled out the need as follows:

> "That need is accentuated by the current state of the economy and the current aims of policy. Sustaining expansion close to the

economy's potential growth path is a more difficult task than that of merely attempting to moderate wide swings in output. In a slack economy, it was often sufficient for the indicators merely to point in the right direction. Now more accurate information about the speed of the movement and the distance from full employment is called for. The need for early and careful diagnosis of the extent and location of inflationary dangers also requires comprehensive information about the price, cost, and productivity performance of various sectors of the economy. Capital markets and especially the mortgage market have taken on a key role, calling for more comprehensive data and indicators. The current importance of our international trade position places added emphasis on the need for better information about export and import prices."

The 1968 report of the CEA proposed 10 key items for improvement in the area of economic statistics. Although FSUC agrees with and recognizes the need for economy and establishment of priorities in connection with Federal programs, we supported those 10 key items because we considered them priority items. We further agreed with the Economic Report in its statement that each improvement was recommended because it met these tests: "That it assist current policy formulation, that the proposal be capable of rapid implementation and that its costs be moderate, given the present budgetary stringency."

We are pleased to learn that action has been initiated to implement the recommendations on four of these 10 key items. However, no action has been taken on six of these items, because the Congress failed to approve the 1969 budgets requests of the three agencies involved in implementing the recommendations. They are the Office of Business Economics, the Bureau of the Census, and the Bureau of Labor Statistics. The six items are:

(1) *Nonmanufacturing industries.*—Additional information on employment, wages, investments, sales, and other indicators for trade, services, and finance that will bring the data closer to the coverage and quality of the data now available for manufacturing industries.

(2) *Business investment.*—Extension of coverage of the plant and equipment survey to all nonfarm industries, and collection of separate quarterly data on business investment in plant, as distinguished from equipment.

(3) *International price competitiveness.*—A better comparison of price trends of internationally traded goods.

(4) *Improved price indexes.*—Covering individual industries systematically, emphasizing actual transactions rather than quoted prices, and developing methods to make more adequate allowance for quality changes in our measurement of prices.

(5) *Quarterly data on national product by industry.*—A new economic tableau that will ultimately provide comprehensive information on output, labor input, prices, and productivity by major sectors on a quarterly basis.

(6) *Manufacturing inventories.*—Expanded coverage and increased detail.

The fiscal 1968 budget also included appropriation requests for some of these improved programs, but the Congress failed to approve the requests. The range in costs of these individual programs is from $100,000 to $200,000. The total cost for all would approximate $800,-000–$900,000.

The 1968 Joint Economic Report emphasized that high priority should be accorded to research in the area of prices and price indices and also that Government agencies should push rapidly ahead with the development and regular publication of industry data on output, productivity, prices, capital, labor, and incomes. In view of this we wish to call the committee's attention to the fact that the following programs of the Bureau of Labor Statistics (included in the 1968 and 1969 budget requests and denied by the Congress) were not even included in the 1970 budget:

(1) Inauguration of a semiannual survey of general changes in wage rates and benefits in the *nonmanufacturing* sector.

(2) Extension of wholesale price index series to 75 additional industries.

(3) Collection of data on transaction prices rather than list or quoted prices for 40 major commodities in wholesale markets.

(4) Initiation of work on obtaining price data for commodities in U.S. import and export trade.

These are certainly high-priority items so far as our economic information needs are concerned, but rate a low priority when it comes to appropriation of funds.

The 1970 budget includes a request of the Office of Business Economics for $100,000 to strengthen the plant and equipment survey by expanding its coverage to include the service-type industries and nonprofit institutions, and to obtain from all industries a separation of their investment activity as between plant and equipment. In the previous 2 fiscal years, the OBE had requested, but was denied, funds for beginning the preparation of real GNP by industry on a quarterly basis ($76,000). The 1970 budget does not include this program.

Other priority items included in previous budget requests of OBE are not in the 1970 budget. These include: Publication of personal income by States on a quarterly basis, and initiating work on estimates of the total tangible capital stock of the United States.

The total budget of the Office of Business Economics ($3.3 million estimated for 1970) is indeed small considering the significance and widespread use made of its data for measuring the state of the U.S. economy and for guiding decisionmakers regarding economic policies and programs.

The need for the above-listed improvements has long been recognized. How much longer must we wait before constructive action is taken to implement these recommendations? Although the most significant increases in statistical programs in recent years has been in the area of social statistics, major advances in economic statistics must not be neglected. We respectfully urge that the Joint Economic Committee emphasize in its report that these are priority items deserving immediate attention and funding.

At this point, we wish to call the attention of the committee to developments in the Congress that could impair the future collection of vital economic data and particularly at subnational levels. The first is a proposal that would allow only six mandatory questions in the 1970 Census of Population and Housing, all other questions being on a voluntary basis, including questions on education, employment, housing and income. If this legislation is passed, there is a good possibility that it would eliminate data on a block basis; it would severely limit, or perhaps completely eliminate certain data on a census tract or county basis; and that it would severely reduce, or make questionable, the reliability of data for larger cities, SMSA's, larger counties, and even for some States. Officials concerned with urban and rural problems have a crying need for more and better information on the economic characteristics of the population at these various subnational levels. The need for data for very small areas has grown rapidly as more and more communities analyze their own problems and make plans for dealing with them, neighborhood by neighborhood. Their ability to deal with these problems would be severely impaired if certain types of data are denied them at the desired area levels.

A second proposal would place all questions contained in the 5-year economic censuses on a voluntary basis. If this is done, then there is a real danger that the comparability of data as between censuses would be greatly diminished and especially at subnational levels. There is even a possibility that some of the economic censuses would be of no value whatsoever because it might not be possible to obtain meaningful totals for certain industries. This could result, for example, if several major firms in an industry category should decide not to participate in the census.

We must also point out that there is a great deal of misinformation and misunderstanding about the purposes of these censuses and the valuable contribution they make toward a better understanding of the nature and composition of our economy and society. Those who are proposing a curtailment of the population, housing and economic censuses need to be made aware of the serious effect such proposals would have on the continued collection of adequate, reliable, and comparable data that have been so carefully developed over the years to aid us in dealing with the myriad of problems that beset this Nation today. In our opinion, passage of this type of legislation would be the most damaging step Congress could take regarding our statistical system and it would reverse the intent and policy of the Congress which has been repeatedly expressed over the long history of the census.

On the more positive side, we agree with the Report of the Council of Economic Advisers which says: "Although there are still gaps in economic statistics, considerable progress has been made in recent years by the Department of Commerce, the Department of Labor, and other Federal Government agencies in increasing the quantity and improving the quality of statistical data available for assessing the performance of the economy."

We believe that the following examples of recent accomplishments are worthy of note:

By the *Bureau of the Census*.—Launching of a new publication, *Defense Indicators*, which replaces the Department of Defense publication, *Selected Economic Indicators;* enlargement and improvement of *Business Conditions Digest* (formerly *Business Cycle Developments*); extension of the business censuses and greater use of administrative records to minimize reporting burden; initiation of first census of construction industries to be taken since 1939; and initiation of a new monthly report of Export and Import Merchandise.

By the *Office of Business Economics.*—Completion of estimates of personal income for selected years through 1966 for all standard metropolitan statistical areas (SMSA's) and for all counties lying outside SMSA's; calculation of alternative measures of corporate profits based on investment statistics in the national accounts; updating of the measurement of fixed business capital in the United States to extend the estimates through 1966.

By the *Bureau of Labor Statistics.*—Publication, jointly with the Bureau of the Census, of a report entitled "Social and Economic Conditions Affecting Negroes in the United States"; publication of the standard household budgets for differing family and rural or urban situations; launching of a comprehensive data collection system in the slums of six large cities to measure in depth job problems and barriers to employment of slum area residents; and studies of labor force characteristics in the 20 largest metropolitan areas and 14 central cities; and the poorest one-fifth of the neighborhoods in the Nation's 100 largest metropolitan areas.

In conclusion, we wish to thank the Chairman and the committee for inviting our comments on the economic issues which concern the Nation and our own organization. We also wish to commend the committee for the vital, necessary, and leading role it has played in the development of improved statistical programs. It has indeed become a strong voice urging and defending adequate and proper economic statistics. We pledge our continued support and cooperation to the work of the committee.

MACHINERY AND ALLIED PRODUCTS INSTITUTE

By Charles Stewart, President

The institute is always privileged to receive an invitation from the Joint Economic Committee to submit comments on the economic issues which concern the Nation and private business, including the capital goods and allied equipment industries which we represent. In responding to such an invitation, we try to give central consideration to our view of the public interest as well as attempting to underline problems and opportunities affecting our sector of the economy.

The Inflation Dilemma

We have delayed our response until we could make available to the committee a very timely, and we feel quite informative, economic study conducted by Research Director Terborgh of the institute as a part of the total research effort of MAPI. This study is entitled, "The Inflation Dilemma." It is presently being printed as a pamphlet but we thought that the committee would appreciate having access to an advance copy in mimeographed form.

The study speaks for itself but it might be useful to call the attention of the committee to the central point in the conclusion to the document which is stated by Mr. Terborgh as follows:

> A final comment on our present predicament. If we are right that the principal inflationary dynamic of the past few years has been rising labor costs, if exhortation has failed to restrain them, and if direct controls are out, only one effective remedy remains: relaxing the labor market. So long as we continue to have a drum-tight market in the major wage-determining category—adult males—the chance of slowing down the advance of hourly compensation, and with it the advance of prices, is slim.

I commend this study to the readership of the committee.

Investment Tax Credit

The Joint Economic Committee has consistently expressed interest in the investment tax credit, and during the recent hearings this matter was again raised, at least during periods of interrogation. The institute has given extensive study to the investment tax credit and supports it unequivocally as a permanent part of our tax structure. Moreover, our study work and the 1966 experience with attempting to use the investment credit as an economic control device, in our judgment, demonstrate conclusively that the investment credit is totally unsuitable for manipulative application as a device for economic control purposes. We submit for the record *Capital Goods Review* No. 67 published in September 1966 entitled "The Investment Credit as an Economic Control Device." We suggest respectfully that we should learn from the lessons of the past and the 1966 experiment with manipulation of the investment credit was a debacle and should not be repeated. Also in this connection, we call your attention to the statement submitted by the institute on March 31, 1966, to the Subcommittee on Fiscal Policy of the Joint Economic Committee entitled "The Investment Credit—The Case for Its Permanency." A copy of that statement is attached with the conviction that the central points underlined in that presentation are just as valid today as they were in 1966.

Extending one of the points referred to in the earlier MAPI presentation on the investment credit, the committee we are sure is sensitive to the fact that U.S. industry has been confronted for an extended period with a terrifically steep trend upward in the index of labor cost per unit of output in manufacturing. From a low of 98.6 in July of 1965 (1957–59—100) the index has increased to 112.9 in January of this year which is the latest month for which figures are available. The only way in which American industry can meet this cost-push inflation is through modernization and the investment credit is an extraordinarily important tool to facilitate the process of modernization in U.S. industry.

Finally, as to the investment credit, we are gratified to note that in remarks before the Business Council on Friday, March 21, the Secretary of the Treasury made the following statement:

> We have no plans for tinkering with the investment tax credit. Congress intended the credit to be a part of the regular tax system, and not a device for stimulating or slowing the economy. Moreover, the credit has been highly effective in encouraging the longrun investment that creates additional jobs and income.

Controls on Foreign Investment

Turning to another area of public policy; namely, controls on U.S. direct foreign investment, it has been the consistent position of the institute since these controls were first placed in effect in January 1968 that the basic policy decision was a national mistake and that the structure of controls implementing that decision is wholly unsound. In this connection, we submit for the record a copy of a letter addressed by the institute to President Nixon dated January 7, 1969. MAPI is presenting a current statement on the subject of foreign investment controls to the Subcommittee on Foreign Economic Policy of the House Committee on Foreign Affairs in public hearings tomorrow, March 27, and that presentation is, of course, available to the members and staff of the Joint Economic Committee.

Trends in Capital Goods

By way of helping to give the committee a broader perspective with respect to developments in the sector of capital goods, we refer the committee to George Terborgh's recent analysis of the behavior of the capital equipment industries over the last decade. It is published in the form of *Capital Goods Review* No. 77, March 1969, copy enclosed. As the committee will note, this decade shows a remarkable stabilization of the orders-shipments ratio for capital equipment. In other words, there has been for this extended period of time a comparatively orderly behavior of equipment demand and a generally excellent response of suppliers representing a remarkable and gratifying achievement for stability in our economy.

(Additional materials offered by MAPI for inclusion in the record follow:)

THE INFLATION DILEMMA *

BY GEORGE TERBORGH, RESEARCH DIRECTOR

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APPENDIXES

Chapter 1

THE TRADE-OFF BETWEEN UNEMPLOYMENT AND INFLATION

Early in 1962, the Council of Economic Advisers proposed an unemployment target for the American economy. "In the existing economic circumstances," it declared, "an unemployment rate of about 4 percent is a reasonable and prudent full-employment target for stabilization policy." [1]

As the reference to "existing economic circumstances" suggests, this was not conceived as a permanent target. The Council observed that "If we move firmly to reduce the impact of structural unemployment, we will be able to move the unemployment target steadily from 4 percent to successively lower rates." Four years later, indeed, it felt that a reduction had become appropriate: "The unemployment rate has now virtually reached the interim target and is projected to fall below 4 percent in 1966. There is strong evidence that the conditions originally set for lowering the target are in fact being met, and that the economy can operate efficiently at lower unemployment rates." [2]

This conviction was short-lived, however. After a year's experience with lower rates (the average for 1966 was 3.7 percent), the Council reaffirmed the original figure. After citing advocates of 5- and 3-percent targets, it concluded that "The experience of the past year provides a partial answer, suggesting that the 4-percent judgment was nearest to the mark." [3] This figure was again reaffirmed 2 years later:

> "In light of the considerations discussed above, a 4-percent unemployment rate was established as an 'interim' target for national policy early in the Kennedy administration. In each of its last seven annual reports, the Council of Economic Advisers has based its estimates of potential output on a 4-percent rate of unemployment. This report continues to make use of this definition." [4]

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[1] *Economic Report,* 1962, p. 46. It is interesting to note that as early as 1947 the Committee for Economic Development defined "high employment" as an unemployment rate of 4 percent, and geared its "stablizing budget" proposal to that figure. See *The New Economics,* MAPI 1968, p. 6.

[2] *Ibid.*, 1966, p. 75.

[3] *Ibid.*, 1967, p. 42.

[4] *Ibid.*, 1969, p. 64.

While the 4-percent target has been consistently maintained by the recently retired Council (save possibly for the brief wavering in 1966 just noted), it is not yet clear whether it will be continued by the new one, or indeed whether *any* specific target will be named. For the purpose of this discussion, however, we are going to assume that is still the official target.

The dilemma

Given this assumption, we submit that the United States is impaled on the horns of a dilemma: its employment and price-level objectives are incompatible. Like a modern Tantalus, it strains for the alluring fruit of full employment without inflation, but the prize continues to elude its grasp.

The dilemma arises from the tendency for increases in labor costs to outrun productivity gains, hence for the price level to advance, when the unemployment rate is at or below the target figure. The rate compatible with price-level stability is substantially *above* that figure. As things now stand, the country can enjoy either full employment or a stable price level, but not both.

Since unemployment and inflation are alike evils to be minimized, and since they are in substantial degree alternative (the more of the one, the less of the other), we confront the problem of a "trade-off" between them. This problem presents two questions, one of fact, one of policy. The factual question concerns the *terms* of the trade-off: what is the relation between unemployment and inflation? The second concerns *policy:* given these terms, at what point is more unemployment better than more inflation, or vice versa?

We deal in this chapter with the factual question only. Obviously, the policy decision depends in large measure on the terms of the trade-off. How much acceleration of the inflation rate is associated with a given reduction in the unemployment rate? How is this inflation response related to the *level* of unemployment from which this reduction is effected? Unless we have a fix on the answers to these questions, the determination of policy proceeds in the dark.

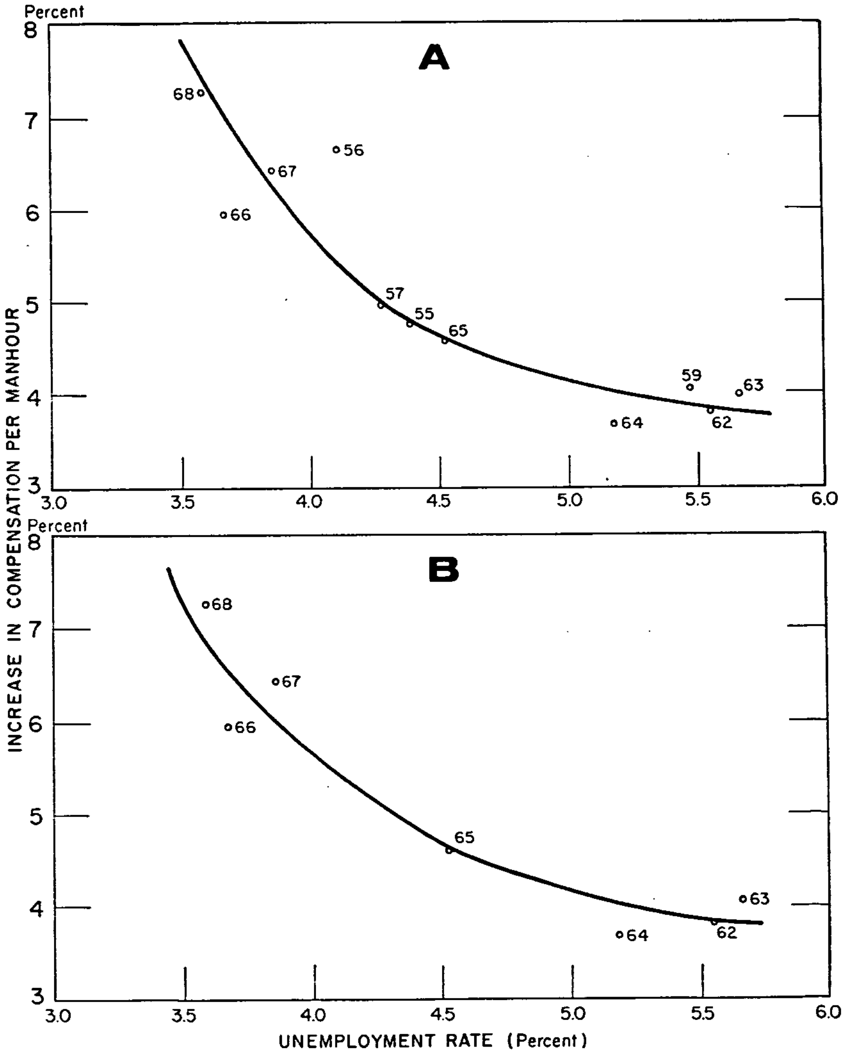
I. Relation Between Unemployment and Increases in Labor Compensation

We can explore the trade-off problem by analyzing first the historical relation between the unemployment rate and the rate of rise in hourly labor compensation.

For this purpose, history means the postwar period, since comprehensive figures on hourly compensation were not available earlier. But not all of the period is properly includable. Some portions were clearly abnormal. There were wage explosions in 1946–47 following the release of World War II controls, and in 1950 following the outbreak of the Korean war. There were wage controls during that war, affecting the years 1951–53. There were recessions in 1949 and 1954. In fact so little of the postwar prior to 1955 can be considered indicative of the normal relation between unemployment and increases in compensation that we begin our analysis with that year.

Chart 1

Relation Between the Average Unemployment Rate and the Percentage Increase During the Year in the Average Hourly Compensation of All Employees in the Private Nonfarm Economy: A. Nonrecession Years, 1955-68; B. All Years, 1962-68*



* For sources and methods, see Appendix A. Compensation includes fringe benefits.

But this does not exhaust the exclusions. It is obvious from a study of the four postwar recession years—1949, 1954, 1958, and 1961—that there is no semblance of a standard or normal relation between unemployment and wage behavior in such years. (In 1949 the increase in average hourly compensation was drastically below that of the preceding year, in 1954 moderately below, in 1958 about even, and in 1961 sharply above.) Accordingly, we exclude from our analysis of the post-1954 period the recession years 1958 and 1961, and also, for a special reason, 1960.[5] This means, of course, that *we draw no inferences as to the relation between unemployment and compensation increases during recessions.*

These exclusions leave us with only 11 annual observations, fewer than we would like, but enough to yield at least the broad outlines of the relation we are investigating.

The picture

The chart on page 3 shows on the horizontal axis the average unemployment rate for the year and on the vertical axis the percentage increase in average hourly compensation during the year. Data for the 11 years are plotted in section A. Those for the most recent 7 years are shown separately in section B.

It is obvious at a glance that increases in compensation have tended to be lower with higher unemployment rates, but equally obvious that the relation is not completely regular. There can always be an argument in such cases about the precise location of the line of central tendency and there is unavoidably some arbitrariness in drawing it. The one shown on the chart is not sacrosanct, but it is certainly somewhere "in the ball park." You can draw your own.

Suppose we tabulate the trend values of the two lines for a few pertinent unemployment rates:

Unemployment rate (percent)	Associated annual increase in average hourly compensation (percent)	
	A	B
3.5	7.7	7.2
4.0	5.8	5.6
5.0	4.2	4.1
6.0	3.7	3.6

Note that in both cases the increase in hourly compensation associated with the official 4-percent unemployment target is *in excess of 5.5 percent a year.*

II. Relation Between Unemployment and Unit Labor Costs

Increases in hourly labor compensation do not, of course, imply equal increases in labor costs per unit of output, commonly referred to as "unit labor costs." For the latter fall short of the former by the rise of productivity per man-hour. Thus, if hourly compensation is

[5] We have defined recession years as the ones in which the movement *bottomed.* In the recession of 1958, the decline started so late in 1957 that the averages for that year were very little affected but the decline culminating in 1961 started early in 1960 and was largely completed by the end of the year. In that case the averages for both years were seriously affected by the recession, and we have consequently excluded both.

up 5 percent and output per man-hour gains 3 percent, unit labor costs are up 2 percent.

For the private nonfarm economy as a whole (and even more so, of course, for components thereof), the rate of gain in output per man-hour is highly variable over time. But if we subtract the *average* rate for the most recent decade, 1959–68 (2.8 percent per year) from the lines of central tendency in chart 1 we get the following:

Unemployment rate (percent)	Associated increase in unit labor costs, assuming average productivity gain (percent) A	B
3.5	4.9	4.4
4.0	3.0	2.8
5.0	1.4	1.3
6.0	.9	.8

Note here that the rise in unit labor costs associated with the target unemployment rate is 3.0 percent a year for A and 2.8 percent for B. While we have not extended our trend lines beyond the 6-percent unemployment rate, it is evident that if they were so extended the rate associated with *stable* unit labor costs would be higher.

Other estimates

This last conclusion agrees fairly well with the findings of other investigators for earlier portions of the postwar period. The results of several studies (all assuming an annual increase of 2.5 percent in output per man-hour) are summarized below:

Unemployment rate associated with stable unit labor costs

Study:[1]	*Percent*
A—1947 to 1958	5.5
B—1948 to 1958	8.0
C—1948 to 1957	8.0
D—1948 to 1957	5.6
E—1947 to 1960	6.6
Average	6.8

[1] These studies are summarized in a report, *Price Stability and High Employment* (1966), prepared for the Economic Council of Canada by Ronald G. Bodkin, Elizabeth P. Bond, Grant L. Reuber, and T. Russell Robinson, p. 72. Since the results shown assume an average gain in output per man-hour of 2.5 percent, they would be reduced somewhat by our assumption of 2.8 percent.

Unit labor costs and prices

If prices reflected nothing but the compensation of employees, they would, of course, move exactly with changes in unit labor costs, but there are other components—capital consumption charges, earnings of proprietors, corporate profits, interest, taxes, etc., which impair this 1 to 1 relationship. There are cyclical and other variations in these components, but under similar economic conditions, or over a long period of years, changes in price averages tend to match fairly closely the movement of comparable averages of unit labor costs. The Council of Economic Advisers has commented on the proposition as follows:

> "Simple arithmetic requires that, for the average of unit labor costs in the entire economy to be stable, it is necessary that the average change in hourly compensation match, as a percentage, the average change in output per man-hour in the entire economy;

and, for the average of prices to be stable, the movements of prices should conform to the movements of unit labor costs." [6]

That the movements of prices do conform in this fashion the Council demonstrated by the following table (for the private domestic nonfarm economy):

Period	Percentage change per year [1]	
	Unit labor cost	Index of prices
1947-53	3.0	3.2
1953-59	2.1	2.3
1959-66	1.1	1.3
1947-66	2.0	2.2

[1] Economic Report, 1968, p. 123. Labor compensation in this case includes wages, salaries, and supplements of employees, and imputed labor income of the nonfarm self-employed. The price index is the implicit gross product deflator. The periods were chosen to obtain terminal years of "relatively high employment."

The close relation between price-level and unit-labor-cost increases *over a period of years* is readily apparent. That the former have been slightly higher is explained largely by the rising tax load (Federal, State, and local) per unit of private production. While this trend continues, the unemployment rate consistent with *price* stability may be expected to average somewhat higher than the rate consistent with stable *unit labor costs.*

III. Relation Between Unemployment and Prices

We have already said enough to suggest that even if the relation of wage changes to the unemployment rate were completely regular, the relation of price-level changes to that rate would still be irregular because of two variables between wages and prices: productivity gains and nonlabor costs (including profits). But since the first relation is in fact irregular, as chart 1 attests, we have in the second the combined irregularities of both.

That the relation of the inflation rate to the unemployment rate is a rather loose one has been pointed out by the CEA:

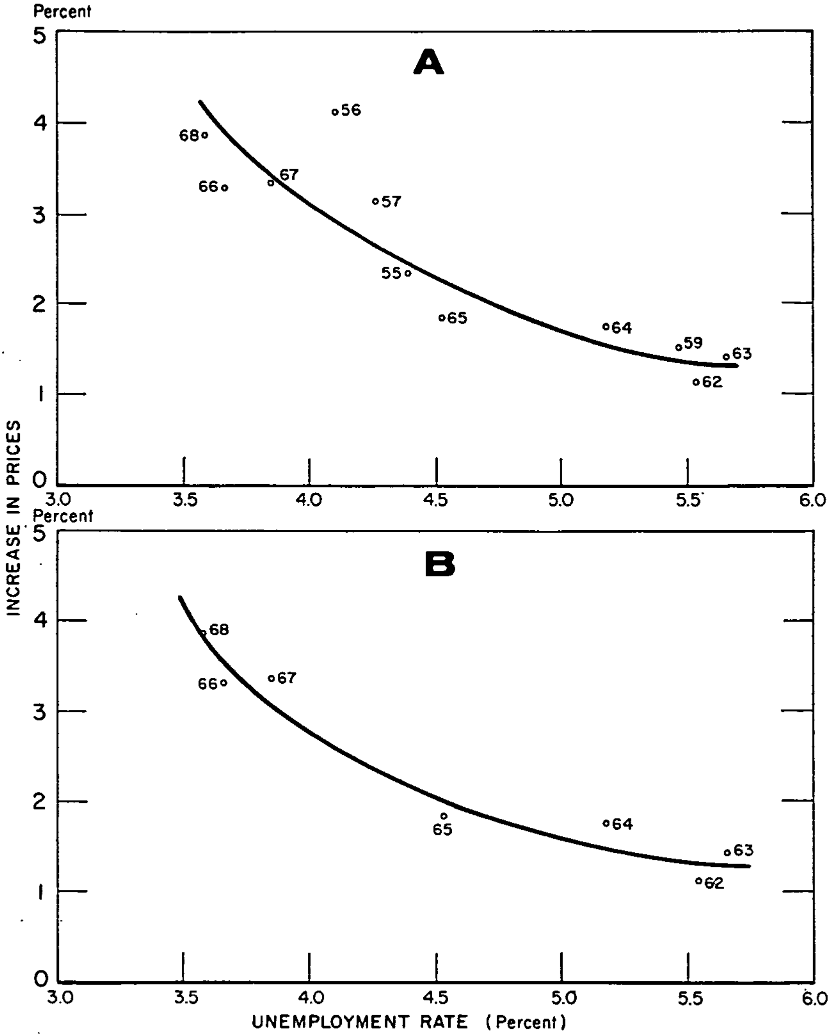
"The historical relationship has been neither mechanical nor precise. In some periods, the overall price level has been affected by special and erratic factors such as crop failures, shifts in foreign demand, or bottlenecks arising from a spurt of demand in one sector of the economy. Moreover the price performance of any year is influenced by cost developments arising from conditions in prior years." [7]

Notwithstanding such factors, however, the unemployment-inflation relation has been less erratic than might be supposed. Note chart 2 on the preceding page.

[6] *Economic Report,* 1968, p. 122.
[7] *Economic Report,* 1969, p. 94.

Chart 2

Relation Between the Average Unemployment Rate and the Price-Level Change During the Year: A. Nonrecession Years, 1955-68; B. All Years, 1962-68*



*The price index is the implicit GNP deflator.

Comment

You will observe that over the past 7 years (sec. B) the deviation of the inflation rate from its normal relation to the unemployment rate, as defined by the line of central tendency, has in no case been as much as one-half a percentage point, and that over the longer period (sec. A) only two of 11 deviations exceeded that limit. This is not half bad. You will note also (as in chart 1) that the normal line is a little higher for the larger set of observations than for the smaller, but is otherwise quite similar. Selected trend values for the two lines are as follows:

Unemployment rate (percent)	Associated annual increase in prices (percent) A	Associated annual increase in prices (percent) B
3.5	4.6	3.8
4.0	3.1	2.9
5.0	1.7	1.6
6.0	1.2	1.1

Note in this case that the annual price increase associated with the 4-percent unemployment rate is a shade over 3 percent for A and a little under that figure for B, and that the rate associated with price stability is over 6 percent.

CEA chart

It is interesting to note that notwithstanding its espousal of the 4-percent unemployment target, the Council of Economic Advisers has never said in so many words what rate of inflation can be expected to accompany it. However, in the final report of the outgoing Council there is a scatter diagram portraying the relation between unemployment rates and changes in the price level, from which it is possible to derive the missing figure. Although the Council drew no line of central tendency, any reasonable line shows the 4-percent unemployment rate associated with an inflation rate *in excess of* 3 percent a year (somewhere amount 3.25 percent).[8]

There is no point in being too precise here. It is sufficient to say that on the basis of recent history the inflation rate associated with the official 4-percent unemployment target is *around 3 percent a year.*

Conclusion

The foregoing calculations are subject, of course, to a substantial margin of error, and we should be the last to attach any great significance to the decimal points or to claim an exact reconciliation of various results. The underlying figures leave much to be desired, the number of observations is limited, and there is an element of judgment in the manipulation of the data. Nevertheless, the broad picture is reasonably clear. The average, or normal, relation between unemployment and inflation indicates that price-level stability can be achieved only with an unemployment rate far above the official target.

It may be objected that the normal relation has been derived from historical data, and is subject to change as time goes on. That is of course true. It has changed in the past and will do so in the future.[9]

[8] *Economic Report,* 1969, p. 95. The measure of inflation is the same we used in chart 2, the GNP deflator.

[9] See Michael E. Levy, "Full Employment Without Inflation," *Conference Board Record,* November 1967, p. 36.

It is fervently to be hoped, of course, that the future will see improvement, but not matter how earnestly this end is pursued, progress is likely to be slow. In the meantime, we have only recent history to go on, and it would be irresponsible to disregard it. The trade-off between unemployment and inflation must be made on the information we now have.

So much for the *terms* of the trade-off. As we indicated earlier, we do not undertake at this juncture to address the *policy* question of where the balance should be struck. Before we get to that issue there are a number of related questions to discuss, the first of which—how we got into the present dilemma—is considered in the next chapter.

Chapter 2

HOW DID WE GET THAT WAY?

The phenomenon that creates the bitter trade-off dilemma described in the preceding chapter is the responsiveness of labor compensation to low unemployment rates. As our chart indicates, wages and salaries "take off" as the rate declines toward the target figure of 4 percent, and virtually explode if it goes much below that level. Obviously, if we are to understand the dilemma we must address the question: why this hypersensitive response?

It was not ever thus

The first thing to note is that it appears to be a fairly recent phenomenon. While the figures for remote periods are poor, and not too closely comparable with those now available, they are nevertheless suggestive.

In the 30 years following the Civil War, the average hourly compensation of nonfarm employees underwent some substantial swings, but apparently finished the period about where it started.[10] From the midnineties to the outbreak of World War I, it rose at an average rate between 2.5 and 3 percent a year.[11] More significant for the present, in the prosperous period of the twenties, 1923–29, the rise averaged between 2 and 2.5 percent.[12] Contrast this with the postwar period 1947–68, when it averaged over 5 percent.

Sharpening the contrast between 1923–29 and 1947–68 is the indication that in the former period the unemployment rate averaged somewhere between 2.5 and 3.5 percent, against an average of 4.7 percent for the latter.[13] You will recall from chart 1 (p. 3 of ch. 1) that the rise in average hourly compensation now associated with an unemployment rate of 3.5 percent appears to be *in excess of 7 percent* a year. Obviously, something has happened to alter radically the relation between unemployment and wage inflation. What is it?

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[10] Stanley Lebergott, *Manpower in Economic Growth*, McGraw-Hill Publishing Company, 1964. We have adjusted Lebergott's estimates of *annual* earnings of nonfarm employees (p. 528) for the decline in hours worked per year.
[11] *Ibid.*, pp. 524, 528, similarly adjusted.
[12] *Ibid.*, p. 524, similarly adjusted.
[13] Lebergott's average for the earlier period is 3.3 percent (*op. cit.*, p. 512). That of the National Industrial Conference Board is 2.5 percent (*Economic Record*, March 1940, p. 78). The postwar average is that of the U.S. Department of Labor.

I. The Role of Collective Bargaining

One theory or hypothesis commonly advanced is that the difference stems from the greatly expanded role of collective bargaining in the postwar period. Suppose we give this our first attention.

In the period of the twenties to which we have referred, only 12 or 13 percent of private nonfarm employees were unionized. Nearly two-thirds of these were concentrated in mining, construction, transportation, and public utilities, with only a scattering in manufacturing and fewer still in trade, services, and finance. Collective bargaining was a localized phenomenon with limited impact on the general labor market, which continued to function for the most part without reference to it.

The postwar picture has been quite different. Thanks to the policy of governmental protection and promotion of labor organization begun under the New Deal and continued since, the proportion of private nonfarm employees in unions has fluctuated generally in the 30–35 percent range. Naturally, this has resulted in a much wider diffusion of collective bargaining, particularly in manufacturing, and has given it a much more pervasive influence on the labor market as a whole.

The theory stated

A distinctive feature of collective bargaining is the concept and practice of annual across-the-board increases in compensation. What has happened, the theory runs, is a diffusion throughout the labor market of the pattern of expectations generated by this practice. The pattern has become deeply embedded in the mores of the market, and is followed in the unorganized sectors no less than in the organized. Everyone expects to be "sweetened up," either annually or on some other schedule, without much regard to employment conditions.

In many cases, of course, the pressure on nonunion employers to match union wage gains is immediate and compulsive. If they have unorganized employees in an otherwise organized plant, the issue is hardly debatable. If they are trying to forestall unionization, they must at least meet, and probably better, union gains elsewhere. If they operate in a union town, with numerous and well-publicized local settlements, they had better stay in line. But even when the pressure is less direct, they are likely for the sake of worker morale and good personnel relations to keep up with the parade. It is the price that must be paid in a labor market conditioned to annual "rounds" in the organized sector. It follows, according to the theory, that this conditioning is the fundamental reason for the wage dynamism now displayed by the labor market in general.

In considering this theory, it is convenient to separate the *opinions* held about it from the *statistical evidence* for it. We begin with the former.

A. Opinions

Thousands of opinions have been expressed over the years on this subject, and we shall have to be content with a small sampling. We start with the view of organized labor.

Views of organized labor

There has never been any doubt, so far as unions are concerned, that the *purpose* of collective bargaining is to get more than the labor market would otherwise give. Witness an official statement:

> "The object of the union is to secure higher living standards for its members. A major way unions hope to accomplish this objective is by winning for their members wages and other monetary benefits higher than they would be able to obtain without union representation.
>
> "There is a major element in the academic community that argues that despite the most vigorous efforts, unions are restrained by the economics of the marketplace so that they cannot obtain for their workers any significant advantage over nonunion workers. Although it is obvious that this issue is not subject to conclusive proof, we wonder why, if this viewpoint is correct, employers so vigorously object to proposed union wage settlements. Moreover, there is major evidence that wages for union members in the same industry and area of the country are higher than wages paid to nonunion workers." [14]

While organized labor clearly believes in the *direct* wage impact of collective bargaining, it is less clear whether it agrees with the hypothesis that its activities contribute to wage dynamism in the *unorganied* sector of the labor market. Presumably it does, provided this effect is not construed as impairing the value of collective bargaining itself. Its view appears to be that even though wages in the unorganized sector tend to follow negotiated rates, they lag behind. If this inference is correct, we have what amounts to an endorsement of the theory of union wage leadership.

View of economists

The opinions of economists on the theory under discussion range, as usual, over a wide spectrum, from a doctrinaire denial that collective bargaining can affect the general wage level at all, to the opposite view that it is chiefly responsible for the phenomenon of wage inflation.

About a decade ago, following the inflationary surge of 1955–58, there was a grand roundup of professional opinion on this subject (among others) in the hearings on "Employment, Growth, and Price Levels" conducted by the Joint Economic Committee of Congress. After listening to testimony on the question by a large panel of economists, the committee contented itself simply with the observation that "The exercise of market power by strong unions has contributed in some degree to the inflation of recent years." [15]

Whether this is a fair distillation of the testimony may be arguable, but it is at least an understandable reaction to the caution and reserve with which most of the witnesses stated their own conclusions. A sample of these formulations will give their flavor:

> "Prudence dictates, I believe, that we conclude collective bargaining has contributed to the rise in the wage level since World War II. For the same reason it is safe to assume that it bears

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[14] Statement of the AFL–CIO, *Hearings* on Employment Growth and Price Levels, Joint Economic Committee (1959), pt. 9B, pp. 3117–8.

[15] *Report*, Jan. 26, 1960, p. 51.

some responsibility for creeping inflation. However, it has not been the main factor." [16]

* * * * * * *

"It is my judgment that our collective bargaining institutions contribute, under conditions of high employment, an independent element making for a faster rise in wage rates. * * * But this independent effect is not large." [17]

* * * * * * *

"It would strain the imagination too much to be asked to conclude that wages and supplements on average have been increased through collective bargaining at most only by as much as would have occurred anyway in a completely nonunion economy. * * * However, no one has yet determined the net contribution of collective bargaining, although there is reason to doubt that it has been large." [18]

Small wonder that the committee was cautious in its conclusions.

It is interesting that about the same time the Organization for European Economic Cooperation appointed a task force of six eminent economists to study the problem of rising prices, primarily in the European context. Thanks perhaps to the greater prevalence of unionization and collective bargaining in most countries of western Europe, the group was able to reach somewhat stronger conclusions on their inflationary impact. After reviewing the record for individual countries, it concluded:

"Summing up, we believe that wages have generally risen faster than they would have done solely under the influence of demand in a competitive market. Furthermore, while the state of the labour market has obviously had some influence on bargaining attitudes, we have not found evidence of any unique and predictable relationship between demand and the rate of increase in wages. In our view, the pressure exerted in wage negotiations and the use made of the wage negotiating machinery has been a vital factor in the equation." [19]

Both the Joint Economic Committee hearings and the OEEC report date from 10 years ago, and it is proper to ask about the trend of professional opinion since then. What has been the effect of another decade of observation and experience? It is our impression that economists are now inclined to give more weight to the role of collective bargaining in wage inflation, but it would be an exaggeration to say that there is a consensus on the subject. In the United States, at least, the spectrum of opinion is still wide.

View of the Council of Economic Advisers

Whatever may be true of economists in general, the recently retired Council of Economic Advisers appears to have entertained decided views on the role of collective bargaining in wage dynamism. Its entire discussion of wage restraint has run in terms of the moderation of negotiated settlements. The so-called guideposts, as applied to wages, were standards for such settlements. Note the following:

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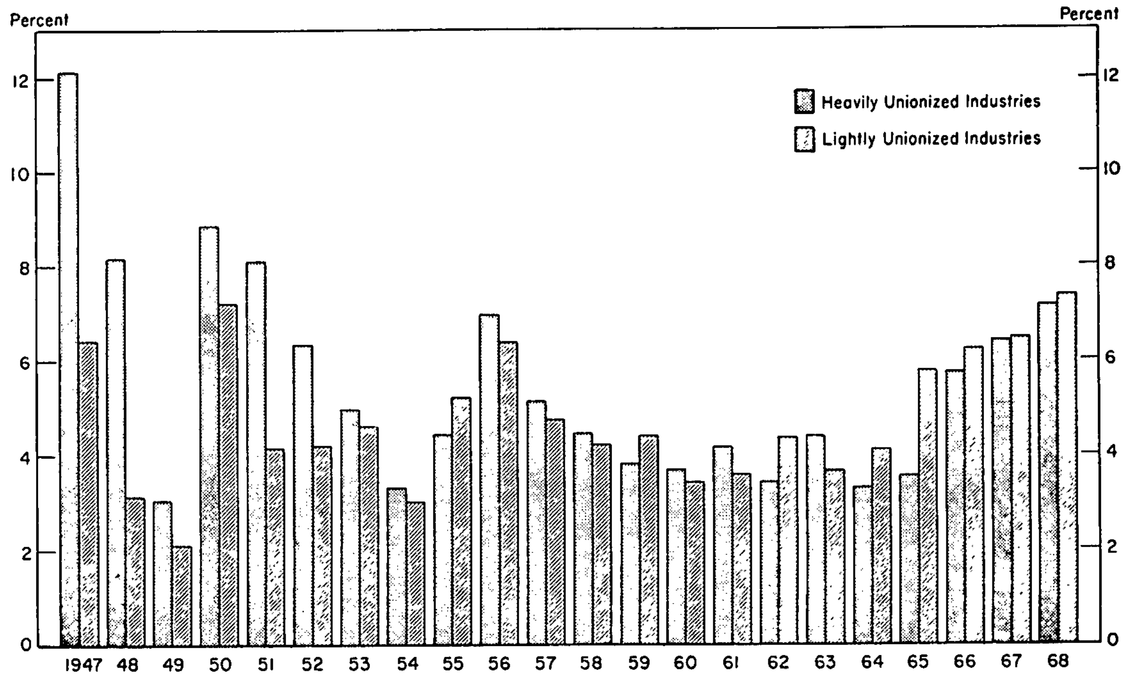
[16] *Hearings* on Employment, Growth, and Price Levels, 1959, pt. 8, p. 2531.
[17] *Ibid.*, p. 2739.
[18] *Ibid.*, p. 2530.
[19] OEEC, *The Problem of Rising Prices* (1961), p. 50.

Chart 3

Percentage Increase During the Year in Average Hourly Compensation of Heavily Unionized and Lightly Unionized Industries*



* Includes fringe benefits. See Appendix B.

"When demand outruns the growth of productive resources, prices and wages will rise even in the most highly competitive markets. (Indeed, they may rise faster and farther than where large firms and long-term labor contracts give some degree of stability.) That kind of 'demand-pull' inflation can be held in check by fiscal and monetary policies which keep demand in line with productive capabilities. If labor markets are efficient, control of demand-pull inflation will not require restraints on demand that would lead to a high unemployment rate.

"But businesses and unions can push prices up even when resources are not fully utilized. That kind of 'cost-push' inflation, too, can be controlled by lowering demand, but only at the cost of an unacceptable degree of economic slack. * * *" [20]

What the Council seems to have said here is that except in very tight labor markets, when wages in the unorganized sector rise spontaneously (and perhaps even faster than collectively bargained wages), the leadership comes from the organized sector. Save for such "demand-pull" situations, the limitation of wage increases to the general rise in productivity (and hence their compatibility with price stability) depends on restraint in that sector. "Cost-push" wage inflation is a phenomenon of collective bargaining.

So much for theoretical *opinions* on the issue. We turn now to the second part of our inquiry, the nature of the *statistical evidence.*

B. STATISTICAL EVIDENCE

While the leadership of collectively bargained wages (except in the case of "demand-pull" inflation) is a plausible hypothesis, it is not easy to prove statistically.

In part this is due to lack of data. There are no comprehensive historical series for union and nonunion wagse as such; all we can do is classify *industries* as heavily unionized or lightly unionized and compare the wage movements of *all* workers employed therein. The first group includes mining, manufacturing, construction, transportation, and public utilities, with over 85 percent of all union members (exclusive of Government) and an average unionization ratio of 55 percent; the second, trade, services, finance, insurance, and real estate, with less than 15 percent of all union members and an average ratio under 10 percent. The chart on the preceding page gives the picture for the postwar period.

This shows clearly (1) a consistent and substantial lead of the heavily organized industries during the early postwar years (through 1952): (2) an extended period thereafter (1953 through 1964) when gains in the two areas were generally similar; and (3) a recent period (1965–68) when the lightly organized sector made the larger gains.

The recent period

The recent period is of special importance for the theory of union wage leadership, for it is the one in which the currently troublesome inflationary pressures have developed. It may be well, therefore, to take a closer look at it.

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[20] *Economic Report,* 1967, p. 119.

It is often argued that in periods when wage rates are rising rapidly union rates tend to lag because of the drag of long-term contracts negotiated in prior years, and that the real measure of union wage leadership in such circumstances is the increases currently being negotiated in *new* contracts. Suppose we examine this measure for the recent period.

The accompanying table compares the median increase in hourly wages and benefits in new collective bargaining agreements with the average increase in hourly compensation in the same years for the two sectors of the economy. (As of interest also, we show the median increase effective each year under *new and existing* contracts.) [21]

Year	Median wage and benefit adjustment in major new agreements (percent)			Median wage adjustment effective under new and existing major agreements[4]	Increase during the year in average hourly compensation[5] (percent)	
		Averaged over contract				
	1st year[1]	Actual timing[2]	Equal timing[3]		Heavily organized industries	Lightly organized industries
1965	3.8	[6]3.7	3.3	3.4	2.6	5.8
1966	4.8	4.5	4.1	3.6	5.7	6.2
1967	5.6	5.2	5.2	4.4	6.4	6.5
1968	7.5	6.6	6.0	5.5	7.2	7.4

[1] The 1st-year adjustment (as distinguished from the averages over the contract life) is for wage rates only.
[2] Takes account of "front loading" of contracts.
[3] Total increase over contract life spread evenly.
[4] Adjustments in wage rates negotiated during the year, plus those decided on in earlier years, plus cost-of-living adjustments effective during the year.
[5] From chart 3.
[6] Our estimate.

It appears that in both sectors the increase in average hourly compensation exceeded the median wage and benefit adjustment in new collective agreements (averaged over the contract life), and except for 1968 exceeded even the first-year wage adjustments in such agreements.[22]

The record reviewed in chart 3 may seem at first glance to demonstrate the absence of union wage leadership over the past 16 years (since 1952), but this does not necessarily follow. Three lines of comment suggest themselves. First, the comparative-rate-of-gain test may be misleading. Second, it is necessary to take account of different rates of employment growth in the heavily organized and lightly organized sectors. Third, increases in the statutory minimum wage (and its coverage) have affected predominantly the lightly organized sector.

Comparative-rate-of-gain test

It will be obvious on a moment's reflection that union wages in general cannot continue to outrun nonunion wages *indefinitely*. Eventually the gap becomes so wide that the rest of the labor market follows along. After this point is reached, union leadership is no longer manifested by larger relative gains than those of the unorganized area,

[21] All figures on contract provisions are from the U.S. Department of Labor.
[22] It is true, of course, that *average* increases in negotiated agreements tend to be a little higher than the *medians* shown here. On the other hand, the data are for large contracts only (5,000 workers or more—10,000 in 1965—for the package increases averaged over the contract, 1,000 or more for the first-year wage increases only). There is some evidence (in manufacturing) that wage increases in large contracts during this period were generally higher than in small ones. (See Leon Bornstein, "Wage and Benefit Developments in Manufacturing," *Monthly Labor Review,* November 1968, p. 42.)

even though it may still be basically responsible for the wage dynamism of both sectors of the market.

It can be argued that the greater relative gains of the heavily organized sector in the early postwar years (through 1952), following, as they apparently did, greater gains in the prewar period,[23] developed enough tension or pull on the lightly organized sector to bring it along thereafter in line with the leadership.[24] By this interpretation, the generally similar advance of the two sectors after 1952 represented such a delayed or lagged response of the lightly organized sector. The latter maintained its *relative* position, but at a lower *absolute* level of compensation.

Statistical confirmation of this theory would require at the very least a showing that union rates of compensation have been significantly higher over the period than nonunion rates. Obviously, the overall averages for the heavily organized and lightly organized sectors are not comparable, since the former consists predominantly of high-wage and the latter of low-wage industries. As for union and nonunion rates in the *same* industries, the data are sparse, but such as they are, lend at least some color to the theory.[25]

Comparative employment growth

It can be argued also that union wage leadership was masked after 1952 by the effect of shifts in employment. From the beginning of 1953 to the end of 1968, employment in the heavily organized sector rose only 11 percent, against a rise of 58 percent in the lightly organized sector. That hourly compensation rose almost as fast for the former as for the latter notwithstanding this tremendous difference in the requirements for additional manpower may be construed as evidence of the dynamic effect of collective bargaining. If the employment growth rates had been equal, union leadership might have been more evident.

This surmise has special application to the period 1958–64, when unemployment rates were continuously high (averaging nearly 6 percent), and when union wage leadership ("wage push") was a normal expectation. That hourly compensation rose slightly faster in the lightly organized sector even under these conditions (the average annual gain being 4 percent against 3.9) may have been due to the more rapid expansion of employment in that sector (20 percent against 4 percent). Here too it may be conjectured that if the expansion rates had been equal the heavily organized sector would have made the larger gains.

Impact of the minimum wage

As to this factor, there can be little controversy. The frequent notching up of the minimum wage over the past 16 years, especially rapid recently (12 percent in 1967, 14 percent in 1968), and the progressive

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[23] While there are no figures for *hourly* compensation in the two areas prior to 1947, we do have the average *annual* compensation of full-time-equivalent workers. The relative gains by this measure for the period 1935–41 were 36 percent and 15 percent for the heavily organized and lightly organized sectors, respectively. While the former apparently lost some ground during the war, this only partially offset the earlier advantage.

[24] Actually, the lightly organized sector made slightly larger gains after 1952 than the other, the annual averages for the period 1953–68 being 4.84 and 4.69 percent, respectively.

[25] Studies of 22 manufacturing industries by the U.S. Department of Labor, spread over the period 1962–67, show average straight-time hourly earnings of $2.39 for establishments with a majority of hourly workers unionized and $2.02 for those with a minority or none (our computation). However, since the data have not been analyzed by geographical area and size of establishment, the results are inconclusive.

extension of its coverage, have had their impact predominantly, indeed overwhelmingly, on the lightly organized sector.

It is a well-recognized phenomenon that an increase in the minimum wage, where effective, results in an upgrading of pay scales above the minimum. This has undoubtedly been a factor (how large we do not attempt to estimate) in the rise of average hourly compensation in the nonunion area, and in the relatively strong showing of that area in wage-trend comparisons.

Adding it up

To what extent these factors account for the absence of clear union wage leadership after 1952, it is hard to say. To some extent they are not even consistent with each other (the first suggests that we should not *expect* continued rate-of-gain leadership; the others, that save for the special factors cited—differential employment growth and the minimum wage—we would have seen more of it).

Whatever weight is attached to these explanations, the fact remains that the purely *statistical* evidence of union wage leadership in recent years is ambiguous and inconclusive. This does not necessarily mean that such leadership has been lacking, but it does imply that its presence and effects must be inferred from nonstatistical observation.

II. Composition of Unemployment

We should like to comment next on an alternative explanation of the phenomenon under study (the apparent contrast between recent wage behavior and that of the twenties) that does not involve the question of wage leadership. It finds the source of this contrast in a statistical disparity arising from differences in the composition of unemployment in the two periods.

All we have for the twenties in the way of unemployment figures are global, or overall, estimates, with no breakdowns by age, sex, marital status, color, and so forth. We do have such breakdowns for the postwar period, however, and it is evident that unemployment in that period has been very unevenly distributed. We can illustrate by the figures for 1968.

Average unemployment rate, 1968

	Percent
Total	3.6
Male	2.9
Adults (20 and over)	2.2
White	2.0
Nonwhite	3.9
Teenagers (16 to 19)	11.6
White	10.1
Nonwhite	22.0
Female	4.8
Adults (20 and over)	3.8
White	3.4
Nonwhite	6.3
Teenagers (16 to 19)	14.0
White	12.1
Nonwhite	28.7

Note that unemployment rates ranged from 2 percent for white adult males to 28.7 percent for nonwhite teenage females.

Effect of dispersion

While this is the pattern for a single year, the wide dispersion of unemployment rates for different segments of the labor force has characterized the entire postwar era (though somewhat less the first decade than the second). The rates have consistently been higher for women, and much higher for teenagers, than for adult males.

Whether a similar pattern obtained in the twenties, we do not know, but there is reason to suspect the dispersion was considerably less. If so, there was a better matching of the qualifications and capabilities of the unemployed with the requirements of the labor market. This means that the overall unemployment rate could be lower than it can now without developing acute shortages in major sectors of the market. Stated otherwise, a given overall rate meant fewer tight sectors than now. Thus when the 1968 rate of 3.6 percent obtained in the earlier period, it presumably included a substantially higher rate for adult males than the 2.2 percent report for the later year.

Increase in frictional unemployment

Another probable change in the composition of the overall figures since the twenties is a rise in the relative importance of "frictional" unemployment, that is to say, the unemployment normally incident to the process of finding new jobs.

As the technology becomes more elaborate and the average level of worker skills rises, the search for new employment connections becomes a more exacting undertaking than before, and workers tend accordingly to spend more time between jobs. Moreover, with rising affluence they are better able to do so. Add to this the support derived from unemployment benefits—unknown in the twenties—and we have the possibility of quite a change in this respect.

The effects of unemployment benefits on frictional unemployment have been discussed by one writer as follows:

> "It is important to realize that today the reported unemployment figures include a greater, probably much greater, percentage of 'voluntary unemployment' than in former times. It stands to reason that as time goes on, as the policy of unemployment relief is progressively liberalized, and as eligibility requirements for unemployment are reduced, more and more people find out how to take advantage of unemployment benefits. Arthur Burns has pointed out that today a larger percentage of the labor force, and a much larger percentage of recent additions to the labor force than formerly, consists of part-time and intermittent workers—housewives seeking part-time work, students looking for summer jobs, pensioners trying to work here and there but never long enough to violate too blatantly the low maximum income that the law permits a social security beneficiary to earn while he draws his pension. This greatly increases the scope for drawing unemployment benefits by perfectly legal or legally doubtful means." [26]

Workers "voluntarily" unemployed while drawing these benefits of course appear in the statistics along with others, thus enlarging what appears to be frictional unemployment.

[26] Gottfried Haberler, "Inflation and Its Causes," American Enterprise Institute, 1966. p. 6.

What these various observations imply is that a given overall unemployment rate represents a tighter labor market today than it did in the twenties. No doubt there is a good deal to this contention. No doubt it explains in part the apparently lower wage responsiveness of the earlier period. But it can hardly be more than a partial explanation. The gap seems too wide. If, as the figures suggest, an overall unemployment rate of 3.5 percent was then associated with a rise in the wage level of only 2 to 2.5 percent a year, and is now associated with more than 7 percent, something else must be involved than the change in the composition of unemployment.

III. Conclusion

If the foregoing observations have any validity, there is no clear, simple, and conclusive answer to the question, "How did we get that way?"

Certainly *something* has happened since the twenties to increase wage dynamism, and since the changed composition of unemployment appears to be only a partial explanation, we are thrown back on the theory discussed earlier, that the principal factor is the increased prevalence of collective bargaining and in the postwar era and the altered pattern of labor-market behavior and expectations that it has developed. In view, however, of the inconclusiveness of the statistical evidence of union wage leadership since 1952, and the impossibility of arriving at a judgmental consensus on just *how* important the effect of collective bargaining has been, it is pertinent to ask why the issue has to be resolved at all. Is it essential for the purpose of anti-inflation policy?

We shall anticipate the results of later discussion by saying that in our opinion the answer to this question is negative. It is *not* necessary, in coping with our present predicament, to determine the precise role of collective bargaining in wage dynamism. Over the long run, it may be important, but for the near term *the remedy is the same whether that role is great or small.*

Chapter 3

SALVATION BY EXHORTATION

Whatever the causes of the wage dynamism that now afflicts the American economy, few will deny that so long as it persists we confront the painful trade-off between unemployment and inflation described earlier. This raises with great urgency the question whether, and by what means, the terms of the trade-off can be improved. How can we reduce the responsiveness of labor compensation to low unemployment rates?

Controls

There is one approach to the solution of this problem that we shall not even discuss: direct controls. Anyone who thinks that general wage and price controls (price control is inevitably wedded to wage control for political, if not for economic, reasons) can be successfully maintained in time of peace must go elsewhere for enlightenment. On this point we agree fully with the Council of Economic Advisers:

"The most obvious—and least desirable—way of attempting to stabilize prices is to impose mandatory controls on prices and wages. While such controls may be necessary under conditions of an all-out war, it would be folly to consider them as a solution to the inflationary pressures that accompany high employment under any other circumstance. They distort resource allocation; they require reliance either on necessarily clumsy and arbitrary rules or the inevitably imperfect decisions of Government officials; they offer countless temptations to evasion or violation; they require a vast administrative apparatus. All these reasons make them repugnant. Although such controls may be unfortunately popular when they are not in effect, the appeal quickly disappears once people live under them." [27]

Granted that direct controls are out, what then? A variety of approaches have been suggested, but we propose to discuss first one that has already been employed. This we may call the 'hortatory" approach. It consists of governmental exhortation of business and labor to induce the observance of noninflationary price and wage policies.

I. Evolution of the Hortatory Approach

Ever since the Employment Act of 1946 charged the Federal Government with responsibility for regulating the economy, it has been customary, especially in inflationary periods, for the President and/or the Council of Economic Advisers to exhort industry and labor to moderation in their price and wage policies. The practice began with the Truman administration in the inflation of 1946–48, was resumed by the Eisenhower regime during the 1956–58 inflation, and was later institutionalized by the Kennedy regime in the guideposts of 1962. Thereafter it became a standard feature of official economic pronouncements.

Judged by the character of these exhortations, history divides into preguidepost and postguidepost periods, hence it may be worthwhile to take a sampling from each.

Preguidepost formulations

First a couple of specimens from the Truman era.

"Business should reduce prices wherever possible in order to bring about the necessary increase in consumer purchasing power. * * * Labor, on its part, must recognize that high volume at low costs and low prices requires high productivity and the absence of restrictions on production. For its own advantage as well as that of the country at large, labor should refrain from demands for excessive wage increases. * * *" [28]

* * * * * * *

"Business men should hold the line against price increases and reduce prices wherever they can, forgoing a quick and dangerously excessive profit in favor of long-run stability. And labor should be moderate in its wage demands, mindful of recent experience which demonstrates the impossibility of registering real gains in an inflationary spiral." [29]

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[27] Report, 1968, p. 119.
[28] Economic Report, 1947, p. 20.
[29] Economic Report, 1948, p. 52.

Next a couple from the Eisenhower period:

"Business and labor leadership have the responsibility to reach agreements on wages and other labor benefits that are fair to the rest of the community as well as to those persons immediately involved. Negotiated wage increases and benefits should be consistent with productivity prospects and with the maintenance of a stable dollar. And businesses must recognize the broad public interest in the prices set on their products and services." [30]

* * * * * * *

"Business managements must recognize that price increases that are unwarranted by costs, or that attempt to recapture investment outlays too quickly, not only lower the buying power of the dollar, but also may be self-defeating by causing a restriction of markets, lower output, and a narrowing of the return on capital investment. The leadership of labor must recognize that wage increases that go beyond overall productivity gains are inconsistent with stable prices, and that the resumption of economic growth can be slowed by wage increases that involve either higher prices or a further narrowing of the margin between prices and costs." [31]

The guideposts

We have been savoring a series of pious homilies, moralistic in tone and vague in content. This approach was changed in 1962 with the promulgation of the now-famous "guideposts." These sharpened the criteria of acceptable wage and price behavior and added a new feature, selective intervention by the Government to induce compliance. The official formulation (by the Council of Economic Advisers) is as follows:

"1. The general guidepost for wages is that the annual rate of increase of total employee compensation (wages and fringe benefits) per man-hour worked should equal the national trend rate of increase in output per man-hour.

"2. The general guidepost for prices is that prices should remain stable in those industries where the increase of productivity equals the national trend; that prices can appropriately rise in those industries where the increase of productivity is smaller than the national trend; and that prices should fall in those industries where the increase of productivity exceeds the national trend." [32]

The Council explained that these rules are subject to exception in certain cases:

"Wage increases above the general guideposts may be desirable (1) where wage rates are inadequate for an industry to attract its share of the labor force necessary to meet the demands for its products; (2) where wages are particularly low—that is, near the bottom of the economy's wage scales; or (3) where changes in work rules create large gains in productivity and substantial human costs requiring special adjustment of compensation."

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[30] Economic Report, 1957, p. 3.
[31] Economic Report, 1958, p. v.
[32] Economic Report, 1966, pp. 89–90. This is a "restatement" of the original formulation of 1962.

"On the price side, increases in price above the general guidepost standard may occasionally be appropriate (1) to reflect increases in unit material costs, to the extent that such increases are not offset by decreases in other costs and significantly impair gross profit margins on the relevant range of products; or (2) to correct an inability to attract needed capital." [33]

II. Guideposts Examined

A few comments on this prescription may be in order.

Wage guideposts

As to wage policy, the "general" guidepost adheres to the so-called productivity principle; namely, that the increase in hourly labor compensation should not exceed the overall, or national, increase in man-hour output.[34]

Since this overall output gain is variable, and unknown currently, for practical reasons the guidepost substitutes as the wage target "the national trend rate of increase," this being determined by reference to past history. (You will recall the famous trend figure of 3.2 percent a year, derived in this fashion.)[35] This means, of course, that the "productivity principle" is exactly satisfied only when the current rate of gain coincides with the computed trend rate.

The exceptions to the general wage guidepost, it will be noted, are all on the up side.

Price guideposts

Given its costs, the only way a firm can affect prices is by varying its margin of profit on those costs. It follows that what purport to be guideposts for pricing policy are really guides for profit policy.

Although the CEA did not espouse this concept too explicitly, it appeared to accept it. The real norm of compliance with the general price guidepost is found in the behavior of the profit margin. It calls, in effect, for the maintenance of a stable relative, or percentage, margin on labor costs.

This inference is supported by the Council's repeated efforts to rebut the contention that conformity to the wage guideposts would give labor the total gain from productivity improvement. Note the following:

> "Adherence to these standards would mean, that *all* participants in the productive processes—employees and owners of invested capital—would share in the overall gains in productivity * * *. Thus the division of income between labor and capital would remain unchanged." [36]

While the quoted statement refers to the situation where the wage guideposts are observed, presumably the price guideposts are met by the maintenance of unchanged relative profit margins even when the wage guides are not observed. Presumably also the rule applies to the nonlabor costs mentioned in the exceptions to the general price guideline (material costs, for example). Thus we appear to have a standard

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[33] Ibid., p. 91. This too is a "restatement" of the exceptions originally noted in 1962.

[34] This principle was not new, of course. It was advanced in the Economic Report of 1950 (p. 101), and reiterated in several subsequent reports. (Note the reference to it in the second quotation from the Eisenhower period, above.)

[35] It was originally computed by the CEA as the average of overall productivity gains for the 5-year period 1959–63, Economic Report, 1964, p. 114.

[36] Economic Report, 1966, p. 90.

which says that the profit margin on total costs should maintain a stable relation thereto. Certainly this is implied in the statement that—

"Every management with some market power must ask itself: Is a price increase justified by increases in costs? Or is it an attempt to take advantage of prosperity to widen profit margins?" [37]

If this interpretation is correct, it means that the price guideposts are not violated by an increase in the absolute amount of profit proportional to the rise in costs; what is proscribed is an increase in its relative amount. So long as the percentage margin on costs remains constant, any price effect from a rise in the absolute amount of profit is simply a byproduct and reflection of a rise in the underlying costs themselves. It is a problem for cost control, not for price control.

III. Difference Between Wage Restraint and Price Restraint

It is a political axiom in most Western countries, and certainly in the United States, that any attempt to restrain wage increases, whether by direct action or by exhortation, must be accompanied by parallel measures to restrain prices. For the hortatory approach, this means that all admonitions to well-doing must be strictly bilateral, and must convey the impression that industry and labor are equally responsible for inflation and equally able to control it.

The propagation of this myth by politicians, and by economists in political office, has given rise to a delicate semantic balancing act, of which we have seen examples in the preguidepost exhortations quoted above. Pleas for wage and price restraint are invariably conjoined, usually in the same paragraph, often in the same sentence. You can read dozens of them without findings so much as a hint that one factor is more important than the other.

Notwithstanding this ritual neutralism, there is a profound difference in the potentialities of wage and price restraint. This arises from the fact that wage restraint affects the major cost of production, whereas, as already noted, price restraint affects the profit margin on this cost (and others). The price impact of changes in labor costs can be, and historically has been, far greater than the impact of variations in profit margins.

Relative profit margins are subject to fluctuation, depending on economic conditions, but they show no tendency to increace secularly. While the fluctuations contribute at times to raising prices and at others to lowering them, over the long run they are neutral. They are not, therefore, a cause of sustained inflation. Contrast this with wages. Labor costs per unit of output can rise year after year over long periods, with growing cumulative effect.

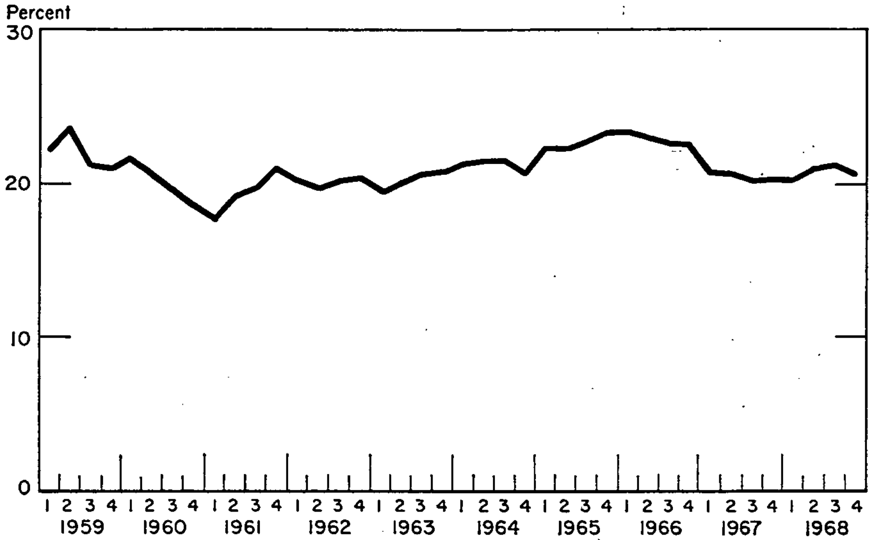
Margin variance

We can illustrate this statement about the behavior of relative profit margins by reference to the corporate system, the only sector of the economy for which separate profit figures are available. The following chart shows the picture for the past decade (p. 32).

[37] Ibid., p. 93. It is true, of course, that in recent years the Council has exhorted industry to reduce profit margins. Thus in 1967 it observed that "The public interest requires that producers absorb cost increases to the maximum extent feasible" (Economic Report, 1967, p. 133). In 1969 it suggested that business should absorb "a share of unavoidable increases in costs through acceptance of lower profit margins" (*Ibid.*, 1969, p. 59). We construe this as evidence of the Council's desperation over the collapse of wage restraint (of which more later) and the accompanying inflation, not as a revision of the basic philosophy of the guideposts.

Chart 4

Corporate Profit as a Percentage of Costs*
(Seasonally adjusted quarterly data)



* Costs exclusive of purchases from unincorporated business. Profit is before tax and after inventory valuation adjustment. See Appendix C.

The basically horizontal movement of the profit-to-cost ratio is evident at a glance. While there were fairly substantial variations, the ratio finished the decade slightly lower than it started.[38]

Hypothetical calculation

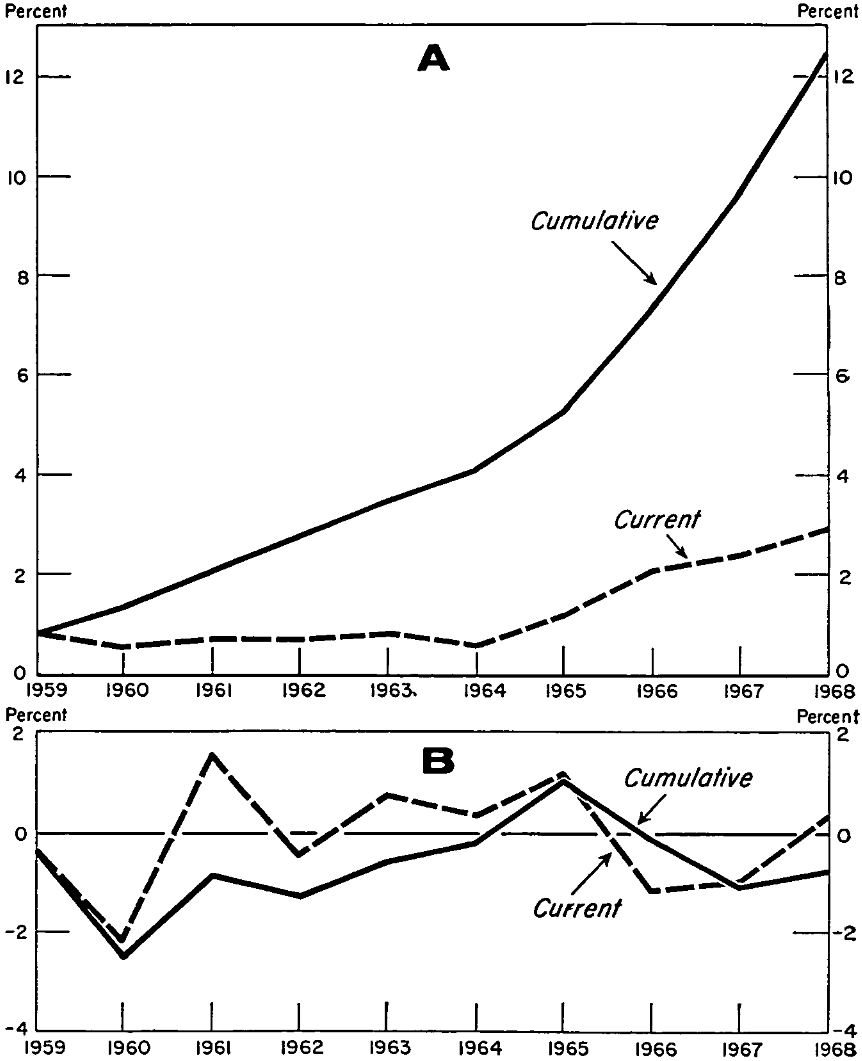
We shall consider later the extent to which the guideposts have actually affected wage and price behavior, but in the meantime should like to offer an hypothetical calculation, again for the corporate system.

Suppose that the guideposts had been in effect over the entire past decade, the wage target being the "trend increase" in man-hour output over the period, 2.8 percent per year.[39] What would have been the price effects of (1) the excess of actual wage increases over this standard (deviations from the wage guideposts), and (2) variations in relative profit margins (deviations from the price guideposts)? The results appear in chart 5 (p. 33).

[38] This was true also of the preceding decade.
[39] For the private nonfarm economy.

Chart 5

Current and Cumulative Price Effects of Deviations:
A. From the Wage Guideposts; B. From the Price Guideposts*
(All Corporate Business)



* For derivation, see Appendix C.

Note that the price effect of deviations from the wage guideposts was positive in every year of the period and cumulated over the decade to more than 12 percent. Contrast this with the effect of deviations from the price guideposts, which were positive in some years, negative in others, and cumulatively negative for the period as a whole.[40]

The moral

The Siamese twins of wage restraint and price restraint, invariably bound together in the great semantic balancing act to which we referred earlier, are neither equal nor inseparable. Their union is a political, not an economic, necessity.

Even if it were in the power of exhortation to secure universal compliance with the price (profit) guidelines, this would have very little anti-inflationary effect. The normal variations in profit margins produce temporary and minor price movements, without lasting effect either way. The real key to sustained inflation is the rise of costs, principally, of course, labor costs. Exhortation will get nowhere unless it is effective in controlling them.

Chapter 4

THE GUIDEPOSTS IN APPLICATION

No serious effort was made to promote, and none to enforce, the general prachments that appeared intermittently in the Economic Report before the promulgation of the guideposts. For the guideposts themselves, however, there was an intensive educational campaign, together with an enforcement effort in the form of selective intervention. Although both have apparently been abandoned by the new administration (a matter for later comment), it is worthwhile to review the operation.

I. Promotion and Enforcement

We shall let the former Council of Economic Advisers describe it in its own words:

> "Three major types of activities have been undertaken. First, the members of the Council of Economic Advisers, various Cabinet and sub-Cabinet officials, and the President himself have made numerous addresses about the guideposts to business and labor groups and to the general public. As might be expected, the Council of Economic Advisers has taken a leading part in this activity, with literally dozens of speeches, articles for the popular press, and radio and television appearances. Many of these have received substantial coverage in both the general press and in the specialized press of a number of industries.
>
> "The second type of activity has been an increasing number of private communications and meetings between Government officials and leaders of business and labor designed to underscore the public interest factor in wage and price decisions and to solicit the cooperation of union and corporate leadership in specific situations. With labor organizations, most of this activity has been

[40] It is interesting to note that the computed cumulative price impact for the two deviations combined, nearly 12 percent, is close to the actual rise in the price index for the (nonfinancial) corporate product (gross product deflator) which was less than 14 percent.

carried on by the Secretary of Labor and his associates. With industry, the Council of Economic Advisers, the Secretaries of Commerce, Treasury, Agriculture, Interior, Defense, and others have participated. However, since the largest number of these contacts has been made by the Council of Economic Advisers, it seems appropriate that the Council should provide a report on these activities.

"In the past year (1966), the Council became involved in regard to perhaps 50 product lines for which price increases were either imminent or had been announced by one or more firms. In the typical case, the Council learned in one way or another of a price increase that was contemplated or that had been announced by one or more producers. In some instances, companies contemplating price changes themselves brought the subject to the Council's attention. Where the Council learned of an important actual or impending price increase, its procedure was to send letters or telegrams to all principal producers of the product. In urgent cases, telephone calls substituted for letters or telegrams. If some firms had already announced price increases, they were asked to reconsider. Those who had not so announced were asked to avoid them if possible. In all cases, an invitation was extended to meet with the Council to discuss the matter." [41]

Three aspects of enforcement

There are three aspects of this enforcement technique on which we should like to comment.

The first has to do with the voluntarism of compliance. We cited the guideposts system as an example of the hortatory approach to wage and price restraint, but in candor should add that it has not always been applied in the genteel fashion suggested by the official account. On the side of industry, the record discloses occasional resort to crude coercion—bitter denunciations in the press, threats of antitrust action, threats of withdrawal or withholding of government business, countervaling stockpile releases, restrictions on exports, etc.—and even in one or two cases there were threats against unions, but in view of the waning of such actions in recent years, and the evident disposition of the authorities to regard them as aberrations, we shall say no more about them.[42] It would be naive, however, not to recognize that there is an element of duress in the armtwisting of large public corporations by the Federal Government even when it is done with more subtlety.

The second aspect concerns the basic character of the system. It is highly arbitrary in the selection of cases for intervention and makes no adequate provision for investigation and factfinding. One observer has commented on this as follows:

"The actual administration of the guideposts, not in the form of general preachment but rather in the mobilization of governmental pressures in particular cases, raises two groups of questions of deep concern. (a) Why were particular situations selected for confrontation rather than others, and what criteria are to be used

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[41] Economic Report, 1967, pp. 125–126.

[42] The Council may have had these earlier episodes in mind when it admitted in its 1967 Report (p. 125) that "Undoubtedly some mistakes have been made." For the particulars see John Sheahan, "The Wage-Price Guideposts," The Brookings Institution, 1967, chs. IV–VI.

in the selection of such cases in the future? (b) What review of the facts and arguments regarding wage and price decisions is to be made, and in what forum, in advance of the conclusion that the 'guideposts have been violated' and that a wage or price decision is 'against the public interests'? * * *

"I am personally disturbed by the absence of due process in the administration of the policy. * * * The judgment that a wage or price increase is violative of the public interest is a serious conclusion that should warrent dispassionate review with full opportunity for the presentation of contesting views. The present policy does not afford this elementary right." [43]

The third aspect is discrimination in enforcement policy as between industry and labor. Public confrontations with industry over prices have been numerous; those with unions over wages, few and far between. Even when they have occurred, moreover, the action has been irresolute and largely ineffective:

"Despite many public statements about the desirability of following the guideposts, the Government has been exceedingly wary about backing them up when it seemed likely that a strike might result, or might be prolonged by insisting on them." [44]

One reason for the lopsidedness of the enforcement effort has been the difference in the receptivity of the two sides to hortatory intervention. The CEA has reported its experience with industry as follows:

The response on the part of the businesses involved has been extremely encouraging. Only in rare cases has the Council been told that it had no right to question private decisions. Almost invariably the companies involved have recognized a larger public interest in their pricing decisions and have made a sincere effort to take that interest into account. Some large companies agreed to give the Council advance notice of their intention to change prices.[45]

There has been no similar report by the Secretary of Labor, and for obvious reasons. The unions have been generally resentful of interference, and frequently defiant. Concentrating on industry has therefore been the line of least resistence.

Limited coverage

Enforcement of the guideposts has been directed on both sides to those possessing something called "discretionary" or "market" power:

The guideposts were never intended to apply in highly competitive sectors where market forces determine prices and wages in an impersonal manner. They are applicable to markets in which discretionary power exists.[46]

On the wage side, such power has been imputed to organized labor only (unorganized workers being deemed to have none); on the price side to "firms which have appreciable discretion with regard to their prices," these being identified alternatively as "large" firms and as firms "in industries where the number of competitors is limited." [47]

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[43] John Dunlop, *Guidelines, Informal Controls, and the Market Place* (symposium), pp. 87–88. University of Chicago Press, 1966.
[44] Sheahan, *op. cit.*, p. 45.
[45] Economic Report, 1967, p. 127.
[46] Economic Report, 1969, p. 119.
[47] Economic Report, 1964, p. 114 and ibid., 1967, p. 119.

So far as we are aware, the Council has never published an estimate of the proportion of the Nation's business handled by firms with "appreciable discretion" over their prices. Obviously, many large firms (regulated public utilities, for example) have little or none. Moreover, many concentrated industries are highly competitive, with scarcely more price discretion in individual firms than prevails where suppliers are numerous.

Apparently the principal area where the Council finds significant price discretion is manufacturing (it has not addressed its pricing admonitions to any significant extent to agriculture, public utilities, trade, service, finance, or construction). Since this area constitutes only a third of the private economy, even if we make the generous assumption that half of it has "appreciable" price discretion, we arrive at only one-sixth of the total.[48] Certainly it is a far smaller proportion of the economy than is under collective bargaining agreements, and even if the power of industry over prices, where it exists, were equal to that of unions over wages, the contrast in coverage suggests that enforcement activity should be concentrated on wages, not, as it actually has been, on prices.

The CEA has been bemused by the literature of "administered prices" and "obligopolistic competition." This is not the place to argue the issue, and we can only record our opinion that the "market power" of large firms or firms in concentrated industries has been grossly exaggerated. In any case, the Council has offered no evidence that margin fattening (violation of the price guideposts) by such firms has been greater than elsewhere, much less that it has been a significant factor in the inflation that has overtaken the economy. It is relying simply on a theory.

If we are right in the conclusion of the preceding chapter that guidepost violations by all corporations had only limited and temporary price effects during the past decade, and none for the decade as a whole, it is obvious that the jawboning of a few firms deemed to possess "market power" is an exercise in futility. It only distracts attention from the real dynamo of inflation, the rise in costs.

II. Effects

In analyzing the actual effects of the hortatory approach to wage and price control, little time need be spent on the occasional pious homilies that preceded the guideposts. As already noted, they enjoyed neither promotion nor enforcement, and while they may have had some educational value, we know of no competent observer who would accord them more than the most marginal effect on actual wage and price behavior. The real question is the impact of the guideposts.

There is one effect that is hardly debatable: a significant contribution to public enlightenment and sophistication on the criteria of noninflationary wage policy. While the "productivity principle" may be, and is, difficult to apply to individual situations, the authority it has attained as the overall norm and goal of policy has virtually eliminated from the arena of public discourse a host of fallacious argu-

[48] This is in line with other estimates of significant price discretion. Perry, for example comes up with industries having 15 percent of total employment. George L. Perry, *Hearings*, Joint Economic Committee, Jan. 31, 1968, p. 18.

ments that formerly contested the field. Whatever else the guideposts have accomplished, this is a solid achievement.

Statistical studies

A number of statistical analyses have been made of wage and price behavior before and after the guidelines. The results differ, and are in some respects inconsistent; however, several investigators find some degree of improvement under the guideposts.

The question, of course, is whether the improvement might have been due to other factors. After a careful review of studies covering the first 4 or 5 years of the guideposts (through 1965, in some cases through part of 1966), Sheahan commented as follows:

> "While the evidence is good that wage and price behavior became more restrained after 1961, anyone determined to resist the suggestion that the guideposts were responsible for the difference can readily find alternative explanations. And it should be recognized that the statistical tests discussed above give good reason to expect that factors other than the guideposts might have acted to change wage and price behavior * * *. Among the more plausible reasons * * * three may be singled out for consideration: (1) a lessening of inflationary expectations after the successive recessions of 1957–58 and 1960; (2) an increase in competitive pressure from abroad; (3) a more even pace of expansion, both as to overall rate and as to balance among sectors." [49]

There have been a few studies covering longer periods than those reviewed by Sheahan, but they do not alter the basic conclusion. The guideposts appear to have had some beneficial effect, but it may have been due to other factors.[50] That is about as far as purely statistical analysis can take us.

Opinion testimony

In view of the uncertainty of the statistical evidence it may be worthwhile to cite the opinions of a few knowledgeable observers. The first finds some effect on both wages and prices:

> "Quite apart from these statistical studies we know that interventions by the Council of Economic Advisers were frequently effective in moderating or delaying planned price or wage increases in a substantial number of significant cases, although these were a tiny fraction of total wage and price actions during the period. It seems self-evident that application of the guideposts did have some effect." [51]

The second opinion finds some effect on prices, but little or none on wages:

> "In enterprises that have a measure of control over price, and where price decisions are prominent and publicly exposed, it appears that a degree of additional caution and care, and in-

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[49] Sheahan, *op. cit.*, p. 92.

[50] See, for example, the studies of Gary Fromm (through 1966) and George L. Perry (through 1967), reported in Hearings, Joint Economic Committee, January 1968, pp. 3 and 12. As to his own study (which dealt with wage behavior only), Perry concluded:

> "While the tests are necessarily rough ones and cannot preclude explanations other than the guideposts for the observed behavior of wages, the results seem plausible and more compelling than any contrary evidence I have seen. But one should not push them too far. In particular, one has to place very wide bounds on any numerical estimate of how much the guideposts have done." (P. 16.)

[51] John W. Kendrick, Hearings, Joint Economic Committee, January 1968, p. 9.

creased subtlety, has been introduced by the guideposts. My impression is that the guideposts to date probably have constricted price increases to a small degree.

"On the wage side, it is my considered judgment that the guideposts probably have had no independent restraining influence on wage changes in private industry. * * * I know of no person actually involved in wage setting on the side of industry, labor organizations, or as a government or private mediator or arbitrator who thinks that the guideposts have had on balance a constrictive influence; and I have discussed the issue in detail with scores of such persons in the past 6 months." [52]

We may add one more citation:

"It seems fair to conclude that the guidelines have had some effect in restraining wage and price settlements in certain 'bellwether' industries. * * * On the other hand, wage and price increases were realized in other industries by the hundreds, and we have now reached a point where these increases are regularly exceeding the guideposts. When this is coupled with the risks entailed in further government intervention in the economy, the guideposts have outlived their usefulness." [53]

Since these statements fairly well box in the range of responsible opinion, it is evident that judgmental testimony is as uncertain as the findings of statistical studies. Both suggest on balance that the guideposts have had some effect, but probably not much.

Recent experience

Most of the statistical studies cited earlier and two of the statements of opinion relate to the period 1962–65. What of the subsequent 3 years 1966–68?

In 1966, the average hourly compensation of private employees rose 6 percent, against a guidepost target of 3.2 percent.[54] The Consumers' Price Index also rose rapidly (by 3.3 percent). By the end of the year the Council was ready to throw in the sponge on the wage guideposts, and in its January 1967 report expressly did so:

"The Council recognizes that the recent rise in living costs makes it unlikely that most collective bargaining agreements in 1967 will fully conform to the trend increase of productivity. But it sees no useful purpose to be served by suggesting some higher standard for wage increases, even on a temporary basis." [55]

It contented itself simply with a limp plea that wage settlements should average less than the combined amount of the rise in the cost of living and the trend rise of productivity.

Although the wage guideposts have been suspended over the past 2 years, the price guides have remained nominally in effect, and the jawboning of industry has continued, but certainly with no more than the marginal influence accorded it for the earlier period. One thing is

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[52] John T. Dunlop, "Guidelines, Informal Controls, and the Market Place" (symposium), pp. 83–84. University of Chicago Press, 1966.

[53] Richard R. MacNabb, "From 'Guideposts' to 'Guideposts' to '?'," MAPI 1966 (April), p. 11.

[54] We have already explained that this figure was the estimated average increase in man-hour output for the 5-year period 1959–63. The average turned out to be the same for 1960–64. When the period moved to 1961–65, however, it was up to 3.6 percent. Nevertheless, the Council insisted, against the outraged protests of organized labor, on adhering (for 1966) to the earlier figure of 3.2 Economic Report, 1966, p. 92.

[55] Economic Report, 1967, p. 128.

clear. The inflation of 1966–68 was not due to any overall violation of the price guideposts. Relative profit margins were lower at the end of the period than at the beginning (chart 4, p. 32). The overwhelmingly predominant factor was rising labor costs. That the wage guideposts failed when they were needed most is a doleful commentary on the efficacy of the hortatory approach to the restraint of inflation.

III. Abandonment

At his first press conference, President Nixon stated:

> "I do not go along with the suggestion that inflation can be effectively controlled by exhorting labor and management and industry to follow certain guidelines. I think that is a very laudable objective for labor and management to follow. But I think I am aware of the fact that the leaders of labor and the leaders of management, much as they might personally want to do what is in the best interest of the Nation, have to be guided by the interests of the organizations that they represent. So the primary responsibility for controlling inflation rests with the national administration, and its handling of fiscal and monetary affairs." [56]

In its first appearance before the Joint Economic Committee of Congress, the new Council of Economic Advisers delivered itself on the following:

> "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. 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.
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> * * * * * * *
>
> "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 arbitarry 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.

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[56] Washington Evening Star, Jan. 27, 1969.

"The President has the right and duty to use the moral leadership which goes with his office to achieve major national objectives. He cannot foreswear 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." [57]

Thus ends, for the present at least, the hortatory approach to wage and price restraint. The question of alternative policy remains, however. To that we turn in the next chapter.

Chapter 5

ADDING IT UP

If the American economy suffers from the responsiveness of labor compensation to low unemployment rates, if the hortatory approach to wage restraint is only marginally effective (and the least so when needed most), and if mandatory controls are out, what then? We suggest that it is necessary to accept a higher rate of unemployment than would be required in the absence of this wage sensitivity.

I. The Trade-Off Problem Again

You will recall our discussion of the trade-off concept in the first chapter. At what point does the loss from the acceleration of inflation outweigh the gain from further reduction of unemployment? Conversely, at what point does the loss from increased unemployment outweigh the gain from the retardation of inflation?

Unfortunately, there has been very little direct confrontation of this issue in official quarters. The Council of Economic Advisers has approached it only indirectly, in connection with the definition and measurement of the potential output of the economy (potential GNP). The most recent discussion appears in the final report of the now-retired Council:

"To operate the economy at its utmost technical capacity would require demands far in excess of supply in most markets, with resulting rampant inflation. The relevant concept of capacity, therefore, must allow for some margin of idle resources. The choice of a specific margin involves an appraisal of the behavior of prices and costs in a high-employment economy. But this appraisal involves more than a technical evaluation. If potential output is to be viewed as a target for policy, the choice of the ideal level of utilization is a social judgment that requires a balancing of national goals of high employment and reasonable price stability."

After a recital of the disadvantages and burdens of unemployment, too obvious to need repetition here, the Council looked at the consequences of inflation:

"Inflation has highly arbitrary and inequitable effects on the distribution of income and wealth. It benefits debtors at the expense of creditors; it hurts persons, such as some pensioners, whose incomes and asset values are fixed in money terms, and benefits those whose incomes and asset values increase more than in pro-

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[57] Statement of the Council, Feb. 17, 1969.

portion to the overall rise in prices. * * * There is also a danger that inflation can set in motion speculative behavior that will cause further acceleration of price increases, with serious consequences for economic and social stability. * * * Finally, inflation may have adverse consequences for our balance of payments. If prices rise more rapidly in the United States than in other countries, our competitive position in world markets can be seriously undermined."[58]

Obviously, this poses the problem, but it does not identify the trade-off point between unemployment and inflation. If that has been indicated at all by the recently retired administration, it is only by implication, in its adherence to the 4-percent unemployment target.

One-way target

It is evident that when this target was nominally in effect it tended to become more and more a one-way street. Although the concept of a target implies that there are deviations on both sides, and that policy works toward the norm from either direction, it has never been so applied.

No politician who values his neck would even hint that he considers unemployment too low, much less that he favors its increase. Rarely, we may add, would an economist in political office. Thus when the unemployment rate was above the target, the Council of Economic Advisers spoke of bringing it down to that level, but when it was below, the language turned evasive. The objectives of policy were couched in other terms: cooling off an overheated economy, reducing pressures on capacity, preventing undue rates of expansion, and so forth. Even when the main engine of inflation was an excessively tight labor market, the fact that a correction involved more unemployment was suggested only by indirection.

While this may reflect semantic asymmetry rather than unsymmetrical policy, it raises the question whether a target that can be publicly invoked only from one side has much value as an anti-inflationary device. It may, indeed, be positively detrimental. Increasingly the 4-percent unemployment rate has become identified in the public mind as a ceiling, upside deviations from which are unacceptable. Thus it operates as a restraint on the flexibility of economic policy and a barrier to achievement of a rational trade off with inflation.

Absence of an inflation target

Since unemployment and inflation are in substantial degree alternative, hence call for a trade off, it is legitimate to ask why there should not be targets for both. Yet there has been none for inflation comparable to that for unemployment.

The reason may be that the inflation target was assumed to be zero. Indeed, the CEA once implied as much: "The guideposts must continue to aim at complete stability of average domestic prices."[59] If it was the target at that time, however, it was subsequently abandoned as impracticable, at least for consumers' prices:

"A realistic stabilization policy cannot expect to hold down to zero the average change of prices of consumer goods and services. From 1961 to 1965, although wholesale prices remained virtually

[58] Economic Report, 1969, pp. 62–64.
[59] Economic Report, 1966, p. 93.

> constant and there was obvious slack in the economy, consumer prices rose between 1 and 1½ percent each year. Such a moderate rate of price increase, however, does not represent a significant erosion in the purchasing power of the consumer's dollar. This is especially true because improvements in quality and the introduction of new goods add to consumption opportunities even when they are not fully reflected in price indexes as reductions in prices."[60]

This appears to be more in the nature of a reluctant acknowledgment that a zero-change target is impracticable than an espousal of the 1–1.5-percent inflation rate for consumers' prices as a goal of policy. It was not properly a target at all.

Are targets necessary?

One argument for having two targets is that it would accomplish a clarification of the trade-off calculation. For it would permit the comparison of actuals with standards on both sides. Suppose, for example, the inflation target were 1.5 percent a year in the consumers' price index. In 1968 the rise was 4.7 percent. Unemployment, however, averaged 3.6 percent against the standard 4 percent. Obviously, by this showing the economy was farther off course with respect to inflation than with respect to unemployment, suggesting a shift of the trade off in the anti-inflationary direction.

This may have some slight value as an indication of the direction of adjustment, but it sheds little light on its amount. What it really discloses is that the targets themselves are incompatible. For increasing the unemployment rate to 4 percent would not realize the inflation target of 1.5 percent. Of what use are incompatible targets? Obviously, they leave the determination of the optimum trade off up in the air.

We pointed out earlier (p. 1074) that the outgoing Council of Economic Advisers never said in so many words what rate of inflation could be expected to accompany a 4-percent unemployment rate, although a chart displayed in its final report indicates a normal expectancy of around 3.25 percent a year.[61] Never, so far as we know, did the Council claim that this was an acceptable rate of inflation.[62] We can only conjecture whether it found 4-percent unemployment the best trade off obtainable or was restrained in the expression of other views by political inhibitions.

We conclude that it makes no sense to have incompatible unemployment and inflation targets, and that the only valid goal of policy is the optimum trade off itself.

III. The Trade-off Target

Although the statements of its various spokesmen have not been wholly consistent, it appears to be the view of the new administration that some increase in unemployment will be necessary to curb inflation. In his first press conference (January 27), President Nixon observed that, "We are considering what actions can be taken which will not cause an unacceptable rise in unemployment." In his confirmation hearings on the same day, the nominee for Chairman of the CEA, Dr.

[60] Ibid., 1968, p. 100.
[61] Measured by the GNP deflator. Economic Report, 1969, p. 95.
[62] It once declared an inflation of 1.7 percent in wholesale prices and 3.3 percent in consumers' prices to be "clearly unacceptable." Economic Report, 1967, pp. 74, 79.

Paul McCracken, confessed that "I cannot honestly say we can slow down the rate of inflation without some effect on unemployment." [63]

While both statements are vague, there is substantial dissent even from this implied trade off. There are those who never find any attained unemployment rate too low. They may concede the abstract or theoretical possibility of too low a rate, but somehow never find one in practice. The most conspicuous example of this attitude is, of course, organized labor. But there are others. Witness the following from the recently retired Secretary of Labor, written at a time when the unemployment rate was 3.3 percent:

> "This country is playing today with the dynamite notion that it will 'risk a little increased unemployment' in order to 'cure inflation.' That won't work. * * * The 'trade off' idea—that inflation can be traded off for some unemployment—may satisfy economic theory. It ignores social reality." [64]

Here we have an official of the administration that set the 4-percent target arguing against a move toward it from a substantially lower, and palpably inflationary, level. Apparently he rejects restraint on inflation that involves an increase of unemployment from any attained level, whatever it may be. Since we have had serious and accelerating inflation under the labor market conditions prevailing when the statement was made (in 1968 nearly 4 percent a year by the GNP deflator, 4.7 percent by the Consumer Price Index) this is a recipe for inflation without term or limit.

A. THE SLUM UNEMPLOYMENT PROBLEM

It turns out that the "social reality" to which Secretary Wirtz referred is unemployment in the slums:

> "Whatever success there has been in getting the 'hard core unemployed' into jobs has resulted essentially from there being jobs these people could go into *without displacing other people.* If 'cooling off the economy' means—and it does—that the economy would be slowed down so that a quarter of a million to a million people would have to be laid off, there would be just two possibilities. One would be that several hundred thousand people who were the 'hard core disadvantaged' would be put out of work. The other would be that several hundred thousand people who would otherwise be employed would be laid off to protect the employment of the 'hard core disadvantaged' group. It is clear from the record that neither group would take it. * * * The measures by which unemployment has been reduced among those who are poor and those who are black * * * will make *any* significant increase in unemployment not just a misfortune but a disaster." [65]

According to this view, we are locked into a low overall unemployment rate because of the urban slum problem, and must sacrifice all other national values to its continuance. Since the idea has gained a considerable following of late it deserves at least brief attention. We confine ourselves to four main points.

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[63] Pressed for the unemployment rate he would accept, he declined to name one, but said in reply to a question that 6 percent was too high.

[64] *Annual Report* of the Secretary of Labor, 1968, pp. 31–32 (mimeo). (Italic in the original.)

[65] Ibid., pp. 31–32.

Four observations

(1) The total unemployment in "urban poverty neighborhoods" when the Secretary wrote was under 350,000, only a fraction of which was "hard core," and talk of an increase of "several hundred thousand" in the latter from a moderate rise in the national unemployment rate is sheer nonsense.

(2) While the cooling-off-without-recession strategy espoused by the administration implies an increase in unemployment, it does not necessarily imply a reduction of employment. It contemplates a slowing of economic expansion until the growth of the labor force restores a more relaxed and less inflationary labor market. This may or may not involve a shrinkage of total employment, but assuming the strategy works out as planned the decline, if any, should be small, whether in urban poverty neighborhoods or elsewhere.

(3) The former Secretary's statement implies that the only reason the formerly hard-core unemployed lose their jobs is a decline in the total number of their kind at work. But this is not the case. While we lack statistics for this group separately, it appears that for all workers the number of involuntary job severances runs to 5 or 6 million a year even when total employment is steady.[66] The necessity for finding new jobs arises primarily from this turnover—not from declines in aggregate employment. To the extent this is true of slumdwellers, the problem is already here. While it would be worsened somewhat by a softening of the national labor market, the difference should not be great, for reasons suggested in our next point.

(4) Unemployment in the slums is a *special* problem, relatively independent of the overall situation. Oddly enough, the Secretary chose to ignore a finding to this effect in a study he had just submitted to the President:

> "Three facts stand out from all these statistics. One is that unemployment—or subemployment—in the city slums is so much worse than it is in the country as a whole that national measurements of unemployment are irrelevant. Any thinking about unemployment in terms of 3.7 or 4 percent just leaves the slums out * * *.
>
> "The second salient fact is that unemployment and subemployment in the slums are—much more than in other areas—a matter of *personal* rather than *economic* condition. No conceivable increase in the gross national product would stir these backwaters. The problem is less one of inadequate opportunity than of inability, under existing conditions, to use opportunity. Unemployment in these areas is *primarily* a story of inferior education, no skills, police and garnishment records, discrimination, fatherless children, dope addiction, hopelessness.
>
> "But third: Though the *percentages* involved here are deplorably high, the *number of people* involved is comparatively small. The bariers to their useful employment are serious, but they are removable barriers. *The problem is clearly of manageable proportions.*"[67]

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[66] See *The Automation Hysteria*, MAPI, 1965, appendix E. These severences reflect shifts in market shares among competitors, geographical relocations, business failures, seasonal fluctuations, terminations of temporary jobs, and many other factors.

[67] Department of Labor, *A Sharper Look at Unemployment in U.S. Cities and Slums*, 1968, Summary. (Italic in the original).

If it is true that "No conceivable increase in the gross national product would stir these backwaters"—meaning, of course, no conceivable reduction of the national unemployment rate—it is true in reverse that an increase of a point or two in that rate is not going to wreck remedial efforts.

That a low overall unemployment rate is no panacea for special situations is illustrated by the experience of the last 3 years. Although this rate averaged 3.7 percent over the period, the rate for nonwhite teenagers (16–19), which was 25.8 percent at the beginning, came down only to 22.2 percent at the end. The effectiveness of special measures, on the other hand (to which some of the reduction just cited is attributable), is shown by the decline of nonwhite teenage unemployment in "urban poverty neighborhood" from 34.3 to 27.3 percent in the course of the 1 year (from the fourth quarter of 1967 to the fourth quarter of 1968).[68]

No one will deny that a relaxation of the general labor market will make the rehabilitation of slumdwellers somewhat more difficult, but to erect this into an impassable barrier to the restraint of inflation is foolish and irresponsible. It is even of doubtful service to the slumdwellers themselves, who not only suffer from inflation, but would suffer also from the economic recession almost certain to come if it is not restrained.

B. WHAT RATE IS ACCEPTABLE?

If we reject this exaggerated obstacle to anti-inflation policy, the question remains what overall unemployment rate is "acceptable." Where, in other words, is the trade-off target?

Of high relevance to the answer is the *pattern*, or *contour*, of the lines of central tendency displayed in chart 2 above (p. 1073). Granted some degree of arbitrariness and discretion in their location, no reasonable variance can alter the central fact that they decline steeply on the left and gradually on the right. The significance of this phenomenon is obvious. At low unemployment rates, further reductions are purchased at the cost of large increases in prices, whereas at higher rates the gains come cheaper. Thus, a reduction in unemployment from 6 to 5 percent steps up the annual inflation rate by less than half a percentage point, while a reduction from 5 to 4 percent raises it by 1.5 points for the larger sample (section A) and by 1.2 for the smaller (section B). A further reduction from 4 to 3.5 percent raises it additionally by 1.2 and 1.1 points, respectively.

If these trade-off curves are anywhere near right, they pose a problem to policymakers for which there is no pleasant or easy solution. Our own view, with which we suspect most economists will agree, is that an inflation rate of 2 percent a year—measured by the GNP deflator—is the outside limit of acceptability.[69] Given this limit, the question then becomes how high a rate of unemployment is necessary to stay within it.

It is interesting to note that the CEA chart to which we referred earlier confirms the results of our own study (p. 1074) that in terms of normal expectancy the rate is between 4.5 and 5 percent. In view of the deviations of individual cases from the norm, there is no point to

[68] U.S. Department of Labor.

[69] The Consumer Price Index deviates considerably from this measure over short periods—as it did in 1968—but in the long run conforms quite closely.

being more precise. Somewhere within this range is the trade-off point that satisfies the stipulation.

This is not, of course, an ideal solution. An inflation rate of even 2 percent a year is deplorable, to be accepted only with the greatest reluctance. But so long as we have the present responsiveness of wages to low unemployment rates, we must, in our opinion, take something close to this figure. The unemployment rate required for a complete stabilization of the price level—over 6 percent—is politically, economically, and socially unacceptable.

Others, of course, can fix the trade off elsewhere. Thus if 3 percent a year is the inflation limit, the unemployment rate can be around 4 percent. But there is no escaping the painful choice: a gain on one side is purchased with a loss on the other.

III. Unwinding the Boom

We are presently in an inflationary boom that must be cooled off by some means or other. The universal desire is to accomplish this gradually and easily simply by slowing up the growth rate of the economy until it attains a more relaxed condition. This is obviously the proper strategy, though history offers little encouragement for its success. Previous booms of comparable magnitude and character have been cooled by recessions. There are, therefore, few if any precedents to go by.

The time factor

An interesting question presented by this strategy is how long it will take to work the inflation rate down from almost 4 percent a year to the 2 percent we have characterized as the upper limit of acceptability. Basically, this is the question of how long it will take to work down the rate of increase in average hourly compensation from its recent (1968) rate of more than 7 percent a year to something under 5 percent.

Let us state the problem in a different way. Granted that an unemployment rate of 4.5 to 5 percent will hold the inflation rate at or below the 2-percent limit once the latter is attained, how long will it take, starting from where we are now, to attain that limit? This is the sum of (1) the time required for unemployment to expand from its present rate—3.3 percent—to the 4.5–5-percent range, and (2) the time required to bring down the growth of average hourly compensation from its then-attained rate to the required level. We know very little about what to expect for either of these stages. The first might require a year or more, the second considerably longer. It is obvious, in any case, that the cooling-off-without-recession strategy, if successfully executed, will involve a very slow return to the 2-percent inflation rate, and if a more exacting standard is set will require longer still.

Will it work?

Granted that the correction will be slow, it is by no means certain that it will develop as planned. As noted, earlier wage spirals have been broken by recessions, and it remains to be seen whether the present one can be eased off by the mild and gradual relaxation of the labor market contemplated in the official strategy. Such spirals tend to acquire a life of their own and are hard to turn around without shock treatment.

There is another point to be made in this connection. While it is understandable that the new administration should seek to minimize the rise in unemployment required to cool the boom, it is clear that to bring the inflation rate down to 2 percent is going to take more of an increase than suggested by the cautious and delicate adjectives now bandied about. A rise to the 4.5–5-percent range is more than "a little," "slight," or "modest"; in relative terms, it is an increase of more than 40 percent.

IV. Long-Range Improvement

We pointed out in the second chapter that the overresponsiveness of average hourly compensation to high employment is a fairly recent phenomenon and that it is not necessarily permanent. This appears to be the view also of the outgoing Council of Economic Advisers:

> "It is not inevitable that pressures on the labor supply should begin to appear when the unemployment rate falls below 4 percent. It is not inevitable that wage increases should substantially exceed productivity gains, and that prices should begin to rise rapidly, as the economy reaches high employment. It is not inevitable that price stability should be restored only through the wasteful remedy of repeated doses of economic stagnation and high unemployment." [70]

To support this thesis, the Council outlined a number of measures for the improvement of the situation, some of which relate to product markets, others to the labor market. Since we have expressed the view (p. 34) that the rise of labor costs is the heart of the inflation problem, we shall refer only to the labor-market suggestions, and then only to the extent of listing them.

- Improvement of labor mobility, through—
  - Better information on job opportunities.
  - Relocation assistance.
  - Vesting and portability of pension rights.
  - Interstate reciprocity in occupational licensing.
- Improvement of manpower training.
- Removal of discrimination in employment.
- Reduction of seasonality.
- More flexible job requirements.[71]

No doubt the pursuit of such measures over a period of years would reduce the extraordinary dispersion of unemployment rates by classes of workers, which we discussed earlier and displayed on page 1083. Insofar, therefore, as the responsiveness of wage rates to high employment is a result of this dispersion, the inflation problem may be relieved. You may recall, however, that we found this factor only a partial explanation of excessive wage responsiveness, and if this conclusion is correct the improvement of the composition of unemployment would be only a partial remedy.

It is interesting that the foregoing list of suggestions contains no measures to abate the market power of organized labor, which the Council has repeatedly identified as a major contributor to inflation.

[70] Economic Report, 1969, p. 121.
[71] Ibid., p. 99, ff. Our arrangement.

If it was correct in its assessment of the role of collective bargaining in wage dynamism, its failure to offer any remedy but voluntary restraint leaves the prospect for long-range improvement rather cloudy.

V. Conclusion

We have chronicled the failure of the hortatory approach to anti-inflationary action, and the abandonment of the wage and price guide posts. While the passing of guideposts enforcement efforts is unlamented, we should like to record the hope that the campaign of public enlightenment of the criteria of noninflationary wage policy—specifically, the productivity principle—will continue to be pressed. If it does nothing more than inhibit the proliferation of fallacious doctrines in this field, it will serve a useful purpose.

One thing is clear. If general preachments on wage and price behavior are to enlist any significant degree of voluntary restraint they must be actively endorsed both by labor and by management. This means that both must have a voice in their formulation. They cannot be imposed externally as the revelation of a government agency, even as distinguished a body as the Council of Economic Advisers. If there are any possibilities in the idea of voluntary restraint—and we consider them limited—their realization will require a fresh start on a new basis.

These possibilities are limited in part because of the structure of the American labor movement. Not only is it fragmented at the top; the major federation leaves collective bargaining to its individual unions and disavows any responsibility for the results. Even if it were to assent to a national wage policy, it could implement it only by moral suasion—better than nothing, perhaps, but unlikely to prove very effective.

A final comment on our present predicament. If we are right that the principal inflationary dynamic of the past few years has been rising labor costs, if exhortation has failed to restrain them, and if direct controls are out, only one effective remedy remains: relaxing the labor market. So long as we continue to have a drum-tight market in the major wage-determining category—adult males—the chance of slowing down the advance of hourly compensation, and with it the advance of prices, is slim.

It is slim, be it noted, no matter what the explanation of the predicament. We observed earlier that it is not necessary to determine the proportionate contribution of collective bargaining to the wage dynamism that now afflicts the economy. Neither, we may add, is it necessary to decide the relative importance of "cost push" and "demand pull" in the current inflation. The answers to these questions may be relevant to the longrun solution of the problem, but the remedy for the present situation is the same no matter how they are answered.

It is fervently to be hoped that in time we can work down the excessively high unemployment rates for certain sectors of the labor force—juveniles, slum dwellers, to a lesser extent women—and thus lower the overall unemployment rate consistent with reasonable price stability. It is no less to be hoped that we can gradually abate the extravagant expectations that have developed in recent years for increases in compensation. But until these objectives are achieved, there is no feasible alternative to labor-market relaxation. It is the sine qua non of inflation control.

APPENDIX A

Chart 1

The average annual unemployment rate was computed from Department of Labor estimates of unemployment and civilian labor force. It is the official rate carried to two decimal places.

The unemployment and labor force estimates have undergone some changes over the period covered. One has been carried all the way back, the exclusion of 14- and 15-year olds from the figures. Others—the inclusion of Alaska and Hawaii in 1960, and the 1962 adjustment to the 1960 census—have been of negligible effect. One, however, has been more significant. A change of definitions in 1967—carried back to 1966—reduced the then unemployment figure by about 100,000, and the rate by about 0.12 percentage points. The rates for years before 1966 are presumably a shade high by present definitions.

The intrayear changes in compensation per man-hour were figured by dividing quarterly Department of Labor estimates of man-hours worked by all private nonfarm employees into quarterly Department of Commerce estimates of the total compensation of these employees. Opening values for each year were derived by averaging the figures for the fourth quarter of the prior year and the first quarter of the current year; closing values, by averaging the fourth quarter of the current year and the first quarter of the following year. The figures for 1968 are the change from the fourth quarter of 1967 to the fourth quarter of 1968. To reduce distortions due to shifts of employment—man-hours—from high- to low-wage industries, and vice versa, we have factored out such shifts among seven major areas: mining, manufacturing, construction; transportation and public utilities, trade, finance, insurance, and real estate, and services.

APPENDIX B

Chart 3

The procedure described in appendix A for deriving intrayear changes in the average hourly compensation of all private nonfarm employees (chart 1) was employed in the present instance for deriving similar changes for two components of the total: heavily unionized industries—mining, manufacturing, construction, and transportation and public utilities—and lightly unionized industries—trade, services, and finance, insurance, and real estate. An opening value for compensation per man-hour in 1947 required an extrapolation of quarterly data back to the fourth quarter of 1946 since Government sources did not permit a direct estimate for that quarter. Again the effect of employment shifts among the listed subgroups was excluded.

The figures for 1968 are the change from the fourth quarter of 1967 to the fourth quarter of 1968.

APPENDIX C

Chart 5

For the purpose of chart 5, we computed intrayear changes in profit margins as differences between successive end-of-year estimates, these being averages of fourth-quarter and first-quarter figures. The figure for 1968 is the change from the fourth quarter of 1967 to the fourth quarter of 1968. To get the contribution of these intrayear margin changes to price changes, we related profits directly to the corporate gross product for the year in question rather than to corporate costs.

Average hourly compensation data are not available for the corporate sector separately. Accordingly, we used the intrayear percentage changes for the total nonfarm private sector, described in appendix A. Each change in this series was reduced by 2.8 percentage points, the average increase in man-hour output for all persons in the private nonfarm sector during the decade 1959–68, as estimated by the Department of Labor. To get the price effect of the percentage increases in average hourly compensation, thus reduced, we applied to them the ratio of corporate employee compensation to corporate gross product for the year in question.

MACHINERY & ALLIED PRODUCTS INSTITUTE—CAPITAL GOODS REVIEW

THE INVESTMENT CREDIT AS AN ECONOMIC CONTROL DEVICE

In the election campaign of 1960, both presidential candidates expressed dissatisfaction with the progress of the American economy and a determination to accelerate its future growth by providing additional incentives for business investment.

The nature of this concern is evident from the remarks of Secretary of the Treasury Dillon in presenting the first incentive proposal of the new administration the investment credit:

> "As we look back over the past century we see that our record of economic growth has been unmatched anywhere in the world. But of late we have fallen behind. * * * In the last 5 years Western Europe has grown at double or triple our recent rate and Japan has grown even faster. While there is some debate as to the precise annual growth rate of the Soviet economy, CIA estimates that their GNP grew at a rate of 7 percent in the fifties. Clearly, we must improve our performance, otherwise we cannot maintain our national aspirations. The pressing task before us, then, is to restore the vigor of our economy and to return to our traditionally high rate of economic expansion and growth. I am confident this can be accomplished. But it will require a major effort by all of us.
>
> "I have been impressed during recent travels abroad by the great progress our friends overseas have made in reconstructing their economies since World War II and by the highly modern and efficient plants they now have at their disposal. * * * All the information we have indicates that their plant and equipment are considerably younger than ours. Although this difference reflects the rebuilding of the shattered European economies, I think it is important to emphasize that it was due in good part to the vigorous policies of the European governments. Tax incentives for investment played a significant role, including accelerated depreciation, initial allowances and investment credits." [1]

[1] Testimony of the Secretary before the House Ways and Means Committee, May 3, 1961.

Original concept

This statement was made during the recession of 1960–61, following several years of relatively low business capital investment (after 1957). It is obvious, however, that the administration was concerned not simply with the cyclical recovery of investment, but with the broader objective of raising its general level over the long run. The main goal was a higher economic growth rate through increased investment in productive facilities.

This view was well expressed by the Council of Economic Advisers in a report to the Joint Economic Committee:

> "Measures to stimulate business investment directly will contribute to our recovery from the present recession, but that is not their main purpose. All who have confidence in the American economy must look ahead to the day when the slack will be taken up and high levels of output and employment will again be the rule. The full benefit of our decision to supplement increases in consumer demand now with a higher rate of capital expansion and modernization will then be realized." [2]

It is interesting to note that this concept appears to have been shared by the fiscal committees of Congress:

> "The tax credit provided by this bill is complement to the administration's plans for revising the guidelines for the tax lives of property subject to depreciation. It is believed that the investment credit, coupled with the liberalized depreciation, will provide a strong and lasting stimulus to a high rate of economic growth and will provide an incentive to invest comparable to those available elsewhere in the rapidly growing industrial nations of the free world.[3]
>
> "Realistic depreciation alone, however, is not enough to provide the essential economic growth. In addition, a specific incentive must be provided if a higher rate of growth is to be achieved. * * * The objective of the investment credit is to encourage modernization and expansion of the Nation's productive facilities and thereby improve the economic potential of the country with a resultant increase in job opportunities and betterment of our competitive position in the world economy." [4]

Question of manipulation

It will be recalled that the initial reaction to the investment credit proposal was critical, and even hostile, in many quarters. There were a variety of reasons, only one of which concerns us here. It was charged that once in effect the credit would inevitably be manipulated for economic control purposes.

This charge was indignantly denied by the administration. Its spokesmen insisted that the credit was designed to be a permanent feature of the tax system, that its purpose was to raise the average level of investment over the long pull, and that there was no intent to employ it as a contracyclical device. As for the Congress, the legislative history strongly suggests that it concurred in the administration position.[5]

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[2] *The American Economy in 1961: Problems and Policies*. March 6, 1961. p. 49.
[3] Report of the House Ways and Means Committee on the Revenue Act of 1962, p. 8.
[4] Report of the Senate Finance Committee on the Revenue Act of 1962, p. 11.
[5] Witness the committee reports quoted earlier.

At the time the credit was proposed (1961), and enacted (1962), no one was worrying about excessive capital investment. The whole drive was for expansion. Any possible need for restrictive action was obviously far in the future, and except for the administration assurances just referred to the problem was treated as academic.

Recent developments

We cite this historical record to indicate the original concept and purpose of the investment credit. But conditions have changed radically since then, and the question is now before us of withdrawing or suspending the credit as a means of curbing a capital goods boom in an overheated economy.

Last January Senator Gore introduced a bill (S. 2806) calling for the outright repeal of the credit. Later he proposed an amendment to the Tax Adjustment Act of 1966 suspending it for 2 years (rejected by the Senate on March 8). Shortly thereafter, the Joint Economic Committee recommended immediate suspension to a future date prescribed by Congress. Numerous economists, including three former chairmen of the Council of Economic Advisers, have joined in urging suspension, usually for a 1-year period. Several bills directed to this objective have been introduced in Congress. Recently the chairman of the Senate Finance Committee, Senator Long, proposed an amendment to the Foreign Investors Tax Act of 1966 (H.R. 13103), providing for indefinite suspension.[6] Still more recently, the administration has proposed suspension for 16 months (H.R. 17607).

Present project

In view of this altered situation, it is an appropriate time to consider the basic question of the merits of the investment credit as an economic control device. Is it suitable for on-and-off application? This question is the subject of the present inquiry.

It is a safe guess that most of the proponents of on-and-off application have not thought through the problems to which it gives rise, if indeed they are even aware of them. They involve questions of fairness, administrative feasibility, timing, and effectiveness. We suggest that until these questions have been confronted it is irresponsible to urge manipulation, whether by temporary suspension or otherwise. Since temporary suspension appears to be the most favored form of manipulation, we propose to consider the difficulties associated with that form. Because they are somewhat different at the suspension (cut-out) phase of the operation than at restoration (cut-in), we shall discuss the two phases separately, beginning with suspension.

1. PROBLEMS ASSOCIATED WITH SUSPENSION

As a rule, capital equipment has a long production period. Moreover, a large proportion is produced on order. This means that customers must wait during its fabrication, and that there is normally an extended period between the placement of orders and their delivery. The interval between orders and the completion of installation (the point at which the credit can be claimed) is, of course, longer still.

[6] *Congressional Record,* August 30, 1966, p. 20321.

No one knows within a wide margin the current overall average of this order-to-completion period for credit-eligible equipment, but Treasury estimates place it in the range of 9–12 months.[7] Even if we take the lower limit of this range, we are dealing, obviously, with a very long leadtime, the existence of which has important implications for the problem in hand.

Fairness

As just noted, the investment credit is claimable on the completion of installation and the placement of the equipment in service. This means that if the suspension is on the same basis industry will lose the benefit of the credit on outstanding commitments representing say three-quarters of a year's investment in eligible equipment—commitments entered into in good faith in expectation of that benefit.

The unfairness of denying the credit to such commitments was recognized in the Gore amendment, to which we referred earlier, by a provision protecting the eligibility of equipment for which firm contracts had been entered into prior to the effective date. It has been recognized also in subsequent suspension proposals, including the Long amendment and the administration bill.

To afford complete protection of outstanding commitments, it is necessary, of course, to allow time for them to work through the production pipeline. The Gore amendment allowed 1 year, a period sufficient for most, but not all, of them to clear. The Long amendment, on the other hand, allowed only *4 months*. This is grossly inadequate and would leave a substantial proportion of the carryover unprotected. The administration proposal is better in this respect: it imposes no time limit at all.

While the complete protection of outstanding commitments eliminates a considerable part of the inequity at the suspension stage, it does not remove all of it. Industry often makes a heavy investment in the planning and engineering of equipment programs before firm contracts are entered into. To the extent that this investment is conditioned on the availability of the credit, the suspension destroys its value and usefulness. Moreover, there is a large element of chance in the impact of the suspension. The commitment flow of individual companies is extremely "lumpy." The cutout date is certain to catch some of them with large placements just inside the line and others with similar placements just outside. (For example, the administration proposal for a cutout on September 1 finds a large airline with an order dated September 2 for $410 million worth of equipment.)[8]

Although a partial equity can be secured by putting the credit suspension on a commitment basis, given a sufficient workout period, unfortunately this creates difficult administrative problems.

Administrative difficulties

The completion of the installation of a piece of equipment is ordinarily a clearly identifiable event, but the timing of a "firm contract" for its procurement may not be. For this reason the switch from an installation to a commitment basis presents administrative problems.

[7] Quoted by Senator Proxmire from a Treasury communication to him. *Congressional Record*, August 23, 1966, p. 19421. It is estimated further that 40 percent of eligible equipment has an *order-to-delivery* period of less than 6 months, 40 percent between 6 months and a year, and 20 percent over a year (the average for the last group being about 2 years).

[8] *Wall Street Journal*, Sept. 9, 1966, p. 2.

This was pointed out by Senator Long in the debate on the Gore amendment:

"This rule will open up difficult areas of dispute between the Internal Revenue Service and business firms over what constitutes a binding commitment. I doubt if any mechanical rule can be followed here. Each case will have to be examined on its own merits." [9]

When is a "firm contract" entered into? Is it on the date a purchase order is sent, or when confirmed by the equipment producer? Must the order be noncancellable? If not, what kind of cancellation penalties are required to make it "firm"? Must the delivery date be fixed, or can it be indefinite? What about supplements and amendments? Do they take the date of the original order, or must they be broken out? These and other vexing questions are bound to bedevil both industry and tax administrators, giving rise to uncertainty, controversy, and litigation.

There is another aspect of the matter. Suspension on a commitment basis will give rise to deplorable pressure on equipment suppliers for the redating of orders that fall on the wrong side of the line, the shifting of items from later to earlier orders, etc. No one will contend that this is desirable, least of all the suppliers themselves.

As a matter of fact, the administration explored very thoroughly the possibility of putting the credit on a commitment basis at the time it was first proposed. In the words of Assistant Secretary of the Treasury Surrey, "It was found not to be feasible." [10] If it was not feasible to *introduce* it on that basis, can it be feasible to *suspend* it in the same fashion?

Timing

Because of the long leadtime between orders and delivery, the cutoff of the investment credit at the ordering stage would obviously have a *delayed* effect on equipment production. Senator Proxmire recently commented on the point as follows:

"Because the suspension of the credit would have to provide an exception for projects already under commitment, but completed in the future, it follows that suspension would generally not alter investment expenditures or tax revenues for a substantial period of time. . . . If we repealed the credit today or tomorrow, it would be at least the middle or the end of 1967 before the real effect would be felt. If we acted next March or April, it would have no decisive effect until 1968.[11]

This means that the suspension should occur long *before* capital investment attains the level at which restraint is deemed desirable. It requires action on the basis of predictions and forecasts. This is not necessarily a prohibitive requirement, but past experience with the application of restrictive measures in a political environment (especially in election years) is not reassuring. The chances are that the suspension will come late, in response to *current*, rather than anticipated, conditions. In some cases, certainly, this will lock the barn door after the horse is gone. Indeed, there is always the risk that the delayed

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[9] *Congressional Record*, Mar. 7, 1966, p. 4972.
[10] *Hearings* before the Subcommittee on Fiscal Policy of the Joint Economic Committee, Mar. 16–30, 1966, p. 242.
[11] *Congressional Record*, Aug. 23, 1966, pp. 19421, 19422.

effects will fall in the receding phase of the capital goods cycle, thus aggravating the decline.

Perverse reactions

In a parliamentary system, the minister of finance can guard the secrecy of his budget proposals until they are formally presented to the legislature. Moreover, the budget, once disclosed, is practically certain to go through. (If it doesn't, the government falls with it.) In this setup, a measure like the suspension of the investment credit can be imposed as of a date already past, and *there is nothing industry can do about it.*

In the American system, things do not happen this way. Proposals can be tossed into the hopper by any Member of the Congress at any time, and it is often difficult, if not impossible, to assess their chances. Even if they progress in the legislative machinery, they are likely to be pending for months, and no one can be sure whether, or in what form, they will finally emerge. Proposals of the administration must run the same legislative gauntlet, and even if acceptable in principle are commonly exposed for extended periods to discussion and amendment. On many crucial details the final result is often uncertain up to the moment of enactment.

This makes it extremely difficult to suspend the investment credit without triggering perverse reactions on the part of industry. Since the effect of suspension is an across-the-board increase of 7.5 percent in the cost of eligible equipment, the moment a suspension bill is introduced there is an incentive to rush the placements of commitments.[12] Even though the cutout date is already past, there is no certainty that it will stick; hence prudence calls for protective action. Some other bill with a later cutout may supersede the first one. Even if the original proposal eventually goes through, it may be some months hence, and the final effective date is unpredictable. The response to these uncertainties can only aggravate the pressure on capital equipment suppliers which it is the purpose of the suspension to abate.

But this is not all. If the practice of manipulating the credit becomes established, industry will take anticipatory action even before there are overt moves for suspension. (This would occur, of course, even under a parliamentary system.) As soon as capital goods activity rises to a level suggesting the imminence of such moves, protective commitments are in order.

These observations assume suspension on a commitments basis, with sufficient time allowed to work off the outstanding backlog. Where this allowance is cut short, as in the Long amendment mentioned earlier (4 months), there is an additional incentive for perverse reactions. If the threat of enactment is taken seriously by industry, such a proposal is bound to touch off a stampede for the acceleration of equipment deliveries scheduled after the deadline (its enactment would, of course, have the same effect). Again the result will be the opposite of that intended.

These consideration raise grave doubts about the *effectiveness* of credit suspension as a means of restraint, quite apart from the administrative difficulties to which it gives rise. It may well prove counterproductive.

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[12] The 7.5 percent applies to equipment with a service life of 8 years or over. For shorter lived items, the credit is scaled down.

2. PROBLEMS ASSOCIATED WITH RESTORATION

It is obvious that the restoration, or cut-in, phase of the temporary-suspension cycle raises in reverse some of the same problems confronted at cutout. There is again the question of basis: should the cut-in be by installation or by commitment? There is the question of timing: how can anyone tell at suspension whether the scheduled restoration will be timely? There is also the problem of anticipatory reactions: with the cut-in date known in advance, how can perverse effects be avoided?

Basis

While the average leadtime between the commitment and installation of eligible equipment is likely to be somewhat shorter at restoration than at suspension, it is bound to be at least 6 months, and probably longer. This means that if the restoration is on an installation basis it will apply to commitments made long before the cut-in date. If, on the other hand, it is on a commitment basis, it will present the difficult administrative problems described earlier in connection with the suspension phase. (In either case it will generate perverse reactions, about which more in a moment.)

Most of the temporary-suspension proposals we have seen contemplate restoration on an installation basis, though in the administration plan it turns on commitments. Here it is a question of balancing the administrative simplicity of the installation-basis cut-in against the windfall gains conferred on then-outstanding commitments. With a fixed cut-in date, such gains are certain to be far smaller than the windfall losses from the exclusion of existing commitments at the suspension stage. For since the cut-in date is known in advance, most of these commitments will have been made in expectation of the credit. (Where the restoration date is indefinite, more of them will have been entered into without reference to the credit.)

Timing

If there are timing problems at the suspension stage, they appear also, though in different form, at restoration. No one can tell at the time of suspension how long the period should last. Should it be 1 year, 2 years, or 3 years? If the cutout is likely to come, as we have suggested, near the end of the capital goods boom, even 1 year may be too long. In other cases it may not be long enough.

Some temporary-suspension schemes allow the President to extend (but not to shorten) the period by proclamation. This gives one-way flexibility, but it introduces an undesirable element of uncertainty in business planning. Until it is known whether the scheduled cut-in date will be deferred, capital budgeting must proceed in the dark. A similar climate of uncertainty will exist, of course, if the suspension is for an indefinite period in the first place.

Perverse reactions

It is here that the greatest difficulty arises. The restoration of the credit after a period of suspension is equivalent to a general price reduction of 7 percent.[13] This is worth waiting for.

With suspension to a time certain, there is bound to be a massive deferment of commitments (if the cut-in is on a commitment basis) or

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[13] Again with the exception noted earlier for equipment with a life of less than 8 years.

of delivery instructions (if it is on an installation basis) as the restoration date approaches. Unless the cut-in comes at just the right moment (right with this deferment taken into account), the resultant "air pocket" in equipment activity will be both untimely and injurious. It will be the more so, of course, the later the cut-in relative to the correct timing.

The chance that a predetermined suspension period will end at or near the right time is very slim. So also is the chance that the preceding "air pocket" in equipment activity will be rightly timed. There is grave risk that the inevitable wait for restoration will serve to aggravate capital goods recessions.

But what if the restoration date is indefinite, subject to the future action of Congress or the President? In this case the basis for the anticipatory deferment of orders or deliveries is uncertain, and the affair turns into a guessing game. Industry will guess when the cognizant authority is going to move and will regulate its capital programs accordingly. The air pocket will be less sharply defined than when the cut-in date is known (there will be differences of opinion on the prospects), but it will be present nevertheless. The pendency of the restoration will exert a drag on the recovery of investment (or will aggravate its decline) until the effective date is passed.

3. CONCLUSION

The moral of this discussion is clear. The investment credit is not suited to manipulative application. It is not, therefore, an appropriate device for economic control purposes. It was not intended for this use in the first place and should not be so employed.

The practical alternative that confronts policymakers is either to maintain the credit as a permanent feature of the tax system or to abolish it. As to this choice, we entertain no doubt. It is still as important to accelerate the longrun growth of the American economy as it was when Secretary Dillon made the statement quoted earlier. There are now, moreover, two additional factors that did not obtain at that time: the accelerated growth of the labor force, and the declining growth of tax depreciation deductions. A word on each.

We estimated in an earlier *Review* that the stepped-up growth of the labor force (which began around 1965) will require an annual investment in productive facilities $5 billion to $8 billion *larger* than would be needed with a continuation of the labor-force growth rate obtaining previously.[14] Obviously, these expanded requirements will have to be financed somehow.

It is here that the second factor comes in. Over the 20 years 1945–65, the tax depreciation deductions of American corporations rose at an *average* rate of nearly 11 percent per annum, a rate far more rapid than the expansion of depreciable assets (7 percent). But this situation has now come to an end:

"The great postwar surge of corporate tax depreciation is over. From now on, the increase in accruals will be more closely geared to the longrun growth trend of corporate capital expenditures. There is considerable reason to believe, moreover, that the rate of increase will

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[14] "Labor Force Growth and Business Capital Formation," *Capital Goods Review* No. 61, March 1965.

actually fall below this trend. The future of capital expenditures is, of course, unpredictable, but if they rise over the next decade at the average rate of the past 15 years (about 5.5 percent per annum), a shortfall of depreciation growth below this rate seems probable. The probability arises principally from the prospective fadeout of the relative net benefits from the accelerated writeoff methods of the 1954 code and from the guideline-life system." [15]

Both of these factors conspire to make the investment credit more, rather than less, urgent than when first proposed. If under present conditions additional measures of economic restraint are called for—a question we do not consider here—there are better ways to accomplish this end than manipulation of the credit. Indeed, if the foregoing analysis is valid, its manipulation is likely to do more harm than good.

MACHINERY & ALLIED PRODUCTS INSTITUTE,
Washington, D.C., March 31, 1966.

Representative MARTHA W. GRIFFITHS,
Chairman, Subcommittee on Fiscal Policy, Joint Economic Committee, Congress of the United States, Washington, D.C.

THE INVESTMENT CREDIT—THE CASE FOR ITS PERMANENCY

DEAR MRS. GRIFFITHS: We appreciate the opportunity extended by your letter of March 11, 1966, to present the views of the Machinery & Allied Products Institute and our affiliate, the Council for Technological Advancement, on the issues and problems involved in alternative approaches to shortrun economic stabilization. Our comments will be directed to the role of the investment credit in the economy and to a consideration of its appropriateness as a countercyclical device. The reason for this concentration is threefold:

1. We believe the investment tax credit as applicable to productive equipment was an imaginative and sound proposal. Further, we believe the credit has worked and has proven its merits as a permanent part of our tax structure.

2. The investment credit is the subject of one of the recommendations of the full Joint Economic Committee in its 1966 Joint Economic Report, to wit:

"We should immediately suspend the 7-percent investment credit provision in view of the extraordinary exuberance indicated by investment programs. This is one of the major inflationary threats of this year. This action should be accompanied by a provision that the 7-percent credit would go back into effect at a fixed future date unless Congress acts to extend the suspension."

3. As a national organization representing the capital goods and allied equipment industries, the institute speaks on behalf of firms who have the unusual vantage point of being at one and the same time both the producers and major users of the productive equipment subject to the investment tax credit. This vantage point also includes familiarity with the impact of the credit on the wide range of customer industries

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[15] *The Fading Boom in Corporate Tax Depreciation,* Machinery and Allied Products Institute, 1965, pp. 1, 12.

served by capital goods producers. Finally, from the original conception of the credit, the institute has studied it closely.

We turn first to a brief discussion of the investment credit in relation to the goals of our economy.

Goals—One theme with different arrangements

After 20 years under the Employment Act of 1946 its goals of "maximum employment, production, and purchasing power" have come to be generally interpreted as full employment, economic growth, price stability, and balance of payments equilibrium. Since it is impossible to maximize everything at once—and since conditions change as well—the individual goals have been given different priorities at different times. Currently, the goal of stability is receiving the most attention and, because of this, there is a strong tendency to analyze and pass judgment upon a particular measure only in terms of its contribution (or lack of it) to this one goal. We make two observations in this connection:

1. There is a great danger that in attempting to avoid inflation and maximize price stability we will sacrifice the progress we have made in achieving present levels of full employment, economic growth, and balance of payments equilibrium.

2. The investment credit has played—and can continue to play—a major role in achieving the essential economic goals of full employment, economic growth, and balance of payments equilibrium. Further, it is not without merit in its contribution to reasonable price stability as well.

The positive role of the investment credit

The rationale of the credit.—In the current dialog on the investment credit it is frequently overlooked that there was a basic and longrun consideration in enacting the investment credit upon the recommendation of President Kennedy. This was brought out at the time by then Secretary of the Treasury Dillon in testimony before the House Ways and Means Committee: [1]

"As we look back over the past century we see that our record of economic growth has been unmatched anywhere in the world. But of late we have fallen behind. * * * In the last 5 years Western Europe has grown at double or triple our recent rate and Japan has grown even faster. While there is some debate as to the precise annual growth rate of the Soviet economy, CIA estimates that their GNP grew at a rate of 7 percent in the 1950's. Clearly, we must improve our performance, otherwise we cannot maintain our national aspirations. The pressing task before us, then, is to restore the vigor of our economy and to return to our traditionally high rate of economic expansion and growth. I am confident this can be accomplished. But it will require a major effort by all of us.

"I have been impressed during recent travels abroad by the great progress our friends overseas have made in reconstructing their economies since World War II and by the highly modern and efficient plants they now have at their disposal. * * * All the information we have indicates that their plant and equipment are considerably younger than ours. Although this difference reflects the rebuilding of the shat-

[1] "President's 1961 Tax Recommendations," 87th Cong., first sess., May 3, 1961, pp. 21, 22.

tered European economies, I think it is important to emphasize that it was due in good part to the vigorous policies of the European governments. Tax incentives for investment played a significant role, including accelerated depreciation, initial allowances and investment credits."

This same point was made even more directly in the statement of the Council of Economic Advisers before the Joint Economic Committee:[2]

"Measures to stimulate business investment directly will contribute to our recovery from the present recession, but that is not their main purpose. All who have confidence in the American economy must look ahead to the day when the slack will be taken up and high levels of output and employment will again be the rule. The full benefit of our decision to supplement increases in consumer demand now with a higher rate of capital expansion and modernization will then be realized."

The message is clear. There are longrun advantages to the investment credit for productive equipment that outweigh any use it might have as a device to offset cyclical changes in the economy. What are these advantages?

The case for the credit.—In essence, the investment tax credit is vital to economic health in that it provides an incentive to continued growth of the Nation's productive capacity and the modernization and replacement of its existing equipment. In so doing, it provides the assurance the economy can—

1. Provide the goods necessary to meet its domestic needs—civilian and defense—and, in so doing, combat inflation;
2. Provide the additional jobs and equipment required by an expanding labor force;[3]
3. Enable the economy to provide wage increases in accordance with productivity without inducing price increases;
4. Fulfill our international obligations; and
5. Meet the competition for world markets and thus contribute to the solution of our balance-of-payments problem.

To make its proper contribution to the performance of these tasks, the investment credit should be—as it was originally considered to be—a permanent part of our tax structure. To convert the credit to meet the requirements of a countercyclical tool—for example, that it be used on an on-again, off-again basis—would run the risk of sacrificing its effectiveness in fulfilling the vital goals for which it is uniquely designed. But even assuming that serious consideration should be given to its use as a countercyclical tool, how will the credit function in that role?

The credit as a countercyclical tool

It is generally agreed that the criteria that should be met by any tax used as a countercyclical tool include the following: (1) it must be promptly effective and its economic results consistent with desired effects; (2) it must be equitable; and (3) it must not create uncertainty in business planning, investment, and output. We conclude that

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[2] "The American Economy in 1961: Problems and Policies," Mar. 6, 1961, p. 49.

[3] *Capital Goods Review* No. 61, "Labor Force Growth and Business Capital Formation," MAPI, March 1965.

the investment tax credit fails on all three grounds and as we understand Assistant Secretary of the Treasury Surrey's testimony, before this subcommittee on March 30, he makes the same judgment.

Delayed effects.—Under present circumstances, there is an average lag of 9 or 10 months between the go-ahead decision (appropriation or authorization) and the installation [4] of credit-eligible equipment. This means that the major part of the equipment to be installed during the remainder of 1966 is already in the pipeline. Denial of the credit at this juncture might have some effect on projects authorized but not yet committed, but it would not affect significantly those already on order. It follows that the restrictive effect on capital goods activity would be largely deferred. Most of it would come in 1967.[5]

Perverse reactions on suspension.—Unless the effective date of the credit suspension is definitely and convincingly *in the past*, the legislative consideration of the proposal will trigger a frantic rush to obtain deliveries of credit-eligible equipment before the deadline. This will aggravate the pressure on the equipment producer that it is the object of the suspension to abate.

It appears to be the view of leading proponents of suspension that equipment orders outstanding at the time of suspension must necessarily be exempt from its application on grounds of equity. In this case, the legislative consideration of the proposal—unless again the cut-in date is convincingly *in the past*—would lead to an *orders* stampede. This might not be as harmful as a deliveries stampede, but it could be very disturbing to capital goods suppliers, and is certainly not calculated to relieve the pressure on them in the near term.

Perverse reactions on restoration.—If the restoration of the credit were either dated in advance or anticipated by industry, it would obviously provide a powerful inducement for the deferment of new equipment installations until after the deadline. If the restoration applied to *orders* placed after the deadline, it would have an even more retarding effect. On either basis, the arrangement would produce an artificial depression in capital goods markets at the wrong time and contrary to the intention of its sponsors.

Timeliness.—In view of the delayed impact of a credit suspension on capital goods activity, the question arises whether the move is timely. There are powerful forces of restraint already at work in this area—falling corporate liquidity, increased pressure on internally generated funds, reduced credit availability and higher interest rates, rising costs of capital projects, severe shortages in skilled manpower, etc.—and there is informed opinion that the peak of new authorizations has already been reached. If this is correct, the effect of suspension—especially if delayed for 2 or 3 months—would come too late to be of much value. It would have its chief impact after the squeeze is over, and would aggravate any subsequent correction.

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[4] Note the significance of the "installation" test under the investment tax credit provisions. As Assistant Secretary Surrey said, "Actually, I think people who have advocated suspension of the credit really have an image of its operation that would have it turn on orders rather than installations as it now does. This possibility was explored at the time the credit was originally set up and found not to be feasible."

[5] Senator William Proxmire made this same point in his supplementary views in the "1966 Joint Economic Report" at p. 23:

"Because there is a considerable 'leadtime' in carrying out investment projects; because the investment credit becomes available when assets are put in service and hence present contracts are being undertaken in reliance on the availability of the credit when the project is completed; because suspension of the credit would have to provide an exception for projects already under commitment, but which will be completed in the future; it follows that suspension of the investment credit would generally not alter investment expenditures or tax revenues for a substantial period of time."

Inequity.—In addition to the problem of long leadtimes mentioned above, capital expenditures also involve a good deal of preplanning and preparatory expenditures for such items as plant design, engineering work, etc. Any removal of the credit forcing a change in plans obviously results in certain losses or penalties to the company. Further, many such commitments are not only planned long in advance, but are contracted for. Where this is the case a change in plans is no longer feasible and this raises questions of the Government's keeping good faith with the taxpayer.

There is another matter of equity that merits attention here. The credit is a vital and necessary part of our tax system as long as industry is subject to the present extremely high corporate rates which have such a penalizing effect on investment.[6]

Uncertainty.—Frequent reversals of tax policy tend to destroy incentives. Under such conditions there is a reluctance to make capital expenditures when there is uncertainty as to the character and timing of congressional action. This is an important consideration at a time when industry is increasingly engaging in long-range planning and that planning with respect to expenditures on production equipment takes the investment credit into consideration. Thus, to the extent that the investment credit becomes an on-and-off device, its usefulness will be severely impaired.

Summary.—The moral is clear. The investment credit, potent as it is as a device to support and facilitate capital investment, does not lend itself readily to manipulative application because of its inherent limitations as a countercyclical tool.

The crucial element of timing

The proper tools.—Unquestionably, the practice of economics has become more sophisticated in recent years. We believe that through the efforts of economists in government, academe, and industry we know a great deal more about the economy and we are hopeful that government itself has become somewhat more astute and sophisticated in the use of economic tools. However, at this time it must be admitted that there still remains a good deal to be done in improving our analytical techniques and until this is accomplished we are not in a position to proceed with a great deal of reliability into the niceties of countercyclical fiscal policy.

Where are we now?—There are some who believe that the forces of inflation are severe and will grow much worse. There are others, with whom we are inclined to join ourselves, who feel that, although there are some significant inflationary signs, it is unlikely that we confront a runaway situation; indeed, it is very likely that we are near the top of the cycle and may be leveling off. As noted above, there are powerful forces of restraint already at work. These include the tight money situation both as to availability and rates, declining profit margins, and the decline in common stock prices in heavy trading. In terms of capital expenditures, this does not necessarily mean that we are about to face a recession, but rather a significantly slower rate of growth in physical output and a growth rate in plant and equipment expenditures closer to that of the economy as a whole.

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[6] *Effect of Corporate Income Tax on Investment,* George Terborgh, Machinery and Allied Products Institute, March 1959.

Forces at work.—In addition to the straws in the wind we have mentioned, there are a number of basic forces at work which will increasingly exert a restraining hand on the economy. President Johnson himself has identified these factors. These, of course, include the Tax Adjustment Act of 1966 which it is estimated will raise some $6 billion in Federal revenue over the next 15 months, the increase in social security and medicare taxes of some $6 billion at annual rates which went into effect on January 1, 1966, and the recent action of the Federal Reserve Board in raising the discount rate. In addition, it must not be overlooked that Congress can, and we think should, assert a firmer control over Federal expenditures and the executive department has leeway in certain of its actual *spending* decisions.

Beyond these factors, there is one other that to our knowledge has been overlooked by commentators on this subject; namely, the fading boom in corporate tax depreciation. Since the institute has documented this at length elsewhere [7] we will simply excerpt the relevant portion of the conclusion of that study:

"The great postwar surge of corporate tax depreciation is over. From now on, the increase in accruals will be more closely geared to the long-run growth trend of corporate capital expenditures.

"There is considerable reason to believe, moreover, that the rate of increase will actually fall below this growth trend. The future of corporate capital expenditures is of course unpredictable, but if they rise over the next decade at the average rate of the past 15 years (about 5.5 percent per annum), a shortfall of depreciation growth seems probable. The probability arises principally from the prospective fadeout of the relative net benefits from the accelerated writeoff methods of the 1954 code and from the guideline-life system."

Summary.—In light of the margin of error that exists in the application of macroeconomics, the relatively crude state of our analytical tools at this time, and the forces for restraint that have yet to reach their full potential, it would appear precipitous to take action to suspend the investment credit at this time on these grounds alone.

Summary and conclusion

The investment tax credit was enacted by the Congress upon recommendation by the Kennedy administration in order to stimulate sound capital investment as a means of both increasing our rate of economic growth and making U.S. industry more efficient and thus more competitive at home and abroad. It was later liberalized in the same spirit. The objectives of the act are just as vital today as when the law was enacted, despite some changes in economic conditions.

When the investment credit was proposed and enacted it was in the spirit of permanency. There is a clear legislative record to this effect. To attempt to use the credit as purely a countercyclical tool on an in-and-out basis would be a breach of faith, in addition to interfering with the longer-range goals to which it is addressed.

Most persuasive in terms of the applicability of the credit as a countercyclical device is that it simply would not be effective. The credit is not well suited to such use both because of the cutout and cut-in problem and the fact that it will lead to perverse reactions due

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[7] *The Fading Boom in Corporate Tax Depreciation*, George Terborgh, Machinery and Allied Products Institute, 1965.

to the effect of anticipated changes in the credit on the behavior of industry.

Frequently the arguments in favor of suspending the investment credit seem to assume that success or failure in the fight against inflation turns on this single proposal. This obviously is not the case. The Tax Adjustment Act of 1966, the increase in social security and medicare taxes which went into effect in January of this year, and the recent action of the Federal Reserve Board in raising the discount rate all have a restraining effect—both directly and indirectly—on capital expenditures and have not yet attained their potential impact. In addition, the supply of corporate funds will be adversely affected by the passing of the postwar boom in corporate tax depreciation, and the prospect of a deteriorating relation between capital requirements and financial availabilities.

The great economic challenge to the United States today remains the achievement and maintenance of the most modern technology and industrial plant in the world. It is only in this way that we can conserve the progress we have made, protect our national security and our international competitive position, and insure the highest level of job creation.

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This concludes our comments on the role of the investment credit in the economy and its appropriateness as a countercyclical device both in the current economic context and as a general principle. We should like to express again our appreciation of your kindness in permitting us to present the views of the institute on this subject. If the institute and its staff can be of assistance to the committee in its studies we hope you will not hesitate to call on us.

Respectfully,

CHARLES STEWART, *President.*

MACHINERY & ALLIED PRODUCTS INSTITUTE,
Washington, D.C., January 7, 1969.

Hon. RICHARD M. NIXON,
President-elect of the United States,
New York, N.Y.

DEAR MR. NIXON: In your letter to me of October 3, 1968, you expressed the opinion "* * * that the imposition of arbitrary controls on foreign investments is harmful to our Nation's long-range interests * * *. My administration will welcome comments and suggestions in this vital area from leaders of finance and industry, like yourself, who have a working understanding of these problems." Acting upon that suggestion, we advance herein for your consideration a number of recommendations concerning the present foreign direct investment program.

As you may know, the Machinery & Allied Products Institute is a national organization of capital goods and allied equipment manufacturers. The membership of the institute's executive committee appears on this letterhead. The machinery and transportation equipment industries represented by MAPI have an immense stake in foreign investment and foreign trade. By way of example, the value of foreign direct investments by these industries totaled $6.7 billion in 1964, the last year for which data are available, and their exports in 1967 were $12.6 billion. Our membership's overseas commitments are both long standing—in some cases dating back into the 19th century—and, by competitive necessity, continually enlarging, particularly as part of the greatly expanded international trade which followed World War II. We record these facts not merely to qualify the witness but in order that you may understand the point of view from which we approach this subject.

The institute has opposed the foreign direct investment controls from the hour of their inception, and we still oppose them, both as to the policy decision which created them and as to their specific structure. Such controls are repugnant to the goal of freer world trade so vigorously advanced by this country since World War II, and they are at least inconsistent with the spirit of numerous U.S. treaty undertakings which bear on this subject. Not only are they self-defeating, but, because of the conditions which they produce, they tend to be self-perpetuating. The institute's initial and continuing opposition to the program is documented in the MAPI pamphlet, "The Case Against Balance-of-Payments Controls," which reproduces our testimony before the House Ways and Means Committee on February 21, 1968. A copy is attached.

The general opposition expressed here is shared with rare unanimity among American business. Nor is opposition limited to the business community. Congressional opposition has already manifested itself in the form of the Tunney resolution, introduced with substantial bipartisan support in the last day of the 90th Congress. We are informed that it will be reintroduced in the new Congress, again with substantial bipartisan cosponsorship. At least two distinguished academic economists, Prof. Fritz Machlup of Princeton and Prof. Gottfried Haberler of Harvard, have vigorously and repeatedly denounced this system of controls. Indeed, the administration which invoked these controls did so "reluctantly" and with solemn assurances as to their temporary character. Yet the controls are not only continuing—with appropriate expressions of regret—but their continuance is accompanied by the prediction that they must be continued into the seventies.

Incidentally, something of the character of the program is illustrated by the administration's after-the-fact rationalization of it in the form of a Treasury Department-sponsored study entitled *Overseas Manufacturing Investment and the Balance of Payments, Tax Policy Research Study No. One*, prepared by Prof. G. C. Hufbauer of the University of New Mexico, and F. M. Adler of Columbia University. The conclusions of the study have been challenged in a detailed MAPI critique published in November 1968.

A matter of philosophy

Although we have no wish to reargue *in extenso* the merits of the foreign direct investment program, it does not seem to us inappropriate to comment briefly on the philosophy underlying the program. We have for some years been governed by a controls-minded administration. The foreign direct investment program is but one example of this philosophy, which recently received a most disturbing expression in the report of the Cabinet Committee on Price Stability released by the White House on December 29, which suggests that as part of a broad pattern of voluntary restraint business should absorb "* * * a share of unavoidable increases in cost through acceptance of lower profit margin targets." But this is an aside—our topic here is controls over foreign trade.

As you will recall, a first step in the establishment of Government controls over international business transactions was the adoption of the interest equalization tax on a "temporary" basis—a step that now appears to have become quasi-permanent. Still later a voluntary program of controls over foreign direct investment was adopted which in turn was converted a year ago into the system of compulsory controls with which this statement is concerned. There are still other examples which might be offered in support of this thesis—controls over foreign lending, the attempt to restrict foreign travel, etc.—but the examples cited will suffice to indicate the direction of Government policy in recent years.

We have no doubt that your administration is prepared—even eager—to reexamine the general drift of governmental philosophy that has produced these and similar encroachments on freedom in the conduct of foreign business. It is our hope that your administration will give an early and an especially hard look at the foreign direct investment program. What is needed is a fundamental redirection of policy. We acknowledge, to be sure, that once governmental controls are instituted it becomes extremely difficult to reverse or abolish any such program overnight but, if the net of expanding Government controls—in this and in other areas—is to be eventually unraveled, a start must be made. A small step would be altogether inadequate in the case of the foreign direct investment program. Indeed, adoption of no more than those trifling changes in the foreign direct investment program proposed for 1969 by the present administration might, by reducing the volume of protest, tend over the longer run to extend the program's existence. Decisive action of a fundamental character is required.

However, above and beyond the foreign direct investment controls program per se, there are broader policy considerations respecting foreign trade that require restudy and reshaping. One fallacy implicit in the direct investment controls program is the conviction that it is possible for Government in its wisdom to segregate and to deal separately with foreign trade and international capital flows. Perhaps even more dangerous is the fragmentation and at times the inconsistency of Government policy respecting our foreign trade in all its aspects. In fact, the controls program contains one such inconsistency—the combining therein of restraints on foreign investments with a clear intention to encourage foreign investment in lesser developed countries. Perhaps new governmental institutions are required or the responsibilities of existing institutions will have to be rearranged but, until our Government devises a practical means for developing and pursuing a unitary national foreign trade policy, existing problems in this area will persist and perhaps grow worse.

One further aspect of the present situation requires special mention. It is our observation that there has developed in Government in recent years a creeping and clearly discernible antipathy toward foreign investment. When one considers the enormous contributions which direct investments abroad have made to our international balance of payments, it seems evident to us that any remaining trace of such an attitude within Government should be extirpated at once.

The adoption of foreign direct investment controls

The foreign direct investment program was triggered, of course, by our continuing balance-of-payments deficits. And they in turn resulted from a too-long-continued failure to face up to the root causes of our problem, to curtail Government spending abroad, from the foreign exchange costs of the Vietnamese war, and from a failure to promote American exports more vigorously. Above all, these deficits are traceable in large part to excessive domestic spending which encouraged inflation and at once induced imports and made our exports less competitive.

Confronted as it was a year ago with a situation where a weakening loss of gold had become a destructive hemorrhage, the present administration undertook crisis surgical measures of a "temporary" nature. The balance-of-payments program as proposed by the President called for a substantial tax on foreign travel, a reduction in Government spending abroad, a vigorous promotion of foreign travel in the United States, a governmental program to expand U.S. exports, encouragement of foreign investment in the United States, an attempt to eliminate nontariff foreign barriers to American exports, controls on foreign lending, and direct controls on foreign investment. Except for very small beginnings toward the enlargement of U.S. exports and preliminary negotiations for the removal of nontariff barriers to our foreign trade, and some increase in foreign investment in the United States, the program has produced significant results only as it controlled directly the outflow of capital in the form of direct foreign investments and loans to foreign citizens. In short, those elements of the balance-of-payments equation which had in the past made the greatest positive contributions to our balance of payments were made to bear the brunt of the present administration's achievements.

We agree, of course, with your statement of October 3 that "This controls program is a palliative * * *"; but, palliative or not, the fundamental circumstances which have led to our present balance-of-payments situation have been altered little if at all in the year which has intervened since adoption of the controls program. Indeed, those who argue for the program's continuance cite three conclusions in support of this necessity. One is that American industry, prohibited from investing normally from its domestic funds, has continued its foreign investment program by borrowing abroad, and that, if controls were removed, American borrowers would refinance this foreign debt from U.S. sources and thus precipitate a greater balance-of-payments crisis than we have ever faced in the past. In addition, it is argued that restoration of normal liquidity among foreign subsidiaries and the resumption of a higher rate of foreign investment, both of which could be expected to follow cessation of controls, would impose new and unacceptable stresses on our balance of payments. Without arguing these conclusions here it seems appropriate to observe that nothing illustrates more conclusively the truism that controls beget controls.

We hope, of course, that, consistent with your personal commitment to the greatest possible freedom in business affairs, it may be possible to dismantle this system of controls promptly and fully. It will not be easy, not only because underlying balance-of-payments problems remain unsolved but because the controls themselves have so distorted the normal activities of international capital markets as to create new and very difficult problems which must also be solved before the system of controls can be altogether abandoned. Despite these problems, we hope the effort will be made because we are convinced that to delay this could only further postpone the too-long-delayed attack upon fundamental problems and would tend simply to magnify the distortions which controls have already created. To discontinue controls at once would be a bold step—one requiring courage, imagination, and the utmost cooperation of U.S. industry and the banking fraternity. If your administration can bring itself to make the effort, you can be assured of industry's cooperation, as evidenced by its magnificient response to the voluntary balance-of-payments program, even though in the latter case those who responded most generously suffered most greviously when the voluntary program was changed to a mandatory system of controls.

If, on the other hand, you and your advisers consider the present situation to be such as to require continuation of the controls program for a further limited period, we hope that you will accompany your decision to extend it with a firm resolution, publicly announced, to phase out the program on an orderly basis and one wholly coordinated with such other administration moves as may be adopted to deal with the whole of the larger problem. Moreover, if it is your decision to continue the controls program for a further period, we hope that it may be substantially revised to minimize its ill effects and to provide a proper transition to its oblivion.

Recommendations for change in the foreign direct investment controls program

Although we oppose completely the present system of Government controls over direct foreign investment—as previously suggested—we acknowledge the possibility of its continuation for some period of time in the future. In acknowledging this possibility, one cannot resist repeating the observation that the creators and administrators of this system—who in deploring the necessity of its adoption emphasized its temporary nature—now argue for its indefinite extension on grounds that its operation has created conditions which make its immediate abolition impossible as a practical matter. The fact is that only 1 year of foreign direct investment controls has taken us far down the road toward permanence. If the new administration does not move promptly and decisively to fulfill its pledge of abolishing controls over foreign direct investment "at the earliest possible time," then we believe that the distortions in international capital flows which those controls have already produced will be so intensified and multiplied that—because of fear and continually enlarging danger—we may become permanently addicted to this regulatory tranquilizer.

Assuming, without admitting, that the present system of controls cannot be abolished forthwith, let us consider some practical steps that can be taken administratively to minimize the adverse effects of the present system and to lay a foundation for the cessation of controls at the earliest possible time. Some suggestions to this end follow.

Reinstitution of voluntary system.—We repeat that the situation calls for a fundamental change in policy accompanied by boldness in its execution. No small step will do the trick. It seems to us possible to achieve most of this objective without subjecting the United States to those dangers so vividly described in recent months by those who favor continued controls.

For 2 years American foreign direct investors met every goal established for them under the Government's voluntary system of controls. It was not a desirable system, of course, but it had the virtue of preserving to industry a degree of flexibility in managing its incredibly diverse affairs that can never be attained under a compulsory system. At the least, the possibility of substituting some new system of voluntary controls for the present mandatory system should be fully and sympathetically considered. We have no doubt that U.S. business would respond as patriotically as it did in the past.

If this cannot be done, then we urge that the new administration consider such changes in the mandatory system of controls as are outlined below.

Repatriation.—The primary objective of the present investment controls system is to improve our balance-of-payments position by reducing capital outflows from the United States. As a concomitant measure, the system provides for repatriation of foreign earnings under rules which vary in accordance with the division of the globe into three "scheduled" groups of countries.

We recommend that present repatriation requirements be abolished in their totality or, if this is deemed too radical a step to take at once, that they be reduced substantially and abolished altogether as soon as possible.

As presently administered, the system of controls permits U.S. direct investors to borrow in foreign countries for purposes of capital investment abroad and to guarantee such foreign borrowings by affiliated foreign nationals without such investments being chargeable to controls-ordained "investment allowables." However, such authority is subject to the proviso that as to such indebtedness incurred after January 1, 1968, the foreign direct investor shall have certified to the Secretary of Commerce that it will not make any transfers of capital in connection with repayment of the borrowings within 7 years, or if such transfers are made, they will be within investment allowables.

For reasons which it is unnecessary to recount here, industry has, since initiation of the voluntary program in 1965, borrowed an estimated $5 billion for such purposes, largely in the capital markets of Western Europe. Further, the Department of Commerce expects that it may be necessary for American business to borrow an additional $2 billion or $2.5 billion in 1969. The existence of this debt "overhang" is now cited by those who argue for continuance of investment controls as a principal reason for the inevitability for such continuation.

We are told that, if the system were abandoned at once, American industry would, as quickly as possible, refinance this indebtedness in the United States at lower interest rates and that we might thus confront an altogether unacceptable balance-of-payments deficit as a result. This may well be true but the potentialities of this controls-created condition are even worse than their present effects—bad as they are. The reason is a simple one. The program requires the very substantial repatriation of foreign earnings, amounting in the case of Western

Europe to 80 percent of all such earnings in any accounting period or, alternatively, the greater of (1) all such earnings for that accounting period in excess of 35 percent of the average of capital investments in schedule C countries by the direct investor in 1965–66, or (2) all earnings in excess of the percentage of earnings reinvested in 1964–66. Thus, the controls system in large measure denies to direct investors the wherewithal to service these debts and to reduce the overhang which now is advanced as the principal reason for continuing the controls system. It follows that the immediate abolition or the very substantial scaling down of present repatriation requirements should be undertaken at once. Aside from the necessity of abolishing or greatly reducing the repatriation requirement if we are to make our foreign debt manageable there are other objections to this requirement that deserve mention.

Although not yet tested in the courts, the legality of the foreign direct investment controls program has been seriously questioned. Nowhere, in our judgment, is the legal challenge to the program more serious than as it applies to compulsory repatriation and, as part of the legal review of the program which we recommend, we urge that this point receive special attention.

Repatriation, as presently required, imposes uneven and inequitable tax impacts on companies subject to investment controls; a result of the program from which the Treasury Department has consistently declined to recommend relief.

Finally, let us frankly acknowledge that the abolition or scaling down of the repatriation requirement will adversely affect our balance of payments. We think this result must be faced and dealt with or we shall never rid ourselves of controls. The adverse impact of such a move will have to be made up by "* * * solving the real causes of our balance-of-payments deficit, reestablishing the integrity of our fiscal and monetary policies, stimulating exports and encouraging travel to the United States," as pointed out in your statement of October 3. The offset will have to come from measures outside the foreign direct investment program. In no case should any loss occasioned by reduction or abolition of the repatriation requirement lead to an offsetting reduction in investment allowables.

A schedule of phaseout.—In *Nixon on the Issues* under the heading "Balance of Payments," you suggested that your administration will adopt "* * * new policies of prudence and restraint * * * [to] put our own house in order." Clearly this does not contemplate our limping forward painfully from one balance-of-payments crisis to another with controls on direct foreign investment as the principal crutch supporting that uncertain passage. Yet, controls beget controls and the mere passage of time magnifies the distortions which controls create and makes their indefinite continuation seemingly more needful. Because this is true, we think your administration should announce forthrightly and at a very early date a general schedule for phasing out the direct investment controls system.

Consistent with our recommendation concerning abolition or reduction of present repatriation requirements, any such phaseout schedule must make due allowance for the probability that when the system of controls is finally dismantled there will remain a threat to our balance of payments in the form of unpaid foreign debts incurred by direct investors during the pendency of the controls system. Some means will have to be found of dealing with this lingering side effect of the controls but it is better now we think to face and deal forthrightly with this unavoidable problem than to employ it as an excuse for a continuance of the program.

Not only do we believe the new administration should announce promptly a program for the phaseout of foreign direct investment controls, we also think it should designate a senior Cabinet officer to preside over the system's dissolution and with authority to take such steps as are necessary to accomplish its scheduled interment.

Incentives.—Given the distasteful character of the foreign direct investment program, Mr. Fiero and his very able staff, in our judgment, have administered the program evenhandedly and well to date. As with any controls program, however, it depends upon compulsion for the achievement of its objectives. Citizens accustomed to freedom do not take kindly to compulsion. Moreover, we are inclined to believe that the investment controls program's necessary—and thus far total—reliance upon compulsion may have resulted in its making a less favorable contribution to our balance of payments than could have been possible. What we have in mind are incentives appealing to the self-interest of direct investors subject to the program and which could, in our judgment, contribute materially to improvements in the balance of payments beyond those arbitrarily achieved by the program's restrictions.

It is unarguable that an enlargement of our export trade balance is badly needed if we are to close the balance-of-payments gap with or without controls on foreign direct investment. So long as the controls are continued, why not employ them as a lever to advance the equally important national objective of export expansion. Toward this end, we recommend that foreign direct investors subject to the controls program be permitted to increase investment allowables to which they are otherwise entitled by a fixed percentage of the amount by which their current exports exceed the average of their exports in 1965–66. We lack sufficient information to suggest what that percentage ought to be but, within whatever limits are acceptable to the general program, we have no doubt that the more generous the percentage the more favorable the reaction. Similarly, if it is decided not to abolish but rather simply to reduce the present mandatory repatriation requirement, then consideration should be given to incentives in the form of increased investment allowables to encourage repatriation beyond that still required.

Similarly, the administration, if it decides to continue the foreign direct investment program, should undertake a thoroughgoing study of the taxation of foreign earnings. This subject, to be sure, deserves study on its own and thus in a larger sense is only peripherally related to the foreign direct investment program. If, however, as Prof. Dan Throop Smith has recently suggested, there are sound reasons of national policy for considering the taxation of foreign earnings at a lesser rate than that applicable to domestic earnings, then a study of this problem becomes a matter of urgency. Reduced taxes on foreign earnings would clearly be a great incentive for the prompt repatriation of such earnings. Consideration should also be given to a tax incentive to encourage exports. Obviously, all such measures would conduce to the benefit of our international balance of payments. Moreover, the beneficial contributions of such a tax incentive to our balance of payments would continue in the future regardless of when or how the foreign direct investment program is ended.

Abolition of area "schedules".—As you are aware, the foreign direct investment program divides the world into three "schedules" of countries. In brief, schedule A consists of lesser developed countries; schedule B of Japan, the British Commonwealth of Nations (except Canada), and the oil-producing nations of the Near East; and schedule C consists of Western Europe plus South Africa. Each "schedule" is treated differently in terms of investment allowables and repatriation requirements with the least stringent applying to schedule A and the most stringent applying to schedule C. One must infer that the principal reason for this discrimination results from a mixture of inconsistent motives—that is to say, an attempt to engraft upon what is essentially a system of compulsion respecting private investment abroad a national policy objective of encouraging private investment in lesser developed nations. Quite aside from the illogicality of attempting to achieve an affirmative objective by a negative approach, our pragmatic view of the matter is that the "schedular" approach has resulted in little if any increased investment in lesser developed nations, nor is it likely to. The fact is that a foreign investment may spring from any of a variety of motivations and the mere fact that one is not permitted to invest in the relatively low-risk countries in schedule C is not by itself a reason for diverting such an investment to the relatively high-risk countries in schedule A.

From an even more practical standpoint, the division of the globe into three schedules has trebled the administrative difficulties and burden of compliance with the controls program, has greatly reduced management flexibility as to total foreign operations, and, so far as we can see, there has been no commensurate benefits in terms of increased investment in lesser developed countries.

We suggest that the schedular approach be abandoned and that for purposes of any continuation of the foreign direct investment program the globe be treated globally. If it continues to be our national policy to encourage private investment in less developed nations, then such an objective can be more fruitfully served by qualifying such investors for an investment tax credit, suggested already and long considered both in the Congress and in the executive branch. We acknowledge that the Office of Foreign Direct Investments has already relaxed in some degree the rigidity of the original schedular approach by sanctioning limited "upstream" transfers of capital. Although a welcome step in the right direction, it is too limited a step, an aspirin approach to an organic problem that demands surgery.

Finally, let us emphasize that abandonment of the schedular approach—just as in the case of our recommendation for abolishing or reducing the repatriation requirement—should not be permited to serve as an excuse for reducing investment allowables. At the least, global allowables should consist of appropriately weighted averages of preexisting schedular allowables.

Open accounts and increased exports

Present OFDI regulations define as a net transfer of capital to affiliated foreign nationals, "* * * increases (or decreases) in the debt obligations (including trade credits, loans, or advances, whether or not an open account) or the incorporated affiliated foreign nationals held by the direct investor." Our comments here relate specifically to debt obligations, largely as a result of export sales, carried on open account.

The net effect of the regulatory definition cited above is to require that any year-to-year increase in an open account balance with an affiliated foreign national is to be treated as a direct investment and hence chargeable to the direct investor's investment allowable. If the investor has conventional investment plans adequate to exhaust the full amount of his investment allowable, the result—assuming it is not possible to shorten payment terms—is to restrict his exports to affiliated foreign nationals to an amount no greater than that exported in the preceding year. Indeed, the tendency may well be to reduce exports if there exists any danger of exceeding the ceiling of his allowable by export sales. In light of this possibility, we are convinced it would be advantageous to write into the regulations of the foreign direct investment program a general authorization permitting increases in open accounts related to increases in exports.

The fact is, of course, that OFDI is well aware of this problem and has sought with very considerable understanding to accommodate situations of the type here described by appropriate specific authorizations. Recognizing the sensitivity of past administration on this point, we wish to reemphasize that it is not in the interest of expanding exports to have investment needs and export credit requirements competing for the same volume of investment allowables.

Consequently, we urge a general authorization, as suggested above, that would permit a company to increase its open account balances, automatically and as a matter of right, in the same proportion as its increases in such balances have accompanied increases in exports in the past. That is to say, a company that customarily collects from affiliated foreign nationals on a 6-month basis could increase its open accounts in an amount equal to one-half of the increase in exports to the affiliated foreign nationals. If it customarily collects in 3 months, then the increase would be one-fourth of the amount of the increase in exports. The specific authorization route should still be made available to firms which have a special problem as could be the case with a company whose exports are shifting from products for which prompt payment is appropriate to products for which more extended terms are customary.

The Office of Foreign Direct Investments may argue—and with some justification—that its experience indicates there are so few companies affected that continuation of the present requirement for a specific authorization in each needful case is justified. Even if this is true, we suggest that—so great is the need for increased exports—nothing should be done that could conceivably impede export expansion. Worldwide sourcing decisions are frequently close and nothing should be done which might dictate against the selection of the United States as the production source. If a specific authorization would be required for increases in credit to foreign affiliates, the very uncertainty of obtaining such an authorization might be sufficient reason in some cases to divert production to a foreign source.

Exports of capital goods for investment use without charge to allowables

As presently administered, OFDI regulations require that equipment purchased in the United States and sent abroad as an investment must be chargeable in full against the firm's investment allowables for the current year—if it has sufficient allowables in the current year. At the same time, equipment purchased with the proceeds of borrowing abroad is not currently chargeable to allowables and is so chargeable in further years only as the borrowing is repaid.

Exports follow financing and, because this is true, present restrictions on shipments of equipment for production use by affiliates may be affecting our exports detrimentally. We believe that the program-induced resort to overseas financing (necessarily coming primarily from Western Europe) will not only permit the camel's nose in the tent in Latin America and other areas where U.S. companies traditionally have enjoyed a predominant position but, for the same reason, will affect adversely our export position in those Western European countries which provide the financing.

While it is difficult to quantify the effect that this shift in financing to Europe (and other financial centers) is having on purchases of U.S. equipment, in our judgment it can be quite substantial except in those relatively few areas where U.S. technology is clearly far ahead of foreign technology. We believe the export losses will be particularly severe in those cases where additional equipment purchases must be financed by foreign borrowings and management of a foreign affiliate is charged with determining the source of the procurement. As I am sure you realize, opportunities lost now for placing U.S. equipment in foreign plants will result also in the loss of further replacement business and the loss of the normally remunerative spare parts business. Further, it should be noted that, at least in some measure, the present requirement may result in the deferral of replacing equipment in this country. As more technologically advanced equipment becomes available here, some companies transfer less productive machines—as a form of further investment—to overseas subsidiaries, generally in less developed countries, where such equipment is perfectly adequate for competitive conditions in such countries.

We believe that this problem must be dealt with promptly lest patterns of financing induced by the controls program lead to establishment of new patterns of trade disadvantageous to this country. We have alternative suggestions.

Our principal suggestion is that shipments of production equipment from United States direct foreign investors to their foreign affiliates be permitted without charge to authorized investment allowables. Alternatively, some lower percentage might be used as a beginning. If it is considered inappropriate to take such a major step at this time, then we recommend an alternative, designed both to surmount this danger to the present level of U.S. exports and to provide a further incentive for increasing exports, as spelled out in appendix "A" to this letter.

Summary and conclusion

Let us summarize briefly our recommendations:

1. Regardless of difficulties, every effort should be made to abolish the foreign direct investment program forthwith.

2. If it is the judgment of your administration that present circumstances require continuance of the program for a further period, then we recommend:

(*a*) Reinstitution of the voluntary program should be given first consideration.

(*b*) The legal basis for the present program should be reexamined, with particular attention given to required repatriation of foreign earnings.

(*c*) The requirement for repatriation of foreign earnings should be abolished or reduced by as great a percentage as present circumstances will permit.

(*d*) The new administration should reaffirm its intention to phase out the program in accordance with a schedule coordinated with other governmental actions designed to improve our balance of payments.

(*e*) As measures to further improve our balance of payments, consideration should be given to program incentives in the form of increased investment allowables in return for increased exports. If any requirement for mandatory repatriation is continued, then incentives in the form of increased allowables should be devised to encourage additional repatriation. Consideration should also be given to legislative recommendations for tax incentives to increase exports and to increase repatriation of foreign earnings.

(*f*) The program's division of the world into "scheduled" areas should be abolished.

(*g*) Regulations of OFDI should be revised to permit automatic increases in investment allowables corresponding to increased exports sold to foreign affiliates on open account.

(*h*) United States direct investors should be permitted to export capital equipment to foreign affiliates for production use without charge to investment allowables. If the full step is not presently feasible, some interim step at some lesser percentage should be considered. As a further alternative, consideration should be given to permitting limited shipments of this character without charge to investment allowables as spelled out in appendix "A" to this letter.

This concludes our suggestions for revising the foreign direct investment program in pursuance of your administration's pledge to do away with the program at the earliest possible time. We are taking the liberty of sending copies of this letter to the Secretaries-designate of State, Treasury, and Commerce, and to the Chairman-designate of the Council of Economic Advisers.

If you or your staff should have questions concerning these suggestions or if the institute can otherwise be of assistance in achieving this end, I hope that you will not hesitate to call upon us.

Respectfully,

CHARLES STEWART, *President.*

APPENDIX "A"—EXPORTS OF CAPITAL GOODS FOR INVESTMENT USE

If it is deemed inappropriate to permit immediately transfers of production equipment from United States direct investors to foreign affiliates with no—or something less than a total—charge to investment allowables, then as an alternative we suggest:

1. Permit, within established limits, investments in foreign affiliates in the form of shipments of American equipment without charge to investment allowables. These transactions, it should be noted, would have no net effect on the balance of payments.

2. Authorize use of this privilege by permitting foreign direct investors elective use of either of two standards—one a fixed minimum available to all such investors and the other an incentive variable. One practical starting point in developing such standards is suggested by existing U.S. Department of Commerce statistics from which one may calculate percentage relationships between exports of capital equipment for investment use and exports to affiliates as well as exports of capital equipment for investment use to total exports. The most recent Commerce figures are for the year 1964 as given in the *Survey of Current Business* for December 1965. Using these figures as a point of departure, consideration might be given to the following:

(*a*) The ratio of exports of capital equipment for investment use ($345 million) to total exports to foreign affiliates ($6,290 million) is 5.5 percent.[1] We suggest that 5.5 percent of the average of total exports to foreign affiliates by a direct investor during the 1965–66 base period be taken as the *minimum* figure for shipment of capital equipment for investment use without charge to allowables. We believe the figure is well on the low side, since in many cases reporting firms may not have included equipment purchases from other U.S. companies in their reporting of shipments for investment use.

While it is true that similar Commerce data is being compiled for 1965 and 1966 by the Office of Business Economics, those years may not be as typical as 1964 because of the impact of the voluntary program.

It should be emphasized that we consider this 5.5-percent standard—or some similar figure—to be a minimum available to any foreign direct investor without charge to investment allowables. Beyond this, we think such investors should be permitted to export greater amounts of capital equipment for investment use where, by increasing exports, they have made a more-than-offsetting favorable contribution to the balance of payments. Let us turn now to that further proposal.

(*b*) Our suggestion for an incentive variable standard, permitting shipment of capital equipment for investment use without charge to investment allowables, also has its source in those Commerce statistics cited above. Inasmuch as exports by U.S. firms to their foreign affiliates in 1964 were 25 percent of total exports, we suggest that consideration be given to permitting foreign direct investors—as an option in lieu of the minimum standard—to export capital equipment for investment use without charge to allowables up to 1.4 percent (or one-fourth of the 5.5-percent figure indicated above as a minimum) of total exports to affiliated *and* nonaffiliated companies in the preceding year. We think it is important to offer foreign direct investors subject to the present

[1] These data are, of course, based on shipments to foreign firms owned 25 percent or more by U.S. companies while the FDIP applies to firms owned 10 percent or more by U.S. companies. It does not appear that this disparity would seriously affect the relevance of the statistics for this purpose.

controls program some broadly applicable and easily applied incentive to encourage companies to improve their individual balance-of-payments position.

3. We recommend that shipments of capital equipment for investment use under either of these optional standards be permitted without reference to area or schedule-of-countries limitations which might otherwise continue to apply.

4. The special incentive suggested in 2 above should be considered as a matter wholly separate and apart from any general incentive to increase exports as suggested earlier.

MACHINERY & ALLIED PRODUCTS INSTITUTE—CAPITAL GOODS REVIEW

A REMARKABLE DECADE FOR BUSINESS CAPITAL EQUIPMENT

Save for the minirecession of 1960–61, the American economy has now enjoyed a full decade of expansion, with only the mildest of interruptions. It is not surprising that this relatively stable growth has been reflected in the behavior of the capital equipment industries. They, too, have turned in a remarkable performance.

We can illustrate this proposition by reference to the monthly census series on orders, shipments, and backlog of "machinery and equipment." This is by no means an ideal classification, since it omits some categories of capital equipment and includes a certain amount of other business.[1] Moreover, the figures have shown a tendency in the past to drift downward relative to more comprehensive benchmark data. The defects of classification are not too serious for our purpose, however, and as for the downdrift, that has been corrected through 1966 by the revision described in the preceding *Review*.

The limitations of the series would be important if our object were to measure the *absolute* magnitude of the capital equipment market, and changes therein, but it is not. There are better sources available for this purpose (the GNP estimates, for example). What we have in mind is something quite different; namely, an analysis of the *interrelation* of orders, shipments, and backlog. For such *relative* measurements, downdrift and defects of coverage are of little consequence. The relations among these magnitudes developed by the census series are almost certainly valid in broad outline (though not, of course, in detail) for capital equipment correctly defined and measured.

The results

With this introduction, we turn to the results. The chart on page 1138 shows monthly orders, shipments, and backlog in dollars, orders as a percentage of shipments, and backlog in months' shipments. The heavy vertical line divides the timespan into the most recent dec-

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[1] Among the omitted lines are farm equipment, communications equipment, business motor vehicles, and civilian aircraft. The inclusion of some nonequipment business (such as defense products and consumers' durables) arises from the way the basic data are reported. Until recently, they were filed primarily by *company*. Each company was assigned to the industry of its major activity, and its whole output, of whatever character, appeared in the figures for that industry. Thus a huge multiplant enterprise with production in several major industries fell in a single category. The results, of course, was a serious "blurring" of industry and product lines. In the last few years the census has been developing divisional or plant reporting by such companies, and as this spreads it should make the industry classifications considerably "cleaner," but it can never purge them entirely of alien elements.

ade (1959–68), the subject of special attention here, and the previous period, which is presented for contrast.

A quick glance at the three diagrams composing this chart discloses two distinct and remarkable different periods. In the first, which extends to late 1958, orders swung in major cycles alternately far above and far below shipments, producing in consequence two major swings in the backlog. In the decade since 1958, the orders-shipments relation has been much closer, with no clearly defined backlog cycle. Over this period, there have been in fact only two sustained intervals when orders exceeded shipments by more than 5 percent, and none when they fell short by that ratio.[2]

Comment

One reason for this relative stabilization of the orders-shipments ratio is apparent at once. The flow of orders in the past decade has itself been fairly regular, in contrast to the wide swings of the earlier cycles.

In the Korean war boom, the upsurge was fantastic, the flow of placements more than doubling in a year's time from a starting position already above shipments. In the 1955–57 boom, it rose 70 percent in a year and a half and more later (though in this case from a starting position below shipments). In the recovery from the 1958 recession, the rise was about 30 percent over a year's time.

There have been no equivalent surges in the past decade. Following the completion of the 1958 recovery, the orders flow moved generally sidewise until mid-1961, when it began a gradual and relatively steady expansion at an average annual rate of about 12 percent. The pace quickened after mid-1965, and ran for a year at nearly 25 percent, but this was followed by an irregularly sidewise movement until the spring of 1968, when a new rise got underway.

The 1965–66 surge was the nearest thing to an oldtime orders stampede the decade provided, and it is interesting to note that like the blowup of 1950 it was associated with a sudden expansion of military requirements. There is good reason to believe that had it not been for the Vietnam buildup the previous orders-shipments pattern would have been maintained, and that this blemish on an otherwise exemplary record would have been avoided.

One of the factors tending to regularize the flow of orders has been an improvement in the capacity of equipment manufacturers relative to requirements. The long climb of orders from mid-1961 to mid-1965 appears to have met a reasonably prompt production response. Shipments remained generally 95 percent or more of current bookings, and the rise of the relative backlog (the backlog stated in months' shipments) was moderate. By contrast, the surge of 1965–66 clearly outran the response capability of the equipment suppliers. Shipments lagged bookings by 10 percent for 6 months, and by more than 5 percent for a year and a half, building the backlog from 3.8 months' shipments in early 1965 to 4.3 months in late 1966, the highest ratio of the decade.

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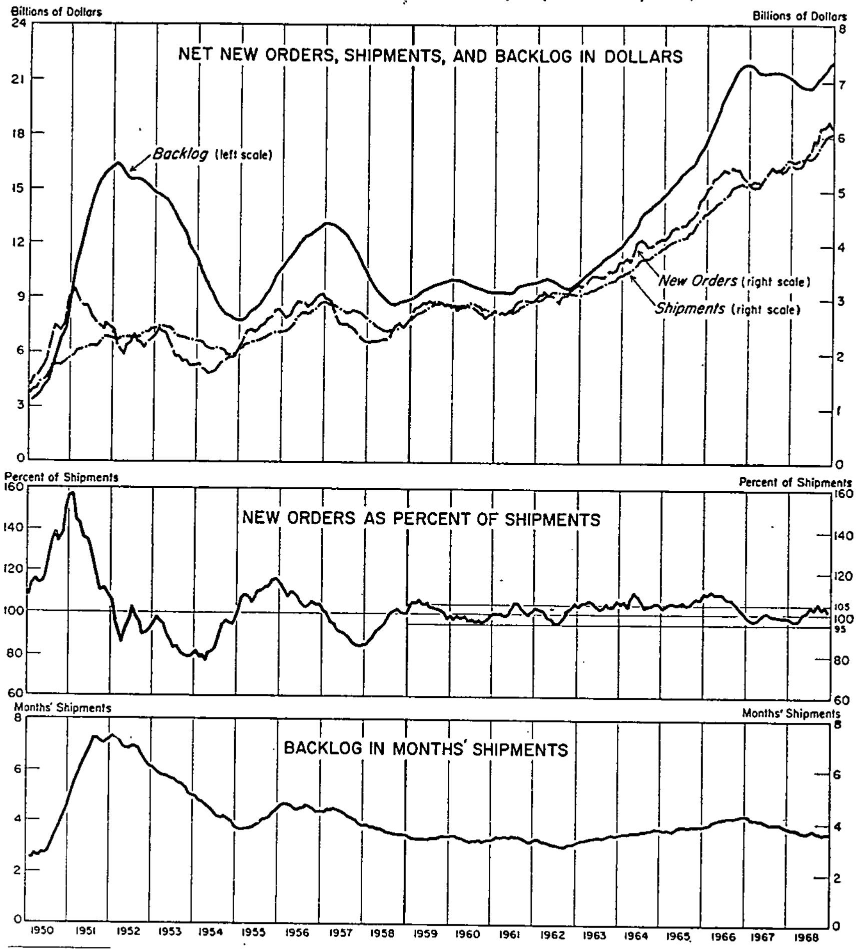
[2] The first such period of excess, in 1964, was essentially a fluke, reflecting the bunching of some large shipbuilding contracts.

CHART 1

Net New Orders, Shipments, and Backlog, Orders as Percent of Shipments, and Backlog in Months' Shipments, for "Machinery and Equipment" Manufacturers[a]

(Three-months moving averages of seasonally adjusted monthly data)



[a] The "machinery and equipment" series has been carried back by the Census only to 1953. To complete the cycle then in progress, we have extrapolated it back to 1950 by the movement of the "nonelectrical machinery" series.

It is interesting to note that the orders surge that got underway in the second quarter of 1968 elicited an excellent production response. Despite its rapidity (a 20-percent annual growth rate to the end of the year), shipments stayed generally within 5 percent of bookings, and the relative backlog finished the year no higher than when the move started. Obviously, the capacity of the equipment builders has risen substantially since the 1965–66 episode. The present backlog is lower in relation to shipments than in late 1964, and on the basis of past experience is not far above a practical minimum for a sustained orders flow. The equipment industries are "breathing easily" with the highest bookings in history.[3]

[3] The highest even after adjustment for price changes. See *Review* No. 76, chart 2.

Conclusion

The comparatively orderly behavior of equipment demand over the past decade, and the generally excellent response to suppliers, represent a remarkable and gratifying achievement.[4]

It may not be amiss to point out that if the pattern continues it will have an interesting effect on the economy. With only a working backlog on the books of equipment manufacturers, the cushioning effect of its absorption is limited and brief. Any downturn in orders is followed rather promptly by declining production and shipments. Contrast this with the pattern for the two cycles in the early part of the period reviewed. In the first, shipments rose for 2 years after orders began to recede. In the second, they were relatively stable for a year thereafter. No comparable lag is in prospect with a working backlog only.

However generous the capacitation of the equipment industries, it can never be sufficient to keep abreast of the kind of wild surges in orders experienced so often in the past. While the existence of generous capacity can contribute to the abatement of these flare-ups, the fundamental remedy is a more enlightened procurement policy on the part of the customers. As we have shown elsewhere, the traditional cyclical pattern of commitments is bad for both producers and users of equipment.[5] We may add that it is bad also for the country. Regularization of the orders flow can make a major contribution to economic stabilization policy. It is to be hoped, therefore, that the gratifying record of the past decade will not only be maintained but bettered in the years ahead.

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[4] It is an interesting fact that the production of business capital equipment was more regular and stable over the decade than that of consumers' durable equipment. See "Comparative Variability of Producers' and Consumers' Fixed Capital Formation in the Postwar Period," *Review* No. 72.

[5] *Review* No. 55.

NATIONAL FARMERS UNION

By Angus McDonald, Director of Research

The report of the President and particularly the annual report of the Council of Economic Advisers, suffer from a number of fundamental weaknesses and omissions. The Council is completely blind to the erroneous policies of the Federal Reserve Board. The Board's vagaries, its lack of an agricultural policy, the inconsistencies, the contradictions and the lack of action to do anything about skyrocketing interest rates has made the Federal Reserve Board the laughing stock of the financial and metropolitan news world.

The report of the Council is a self-serving document which apologizes and attempts to sweep under the rug the dismal failure of the past Administration in regard to interest rates and the erroneous monetary policies of the Federal Reserve Board. Over and over again the President's Council attempts to explain away the housing debacle of 1966 and the failure of the Administration to adopt realistic measures as advocated by Members of the House and the Senate.

In regard to agriculture, we have commented annually over a period of years on the failure of the President's Council to take cognizance of the roots and causes of low prices and other situations which have made the farmer, as Senator Proxmire has pointed out, a second class citizen in our so-called prosperous economy. The Council completely ignores the lack of bargaining power and as yet is not even aware that the Food Marketing Commission conducted an exhaustive investigation and came up with a number of contructive recommendations which would correct the maladjustment in the agricultural economy. The Council swallows hook, line and sinker the conclusions of an absurd study of the Department of Agriculture. This study is referred to on page 116 of the document.*

One further observation may be made in regard to USDA statistics. According to the Internal Revenue Service the total net income of farmers for the year 1965 was as follows:

	Number of businesses	Net profit (less loss)	Net profit
Farm proprietors	[1] 3,225,266	$3,385,962,000	$5,266,887,000
Farm partnerships	[2] 116,317	676,917,000	915,849,000
Farm corporations	[3] 18,526	187,676,000	340,552,000
Total		864,595,000	1,256,401,000

[1] 2,013 reported a profit.
[2] 92,417 reported a profit.
[3] 10,387 reported a profit.

Source: "Statistics of Income, 1965: Business Income Tax Returns," U.S. Treasury Department, Internal Revenue Service.

*A critique of this study, "Parity Returns Positions of Farms", which attempts to prove that farmers are better off than nonfarm workers and investors, is attached to this statement. (Attach. "A".)

According to the U.S. Department of Agriculture, farmers during the past few years have been realizing from $13 to $15 billion in net income. It is seen that there is a wide variance between the reports of the Internal Revenue Service and USDA. Even discounting the fact that a certain allowance is made in USDA statistics for home living and legitimate tax deductions in regard to soil conservation and other items, it appears that the Department of Agriculture is overstating greatly the amount of net income realized by farmers.

Attached to this statement is a sheet giving USDA farm net income statistics for the years 1963–68 and statistics published in *Economic Indicators*.

The Council neglects completely the dangerous trends of the last few years in regard to mergers, monopolistic domination of the marketplace and the invasion of agriculture by corporations and wealthy individuals. It passes over lightly the conglomerate revolution with the assertion that the taking over of a company which is unrelated to the conglomerate's activities, often infuses new vigor and competition in the industry which is unrelated to the company which makes the acquisition. Furthermore, there is a blatant attempt in the report to sabotage and discredit the Robinson-Patman Act by suggesting that it discourages competition in certain instances by forbidding discriminatory practices.

The President's Council provides no remedies as to interest rates, taxes, or antitrust problems. It apparently is the only agency in Washington which is unaware that something must be done to hold skyrocketing interest rates, the invasion of conglomerates into agriculture and to close up the gigantic loopholes which exist in our tax laws. It is well known that tax dodging activities by wealthy individuals and corporations have become a public scandal. Congressmen in both parties are much exercised over this situation and hardly a day passes that a bill is not introduced or a speech made on the floors of Congress demanding that something be done and *be done now*.

Inasmuch as a sizable portion of the report of the President's Council is devoted to the past history of the Federal Reserve Board, we feel that a few comments are necessary. It will be recalled that in December 1965 the Federal Reserve Board raised the discount rate and also raised the interest rate which may be charged on time deposits. By this action, protested by President Johnson, it raised interest rates on certificates of deposit from 4 to 5½ percent—an increase of 37½ percent.

This, as the eminent chairman of this committee predicted, resulted in catastrophe in the housing and farm sectors of the economy. It set off a rapid increase of interest rates and drained billions of dollars out of the rural areas and into New York banks—dollars which would otherwise have been available for agriculture and housing. The explanation of this flow of funds from the interior of the country into Wall Street is obvious. Why, for example, should an individual or corporation in the Midwest continue to loan money to farmers, small business, and housing authorities at 4 to 5 percent when it could obtain up to 5½ percent by merely depositing funds in a New York bank with no risk and no redtape or inconvenience at a higher rate?

The Federal Reserve Board, as well as the administration, refused to act in 1966 (contrary to statements made in this report) until September when the housing industry was flat on its back and it was apparent that a tremendous recession had developed which was wiping out small business and causing the liquidation of thousands of farmers. It was at this point that the Federal Reserve and the Administration changed their policies. The President announced that he would no longer pursue the participation sales policy which had been used as a gimmick to reduce on paper appropriation of funds and make the budget look good to those unfamiliar with sophisticated bookkeeping.

Having brought the country to the brink of catastrophe, the Federal Reserve Board reversed its policy and injected large amounts of new funds into the money bloodstream. This has been referred to by *Barrons* magazine, a very conservative publication, as a "zig-zag policy" which we think is a very apt description of the Fed's activities.

At the present time, not only have the policies of the Federal Reserve been questioned in the Halls of Congress, the metropolitan press and by various interested expert individuals, but in the financial world.

Attention is called to an article published in the *New York Times* on January 3, 1969, titled, "Laughing at the Fed." The writer of this witty article, Edward L. Dale, Jr., says in regard to the Federal Reserve System, "Banks are laughing at it; economists are laughing at it; businessmen—getting loans like crazy—are probably laughing at it. Congressmen are not in the 'in-group.' They are just frustrated and puzzled by it. The easiest laugh around is to say at a party, 'Say, have you heard? The Fed is tightening money . . .' "

If the Federal Reserve Board was not so powerful and did not affect the lives of so many millions of citizens, we could laugh too, but we assure you that farmers are not laughing at the present time at skyrocketing interest rates which have reached disastrous proportions. Farmers are struggling now under a total debt of $55 billion. They are having to pay not only the 8 percent rate which is charged those who obtain funds from the Housing Authority, but as much as 10, 12, and 15 percent on short-term loans. Federal agencies particularly the Farmers Home Administration, are out of money and farmers are dying on the vine by thousands. Fortunately, within the last few days the new administration has made $25 million of new money available under the emergency FHA program.

Some comment is called for, we feel, in regard to the threats made by Federal Reserve Board Chairman William McChesney Martin. In 1968, having injected too much new money into the money bloodstream, Chairman Martin began threatening the Congress and the American people with a recession if Congress did not do his bidding in relation to a balanced budget and a new tax law. He said, according to a statement inserted by Congressman Holifield in the *Congressional Record* of April 24, 1968, "We are in the midst of the worst financial crisis since 1931." Martin said the Nation faces either "uncontrollable inflation" or an "uncontrollable recession" because of an "intolerable balance-of-payments deficit side by side with a budget deficit."

In this hysterical statement Chairman Martin ignored the fact that the national debt and the deficit were not high—in fact, extremely low—as compared to the debt as a percentage of the gross national product during the years 1941–47. The following figures succinctly prove this point:

[Dollar amounts in billions]

	Gross national product	Public debt, yearend	Percent of gross national product
1941	$109.4	$55.3	50.5
1942	139.2	77.0	55.3
1943	177.5	140.8	79.3
1944	201.9	202.6	100.4
1945	216.8	259.1	119.5
1946	201.6	269.9	133.9
1947	219.8	258.4	117.5
1961	506.5	289.2	57.1
1962	542.1	298.6	55.1
1963	573.4	306.5	53.4
1964	612.2	312.5	51.0
1965	653.5	317.9	48.7
1966	718.7	320.4	44.6
1967	763.1	326.7	42.8

The following table also proves that Chairman Martin didn't know what he was talking about in regard to deficits. During 1941 through 1947, total deficits amounted to $210.4 billion, while during the period 1961–67, total deficits amounted to only $40.3 billion.

Annual deficits

	Billion dollars		*Billion dollars*
1941	$6.2	1961	$3.9
1942	21.5	1962	6.4
1943	57.4	1963	6.3
1944	51.4	1964	8.2
1945	53.9	1965	3.4
1946	20.7	1966	2.3
1947	.8	1967	9.9

At the present time the Fed is pursing its stupid policy of tightening money across the board, ignoring the needs of agriculture and the housing industry. Furthermore, Martin is continuing his threats. I call attention to an article in the December 15, 1968, *Washington Evening Star* by Lee M. Cohn. The writer asserts in this article that the Federal Reserve will squeeze credit harder and push interest rates higher unless President-elect Richard M. Nixon soon indicates clearly that he will operate a tight budget. By a tight budget, informed sources said, according to the writer, the Fed means strict curbs on Government spending and extension of the income tax surtax beyond its scheduled expiration next June 30.

There is no doubt in our minds that efforts will be made along this line, ably assisted by the Federal Reserve Board. Already it has been announced that the 4¼-percent interest rate ceiling on long-term bonds will be done away with. Farmers Union has obtained a copy of a secret report, probably motivated in part by the Federal Reserve Board, which recommends that the rural electrification program and the Farmers Home Administration be done away with. We have no idea whether President Nixon will act on these recommendations or not.

The committee is well aware of skyrocketing interest rates and the fact that New York bankers have announced that the prime interest rate has now been raised to 7 percent. This means that farmers and other borrowers will pay much more than that. The prime customers of the New York banks are required to pay an effective 8.4-percent rate because they must keep 20 percent of their loan on deposit at the bank. Details of this situation are set forth in an article in the *Wall Street Journal* of February 8, 1969.

The Federal Government is one of the first to feel the pinch of this raid by bankers. The *Wall Street Journal* of January 30, 1969, reports that the Nixon administration in its first big Treasury financing plan is faced with the highest interest rate on an issue in more than 100 years. In an exchange of $14.47 billion of securities maturing on February 15, the Treasury offered holders their choices of a 15-month note with a 6⅜-percent coupon, or a 7-year note with a 6¼-percent coupon. This 15-month note slightly discounted will pay investors 6.42 percent—the richest return on Federal securities since 1865. There was an issue in that year on a $600 million 3-year note which carried a 7.3-percent interest rate.

Banks and institutional investors constitute the groups which are able to take advantage of the high interest rates. Farmers at this time do not have extra funds to invest in Government securities. Banks are keeping on deposit, because of the generosity of the Federal, State, and local governments, $40 billion on which they pay no interest. They use this money to make loans to those who are outside the banking fraternity. The Federal Government subsidizes the commercial banks by keeping on hand some $5 to $6 billion of deposits on which no interest is paid. These funds are called "Tax and Loan Accounts." The greed of bankers can never be satisfied—they are not satisfied even with the highest interest rate in 100 years.

John A. Mayer, chairman of Mellon National Bank & Trust Co., was quoted in the *Wall Street Journal* of February 26, 1969, as saying, "Another increase in bank prime rates is a possibility that shouldn't be ignored." Mayer said he expects Federal Reserve Board authorities to continue to keep the money supply tight for a while. With a continuation of this policy and continued strong loan demand by bank customers, he said, "to put it mildly, interest rates aren't going to go down—and they could go up some more."

The disastrous results of the monetary policies of the Federal Reserve Board and the failure of the Johnson administration to do anything about it, are set forth in an article in the *U.S. News & World Report* of February 17, 1969. This conservative publication apparently is alarmed at the effect that skyrocketing interest rates are having on the housing industry. It published a chart which graphically shows the interest which those purchasing automobiles and other consumer items are paying. In 1960 a total of $14.7 billion was paid in interest charges by such groups. By 1968 the interest load for these consumers had increased to $31 billion.

U.S. News reports that mortgage loan rates have reached 9 percent for some homebuyers on the west coast. Many lenders, squeezed for loanable funds, are weeding out many of their customers. Even if a family has the necessary credit standing and security to secure a loan, it is subjected to an intolerable interest burden.

According to the article, "If a family buys a $40,000 house with a $30,000 mortgage at 8 percent for 30 years, total interest payments come to over $49,000. A 7-percent mortgage on the same house means $7,300 less in interest payments over the term of the mortgage; at 6 percent the homebuyer pays $14,500 less in interest than he would on an 8-percent loan."

Mortgage rates are bumping statutory ceilings all over the United States. Many States in the past have enacted usury laws. In Eastern and Southern States the general usury ceiling is 6 percent. Recently the Vermont ceiling has come up from 6 to 6½ percent; the Maryland ceiling from 6 to 8 percent; and in New York from 6 percent to as much as 7½ percent.

High-interest rates are affecting needed public expenditures for schools and other facilities. In Virginia, both Fairfax County and the city of Alexandria have been forced to either postpone or reduce planned bond sales. The State of Virginia has postponed a proposed January 15 bond issue. Fairfax County, Va., had planned to issue nearly $18 million worth of school and park bonds in mid-January. When the county sold bonds in September 1968 the rate of interest was 4.6 percent. Fairfax officials have been advised that the mid-January issue would require an interest rate of at least 5.2 percent. This interest differential will cost the county an additional $1.3 million over the life of the $18 million bond issue.

The city of Alexandria has been forced to reduce to $4½ million a proposed $10 million bond sale because of soaring costs in the financial markets. The State of Maryland is in a quandary about a $55.8 million bond sale which was planned for January 21. Interest costs are exorbitant now, but State officials fear that things may get worse.

The final burden is borne by the citizens of the States and localities involved. They suffer from overcrowded schools, insufficient health, transportation and recreational facilities and all the many essential services that should be provided through other State and local public facilities.

According to the *American Builder*, the outlook for housing in cities, suburbs and rural areas is indeed grim. In the November issue of this publication there is a series of articles pertaining to these different areas. The author of these articles contends that in the cities, housing is "heading for a decade of failure." In the suburbs, the public "couldn't care less." In the rural areas, "everyone is leaving," and the article comments that those responsible for housing do nothing but "talk, talk, talk."

The National Farmers Union during the past few years has been much exercised over the invasion of agriculture by corporations and wealthy individuals. Recently this witness appeared before the House Ways and Means Committee and pointed out that multimillionaires were using tax loopholes to escape payment of their fair share of the tax burden. Statistics were put in the record from the Internal Revenue Service of the Treasury Department indicating that 86 percent of the individuals who had a net income of $1 million or more were reporting losses on their farm investments.

During the past 2 years, Farmers Union in its newsletter and in other places has published such figures and they have attracted a great deal of attention. So much significance was attached to these figures which were widely quoted all over the United States that Senator Lee Metcalf, at our suggestion, introduced a bill which would close the tax loophole by limiting farm losses to $15,000 plus taxes, interest and several other items. An alternative offered in this bill is that farm investors may use the accrual method if they will report inventory as income as do other businesses and capitalize investment in land improvement.

About a year ago Secretary of Agriculture Freeman apparently having noticed the figures on farm tax losses published by the Farmers Union, instigated an investigation by the U.S. Department of Agriculture. The result of this investigation was a whitewash. Apparently deliberately, States such as California and Texas, where corporations have made great headway, were omitted from the study. A preliminary report was published which concluded that corporations presented no threat to the family farmers and that anyway most corporations were family corporations entitled to report their income as partnerships. Family corporations are designated as 1120–S corporations under the authority of a law passed by the Congress in 1958.

On February 18, 1969, M. L. Upchurch, Administrator of the Economic Research Service, USDA, made a report on the corporate farm situation at the Outlook Conference. According to the press release issued, Mr. Upchurch commented on the survey which his agency had made. He said that there were 11,000 farms operated by corporations in 47 States. Most of these, he said (about 7,500) were family corporations. Upchurch said that few of these corporations had really big farming interests. Only 8 percent grossed more than $500,000.

In the speech presented to the Outlook Conference, Upchurch says that the "number of corporations in farming amounted to 18,526." In the same speech he said that the number amounted to only 11,000. No explanation was given for this discrepancy. The Internal Revenue Service reported that in 1966 there were only 4,862 family farm corporations.

Attention is called to certain statistics which this witness presented to the House Ways and Means Committee. According to the Book of Statistics of Income, U.S. Treasury Internal Revenue Service, the number of corporations engaged in farming for the period July 1965–June 1966 was 18,526. Of this number, 8,139 reported they had no net income. The number of family corporations referred to as 1120–S, amounted to 4,862. Of this group, 2,330 reported they had no net income. It is seen that the figures presented by the head of the Economic Research Service are in large part erroneous. We haven't the faintest idea where ERS got the figure of 7,500 family corporations or where it got the figure of 11,000 corporations.

Incidentally, the press release which recites incorrect figures which purported to prove that corporations are not a threat to family agriculture has been widely publicized. One large farm organization recited the ERS statistics on its front page.

The President's Council is only faintly aware of the economic concentration problem. It is not alarmed by the merger movement which has reached gargantuan proportions during the last few years. It is not concerned that conglomerates are taking over hundreds of unrelated companies and evading the intent of the antitrust laws. It is unaware of the Banking and Currency Committee's monumental study which indicated that 49 banks in 10 large cities had a total of 8,019 director interlocks with 6,091 companies. There were an average of 164 director interlocks per bank and an average of 135 companies interlocked per bank. This study, in our opinion, proves beyond the shadow of a doubt that the banking industry has a stranglehold on the entire economy. We also feel that no existing law can reach this problem.

Of interest to farmers is the fact that many of these conglomerate acquisitions are directly related to the food industry. During the year 1968 in the grocery business there were 25 acquisitions of more than one store which is up about 24 percent from the average of the last 10 years. The number of stores involved was 687. Farmers Union is interested in such details because farmers must, in many instances, deal directly with the grocery chains which are partially integrated.

Attention is called to legislation introduced by Congressman Wright Patman which would attempt to curtail the conglomerate activities of banks. H.R. 6778, introduced by Mr. Patman, would regulate one-bank holding companies. The Congressman comments as follows on the need for such legislation: "Through the loopholes in the Holding Company Act, commercial banks have been moving rapidly into non-banking activities throughout the Nation. Giant, conglomerate cartels are being formed around large banking institutions and this concentration of economic power threatens to change the very nature of the whole economy."

A few days ago this witness attended a luncheon sponsored by a national housing organization. Several members commented that nothing could be done about rising interest rates. Apparently members of this group were unaware of a law which is a part of the Federal Reserve Act and which was reaffirmed by the Congress on September 21, 1966. This law is so important that I am quoting it at length.

Language set forth in section 14, 3(b)(1) of the Federal Reserve Act says that every Federal Reserve bank shall have the power to "buy and sell, at home or abroad, bonds and notes of the United States, bonds issued under the provisions of subsection (c) of section 4 of the Home Owners' Loan Act of 1933, as amended, and having maturities from date of purchase of not exceeding six months, and bills, notes, revenue bonds, and warrants with a maturity from date of purchase of not exceeding six months * * *."

Section 13, 3 of the Federal Reserve Act provides that "in unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal Reserve Bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 14, subdivision (d) of this Act, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange of the kinds and maturities made eligible for discount for member banks under other provisions of this Act when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal Reserve Bank * * *."

In other words, the Congress has over a long period of years provided that the Federal Reserve Board and the Open Market Committee may act to prevent interest rates from getting out of hand. As pointed out in the above section, the Federal Reserve bank may even discount "in unusual and exigent circumstances" in order that individuals, partnerships, and corporations may obtain relief.

This law states that the Federal Reserve Board shall have the power to buy and sell in the open market at the direction and regulation of the Open Market Committee. On September 11 and 17, 1968, your committee held hearings in regard to the possibility of making needed credit available. The Federal Reserve, about a year ago made a great to-do about loosening up credit and making it available where needed.

They had investigated and announced that they would open discount windows in certain banks. However, nothing was done to relieve the situation in regard to the mortgage market where the savings and loan institutions primarily operate.

Congressman Reuss at this hearing asked Federal Reserve Board member Mitchell about helping out the homebuilding industry. He said, "Chairman Proxmire in the Senate, and I and others in the House in recent months flirted with the idea, as you know, of having the Federal Reserve help out the savings and loans and the homebuilding industry by buying either directly or through the open market securities of Home Loan Bank Board and FNMA and similar agencies.

"The Fed rebuffed us quite firmly on this, saying, 'No, we don't want any directive to have any particular portfolio mix,' and the Fed in fact has not to this date bought any, or perhaps I should say any appreciable amount, of these housing-oriented securities."

Congressman Patman in his supplementary remarks as a result of this hearing, commented that the changes in policy in regard to discount windows would help the situation very little. He pointed out that commercial banks were in competition with savings and loan institutions and using commercial banks as a conduit to make funds available to savings and loan institutions would help very little. He said, "Commercial banks have several sources where they can obtain the liquidity needed by their business customers. They can sell holdings of Government securities; they can attract funds by raising the interest offered on certificates of deposit; they can borrow on the Eurodollar market. As a result of the suggested redesign of the Federal Reserve discount window, they would have an extra easy source of credit.

"The thrift institutions have none of these options. When credit gets tight, they suffer a loss of funds to the more powerful investment opportunities. The major casualties of this loss of liquidity are the housing industry and home-mortgage seekers."

So there it is. The Federal Reserve Board not only will refuse to act, and it is apparent it has existing authority, but has said flatly that it will not act. It will only act to help the banking industry. It will not make funds available to farmers through subsidized interest rates as was suggested by Farmers Home Administration during the credit crisis of 1966. I quote a recommendation which was made by Farmers Home Administration when FHA was being crushed by rising interest rates:

> "We recommend that the present interest rate limitations be retained. If sufficient loan funds cannot be obtained under existing rates of interest, the law should be amended to permit the Government to cover the losses incurred by the Federal intermediate credit banks during this period of high interest rates on a sufficient amount of debentures to obtain the monies needed by the Farm Credit Administration."

Apparently the matter of subsidizing interests rates is abhorrent to those who are in charge of money and credit in this country. However, it would appear that it is okay to subsidize funds made available to other countries. I call attention to an editorial in the *Washington Evening Star* of March 10, 1969. Treasury Secretary Kennedy, who formerly was president of Illinois Continental which it is reported is the largest holder of Farmers Home Administration paper, told the Banking and Currency Committee that he fully approves and supports the U.S. contribution to the International Development Association. This program provides that borrowers may pay as little as one percent on loans. We are not in any way suggesting that we are opposed to such a program, but we feel the principle of subsidized interest rates should be extended to our citizens as well.

Attachment "A"

Critique of "Parity Returns Positions of Farms"

(Report of Economic Research Service, U.S. Department of Agriculture, July 7, 1967)

A recent study of the Economic Research Service of the Department of Agriculture, "Parity Returns Positions of Farms," attempts to prove that greater parity returns on labor and capital received by farmers results in a greater return on labor and capital employed in the nonfarm economy. It is stated that the parity returns on capital equals the value of capital plus the rate of return plus capital gains. This is one standard that is used in the study.

Another is the landlord standard which equals the rent from the farm plus capital gains. The study alleges that capital gains on farms amounts to 3¾ percent per year or 12 percent since 1964. This is compared with the stockholder standard which adds the dividends of 3 percent plus capital gains of 8 percent which equals 11 percent for the 3-year period.

Finally after wading through a mass of statistics, many of which seem unrelated to the problem, the study comes up with the conclusion that the wage of a farm family is 105 percent of the wage of a manufacturing worker.

We have a few comments. It is ridiculous to compare a farm operator to a factory worker; it is ridiculous to compare capital gains on farms to gains on stock; it is ridiculous to lump all farmers above $20,000 gross together. I asked an economist in USDA several years ago why they lumped farmers who grossed $1 million together with the family farmer.

"Why not," I said, "break down the categories to farmers with gross incomes of $25,000, $30,000, $35,000, $40,000, and so forth." The answer I got was that nobody was interested in the U.S. Department of Agriculture in such statistics. It is obvious that lumping the millionaire farmers in with the $20,000 gross farmers distorts the picture.

It is also ridiculous to lump 500 stocks together in order to determine whether or not a stockholder is better or worse off than a family farmer. Growth stocks don't pay dividends—some stocks pay nothing. This is the age of conglomerates. Hundreds of companies buy up other hundreds of companies for tax advantages. Furthermore, companies often issue two shares, or three or four, for one. This obviously further distorts the USDA statistical picture.

The study lightly says that unrealized capital gains can be turned into income at the owner's option. This is not true for farmers. Three out of every five purchasers of farmland are farmers. The farmer suffers more often than not from the increased price of farmlands. The study claims capital gains resulting from increased price should be listed as income. Increased value of farm lands increases the net worth of farmers, but does not increase their income.

The price of stocks is not a good statistic to introduce into a study attempting to determine which investor is better off. The prices of stocks in 1966 were 5½ times what they were in 1959. Capital gains resulting from increased price of stocks should not be compared to capital gains from increased value of farmland. Stocks may be sold by merely making a telephone call. Disposal of farmland is a much more complicated matter and, as indicated, more often than not the farmer doesn't want to sell his land unless he wants to retire and get out of farming altogether.

It is ridiculous to compare the entrepreneur in the farm business with the factory worker. It is like comparing apples with oranges. Even if farm operators and farmworkers are compared with manufacturing workers there are factors such as age which would prohibit the farm worker from getting a job in any manufacuring industry. The study admits that the median age of farmers in various groups is from 46½ years to 70 years. It seems to us the proper approach would be to compare an agricultural entrepreneur with a manufacturing entrepreneur. This is not attempted in the study.

After introducing hundreds of statistics, on page 37 of the report the authors virtually admit their study is no good. They admit a wide range of error. They discuss the impossibility of the task of coming up with parity returns as a primary measure of economic well-being. They say in order for their conclusions to be valid they must have a regular collection of data and not rely on 5-year periodic publications. They say that they have had to rely on "bits and pieces of information subject to a wider range of error than is generally considered acceptable." They further say that relying on only 5-year reports would "seriously impair public condence in the accuracy and objectivity of the parity returns calculations." With these last two statements we agree.

ATTACHMENT "B"

Net farm income by years according to U.S. Department of Agriculture Statistics (Including Government payments, but not other income)

1963	$13,206,000,000
1964	12,266,000,000
1965	14,987,000,000
1966	16,086,000,000
1967	14,644,000,000
1968	14,400,000,000

USDA estimates that farm income for 1969 will be somewhat lower.

Net farm income by years according to economic indicators

	Billion
1963	$13.2
1964	12.3
1965	15.0
1966	16.1
1967	14.6
1968	15.4

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

By John W. Harder

We appreciate your request that we furnish to your committee our views on the economic issues which concern the Nation and our membership. We would point out, that these views originate directly with our more than 265,000 member-firms actively involved in smaller, independent business and professional pursuits—which comprise a valid cross section of our country's 5.1 million unit small business sector.

This sector's importance cannot be overestimated. Its members provide jobs for more than half of our civilian labor force. They generate an estimated 70 percent of national retail sales, 73 percent of wholesale sales, 83 percent of the construction activity, 80 percent of the service function, and 34 percent of the manufactured value added to the economy each year. Continuing federation economic surveys suggest strongly that this sector played a major role in reducing the unemployment rate from 6.1 percent in 1960 to under 4 percent today.

The issues which concern our membership are many and varied, but they can be summed up as all things affecting the ability of small business to expand and modernize, in the process creating additional job openings. Our members feel that decisions by Congress and the executive branch in the areas of labor, taxes, antitrust, and representation vitally affect this concern.

First, in the field of labor they face many problems, but currently chief among these is the affect of the minimum wage law. In our 1967 and 1968 surveys we questioned members about the effect of the 1966 revisions on their employment. Among those reporting it lower than 1 year earlier, the proportion ascribing the reduction to the wage law rose from an average 15 percent in 1967 first quarter to 36 percent in 1967 fourth quarter, then leveled in the area of 25 percent for 1968. This year we are questioning members specifically about teenage employment. Our first subsample suggests that as many as 42 percent of all small businesses employed teenagers in 1966, with such employment averaging three young people each. However, of this group only 54 percent report their teenage employment today at 1966 levels. Among the balance the average reported employment drop is 1.1 each, and 40 percent of these hold the minimum wage responsible directly or indirectly.

For these reasons our members recommend that Congress: (1) rescind the second phase of the 1966 enactment which has lowered the minimum wage dollar volume exemption from $500,000 annually to $250,000 annually; (2) provide relief from the law's requirements in the cases of workers of marginal productivity; (3) liberalize regulations affecting the employment of teenagers and simplify accompanying paperwork burdens; and (4) refrain from further expansions in the law.

Second, studies show that we will have to produce 1.7 million new jobs annually in the years ahead. At the same time federation surveys have indicated that new and additional jobs are provided through small business expansions and modernizations. But these depend on financing. And here we get into the area of taxes, for studies show that smaller firms depend importantly on internal sources for funds for business improvements (in our first subsample for 1969 we find that only 30 percent of respondents received business loans within the past half year). At the same time we find, and authoritative economic studies concur, that constantly rising tax rates, are eroding seriously the strength of these internal sources. Concurrently, our economic data indicate a series of constant increases in the cost of goods, which in turn reflects on investment in both inventories and receivables.

Because of the foregoing, and in an effort to cut through the current economic squeeze, our members recommend strongly that Congress, in its current overhaul of the tax structure, enact a "plowback" allowance which would permit them to reinvest in their operations, tax free, up to 20 percent ($30,000 ceiling) of their additional yearly investment in additions to inventory and receivables (we might note that in the 7 percent investment credit, small business has, in effect, a "plowback" for investments in depreciable equipment).

Third, and further in the area of taxes, our members are concerned with the plight of people in economically depressed areas. They are concerned with the problem of the ghettos. But they feel that there can never be an end to the ghetto problem unless action is taken to restrict the migration from rural to urban areas. They have seen (as reflected in our surveys) how well tax incentives have worked in encouraging job-producing expansions and modernizations, and they urge that this concept be expanded and extended, as proposed by Congressman Joe L. Evins, yourself, and others, in the form of the rural development bill which provides an extra 7 percent credit and other features for firms locating new plants in underdeveloped nonurban areas.

Fourth, as your committee has pointed out in the past, the goals of the Employment Act cannot be reached without there being a free, competitive economy. This, as you said, cannot exist without strong enforcement of the antitrust laws. Reports being received from federation members indicate considerable concern over the rash of conglomerate mergers which has beset the economy and bedeviled small business through the resultant increase in concentration in our economy. Equal, if not greater, concern is being expressed over the growth of dual distribution in the many industrial classifications of the country which so often results in unfair competition with supplier-retailer selling in the same markets with his independent distributors at prices which approximate their buying costs. And, concern is voiced over our stop-start antitrust policies under succeeding administrations, much of which is due to the fact that the position of Assistant Attorney General in charge of antitrust seems to be but one seat in a game of musical chairs.

To correct these situations in antitrust enforcement, our members recommend that Congress: (1) insist that the Federal Trade Commission complete as quickly as possible its current study of the conglomerate merger problem, with recommendations that where necessary the laws be strengthened; (2) make it clear to the Justice Department that enforcement procedures be expedited; (3) enact legislation which will bring manufacturers who compete directly with their own independent channels of distribution under the Robinson-Patman Act; and (4) provide some permanency of tenure for the post of Assistant Attorney General in charge of antitrust, the same as is enjoyed by the Comptroller General.

Finally, Mr. Chairman, for our members it has become steadily clearer that in order to achieve the consideration their sector deserves, it is vital that they be represented in the councils of Government effectively. They have nothing but praise for the fine jobs done over the past 28 years by the Small Business Committees of House and Senate, but feeling that their problems, those which are the concern of Government, will increase rather than decrease they urge that these bodies be strengthened, by at most granting legislative authority to both bodies or at least bringing up to parity in permanency with the Senate committee the House committee. Further, they appreciate the services rendered by the Small Business Administration. But they are concerned over its own stop-start record in lending, the restrictions on its lending, the uncertainties which have arisen regarding its future, and its operations at times without an appointed Administrator. They feel that these defects demand congressional as well as executive branch attention, and demand prompt remedy.

These, then, are among the chief concerns of our membership. They do not exhaust areas of interest. But action on them is certain to provide a more favorable climate of growth for small business and strengthen the fabric of our economy.

NATIONAL FEDERATION OF INDEPENDENT UNIONS

By Don Mahon, Executive Secretary

Speaking in behalf of the unions affiliated with the National Federation of Independent Unions our greatest concern is with regard to the impact of inflation and continually rising taxes on the future of American workers and our country.

Referring to the report filed by President Johnson on January 16, 1969, we note that the proposed budget calls for the extension of the income tax surcharge, at its current rate of 10 percent, for 1 year from July 1, 1969, to June 30, 1970. It is our position that this income tax surcharge should be eliminated as of its expiration date on June 30, 1969. We feel that this tax is most burdensome on those least able to pay; namely, workers and wage earners in the lower brackets who must use the major portion of their earnings for day-to-day family and living expenses.

The original intent of the surtax, as previously stated by the Johnson administration, was to curtail inflation. Actually, Government spending has increased since that time. Thereby, and as one direct result, inflation has also increased. In this respect the additional tax revenue has been self-defeating so far as controlling inflation was concerned.

We believe that the closing of many existing tax loopholes, that have permitted those in higher income brackets to evade or avoid their fair share of taxes, is most important. By shifting the tax burden more equally to those most able to pay it will also increase the buying power of workers. As a result middle and lower income families will be able to buy and consume more goods and thereby bring about the higher employment and maintain the greater productivity that is so essential to our country.

For the purpose of obtaining more economic stability we believe that encouraging more labor-management cooperation can result in greater benefits for all concerned and especially the general public. This cooperation will result in higher employment as well as greater price stability. The Government can enhance this positive program by endorsing progressive policies with regard to eliminating waste, duplication, and unfair competition. Also, the sponsorship of worker training programs. This will help close the gap between supply and demand for skilled workers. As a result, those displaced through automation and industrial changes, with regard to plant location and other economic factors, will be greatly assisted.

Referring to the international economy: We suggest a reappraisal of the present situation so as to protect American workers from competition resulting from the imminent flood of products of the so-called Iron Curtain countries.

On the homefront our organization is particularly interested and concerned with regard to public safety programs. We advocate more adequate on-the-job safety protection for industrial workers. We would also include more adequate protection for the general public who are subjected to the use of unsafe passenger elevators, defective public transportation equipment, non-fire-resistant consumer products, and dangerous drugs.

We also advocate Federal legislation to require pension provisions for the employees of all companies that engage in interstate commerce. This should include protection of the vested rights of longer service employees covered by such pension plans. We believe that any employee who remains in the employment of a company for a period of 5 years, or longer, should have vested rights in an insured pension plan.

Conclusion

We appreciate this opportunity to express our views to this committee. Following receipt of the economic report of the Nixon administration we hereby request and appreciate an opportunity to elaborate further with regard to this matter.

UNITED AUTOMOBILE, AEROSPACE, AND AGRICULTURAL IMPLEMENT WORKERS OF AMERICA (UAW)

By Walter P. Reuther, President

The economy of the United States has made great progress in the past 8 years. The most visible sign of that progress, of course, is the fact that we are now completing 8 years of unbroken economic expansion—a period of growth unparalleled in our recorded history. For the first time there is reason to hope that we have learned enough about how our economic system works and how it can be guided in desirable directions that we may be able to break the inexorable alteration of boom and recession, and learn how to move forward through indefinite periods of sustained and sustainable growth.

THE FRUITS OF GROWTH

The consequences of continuous growth are reflected in a wide variety of economic indicators, and are best shown by comparing developments in the growth period with those of the immediately preceding years.

Thus, for example, if the 8 years of the Eisenhower administration (fourth quarter 1952 through fourth quarter 1960), in which we experienced three recessions, are compared with the 8 years of expansion under Kennedy and Johnson (fourth quarter 1960 through fourth quarter 1968), some very impressive differences are seen. In the Eisenhower years, for example, the gross national product (GNP) after adjustment for price changes grew by 19.3 percent; in the Kennedy-Johnson years it grew by 48.7 percent—over 2½ times as much. Per capita real disposable personal income (that is, average income per person after taxes, also adjusted for price changes), which is a good measure of actual improvements in personal living standards, grew by only 9.4 percent in the 1952–60 period, compared with 33.3 percent in 1960–68.

Significant as they are, these figures are of course affected by the fact that they begin and end at different points on the business cycle. Elimination of this anomaly, however, does not void the comparison. It is shown in the following table, which compares the movement of selected economic indicators from the trough of the 1954 recession to the peak of the 1960 expansion, and from the trough of the 1960–61 recession to the end of 1968. In order to adjust for the different length of the two periods, all changes are shown in terms of annual rates.

SELECTED ECONOMIC INDICATORS—COMPARISON OF CHANGES, 1954-60 AND 1961-68

	Annual rate of increase	
	3d quarter 1954 to 2d quarter 1960 (percent)	1st quarter 1961 to 4th quarter 1968 (percent)
GNP in constant dollars	3.3	5.3
Per capita real disposable income	1.8	3.7
Unemployment (decline)	0.9	7.2
Industrial production	4.4	6.4
Output per man-hour private economy	2.6	3.6
Manufacturing capacity	4.6	5.0
Manufacturing output	4.4	6.6

Source: Office of Business Economics, Bureau of Labor Statistics.

As the table shows, GNP valued in dollars of constant buying power increased at an average rate of 3.3 percent per year in the 1954–60 period, but advanced to a pace of 5.3 percent in the period 1961–68. Per capita real personal income more than doubled its rate of advance, from 1.8 percent a year to 3.7 percent. The number of unemployed, which had declined at an average rate of 0.9 percent per year in the earlier period, sank by 7.2 percent per year in the later. The pace of industrial production advanced from 4.4 percent per year to 6.4 percent. In large part, because an expanding economy is able to make more efficient use of its productive equipment, output per man-hour in the private economy (productivity) rose from 2.6 percent per year to 3.7 percent. There was a small increase in the rate of growth of manufacturing capacity, but a large increase in growth of manufacturing output, from 4.4 percent annually to 6.6 percent.

STILL SLACK IN THE ECONOMY

Great as the achievements of the past 8 years have been, they have not been great enough. Our rate of economic growth has not matched our true potential. Our unemployment rate, although it has been greatly reduced, is still far higher than would be tolerated in most of the industrialized nations of the free world. To more than 2½ million full-time unemployed must be added the time lost by approximately 2 million part-time unemployed, who work at a part-time job because they can't find full-time work, or who work short workweeks for economic reasons beyond their control. In addition, there are probably close to a million workers who are involuntarily idle, but who are not counted as unemployed, or even in the labor force because they have become discouraged and have given up looking for a job.

When all these factors are added together, the total time lost in 1968 by people who could and should have been employed would average something over 5 percent of total labor force time available.

Further evidence that there is still too much slack in the economy comes from the relatively low-utilization rate of manufacturing capacity, and the fact that it has been falling for more than 2 years—from 90.8 percent of capacity in the second quarter of 1966 to 84 percent in the third quarter of 1968, and 84.1 percent in the fourth quarter. In some industries, it is below 80 percent. Since, according to McGraw-Hill, the preferred rate of utilization is about 93 percent, it is clear that there is room for a substantial increase in production before it begins to press uncomfortably upon our productive capacity.

What is more, a continuing high rate of investment in new plant and equipment is one of the 1969 prospects on which most economists seem agreed. In these circumstances, it is difficult to understand the claim that the economy is overheated and needs to be slowed down.

It may be argued, particularly with regard to availability of manpower, that even though there is some slack in the economy as a whole, there are sectors in which needed manpower, possessed of necessary skills, is not available. But surely this calls not for a slowing down of the whole economy to ease the pressure at a few points, but for special measures to ease those pressures where they exist. There is still ample room for strengthening of our training programs, including the payment of more adequate training allowances. There is still much room for improvement of placement services, including a computerized national employment service which could greatly facilitate the matching of available men to available jobs. There is still room for measures to increase the mobility of workers, employed and unemployed, such as payment of moving allowances. As the staff of President Johnson's Cabinet Committee on Price Stability has pointed out, manpower programs to increase the employability of those who are in any way competitively disadvantaged not only helps to improve the employment picture, but also helps reduce inflationary pressures by increasing the number of workers available. To attempt to solve special problems of manpower shortage with tools of overall economic restraint is like trying to kill a mosquito with a sledge hammer—it gives an awful jolt to the body being hammered, and probably misses the mosquito in the bargain.

HOW EXPANSION HELPED NEGROES

Another area in which we have made real progress, but still not nearly enough, is in providing equality of opportunity for Negroes. According to census data cited by the Council of Economic Advisers, during the 7 years of expansion from 1960 to 1967 (latest data available), the median income of nonwhite families increased by 41.1 percent, or at an average rate of 5 percent per year. This was substantially faster than the 3.3-percent rate at which the median income of all families increased. (The median is the point at which half the families are above the line and half are below it.)

By contrast, during the 8 years from 1952 through 1960, which saw three recessions, the median income of nonwhite families grew at a rate of only 2.7 percent per year. This was not only just over half the rate at which it grew during the period of expansion; equally important, the 2.7-percent growth rate for median nonwhite family income between 1952 and 1960 was substantially below the rate for all families, which averaged 3.3 percent per year.

In other words, not only did the lower income half of Negro families improve their absolute position much faster in the period of continuing expansion than in the previous period, but in the period of expansion they improved faster than other groups in the Nation, thus making up ground lost in the previous period when they had improved more slowly than those other groups.

This has important considerations in terms of the social consequences of any attempt to slow down economic growth. A figure of 1 percentage point rise in unemployment as a result of such a slowdown has frequently been used. Of course, no one can know whether it would stop there. But even a rise of only 1 percentage point would mean that over 750,000 people would lose their jobs. A disproportionately high percentage of them would be Negroes and other disadvantaged groups who have just recently found their way out of the ranks of the hardcore unemployed and, as they were last in, would be first out when layoffs occur. Not only would they feel thwarted and frustrated in their legitimate aspirations, but feelings of insecurity and alienation from the white world would undoubtedly extend to those of their fellows, still employed, who could not help but wonder if they might be next.

If we are to avoid such serious consequences, it is imperative that we keep the economy running as close as possible to full employment—and by full employment we mean, not the 4-percent unemployment rate that condemns 3 million people to involuntary idleness, but a genuine condition of full employment where there is a job available for every person able and willing to work—male or female, old or young, black, white, brown, or yellow.

THE ECONOMY IS SLOWING DOWN NOW

It is important to emphasize the undesirable consequences of a slowdown in the economy because, in fact, it is already slowing down. GNP at constant prices, increased by 1.6 percent in the first quarter of 1968, by 1.5 percent in the second quarter, by 1.3 percent in the third quarter of 1968, and by only 0.9 percent in the fourth quarter of the year. Personal consumption expenditures, after an increase of 2.5 percent in the third quarter, rose by less than 1 percent in the fourth quarter. This slowdown is a direct and intended result of Government fiscal policy, notably the cut in Federal spending and the imposition of a 10-percent income surtax. It is true that the slowdown in consumer spending did not take place as quickly as had been anticipated, in large part due to an unusually high savings rate which consumers chose to reduce before cutting into spending. However, that is a process that cannot continue indefinitely, because much of consumer saving is in the form of contractual savings—mortgage payments, insurance, installment payments, etc.—which are in large part outside the discretion of the saver.

This is not to say that inflation is not a problem. Clearly it is. The CPI since December 1965 has risen at an annual rate of 3.7 percent, and the rise has continued to accelerate in the most recent period. While the worst sufferers have been those with fixed money incomes, workers who were unable to negotiate adjustments in their wages with sufficient rapidity or frequency have suffered also. Workers as a group have seen their buying power also eroded in the past 3 years. Expressed in constant dollars of 1957–59 buying power, spendable (after-tax) weekly wages in manufacturing for a worker with three dependents amounted to $89.19 in December 1968, as compared to $89.75 in December 1965. They had dropped to as low as $86.07 in July 1967. Thus these workers and their families as a group have had no share in the advancing productivity of the national economy for the past 3 years.

We are deeply concerned about inflation that thus deprives working people of their share of national progress. But we are also deeply concerned about proposals which we do not believe will control inflation, but which will add to unemployment and slow down economic progress in this country. As we shall subsequently show, measures of economic restraint in a period when the economy still has slack in it have not controlled inflation in the past, here or in other countries; and at the same time there are countries in the free world which have succeeded in maintaining full employment at levels which we have not been able to approach, and have done so without suffering sharp increases in price levels. We shall come back to this subject with some proposals as to how the U.S. economy could enjoy the benefits of full employment without serious inflation.

As this is written, the "prime rate" has just been raised again, from 7 to 7½ percent. The prime rate is the interest rate charged by the large banks to their most credit-worthy customers. This rate has been increased four times in the last 3 months. It was raised from 6¼ percent at the beginning of December to 7½ percent on March 18, an increase of 1¼ percentage point.

This means a further rise in the cost of living as other interest rates increase in accordance with the rise in the prime rate. The rise in interest rates for mortgages will tend to increase housing costs, and the rise in interest rates for installment credit will raise the cost of cars, furniture, electrical appliances, and a host of other consumer goods.

In addition to the increases already effected, there are rumors that the Federal Reserve Board intends to raise its discount rate once more, which would almost certainly boost all interest rates still higher. We strongly oppose such a move, because there is a serious danger that this would start another round in the upward inflationary spiral.

Instead, we urge the Federal Reserve Board to raise the reserve requirements if further tightening of the money supply is needed. On the basis of past experience, the Board can be counted upon to cut reserve requirements during a recession, but it prefers to raise the discount rate rather than raise reserve requirements during periods of inflationary pressure. Such a one-sided policy coincides with the selfish interest of the bankers but it does not reflect the best interest of the general public.

The policy of the Board is well illustrated by what has happened in the current business cycle. During this period the discount rate nearly doubled. It was increased by 2½ percentage points from 3 percent in February 1961 to 5½ percent in March 1969. Reserve requirements, on the other hand, for demand deposits were raised by only one-half of 1 percentage point and this increase was limited to large banks with deposits in excess of $5 million. The reserve requirement for savings accounts was cut by two-fifths, and although this cut was partly offset by an increase of reserve requirements for other time deposits, nevertheless, overall reserve requirements for all types of time deposits have declined, thus adding to the inflationary pressure.

The Prospect Before Us

Unless there is a change in policy, it may be expected that restraints on economic expansion will be tightened in the immediate future. They are already tighter in 1969 than they were in 1968 after the imposition of the income surtax. The reasons are that (*a*) social security taxes were increased in January 1969 by $3 billion with no corresponding increase in benefits; (*b*) final payments required by April 15 to cover retroactivity of the surtax will take $1.5 billion more from taxpayers; and (*c*) increases in expenditures will be less than the $13 billion increase in tax revenues which is the trend figure at high employment growth rates. In consequence, by the spring of 1969 the Federal budget is expected to show a surplus, so that Federal Government operations will be taking purchasing power out of the economy rather than putting it in. Arthur Okun, Chairman of the Council of Economic Advisers under President Johnson, has said of this change: "Involved is a $20 billion swing in the budget [since the spring of 1968]—the biggest swing toward restraint we will have had in any year in the past 20." And he adds, "Nobody can be sure that the economy can take it."

We believe Mr. Okun has good reason to be apprehensive. The last time a comparable fiscal swing occurred was in the 15-month period between the fourth quarter of 1958 and the first quarter of 1960. During that period the budget situation changed from a $10 billion deficit to a more than $7 billion surplus on a national income and products account basis. This sharp swing to restraint was followed only a few months later by the recession of 1960–61, in which the unemployment rate rose to more than 7 percent. While attempting to balance the budget, the administration unbalanced the economy.

STATE AND LOCAL GOVERNMENT SPENDING

Looking at other sectors of the economy, demand for the services of State and local governments is perpetually on the increase, with the result that State and local government expenditures have been rising steadily at a rate of more than 10 percent per year in recent years. This pressure will continue as respects current expenditures, but, on the other hand, State and local capital expenditures are sensitive to the level of interest rates. If these remain at the current exorbitant level, or rise even higher, it is quite likely that some public fixed investment projects now planned for will have to be postponed.

CONSUMER SPENDING

As previously noted, real consumption expenditures increased by more than the normal rate in third quarter 1968, in spite of the income surtax, doing so at the cost of a sharp reduction in the savings rate. In the fourth quarter this trend was reversed and consumption expenditures, after adjustment for price changes, actually declined. It is expected that real consumption expenditures will continue to be weak in the first half of 1969 because of the factors already noted—the increase in social security contributions, payment of the retroactive portion of the surtax, and the relative inflexibility of contractual savings.

BUSINESS INVESTMENT

In the fourth quarter of 1968 private fixed investment expenditures for plant and equipment increased substantially over the previous quarter, and both the McGraw-Hill survey and the FTC–SEC survey predict further substantial increases in the first half of 1969. But these predictions must be evaluated with some skepticism. The surveys can be taken to reflect correctly the mood of the business community at the time they were taken. But they probably reflected a reaction to the sharp increase in real consumption expenditures, which between the fourth quarter of 1967 and the third quarter of 1968 had been rising at an annual rate close to 7 percent. Assuming that the slowdown in consumer expenditures in the fourth quarter of 1968 carries forward into 1969—and no other assumption seems valid—businessmen will tend to revise their investment plans. If they did not they would merely be creating the basis for a later slump because the margin of unused capacity was undesirably large even at the peak of demand, and if it is substantially added to while demand slows down, will rapidly become intolerable.

RESIDENTIAL CONSTRUCTION

In terms of social need there is a serious housing shortage. Vacancy rates are abnormally low, and there is a backlog of overcrowded housing, and of actually substandard housing which ought to be replaced. But effective demand is another matter. It is doubtful that residential construction can expand significantly as long as that demand is held back by exorbitant interest rates, as well as the excessive cost of speculatively held land and the high-cost, obsolescent nontechnology which burdens the residential construction industry.

High interest rates hit residential construction from the supply side as well as from the demand side. On the one hand, they impose heavy financial burdens on buyers, which many would-be buyers cannot meet. On the supply side, builders experience increasing difficulties in obtaining mortgage money. At times of rapidly rising interest rates, the savings and loan associations, which account for a substanital proportion of all mortgage loans, find it difficult to compete for deposits because they suffer from the disability that the bulk of their funds are invested in long-term loans granted at a time when interest rates were much lower. Consequently, savings which would normally go to these associations are diverted to other institutions which can pay higher interest rates, and are then used for purposes other than mortgage loans.

For these reasons it is likely that residential construction will tend to stagnate at current levels, or even to decline in the coming months. Any sustained upswing will depend on a reversal of the present monetary policy.

In summary, these are the factors which will tend to slow down the economy in the first half of 1969:

—The deflationary fiscal policy which tends to reduce the purchasing power originating in the private sector;

—The exorbitant interest rates which tend to depress private residential construction and public investment of State and local governments;

—A further slowdown of real consumption expenditures resulting from a larger tax bite which cannot continue to be offset by lower savings;

—Eventually a downward adjustment of real inventory spending and real fixed investment spending in response to the slowdown of the activities in other sectors.

Policies of the Nixon Administration

The prospective developments considered so far are those which may be expected to flow from a continuation of policies adopted by the previous administration, or imposed on it by Congress. As this is written no really clear picture has yet emerged of the economic policies to be followed by the Nixon administration. (One exception is the firm statement by Labor Secretary George P. Schultz that there will be no increase in the minimum wage in the immediate future. This will continue to condemn some millions of workers and their families to live in poverty, even though they work steadily at full-time jobs.) The general impression, however, is that there will be no abrupt change in policy and, if any change is made, it will probably be in the direction of further restraints on economic growth—slowing down the economy as a means, hopefully, of slowing down inflation. The consequence, of course, must be a rising level of unemployment, and this is recognized by President Nixon's economic advisers.

Thus, for example, Paul McCracken, the new Chairman of the Council of Economic Advisers, said at a meeting of the National Industrial Conference Board, last September:

> "We must recognize that there is no steady state trade off between the rate of price increase and the unemployment rate that will be acceptable or even viable on a continuing basis. At some times the reduction of unemployment is the prime problem. At other times minimizing the present value of future economic distress will require a disinflationary policy even if it means some short-term rise in unemployment. And clearly now is one of those times."

David Kennedy, Secretary of the Treasury, under questioning by Senator Vance Hartke, said, according to the *Congressional Quarterly:*

> " 'The effort would be to take the inflationary steam out of the economy with a minimum of increase in unemployment.' He agreed that some increase in the jobless rate was invitable and said an increase of one-tenth of 1 percent 'would sound better at the moment but 1 percent would be more likely.' "

We have already referred to the disastrous consequences of a 1 percentage point rise in the unemployment rate, which would mean that an additional three-quarters of a million men and women would join the ranks of the unemployed. But an even more serious danger is that the slowdown will not stop there. We can expect Mr. McCracken to agree with Mr. Ira T. Ellis, chief economist of the Du Pont Corporation, who said in *U.S. News & World Report* for February 17, 1969:

> " 'The critical problem is to adjust slower growth and not scream for the Government to do something about it. If we rush in with big spending programs, we're going to keep prices continuing to rise too rapidly.' "

Mr. McCracken can be relied upon not to rush in with big spending programs. He has already said that he feels the big mistake of the previous administration was that they were "economic hypochondriacs who were excessively worried over every wiggle in the business statistics." McCracken instead is worried about the perverse effect economic policy can have if it tries to follow the economic indicators too closely, and about the danger of overreacting. For these reasons he will insist on fixed policy rules. One of these rules is the concept of full employment budget surplus. A supplementary concept is the concept of full employment money supply.

But there is also the danger of underreacting and the perverse effects of fixed policy rules. In an interview with the *New York Times* McCracken explained that for domestic policy purposes he would define the full employment surplus as a condition under which at full employment the net budget balance fluctuates between a deficit of $2 billion and a surplus of $2 billion. But because of our international payments situation, he prefers a concept under which the net balance fluctuates between 0 and +$2 billion. And he adds: "I think there would be a great therapy to be had from our running a surplus for a while. It doesn't have to be a large one." (*New York Times*, January 24, 1969.)

McCracken does not define full employment but presumably he means 4-percent unemployment since he considers that the present unemployment level represents over-full employment, and that unemployment has to be raised. Since he is anxious to maintain a surplus, he will be likely to estimate the surplus at the 4-percent level conservatively, which would mean that the budget would be balanced at an unemployment level in excess of 4 percent. Given our lack of precise knowledge and McCracken's tendency to be conservative, the unemployment level at which the budget will be balanced might very well be 5 percent or more.

Since he is afraid of overreacting, and does not believe in responding to every wiggle of the statistics, then if he does make a mistake, and allows unemployment to go higher than he had planned, there will be a lag before he will be sufficiently convinced of his mistake to recommend a change in economic policy. Then there will be a further lag, probably one of several months, before Congress can be relied on to approve the necessary changes in fiscal policy, either by increased spending appropriations or by reducing taxation. And finally, there will be a still further lag before such changes can have an impact on the economy. By that time, what was originally intended to be a mere slowing down of the economy may very well have developed into a full-scale recession.

The Experience of Others

Restricting economic growth is not necessarily an effective method and is certainly not a necessary method of preventing or controlling inflation. This is borne out by the recent experience of two other free world countries, Canada and West Germany.

THE CANADIAN EXPERIENCE

Early in 1966 the Government of Canada began to fear the onset of inflationary pressures, and undertook to counter them by the process of economic restraint. A number of measures were taken in the budget produced in March 1966, for the fiscal year beginning May 1, 1966, which were aimed directly at slowing the rate of public and private spending and investment. Income tax rates, which had been cut in 1964, were restored to close to the previous level. A special refundable tax was imposed on corporation profits and depreciation and depletion allowances which in effect constitute a forced loan from business. Special tax provisions for accelerated depreciation on a wide variety of capital investments were ended. Exemption in two stages of production machinery and equipment from the 11-percent general sales tax was announced, but the first reduction did not take place until April 1967, in the hope that this would encourage firms to postpone for a year or longer plans to buy such equipment. The construction programs of all Government departments and crown corporations for the 1966–67 fiscal year were cut by 10 percent.

In addition to these fiscal measures, a very tight money situation was permitted to develop by the summer of 1966. And on January 1, 1967, the general sales tax was increased by 1 percentage point to a total of 12 percent. Finance Minister Mitchell Sharp predicted that the effect of these various measures would be to restrain price increases while probably reducing the rate of growth in gross national product by about 5 percent in real terms.

The effect on economic growth was far more drastic than that. The former vigorous expansion was slowed to a crawl.

The accompanying table shows what happened. For each quarter it gives the volume of GNP, seasonally adjusted and expressed at annual rates in dollars of constant buying power, and also the amount by which it exceeded GNP for the same quarter of the previous year.

Before the applications of restraints, real GNP had been growing at a rate of about 5 to 8 percent per year. For the previous 5 years, it had averaged 6.4 percent per year. But in the second half of 1966 it fell to about 5 percent, in the first three quarters of 1967 to about 3 percent and in the fourth quarter 1967 to 2 percent.

This sharp decline in the growth rate was particularly serious because of the rapid rate of increase in the country's labor force. Between 1961 and 1967 the Canadian labor force grew at an average annual rate of 2.6 percent, compared with 1.7 percent in the United States. Between 1966 and 1967 it increased by 3.7 percent.

ECONOMIC GROWTH, UNEMPLOYMENT AND CONSUMER PRICES IN CANADA, 1964–68

Year and quarter	Gross national product [1]		Unemployment		Consumer Price Index	
	Amount (millions)	Growth over same quarter of previous year (percent)	Number [2] (thousands)	Rate [2] (percent)	1949=100	Change from same quarter of previous year (percent)
1964—I	$41,252	7.0	335	4.9	134.4	1.7
II	41,872	7.4	328	4.7	135.1	2.0
III	42,004	6.3	317	4.6	136.0	1.8
IV	42,440	5.2	314	4.5	136.1	1.6
1965—I	43,648	5.8	290	4.1	137.1	2.0
II	44,180	5.5	296	4.1	138.2	2.3
III	45,364	8.0	269	3.8	139.3	2.4
IV	45,832	8.0	251	3.5	140.1	2.9
1966—I	47,188	8.1	259	3.5	141.9	3.5
II	47,728	8.0	257	3.5	143.5	3.8
III	47,520	4.8	289	3.9	144.8	3.9
IV	48,244	5.3	276	3.7	145.6	3.9
1967—I	48,552	2.9	289	3.8	146.2	3.0
II	49,252	3.2	317	4.1	148.2	3.3
III	49,012	3.1	317	4.1	150.6	4.0
IV	49,212	2.0	355	4.6	151.1	3.8
1968—I	50,392	3.8	353	4.5	152.8	4.5
II	50,796	3.1	397	5.0	154.3	4.1
III	51,380	4.8	401	5.1	156.0	3.6

[1] Seasonally adjusted at annual rates and in constant (1957) dollars.
[2] Quarterly averages of seasonally adjusted monthly data.

Source: Dominion Bureau of Statistics.

An immediate result of the lag in economic growth, therefore, was an increase in unemployment. From a peak of 7.6 percent at the beginning of 1961 it had been reduced to 4.5 percent at the end of 1964, based on quarterly averages of seasonally adjusted monthly figures. As the table shows, the decline continued at a slower pace through the end of 1965, and then held steady at 3.5 percent through the first half of 1966. This compares with an average of 3.8 percent in the United States.

Commencing with the third quarter of 1966, however, both the number of unemployed and the unemployment rate began to rise. By the third quarter of 1968 there were 140,000 more unemployed than at the beginning of 1966, and the unemployment rate had risen to 5.1 percent.

The Canadian economy had been "cooled down" with a vengeance. But what was the effect on prices? It was minimal and short term. The Consumer Price Index, which had risen by 3.5 percent between the first quarter of 1965 and the first quarter of 1966, rose by another 3 percent between the first quarter of 1966 and the first quarter of 1967, and then shot up still more rapidly than before restraints were imposed. By the first quarter of 1968 it had risen by a further 4.5 percent.

Altogether, between the first quarter of 1966 and the third quarter of 1968, a rise in the unemployment rate from 3.5 to 5.1 percent was accompanied by an increase in the price index of 9.9 percent. During the same period, in the United States, a drop in the unemployment rate from 3.8 to 3.6 percent was accompanied by a price rise of only 9.3 percent. The restraints in Canada succeeded in slowing down the growth rate and forcing up the unemployment rate, but they had no appreciable effect on the rate of price increases.

THE GERMAN EXPERIENCE

The performance of the West German economy in recent years shows a startling contrast. Unfortunately there is a certain lag in the availability of German data to us, so that complete data are not available beyond 1967. In the comparisons that follow, the United States and German data cover the same period, 1962 to 1967.

5-YEAR ECONOMIC PERFORMANCE, UNITED STATES AND GERMANY, 1962-67

[In percent]

	Total change		Annual rate	
	United States	West Germany	United States	West Germany
GNP at constant purchasing power	27.0	19.1	4.9	3.6
Real GNP per person employed	13.9	21.4	2.6	4.0
Gross hourly earnings in manufacturing	18.4	41.9	3.4	7.2
Cost of living	10.3	14.4	2.0	2.7
Real hourly earnings	7.3	24.0	1.4	4.4
Average unemployment rate [1]			4.6	[2].5

[1] Absolute level.
[2] Adjusted to U.S. definition.

Source: OECD "Germany," I.G. Metall; "1969 Economic Report of the President."

Between 1962 and 1967, GNP expressed in dollars of constant buying power grew in the United States at an average rate of 4.9 percent per year, and in Germany at an average annual rate of 3.6 percent.

This difference is more than accounted for, however, by the fact that over this period the U.S. civilian labor force grew at an average annual rate of 1.8 percent, while in Germany the labor force actually declined in size. Thus, real GNP per person employed—a rough measure of the productivity performance of the economy—grew at an annual rate of 2.6 percent in the United States but at a rate of 4 percent in Germany.

During the same period, the U.S. unemployment rate averaged about 4.6 percent and the German rate, adjusted to U.S. definitions, averaged 0.5 percent.

Yet during this same period, under conditions of what American economic managers would consider a gross overheating of the German economy, the German cost of living rose at an annual average rate of 2.7 percent, only somewhat higher than the annual U.S. rate of 2 percent.

Nor was this price stability attained at the expense of German workers' wages. On the contrary, they did much better than their counterparts in the United States. During the period, gross hourly earnings in manufacturing increased at an average annual rate of 3.4 percent in the United States and 7.2 percent in Germany. After adjustment for changes in the cost of living, real hourly earnings rose at an average annual rate of 1.4 percent in the United States and 4.4 percent in Germany. It is interesting to note that in Germany the buying power of an hour's work increased at a slightly faster rate than the physical volume of production per person employed, while in the United States it lagged far behind.

The rate of increase in money wages was more than 50 percent higher in Germany than in the United States. This faster increase in wages is partly the cause and partly the effect of the better productivity performance. On the one hand, the rapid expansion of domestic demand due to the rapid increase in wages enabled overhead labor to be spread over a larger volume of production and consequently helped speed up productivity. On the other hand, the rapid expansion of output made it easier to raise wages and consequently demand without increasing inflationary pressure.

Although there was a lag in German expansion in 1967, such data as are available for 1968 indicate that the former strong performance has been resumed. In the first half of 1968 real GNP rose at an annual rate of 6 percent over the last half of 1967. Consumer prices in October 1968 were only 2 percent higher than in October 1967, and the unemployment rate in November 1968 was 1 percent.

The Government is planning for a continuation of this state of affairs, for we find the same combination of low unemployment, high price stability, and high growth rate in the German medium-term economic plan, which covers the years 1969–72. In this plan the Government has set itself the following targets:

(*a*) Full employment, defined as an unemployment rate of 0.8 percent.

(*b*) Price stability, i.e., a rise in the GNP deflator not exceeding 1 percent per year.

(*c*) External equilibrium, defined as a surplus on the balance of trade in goods and services on a national accounts basis of 1.5 percent of GNP.

(*d*) A reasonable economic growth corresponding to a trend rate of 4 percent of real GNP.

At time of writing we do not have information as to the institutional means by which the Germans have achieved this amazingly good economic performance. Unudoubtedly the much better productivity performance than in the United States, contributed to price stability, and it is very likely that the competition forced on German industry through its participation in the Common Market contributed to the superiority of both the productivity and the price performance.

Economy Must Continue To Expand

Because there is still a slack in our economy—idle capacity in our factories, and a level of unemployment that most other industrialized countries would consider intolerable—we must again resume expansionary economic policies in place of the restrictive policies now in effect, and avoid any more restrictive policies that might be contemplated.

One of the changes which could be made fairly quickly would be to let the 10-percent income tax surcharge die a natural death on June 30 next. That would immediately put about $10 billion per year back into the taxpayers' pockets, and while not all of it would be in the form of consumer buying power, a great deal of it would.

There is a compelling reason, however, for preferring another course. For many years now, while the majority of consumers have become relatively affluent, the public programs required to meet the social needs of our Nation have been virtually starved. In some of our larger cities important sectors of the educational machine are grinding to a halt, with teachers being laid off and classes discontinued because of lack of funds. As regards other problems of the inner cities, urban blight, slum conditions, air pollution, delinquency, and just plain poverty, we have barely begun to scratch the surface. Our entire apparatus for health care for the citizen is woefully inadequate and disorganized. As a result, for example, our life expectancy is lower than that of many other countries whom we surpass in most material ways. There are at least 10 and probably 11 other countries where a girl baby, when she is born, can expect to live longer than one born in the United States. There are at least 17 and probably 20 other countries where a male can anticipate a longer life expectancy than in the United States. And these include such countries as East Germany, Bulgaria, Japan, Greece, and Italy, whose per capita wealth is far below ours.

One of the best measures of a nation's standard of health care is the relative proportion of children who survive or die in their first year of life, as measured by the infant mortality rate. Here the record of the United States is not only poor in comparison with many other countries, but is getting relatively worse. In 1953, there were only seven countries which had an infant mortality rate below the U.S. rate of 27.8 per 1,000. By 1963, 12 had lower rates than ours, and by 1965, 15 were ahead of us. As of 1966, the United States was tied in 17th place with Czechoslovakia. True, we had reduced our rate from 27.8 in 1953 to 23.7 in 1966. But that was far less progress than many other countries had made. Sweden, for example, had only 12.6 deaths per 1,000 infants under 1 year in 1966. In that year, some 40,000 babies died in the United States who would have lived had our infant death rate been as low as that of Sweden.

Countless other unmet social needs abound on every hand. President Johnson's Cabinet Coordinating Committee on Economic Planning for the End of Vietnam Hostilities has listed new programs which should be adopted and existing programs which should be expanded to a total amount of $39.7 billion per year when funds and resources become available.

Obviously, not all of these programs can be undertaken while a large part of our discretionary resources are going into the Vietnam war. But a considerable part of them can, to the extent that additional spending stimulates the economy and leads to fuller employment and higher production.

We, therefore, propose that the 10-percent income tax surcharge be continued for 1 year, but that the revenues from it be devoted to meeting social needs, in particular, our needs in education and in the cities. (The 1-year limit is proposed in the hope that peace can return to Vietnam and the money now spent on war can be diverted to these needs.) Education and the cities are two major fields where performance has fallen short of public policy pronouncements and where recent legislative enactments fail to overcome huge deficits.

EDUCATIONAL NEEDS

The quality of education in urban public schools and its close tie to the economic and social development of our urban communities ranks high among our major domestic problems. The enormity of the needs will require massive injections of Federal moneys, as well as creative innovations, to deal with the special problems of the disadvantaged child in our urban areas.

Just what are the dimensions of the shortages of our school system that demand action? Fully one-third of the present stock of 1.7 million classrooms are more than 35 years old—a figure which coldly describes a large supply of antiquated equipment and inadequate facilities in our Nation's schools. One-half of the classrooms in slum areas are over 50 years old.

According to the Department of Labor, about one-third of the young people currently in the Nation's schools will drop out before getting their diplomas. In some of our cities' slums, this percentage runs much higher. Those who drop out have an unemployment rate two-thirds greater than others in the same age group who complete their education.

How does current performance measure up against these visible needs? The simple answer is that these needs are not being met. In the words of the authoritative study of HEW's Office of Education, *Projections of Public School Facilities Needs*, "Public elementary and secondary school construction in recent years has done little more than keep pace with the urgent demand for facilities created by enrollment increases." In short, the backlog of inadequate educational facilities persists at a disgracefully high level—over 500,000 classrooms, according to the Office of Education study.

This backlog has several components. To reduce classroom overcrowding and achieve the median size of 27.4 students per elementary class and 27.5 students per secondary class would require the construction of about 100,000 new classrooms. Using average cost of $50,000 per new classroom in 1968, the construction bill to achieve median classroom size for overcrowded units would come to $5 billion.

To eliminate makeshift classrooms, which over 1 million students now attend, would require the construction of 40,000 new classrooms at an estimated cost of $2 billion. To replace classrooms with four or more defects [1] would require the construction of 194,000 new rooms at an estimated cost of $9.7 billion.

Education professional have argued that for far more effective school experiences, the median class size should be 25 students per elementary school class and 20 students per secondary school class. An additional 187,000 new classrooms would be needed to achieve this goal—at an estimated cost of $9.4 billion.

In sum, construction costs to eliminate these various school shortages would require $26 billion—over a $5 billion outlay per year for the next 5 years or over $2½ billion a year for 10 years. (It should be noted that these projections and estimates are conservative ones. They do not take into account the likelihood of appreciably higher construction costs in the coming years.)

Far from catching up on this backlog, we are adding to it. For the period of 1967–68, the projected classroom need to take care of growth and to improve some of the unsatisfactory facilities amounted to 77,000 classrooms. However, estimated construction for the calendar year 1968 is only 66,700 (*School Management*, July 1968).

Adjustments in teachers' salaries must also be added to any cost projections for improvements in urban education. Recently released statistics show that teachers' salaries in all public elementary and secondary schools average slightly above $7,000 per year. Salaries in the teaching profession must be made more competitive with salaries in other occupations to encourage recruitment of new teachers. Aggregate compensation for teachers will continue to rise as more teachers are hired to staff newly constructed classrooms.

The magnitude of our financial needs in education underlines the necessity for the Federal Government to allocate billions of dollars so that we can provide quality education for the pupils in our public elementary and secondary schools. State and local governments cannot support the necessary school expenditures without such aid.

Schools in States with low per capita income and schools in our city slums and impoverished rural areas are already hard pressed to acquire enough funds to maintain the present educational system. Nationally, nearly 34 percent of the 1,600 school bond issues proposed in 1967 were defeated, totaling more than $945 million. And, the record for the first 3 months in 1968 indicates that more than four out of every 10 bond issues proposed were turned down. It is obvious that homeowners are reacting to the fact that they are carrying a disproportionate share of the increasing tax burden.

In addition to the difficulties in obtaining necessary financial support locally, school districts in low-income urban centers receive a

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[1] "School defects" include such conditions as building partially or totally nonfire resistant, inadequate plumbing, nonpermanent facilities (e.g., quonset huts), and insufficient acreage for playing area, etc.

disproportionately low share of what State aid is available because of the traditional political domination of State legislatures by the rural and suburban districts in the State.

The gap in per pupil expenditures between the wealthiest and the poorest States has been widening. On a per pupil basis, major cities generally spend only about two-thirds of the amount spent by the suburban communities which surround them. This despite the fact that it is the poor children living in urban centers who are most desperately in need of the highest quality of education.

In addition, this projection of needs and costs of quality education in elementary and secondary schools throughout the Nation avoids, but should not obscure, the equally pressing problems in the field of higher education.

URBAN DEVELOPMENT

Turning to the problems of our urban centers, we find the list of needs and the amount of funds necessary to meet them are even more overwhelming and staggering than for education. Here, with little difficulty, the full $10 billion of surtax revenue could be allocated to vital facilities and services necessary to make our major cities livable. The $10 billion, even when added to our current outlays, would only begin the mammoth task of transforming our blighted, decaying urban centers into communities with healthy physical environments, decent housing accommodations, and with the amenities of life which the average American has the right to expect.

Our cities reflect the myriad sociological and economic problems which have engulfed our Nation. The extensive migration of Negroes from essentially rural, southern communities to northern urban areas has worsened the already intolerable slum conditions in those areas. Racial discrimination in housing has prevented many Negroes and other minorities who have improved their economic status from leaving the ghetto or other substandard environments.

The interrelationships of the problems of our deteriorating cities can be seen from the programs listed by the Cabinet Committee referred to above, and outlined in the latest report of the Council of Economic Advisers.

As the Committee points out, in many cases the hypothetical expenditure figures contained in the table were "*considerably below the recommendations*," (emphasis added).

Omitting the education expenditures which, to a major extent, were discussed earlier in this statement, here are the key programs relating to urban life and their costs.

Program	*Expenditure (billions)*
Community Service Programs—for expanded day care centers for children of needy working mothers, etc	$0.8
Public Jobs—500,000 jobs for public service employment for the chronically disadvantaged	1.8
Crime, Delinquency, and Riots—of this amount, some $600 million is for rehabilitation and prevention of delinquency	1.0
Quality of the Environment—primarily for prevention and control of air and water pollution, and sewerage treatment	1.7
Economic Aid in Rural Areas—this program is included because it can help stem part of the migration trend to the cities	1.0
Total	6.3

As for urban development itself, the task forces and study groups came up with a series of programs with a price tag of $5.5 billion (one-half billion dollars of which was for land acquisition and financial planning in suburban areas).

Major expenditures for health and such income supports as public assistance have not been made part of the above calculations, although; indeed, such expenditures are inextricably involved in the living standards of urban dwellers. However, even without these, the expenditures total over $11 billion *on an annual basis.*

HOUSING

Nor does this immense sum provide for allocation of funds to meet the vital housing needs facing this country. Currently there are from 7 to 9 million housing units which are substandard because they lack decent plumbing facilities or otherwise fail to meet minimum standards of adequate accommodation. In addition, of the present housing stock, there are some 15 million units which are in various stages of deterioration, and they too must be considered in any planning for new construction and rehablitation. Experts who have been working on the statistics of housing, and special groups, like the Kaiser Commission and the National Commission on Urban Problems, agree that from 26–28 million housing units must either be constructed or rennovated within the next 10 years. (The overwhelming proportion represents new construction.)

During the past several years we have been adding an annual average of 1.3 million housing units; the projections call for a doubling of that rate.

Those in the most dire need of improved housing are the families with income below the poverty line and those who, while above the line, pay more than 20–25 percent of their income for housing. An estimated 6 million units of the total must be provided for these two disadvantaged groups. For poor families with a head who can work, public service employment is a vital part of the strategy which will enable them to improve their living conditions.

Illustrative of those who pay a disproportionate share of their income for housing was the finding by the Kerner Commission that in Detroit "over 40 percent of the nonwhite occupied units in 1960 required rent of over 35 percent of tenant's income."

In dollar terms, the Kaiser Commission data indicate that over the 10-year period, to meet the goal of 6 million units will require the expenditure of $1.4 billion per year on the average. By 1978, the yearly total will be roughly twice as high as the number of those benefiting from the several programs rises. Unless the Nixon administration requests and the present Congress fully funds what the 1968 Housing Act authorized, the Nation will fall further behind in meeting its 10-year housing goal. However, even that is not enough, for our neglect of housing needs has been so prolonged and severe that an acceleration of meeting those needs would be sound social policy. A portion of the $10 billion surtax revenue should be used for this purpose through appropriate adjustment in the expenditures allocated to other vital urban needs.

While on the housing issue, let me make clear that a whole range of institutional changes are necessary to bring new technologies and economics of scale to housing production, consumption, and marketing. Assembling housing markets in order to obtain the volume necessary to assure the use of advanced technology, is one such change. This will require updating obsolete building codes and zoning regulations.

In turn, these methods would create pressures to obtain land for housing and other public purposes through advanced land acquisition and land banking.

A rational land policy should empower the Federal Government to:

—Preempt local zoning and building codes for federally subsidized housing;

—Assist local governments to acquire land for housing and related facilities;

—Pay costs of relocation, demolition, and acquisition;

—Aggregate large parcels of land through direct acquisition of land for subsidized housing and related facilities.

Obviously, all the programs discussed here cannot be financed even with the $10 billion of surtax revenues. (A considerably larger amount could be made available through appropriate measures of tax reform, but that is a subject more appropriate for discussion before another committee.)

Nor is it our purpose to indicate priorities. Those will have to be allocated on the basis of many considerations which only the appropriate governmental bodies can fully weigh. We do urge, however, that the principle of using at least the surtax revenues to meet pressing social needs be endorsed—and implemented.

The Problem of Inflation

As indicated at the beginning of this statement, we in the UAW are deeply concerned about the problem of inflation. We do not agree, however, that a program of overall restraints on economic growth is the proper method or necessarily an effective method of controlling inflation in an economy which still retains substantial slack in its productive machinery and sizable levels of unemployment. In this connection, it is worth noting that Prof. Daniel B. Suits, of the University of Michigan's Research Seminar in Quantitative Economics (who has been a close student of the relationship between the level of economic activity and the price level) predicts that in spite of a sharp economic slowdown and an unemployment level close to 5 percent by the end of this year, prices will rise even faster in 1969 than in 1968.

He estimates that in order to slow down price increases by this route, we would have to hold back economic growth for several years, with an implied unemployment rate of 5 to 6 percent.

The theory that restraints on economic growth will control inflation contains a major premise that unemployment and inflation are bound together in a simple inverse relationship—the less unemployment, the more inflation; the more unemployment, the less inflation.

The concept was much more crudely stated a few months ago by an anonymous economist quoted by *Business Week*. He said: "You have to keep unemployment high enough so that workers don't get too greedy."

Interestingly enough, *Business Week* also revealed in the same article that it is no longer "greedy unions" but greedy unorganized and low-paid workers who are now the villains in the piece. It reported:

"The current wage spiral has been led not by members of strongly entrenched unions but by the loosely organized workers in poorly paid industries such as textiles, furniture, and retailing. Apparently, a tight labor market creates upgrading opportunities for unskilled workers and, to hold on to experienced help, employers must pay premium wages.

"Against this type of wage inflation, guideline policies are ineffective. The only way to keep labor costs to a level in line with productivity is to reduce the bargaining power that comes with relative prosperity."

In other words, we should renounce forever the goals of full employment, full production, and full prosperity for this country, because by achieving them we would give too much bargaining power to the workers—especially the poorly paid ones who need it most.

The brutal irresponsibility of such a doctrine is exceeded only by its economic absurdity.

The concept of a simple inverse relationship between unemployment and inflation is based on the belief that changes in labor costs are the major factor in determining whether prices rise, fall, or remain stable. This simply is not so.

PRICE INCREASES PRECEDED LABOR COST RISE

In 1967 and again in 1968, in appearances before this committee, we of the UAW produced detailed facts and figures, for example, to show that labor costs had nothing whatever to do with the initiation of the present round of inflation. We showed that prices of manufactured goods began to rise while unit labor costs were stable or even falling, and that it was profits, not labor costs, that responded initially to those price increases. Labor costs remained stable or even fell a little for over a year after prices had begun to rise. Eventually, of course, rising living costs forced workers to demand compensating wage increases, but that came much later on in the spiral.

It is some satisfaction that these facts were subsequently recognized by as business oriented a publication as the *Wall Street Journal*. The *Journal*, in fact, did a little more digging and discovered that the phenomenon of prices and profits rising first, and unit labor costs only some time later, was not confined to the present round of inflation. On August 5, 1968, the *Journal* reported:

"In the past 20 years, there have been three distinct periods in which factory prices climbed substantially over a prolonged interval.

"In each instance, labor costs per unit of factory output were *declining* when the price climb began—and these costs continued to decline for a considerable period after the price rise was underway.

"In each case, corporate profits began to increase sharply well *before* the price climb started.

"Such facts, at least to some economists, bear an obvious message. 'The pattern is clear enough,' says Peter L. Bernstein, president of Bernstein-Macaulay Inc., a New York investment counseling service. 'Instead of labor costs pushing prices up, what we see instead is a sort of profit-push. Profits are already well on their way up before prices begin to rise, and prices are well on

their way up before wages begin to rise faster than output.' "
[Emphasis in original.]

This idea of "a sort of profit-push" is supported by Prof. George L. Perry of the Massachusetts Institute of Technology, and a former member of the Council of Economic Advisers. In his book, *Unemployment, Money Wage Rates, and Inflation*, he says:

"Profits enter the inflation problem at two distinct points. First in the product market, profits are the goal of pricing policies. Price increases may be initiated to restore profit margins (or maximize profits) in the face of cost increases; or may be initiated to augment (or maximize) profits independently of cost changes. Second, in the labor market, profit rates have been identified as a major determinant of wage changes.

"This interrelationship in which profits both affect and are affected by wage changes gives rise to a range of possible explanations of inflationary phenomena. Wage increases that raise unit costs will initially reduce profit margins which may be restored, at least in part, through price increases. This is a standard wage-push argument. Alternatively, an initial attempt to raise profit rates through higher prices will lead to accelerated wage increases which then in turn may be passed forward into still higher prices if the higher profit rates are to be maintained. Or the same sequence can arise through an initial rise in profit rates stemming from exceptional productivity gains with no reduction in prices. In some circumstances, these could properly be labeled instances of profit-push inflation."

Professor Perry's findings, based on a mathematical analysis of actual wage-price-profit relationships between 1948 and 1960, is that there is not only a possible "tradeoff" between unemployment and inflation, but there is also a tradeoff between profits and unemployment. Specifically, he finds that with an after-tax manufacturing profit rate of 5.7 percent return on investment, and an unemployment rate of 3 percent, an inflation rate of zero (overall price stability) may be expected. If the profit rate goes up to 11.5 percent, however, it requires an unemployment rate of 6 percent to keep prices stable.

In the shame way, if the profit rate is 11.7 percent and the unemployment rate 3 percent, prices may be expected to rise at a rate of 3 percent per year. If the profit rate goes up to 17.4 percent, however, it will require an unemployment rate of 6 percent to keep the inflation rate at 3 percent per year. (See table below from Professor Perry's book.)

MANUFACTURING PROFIT RATES ASSOCIATED WITH VARIOUS UNEMPLOYMENT RATES AND RATES OF INFLATION

[3 percent rate of productivity growth assumed] [1]

Inflation rate (percent per year)	Unemployment rate (percent) 3.0	4.0	5.0	6.0
0	5.7	8.6	10.3	11.5
1	7.2	10.1	11.8	[2] 13.0
2	8.7	11.6	13.3	[2] 14.4
3	11.7	14.6	16.3	[2] 17.4

[1] Calculations are based on equation 3.15, the central case which assumes unchanging income distribution, labor force distribution, and appropriate relative price shifts, with wages in all sectors of the economy changing at the same rate as those in manufacturing. The kinds of changes introduced by relaxing some of these assumptions were discussed at the end of ch. 3.

[2] Associated manufacturing profit rates.

Source: George L. Perry, "Unemployment, Money Wage Rates, and Inflation" (table 6.1).

In this connection it is worth noting that many major corporations, such as General Motors, which have and use discretionary pricing power, set themselves and regularly achieve profit targets well in excess of 17.4 percent on investment.

Incidentally, another of Professor Perry's findings is of significance to anti-inflation policy. He finds that the elasticity of wages to living costs, and the elasticity of living costs to wages, are both less than unity. That is to say, a given percentage rise in living costs will generate a smaller percentage rise in wages, which in turn will generate a still smaller percentage rise again in living costs. As a result, the price-wage spiral is not endless, but tends rather to damp itself out. As Professor Perry puts it:

> The circular process whereby prices affect wages which in turn affect prices and profits (negatively) gives some appearance of a wage-price spiral, but one that disappears rather than becoming explosive or indefinitely self-perpetuating.

This is important because it effectively answers the often-heard argument that even though wages may not have been responsible for initiating an inflationary spiral, wage restraint—whereby workers accept increases in real wages substantially below the rate of productivity advance—is essential to bring the spiral to an end.

THE SOURCE OF PROFIT PUSH

What is the source of the profit push which was certainly responsible for the current round of inflation, and according to the *Wall Street Journal* has been responsible for the last three such rounds? It is the lack of effective competition in too large a sector of the economy. This results in some corporations, which hold controlling positions in particular industries—frequently in more than one industry—being able to exercise a discretionary pricing power. That is, within certain limits, they are freed from the normal restraints of the competitive marketplace, and within those limits are able to set the prices of their products at their own discretion.

The existence of such discretionary power is now taken for granted by nearly all economists—though too few of them have taken this factor sufficiently into account in formulating their theories as to how the economy operates—and by at least those businessmen who exercise it. Executives of General Motors Corp. have more than once admitted to congressional committees that their corporation does determine prices on the basis of a profit target. Many other large corporations are well known to follow the same practice. This would be impossible to them if they did not have at least limited freedom to determine a selling price for their products and to make that price stick.

A very illuminating analysis of the role of discretionary power in promoting inflation is to be found in the recently released studies by the staff of President Johnson's Cabinet Committee on Price Stability.

The major source of such discretionary pricing power lies in the domination of particular industries by a relatively small number of companies. When there are many sellers, no one of which enjoys a very large percentage of total market sales, the activities of all of them are constrained by market forces. If such a force—an increase in costs, say, or a sharp increase in demand—comes into play, it affects all sellers and they will all respond in the same way. But lacking such a force, if any one seller tries to raise his price merely to increase his profits, he will quickly lose sales to his competitors and be unable to maintain the increase.

In the same way, when market forces permit or require a reduction in prices, if some sellers try to maintain prices there will always be others who will find it more profitable to reduce prices and increase their sales, and the holdouts will be forced to follow the market trend.

It is very different when the number of sellers is few. The simplest example is an industry with only two firms in it, A and B. Let us suppose that A makes a discretionary decision to raise his price because he wants a larger profit. B then has two choices. He can maintain the lower price, and this will soon force A to roll back his price especially if B is operating below optimum capacity. Or B can raise his price to A's level, *in which case both firms will enjoy higher profits* as long as the higher price was set in such a way that the drop in demand is more than offset by the rise in profit per unit. B's decision is virtually automatic. The situation is essentially the same when there are any small number of sellers dominating the market. It is particularly so when one seller enjoys a particularly high percentage of the total market. He then tends to become the recognized price leader, and the others follow his lead.

Concentration alone is not the only factor affecting price discretion. Ease of entry is another. If it is relatively easy for newcomers to start up in business, high profits will quickly attract them. But if that is a very expensive undertaking, as it is, for example, in the automobile industry, such newcomers will be very few. Product differentiation is still another factor. Heavy advertising of a company's brands or models tends to develop consumer loyalties and to reduce the competition they face from others. This is inflationary in two ways. It adds to the cost of selling, which is passed on to the consumer, and at the same time it permits such higher price level. It also increases the difficulty of entry for newcomers.

The study points out the relationship between these factors and the pricing and profit policies of the corporations possessing them. It says:

> Recent empirical studies demonstrate that each of these market characteristics—market concentration, entry barriers facing potential entrants, and the degree of product differentiation—has a bearing on the market power and pricing behavior of sellers. A growing number of studies confirms that there is a significant positive relationship between the level of industry concentration and reported industry profits. The studies show that profit rates tend to be 50 percent (or more) higher in highly concentrated industries than in moderately concentrated ones. Other studies demonstrate that the entry barriers protecting an industry from potential competitors also affects the level of profits. That is, the more difficult it is to enter an industry, the higher the prices at which firms may sell without inducing new competitors. Research studies also support the hypothesis that the degree of advertising-created product differentiation has a direct effect on industry profits. According to a recent study, consumer industries with high advertising outlays enjoy profit rates about 50 percent above those with low advertising outlays. The costs of advertising and of maintaining other barriers to entry will raise prices without appearing in reported profits.

There are other factors also which can enhance discretionary pricing power. One is the development of "conglomerate" corporations—the merger into one of various enterprises with a wide variety of totally disparate products. This alone does not give them market power, but it gives them economic power which may be used to obtain market power. For example, a large conglomerate may be able to mount for one of its divisions a massive advertising campaign directed at product differentiation, which the division alone, if operated as a separate enterprise, could not afford.

Other factors that may tend at least to blunt competitive rivalry are those which produce a community of interests among competitors—such as joint ventures and interlocking directorates. As the study says:

> If such ties became extensive enough, they would create a cartel-like atmosphere that would replace independent behavior with cooperation leading to a live-and-let-live attitude.

AGGREGATE CONCENTRATION

The study goes on to discuss the actual incidence of these various factors. It says:

> Aggregate concentration of control exists in many forms. We have evidence of increasing control of manufacturing by the 200 largest firms. We also are witnessing increasing numbers of joint ventures among large manufacturers, interlocking officers and directors, interconnections among banks and firms in other sectors, and growing concentration of financial control outside manufacturing.
>
> Between 1948 and 1967, there was a persistent and substantial upward movement in the share of assets controlled by the 200 largest U.S. manufacturing corporations. The sharpest rise occurred in the last 2 years, when merger activity reached an all-time high. By 1967, the 100 largest corporations held 47.6 percent, and the 200 largest corporations held 58.7 percent of the assets of all manufacturing corporations. By 1967 the 100 largest manufacturing corporations held about the same share of assets held by the 200 largest in 1948.

An even more startling figure is that only 78 corporations, those with assets of $1 billion or more, held 43 percent of total manufacturing assets.

The study continues:

> Concentration of profits within the largest manufacturing corporations is even higher than assets. In 1968 the 78 largest manufacturing corporations received 49 percent of all manufacturing corporation profits. Thus these companies enjoy not only large earnings, but also access to a reserve of uncommitted funds sufficient to afford them substantial independence from capital markets.

This latter point is of particular importance with regard to an anti-inflationary money policy, since it means that the investment plans of these corporations are virtually free of the restraints intended by such a policy.

The largest corporations are also especially prominent in those industries where discretionary power is most common—consumer goods as against producer goods, and especially those industries producing highly differentiated consumer goods, where the 200 largest manufacturing companies were responsible for 73 percent of value added.

The largest corporations are steadily entrenching their leadership positions, frequently in several industries. Thus, in 1958, of the 100 largest manufacturing corporations, 29 were each among the four leaders in four or more industries; by 1963, that figure had grown to 48 companies.

Joint ventures are particularly common among the largest corporations. The staff study declares:

> One study reported that the 100 largest manufacturing corporations appear as parents of joint ventures 210 times.

Another source of close relationships between corporations is through interlocking directorates. The study cites a report to the Senate Antitrust Subcommittee which shows that in 1962 the 29 largest industrial and commercial corporations had officers and directors who were also on the boards of 745 other industrial and commercial corporations, 330 banks and 51 other corporations.

MARKET CONCENTRATION

The above facts indicate that the *aggregate concentration* of economic power in industry is growing, and that some of the developments will tend to reduce competitive rivalries. The figures themselves do not show that *market concentration*—the concentration of economic power among a few firms in single industries—has also increased. And at first sight it would appear that it has not.

The degree of concentration is expressed by a "concentration ratio." This is a figure representing the proportion of industry shipments by a specified number of the top firms in the industry. Thus, a "four-firm concentration ratio of 60 percent" means that the top four firms control 60 percent of the shipments in that industry.

The average of four-firm concentration ratios for all manufacturing industries rose from 41.2 percent in 1947 to 41.9 percent in 1966—a negligible increase. But this picture changes when the industries are broken down by type of industry (see accompanying table). Thus, the concentration ratio in producer goods industries fell by 1.7 percentage points, while the concentration ratio in consumer goods industries rose by 4.8 percent. What is more significant, the concentration ratio in 17 highly differentiated consumer goods industries rose by 12 percentage points, from 48.2 in 1947 to 60.2 in 1966. Since total shipments of these industries in 1966 amounted to more than $40 billion, or more than 45 percent of all consumer goods industries, the impact of this increase of market power on pricing policies and thus on prices is substantial.

4 FIRM CONCENTRATION RATIOS IN MANUFACTURING, 1947 AND 1966

	1947 (percent)	1966 (percent)	Change (percentage points)
213 manufacturing industries	41.2	41.9	0.7
132 producer goods industries	45.1	43.4	−1.7
81 consumer goods industries	34.8	39.6	4.8
17 highly differentiated consumer goods industries	48.2	60.2	12.0

Source: Studies by the staff of the Cabinet Committee on Price Stability.

Competition is further weakened by the fact that the largest corporations dominate not just one product line, but frequently dominate the market of many related lines. This means that frequently the monopoly price for a specific product line is bolstered by the monopoly price of the substitute product which is set in such a way that the combined profit of both lines is maximized.

The prevalence of this sort of situation is illustrated by the example of the food industry. In 1963, the food industry covered 116 product classes. In only 2 percent of these product classes the 100 largest food producers occupied none of the eight top ranks. In 70 percent of all product classes, the 100 largest food producers occupied at least four of the eight top ranks. This type of concentration has increased substantially in recent years. The percentage of product classes in which the 100 largest food producers occupied at least four of the eight top ranks increased from 50 to 70 percent in less than 10 years.

An interesting feature of the staff study is its finding that this increase in concentration in consumer goods industries is not due to technological requirements, "but rather to product differentiation created by advertising." It continues:

> Empirical studies demonstrate that product differentiation and the requirements of large-scale advertising are the major barriers to entry and causes of high market concentration in many consumer goods industries.

WHAT IS TO BE DONE?

We have seen thus far that the current round and probably also previous rounds of inflation have not been caused by the "cost push" pressures of rising labor costs, but by the "profit push" demands of large corporations with increasing economic power in the whole of industry and increasing market power in key consumer goods industries. How is that power to be curbed in the public interest?

The staff study makes a number of useful suggestions. These include:

—Vigorous enforcement of the antitrust laws.

—More exercise by the Federal Trade Commission of its powers to investigate the organization, business conduct, practices, and management of corporations, with particular reference to industries that pose special competitive problems.

—A thorough and expeditious study of the whole problem of conglomerate mergers by the antitrust agencies, with a view to seeking legislative remedies.

—Careful study of the impact on the economy of the trust activities of commercial banks, whose trust departments control a large and growing proportion of the stock of American corporations.

—Tightening up of the rules governing reporting by conglomerate corporations to the SEC so as to require them to report separately their sales and revenues with respect to each product class representing the lesser of 5 percent of sales volume or sales of $25 million, and requiring them to report separately for a period of years the finances of acquired companies.

—Careful study of the special problems in competition raised by multinational corporations, and of the general problem of policing international competition.

—Elimination of resale price maintenance.

—Better consumer information about products.

All of these are useful suggestions, and we endorse them all. But none of them really gets right down to the point of stopping inflation where much of it begins—at the point price decisions, and sometimes possibly wage decisions, are actually made.

PUBLIC INFORMATION NEEDED

We believe that one of the reasons large corporations are able to get away with some of the price decisions they make is because the public generally is uninformed about the economic issues involved. The decisions are made in the privacy of a corporate board room. The public may not even be informed of it until the housewife notices a higher price tag on the package in the supermarket. If the public is informed, it is through an unctuous statement prepared in the corporation's public relations office, attributing the increase to some cause beyond the corporation's control—usually a vaguely worded reference to "higher costs of labor and materials." But the public is rarely, if ever—and certainly never voluntarily by the corporation—given the answer to such vital questions as:

> What are the facts regarding unit labor costs?
>
> What has been the rate of productivity advance in this firm?
>
> How big are the firm's profits, and how do they compare with those of other firms or of industry generally?
>
> How much of the "cost" of the product is really the cost of advertising or other methods of product differentiation?

These questions, and many more like them which could be asked, are matters of public interest and concern when the answers to them affect the prices consumers will have to pay for a large proportion of their daily needs. What is even more important, if the corporations with discretionary pricing power knew that they would be required to answer such questions before a public forum as a condition of raising prices, we believe that they would be much more reluctant than they are now to initiate an increase which could not be justified.

PRICE-WAGE REVIEW BOARD

As a means of providing such a forum, the UAW has long advocated the establishment of a Price-Wage Review Board and a Consumer Counsel.

Under legislation establishing the Board, any corporation holding a dominant position in a key industry—for example, controlling 25 percent or more of the industry's sales—would have to give at least 60 days' notice to the Price-Wage Review Board of any intended price increase. The board would have authority to call the company before it for a public hearing.

As a matter of fact, new leigslation might not even be required. The FTC already seems to possess the necessary powers under the Federal Trade Commission Act. This act states:

> The Commission shall also have power—
>
> (a) To gather and compile information concerning, and to investigate from time to time the organization, business, conduct, practices, and management of any corporation engaged in commerce, excepting banks and common carriers subject to the act

to regulate commerce, and its relation to other corporations and to individuals, associations, and partnerships.

(b) To require, by general or special orders, corporations engaged in commerce, excepting banks and common carriers subject to the act to regulate commerce, or any class of them, or any of them, respectively, to file with the Commission in such form as the Commission may prescribe annual or special, or both annual and special, reports or answers in writing to specific questions, furnishing to the Commission such information as it may require as to the organization, business, conduct, practices, management, and relation to other corporations, partnerships, and individuals of the respective corporations filing such reports or answers in writing. Such reports and answers shall be made under oath, or otherwise, as the Commission may prescribe, and shall be filed with the Commission within such reasonable period as the Commission may prescribe, unless additional time be granted in any case by the Commission.)

Because the Commission has not always been as zealous as it might have been in carrying out the functions now entrusted to it, there is room for doubt as to whether it would be the most suitable body to direct the operation of a Price-Wage Review Board. However, the powers are there, and could be given to an autonomous board.

Certainly it is essential that the Board should have the power to subpoena and examine witnesses under oath, and to demand the presentation of all pertinent books, papers, and other sources of information. Following its hearing the Board would publish its findings and recommendations and the facts supporting such recommendations.

The recommendations would be based upon a set of standards carefully designed to assure equity to all affected parties on a basis compatible with reasonable stability of the general price level.

The Board's recommendations would not take the form of binding determinations, however, and once the Board's report was published, the corporation would be free to act as it saw fit. But if the public were informed with facts and figures which made it clear that the price increase was not justified, it is highly doubtful that the corporation would attempt to effectuate such a price increase in the face of enlightened public opinion. Indeed, as we have said, just the knowledge that such an investigation was probable would deter most large corporations from even proposing price increases unless they could in fact be fully justified.

The number of corporations that would be subject to such hearings procedures is relatively small, for it would need to apply only to the one dominant company in each major administered price industry. If that company were restrained from raising its prices, the smaller ones would have to follow suit.

OFFICE OF CONSUMER COUNSEL

It has been suggested, as an argument against the Price-Wage Review Board proposal, that under such a system corporations would never reduce a price because of the difficulties in the way of restoring the price cut if it should become necessary. And in any case, a procedure that could be triggered only by a threatened price increase would fail to meet the problem posed by high-productivity industries which refuse to grant the price cuts they could well afford.

Both of these objections can be met by the establishment also of an Office of Consumer Counsel. The Consumer Counsel would have two main functions. He would represent the interest of consumers in all hearings before the Price-Wage Review Board. And he would be authorized to initiate hearings when sufficient evidence was available to suggest that prices of any corporation subject to the procedure were already too high.

UNIONS ALSO COVERED

Unions would also be subject to the hearings procedure when appropriate. Whenever a corporation subject to the procedure claimed that it would have to raise prices if it gave in to union demands, it could so notify the Board, and both the union and the corporation would then be summoned to a hearing and required to produce the relevant facts.

The Council of Economic Advisers has pointed out in previous years that there are circumstances in which a wage increase is justified even if it does require a price increase. If his were the situation in a given industry, the hearing would reveal it. But if the union's demands were exorbitant, that would be revealed. If, on the other hand, the company could well afford to grant them without raising prices, that fact would be made apparent.

As in the case of a hearing involving a corporation alone, the Board would publish a report containing its findings and recommendations and the supporting facts. Both sides would then go back to the bargaining table free to act as they saw fit, but with the knowledge that the public had the facts, and was equipped to pass an informed judgment on the result of their negotiations. The union and the corporation alike would be subject to the same discipline—the need to accept full public responsibility for private, voluntary decisions which affect the public interest.

We believe that unions generally would welcome the opportunity, in a collective-bargaining situation, to have a public forum before which they could explain the economics of their demands. One of the difficulties perpetually faced by unions in such situations is not only the simplistic and misleading propaganda too frequently put forward by employers, but the fact that the greater part of the public have an extremely rudimentary and simplistic understanding of economic processes. The difference between hourly wage rates and unit labor costs, for example, is a closed book to most people, and the concept of financing wage increases out of the friuts of productivity advance has never entered the minds of many, so that the union in its public relations is faced at every turn with dogmatic attitudes such as that "every wage increase causes a price increase."

If both sides were free to state the issues as they see them in a public hearing, and if an impartial tribunal then issued its findings on the basis of the objective facts, we believe that the economic understanding of the public would be advanced and public confidence in the democratic process of collective bargaining would be strengthened.

A further advantage of this procedure is that it can restrain inflationary decisions without the necessity of any form of governmental price or wage control. Price and wage actions would still flow from the voluntary decisions of free men in a free society. But just as the freedom to make such decisions is limited in a completely competitive economy by the restraints of the competitive marketplace, so under this proposal the freedom to make such decisions would be limited by the restraints imposed by an informed public opinion, which should be mobilized to discipline voluntary actions and make them responsible. Thus the democratic concept of ultimate public authority over decisions which vitally affect the public interest would be extended from the political sphere, where it is recognized as the cornerstone of a free society, to the economic sphere where it is equally important that the concepts and the processes of democracy should prevail.

CONCLUSION

Our economy today faces three vital domestic problems:

With industry still operating at far less than capacity, and unemployment still much higher than it should be or need be, our economy is slowing down.

We have vast areas of social needs unmet, especially those which affect our ability to solve the problems of our cities, of our minorities and of the poor, which increasingly threaten the stability of our whole society.

We are undergoing a round of inflation which causes hardship to millions of families and also threatens to disturb our economic stability.

We in the UAW believe that for the first two problems there is only one answer—we must adopt programs to meet our social needs, and do so in such a manner as will stimulate the economy to produce the necessary goods and services and so reduce unemployment.

To solve the third problem, we must stop relying on processes of economic restraint which increase unemployment and reduce our ability to meet social needs, without effectively checking inflation. Instead, we must examine carefully the real sources of inflation and the institutional forms and structures which foster it. Having done that, we can then develop new approaches, based on the economic realities of the situation, to restrain the inflationary forces. In particular, we must find means to insure that those who make private decisions vitally affecting the economic welfare of all the people are subjected to the democratic pressures of an informed and enlightened public opinion.

We hope that this statement has contributed to the achievement of these goals.

UNITED MINE WORKERS OF AMERICA

By W. A. Boyle, President

We appreciate the opportunity to present the views of the United Mine Workers of America on the state of the U.S. economy.

We believe that the objective of governmental policy in the economic sector should be the fullest development of the human and material resources of the United States. This development should be carried on within the framework of our social and political institutions and should reflect the dedication of our Nation to the cause of human dignity and justice.

President Johnson, in his economic message this year, stated the objective of governmental policy very well when he said:

> "I regard achievement of the full potential of our resources—physical, human, and otherwise—to be the highest purpose of governmental policies next to the protection of those rights we regard as inalienable."

We share these views. Our remarks are aimed at helping to create policies which will further their implementation.

We would like to comment in this paper upon three areas which are in need of governmental action in order to insure the fullest development of our human and material resources. There areas are:

(*a*) Research and development.
(*b*) Import programs.
(*c*) A national energy policy.

Research and development is perhaps the single most effective means to achieve national economic growth. Unfortunately, in our view the current status of research and development is such that it does not contribute all that it could to such progress.

When considering the efforts made by the Government in the field of research, we should not confine ourselves only to dollars. It may be argued that we have an almost unlimited fund of dollars. But, it is obvious to even the most uninformed that we do not have an unlimited number of men of science. Thus, when we commit a part of that human resources to one project, we forgo its application in other areas where such talent might be used to better advantage.

As it now stands, the bulk of the money for energy research is being spent in the atomic energy field. For the fiscal year 1970 the Atomic Energy Commission has budgeted more than $700 million to this area. This compares with the total request for the Office of Coal Research of $13,300,000.

The discrepancy is obvious. It is all the more apparent when we consider that the Atomic Energy Commission has spent more than $3 billion to develop the civilian atom since 1946 and that the Federal Government has granted to the atom privileges accorded to no other agency of government in our history.

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There are many arguments that can be made against the disproportionate share of research resources going to atomic power. There are many arguments that can be advanced that coal is being shortchanged. In the final analysis, however, coal research should be expanded because coal research holds the brightest promise of future benefits to the American people, benefits that can be measured in terms of economic progress and human welfare. Consider some of the following facts:

(a) Coal is the most abundant energy resource available within the continental United States. It is estimated that coal reserves form more than 80 percent of our total energy resources.

(b) Coal is well situated geographically with reserves located throughout most of the United States. Coal is mined in 26 of our States.

(c) Coal mining is a well-known and highly efficient technology.

(d) Coal miners are the most productive workers in the world.

(e) Coal is the mainstay of the American industrial economy, fueling more than 50 percent of the electric generation in the United States. It is also vital to the manufacture of steel and is an important contributor to the making of cement and many other industrial products.

(f) Coal is the "mother" fuel and as such is capable of producing most of the hydrocarbons upon which America depends.

(g) Coal, in its production, transportation and consumption, is one of the major American industries and contributes directly and indirectly several billion dollars to the U.S. economy each year.

To say that coal is important is to state the obvious. It is apparent that coal will be needed for many decades and even centuries to come. From this it is easy to reach the conclusion that the Federal Government would be wise to provide for an adequate coal research program. With coal research the following results can be accomplished:

(a) The efficiency of electric generation can be increased to a significant degree, with the resultant economy in fuel utilization, a lowering of thermal pollution and a wiser utilization of our national energy resources.

(b) Many of the problems of environmental pollution incident to the burning of coal would be reduced and eventually eliminated.

(c) The conversion of coal to liquid and gaseous fuel would be made a reality with a fuller development of our coal resources and an increase in industrial activity in coal mining areas.

(d) America could once again become self-sufficient in energy. In short, we are suggesting that the application of research dollars to coal would be beneficial to the economy and would foster economic progress out of all proportion to the actual money expended.

Finally, research in the fields of coal mine health and safety is vital to the national effort to reduce death and disease among our Nation's miners. For too long research in this area has been given short shrift by the Government. But, it is now obvious that unless new methods are developed to permit a safe and healthy environment in our Nation's coal mines, America will refuse to accept the cost in human lives that is now a tragic part of coal mining.

Over the past several years the American coal industry and many others have staggered under the burden of unfair foreign competition. At the same time, American industry has been prevented from entering foreign markets by a variety of controls imposed by foreign governments to protect their own industries. This situation has reached a point of crisis.

Last year, approximately 93 million tons of residual oil in coal equivalent entered the United States. This total represents a 12.1-percent increase from 1967 and a 125-percent increase from 1959 when import controls were first introduced.

Because of the policies surrounding the administration of the residual oil import program, there is in fact no program. The result has been the accelerating loss of markets for coal along the east coast of the United States. Each day we hear of other consumers who have switched from coal to imported residual and each day the danger of even more conversions becomes more and more acute. The result of this invasion has been twofold:

(*a*) It has reduced the ability of coal to compete along the east coast.

(*b*) The east coast is fast becoming a captive of foreign nations for its fuel supply.

But, there is another and perhaps more dangerous implication behind the increase in foreign oil imports. That is the effect which such imports have on the over-all oil import program and thus the fullest development of our own national resources, especially our coal resources.

It is well known that coal is the basic energy reserve in the United States. It is also well known that coal can be made into oil and other hydrocarbon products.

However, we are at the moment of decision in this area. We can proceed to develop our coal resources for such uses and reap all of the advantages of such development. Or, we can kill the fledgling coal-to-oil industry by overdependence upon cheap foreign oil.

America in her infancy faced a similar dilemma. At that time she chose to develop her own industries rather than to rely solely upon the good will of foreign nations. Such a choice must be made today and the same decision should also be made.

Other nations have learned this lesson well. In nation after nation restrictions have been raised against the import of American goods in favor of domestic industries. To prove our point, we have only to look to the experience of coal which is barred from at least one major industrial nation and restricted in many others. The moral is obvious. We must protect ourselves as other nations are doing, or we will soon lose that strength which flows from our industrial economy.

Finally, there is the question of energy policy.

America is both a major producer and a major consumer of energy. Coal, oil, natural gas and electric energy constitute four of the major industries in our Nation. Each are expected to continue to grow as the energy demand of the nation expands.

America consumes tremendous amounts of energy. The United States consumed in 1967 (the latest year for which figures are available) 2.2 billion tons of energy in coal equivalent. Of that total, 21.9 percent was in the form of coal. The bulk of the energy consumed in this country is produced within our borders. But, in recent years an ever-increasing amount has come from abroad.

The atom is now a force in the American industrial scene, due largely to Federal subsidies and a favorable climate created by the Federal Government.

Laws covering the energy industry are a crazy patchwork which are often in conflict and which rarely complement each other. Government agencies view a sector of energy from a particular standpoint, but no single agency has the authority or the mandate to view the subject of energy in a rational, overall sense.

For example, the Atomic Energy Commission promotes the development of atomic energy as a competitor of coal. The Interstate Commerce Commission makes freight rates which have a direct impact upon the competitive ability of coal but that Commission has no responsibility for the health of the coal industry. Policies bearing on energy are made by several committees of Congress. Yet, no one committee looks at the question from the overall national view.

There are serious questions concerning the national welfare which can be answered only from this standpoint. There are questions relating to research and development. There are questions on imports and questions on the phasing in of the very large quantities of oil currently being discovered in Alaska and elsewhere. There are questions relating to the impact on the environment and the quality of life caused by the large-scale production of energy. Finally, there are questions regarding the competition between different segments of the energy complex and, indeed, between the parts of any single segment.

There is the question of the desirability of mergers in the energy industry. We have seen this trend with the coal industry and, more recently, we have witnessed the gradual takeover of coal by major petroleum interests. There is a similar development in the atomic field, with the emergence of a virtual duopoly in that area. There is the beginning of a similar trend in the electric utility field where cooperation can easily generate an atmosphere conducive to corporate concentration. The outcome is not yet clear, but the course of the events is ominous indeed.

Such disarray is not conducive to the national welfare, nor to the long-term value of our energy resources. We have suggested for many years that a national energy policy is required in the interest of the people of the United States. We suggest that such a policy is more important now than it has ever been before. We hope that the Congress will begin the task of developing a national energy policy without further delay.

We view the future of the U.S. economy with confidence. It is within our power to continue the long record of our Nation for economic progress within the context of social justice. With wisdom and a rededication of ourselves to this end, we will continue to forge ahead.

JERRY VOORHIS, PAST EXECUTIVE DIRECTOR, COOPERATIVE LEAGUE OF THE U.S.A.

Economic Problems Facing the United States

These comments will be limited to one problem area: that of the extortionate interest rates now prevailing in our economy with particular reference to the effect of those rates upon the shelter of the American people.

Prevailing high interest rates are economically indefensible, dangerously inflationary, and destructive to the supply of homes for the American people.

A few facts about past experience will be helpful. In May 1920 the Federal Reserve Board increased its rediscount rate substantially and advised banks to raise their prime rate to 7 percent, which the banks promptly did. The result was a decline in the total cash income from all farm products from $14,600 million in 1919 to $8,150 million in 1921. American agriculture was plunged into a state of depression from which it did not recover until the middle of World War II.

During the years 1941–46—war years, it will be remembered—the U.S. Treasury was paying as little as three-eighths of 1 percent interest on short-term borrowings. In 1967 the Treasury was paying more than 5 percent on similar borrowings. What these figures mean is that it cost American taxpayers $3,750 a year to borrow $1 million in the 1940's, whereas in 1967 it was costing them more than $50,000.

Each one-fourth percent increase in the interest rate adds about $1 billion to the annual interest which the American people must pay on the national public debt.

During the years of the Roosevelt and Truman administrations average interest rates on Government securities were held at about 2½ percent. If this could be done against the tremendous pressures of the most terrible and costly war in history it is obvious that the same policy could be followed under any conceivable circumstances—given the *will* and the policy on the part of the Government and the Federal Reserve to do so.

But this has *not* been done. Today the U.S. Government is paying more than twice the rate of interest on its borrowings that it paid during the 1940's and very early 1950's.

The result is that interest on the national debt is, next to military expenditures, the largest burden the taxpayers must meet in the entire national budget—amounting at present to about $15 million a year. At the rates prevailing in 1951 that figure would be less than half what it is today.

In August 1967 Chairman Patman reported to the Congress that the American people had paid $43 billion in excess interest charges on the national debt alone since 1951.

Out of a tax payment of $1,000 paid by a married man with two children and a $10,000 income, no less than $120 goes to pay needlessly high interest on the public debt.

The Federal Reserve banks can exercise an almost limitless money-creating power—a power which should be a function of national sovereignty. Therefore, *if* the Federal Reserve Board wishes to—or if the Government of the people is able to persuade it to—it can support Government securities at a decently low and economically justified rate of interest. This is substantially what was done during the Roosevelt and Truman administrations.

The reason it is so important for the rate on Government securities to be kept low is not far to seek. For the rate of interest on Government notes and bonds is the bellwether of all other rates. Investors generally will not buy other bond issues unless their rate of return is somewhat higher than that on Governments, since Government securities are generally regarded as the most secure investments of all. And if the rate of return on bonds goes up, then companies seeking to sell common stocks must try to show a rate of return on those stocks which is higher than the rate on bonds. For, again common stock equity investments are in general more risky than investments in preferred indebtedness like bonds. Hence there exists an insistent pressure upon every corporation which is interested in the market for its securities to increase the prices of its products in order, in turn, to increase its profit margins and thus make possible the payment of higher and higher dividends.

And yet the excuse that is constantly given for a high interest policy is that it is "necessary to curb inflation." We pay further respects to this deceptive myth later on.

The problem is not that interest rates *could* not be lowered if those who control our monetary policies wanted to do so. The problem is that the Federal Reserve Board, which is able to dictate monetary policy, deliberately decided—albeit by a 4-to-3 vote—in December 1965 to embark on a high interest policy. That policy has been in effect ever since and in increasing tempo. And the Government of the people of the United States has not acted to reverse that policy. Indeed, since the power to create the money of this Nation has been permitted by Congress to be taken over by the banking system generally and by the Federal Reserve specifically it is questionable whether under present circumstances the Government could, even if it were to decide to do so, compel the money powers against their will to reverse their escalating interest policy.

Congressman Patman's bill, H.R. 11, would go a long way toward correcting this situation and certainly, at the very least, that piece of legislation should be enacted by the Congress.

For the extortionate interest rates now afflicting our country are endangering the economic health of our Nation and preventing constructive progress in many important directions.

We Live in a Credit Economy

We are living, as everyone knows, in a credit economy. Almost every State, city, town and school district in the Nation, most American families, practically all American farmers and the great majority of American business enterprises are in debt up to their ears. The rate of interest therefore may well be the most critical factor in our entire economic life.

It is probable that a majority of American families are living beyond their present means. And no wonder! For they are bombarded by every advertising medium there is with the most clever blandishments to buy now, fly now, do everything else now—and pay later.

In 1966, the first full year after the Federal Reserve Board raised its rediscount rate by 12½ percent, $125 billion was paid in interest on debts, public and private. Today that figure would be much higher.

In the 20-year period, 1946–65, consumer debt rose tenfold, from $8 billion to $80 billion. And farmers' debt trebled in the 15 years from 1950 to 1965.

It is reliably estimated that between 15 percent and 20 percent of all the disposable income of American families is today obligated for payments on installment and mortgage debt.

And probably 30 percent to 40 percent of the total incomes of the poorer families are so encumbered. It takes no great intelligence to see that the higher the interest rate, the less the likelihood that these families will be able to pay off their debts.

Under such circumstances the suggestion that unemployment be deliberately increased in order to control inflation is not only unbelievably cruel, but economically extremely dangerous. For with the mountain of indebtedness that now hangs over most families even a minor downturn in the economy could trigger such a succession of defaults as would plunge the Nation into a major depression.

The Government therefore cannot conceivably allow this to happen. Therefore the mounting burden of debt being imposed upon the people, aggravated by the spiraling of interest rates, becomes a powerful, if not an imperative influence necessitating ever broader governmental action to forestall the possibly disastrous results of its misguided high-interest policy. Some of the very people who decry governmental interference in the economy are the ones who are making such interference necessary by their extortionate inflation of the interest rates.

And what a job has been done. Beginning with the action of four-sevenths of the Federal Reserve Board in December 1965 we have witnessed—and been victims of—an almost continuous rise in the rate of interest. The rediscount rate of the Federal Reserve now stands at an unprecedented 5½ percent, the prime rate for bank loans is 7 percent and above—again almost unprecedented—and the rate on FHA-insured mortgages and veterans home loan mortgages has just been increased to an effective 8 percent, made up of a basic 7½-percent rate plus one-half-percent insurance fee. To the devastating effects of 8-percent interest on the hopes of the American people to have decent homes and decent shelter over their heads we shall return later on.

In State after State moneylenders are bringing pressure to lift the ceiling in the antiusury laws. In Illinois legislation is pending at this moment which would raise that ceiling to an extortionate 9 percent. And this is the proposed rate not for consumer loans, short-term credit or revolving credit, but for prime lending by banks.

And the end is not in sight. Increasing interest rates is an unjust method of trying to curb inflation.

It is unjust because the burdens of the higher rates fall in exactly the wrong places. First, they fall most heavily upon the poor who are the most defenseless against them. Second, they fall most heavily upon the homebuilders and the home buyers, whereas America's one greatest unmet economic and social need is for more good homes in good neighborhoods at costs they can afford. Third, high interest falls especially heavily on farmers, the very producers of whose production we need vastly more, if world hunger is to be prevented. And, fourth, small competitive businesses are severely penalized by high-interest rates in their struggle to stay alive in competition with giant conglomerate corporations.

Now what we don't need more of are big, fancy automobiles, a fifth color television set in every bathroom, or several billion more cigarettes. Yet the huge corporations that control these manufacturing segments of our economy are, generally speaking, not affected by the high-interest rates for the reason that their profit margins are generally so high that they can get all the financing they need from internal financing and without borrowing a cent.

At this point I cannot refrain from further discussion of the relation between the growing and almost all powerful monopolistic segment of our economy as contrasted with the struggling and disadvantaged sector which remains competitive. Economists frequently discuss our Nation's problems with a complete disregard of the effects of monopoly, oligopoly, and the artificially controlled production and administered pricing which result therefrom. Erroneously it is assumed that the three or four corporations which in each case effectively control such industries as food processing, automobile manufacturing, containers, chemicals, farm machinery, electrical equipment, steel, and many other key industries are subject to general economic influences.

Such, however, is not the case.

On the contrary, and in striking contrast, to small businesses in the competitive sector, these giants are able to do practically all of their financing by the simple process of overcharging the consumer for their products. They thus derive sufficient profit margins to buy out competitors, to expand plants, and to do anything else they decide to do without the necessity of either borrowing any money or selling any stock. They are literally, therefore, private sovereign "nations" responsible to absolutely no one except their own managements and boards of directors.

Raising interest rates has absolutely no effect in "cooling off" these giants.

The prices of their goods are fixed by decision of management and their boards of directors at the point of highest practical and defensible return. The so-called "law" of supply and demand has no effect. The prices of these commodities may actually rise, even in the face of economic conditions which would compel declines in price for competitive industries. Price competition is a thing of the past. It is no great oversimplification to say that the reason farmers receive only about two-thirds on the average in income as do the rest of the population is because the people are compelled to pay monopolistically fixed prices for automobiles.

All this is another and very powerful reason why raising interest rates adds materially to the disadvantage of all competitive and smaller businesses and encourage on the other hand, the monopolistic tendencies already strong in our economy.

Why then, would any nation in its right mind pursue such a mad high and escalating interest rate policy as our Nation is now doing?

Certainly not because there is the slightest economic justification for it. The banks, the money lending institutions generally, are making such large profits—and have been doing so for many years—that their stock is so valuable that it is seldom sold and almost never on the open market. Indeed it has been repeatedly found that many businesses make more money out of their "financing" of sales than they do out of the sale of the merchandise itself. A basic reason why Congress finally passed, after 8 years of struggle, the "truth-in-lending" law was because it has become common knowledge that the extension of credit and the so-called "financing" of sales is the most oppressive, extortionate, racket ridden but fabulously profitable business in our entire economy.

Nor can it be honestly argued that high interest rates are the natural result of the tired old law of supply and demand—a so-called law now observed far more in the breach than in the observance. In the case of money such an argument is almost ridiculous. For under our fractional reserve system the supply of money is virtually a function of the demand for it. The banking system creates the money of our Nation by the costless method of writing up demand deposits on its banks and loaning them into circulation to borrowers. Can anyone find a banker or moneylender who is today refusing to make a 7- or 8-percent loan to a reasonably good risk borrower? Probably not. But when those loans are made—as a result of the demand for money—the supply of money automatically is increased to meet the demand.

So we come back to the threadbare and by now abundantly discredited excuse that high interest rates are necessary in order to curb inflation.

It is frequently lamented that in the past 25 years the dollar has lost 50 percent of its buying power, because of what is called inflation. Well, in that same period, interest rates have more than doubled. In fact they have more than doubled in just the last 16 years. If raising interest rates were an effective method of curbing inflation these two events could not possibly have happened simultaneously.

When the Federal Reserve Board raised its rediscount rate in December 1965 I wrote in my biweekly column "The People's Business" the prediction that it would not be long before we would be paying 10 percent more for houses, and 10 percent more for almost everything else we, the people had to buy. I received some criticism for that statement, including that of one of the Federal Reserve banks.

But my statement was the soul of conservatism. For the fact is that prices have risen considerably more than 10 percent since the high interest policy was launched in December 1965.

My argument then was—and it is today—that the cost of money is, in our present credit economy, a factor in the cost of production of every commodity or service in the market, except those produced by the internally financed giants who need not borrow. Therefore, the greater the cost of money, the higher will be the price consumers must pay for their necessities and amenities of life.

History has certainly proved this to have been the case. The higher interest rates have risen, the worse the price inflation has become.

Even were the facts of history not convincing a bit of widely accepted economic theory can be cited. That theory is that the way to bring less of something onto the market is to reduce the price received by producers. Especially is this argument used against farm price supports.

How then can it be contended with a straight face that the way to reduce the amount of money and credit being created is to *increase* the return to the creators and lenders of that money and credit? Yet that is precisely the position in which the high-interest advocates place themselves.

There is one circumstance in which, it must be admitted, high-interest rates can curb inflation. If these are raised *high enough* to cause widespread unemployment and to bring about a wave of bankruptcies, foreclosures, and defaults, then indeed inflation will be stopped. For we will then be in a downward spiral of deflation, depression, and economic collapse.

But I am confident that no one—not even the most ardent of the high-interest advocates—is willing to pay that high a price to validate the otherwise discredited myth that raising interest rates is a counter-inflationary measure.

In fact, the price we are now paying is indeed far too high.

For the high-interest rates operate as a heavy tax on everyone, not only at the Federal level, as was explained earlier, but at the local level as well. Higher interest rates mean that every school bond issue, every bond issue for urban improvement, or pollution control, or any other good purpose costs the taxpayers just that much more. This was no doubt a major reason why the schoolchildren of a large Ohio city had to forgo their education completely for a 6-week period because the voters turned down an essential bond issue for school financing. Shortly before the Newark, N.J., riots, that city had been forced to cancel a $15 million bond issue, the proceeds of which were to be used for improvements of life in the ghetto. And the finance director of Newark stated at the time that: "The prime factor in our decision was the increasing interest costs municipalities have to pay in recent weeks."

As interest rates rise the cost of government and hence the burden of taxation goes up almost in geometric proportion to the rate increases.

High-Interest Rates Are Depriving the People of Homes

With all the talk about the values of homeownership and despite all the constructive legislation that has been passed by Congress to try to encourage homeownership the fact is that more than half of all American families are priced clear out of the market for homes today.

The one reason for that fact is the extortionate rate of interest. Other cost factors are of comparatively little consequence.

The average cost of homes built in 1968 was more than $30,000. But it takes an annual family income of close to $9,000 for people to be able prudently to afford even a $20,000 home; $9,000 is far above the median income of the American people.

Here are the facts.

In the case of cooperative-owned housing which is built not for profit but solely because people need housing at costs they can afford, the monthly charges to the cooperative homeowners must go up by between $3 and $4 per room per month forever; 1-percent rise in the rate of interest.

Even at 6¾ percent—the rate only a short time ago on FHA-guaranteed loans—a family attempting to buy a $25,000 home on a 25-year mortgage had to pay almost $27,000 in interest alone—$25,000 for the home; $27,000 to the moneylender.

But at the present 7½-percent rate—disregarding the ½-percent additional insurance fee—a $20,000 home bought on a 35-year FHA-guaranteed mortgage obligates a family to pay more than $60,000. Twenty thousand dollars for the home—all the brick, wood, plumbing, fixtures, labor, every other cost—but $40,000-plus just for interest on the money.

Such a situation is manifestly unjust to every American family except the richest ones. It is indefensible from any decent economic point of view. It means in simple terms that well over half the American people are priced clear out of the market for homes. *And it is utterly unnecessary.*

The first reason why it is unnecessary is because Congress could correct it by implementing with adequate appropriations its own Housing Act of 1968.

Under that act provision is made for Government subsidies to home buyers such as would reduce their effective interest payments to 3 percent, or even 1 percent. And it is a fact that for moderate-income families a 3-percent rate is all that can be afforded, and for low-income families even 1 percent may be hard to meet. But very substantial appropriations will be required if this implementation is to be at all meaningful or to have any real impact on the need for homes of the entire lower income half of our population.

And, obviously, the higher the interest rate, the greater the cost of such a subsidy program.

Again, if it is desired to bring more private funds into participation in the housing program, the Congress could provide funds to subsidize the difference between a lending rate that average families could afford to meet and the going rates of interest. Here again the cost to the Government—and hence to the taxpayers—will be multiplied by every ½-percent increase in the going interest rate.

A third method that has been used in other very worthwhile programs of our Government and which is indeed appropriate in the present situation is direct lending by a Government agency.

Such direct lending could have the competitive result of bringing down the usurious rates now in effect in the private money markets. Furthermore, if the funds to be lent were not borrowed by the Government lending agency but were derived from tax revenues, as they should be, then it would be entirely sound economically to make the loans at a rate simply sufficient to cover administrative costs and to provide a reserve against possible losses. Experience with other similar direct lending programs clearly indicates that the Government could "make money" at a 3-percent or even perhaps a 2-percent lending rate through such a direct lending program.

In these comments considerable has been said about the ineffectiveness and the moral wrong of trying to curb inflation by raising interest rates.

Therefore it is necessary to suggest how inflation can be kept within bounds by other, better, more effective, more direct, and more morally defensible means.

A number of such means are available.

First is the rather obvious step of reducing the money-creating power of the banking system. This the Federal Reserve Board can do at any moment by increasing the reserve requirements for demand deposits. In somewhat oversimplified terms here is what such an increased reserve requirement would mean. Whereas before the increase in required reserves the banks could create new money in the form of demand deposits at a ratio of 7 to 1 to their reserves, after the new ruling they would be able to do so only in the ratio of 4 or 5 to 1. Here is the most direct method in all our presently existing monetary system of dampening monetary inflation. Why the Federal Reserve Board has not used it, if it was so alarmed about inflation, would be hard to understand were it not for the fact that all the voting stock in the Federal Reserve System is owned by the very same banks whose money-creating power would be curtailed by such a move.

Nonetheless, an increase in reserve requirements would be a far more direct, immediately effective, logical, and economically defensible counterinflationary move than is raising interest rates.

Second, if anyone—repeat anyone—is really concerned about price inflation, overextension of credit, families living beyond their means, "heating up the economy" or any such matters, a quick look should be taken at the nauseating saturnalia of credit card promotion which is now being foisted on an all-too-gullible public. If anything on earth is inflationary it is to urge people to buy and buy and buy whether they have any money with which to pay for it or not. Once the Truth-in-Lending Act becomes effective on July 1 and credit card promoters have to advise their cardholders of the rate of interest they must pay on their outstanding balances, some of the enthusiasm may be cooled. But meanwhile it is hard to understand why a nation worried about rising prices and increasing cost of living takes no action to regulate this credit card craze.

There have been times when the Federal Reserve Board by regulation has restricted the extension of credit in the economy. Wisely used, this method could act as a controller on the use of "buy now—pay later" inducements to consumers to acquire gadgets they may not need at "financing charges" nobody ought to afford.

Here again such action would be straightforward, could be aimed at the exact place where credit is being overextended, and could have a much earlier effect on any inflationary trends than raising interest rates.

At least two States—Texas and Pennsylvania—have completely abolished the garnishment of wages as a means of collecting debts. Such action by the Federal Congress would end, once and for all, the harassment to which wage earners and their employers are so often subjected. It would also have the effect of cooling the present avidity of unsolicited salesmen in trying to induce families to buy things they cannot wisely afford.

Finaly there is the basic method of taxation.

The fundamental way to stimulate an economy which is sluggish is to put more money in circulation. And if it is felt necessary to slow down economic activity the classic and fundamental way to do so is to produce a governmental surplus by means of taxation. Furthermore, it is the honest way to do it—provided always that the incidence of the taxation falls upon those best able to pay, who are also in practically all cases the ones who receive the greatest benefits from Government services and protection. At present it is highly questionable whether our tax system is just from this point of view. The need for tax reform is quite evident. But with that subject these comments do not attempt to deal.

The only humane, economically sound, or growth-inducing policy that makes sense in this debt-burdened world is a low-interest policy.

And to the extent that taxation—in accordance always with ability to pay—is actually necessary to prevent precipitous increases in the price level, we the citizens of our country should be willing to pay.

Especially should we be willing to pay enough taxes to pay currently the cost of every war in which we may, tragically, become involved.

The 19-year-old youngsters whom we compel to fight in Vietnam didn't cause that war. We did, by our failure to create peacekeeping machinery in the United Nations strong enough to stop and settle it, with justice and in orderly fashion.

Therefore, at the very least—if the older generation of Americans had the decency we should have—if our love for our children were as sincere as we like to claim it is—we should be demanding that taxes be increased at least enough to pay the cost of that war.

Unless the older generation does this, we of that older generation are in the position of not only compelling our children to fight and die and learn to kill in a war they did not make, but also of forcing them to pay our bill for it at some future date, when the bonds come due.

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