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THE 1970 ECONOMIC REPORT OF THE PRESIDENT

HEARINGS

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THE 1970 ECONOMIC REPORT OF THE PRESIDENT

MONDAY, FEBRUARY 23, 1970

Congress of the United States,
Joint Economic Committee,
Washington, D.C.

The Joint Economic Committee met, pursuant to recess, at 10 a.m., in room G–308, New Senate Office Building, Hon. William Proxmire (vice chairman of the joint committee) presiding.

Present: Senator Proxmire; and Representatives Reuss, Griffiths, and Conable.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Loughlin F. McHugh, senior economist; and Douglas C. Frechtling and George D. Krumbhaar, economists for the minority.

Senator Proxmire (presiding). The committee will come to order.

Today we resume our hearings on the President's Economic Report and the State of the Economy.

Chairman Patman is suffering from the flu and has asked me to assume the duties of chairman in his stead today.

We are all anxious for his quick recovery and return to the hearings.

This week we have four distinguished economists who will discuss the outlook. These men have devoted a considerable part of their professional lives to the analysis of business conditions. Drs. Bassie and Lewis are alumni of the Government. Mr. Bassie is currently a director of the Bureau of Economics and Business Department of the University of Illinois. Dr. Lewis is now chief economist of the National Planning Association succeeding the late Gerhardt Colm who for many years helped this committee in its deliberations.

Mr. Murphy is chief economist and manager of economic forecasting operations with the General Electric Co.

Mr. de Vries is now with Morgan Guaranty, and Mr. de Vries, I spent some time with J. P. Morgan & Co., kind of a predecessor.

Mr. de Vries spent a number of years with the Federal Reserve in New York.

The economic outlook is perhaps more challenging this year than it has been in most of the past year. The signs are more conflicting. On the one hand we have many signs of recession, increasing unemployment, lower automobile and durable purchases, depressed situation in housing, to name a few. On the other hand, business investment is apparently increasing at full speed and prices continue their sharp rise.

So, gentlemen, your work is cut out for you.

Our first panelist this morning is Mr. V. Lewis Bassie, professor of economics, University of Illinois.

May I say I have studied all of these statements, and I am very impressed. They are most stimulating and I am looking forward to an enjoyable morning.

STATEMENT OF V. LEWIS BASSIE, DIRECTOR, BUREAU OF ECONOMIC AND BUSINESS RESEARCH, UNIVERSITY OF ILLINOIS

Mr. Bassie. Thank you, Mr. Chairman.

The theme that stands out above all others in the Economic Report and in the design of the Federal Budget is the fight against inflation. There has been much loose talk about the evils of inflation. Among the erroneous ideas appearing in official documents in recent years are the following:

Inflation cuts into our income.
Inflation is a cruel tax.
Inflation is a hardship for all.

All these statements are rhetorical appeals for popular support of something called anti-inflation policy. They err by ignoring the circular flow of income, which specifies that every dollar paid is a dollar received. When more dollars are spent, more income is taken in. Therefore, inflation does not reduce income, it increases it. Inflation is not like a tax, which withdraws income from the stream; it augments the flow of income. Whatever the buyer loses, the seller gains. Therefore, there can be no hardship on everybody; only the losers suffer.

When prices are not controlled, measures may be taken to give relief to the losers. That really represents a counterattack against the evil of inflation, and the recent increase in social security benefits is such a measure. But if action is aimed only at the losers, it cannot solve the problem, and in fact may aggravate it.

Similarly, action taken on the assumption that inflation itself, rather than the harm it does, is the evil to be eliminated is misdirected. Measures to hamper the economy and thus restore equilibrium between demand and supply are uncertain and indiscriminate in their effects. However, they mostly let the gainers keep their advantage. So that approach is essentially an appeasement of the larger majority who do not like to pay higher prices, whether they are better off or not.

The man whose paycheck rises 10 percent but complains because prices rise 5 percent is in effect expressing a selfish desire that only his own income should go up. That kind of greed is typical of the psychological state that develops at the peak of an inflationary boom.

Each group that is profiting tends to find its excuse in the actions of others. Each is "only trying to keep up."

The one group whose prices have risen the most is also the most vocal about the need for preserving the integrity of the dollar. It consists of the bankers and other lenders whose interest rates have been breaking records.

This group has its own special explanations for a price advance which has exceeded that of any other industry. The first is the presumed need to fight other people's price increases through monetary policy. The second is the theory of the "real rate of interest"—a pseudoscientific concept that is used as a rationale for gaining acceptance of high charges. But there is no need for policymakers to agree with this kind of sales pitch.

The spectacular rates achieved were only possible because of Government encouragement and assistance. Policies of the Federal Reserve Board under Chairman Martin consistently supported the financial industry's drive for greater prosperity. The results may be seen in any city; the banks and other financial institutions have built and occupy the tallest, and most luxurious office buildings all across the country.

The Fed is presumably acting to guard the public interest and refers to its policy as tight money. Actually, there has been very little tight money. Belatedly in 1969, when the boom was at its turning point, the money supply was merely held stable from July to December and business loans and consumer credit have continued to rise. All we have had is a high interest rate policy.

A truly tight money policy would, of course, have required interest rate ceilings and rationing of credit. The experience of the Korean war showed that selective controls can work where the market is imperfect, the product is standardized, and the business concerns know their customers. But except for a moderate increase in margin requirements, the Fed has done nothing to control the use of credit in specific areas. And the banks in turn, though cooperating in getting interest rates up, have used every possible means of making ineffective any restraint on credit expansion.

The trouble with high interest rate policy is that it aggravates the cyclical swings of business. On the upswing it stimulates speculative use of credit and contributes to the inflation; people are induced to borrow and spend in order to beat further price increases. On the downswing, the reverse is the order of the day; they hold off borrowing in order to obtain both cheaper money and lower prices later.

There is hardly any evidence that the high interest rates have restrained credit demand. The one sector substantially affected is housing, since credit was diverted away to competitive uses. However, the need for housing is great and construction labor does not readily shift to other employment; so efforts were made by housing and home finance agencies to keep funds flowing into the industry—which they did but without preventing a sharp decline in building.

This illustrates how reliance on market competition to allocate credit prevents the setting of priorities for desirable social goals. Unless other action is taken, extreme distortions occur.

The experience as a whole indicates that high interest rate policy is ineffective in overall terms; it is discriminatory against small and weak enterprises; it has a perverse effect on the income distribution by enriching lenders at the expense of borrowers and consumers; and it is too slow and too vague in timing to do any good after a downturn gets underway.

Recently, complaints that this policy has been maintained too long have been common. Warnings often include references to the misbehavior of the monetary authorities in 1929. Nevertheless, this pretense of control stands as the main reliance in the so-called fight against inflation.

The administration is hoping for a gradual elimination of inflation while the economy continues to grow at a slower rate. Despite all the arguments used to support this gradualist view, all the current statistics indicate that the economy is in the early stages of a recession.

Nobody can tell how far the decline will go because no controls are available to insure its end at any given point. The odds are that it will be minor, though continuing through most of this year and with unemployment rising to the undesirable high rates of a decade ago.

It will be primarily a durable goods recession. Business inventories, business fixed investment, and consumer durables will account for almost all of the decline.

The case for projecting a decline in business inventories is clear cut. Inventories on hand are fully adequate and should not be added to this year.

Attached is a chart (p. 288) which shows actual and calculated values of inventories. You will note that in the last 3 or 4 years the rise in inventories has been substantially above the calculated, and I assume that that condition will continue in the coming year. If it did not, there would have to be a drastic liquidation of inventories so severe that it probably could not be achieved.

This implies, however, a swing all the way to liquidation—as in 1967 but probably deeper and longer lasting. It also implies that business will still want to hold above normal inventories, maintaining about the same ratio to final sales as in the last 3 years.

Fixed investment also faces a setback. This forecast only mildly takes issue with the plans revealed by surveys. The 7 to 9 percent increases presumably contain a price component of about 5 percent. Removing this and allowing for the fact that there has already been an advance as large as the remainder, this indicator could be taken to forecast stability within the year.

But everything else points to a worse result. Capacity utilization is low and declining. The cost of carrying unneeded capacity is high, estimated at over 20 percent annually. Repeal of the 7 percent investment allowance takes away part of the incentive for new investment. Business liquidity is extremely low and will be squeezed further by the decline in profits.

The second chart (p. 288) shows for manufacturing an annual estimate only a little below 1969. Capacity utilization has recently broken through the 84 percent low that has prevailed since 1964, and later this year, with the continuing upsurge in capacity, it is likely to fall below 75 percent.

That is indicated by the little insert chart in the upper left of the second chart (p. 288), which shows how capacity continues up even though production declines in the year ahead.

The apparent stability estimated on this chart is somewhat misleading. During 1969 there was an uptrend in capital outlays, so that we are considerably above the average level, and the decline to the fourth quarter of 1970 will probably be as large.

None of the excesses of the boom have been liquidated. The fixed investment cutback will probably take over late in the year, when inventories approach the point of stability, and keep the recession going.

Note that this implies no basic change in business expectations and planning. Secretary Kennedy recently said "Once the inflationary psychology is broken, salutary effects will be felt." That is quite unlikely. With such a change, the decline could be much worse. The danger lies in a reversal of the whole massive credit buildup that has dominated economic trends during the 1960's.

The best reasons for thinking the recession will be mild remains the same as in earlier postwar years. They are the war programs and the Government supports for consumer income. Military stimuli have been important at critical points: Hungary-Suez in 1956, Sputnik in 1957–

58, the "missile gap" in 1961, Cuba in 1962, and Vietnam in 1965. Although President Nixon is cutting military programs, he has apparently decided to keep the war going on indefinitely by supporting the Thieu government, and indeed threatens to re-escalate if the enemy does not behave properly. New incidents could again have strong effects.

Social security benefits and tax cuts have also been important. Transfer payments rose from $17 billion in 1956 to $62 billion in 1969. The 15 percent added to social security benefits will raise payments by over $4 billion this year. In addition, the repeal of the tax surcharge will make an annual rate of $9 billion more of disposable personal income available to consumers.

Not all of the additional income will be spent. The saving rate will probably rise at least temporarily by about a full percentage point before spending is fully upgraded. The increases in income in small increments will support expenditures for nondurable goods and services more than automobiles and other big ticket items.

Consumer installment credit may again reach the point of actual though moderate liquidation, as in earlier postwar recessions; this would represent a deflationary impact of at least $8 million. Still the rate of real consumption expenditures in the second half of 1970 may hold nearly level with the same half of 1939. In current dollars, of course, they would be higher by most of whatever the price trend contributed.

Government purchases of goods and services will be neutral. The Federal budget projects a substantial decline but this will be approximately offset by continuing increases at the State and local level.

Only minor changes are likely to come from net exports and housing. Greater financial ease in the months ahead is likely to reverse the decline in building but not fast enough to affect the overall outlook substantially by the end of the year.

There is no guarantee that growth will be renewed in the second half or even that any particular level will be maintained.

The combined effect of the changes in prospect may amount to a decline of little more than 2 percent in real gross national product by the fourth quarter.

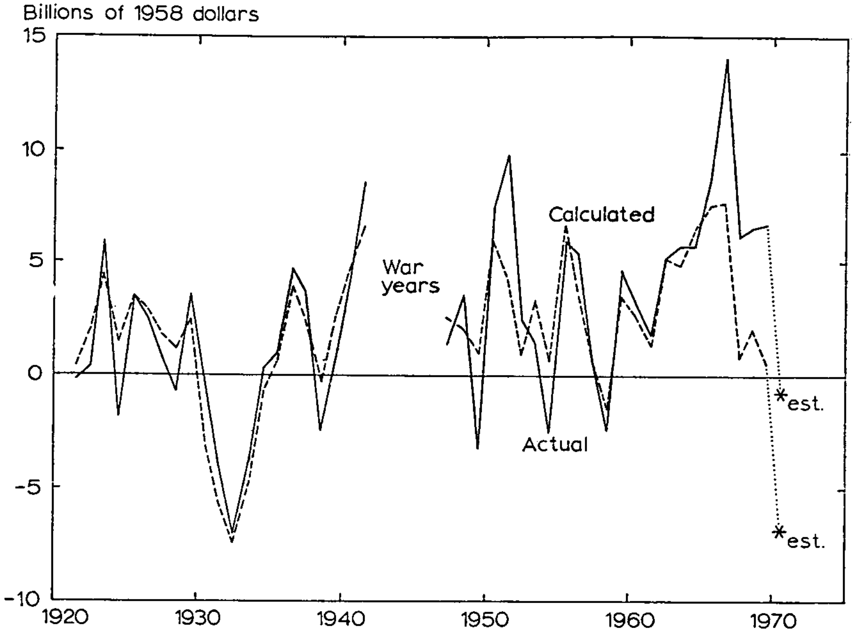
However, in terms of unemployment a recession of this magnitude would be very important. It is hard to calculate because productivity trends are confused and growth in the civilian labor force will probably be lower than the 2 million rate of 1968 and 1969 even with the release of a half million men from the Armed Force. Further cuts in working hours will be partly offsetting. Nevertheless, an increase of unemployment to over 5 million, or 6 percent of the labor force, is probable.

This forecast implies that the Federal budget will again move sharply into deficit. However, this will add no inflationary impetus, because the kind of deficit that arises from a decline in incomes and revenue merely cushions the decline in business.

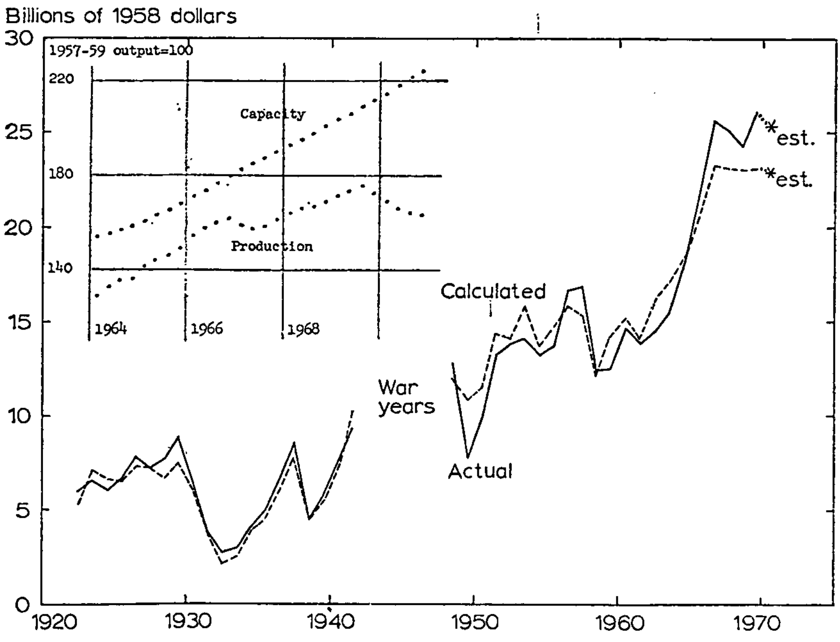
A decline of this magnitude, with idle capacity rising above 25 percent, will also have a distinct effect on price trends. Aside from possible adverse developments in agriculture, the advance in wholesale prices should be halted by the end of the year. Consumer prices will be rising, however, and the frustrations arising from both inflation and unemployment will produce increasing social tension.

(The charts accompanying Mr. Bassie's statement follow:)

Change in Non Farm Business Inventories



Plant & Equipment Expenditures, Manufacturing



Senator PROXMIRE (presiding). Thank you very much, Professor Bassie.

Our next witness is Mr. Wilfred Lewis.

STATEMENT OF WILFRED LEWIS, JR., CHIEF ECONOMIST, NATIONAL PLANNING ASSOCIATION

Mr. LEWIS. Mr. Chairman and members of the committee, all of us should express our appreciation to the Council of Economic Advisers for the highly professional quality of the new Economic Report, and for the full and frank discussion of the economic outlook and of the administration's economic policies. The last time there was a Republican Council of Economic Advisers, quantitative forecasts of the economy were deemed impossible and therefore not suitable material for the Economic Report.

Of course forecasts can never be certain, but that in no way relieves the Council from the responsibility for making them anyway, and of offering them to the public for discussion. There can be no intelligent opinions about today's economic policies without some guesses and targets for tomorrow.

So far as the Council's forecast for 1970 is concerned, it seems to me that the projected GNP of $985, representing a year-to-year increase of about 5½ percent, made up three-fourths by inflation and one-fourth by real growth, is fairly close to the midpoint of the range of plausible outcomes given present and proposed policies.

Moreover, the pattern of change projected within the year, with sideways movement of the economy in the first part of the year, and more rapid expansion in the second half, also appears near the middle of plausible outcomes. Personally, I would guess that GNP would start rising in the second quarter, rather than the third, as implied in the Economic Report, particularly if the Federal Reserve makes an early move toward credit ease and the administration appears to want them to do.

But of at least equal importance, there are very substantial risks of outcomes significantly higher or lower than this middle forecast, as the Council itself is frank to admit. Indeed, the economy appears to be in an unusually precarious position right now. On the down side, business investment appears vulnerable after a long period of stagnant or declining output, declining stock prices, expiration of the investment credit, profits squeeze, and disappointing returns on the large amount of new plant and equipment put in place in recent years.

On the other side, a too early easing of credit could easily touch off the long awaited rally of stock prices, revive inflationary expectations about the long run, and put up quickly back on the path of overrapid expansion of money GNP.

The administration plans to try to avoid both recession and renewed inflation by finely tuned fiscal and monetary policies that would hold real GNP growth to about 1½ percent for the year (compared to the over 4 percent required to maintain full employment), with unemployment rising gently over the course of the year. This is a policy which has a very small chance of succeeding, and if it did succeed, would not give us the kind of economy we should be aiming for. Our knowledge of the precise relations among rate of GNP growth, rate of inflation, and rate of unemployment, and the relation of any of these to small changes in money supply or budget surplus, is not all that exact in the best of years.

It is apt to be a good deal less certain in a year like this than in most years, because there is less consensus about, and more volatility in, longer run expectations. More important, the path being recommended, with GNP to be pushed well below potential and kept there for 2 or 3 years or however long it takes to squeeze inflationary expectations out of the system, is not nearly ambitious enough.

The outlook being offered promises slow growth, excessive unemployment, underutilization of our productive capacity, stiffly rising costs and prices, profits squeeze, and slow growth in Federal revenues. Moreover, there is no early end in sight; this highly unpleasant combination threatens to drag on under the administration's policies for several years with only very gradual relief.

Holding down the economy in this fashion means foregoing over the next 3 years about $40 to $50 billion of output that would otherwise be available for public and private use, and the slow growth of private incomes and Government revenues can only intensify the already bitter conflict between those wanting lower taxes and those wanting more public services. In addition, a promise of 3 years slow growth does much more than deflate inflationary expectations. It makes a mockery of the real output forecasts on which business plant and equipment spending of recent years has been based, which means that we would be living under a constant threat, already with us, I think, of a sizable recession and still higher unemployment which could be touched off by a drop in business confidence leading to cutbacks in inventory and fixed investment.

I do not conclude from this that a significant easing of monetary policy unaccompanied by other policy steps, would be a good move at this time. That would indeed raise the rate of growth of income and employment, but since it does not appear that what has been done so far has significantly cooled inflationary expectations for the long run, it could do so at the expense of touching off a new round of speculative increases in wages and prices, aggravating our already serious problems of inflation and balance-of-payments adjustment.

If there is one thing the events of the last year make clear, it is that our fiscal and monetary policy tools are simply too clumsy to deal appropriately with the expectational component of inflation, and that to deal with this problem we need support from additional policies; namely, wage-price guideposts.

I have the impression that many who were skeptical earlier about the usefulness of guideposts have been shaken by the continuing, indeed stepped-up, aggressiveness of pricing behavior in the face of extremely tight fiscal and monetary policy and very slow real growth of the economy over the past year. I also believe that many responsible business, financial, and labor leaders would not only accept but welcome a renewed guidepost effort.

Indeed, guideposts have a more important role to play in the present situation in which expectations are so clearly harmful to the economy than they did in the early sixties when there were not excessive inflationary expectations. In short, I think the time has come for the administration to admit simply that it overestimated the importance of impersonal market forces in the setting of wages and prices in our economy, and underestimated the importance of personal decisions.

Guideposts would not be asking for charity. Everyone would be better off if the rate of inflation were moderated all around, as we could then earlier resume a more rapid rate of growth of real incomes. Most business and labor leaders know this, but cannot afford to volunteer moderation of their own behavior when moderation is not even being asked for and when there are no rules for responsible conduct and no confidence that anyone else is going to be moderate.

It behooves us to try to set up a system that encourages rather than discourages business and labor statesmanship, and which makes it easier for business and labor leaders to moderate their own price and wage demands because they think that others will be doing the same.

As has been mentioned by several other observers, an important factor neglected last time around is having business and labor leaders participate in the guidepost formulation so that they do not smack so heavily of arbitrary government decision. The means might be an annual or semiannual convention, meeting under a public spotlight, in which it was made absolutely clear that a failure to reach agreement on some general rules for the coming period would entail both slower growth and more inflation.

Subsequent administration of the guideposts would then entail some public body, say a "Prices and Incomes Board" or, in, the language of Representative Reuss' bill of last year, a "Price-Wage Stabilization Board," complaining publically when particular price and wage actions clearly overstepped the general guideposts. Success in this phase of the work would clearly depend on the quality and objectivity of the staff work, and on a freedom from partisan politics. Good people would have to be selected, and then given substantial independence. Close supervision on a day-to-day basis by either the executive or legislative branch would be ruinous.

The effort should not try to delve into every nook and cranny of the economy, but should concentrate on price and wage decisions in key industries in which substantial market power rests in few hands. It is reasonable to expect that there would be substantial beneficial cost and demonstration effects spilling over into other sectors.

Guideposts can in no sense be a replacement for aggregate demand management through fiscal and monetary policy. Rather, they are a supplement to those policies. Since fiscal policy requires the joint efforts of the Congress and the executive branch, and since our ability to forecast the price and employment consequences of a given fiscal and monetary policy mix is less than perfect, we are seldom able to apply needed changes in fiscal and monetary policy in precisely the right amounts at precisely the right times. For these reasons, there must be an element of flexibility in the guidepost formulation. One of the unfortunate features of the previous guidepost effort was that the rules were too rigidly tied to the assumption that aggregate fiscal and monetary policy, working together with the guideposts, would in fact be successful in producing exactly a zero rate of inflation continuously. That is to say, the wage guidepost that was used would have been equitable if and only if there was in fact no inflation of consumer prices. Since policy was patently not able to achieve such an ambitious target, and probably never will be, the wage guidepost quite naturally fell into disrepute, and when demand management slipped badly in 1965 and 1966, the whole guidepost structure came tumbling down. A burden was placed on the guideposts that they can never be expected to bear successfully, namely, the preservation of price and wage stability in the face of excess aggregate demand.

What we need is a formulation that permits the guideposts to roll with the punch and retain some equity, credibility, and effectiveness in the likely event that fiscal and monetary policy will misstep from time to time. What this in turn requires, I think, is price guideposts that permit passing on some, but not all, of cost increases in an inflationary period and wage guideposts that permit wage rates to rise by more than productivity by some fraction of, but not less than the full amount of, recent increases in consumer prices. Just what these fractions should be in a given year is the main thing that has to be hammered out once or twice a year in consultation with business and labor leaders.

Enforcement should rely primarily on voluntary restraint in response to the pressure of public opinion, brought to bear by spotlighting patently unreasonable price or wage actions. Requiring advance notification of important price or wage actions, giving the technical staff of the "Prices and Income Board" time to study the merits of individual proposals in the light of the general guideposts, might be a useful feature. If a purely voluntary approach proves too soft, consideration might subsequently be given to the possibility of allowing the "Prices and Income Board" to issue, say, 6-month cease-and-desist orders if the proposed action clearly violates the guideposts.

We should face the question of equity squarely. A major objection to guideposts seems to be the proposition that since we clearly can't give attention to every one of the millions of price and wage actions that take place, and can never be 100 percent accurate in assessing the exact merits of those we do look at, it is grossly unfair to try intervention anywhere. There are several answers to this. First, there should not be punitive sanctions in the system. That is to say, compliance should be voluntary, and the only actual loss inflicted on someone refusing to comply would be having to answer hostile public opinion. If a business firm or labor union really has a meritorious case, it should be able to stand up to public criticism. Because of the imperfections in the best guideposts efforts, there should not be punitive actions such as penalty taxes or loss of Government contracts.

More important from the standpoint of equity, consider the equity consequences of the alternatives. It is very hard to argue that the arbitrary distribution of costs and benefits of either inflation or unemployment as among different firms, workers, or consumers is somehow less serious or less the concern of Government than the inevitable inequities of a guidepost policy.

When unemployment increases from 4 to 4½ percent because of fiscal and monetary policy actions to cool inflation it is not as though everyone in the country went home from work a few minutes early and took a small cut in pay. Rather some will be laid off altogether including some who have no unemployment compensation while others are as busy as ever and even enjoying pay raises.

Similarly what is equitable about people on fixed incomes having their purchasing power and standard of living eroded by inflation, while others may be making out and repaying their debts with deflated currency.

Incidentally, the argument that guideposts are inequitable certainly doesn't square with the proposal that they have no effect, although we sometimes get both arguments from the same source. In truth, they can have an effect, and while inequities cannot be avoided altogether, the inequities can be kept well below the inequities which go with not having guideposts, and which are no less traceable to Government action.

Guideposts should not be looked at as a panacea, and the effectiveness of a guidepost system will probably erode over time. However, they have a uniquely important role to play right at this juncture helping deflate some of the excessive expectations of our future inflation, so that we can get on with the job of expanding the economy along its potential growth pattern.

Unemployment right now is very near the target rate deemed to be noninflationary in the long term run by both the present and the previous administration. The January rate of 3.9 percent compares to the previous administration's 4 percent longrun target, and the present administration's long-term target, 3.8 percent.

Instead of aiming below potential, in the hope that we can gradually creep back up again after 2 or 3 years, we should move forward with early expansion of the economy along its long-term growth pattern, calculated by the Council of Economic Advisers at a 4.3-percent per year rate of growth of real GNP, while working down the inflation rate through a progressively tougher set of wage-price guideposts.

If we cannot devise a means of having 4 percent unemployment without inflation in the near future what confidence can we have that such a combination will ever be possible through fiscal and monetary policy alone? We certainly ran into inflationary problems the last time we tried to creep toward full employment without guideposts in 1956 and 1967.

When the economy is operating at or near the full employment, one small slip in aggregate demand management could always touch off a new round of inflation. We simply cannot afford to take 3 years off from full employment every time that happens and forgo the corresponding increase in resources needed to meet national goals.

Another important factor to be borne in mind is that many business costs will be lower and increase slower if we achieve 4.3 percent real growth next year than if we hold growth down to 1 or 2 percent. At slow growth, overhead costs have to be spread over fewer units of output, adding very significantly to inflationary pressures from the cost side.

Finally, since the administration seems to be strongly opposed to guideposts in any form, the question arises as to whether there is something the Congress might do on its own. While this would be an awkward second best, it may in fact be possible to set up some kind of "Prices and Incomes Committee" within the legislative branch without Presidential approval, but this would make sense only if the Congress were willing to keep the actions of this agency free from partisan politics.

When the Employment Act was enacted and for many years afterward, it was common to hear that this commitment to full employment biased the U. S. economy toward inflation. For the first 20 years, this fear proved unfounded, mainly because we managed to have frequent enough recessions that inflationary expectations never had a chance to take hold.

With recessions, recoveries, and periods of stagnation coming almost end to end, we managed between the end of the postwar readjustments in 1948 and the Vietnam war in 1966 to get unemployment down to the 4-percent target in not one single year other than the 3 Korean war years.

Now, at long last, we appear much closer to being able to realize the full employment promises of the 1946 Employment Act, which politicians of both parties strongly committed to avoiding recessions and having access to the kind of economic advice that should make that possible. When investors and businessmen talk about the long-range outlook, the discussion usually gets very quickly to President Nixon's strong aversion to recession and unemployment. This kind of promise, much more than the fact that we had large budget deficits during the Vietnam escalation, is what I believe has been making the business community so confident recently that the longrun outlook is inflationary.

Under these circumstances, there is a choice of two broad strategies for dealing with expectations. One is to retreat to the slow-growth policies of the 1950's, in which recession again becomes an ever-present threat. The other is to take advantage of the sophistication we have accumulated over the years in the use of fiscal and monetary policy to induce steady growth of real GNP in line with potential, dealing with the inflationary expectations that are unleashed at full employment by more direct means. I, for one, am sad to see retreat rather than advance in the face of these responsibilities and challenges.

Senator PROXMIRE (presiding). Thank you very much, Mr. Lewis. Our next witness is Mr. Frank Murphy.

STATEMENT OF FRANK P. MURPHY, CHIEF ECONOMIST AND MANAGER, ECONOMIC FORECASTING OPERATION, GENERAL ELECTRIC CO.

Mr. MURPHY. Thank you. My forecast closely parallels that of the Council of Economic Advisers—a slow first half followed by a modest acceleration in the final 6 months of the year. Gross national product in current dollars is expected to rise 5.5 percent during 1970, in real terms about 1 percent. This remains the most likely forecast but by a diminishing margin. Confidence in these prospects rests essentially on the assumption that monetary policy has and would continue shifting toward ease. Recent data on credit conditions have all but dashed these hopes. Credit is tightening again, and the odds on the occurrence of a major economic slowdown are rising rapidly. A recession of considerable proportions will be assured unless credit policy moderates significantly within the next few weeks.

Anti-inflationary policies have become a sacred cow. Acclaimed by businessmen, bankers, and economists with fervor, overly restrictive credit and fiscal policies have remained in place too long. Current evidence indicates only limited success in containing inflationary pressures and points directly toward economic disaster in the future if monetary policy is not eased. Anti-inflationary policies have hammered down real growth, as intended, but inflationary price gains have accelerated. Maintenance of current restrictions until inflation decisively ebbs would be foolhardy brinkmanship; the ensuing setback would be economically costly and socially destabilizing.

Fiscal and monetary policies have been asked to do too much, seeking to lower overall demand, they failed to focus on the specific areas where misalignment of supply and demand generated inflationary pressures. Meanwhile, business and unions, faced with the prospect of general softening in demand in their respective markets, jostled to improve their relative economic position by raising prices and seeking ever higher wages. While waiting for restrictive policies to bite, an inflationary environment was encouraged. Elimination of inflationary psychology may require high and protracted restraint until demand slumps drastically in a recessionary episode.

Avoidance of such an interlude requires greater emphasis on other techniques to supplement orthodox fiscal and monetary policies. Jawboning, casually laid aside and now in disrepute, certainly has a role in dampening the inflationary spirit. The inflation problem has been treated too simplistically, with excess money flows cited as the sole culprit. A considerable part of the inflationary pressure stems from structural deficiencies in the economy. Being long-range, it deserves and requires long-range treatment. Most important, the Nation must adopt policies designed to expand the supply of goods and services. Events have shown that suppression of demand is too inadequate, too clumsy, and too inequitable to be endured for long. We have accepted too readily the belief that the economy was operating at its ceiling. Yet the unemployment rate was high last year by the standards of other industrial nations; in addition, a large fraction of our industrial capacity was unused. Anti-inflationary actions should include greater efforts to lower unemployment and to raise capacity utilization.

Furthermore, new expansive policies which come to grips with the structural changes that have taken place in our economy must be developed. Specifically, we need to—

1. Raise productivity in the service and government sectors;
2. Examine Government spending patterns and operations in terms of optimum allocation of resources, efficiency and inflationary pressures;
3. Eliminate rigidities in industrial and labor markets which have hindered the mobility of labor and capital, both internationally and within the economy;
4. Encourage joint industry and Government sponsored programs to upgrade the skills of our work force; and
5. Encourage investment.

Market areas and industries readily affected by actions designed to crimp demand have shrunk relative to the economy. Durable goods' production and employment have declining shares in our increasingly service-oriented economy. Yet the service sectors, while relatively immune to current restrictive actions, have been leaders in the inflationary price surge. The demand for services, largely nonpostponable, is generally inelastic with respect to price and income changes.

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Thus, policies aimed at lowering overall demand must strongly depress the cyclically sensitive durable goods' industries in order to reduce general price gains. Unfortunately for economic growth, the durable goods' industries are one of the principal sources of increases in manhour productivity.

Instead of directing anti-inflationary policies at lowering total demand, public policies should be used to accelerate the allocation of resources to the service sectors, to enlarge the pool of skills and to raise the extremely low rate of productivity.

The Federal Government's role in accelerating inflation should not be slighted. Its impact extends beyond the well known and regrettable failure to raise taxes promptly when outlays for Vietnam shot up in 1966. Heavy procurement of defense goods shifted scarce labor and plant facilities from the production of civilian goods, increasing price pressures. Enlargement of the armed forces deprived the private sector of sorely needed employees, creating labor shortages. Quickened withdrawal from Vietnam and cutbacks in defense procurement should be considered part of the arsenal of anti-inflationary policies. They will enlarge the stock of resources available in the private sector and help to stem the onrush of prices.

In a more general sense, however, government at all levels is now spending a vastly enlarged share of the Nation's output. While debates have raged on the trend of efficiency in government operations, the evidence indicates that there have been steady but limited improvements. Yet, productivity of government employees especially at the local level, could be stepped up; revenue sharing with States should be conditioned, among other things, upon the State's use of part of the funds for installation of modern equipment and management techniques. Operations of Federal agencies should be studied on a cost-effectiveness basis. Appropriations for installation of new equipment and systems should be raised, particularly in the Defense Department, Post Office, and Internal Revenue Service.

The commitment to maintain high employment and stable prices is the hallmark of modern industrial economies. Today, some of our difficulties stem from a one-sided implementation of this policy.

While government agencies have erred on the side of expansion to assure achievement of growth, rigidities in industrial and labor markets, by impeding mobility of resources, have contributed to inflationary pressures. Restrictions in employment developed years ago in an era of job scarcity when workers, seeking employment security in a cyclical environment, barred easy entry into many occupations and adopted practices to spread the work.

Featherbedding, and craft and factory job rules are now obsolete in an economy achieving virtually full employment. The government's commitment to steady growth must be balanced by the willingness of the private sector to surrender its enclaves of protection. For example, the construction workforce, in limited supply today, has received exceptionally large wage hikes in recent years, feeding inflation. Employment in the building trades should be fully opened to minority groups backed by federally financed and industry operated training schools. Upgrading of industrial workers should be encouraged by subsidized on-the-job training. Immigration of qualified professionals should be expanded in the occupations where shortages prevail.

Occupational restrictions in medicine, education, engineering, and other professions should be reduced so that many routine tasks can be transferred from the limited number of fully trained professionals to qualified semiprofessional groups.

The number of physicians should be increased beyond the goal specified in the budget. Training should be encouraged by enlarged subidies to construct medical schools and increased financial aid for medical students. Generous investment in educational loans and scholarships is sorely needed. Hospital expansion and contruction should be supported by direct grants, the loan guarantee program should be enlarged, and the interest subsidy increased.

Industry, for its part, should be prepared to see imports rise during inflationary periods. Tariffs and import quotas should be flexible and anti-inflationary oriented in order to increase the supply of commodities when prices are climbing rapidly.

To the same end, investment should be encouraged to help lift industry productivity especially in the notoriously inefficient service sectors.

This Nation has inherited an institutional framework and an attitude formed in another age when the Government's major economic problem was to raise employment and the major concern of the workingman was a guarantee of job security lest recession eject him. During the 1970's anti-inflationary policy should turn from solely attempting to lower demand and address itself to tempering the social rigidities which hamper full use of our productive resources and limit output.

In summary, I expect inflation to ebb and real economic activity to increase moderately this year, but only if monetary policy immediately becomes less restrictive. If the present credit restrictions remain in force much longer, a major economic downturn will be assured. Such a setback would be economically costly and socially disruptive. It would reinforce tendencies in business and labor to seek security in further protective arrangements. It would also set the stage for a replay of inflation a year or so hence, since monetary and fiscal policy would become antirecessionary and undoubtedly overreact.

I recommend that anti-inflationary policies also aim at increasing supply and reducing institutional restrictions, which merely add to price pressures while encouraging actions to limit demand at a time when needs are unfilled. It must be remembered that it is the poor who suffer most from inflation—and from the current brand of anti-flationary policies.

Senator Proxmire (presiding). Thank you, Mr. Murphy. Our last witness is Mr. de Vries. Mr. de Vries, we are very happy to have you.

STATEMENT OF RIMMER DE VRIES, VICE PRESIDENT, MORGAN GUARANTY TRUST CO.

Mr. de Vries. Mr. Chairman, 1969 was a paradoxical year for the U.S. balance of payments. There was a deficit of nearly $7 billion, on the liquidity basis, the largest in the postwar period. Yet, it seems that there has been less concern and a more relaxed attitude about the balance of payments.

One of the reasons for this relaxed attitude is that the dollar has been strong vis-a-vis gold. The agreement to create a substantial amount of special drawing rights and the formation of the two-tier gold market have convinced many that an increase of the price of monetary gold can no longer be expected, at least in the foreseeable future. This has contributed to the decline of the price of gold in the free market and its recent stabilization at around $35 an ounce.

Also, the dollar has been strong in the exchange markets. As a result, in 1969 the U.S. gold stock and other reserve assets increased by more than $1.25 billion and liquid liabilities and certain nonliquid liabilities to foreign official institutions fell by more than $1.5 billion, yielding together a nearly $2.8 billion balance-of-payments surplus on an official settlement basis.

The nearly $10-billion difference between the two outturns of the balance of payments in 1969 can be ascribed mainly to the fact that liquid liabilities to foreign private entities increased about $9 billion during the year. Of this, $7 billion represented the increase in U.S. banks' liabilities to their overseas branches and most of the remaining $2 billion reflected other forms of Eurodollar borrowing by U.S. banks. The Annual Report of the Council of Economic Advisers estimated such direct foreign borrowing at $1.7 billion in 1969 as distinct from the banks' redepositing.

Is a somewhat more relaxed attitude toward the balance of payments warranted? Looking into 1970 this country's trade surplus could increase $1 billion or more, if domestic inflationary pressure lessens in accord with official expectations. Military expenditures abroad, which leveled out in 1969, are likely to be about the same as in 1969. And unless Eurodollar rates and those on U.S. obligations held by foreigners drop considerably from present levels, total interest payments to foreigners could be greater. At present, Eurodollar rates are just about at last year's average level, but rates on U.S. Government obligations—of which foreign holders own about $10 billion—are somewhat higher than the average of last year. Moreover, U.S. liquid liabilities to foreigners are now about $9 billion larger than at the end of 1968. The travel and transportation deficit at best is likely to remain the same. In sum, any prospective improvement of the current account of the balance of payments may be relatively small. On the capital account it would be imprudent to be confident about a substantial increase in net foreign purchases of U.S. stocks, and there is unlikely to be much change in the capital outflows of U.S. banks and corporations this year. This, the liquidity deficit, although it could be somewhat smaller this year than last, is still likely to remain very large.

On the other hand, the balance of payments on an official settlements basis could well turn into a substantial deficit this year. In 1969 a deficit on this account was averted because the increase in U.S. banks' liabilities to private foreigners of about $9 billion—by and large representing the increase in their recourse to the Eurodollar market during last year—prevented the dollars made available to foreigners as a result of the liquidity deficit from coming into foreign official hands. In fact, as I noted earlier, foreign official dollar holdings declined last year. The reasons for the banks' increased Eurodollar usage are explained clearly and accurately in the Council's annual report. During 1969, U.S. short-term market interest rates moved considerably above the Regulation Q ceiling, impeding the access of U.S. banks to domestic money markets, and forcing them into the Eurodollar market.

Since last fall, however, U.S. banks' liabilities to their foreign branches have been fairly stable (see chart 1, p. 301) : On February 11, 1970, they amounted to $13.6 billion, about $750 million below the level of September 24. To some extent, this flattening out is misleading, since during the same period U.S. banks' time deposits from foreign official institutions (which like Eurodollar deposits, are not subject to Regulation Q ceilings) increased by almost $2 billion. There was a brief period last fall when the full cost of these time deposits to the banks was slightly below that of Eurodollars, but now they are about the same.

Probably the most important factor in the leveling off of Eurodollar usage by U.S. banks has been the imposition of a 10-percent reserve requirement on any increase in a bank's Eurodollar redeposits over the average level in May 1969—a ruling that became effective early last September. This marginal reserve requirement made Eurodollar usage above the May base the most expensive source of funds to U.S. banks. A cheaper source of short-term funds has been commercial paper issued by bank-related companies. The issue of such paper by banks has increased by an estimated $3 billion since the end of last August. The future course of the issuance of this paper and Eurodollar usage by the banks will depend in part on whether the Federal Reserve imposes reserve requirements and/or regulation Q on the issue of such-paper. Given the present structure of shore-term market rates in the U.S. economy, the imposition of regulation Q on commercial paper would probably increase banks' recourse to the Eurodollar market.

On the other hand, if, as the year progresses, banks are able to compete effectively for funds in the domestic money market, they might well reduce their Eurodollar takings to a level somewhat closer to the May base. Our guess at the moment, however, is that such a reflux may be rather modest and that banks are unlikely to go below the May base. First, as mentioned, the banks' reliance on Eurodollars already has lessened because of their issuance of commercial paper. Second, a reduction in Eurodollar redeposits by the banks may bring Eurodollar rates down to a point where increased use would again be attractive. Third, banks may wish to maintain their participation in the Eurodollar market, which they have found to be a convenient and efficient market in which to raise substantial amounts of funds quickly at rates set by market forces. As regards the last two points, the attached charts show that during the second half of 1967 and again in the summer of 1968 the banks' Eurodollar redepositing rose (and at times rather sharply) even when (*a*) the Federal Reserve pursued an easy money policy and (*b*) the cost of Eurodollars was somewhat above that of CD's.

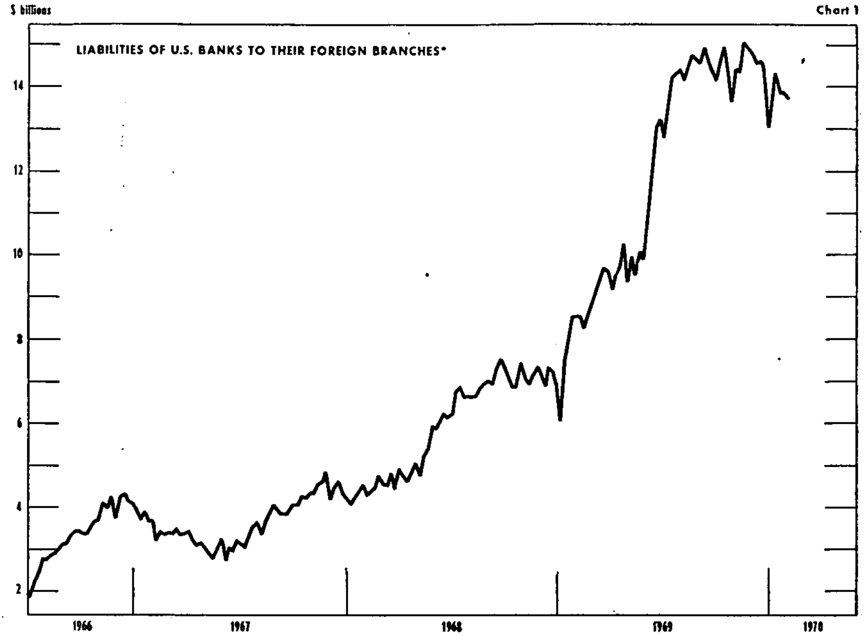
To repeat, both measurements of the balance of payments are likely to show a substantial deficit this year. What should be the balance-of-payments strategy at this juncture? In this connection, it may be useful to look back to 1964. You will recall that toward the end of that year, concern about the balance-of-payments became rather intense. During 1964, this country had a trade surplus of nearly $7 billion and a surplus of goods and services of $8.6 billion, but there was a net U.S. private capital outflow of about $6½ billion, of which U.S. bank lending to foreigners alone constituted $2½ billion. This led to the adoption of the voluntary balance-of-payments restraint programs for banks and corporations in February 1965. These programs have curbed U.S. private capital outflows. As far as the banks are concerned, from the end of 1964 to the end of 1969, their foreign assets subject to the Federal Reserve guidelines fell by nearly $200 million. In other words, none of the increase in the liquidity deficit of the balance of payments over the past 5 years can be attributed directly to U.S. bank lending abroad.

Instead, the deterioration was due to current-account factors such as the $2 billion increase in military expenditures and the $6 billion decline in this country's trade surplus over the past 5 years. During 1965–69, U.S. exports rose at an average annual rate of about 7½ percent while imports increased just about twice as fast. The U.S. share in world exports fell from 17.5 percent in 1964 to 15.5 percent in 1969, while this country's share in world imports rose from 12.6 percent in 1964 to 15.2 percent last year. Therefore, the U.S. balance of payments at present is structurally weaker than in 1964, but the weakness now clearly points at the current account.

I am, therefore, in agreement with the conclusion of the Council's Annual Report (p. 142) that: "For international as well as domestic reasons, it is most important that the United States restore internal balance and achieve sustainable, noninflationary growth. This responsibility, along with reasonably free access to U.S. markets, constitutes our predominant obligation toward international economic well-being." I might add that since the process of curbing inflation and restoring this country's international competitive position may take time, the U.S. Government should encourage the inflow of foreign capital.

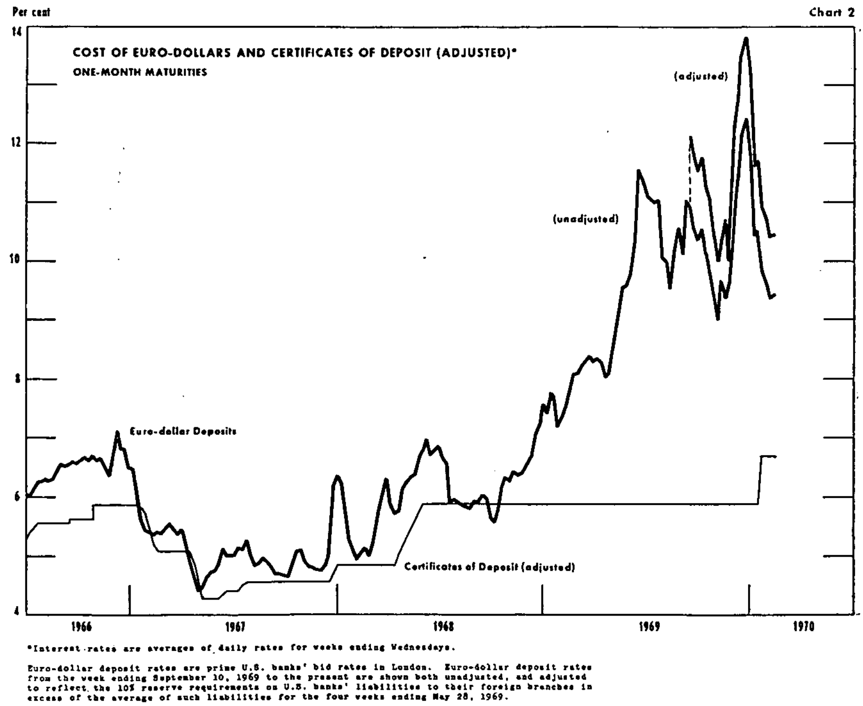
Since a large prospective deficit for 1970 is likely to appear on an official settlements basis as well as on a liquidity basis, it is vital that the United States maintain the confidence of foreign monetary authorities in the integrity of the dollar. This is not likely to be accomplished by either a proliferation or a modification of controls. It is rather to come from the orderly disinflation of the U.S. economy and from the restoration of a sizable current account surplus. A somewhat more relaxed attitude toward the balance-of-payments problem is only justified if one is confident that both these goals will be achieved. Nevertheless, if at some point in the future the buildup of foreign official dollar holdings were to become too rapid, the Federal Reserve could encourage U.S. banks' Eurodollar usage by more liberal treatment.

(The charts accompanying Mr. de Vries' statement follow:)



*The data represent gross liabilities of U.S. banks to their branches in foreign countries as of Wednesdays of each week.

Source: Federal Reserve Bulletin.



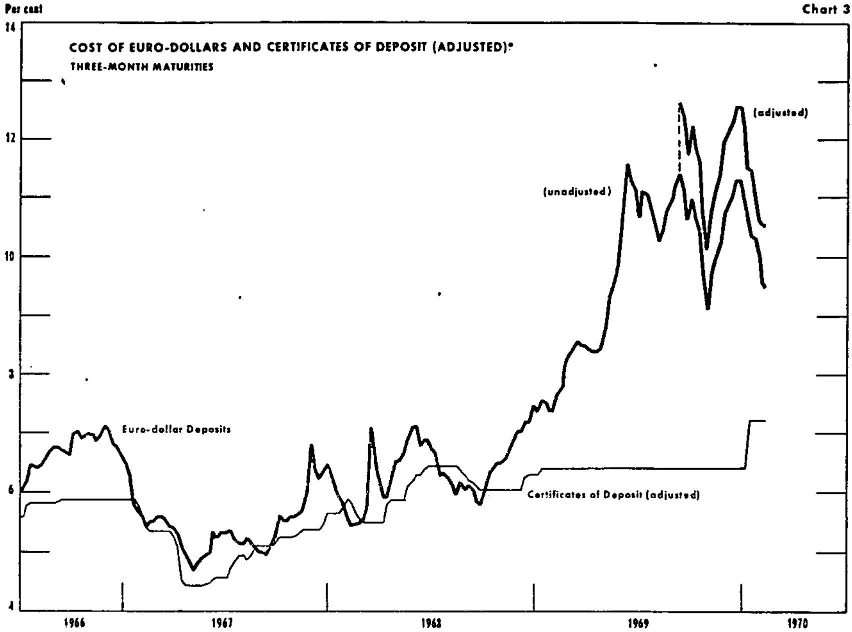
*Interest rates are averages of daily rates for weeks ending Wednesdays.

Euro-dollar deposit rates are prime U.S. banks' bid rates in London. Euro-dollar deposit rates from the week ending September 10, 1969 to the present are shown both unadjusted, and adjusted to reflect the 10% reserve requirements on U.S. banks' liabilities to their foreign branches in excess of the average of such liabilities for the four weeks ending May 28, 1969.

Certificate of deposit rates are offering rates of prime U.S. banks for large-denomination negotiable CDs adjusted to reflect reserve requirements and FDIC fees.

Source: Morgan Guaranty Trust Company of New York.

Chart 3



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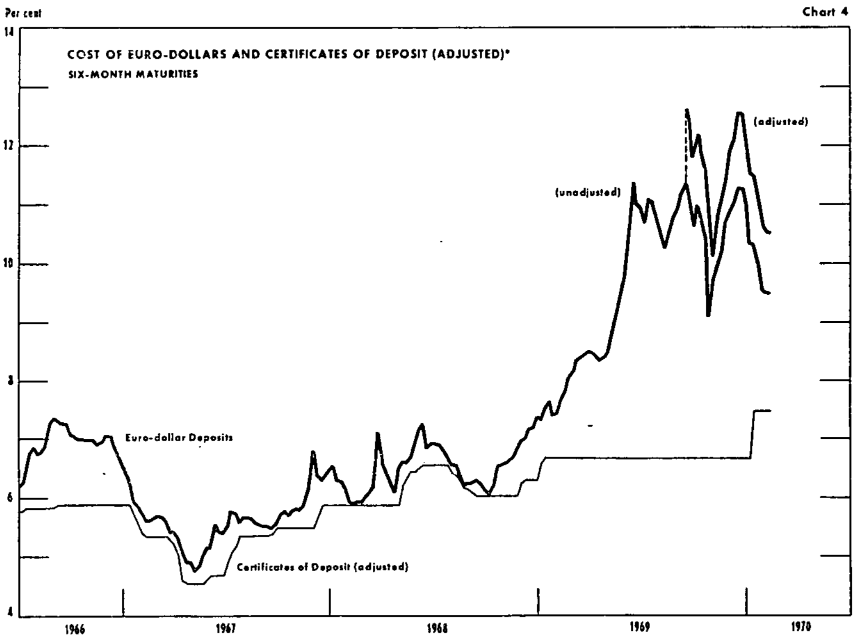
Source: Morgan Guaranty Trust Company of New York.

Chart 4



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Certificate of deposit rates are offering rates of prime U.S. banks for large-denomination negotiable CDs adjusted to reflect reserve requirements and FDIC fees.

Source: Morgan Guaranty Trust Company of New York.

Senator PROXMIRE (presiding). Thank you very much, gentlemen. These are extremely interesting and stimulating papers, and they are a fine supplement to the statements we have had from administration witnesses which we concluded last week. They are different in many respects.

Mr. de Vries, you properly and very helpfully confined your remarks very largely to the international situation, the balance of payments and so forth, although you did have some remarks relating to the domestic economy.

I would like to start off with you other three gentlemen. Mr. Bassie, you said you predicted 6 percent unemployment, which is not so far out on the basis of what we were told by Mr. McCracken, 4.3 percent average during the coming year. Obviously you have to go way above that if you are going to have the average.

Mr. Lewis, you said very slow growth and excess unemployment. Mr. Murphy, you said a recession of considerable proportions, unless we reverse our monetary policy within the next few weeks.

Now I would like to ask you gentlemen, in light of the fact that Arthur Okun, who is the immediately preceding Chairman of the Council of Economic Advisers, has said that we cannot, and he is a great expert in the area where he specializes particularly in inflation, and particularly anti-inflation policy, he said that there is just no way that he knows, that he has seen, that is responsibility supported, for getting at inflation in our economy without paying some price in an economic slowdown and unemployment, more unemployment.

Mr. McCracken, in his gentle and careful manner, seemed to imply pretty much the same kind of an attitude. Do you, do each of you gentlemen support this view, that we have to accept a substantial increase in unemployment in the coming year, if we are going to get inflation under control? First Mr. Bassie.

Mr. BASSIE. Well, this question involves a lot of other things. There is the assumption underlying it that we want to maintain something that we call a free market. Now this free market is largely a fiction to begin with, but that is one thing that dominates our philosophy and keeps us from doing things that might be effective.

Mr. Lewis spoke at great length about guideposts. The administration has brushed off the idea of jawboning. I think that if you have jawboning without any intent to do anything more about controlling prices, then jawboning is useless. But if jawboning is the prelude to some more effective action, then it is not at all useless, and guideposts can serve in the way he indicates.

Please understand that I do believe that in a situation of partial mobilization, such as the present, we should think of general wage and price controls. The mechanism required for that is just too cumbersome. But as I point out in my testimony, in specific areas, you can get controls established fairly effectively, and those are essentially the areas where you have imperfect markets. Where there are just a few firms operating, maybe a local monopoly, such as a utility, we regularly regulate prices——

Senator PROXMIRE. Let me interrupt to ask you would this do the job though? Would this get inflation under control without a substantial increase in unemployment?

Mr. BASSIE. Will it get it under control now?

Senator PROXMIRE. The acceleration of inflation?

Mr. BASSIE. There is so much water over the dam that it is hard to do anything about it at this time, unless you are going to have a real rollback.

It seems to me that the worst profiteering we have seen in three war periods is in the banking industry right now, and unless you are willing to roll back interest rates to some extent, you can't correct that. It is a little bit late to try to put controls on.

In goods production generally, the situation is now in process of correcting itself by having the kind of downturn that we have dreaded.

Senator PROXMIRE. At this point you think we just have to grit our teeth, bite the bullet, and take it; is that right?

Mr. BASSIE. I don't see that there is anything likely to be done to prevent some further price increases.

Senator PROXMIRE. Mr. Lewis?

Mr. LEWIS. I would not quite agree with that. Bear in mind that the administration is promising to eliminate inflation only over about another 3 years of this slow growth, and I respectfully submit that if 3 years is the target we have to beat, that we could get inflation out of this system, that is the excess expectational component of inflation out of the system in 3 years time, at approximately full employment.

Now I don't mean that we are going to drop the GNP deflator, which last year was about 4.6 percent for the year down to 2 percent in 1 year, but I think it could be worked down a point or a point and a half a year.

Senator PROXMIRE. This is very interesting, because I remember last year we had Secretary of Labor Shultz testify. He said that the objective of the administration was to try to hold the unemployment rate, which was low last year, at that rate, while we worked down prices. We haven't brought this up with the administration. We should this year, having Mr. Shultz as a witness, but it seems to me that they have certainly tossed that one away.

Now they are moving to an acceptance of a higher level of unemployment. They pointed out that in the previous years what we had tried to do was to bring unemployment down while prices remained steady, and we did something of that in the first part of the last decade, before prices began to get out of control. You think we could do that then. You think it is possible for us to adopt policies which would hold unemployment at say 4 percent or a little below, and get prices down?

Mr. LEWIS. Yes; I think so. I think we could get 2-percent inflation in 2 years.

Senator PROXMIRE. And that is about the best you expect?

Mr. LEWIS. At the present employment rates.

Senator PROXMIRE. For the present policy to achieve.

Mr. LEWIS. It's a lot better than the present policy because you have a lot more GNP.

Senator PROXMIRE. How would you do it?

It seems to me there is some logic, and an awful lot of prestige, in the position taken by Mr. McCracken and Mr. Okun as well as Mr. Burns and the other people who have testified, that we will not be able to get inflation under control, unless we do slow down the economy, and do provoke substantial increases in unemployment. What are they missing? What should they put into their policy?

Mr. Lewis. One thing, an element in the policy I am suggesting that they don't have going for them is the reduction in unit costs at a larger and more rapidly growing rate of real output.

If you deliberately slow up, you spread fixed costs all over more units of output, so that partly counteracts the disinflationary effects that you get from tight fiscal and monetary policies.

Senator Proxmire. That is exactly what makes your guidelines very tough to work with. You are very heavy for guidelines and I am all for them, and I don't think we should abandon them; it is a tragic mistake when we did, but I think it is a weak reed to pin your whole anti-inflation policy on.

You are right, unless you can get an increase in productivity, guidelines are going to be unsatisfactory, because otherwise if we keyed our wage increases to productivity increases there won't be any. Productivity increase has been so small in the last year, and it still continues to be at a very low rate, you are going to expect the workers to settle for a reduction really in their real income.

Mr. Lewis. You have to start expanding upward again before you begin to get productivity rising.

Senator Proxmire. That is a very good point you make. I am not sure exactly how we get on top of it, but I think you are absolutely correct.

Mr. Lewis. Let me point out that tentatively, for lack of evidence to the contrary, I would agree with both the present and the previous administration that in the absence of an expectational overlay, that we ought to be able to have reasonably stable prices with unemployment in the neigborhood of 4 percent. Or you could even state it more strongly. That is, you could say that the amount of statistically measured inflation that happens at 4 percent unemployment is sort of an irreducible minimum amount of inflation that we will call nil inflation. I think that is really in the long term prescription of both the past administration and the present.

The only question is whether we have to spend 3 years below full employment getting to that combination, or whether we can get to that combination more quickly by trying to skim off this expectational overlay.

Senator Proxmire. This puts the argument very strongly and rightly. After all, if we have less production, we are going to, from that standpoint, have less supply and more inflation. The supply side is not doing its job. I would like to ask Mr. Murphy.

Mr. Murphy. I would concur with what has been said. I think what has happened is that in the past year the slowdown in growth has led to a decline in productivity.

An increase in prices resulted, because managers' first reaction to the reduction in productivity and the increased pressure on profit margins, was to raise prices to protect margins. As a consequence, inflationary pressures accelerated throughout the year. The slowdown in the economy is a major factor, up to now at least, in the inflationary upsurge in prices.

More should be done to improve the long term overall efficiency of the economy. In 1968 and the early part of 1969, if not during the whole year, there was a labor shortage in this country.

Trained, skilled labor was unobtainable in many areas. A great deal more has to be done to train labor, especially the minorities who have been kept out of the mainstream of economic life.

Construction, for example, has been in the vanguard of the inflationary wage movement. One of the reasons has been the shortage of labor, partly due to institutional barriers, and partly due to insufficient skills among the unemployed.

There are many thousands of people who are capable to contributing to this industry; they should be trained and allowed to come into it. The restrictions within the building trade unions should be eliminated.

We also have discouraged investment. The removal of the investment tax credit was anti-inflationary only in the short run. In the long term it is going to be inflationary, because we are going to have less investment in modern equipment.

Inflation is not quite general. Certain sectors have led the price gains, the medical care field, for example. In answer to your inquiry we should recognize the need to reduce price pressures by expanding the supply of critical resources in key areas, to change the institutional arrangements in some of our industries and economic sectors which have hindered mobility and fed inflation. And lastly, we are going to have to get our unemployment rate down to a lower level. Regrettably, 3.5 percent has been accepted as a floor. However, major European nations and Japan, would consider this a very high rate of unemployment. Our rate remained stubbornly high because there was a lack of information about job opportunities, inadequate training among the unemployed and rank discrimination.

If more was done to change the structure of labor markets, we could avoid the problem that we now have, this paradox of accepting unemployment in order to slow down price gains. More people would be available for productive employment, and price inflation avoided.

Senator PROXMIRE (presiding). Thank you, gentlemen. My time is up.

Mr. Conable?

Mr. CONABLE. Thank you, Mr. Chairman. Dr. Lewis, you say that jawboning or guidelines would give an opportunity for economic statesmanship. Isn't it true that the voluntary guideline has generally been rather something to the detriment of the statesman in historical practice?

Hasn't the guy that has gone along with the guidelines wound up behind the eight ball, where the fellow who did not got along with it has had a decided advantage, because he was reacting to market forces?

Mr. LEWIS. I think it would be hard to know or to prove definitively one answer or another to that question, but I think not; that is, I think the statesman gets something back, not through his own actions, but because of the actions of other people. There are interactions, that go with a lot of people working in the same way.

Representative CONABLE. You don't maintain that market forces are likely to reward statesmanship more than——

Mr. LEWIS. I am talking about the whole complex interaction that takes place when you have guideposts. I am confident that this happened before, although I would be hard put to prove it. The statesman does get something back, because other people are also encouraged then to moderate. Also there are spillovers. In other words, if prices are moderated in one section, that means lower costs pressures in another sector, so that you really have to think of the whole economy as a system.

It is true, I suppose that if somebody was excessively charitable, he might suffer more than somebody who just said, "Well, the hell with the guideposts." For that reason I think you cannot have a perfectly equitable system, but I don't think that is definitive, because there are many serious inequities in not having guideposts also.

Representative CONABLE. I notice you say a serious voluntary approach, if it proves too soft, should give away to the possibility of allowing prices and income cease-and-desist orders if there is a clear violation of the guideposts. So that apparently you consider the possibility that voluntary guideposts might not be effective.

In view of the emphasis this panel seems to be putting on increasing production, do you feel implementation of legislation or the use of emergency powers to set up price and income boards would have the effect of stimulating production?

Mr. LEWIS. No; not all by itself. You would have to ease up monetary policy.

Representative CONABLE. It would be quite the opposite would it not?

Mr. LEWIS. Well, you would get adverse announcement effects; that is, you would have to be ready to go with that machinery pretty quickly. Also, the strategy calls for guideposts in cooperation with fiscal and monetary policy. The expansion of output would come from easing monetary policy which I think ought to be done pretty quickly, for the reasons that my two colleagues on each side have announced, that if we hang on to present monetary policies very much longer, we are flirting, I think, with a very serious recession as a strong possibility, although that is not my median forecast.

Representative CONABLE. Dr. de Vries, I would like to ask you this. You have pointed out the interesting juxtaposition of the difference between official settlements and our balance of payments, which are going in opposite directions, actually. It appears that there has been quite a resurgence of confidence in the dollar from those figures. From this can we conclude that our European counterparts tend to be quite conservative economists, and tend to believe that the administration policies that are being used are correct?

Mr. DE VRIES. No. I think the relaxed attitude about the balance of payments prevails more here in this country than in Europe. I do not quite see this relaxed attitude shared even in our own administration. I happen to read this morning Mr. Volcker's statement on the same subject and he is very concerned about our very substantial reduction in the trade and current account surplus, and, I think, this concern is particularly shared in Europe.

We have the largest productive economy in the world. We should have a substantial current account surplus to maintain all our international activities. I feel very strongly about this because this has provided a basis, you might say during the past 50 years, of our international leadership, in World War I, World War II, and thereafter. If we lose that current account strength, I am afraid we may have to give up some of the international leadership.

Representative CONABLE. Yes, I quite agree with you. This is an alarming set of statistics but I am trying to speculate as to why we are not having a considerably greater pressure on our official settlements than we do.

Mr. DE VRIES. Well, I think that——

Representative CONABLE. Apparently the lack of confidence that was evident a year and a half to 2 years ago when our gold was draining away rather fast has been somewhat reversed at least in the minds of the central bankers in Europe.

Mr. DE VRIES. I think most of this—and I think I have explained this in my statement—is due to the activities of the American banking system.

Representative CONABLE. I recall—but is that all?

Mr. DE VRIES. The huge amount of dollars which were made available to foreigners because of our huge balance-of-payments deficit never really reached the central banks' hands because American banks borrowed these funds in the Euro-dollar market from the private entities who were the recipients of these dollars, and even borrowed more than that. Foreign central banks not only did not gain the $7 billion made available to foreign countries, but even lost almost another $3 billion of reserves in the form of dollars and gold.

Representative CONABLE. Despite this, don't the central banks still hold substantial dollar credits?

Mr. DE VRIES. They hold a substantial amount of dollars indeed, but when these begin to decline, the way they did last year for a certain number of countries, they begin to resist this at an early point. European countries are very sensitive to the level of their international monetary reserves.

Representative CONABLE. If they felt we were not doing what we should do, in trying to buoy the value of our dollar, wouldn't they still find ways to present dollars for conversion, since they do still have substantial——

Mr. DE VRIES. I think last year some of the major central banks, even though they may have had $6 to $8 billion of reserves, had hardly any liquid dollars left.

Representative CONABLE. Was it because of the Euro-dollar flow?

Mr. DE VRIES. No, not entirely. Part of their reserves, of course, is already in gold. Secondly, they hold a lot of sterling, which was at one time practically inconvertible, or French francs or long-term assets. The Bank of Italy is one example. A central bank official told me: "At one time after the May 1969 crisis the Germans reached a point where they had to resort to international credit facilities because of their lack of liquid dollars."

Many of these foreign official reserves are tied up in assets which are not really liquid dollar balances.

Representative CONABLE. So what you are saying is the fact that we have favorable official settlements balance does not reflect confidence in any degree?

Mr. DE VRIES. Yes, I would say that is right.

Representative CONABLE. What is the total amount, what total amount of dollars are held in Europe now? Do you have any idea?

Mr. DE VRIES. Yes, I could tell you that if we had a Federal Reserve Bulletin here.

Representative CONABLE. It must be up very substantially over a year ago, isn't it, or is it?

Mr. DE VRIES. No, it is not. It has come down. Because of our official settlements surplus, these official dollar balances have come down.

Representative CONABLE. But the balance of payments has been negative. I am sorry, you have got to understand you are dealing with people here, with me anyway, as someone who does not know a great deal about international finance, and I am trying to understand what you are saying. Doesn't the increase in the deficit, in the balance of payments, mean that more dollar credits are flowing out from the country, even though the official settlements balance has been favorable this past year?

Mr. DE VRIES. It is a very complicated matter indeed. I thought the annual report explained it very clearly. We had a big deficit on the liquidity basis, $7 billion. These dollars were made available to all foreigners.

Representative CONABLE. Yes.

Mr. DE VRIES. Because of the activities of the American banks, they were able to borrow these dollars from foreign individuals and therefore they didn't reach central banks' hands, stated in simple language. In fact, they borrowed even more than the liquidity deficit, so that central bank holdings of dollars, gold, and other monetary assets, went down.

Representative CONABLE. Yes.

Mr. DE VRIES. This created the surplus on the official settlements basis. These are two different concepts, and I would think that Europeans, at least some Europeans, pay more attention to trade and current account balances and the liquidity deficit, while economists in this country, at the moment at least, pay a little more attention to the official settlements account, which has been in surplus.

Now, when the Europeans look at one measurement of the balance of payments that has been a deficit they are worried, while others are looking rather at the other measurement of the balance of payments and are more relaxed.

Looking at the future, that is to say 1970, I believe both of these measurements will probably show a substantial deficit, and therefore in due course, perhaps toward the end of this year, and maybe earlier, we may see much more discussion about the state of our balance of payments, because this paradox of on the one hand a record surplus and on the other hand a record deficit will not last.

Representative CONABLE. The current accounts are likely to be most affected today by the continuance of domestic inflation in this country?

Mr. DE VRIES. That is correct.

Representative CONABLE. That is all, Mr. Chairman.

Senator PROXMIRE (presiding). Congressman Reuss?

Representative REUSS. Thank you, Mr. Chairman.

Mr. de Vries, I have a number of detailed questions suggested by your paper, because the questions are long and because the answers impose the burden on you of going into some of the arithmetic of your statement, if it is agreeable with you and with the chairman, I would like to submit these questions to you, but have you answer them for the record rather than off the cuff here this morning.

Mr. DE VRIES. I will be glad to do so.

(The questions and the answers referred to for inclusion in the record at this point follow:)

Question 1. You note in your statement that there is a nearly $10 billion difference between the 1969 balance-of-payments deficit according to the liquidity calculation of $6.9 billion and the surplus for the same year on the official settlements basis of $2.8 billion.

Could you explain in some detail (1) how we are to interpret this apparent contradiction, (2) what is the conceptual difference in these two different measures of the balance of payments, and (3) how each measure is related to the strength or weakness of the dollar in exchange markets?

Answer. The large difference in the results of the two measurements of the imbalance of the U.S. balance of payments in 1969 is not contradictory but reflects the conceptional difference of the two measurements. The balance of payments concepts and their differences were reviewed and analyzed in great detail in the Report of the Review Committee for Balance of Payments Statistics to the Bureau of the Budget, published in April 1965.

Briefly, the "liquidity" concept of the balance of payments—which yielded the nearly $7 billion deficit in 1969—stresses this dollar's special role in the world economy and this county's unique commitment to gold convertibility. It attempts to measure the extent to which this country's liquidity position is being affected by international transactions. Accordingly, it tries to identify (1) the changes in U.S. liquid liabilities to foreigners (making no distinction between official and private holders, since all foreign-dollar holdings are assumed to be potentially redeemable in gold), and (2) changes in liquid assets held by U.S. monetary authorities.

The official settlements concept is based on the hypothesis that the main responsibility of national monetary authorities is to maintain stable exchange rates. Accordingly, international transactions between monetary authorities should be kept distinct from those between all others. Changes in official reserve assets represents the best available measure of the imbalance in a given country's international payments. This measure of the balance of payments reflects broadly the strength of the dollar in the exchange markets. The liquidity measurement does not aim to do this and may produce an outcome that has no link whatsoever with the strength of the dollar in the exchange markets.

Following the recommendations of the Review Committee, the Subcommittee on Economic Statistics of the Joint Economic Committee, in July 1965 concluded that "At present it is wise to retain a measure of our balance of payments which alerts us to changes in liquid liabilities to private foreigners, because such liabilities could be transferred to foreign central banks and thus become direct claims on our gold reserves." It therefore recommended that "The government continue to compute and publish figures based on the present liquidity concept of the balance of payments, refined as appropriate, and, in addition, begin to publish figures based on the official settlements concept." Now that almost five years have gone by since these recommendations were made and adopted, it may be timely to review the experience with the two measurements of the balance of payments and to examine whether this experience and the major recent changes in the field of international finance have not altered the usefulness of either concept.

The first observation that can be made is that because of (the somewhat arbitrary) distinction between liquid and non-liquid liabilities to foreigners, monetary authorities, in order to influence the liquidity-basis balance of payments, have from time to time switched large amounts of liquid dollar assets into non-liquid assets, some of which were specially created for this purpose. These statistically-oriented official transactions have affected the balance of payments on an official settlements basis much less than the liquidity-basis balance of payments.

Secondly, the movement of short-term funds among industrial nations has greatly increased during the last few years, because of the exchange rate uncertainties, international interest rate differentials and various forms of official intervention. U.S. commercial banks have stepped up greatly their activities in the Euro-dollar market and have transferred back and forth billions of dollars between their overseas branches and head offices. Similarly, individuals, corporations and other entities in the United States have deposited from time to time substantial amounts of funds abroad on a short-term basis. The liquidity-basis balance of payments reflects these short-term capital movements in a very lopsided manner. Outflows by U.S. individuals, corporations and banks are reflected but not inflows by banks. Thus, in 1969 the liquidity-basis deficit was increased by an estimated $2 billion because of short-term capital outflows by non-banks, but did not give "credit" to the inflow of short-term funds by U.S. banks which amounted to several times that outflow.

Thirdly, during the last two years there have been important institutional changes in the international monetary system. There has been the agreement to create a substantial amount of Special Drawing Rights and the formation of the two-tier gold market. Both of these events reflect the tendency that the relative role of gold in the international monetary system is diminishing. This raises the question whether the gold convertibility of the dollar and the changes in the liquid claims on U.S. gold and other monetary reserve assets should still be the key to the U.S. balance of payments concepts and measurements.

These three considerations have tended to make the liquidity approach to the balance of payments much less useful and much more subject to statistical distortions than the official settlement measure.

Question 2. You assert that both measures of the balance of payments are likely to show substantial deficits for 1970. Could you please give us a somewhat more detailed breakdown of your projection for each calculation of the deficit?

Let me explain precisely what I have in mind: you expect some improvement in the trade account and look forward to a surplus of say about $1.5 billion, given the '69 results, this trade surplus would imply a goods and services surplus of about $3 billion, what numerical projections would you put on long-term and short-term capital flows to come up with substantial deficits according to both measures?

Question 4. On page 5 of your statement, you say "Our guess at the moment, however, is that such a reflux, i.e., of Eurodollars, may be rather modest and that banks are unlikely to go below the May base." Further on in the same page, you predict a substantial official settlements deficit in 1970. If any reflux of short-term capital to Europe is likely to be modest this year, how is this official settlements deficit going to come about?

Answers. Capital movements cannot be projected with a high degree of confidence, but one may have some expectations based on certain assumptions. First taking the liquidity-basis balance of payments—which as noted is affected by special transactions with foreign monetary authorities—it is reasonable to adjust the data for the effect of such transactions. In 1969 the liquidity-basis deficit was increased by approximately $1 billion by special transactions; excluding their effect, the deficit would have been $6 billion.

Net foreign purchases of U.S. stocks will depend to a large extent on the performance of U.S. share prices this year. During 1969, net foreign purchases totaled about $1.4 billion, i.e. an average of about $120 million per month. Should a sharp rise in U.S. share prices occur during this year, foreign portfolio investment in U.S. stocks probably will move well above the monthly average for 1969. However, portfolio investment is volatile, and it could drop from last year's monthly average. Also, some foreign governments have become concerned about the high level of long-term capital outflows of their residents. Under these circumstances, it seems to be reasonable—making neither the most pessimistic nor the most optimistic assumptions—to expect no major change in net foreign purchases of U.S. shares from last year. Net U.S. purchases of foreign securities totaled about $1.4 billion in 1969, a decline of about $300 million from 1968. Expecting some decline in Canadian borrowing in the U.S. capital market during 1970, a further modest drop in U.S. purchases of foreign securities may incur this year.

There are no strong reasons to believe that the increase in U.S. banks' foreign loans and U.S. corporate direct investment capital outflow in 1970 will be significantly different from last year. In 1969, bank lending abroad rose about $100 million. Although banks that have been most active in international lending had little leeway under their general ceilings at the end of 1969, they received an additional leeway of several hundred million dollars for export credits.

Net short-term capital outflow by individuals and corporations in 1969 is estimated at close to $2 billion. The balance of payments outturn for 1970 will depend to a great extent on what will happen to this outflow. If last year's outflow is reversed entirely, the 1970 deficit will be reduced by $4 billion. If during the current year there will be no net short-term capital outflow, this year's deficit will be smaller by $2 billion. We know relatively little about the participants and the motivations of the short-term capital outflow during 1969. It seems reasonable to assume that part of it occurred because of anticipation of the German mark revaluation. Furthermore, the large spread between U.S. money market rates and Euro-dollar rates may have attracted substantial short-term funds from this country, particularly from those U.S. entities which had large amounts of idle cash waiting to be invested in U.S. stocks.

The calmer situation in the foreign exchange markets could lead to an unwinding of leads and lags and therefore a return of short-term funds to the United States. U.S. interest rates have also come closer to Euro-dollar interest rates, but there is a spread and this could well remain so, particularly if U.S. monetary policy were to ease, unaccompanied by similar policy actions in Europe (see question 3). However, if the principal participants in the U.S. short-term capital outflow in 1969 were mutual funds and other long-term investors, an upturn in U.S. share prices could lead to a substantial reflow of short-term funds. With these uncertainties, one could take a cautious, middle position and assume that in 1970 there will be no net reflows but also no additional net short-term capital outflows. This would reduce the balance of payments deficit by $2 billion from 1969.

In sum, the projected current account improvement of $1 billion, the adjustment for special official transactions (also about $1 billion) and the middle assumption regarding short-term capital movements, by themselves, could reduce the liquidity-base deficit by $4 billion in 1970.

As regards the balance of payments on an official settlements basis, I refer to my prepared statement. If, during the course of this year, U.S. banks were not to add to their Euro-dollar redepositing—if this were to remain at the $13 billion level—the official settlements deficit could well be of the order of the liquidity-basis deficit. Assuming that there will be no change in existing Federal Reserve regulations and assuming that U.S. banks will tend to reduce their Euro-dollar redepositing to a level closer to their May base (about $10 billion, which is free from Reserve requirements), an additional $3 billion or so may come into the hands of other foreigners, as opposed to overseas branches of U.S. banks. Some of this probably will be absorbed by foreign private entities in order to increase their working balances. Nevertheless, it seems reasonable to expect that foreign central banks this year will increase their dollar holdings by an amount that will exceed somewhat the liquidity-basis deficit projected for 1970.

Question 3. Do you expect interest rates to decrease significantly in the United States during 1970, and if you do, what do you expect will be the reaction in European money markets? Will short-term interest rates in Europe remain at existing levels, will they fall precisely along with U.S. rates, or might they even drop more rapidly than U.S. rates?

Could you detail the implications of these expectations regarding short-term interest rates on the pattern of international capital flows?

Answer. During 1969 interest rates in Europe rose sharply, following the rise in U.S. and Euro-dollar interest rates. The effects of U.S. monetary retraint policies were transmitted to European money markets, particularly through the Euro-dollar market. To some extent the impact of U.S. monetary policies on European money markets was exaggerated by the distorting effects of Regulation Q ceilings. The high Euro-dollar rates attracted large amounts of funds from various European money markets, which added to the external reserve pressures in several countries. Although the authorities in several European countries attempted to isolate their domestic markets from the effects of higher U.S. and Euro-dollar rates by various devices, they eventually had to bring about a rise in domestic interest rates in order to stem capital outflows.

During the course of 1969, the domestic economic situation in a number of European countries has become more inflationary. Price and wage pressures intensified towards the end of last year, particularly in Britain, Germany and Italy. These pressures have given central banks addiitonal reasons to keep money tight and interest rates high in their markets. Accordingly, it it unlikely that the major European countries will take the initiative in reducing interest rates. Instead, interest rates in European money markets generally are likely to follow those in the U.S. and Euro-dollar market.

In fact, this is just about what has occurred since September—with the notable exception of Germany, where short-term interest rates have risen sharply in the last few months. For example, 3-month money market rates in the United States at the end of February were a shade below those at the end of September. Similar rates in the United Kingdom, France, Belgium and the Netherlands, had come down by about the same amount. On the other hand, long-term U.S. government bond yields at the end of January were about 40 basis points above those at the end of September 1969. During the same time, long-term government bond yields in France, Germany, Italy, the Netherlands, Switzerland and Canada had also risen somewhat, although generally somewhat less than in the United States. A notable exception here is the United Kingdom, where long-term rates have come down noticeably in recent months.

The U.S. balance of payments would be affected adversely if European interest rates would follow with some lag a further decline in U.S. interest rates. To the extent that this occurs, there could be a flow of funds from the Euro-dollar market into European national money markets. Moreover, any widening of the differential between U.S. and Euro-dollar rates would tend to encourage short-term capital outflows from the United States, and to induce U.S. banks to cut their Euro-dollar redepositing.

Question 5. On page 4 of your statement you note that "The imposition of Regulation Q on commercial paper would probably increase banks' recourse to the Euro-dollar market." Did Regulation Q play an important role in prompting U.S. banks to seek funds through the Euro-dollar market during the first part of 1969?

Answer. In early December 1968 yields on actively traded money-market instrucents rose above—and have since remained above—Regulation Q interest-rate ceilings for time deposits. Unable to pay interest rates on large-demonination time deposits that were competitive with rates available elsewhere in the domestic money market, U.S. banks experienced a very sharp runoff of CDs. Between mid-December 1968 and the end of June 1969, weekly reporting member banks experienced a cumulative loss of large-denomination CDs of more than $8 billion. Since the end of June 1969 they lost an additional $4½ billion. To avoid the abrupt liquidation of assets that these CD losses would have otherwise brought about, U.S. banks made large acquisitions of Euro-dollars through their foreign branches. U.S. banks' liabilities to their foreign branches rose from about $7.2 billion in mid-December 1968 to $13.2 billion near the end of June 1969.

Question 6. Your statement concludes with the comment that "If at some point in the future the build-up of foreign official dollar holdings were to become too rapid, the Federal Reserve could encourage U.S. banks' Euro-dollar usage by more liberal treatment." It would therefore seem that the Federal Reserve has has selective tools available that can promote increased Euro-dollar borrowing by U.S. banks when we desire to either relax domestic monetary restraint or maintain it—specifically, the Federal Reserve could either reduce the 10 percent reserve requirement on deposit liabilities to foreigners, or, as you suggest earlier, could impose Regulation Q on bank issues of commercial paper. Is this interpretation correct and do you have any comment?

Answer. Yes, this is correct. However, it should be stressed that the 10% marginal reserve requirement was imposed specifically for the purpose to moderate U.S. banks' Euro-dollar usage in order to alleviate pressures in the Euro-dollar market and consequently pressures on external reserves of foreign central banks. By the same token, if at some time in the future foreign central banks would have been able to increase substantially their external reserves, the marginal reserve requirement would have lost much of its original rationale.

Question 7. Could you comment on the suggestion for modifying the controls on bank lending to foreigners recently offered by Governor Brimmer?

Answer. Governor Brimmer has proposed in a speech of February 11, 1970 to replace the present Voluntary Foreign Credit Restraint Program (VRCR) by a reserve requirement against foreign assets. There are a number of serious drawbacks to this proposal.

(1) Foreign loan demand and the ability of U.S. banks to make foreign loans is affected by many factors, including the Interest Equalization Tax (IET), money conditions, interest rate levels both here and abroad, the international political situation, etc. In the light of this, is it possible for the Fed to achieve the proposed fine tuning of capital outflows through the proposed reserve require-

ments? The proposal is presented as "a market force technique" in order to "minimize interference with normal business decisions and the economic forces of the market place." There is a serious question as to whether the proposed alternative represents progress in this direction. The proposed scheme would permit—and in fact encourage—more rather than less interference with "normal business decisions." The temptation to funnel foreign lending into certain areas by use of preferential rates would be difficult to resist. The required reserve ratio could be set according to the borowing country, maturity and type of loan, and lending institution. In contrast, the present VFCR program has left banks relatively free in making loan decisions within their individual quotas.

(2) The supplement reserve would raise the cost of foreign lending, which the banks would pass on to their foreign borrowers as in the case of the IET. If the reserve requirement is applied across the board, it would mean that all foreign loans—including those which have thus far been exempt from the IET—would be subject to new special levies. This would affect in particular borrowers from less-developed countries, which take up about half of U.S. banks' foreign loans. They would have to pay more for their U.S. borrowing than they would under the present VFCR. This would aggravate their external debt burden, with which the U.S. Administration is increasingly concerned and is trying to alleviate. In this respect, too, the proposal would run counter to other policies pursued by the U.S. Government, which through its agencies, such as AID and EX–IM Bank, is increasingly moving in the direction of lower interest cost on foreign loans.

(3) One of the Governor's reasons in proposing the alternative is apparently to remove "inequities inherent in the program which rests heavily on the relative position of individual banks in international finance as of December 31, 1964." Of 13,500 banks in the United States, twenty have accounted for almost 80% of the covered assets subject to the general ceiling fixed under the VFCR. The proposed alternative apparently would be designed to give a large number of the other 13,000 or so banks an opportunity to take part in international lending. However, a substantial part of the Governor's speech, in which he proposed the alternative, is devoted to the outlook of the U.S. balance of payments. According to the Governor, "We are still a long way from achieving a viable equilibrium in our balance of payments." The Governor's desire to give an opportunity to many additional banks to participate in international lending and his concern about the balance of payments, therefore. are inconsistent. The latter concern propably will dominate. Accordingly, if the Governor's proposal were to be adopted, the required reserve ratios are likely to be set at such a level as to discourage an increase in foreign bank lending. Smaller banks are unlikely to benefit from the proposal.

(4) This last point is reinforced by the fact that in recent years the bulk of the leeway U.S. banks had under the VFCR ceilings was held by small and medium-size banks. At the end of 1969 the leeway under the General Ceiling was about $700 million, of which about two-thirds was held by small and medium-size banks. Obviously, many of the smaller banks have not been able to make use of their existing leeway, probably because they were not so inclined nor had the experience to do so.

(5) It is difficult to see how the Governor's proposal can be made effective, since it might be very difficult to apply reserve requirements to non-member banks and non-bank financial intermediaries. Since the proposal would be a mandatory rather than a voluntary program, it would invite the type of avoidance that banks have been loath to engage in because of their moral commitment to the spirit, as well as the letter, of the voluntary program. Unless a complete straightjacket was placed on all financial intermediaries, bank credit could easily flow through many unregulated U.S. financial intermediaries to foreign markets. Foreign borrowers would encourage such a tendency to avoid the extra cost of the reserve requirement and U.S. non-bank financial intermediaries—having acquired a competitive advantage over regulated U.S. commercial banks—would encourage it in order to get into the international lending business. In cases where non-bank financial institutions are not covered by the present VFCR program, banks have refused to make such loans through unregulated intermediaries under the voluntary program. It would be unrealistic to assume that they would decline to make such loans which complied with a mandatory regulation.

(6) The Governor criticized the VFCR because some of the larger banks have allegedly used the guidelines as a competitive lever against their smaller competitors. However, most large banks, as noted, have been consistently close to

their guideline ceilings and had no room for this type of competitive play. In fact, the reverse is probably true because large banks have syndicated a number of foreign loans to the smaller banks, which gave the latter an opportunity to utilize more fully their own ceilings.

Representative REUSS. You have made an excellent contribution, concluding with the observation that one of the best things we could do for our foreign situation would be to control inflation at home, which causes me to turn to your three colleagues here, who have been addressing themselves primarily to that.

Mr. Bassie, Mr. Murphy very eloquently made the point, which you do too, that an immediate loosening of money is necessary. My question to you is this. If that is all that happened, isn't it likely that it would simply add to the existing inflation and to the present tendency toward stagnation by reason of the fact that a large share of the increase in the money supply would, based on past performance, be taken over by the large commercial banks, and thus concentrate it, because they like to lend for business expansion, conglomerate take-over, inventories and so on, and thus add to the pressure on the most inflationary sectors of the economy, and that therefore while an easing of money is eminently desirable, it should not be accompanied by some other policy actions? Would you agree?

Mr. BASSIE. Well, I do not feel that the so-called tight money policy is quite so important as Mr. Murphy does. It seems to me that it should be relaxed, but it never really got to a position where you could say there was tight money until the third quarter of last year. That is when we were just about to pass the turning point in the boom.

Now, the change in the situation will bring about an easing of the money markets whether they intend to have it or not. If the coincidence of intentional easing on the part of the Fed occurs at the same time as the demand for credit slacks off, we could get a very sharp reversal of the uptrend—in short term money rates especially but with some lag in long term rates also. Immediately in such a situation there will be a striving for liquidity rather than for more credit to use in illiquid ways, so this will come about naturally, whether the Fed intends it or not.

Representative REUSS. What would your remedies for the disastrous current economic situation, where we have got boiling inflation and increasing stagnation at one and the same time, what would your remedy be, or do you think that the situation has deteriorated so fast that you are not seeking public office at the moment?

Mr. BASSIE. Well, the idea that you have to do something about everything is not one I would be very sympathetic to. Some of these things are now in process of correcting themselves in a way which I consider unfortunate. As I have indicated earlier, I think the whole policy which is described as a tight money policy, but which I say is only a high interest rate policy, is mistaken.

If we had had a tight money policy for some time and had suppressed demand for a while, that would have been a very good thing, but it would have required rationing credit, and nobody wanted to undertake that unfortunately. Now, we are going to have to pay the penalty for the overexpansion.

Let me just add one more point on this. One of the places where we have had an extreme overexpansion that is simply begging for correction is in the Euro-dollar market. Far from expanding the Euro-dollar market, action ought to be taken immediately to bring that situation under control. If we cannot do it ourselves, we ought to get together with the European governments, because the banks are generating money with no rules over there.

Our banks have to observe certain reserve requirements which are not simply at their own discretion. But the Euro-dollar market goes on booming, without rules or limits other than what they think they can get away with.

Well, excuse me, with that comment I diverted you from your question.

Representative REUSS. My question was that I gather 6 months ago you would have favored the imposition of qualitative credit controls, credit rationing on bank loans for business investment.

Mr. BASSIE. Oh, no, not 6 months ago, a year ago, a year and a half ago.

Respresentative REUSS. A year and a half ago, but that you do not do so today because you see a recession coming all by itself, which will make unnecessary any such credit controls. Do I have you right?

Mr. BASSIE. Well, essentially yes.

Representative REUSS. Mr. Murphy, I thought your testimony was a strong breath of fresh air both in general and because of your emphasis on the supply side. It somehow never seems to sink through the cranium of those who are responsible for these matters that inflation is an equation, demand and supply, and that getting supply up is a good way of fighting inflation, too.

Mr. MURPHY. Yes.

Representative REUSS. Yet we have heard the depressing testimony last week from this administration that their cure for things is to put 700,000 men out of work. When I asked them look, shouldn't those 700,000 men be put to work making useful things to sell to other people, to sop up their inflationary purchasing power, they had no answer.

How do you feel? Are you with me or are you with the administration on that?

Mr. MURPHY. I think I am with you. I think it is a waste of resources to go through a recession that is socially costly, and while we have not satisfied our needs, despite our affluence. There are many things that are left undone that should be done. Our cities, our air, our water are crying for improvement. Risking recession is also a short-sighted policy, it contains a fallacy. Rather than end, it lays the groundwork for renewed inflation. If 700,000 men are out of work, as you gentlemen who are running for office well know, the administration, any administration these days, is going to quickly respond with expansionary policies. As a result, a year and a half hence you are going to have the same inflationary problems that we now have.

We should in my view also look at the inflation problem as a structural problem. Prices are not going up at the same rate in all industries and in all sectors. Where are they going up? They are going up in medical care field and in services area and in foods. What can be done to correct the situation in these particular sectors? Rather than a bludgeon approach, hitting the economy across a broad front, the attack on inflation should be pinpointed.

Representative REUSS. It is so ironic last week listening to the administration witnesses. They keened and howled in general about the terrible inflation that was going on but when you asked them where it was, it was like the old army game. You never could find the walnut under which the pea was supposed to reside.

Mr. McCracken quite rightly I think, when asked what about controls of consumer credit, regulation W, he said "The consumer market is soft and so is the consumer market across the board."

Well, that was fine. That took care of two-thirds of the economy, and then along came I guess it was Dr. Burns, and when I said well what about some controls over lending for business investment, well, it turned out that was off, too. You didn't need it there. So you wonder what those people are thinking about.

One of the suggestions I have made, incidentally, is that the administration ought to appoint a supply ombudsman, somebody to get to work on just the things you mentioned, import quotas on meats and oils, expand on medical schools, and that is why we have this terrible crisis in medical care.

Mr. MURPHY. Exactly.

Representative REUSS. My immediate candidate for this job, Mr. Ralph Nader, evidently is not acceptable to the administration. I think you would make a wonderful successor, and you come from a much more respectable background.

Mr. MURPHY. Thank you very much.

Representative REUSS. I do hope they will consider somebody like you.

Mr. MURPHY. Thank you, sir.

Representative REUSS. Just one little question. And you have been so honest and so forthright that if you want to go soft on this one God will forgive you. You do ask that we examine Government spending patterns and operations in terms of optimum allocation of resources and inflationary pressures.

Well, as General Electric well knows, we have got $290 million in the budget for the supersonic transport plane this year, which is not going to sop up any inflationary purchasing power, even if the thing were any good in the long run. Don't you think we should examine that Government spending pattern?

As I say, this is asking more of mortal man than should be asked of him.

Mr. MURPHY. No, I think that all Government spending programs should be examined carefully, in terms of what they are going to produce in the end. Certainly, the SST is one of the things that we ought to examine. Despite the fact that my organization is involved in it, I think that we would want to see this studied, and put into perspective with other needs in the economy. This raises a question, Is this a priority need? Or are there other programs which have higher priority. My organization has as a continuing procedure for reevaluating projects and I see it applying to the SST as well.

Representative REUSS. All I can say is Daniel comes to justice.

Representative CONABLE. I just wonder if it is the forgiveness of God that we really ought to worry about in this case.

Mr. MURPHY. Everybody has his own gods, though.

Senator PROXMIRE (presiding). Congresswoman Griffiths?

Representative GRIFFITHS. Thank you very much.

I would like to ask you, Mr. Murphy, hasn't General Electric just completed a contract with their union labor?

Mr. MURPHY. Yes.

Representative GRIFFITHS. How long does that contract run?

Mr. MURPHY. It runs for 40 months.

Representative GRIFFITHS. What is the average wage increase in the first year?

Mr. MURPHY. You mean in percentage terms? Unfortunately, I am not an expert in the labor field.

Representative GRIFFITHS. Well, approximately what?

Mr. MURPHY. I would say it looks to be close to the average annual increase in manufacturing in 1969—around 7 to 7½ percent, but there are others in the company more qualified than I to answer your questions.

Representative GRIFFITHS. In the second year?

Mr. MURPHY. In the second and third years it is slightly lower.

Representative GRIFFITHS. Through the entire time?

Mr. MURPHY. Yes. Now, this assumes that the escalation clause will be operative. There is a provision in the contract which ties the increases in wages to increases in the consumer price index. I assume that prices will rise enough to cause this part of the wage package to be paid.

Representative GRIFFITHS. Yes.

Mr. MURPHY. And if it is not paid, then the rise in the second and third years will be substantially lower. There is a 15-cent basic increase in both the second and third years, and in addition an 8-cent maximum increase due to the CPI-based increase in the escalation clause, for a total of 23 cents the second and third years. Of course, if the CPI should level out or even slow down sharply then there would be smaller increases in the second and third years.

Representative GRIFFITHS. Under the circumstances, what can General Electric do, with this built into their price, to lower their prices? What set of circumstances would have to occur or what would General Electric have to do to lower the price?

Mr. MURPHY. You mean of their products?

Representative GRIFFITHS. Of their prices?

Mr. MURPHY. The company will do what it is always doing. In the future, as in the past, we will improve our management and increase the productivity of our workers. We have proceeded in this fashion for many years. Today, the price of refrigerators, for instance, is lower than 10 years ago; and the cost of electric generation equipment per unit of power produced has been in a declining trend for decades.

Representative GRIFFITHS. Does this mean that you will have to put in more automation?

Mr. MURPHY. Well, it will depend upon the type of operation involved. In some plants it would mean more automation, and in others more efficient equipment with longer operating lives.

Representative GRIFFITHS. So that actually it means more people out of work?

Mr. MURPHY. No, I think it means more people available for another occupation. As I said earlier, in the last few years the Nation had a labor shortage. We had 15 percent of our manufacturing plant unused. It wasn't unused because of demand weakness but because skilled employees were hard to find. There was strong demand, more production was needed, but the men to run the plants were not around.

There are many misconceptions about the effects of automation on employment. If the man-hour input to produce a refrigerator can be reduced, labor is freed to work on generating equipment or as a contruction worker. In a low-employment economy, automation increases productivity, lowers inflationary pressures, and expands real output.

The economy does not have a job scarcity today. On the contrary, jobs are going begging. The economy needs more labor, and if we can improve the productivity of the work force so that it is able to make more, with fewer hours of input, we make labor available for other tasks, thus automation does not lead to unemployment; it leads to more job opportunities, to more jobs being filled.

Representative GRIFFITHS. Where is the excess supply at the present time in the judgment of any of you, and a decreased supply available? I have never gone to a store and sought to buy anything that it was not available. Where are these shortages, in what?

Mr. MURPHY. Shortages?

Representative GRIFFITHS. Of goods with which to supply demand. There really are not any; are there? I think you can even raise a real question on hospital charges. Dr. Knowles testified before this committee that there is no hospital shortage, that there should be no further hospitals built. Those we have should be used better.

Mr. MURPHY. That would also be involved. In my paper I indicated improvement in the productivity and in the management of the services sector would increase the number of beds we will have available. The apparent lack of shortages is a complicated problem. To turn it around the other way, prices would not be going up if there were greater amounts of goods and services being put on the market. Prices would tend to be steady or drop.

Representative GRIFFITHS. You know at one time I believed that, but I do not believe that now. I look at my refrigerator, and a refrigerator that I have at a summer place. Three little jars of mustard sauce had gone up 100 percent. Now, I will admit that I think with doctors this is part of the problem, is there any real reason why a flu shot last year cost $5 and this year $10?

Mr. MURPHY. Probably not, and I think it goes back to something that Dr. Lewis pointed out.

Representative GRIFFITHS. Pardon?

Mr. MURPHY. I think it goes back to something pointed out earlier by Dr. Lewis. I think that what we have had in the last year or so is an inflationary environment that enabled people to raise prices and wages easily. Perhaps if there had been more public surveillance of the price activities of business firms and of the bids for higher wages by labor organizations inflation might not have gained such a foothold. Prices were permitted to go up while we waited for market forces, in a setting of damp demand, to operate; they have been a long time in coming.

Representative GRIFFITHS. What do you think, Mr. Lewis?

Mr. LEWIS. Well, I tend to agree with what you are saying. I think all of us have all along perhaps too readily described the inflation in the last 2 years as an excess demand inflaton. In 1966 when there was a very large rate of change in demand, we did run into some distinct shortages, machine tool operators and so forth, but I think aside from maybe a few months in 1966, it would be very hard to say that there were general shortages in our system.

I think manufacturing has been operating at a very low rate of capacity utilization for most of the last 3 years, and what this suggests to me is that we have not really been in a position of over-full employment, but that there is another component of inflation.

It is very easy at 4-percent or 3½-percent unemployment to mark up wages and prices, and I think we are going to have that even if we relax our target to 4½-percent unemployment. I think we really have to devise new ways of dealing with price and wage inflation in a full employment economy, or even approximately full employment economy, but we have not really had over-full employment in the last 3 years.

Representative GRIFFITHS. Where is all this excess capacity that we have today?

Mr. LEWIS. I won't try to tick it off industry by industry but there are statistical measures that are devised.

Representative GRIFFITHS. Is there excess capacity because there is not sufficient demand or is it excess capacity because they have overbuilt, or is it excess capacity because they are holding on the books antiquated plants?

Mr. LEWIS. There may be an element of all three frankly, but the only way to judge the importance of it is to look at say manufacturing operating rates on this same basis of measurement at times past, and compare present rates to times past. Operating rates are relatively low, quite low right now.

Representative GRIFFITHS. Going back to supply, at the present time there is really a good-sized backup of automobiles. I believe one company did suggest they were going to cut the price, but I have not heard of any large price reductions on automobiles. The real reaction of the medical profession to medicare and medicaid was to increase prices, and anybody who says that it is not true has not looked at the facts. The truth is they are doing it. They are getting all kinds of examinations that are totally unnecessary, but they are being paid for them. People are taking pills that are unnecessary, but the medical profession is getting paid for it.

There is a sort of Parkinson's law on hospitals. If you build a hospital room, it is filled, and I think that is quite right that this is what they are doing, and this is one of the real inflationary areas of our whole economy.

How can people speak up enough on this to reduce these prices? Do you have any suggestions? It is being made known. Practically every major paper in the country is running articles on this.

Mr. BASSIE. It seems to me that you are perfectly right about this. I think inflation is in considerable part a mental state. It is a mental state in which everybody is trying to get more than his share, but just call it his share, and in the service industries in general, we have had prices pushed up exorbitantly all over the place. In part this could not have been controlled. and in part perhaps it could have if we had had something like guidelines or something a little bit tighter than guidelines, with some kind of penalties behind it. But it is quite clear that the kind of policy we have had does not touch what has been happening in the service industries, where conditions have permitted the prices to be pushed up the most. Except in the field of money, where we have helped the industry get their prices up to where they are, we did not have a policy to control it. We do not have a policy now.

This talk about 3 years of slow growth is essentially just nonsense in my opinion, because the economy does not work that way. It will not behave so nicely as they would like to make out because idle capacity will keep on accumulating.

On this excess capacity business, you have to go into the background, the war situation, where there existed a real threat that people might be short of capacity if the disturbances got worse, and where they were willing to build for shortages and hold excess inventories. There you get a drive that in this mental state of inflation leads to excesses, and we have been having those excesses now for 3 years. That is why I say the instabilities in the economy are much greater than most people think, including most economists in that statement.

Representative GRIFFITHS. You have a truckdriver in a Detroit service industry that is a very competitive industry making between $20,000 and $30,000 a year for a 4- to 6-hour day, 5 days a week; in a very competitive industry how are you going to cut this down? How is anything that the administration is suggesting going to do anything about it? Not one living thing they say is going to touch it.

Mr. BASSIE. Right, but how can you say it is a very competitive industry under those conditions? If you want to increase the takings of all these things you are talking about, the mustard and so on, they ought to be put on the market at lower prices where people would want to buy them.

Representative GRIFFITHS. Trucking is a competitive industry. The management gives in immediately to the demand, because they are so afraid that they will lose the market. It is a very competitive industry I assure you.

Mr. BASSIE. I see. You meant competitive at——

Representative CONABLE. Management rather than the labor level.

Mr. BASSIE. Not at the labor level.

Representative GRIFFITHS. No. The labor level is not competitive and you are not going to make it competitive, not by anything you are suggesting.

Thank you very much, Mr. Chairman.

Senator PROXMIRE (presiding). Thank you, Mrs. Griffiths.

Along the line that Mrs. Griffiths and Mr. Reuss were asking, it is true as I understand it in the last quarter of last year, the most recent period for which we have statistics, our plants were operating at 81.9 percent of capacity, which of course is very low and close to a recession level, and compares with 85 percent in 1964 when we cut taxes to get the economy moving. I notice that the latest statistic on hours worked in total nonagricultural employment is 37.2 hours a week in January, and this is lower than it has been at any time in many years. You have to go off the chart to find a lower rate of hours worked than we have right now.

I have been trying to get figures back to 1939. You may have to go back that far to find a period when we had that much available capacity and available manpower in plants, not unemployed, statistically listed as unemployed but obviously underemployed. We are just not ready to do this job.

Mr. Bassie, you say, "The best reasons for thinking the recession will be mild remain the same as in earlier postwar years. They are the war programs."

You also add Government support for consumer income. "Military stimuli at important critical periods, Hungary, Suez, sputnik, and so forth." This analysis is interesting and it may be accurate but I wonder what we can do to get away from this.

After all the best example of a country that has been able to improve its real income, it has paid an inflationary price but its real income, is Japan. What is their military budget? Less than 1 percent of their GNP compared to 8 or 9 percent for us. West Germany is another dramatic example of a remarkable increase in the standard of living of their people and they have a very low military expenditure. What are they doing that we are not doing? These are not controlled economies. These are generally pretty much mixed economies like ours.

Mr. Bassie. Well, they have, as a matter of fact, more planning and control than they are willing to admit, and they rely on us to protect them. Their control has been essentially a form of control that is acceptable to their enterprise. It is an expansionary policy from beginning to end, with steps being taken to restimulate the economy every time there tends to be any letdown. Now, the tremendous——

Senator Proxmire. What kind of controls in general are you referring to?

Mr. Bassie. I mean the kind of planning and control that they have operates very largely to keep them moving ahead.

Senator Proxmire. How do they interfere with the free market more than the United States does in say Japan and West Germany?

Mr. Bassie. Well, I do not think that is true in West Germany. I think that in Japan it definitely has been true, that they have planned their industrial development step by step, and they have a whole series of measures to promote it, and, of course, they have maintained foreign exchange controls.

Senator Proxmire. They do not have price controls?

Mr. Bassie. What is that?

Senator Proxmire. They do not have price controls in Japan, do they? In fact they have suffered a considerable amount of inflation.

Mr. Bassie. That is right.

Senator Proxmire. Their wages have gone up rather sharply?

Mr. Bassie. That is right.

Senator Proxmire. So they do not have wage controls?

Mr. Bassie. That is right.

Senator Proxmire. They do have a large sector of their economy in the hands of private industry. It is not as socialized as say England.

Mr. Bassie. Yes; but you see the fact that they have an undervalued currency with exchange controls permits them to get away with a certain amount of overheating of the economy. It is the ideal situation for an economic planner, because he can then push policies of expansion that would not work otherwise.

Senator PROXMIRE. West Germany is another example of how they are able to do this. I just wonder, and I think your paper was excellent the way you went at it, I wonder if we are not paying too big a price for trying to cope with inflation, especially due to the fact that we are not doing it. You question the claim of how cruel inflation is, and I think many people have pointed out that actually the people with lowest incomes are not those who are most seriously hurt by inflation.

Mr. BASSIE. I was just about to take exception to Murphy's statement at the end of his paper, that it is the poor who suffer most in inflation. There are a number of studies which show that this is not so. The fact is that this is the time when they get employment and get wage increases. It gives them an opportunity to improve their position, rather than the reverse.

Now, it is true that there are many people with fixed incomes, people on annuities, for example, who art hurt. But even if you look at the group on annuities—and social security includes the great bulk of people over 65 in the economy—if you look at that group, most have not lagged. This year, to the extent that they were lagging since the last increase, the 15 percent increase in benefits has fully brought them up again. So you can take measures to adjust for most of those special groups who are put at the greatest disadvantage if you want to.

Senator PROXMIRE. The important question is increasing the real income, isn't it, the real income; and of course we have problems of equity distribution, but certainly it is inequitable to be tied to the Phillips curve to such an extent that you feel the only way you can cope with inflation is to create a situation that increases unemployment, because there the inequity is that the 700,000 people to whom Congressman Reuss referred who would rather work are people with low incomes who are pretty inarticulate, by and large do not vote very much, and have much less political power as well as financial power.

Mr. BASSIE. Yes. Well, let me just say that I think that the 700,000 increase is a gross understatement of what we face. In saying 6 percent, citing that figure, I did not cite that as an upper limit. I cited it as a probable figure, under conditions where there are unusually wide margins of error. It might be anything from 5½ to 7 percent, and if the decline turns out to be a bigger recession than I calculate, even 7 is not the top limit.

We do not know exactly how people are going to react in terms of their labor participation, and I think therefore it is appropriate to be a little cautious, and therefore I say 6, but that is by no means the top.

Senator PROXMIRE. Do you want to comment, Mr. Lewis?

Mr. LEWIS. I wanted to comment that although I too think that we should be expanding output, I do not think we can afford to be relaxed about this inflation problem, for one reason, the one that Mr. de Vries has been stressing, our balance of payments, and for another because it is very hard to fix up the people who do get left behind in inflation. I think we need a policy with two parts to it, expand real output and try to hold prices down through some form of direct intervention.

Senator PROXMIRE. I would like to ask any of you gentlemen who would like to respond to this, an article in the New York Times on Sunday indicated something that seems to make a lot of sense. They said there is a growing disillusion with the economic impact of fiscal policy. They point to the dramatic turn around we had in a budget deficit of $25 billion in fiscal 1968 to a surplus in 1969 and another surplus in 1970, and what happened to inflation? It increased. Now you would think with a terrific change of that kind in fiscal policy, with the Government's revenues increasing to the point where they are greater than its expenditures, from this enormous deficit that you would have an effect on prices, that your prices would begin to moderate. It did not do anything of the kind. They went up.

Now, is it the answer that the monetarists are right, that it is a monetary policy rather than fiscal policy rather than the real cutting edge in our economy?

Mr. Lewis. I do not personally think so. Both fiscal and monetary policy are important. It is true that——

Senator Proxmire. Why was it so unimportant during this period? Why didn't fiscal policy have some bite?

Mr. Lewis. Well, because monetary policy was going gung-ho in the other direction, that is the monetary authorities felt that the fiscal authorities had overreacted.

Senator Proxmire. It has been gung-ho in the right direction according to—same direction at least——

Mr. Lewis. They were expanding money very rapidly during 1968 and partly because they did not have good statistical measures of the money supply, the expansion of the money supply went on faster and longer during 1969 than they thought was happening. As Mr. Bassie pointed out, it was not really until the second half of 1969 when monetary policy began to reinforce fiscal policy.

Senator Proxmire. This is true, but since the second half of 1969 we have not had any improvement in inflation. That has been getting worse steadily, even with monetary policy and fiscal policy both working?

Mr. Lewis. This is only part of the answer.

Senator Proxmire. That is what?

Mr. Lewis. The answer I just gave is only part of the answer. The other part is the matter that we have talked about all along, that there is an expectational component to inflation. There is discretionary price and wage power in the system, and fiscal and monetary policy together are very crude weapons for trying to deal with that.

Mr. Murphy. I think the shift in the surplus-deficit position, and the reduction in the growth of money supply and credit had their greatest impact on demand. The logic of the policy was that the change in money supply growth and in the fiscal position would adversely affect money demand. Eventually prices would be affected and inflation eased. But experience during the last year indicates that the effect on prices has a very great lag. In the interim, the initial effect of restricting demand is to raise prices.

Senator Proxmire. Is to what?

Mr. Murphy. Is to raise prices. Businessmen, faced with higher costs and lower margins of profit, react by raising prices to protect margins and maintain their profitability.

Senator Proxmire. That is an effect of the administered price area where we have had relatively less inflation, but in the services area, where you have a tremendous number of small businesses——

Mr. MURPHY. The same phenomenon operates there. It is not only a matter of competition between one firm and another, with all costs going up, business strives to maintain profits and tries to lift prices. In the service sector, the low productivity, limited supply and strong demand contributed to the rise in prices.

Senator PROXMIRE. Yes, but what happens if you are in competition, your demand drops even if your costs are going up, if you are capable of producing, you produce anyway but your margin of profit diminishes to a point where it might vanish or become negative, if you are in real competition.

Mr. MURPHY. The first reaction even of a corner grocery store is to try to protect margins by selling a lower volume of goods at a higher price. That is the first reaction.

Now, what we found out in the last year is that the reduction in demand affects price pressures with a great lag, it is far from being immediately effective, thus, the initial impact seems to be an acceleration, rather than a reduction, in price growth. The administration is counting on the real bite of its antiinflationary policies to come this year, working through a reduction in demand. Manufacturers and others will find that they cannot hold prices up and they will begin to shave them. This is the administration's expectation. It remains to be seen whether it will happen, but in the meantime unemployment is going to have to rise.

Senator PROXMIRE. Mr. Bassie, do you want to comment?

Mr. BASSIE. Yes, I would like to come back to the point you raise. When the economy is moving, the Government surplus or deficit always tends to move in the same direction because revenues rise or fall. Now, as I say in my paper near the end, I think that if we get a rise in Government deficit this year, it will not be inflationary, but will be restraining on the decline. I also think that the rise to a surplus position last year was an element of restraint on the advance, but relative to the other forces moving the economy, it was not sufficient to prevent that.

In the last year people have shifted to this undesirable kind of policy, not just what he is talking about, but the general pattern of policy of getting all you can. The administration says they are not going to do anything about it. The other guy takes himself a bigger cut, so I say I want a bigger cut, and everybody is doing it, and under conditions where you can get away with it, business is quite responsive to the opportunity. So we have been getting price increases that will not be able to stick in many cases.

Senator PROXMIRE (presiding). Congressman Conable?

Representative CONABLE. Thank you.

Dr. Lewis, you indicated that you think inflation is still a problem. You say we need a two-pronged attack here where we work against prices at the same time stimulating increased production. How do we do that?

Mr. LEWIS. I think we should ease monetary policy right away, and I think we should institute guideposts right away.

Representative CONABLE. Guideposts and monetary policy?

Mr. LEWIS. Monetary easing; yes. When you stimulate demand you can always choose between fiscal and monetary policy and in my judgment we have been leaning too heavily on monetary policy and not heavily enough on fiscal policy to restrain demand, and therefore in an expansionary setting, I would use the monetary weapon first.

Representative CONABLE. Do you feel that guideposts would be enough to hold prices down, even though we were pursuing a more expansionary monetary policy?

Mr. LEWIS. Well, I am setting myself the modest target of getting prices down from the 4.6 percent increase last year in the GNP deflater to something tolerable, say 2 percent a year in a shorter period of time than the 3 years or so that the Council of Economic Advisers is promising under their slow growth policy, and I do not think it would be hard for guideposts to do that, if we can keep unemployment at about the present level.

Representative CONABLE. Dr. Murphy, you have said that you are not a labor man, but your company having just completed a very major labor contract, I wonder if you would if you would like to comment about the imposition of guideposts right at this point with respect to prices. Do you think that General Electric would be responsive to a request expressed by the President over nationwide television that nobody raise prices at this point?

Mr. MURPHY. Well, I think the General Electric Co. has always cooperated with Government policy.

Representative CONABLE. It still has to make a profit; is that not correct?

Mr. MURPHY. Yes; that is right. In fact I think one of our concerns about the guideposts is that organizations such as our own that are highly visible would be prime targets of the guideposts, while smaller firms that we buy from, quite often would not be as visible and would not be as prone to hold back on their prices.

Representative CONABLE. Do I take it from that that you do not share Dr. Lewis' enthusiasm about guideposts?

Mr. MURPHY. I am not as enthusiastic.

Representative CONABLE. As equitable devices?

Mr. MURPHY. I am not enthusiastic; no, sir.

Representative CONABLE. Dr. Murphy, I am also very interested in this. The last Department of Commerce-SEC survey conducted in November-December indicated that business planned to increase capital spending in 1970 by 9.7 percent. There was a very substantial increase in capital spending last year as well. Now, this is in the face of factory operating rates at a 7-year low, deteriorating profits and very high cost of raising money.

How do you reconcile all this? It is very difficult for me to understand except in terms of a very high continuing expectation of inflation.

Mr. MURPHY. Well, along with the expectation of inflation they also had expectations of a greater rise in profits. I suspect that realizing those plans will be difficult in many cases. Since the survey was taken, there has been a very decided shift in the profitability of industry.

Representative CONABLE. So you expect the capital spending plans to be adjusted downward very sharply?

Mr. MURPHY. Yes.

Representative CONABLE. As a result of this; do you?

Mr. MURPHY. Yes, sir; I do. Where will the funds come from? Profits and cash flow are down, borrowing costs are high, and they will remain high. Furthermore, due to the slowdown in the economy, many manufacturers will feel that they do not need the facilities as quickly as previously thought. Some will be willing to wait a few years. All these factors will operate to hold down the rate of growth in investment spending during 1970.

Representative CONABLE. You put great stress in your testimony on increasing production, and it certainly sounds very fine in terms of the old laws of supply and demand. What short-term policies to increase production are you referring to?

Our problem is basically a short-term problem at this point, although the long-term problem is always with us. Still, inflation is likely to be a cyclical thing, and therefore it is likely to be most embarrassing in the short-term.

Mr. MURPHY. Well, I suppose my basic position is that it is also a long-term policy question. The short-term inflationary phenomenon now being experienced is about to be modified by the fiscal and monetary policies followed during the last year or so. In fact, monetary restraint has probably persisted too long. Nevertheless, on the basis of the policy moves taken already, a reduction in price inflation is highly probable. I do not think that we will get back to a 2 percent rate of price increase until we look at inflation as a long-term problem. In our economy, there is a commitment by the Government, and accepted by all, to keep employment high—at virtual full employment levels. If the unemployment rate begins to go up over 4½ percent you gentlemen know, and I know, that fiscal and monetary policy will move very rapidly toward ease, thus expanding the economy again, and inflation will be back with us again.

Representative CONABLE. What are you suggesting then as long-term policies to encourage production, such things as the investment credit, for instance?

Mr. MURPHY. I think the investment credit should be restored.

Representative CONABLE. More training programs?

Mr. MURPHY. More training programs particularly in construction, and I would recommend on-the-job training by industry with Federal help, that is a subsidization of job training.

Representative CONABLE. How would you change our present manpower training programs? You certainly will not increase the number of them. We have got virtually hundreds of them now. You would put more emphasis on consolidation and move to on-the-job training more?

Mr. MURPHY. Yes, I would emphasize on-the-job training. I think that some of the faults seen in our manpower programs have stemmed from the simple fact that training has been in the hands of people who did not understand what industry really needs in the way of skills. If industry provided the organization for the training and the instructions, employees would build up skills that are needed. That is the principal modification in the present programs I would recommend. However, the requested funds for these programs should also be increased.

Representative CONABLE. Dr. de Vries, I am sorry I have to come back to this international business again. I asked for some staff figures on this. As of September in 1969, $12.5 billion was the share owed to official foreigners of our total. U.S. liquid liabilities at that point were $42 billion, a little over that.

It still sounds to me as though there were substantial liquid U.S. liabilities to official foreigners then, and I do not understand how that squares with your statement.

I would like to ask you would these official foreigners have held $12.5 billion if they did not think the dollar was as good as gold, at least in relation to the period a year before when they were cashing lots of dollars.

Mr. de Vries. That is right, but I do not quite get the point you are driving at here. The concern about the balance of payments is not the same as running quickly to the gold window and converting dollars into gold.

Representative Conable. Yes; I understand, but are the central banks likely to hold as much as $12 billion in dollar credits, if they are concerned about the continued deterioration of the dollar through inflation?

Mr. de Vries. First, $12.5 billion is not a very high figure.

Representative Conable. No; it is apparently a little less than a quarter of the total liquid liabilities outstanding.

Mr. de Vries. This has been higher, even this particular part of U.S. liabilities to official foreigners. I refer, of course, to the fact that $12.5 billion is truly the short-term part of these liabilities. They hold in addition to this other type of obligations, such as Roosa bonds; these may be another $5 billion, may be somewhat more.

Representative Conable. The highest it has been in the past 5 years is $15.6 billion, so it is not really substantially reduced.

Mr. de Vries. In those particular 5 years, of course, we have had an enormous expansion of world trade.

Representative Conable. Yes.

Mr. de Vries. I mean this——

Representative Conable. Percentagewise it constitutes a smaller amount.

Mr. de Vries. That is right. This underscored the shortage, and certainly the threatening shortage of international liquidity. I think one of the reasons why the Europeans have been willing to agree to a very substantial increase in the creation of special drawing rights, is that we have had an enormous expansion of world trade in the last couple of years, while at the same time there has been pressure on their reserves.

Representative Conable. What I am driving at of course, is this. We are dealing with a very interesting situation in the relation of our official settlements and our balance of payments, and I am interested in what people holding our dollars think about our policies, whether they are well designed or not to achieve the goal of a stable dollar.

Mr. de Vries. Right.

Representative Conable. And I am trying to figure, looking at these totals that I have mentioned, whether the European central bankers, who are in a very practical relationship to the dollar, are satisfied with the steps our Government has been taking, and I have to conclude that they are better satisfied than they used to be, because our official settlements balance has been better.

Now, you ascribe this or at least you did earlier to the fact that there simply were not many liquid liabilities owed to central banks, and I think there has to be a further explanation for this in the light of these particular figures.

Mr. DE VRIES. Well, during 1969 there were very few central banks who felt that they had too many dollars, they were really concerned with losing too many. Because of our official settlements surplus they were losing dollars, of course, because we were taking very firm budgetary and monetary policies during the course of 1969. Then, there was also the changed gold situation, not so much our changed gold policy but rather the gold agreements, et cetera. It is quite understandable why the United States did gain gold.

But, I believe, we should keep in mind, that in the future, when our official settlements surplus has changed to a significant deficit—figures do not mean too much, but we could certainly have $5 or more billion official settlements deficit—and if we do not get our inflation under control. U.S. policies will be a very active point of discussions at the meetings of the OECD, Basel, et cetera.

Now, as to what Europeans can do, whether they would rush in and start converting their dollars, I do not want to speculate. I have my doubts, but there may be other forms of pressure.

Representative CONABLE. My time is up.

Mr. BASSIE. May I comment on that?

Senator PROXMIRE (presiding). Mr. Bassie?

Mr. BASSIE. It seems to me that if you look at this picture in very broad terms, it is a situation in which the world is on the dollar standard, and has been for over two decades. Many countries did not like that position, and they do not like some of our policies today, and therefore we are in a transition to an international form of money; namely, the special drawing rights.

But in the meantime they are stuck with us. The dollar has gained such dominance in the reserves of all the countries that they cannot really do anything about this situation except play ball, and maintain the dollar standard for the benefit of all.

Anything they do will essentially be to their own disadvantage. They can take the rest of our gold, but if we go off gold, they will not want it either; and when our gold is gone, they can devalue the dollar, but they do not want that. They do not want to improve our competitive position in world markets.

They could take more of our goods, but they do not want to do that, and so they are just stuck with whatever our balance of payments happens to come out to, and it is not a situation that pleases anybody very much, but nobody sees a remedy for it.

Senator PROXMIRE (presiding). Congressman Reuss?

Representative REUSS. So we do not lose our thread, I would perhaps ask Mr. de Vries to comment on the statement just made by Mr. Bassie. Do you agree or disagree?

Mr. DE VRIES. I think the Europeans may get together. There has been more talk about and increased pressure for a European currency, perhaps a pooling of their reserves. Whatever they could and will do is likely to be difficult and it may take quite a long time to achieve, but I would not think that the Europeans are entirely powerless. Moreover, I think—and this is another aspect of it—that the balance of payments is a very sound constraint on the country's policies. To reason, in effect, that we should never care about our balance of payments is irresponsible; the balance of payments should be a constraint reinforcing the country's policies to curb inflation.

Representative REUSS. Mr. Lewis, I listened with much sympathy to your account of the need for verified wage-price guideposts, with emphasis on arriving at them in conjunction with management and labor, and administering them through some sort of a board or institution. And I have been a leading exponent of the wisdom of returning to wage-price guideposts myself.

However, as the situation has deteriorated in recent months, particularly in the last 6 months, I am wondering whether it is indeed enough, in order to enable us to get a hold on the inflationary situation in this country, just to restore wage-price guideposts specifically, since productivity is down to zero or close to zero. Nobody in his right mind could dream of asking labor to submit to labor increases because productivity is not going up. Productivity is not going up largely because of the slow-down policies of the administration.

Yet if you are going to say let there be a wage guidepost of 7 percent, in order to let labor catch up, you have kind of given away the game right at the start.

Accordingly, I have come increasingly to feel that in order to take hold on the very dangerous inflationary situation in this country, there needs to be done not only the loosening of credit which Mr. Murphy and yourself have called for, but I think we need a 6-month across-the-board freeze on price increases, in order to enable us to evolve longer term wage and price guideposts, and if you are going to ask labor, for example, to sit still for a meaningful wage guidepost, you are going to have to give it some assurance that there is going to be some burden-sharing by others.

Therefore, I think what is needed is a 6-month freeze on prices in which labor perhaps is asked to restrict itself to wage increases which will not cause price increases, and attempt within that 6-month period to evolve longer term guideposts. Also work very hard, starting with the word go with many of these supply side things that Mr. Murphy has so well described.

In short, doesn't your wage-price guidepost policy need to be augmented by something for the short term at least a little tougher? I think it does.

Mr. LEWIS. Sir, I think a case could be made for a jolt of the kind you describe. Former Under Secretary of the Treasury Mr. Roosa made a very eloquent case for exactly that recently. I won't argue strongly against it, but I am not convinced that it is necessary.

I would argue first that the productivity part of the wage guideposts ought not to be the productivity of that particular year which is zero recently, but trend productivity which averages 3 percent or 3.2 percent year in and year out. In addition, because they are not starting from a position of no inflation but starting from a position of some inflation, the wage guideposts should be 3 or 3.2 plus some fraction, say a half or three-fourths, two-thirds of recent increases in consumer price. And the price guideposts, which always was very flexible, that is, it called for stability, increase, or decrease according to whether it was a high, low, or median productivity industry, similarly needs a component of flexibility, because wages will be going up more than the trend in productivity.

I think with that kind of guidepost approach, starting right now and in the context of real demand expanding along its potential of 4.3 percent, that we could work inflation progressively down in a couple of years.

Representative REUSS. Turning to another subject, revenue sharing, which is in this year's upcoming budget $275 million, revenue sharing, an idea with which I have been sympathetic for some time, is predicated, I always thought, on the notion of large-scale growth, 4 or 4½ percent in real terms for the years of the early seventies, leading to a very substantial fiscal dividend.

In view of the fact that we are, for reasons that are not clear to me, apparently committed to a no-growth economy for the next 2 or 3 years or practically a no-growth economy, shouldn't we put to one side, accordingly, the idea of a start on revenue sharing, because revenue sharing it seems to me does depend upon growth and fiscal dividend?

Mr. LEWIS. You know one of the criticisms of revenue sharing in the past has been that it does not lend all that much stability to State and local revenues, if it is going to be tied to a volatile Federal income tax, if we are going to run an upsy-downsy stop-go kind of economy. Federal income taxes are cyclically volatile, and if the formula is going to tie it to this year's or last year's Federal revenues you are introducing an element of volatility into State and local revenues.

If the administration is seriously proposing a stop-go kind of economy rather than continuous full employment economy, I should think they would go for a revenue-sharing formula that tied it to some trend rate of growth and not so tightly to year-by-year Federal revenues.

Representative REUSS. Thank you, Mr. Chairman.

Senator PROXMIRE (presiding). I would like to commend you very, very much, Mr. Murphy. It is strange and marvelous that from the chief economist of General Electric we get the very first analysis of defense spending, military spending, and its effect on inflation. We got nothing from the Council of Economic Advisers, nothing from the Budget Director, nothing from the Secretary of the Treasury, nothing from the Federal Reserve Board, and this is the first, and I think it is a very important and significant factor.

We got nothing although we belabored CEA last year—the Johnson Council of Economic Advisers, who were almost equally delinquent in failing to analyze it. In your statement you say: "Heavy procurement of defense goods shifted scarce labor and plant facilities from production of civilian goods increasing price pressures."

Then you go on to point out an enlargement of the Armed Forces deprived the private sector of some needed employees. Quickened withdrawal from Vietnam and cutbacks should be part of the arsenal of anti-inflationary policies.

God bless you, it is time that was said. People may disagree and feel that is irrelevant to military policy but I think it is a consideration we ought to have in our mind and I am delighted you brought that to our attention.

Mr. de Vries, along this same line you say: "Military expenditures abroad will be about the same in 1970 as in 1969." Does this mean that all of our Vietnam savings and de-escalations as the Secretary of Defense put it, a $13 billion reduction of spending in Vietnam from 1968 to 1970, calendar 1970, does it mean that all of that saving will be spent elsewhere abroad, or does it mean that we are not really cutting any of our Vietnam expenditures, but somehow reducing the impact of the Vietnam war by $13 billion? What happened to that money? Why can't we reduce our military drain here somewhat, somehow?

Mr. DE VRIES. That was somewhat of a surprising development. Over the past year military expenditures have merely leveled off——

Senator PROXMIRE. That is true, they have leveled off. They were $4.5 billion as I understand it in 1968, then went to $4.8 billion in 1969, but leveled off during the year.

Mr. DE VRIES. During the year, the second half of the year.

Senator PROXMIRE. Now why can't that come down rather sharply with deescalation?

Mr. DE VRIES. I think it will take time, an extra year at least.

Senator PROXMIRE. Why, why should it? If you are withdrawing your troops on a steady basis, cutting down our activities over there?

Mr. DE VRIES. It is still only a small part.

Senator PROXMIRE. Cutting down our B–52 raids, cutting back on search and destroy, cutting this enormous amount in actual expenditures, why wouldn't that be reflected in the amount that we are actually spending abroad?

Mr. DE VRIES. Well, most of these activities, like B–52 raids, probably involve very little direct foreign exchange outlays. These outlays depend primarily on the number of troops we have abroad, and on offshore purchases. All I am trying to say in the statement is that I would be very surprised if military spending would come down by very large amounts, say by $1 billion this year, in order to bring down materially the $7 billion deficit on the liquidity basis. We might see a reduction of a couple of hundred million dollars but that is rather little relief in view of the large deficit that has to be reduced.

Senator PROXMIRE. Let me just ask this: Do you think it is worth our probing it to find out why we do not have more of a saving? If it leveled off last year why shouldn't it decline in 1970, military spending abroad, in view of Vietnam?

Mr. DE VRIES. Yes, I think so.

Senator PROXMIRE. It is worth an inquiry?

Mr. DE VRIES. Yes.

Senator PROXMIRE. Let me ask this, Mr. de Vries. Isn't it true that the large New York banks complicated monetary policy and helped to increase our balance-of-payments deficits by borrowing Eurodollars from their oversea branches in the last 2 or 3 years?

Mr. DE VRIES. Increased our balance-of-payments deficit?

Senator PROXMIRE. Yes.

Mr. DE VRIES. You could argue probably that when the banks borrow in the Eurodollar market—actually the banks do not borrow but their branches borrow and they redeposit the funds with their head offices—the banks pay their branch say 10 percent per annum. If these dollars had not been redeposited through our branches, and foreign central banks had obtained them, they might have purchased Government bonds on which they might have received 7 or 8 percent. The difference between this rate and the rate banks pay to their branches tends to increase the deficit.

Senator PROXMIRE. Let me get away from that. I think we could probably argue on that quite a bit but let me just get down to the fact that it did frustrate monetary policy. If the Federal Reserve Board tries to slow down the supply of credits and the big banks just go over and get a supply of credit from somewhere else, as Mr. Bassie said, no rules, they can get a substantial amount of Eurodollars, doesn't this simply offset the purpose of monetary policy, which is to diminish the supply of credit available to the banks so they would not loan it to their customers, especially their business customers?

The fact is that the bank loans increased during the year.

Mr. DE VRIES. They did increase.

Senator PROXMIRE. Sharply?

Mr. DE VRIES. They did increase. However, Eurodollar borrowing by American banks has really not changed the reserve base of the banking system of this country, except for the required reserves saved, because until May there were no reserve requirements against Eurodollar liabilities against foreign branches. But apart from that consideration, it does not increase the reserve base of the American banking system.

Senator PROXMIRE. It does not?

Mr. DE VRIES. It does not change the reserve base of the American banking system, which is controlled by the Federal Reserve System.

Senator PROXMIRE. The staff points out to me that it reallocates credit from the small banks to the big banks.

Mr. DE VRIES. Sure.

Senator PROXMIRE. The big banks make the loans to the big business firms and they are in a better position to do it.

Mr. DE VRIES. When we receive Eurodollars through our branches we receive them through a check drawn on another bank in this country. In other words we raise funds in a very roundabout way, instead of directly through the Federal funds market or CD market. The Eurodollar market essentially is an extension of the New York money market.

Senator PROXMIRE. Let me follow that up then by asking why do you suggest, which you do, that in order to curb Eurodollar borrowing the Federal Reserve permit large banks to issue commercial paper? It seems to me this is robbing Peter to pay Paul. Why not curb both types of borrowing, so that large banks will be compelled to reduce their lending to large corporate customers, which is what we are trying to do. Almost everybody who has testified in the last year has argued that a highly inflationary element in our economy is the acceleration, that is in business investment of our plant and equipment, which as pointed out by Mr. Conable is expected to go up by over 9 percent this year. This is exactly what the big banks insist on fueling, unsustainable rate, we are operating at less than 82 percent of capacity for the last quarter; this quarter it is probably below 80 percent of capacity, and yet we are following policies that enable the banks to do this, and you are advocating that they be able to sell commercial paper which will make it worse, will it not?

Mr. DE VRIES. Well, you may argue that selling commercial paper has been a safety valve. I believe Chairman Martin has pointed out very clearly that Eurodollar borrowing, and you might say that also for selling commercial paper, has been a safety valve for regulation Q.

Senator PROXMIRE. At any rate it would seem that certainly our policy should be to try and restrict the credit available. I do not blame the banks for trying to do everything they can to open it up. If I was still with J. P. Morgan, which I was in 1940, I would be right with you, probably working under you.

Mr. DE VRIES. I think it would be very unfair to say that the banks have not been applying credit restraint. There has been a very strong credit restraint from the end of 1968 on in the banks, certainly at the Morgan Guaranty Trust Co.

Senator PROXMIRE. I would like to move to a different territory, Mr. Bassie, to ask you this. You say that unemployment this year would be 5½ to 7 percent. It could be that bad, and I translate that into meaning another 1 to 2 million Americans out of work. I have asked a series of administration witnesses what shelf programs they have, what job programs to put people to work if they are employed, and they always come up with the same reply, nothing. They have automatic, of course, elements of unemployment compensation and so forth that will help a little, but they do not have any jobs that are available, big public works programs and so forth for people to work.

What do you suggest as weapons which we could add to the automatic provisions we now have on the books to counteract unemployment, if it is as big as you say is possible?

Mr. BASSIE. I think there will be tendencies to try additional tax reduction. I must say that I am not happy about that alternative, because it is an alternative that does not accomplish what you want to do. It puts money in the wrong hands. It tends to create a bigger problem eventually by affecting the distribution of income perversely, and it gets the wrong things done.

Mr. Murphy a while ago spoke of the many things that needed doing in the economy, things that in many cases only the Government could do, and it seems to me that we ought to be prepared to do some of those things.

Now, you tell me we are not prepared to do them, and, of course, the present policy is directed towards squeezing out small bits of budget all down the line on various things that ought to be done. Frankly, I do not know how you can get this turned around as long as these administrative people believe nothing unfortunate can happen to them.

They too are infected with inflationary expectations, and, I think, that that has to change in order to get effective action.

Senator PROXMIRE. One of the areas in which we could move, if we could somehow get the financial situation in order, would be in housing. We have a terrific shortage of housing. We have set as our goal an average of 2,600,000 housing starts for each of the next 10 years. We are operating this year at about 1.16, far, far below it. Housing employs many more people than on-the-site construction workers with supplying houses and so forth, but I do not see any real likelihood of being able to get mortgage rates down. They are the stickiest of all. Treasury bill rates have already come down, but get mortgage rates down sufficiently so we can get this kind of activity and then get it under the kind of psychological circumstances that you would have in a recession. It seems to me we have to do some hard thinking here, and need some programs we do not have.

Mr. BASSIE. Well, I think, that is true, but the housing picture is very complicated. It seems to me that to say it is just the high interest rate policy which has put the housing market in this state is not entirely correct, and I do not think that if we ease it, the problem will be solved. When we begin to ease, we can bring down short-term rates, but it will take much longer to affect the long-term rates, and especially the mortgage rates. I agree with you completely on that point. But even after we begin to get those rates down, it will not necessarily turn the market around in housing if we are then in a situation where there has been a basic change with respect to inflationary expectations, because that change will react on the negative side.

What has sustained the housing market through most of the post-war period is the growth in employment on the one hand, and the inflation of real estate values on the other. The letter has constantly bailed out mortgagers who got in trouble. They have been able to sell houses at higher prices, and where there would otherwise have been negative equity, they have been able to realize enough to pay off.

So, we have kept out of a troublesome foreclosure situation for all these years, but if we move into it, the housing market could stay depressed for a while; and more specifically, with unemployment rising, it does not seem to me it will be very responsive this year to anything we might do.

Senator PROXMIRE. I would just like to ask a couple of more quick questions, and I apologize for keeping you so long. I would like to ask you, Mr. Lewis, this question.

I was glad to note that you emphasized the sacrifice in real growth which must be made if we follow the administration's economic policy for a year; instead of a real growth rate of around 4 percent the real growth rate will be around $1\frac{1}{2}$ percent. I wonder if you could translate this into dollars, and indicate how much we are losing in dollars in terms of slower growth rate?

Mr. LEWIS. Well, $2\frac{1}{2}$ percent of GNP would be about \$25 billion I guess, would it not?

Senator PROXMIRE. And how many additional homes could be built in 1970 if we were able to recapture part of this lost production into housing? Quite a bit, wouldn't it? Is this practical?

Mr. LEWIS. It would be hard to get \$25 million into housing.

Senator PROXMIRE. I didn't ask that. I asked how much of it?

Mr. LEWIS. I should think the difference between an immediate easing of credit starting right now and holding on for another 3 months, which is about all they will be able to do anyway, that that might add maybe a quarter of a million housing starts by the end of the year, but it would not be that much for the full year, so that it would make only a very small dent in this \$25 billion of lost output.

A lot of this loss I am afraid we are already in for, in that an easing of credit would not immediately go into housing. There would be time lags.

Senator PROXMIRE. It would take a lot of active, much more action on the part of the administration in regard to the 600,000 low-income and moderate-income programs which are subsidized by the Federal Government. Of the 2,600,000 housing starts, 600,000 is the level where we have programed various subsidies. One is the provision of a subsidy of the interest rate down to 1 percent.

To the extent we can step these up, obviously we can do it pretty fast if we are willing to spend the money. It seems to me this would pick up part of it.

One more quick question and then I will yield to Congressman Conable if he has any further questions. That is, if we revive the wage-price guideposts, Mr. Lewis, do you think it would be a good idea if this committee held hearings each year on the guide prices proposed by the administration?

Mr. LEWIS. I would see nothing wrong in that, but as I suggested in my paper, I think the annual guideposts ought to be set not by the administration or the Congress, but in consultation with business and labor. It really ought to be a cooperative undertaking, but I should think that the Joint Economic Committee could find a way to tie into that process very nicely.

Senator PROXMIRE (presiding). Congressman Conable?

Representative CONABLE. Thank you.

Mr. de Vries, Dr. Burns in appearing before this committee last week said that the flow of Eurodollars had not operated substantially to frustrate overall monetary policy this past year, although it might have helped individual banks some. It constitutes such a small part of the total credit available that it has not really had a major impact on the monetary restraint the Government was seeking to impose.

Would you agree with that statement?

Mr. DE VRIES. Certainly with the first half. As I said before, and I believe this view is held in the Federal Reserve System, the practice of Eurodollar re-depositing between the banks and their head offices does not affect materially the reserve base of the banking system. And even if it had, the increase could have been offset immediately by the Federal Reserve through open market policies. The practice has not really interfered with the Fed's monetary policy.

Banks have commitments, and they are under heavy loan demand pressure because of the inflationary situation. Bank loans went up, but they would have gone up far more had their reserve base been much larger. There are difficult situations in individual banks.

I am not in the domestic banking department and am not very familiar with loan transactions but I would not be surprised if about half of new loan demands had been turned down in the period of severe tightness.

Representative CONABLE. This flow of Eurodollars is a pretty short-term phenomenon isn't it? Isn't it likely to be?

Mr. DE VRIES. It is a money market phenomenon. We have to look at the whole Eurodollar market as essentially an extension of the U.S. money market, at least at this stage.

Representative CONABLE. So it would be short term?

Mr. DE VRIES. It is essentially short-term money.

Representative CONABLE. Then by the same token if there is an outflow of Eurodollars this next year, because of changed conditions, do you think it would have any substantial impact on any Government change in monetary policy, an effort to ease money, for instance? Would it operate to frustrate in the other direction then, as has been alleged it has frustrated the tightness of our monetary policy in the past year? Would it still be a comparatively limited phenomenon without major impact on overall Government monetary policy?

Mr. DE VRIES. First, when say during the next 3 months, Federal Reserve policy would begin to ease, and, as I have pointed out in my statement, the banks' Eurodollar borrowing would fall, as a result of which we could get a large balance-of-payments deficit on an official settlements basis, and foreign central banks pick up a substantial amount of dollars, we should not worry about this for a while.

From the figures you already have given, foreign official dollar holdings have come down over the past 2 years. Foreign central banks would be very glad to see a rebuilding of their reserves.

Secondly, there are several central banks, the Bank of England particularly, who still owe this country substantial short-term debts. As of now, Britain's short-term dollar debts are of the order of $1.5 billion. It would be glad to get dollars to repay us.

But after these reserves have been rebuilt sufficiently and the United States continues to run large official settlements deficits, we might get some static from foreigners. In that case as I have suggested, at the very end of my statement, the Federal Reserve could ease up on the banks' Eurodollar usage.

The main rationale why the 10-percent marginal reserve requirement was established by the Federal Reserve last May was that European central banks had been losing their dollars too rapidly because of the tight monetary conditions in this country. By the same token, when during the course of this or next year, European central banks might become concerned that they were getting too many dollars, the rationale for the 10-percent marginal reserve requirement would no longer be there. Therefore, the Federal Reserve could then very well eliminate this requirement, thereby making it more attractive for the banks to use Eurodollars, and thus soak up idle dollars in the process, and prevent dollars from coming into official hands.

Representative CONABLE. Do you favor continuance of restrictions we have had on foreign investment? They were originally put on as short-term devices because of our balance-of-payments difficulties. In the long term obviously we are killing the goose that lays the golden egg if we restrain our foreign investment. How do you think at this juncture, with the transitional economy, we can justify continuance of these restrictive policies, when, of course, our foreign investment is designed to generate profits and to improve the long-term balance of payments?

Mr. DE VRIES. I certainly am not happy about having these restrictions still on the books. I think this reflects our concern, the sad state of our balance of payments.

Where the bank program is concerned, I am fearful, not so much that it will not be liberalized, but rather that it may be tightened sooner or later.

The proposals made the other day by Governor Brimmer, may well, if adopted, turn out to be used as an intensification of controls over bank lending abroad.

I am afraid that in view of the balance-of-payments situation the Government may want to turn away from liberalization, if we are not careful.

Representative CONABLE. Do you have any other short-term suggestions for improving our balance-of-payments situation?

Mr. DE VRIES. No, except that I think we have got to take the export problem much more seriously. Corporations for obvious reasons have focused on direct investments overseas, and have down-graded exports.

The export manager is the second-rate man in companies these days. It is the man who is in the office of overseas investments who is the top man. I think this country's exports should get a much higher national priority than they have had in the recent past.

Representative CONABLE. By that can I take it that you are in favor of a value-added tax?

Mr. DE VRIES. I am not an expert on that, but I think the administration ought to come up with definite suggestions to get exports expanding faster.

Representative CONABLE. Thank you.

Senator PROXMIRE (presiding). Thank you, Mr. Conable.

Gentlemen, thank you very very much. This had been an excellent panel. We have certainly enjoyed it a great deal and it has complemented the testimony we have had before extremely well. I want to thank you a great deal.

The committee will stand in recess until tomorrow morning at 10 o'clock in this room to hear Mr. Arjay Miller, Mr. Frederick O'R. Hayes, and Mr. Paul C. Warnke.

(Whereupon, at 1 p.m., the committee recessed, to reconvene at 10 a.m., on Tuesday, February 24, 1970.)

THE 1970 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, FEBRUARY 24, 1970

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

The Joint Economic Committee met, pursuant to recess, at 10 a.m., in room 1202, New Senate Office Building, Hon. Henry S. Reuss (member of the joint committee) presiding.

Present: Representatives Reuss and Brown; and Senators Proxmire, Fulbright, and Jordan.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Loughlin F. McHugh, senior economist; and Douglas C. Frechtling and George D. Krumbhaar, economists for the minority.

Representative REUSS (presiding). Good morning. The Joint Economic Committee will be in order for its further hearings into the 1970 economic report. Today we are going to concentrate on the question of national priorities, in which this committee has long been interested. The reordering of our priorities is one of the major challenges to economic and social policymaking. We are lucky to have three distinguished, very competent witnesses with us today. Mr. Arjay Miller, dean of the business school at Stanford University, an economist by training, former president of a large company, and a man who has always been dedicated to public interest. Mr. Frederick Hayes, director of the Bureau of the Budget of the city of New York and a former staff member of the Bureau of the Budget here and former official of HUD. As budget director of New York, Mr. Hayes is continually faced with the competition of demands on the public purse.

Our third panelist is Paul Warnke, an able Washington attorney, former Assistant Secretary of Defense, and I know he can give us some needed insights into the question of the relation between civilian and military needs. You are all very welcome. We have the prepared statements of all three of the witnesses and under the rule they will be admitted in full into the record, and now we like to ask each witness to proceed in his own way to summarize or read his statement.

Dean Miller would you lead off?

STATEMENT OF ARJAY MILLER, DEAN, GRADUATE SCHOOL OF BUSINESS, STANFORD UNIVERSITY

Mr. MILLER. Thank you, Mr. Chairman, I am Arjay Miller, dean of the Stanford Graduate School of Business. As you said, the full text of my proposals have been filed with this committee, so in the interest of saving time this morning I will not read parts of it.

National goals and priorities is a phrase heard frequently these days, most often invoked by partisans of particular causes which are felt to be neglected. I should like to speak to the matter, not in a substantive way, but in terms of a systematic approach to the ordering of such national priorities. I am particularly pleased to be invited to make my remarks to members of that deliberative body which can make a real determination of what national goals should be.

Participants in the dialog are typically hard-working, public-oriented, genuinely concerned individuals, who give freely of their own time and talent. In addition, the objectives each supports are collectively desirable. Who is there that doesn't want to eliminate poverty, crime, disease, hunger, war, ignorance, foul air, and polluted water? Somehow, then, we must find not only an objective solution to the problem, but some means to resolve the conflicting priorities and methodologies as well. Recognition of very real limits on total resources compared to the conflicting claims against these resources is the essential first step. The hard choices which must be made depend on the availability of comprehensive objective information.

Considerable progress has been made and is being made on this overall problem, of which the work of this committee is an outstanding example.

In my opinion, however, the current effort falls short of meeting the enormous needs of the general problem. What we need initially, I am convinced, is an overall approach that will do two things. First, tell us what our economy is capable of producing over a given period of time, and, second, project the cost of present and contemplated national programs.

The first of these tasks is the easier by far. We can project, at least the general magnitude of future increases in output. The long-term trend rate of increase in gross national product, as estimated by the Council of Economic Advisers, falls between 4 and 4½ percent per year. With a current GNP of roughly $935 billion, our total output should advance about $40 billion per year, valued at today's prices.

The second step—projecting the cost of present and contemplated programs—is more difficult. But it can be done, I believe, even if we have to settle for ranges of cost in most of our long-term estimates.

First, we could project the cost of existing programs over, say, the next 10 years. The magnitude of built-in increases in these programs is not generally recognized, so the extent of this existing commitment must be made as we estimate the total demand upon our resources. In this calculation, the enormous cost of providing schools, hospitals, roads, productive facilities, et cetera to keep up with projected population growth should be clearly set forth.

Next we could project the cost of attaining generally recognized goals over the next 10 years. Wherever possible, use would be made of existing estimates contained in reports such as those prepared by Presidential Commissions and private organizations like the Carnegie Commission on Higher Education. At the present time, many valuable reports lose their effectiveness because they have no "home"; no place where their claim on national resources can be recorded and evaluated against competing demands.

Proposed legislation and congressional committee recommendations would also be considered.

A listing of all our national goals, together with estimated costs and the resources available to meet those costs, would be published on an annual basis. Probably the most significant figure in such a report would be the "gap" between the total cost of our goals and our ability to pay. In 1965, the National Planning Association published a report indicating this gap would amount to $150 billion by 1975. Recognition of new social needs, plus inflation, would now make that figure much larger.

General recognition of this gap would in itself be valuable, because it would open the eyes of those who believe that our problem is overproduction or that everything is possible in what is sometimes called our economy of abundance. Furthermore, recognition of this gap would throw into perspective such recurrent questions as the shorter workweek and technological unemployment. As long as so many recognized needs remain unsatisfied, the overall problem can be correctly portrayed as one of requiring more work, not less.

One big question remains: How is all this to be done? In my opinion, no existing organization seems appropriate to perform this task. This is why I proposed a year ago, in a talk before the American Economic Association and the American Finance Association, the establishment of a permanent National Goals Institute for the express purpose of developing an overview of America's needs and resources.

Under broad and responsible direction, the institute would be made up of a permanent, full-time professional staff drawn from many relevant disciplines—the behavioral sciences, economics, engineering, urban planning, medicine, and so forth. Its task would be relatively narrow in scope but almost limitless in its implications for sound, coordinated social progress in the years ahead.

It would be most useful—if this idea has merit—for such an institute to be recommended by the President and established by an act of Congress. I would recommend that its board of directors include representation from both the executive branch and the Congress, as well as from nongovernmental areas such as business, labor, and education. Its reports should be made directly to the President and to the Congress, and given wide public distribution.

Now, let me deal with some of the questions I am sure this proposal will raise. Some might contend that an institute of this kind does not go far enough. They would prefer to see a neat ordering of social objectives that could be contained within our ability to pay. Some such restrictions and cutbacks would, of course, have to be accepted in any event, but this cannot be the prerogative of any single group or organization in our society. In a democracy, this is a process that all must and should share.

Reports by the institute would have no binding force or direct authority in and of themselves. They would simply point out directions and possibilities, and provide a factual basis for enlightened public discussion and decisionmaking. Maximum participation in the work of the institute would provide the mechanism for local "goals" programs to properly "mesh" with national priorities; concurrently, this same mechanism would provide greater local support of State national priorities.

A second question that might be raised is why a National Goals Institute is needed now when we have progressed this far without one. The answer lies in the basic shift of emphasis that has occurred from private goods to public goods. The private sector has done such an effective job in meeting the demand for items like automobiles, television sets, and radios that the most critical shortages today exist among such social goods as health, education, and safety—areas in which public participation and planning is absolutely necessary.

Another question that might be raised about a National Goals Institute is whether it is possible to treat in quantitative terms all the goals of society. There obviously are many values in life that cannot be measured. The disposed in our society, however, have no problem in recognizing—and demanding—such basic quantitative objectives as more income, more jobs, more health care, to name just a few. These goals are important in themselves, and they are a foundation for the achievement of such broader goals as dignity and self-respect, social harmony and cultural advancement.

The proposed National Goals Institute, unlike any existing institution, would have the following three characteristics, all of which would contribute to the successful operation of the organization.

DEGREE OF INDEPENDENCE

Although the institute should be supported by both Congress and the White House, it should not be an integral part or fully dependent on either. A quasi-independent status should make it easier to attract nationally recognized leaders on its board of directors, and qualified scholars on its staff. In turn, this would assure objectivity in the work on the institute, a recognition of that objectivity by the general public—both of which are essential for success.

GOVERNMENT SUPPORT

Congressional creation of the institute and backing by the executive branch would give it the kind of support necessary for effective operation, as well as make its output more acceptable to the governmental bodies which would be the primary users. Assurance of continued financial support is essential, and this could probably best be achieved through primary reliance on Congressional appropriations. Compared to the size of the problem, the amounts required would be small indeed. I would estimate expenditures of about $2 million annually would be adequate.

CONTINUITY

The task of establishing national goals should be viewed as a continuous process, reflecting changes in the national mood as well as changes in our technology and social institutions. Continuity of employment would also aid in attracting the kind of personnel needed, and in their gaining the experience and expertise required to deal effectively with the complex issues involved.

The task of setting acceptable priorities for our society is a most difficult one. In the accomplishment of this task the establishment of a National Goals Institute is only one small step, but, nevertheless, a vitally important and necessary one that can and should be taken now.

All the institute can hope to accomplish is to provide a mechanism to aid in the decision making process; it can not be a substitute for leadership action itself. A specific example may help clarify this point. At the present time, leaders from practically all segments of society are calling out boldly for an end to environmental pollution, yet concrete proposals of exactly what steps should be taken are rare indeed. This should not be too surprising, when we realize that no one really knows how to define in objective terms what we mean by pure air or clean water, or what it will cost to attain these objectives. I have heard one estimate that $200 billion would be required to clean up our environment, yet no one to my knowledge has indicated where funds approaching this magnitude will come from. The real character of the problem is brought home when we remember that previously announced national efforts, like the war on poverty and the call for 2.6 million housing starts a year, are falling far short of their objectives, primarily because of a shortage of funds.

In other words, what is lacking most today is not a general recognition of what we would like to accomplish, but rather the ability to establish and communicate realistic programs. In my opinion, a National Goals Institute would help meet this need by enabling legislative bodies and sincere citizens in all walks of life to reach decisions based upon comprehensive and factual information. Hopefully, greater understanding of the true nature of problem dimension would lead to the establishment of attainable national goals and priorities, supplanting false hopes which can only lead to discouragement, frustration, and despair.

We have the ability to make significant progress toward a better life, but only if we make a determined, continuous, and intelligent effort. One factor in our favor today is the widespread unrest present among almost all segments of our society. Change is possible only when we are dissatisfied with the status quo. Let us view the present unrest then as a perilous opportunity—as a challenge to build a better future; using all the vision, good will, and power at our command.

(The prepared statement of Mr. Miller follows:)

PREPARED STATEMENT OF ARJAY MILLER

A PROPOSAL FOR A NATIONAL GOALS INSTITUTE

National goals and priorities is a phrase heard frequently these days, most often invoked by partisans of particular causes which are felt to be neglected. I should like to speak to the matter, not in a substantive way, but in terms of a systematic approach to the ordering of such national priorities. I am particularly pleased to be invited to make my remarks to members of that deliberate body which can make a real determination of what national goals should be.

Participants in the dialogue are typically hard-working, public-oriented, genuinely-concerned individuals, who give freely of their own time and talent. In addition, the objectives each supports are collectively desirable. Who is there that doesn't want to eliminate poverty, crime, disease, hunger, war, ignorance, foul air and polluted water? Somehow, then, we must find not only an objective solution to the problem, but some means to resolve the conflicting priorities and methodologies as well. Recognition of very real limits on total resources compared to the conflicting claims against these resources is the essential first step. The hard choices which must be made depend on the availability of comprehensive objective information.

Considerable progress has been made and is being made on this overall problem, of which the work of this committee is an outstanding example. Significant contributions are also being made by such organizations as the Council of Economic Advisors, the Bureau of the Budget, and the National Planning Association, a non-profit organization located here in Washington. Encouraging recent developments include the presidential establishment last July of the National Goals Research Staff within the Executive Office under Mr. Leonard Garment and Mr. Charles Williams, and the recent work being undertaken by The Brookings Institution under the direction of Mr. Charles Schultz.

In my opinion, however, the combined effort of all these organizations, valuable as it is, falls short of meeting the enormous needs of the general problem. What we need initially, I am convinced, is an overall approach that will do two things: First, tell us what our economy is capable of producing over a given period of time, and, second, project the cost of present and contemplated national programs.

The first of these tasks is the easier by far. We can project at least the general magnitude of future increases in output. The long-term trend rate of increase in Gross National Product, as estimated by the Council of Economic Advisors, falls between 4 and 4½ per cent per year. With a current GNP of roughly $935 billion, our total output should advance about $40 billion per year, valued at today's prices.

The second step—projecting the cost of present and contemplated programs—is more difficult. But it can be done, I believe, even if we have to settle for ranges of cost in most of our long-term estimates.

First, we could project the cost of existing programs over, say, the next 10 years. The magnitude of built-in increases in these programs is not generally recognized, so the extent of this existing commitment must be made as we estimate the total demand upon our resources. In this calculation, the enormous cost of providing schools, hospitals, roads, productive facilities, et cetera to keep up with projected population growth should be clearly set forth.

Next we could project the cost of attaining generally recognized goals over the next 10 years. Wherever possible, use would be made of existing estimates contained in reports such as those prepared by Presidential Commissions and private organizations like the Carnegie Commission on Higher Education. At the present time, many valuable reports lose their effectiveness because they have no "home"; no place where their claim on national resources can be recorded and evaluated against competing demands.

Proposed legislation and Congressional Committee recommendations would also be considered. In addition to some mechanism for costing out generally recognized goals, there should also be some means for gathering and analyzing serious major proposals by groups or individuals wanting to press specific ideas. This participation is essential to the eventual implementation of solutions chosen at the grass roots level in our Country. In effect, we would achieve a national forum for airing of new approaches to public needs—a highly desirable objective.

A listing of all our national goals, together with estimated costs and the resources available to meet those costs, would be published on an annual basis. Probably the most significant figure in such a report would be the "gap" between the total cost of our goals and our ability to pay. In 1965, the National Planning Association published a report indicating this "gap" would amount to $150 billion by 1975. Recognition of new social needs, plus inflation, would now make that figure much larger.

General recognition of this "gap" would in itself be valuable, because it would open the eyes of those who believe that our problem is overproduction or that everything is possible in what is sometimes called our "economy of abundance." Furthermore, recognition of this "gap" would throw into perspective such recurrent questions as the shorter work week and technological unemployment. As long as so many recognized needs remain unsatisfied, the overall problem can be correctly portrayed as one of requiring more work, not less.

One big question remains: How is all this to be done? In my opinion, no existing organization seems appropriate to perform this task. This is why I proposed a year ago, in a talk before the American Economic Association and the American Finance Association, the establishment of a permanent National Goals Institute for the express purpose of developing an overview of America's needs and resources.

Under broad and responsible direction, the Institute would be made up of a permanent, full-time professional staff drawn from many relevant disciplines—the behavioral sciences, economics, enginering, urban planning, medicine and so forth. Its task would be relatively narrow in scope but almost limitless in its implications for sound, coordinated social progress in the years ahead.

It would be most useful—if this idea has merit—for such an institute to be recommended by the President and established by an Act of Congress. I would recommend that its board of directors include represenation from both the Executive Branch and the Congress, as well as from non-governmental areas such as business, labor and education. Its reports should be made directly to the President and to the Congress, and given wide public distribution.

Now let me deal with some of the questions I am sure this proposal will raise. Some might contend that an institute of this kind does not go far enough. They would prefer to see a neat ordering of social objectives that could be contained within our ability to pay. Some such restrictions and cutbacks would, of course, have to be accepted in any event, but this cannot be the prerogative of any single group or organization in our society. In a democracy, this is a process that all of us must and should share.

Reports by the Institute would have no binding force or direct authority in and of themselves. They would simply point out directions and possibilities, and provide a factual basis for enlightened public discussion and decision-making. Maximum participation in the work of the Institute would provide the mechanism for local "goals" programs to properly "mesh" with national priorities; concurrently, this same mechanism would provide greater local support of stated national priorities. In my home area, for instance, there is presently under consideration a county-wide goals program. The necessity for this area-wide program to be coordinated with national priorities cannot be easily overlooked. Additionally, financial support of positive local programs—through block grants or revenue sharing—could have a mutually beneficial effect.

Institute reports should spell out alternatives and the magnitudes involved in each of the different approaches. Individual directors of the Institute would be free to differ with a majority opinion and to add their own comments or recommendations to the basic report. Thus, these reports would be only the beginning point for orderly planning.

Our concern is not with absolutes, but with choices—with the kind of information that we are a people must have if we are to be able to see clearly the various alternatives open to us and choose rationally from among them. In Russia, a five-year plan carries the full force of government authority and the people have no options.

In our case, elected representatives of the people would choose whether to follow one plan or another—or one part of a plan and not another. Coupled with the "forum" concept and the coordination of local programs, this would mean maximum participation by our citizenry. This kind of planning, then, does not in any way supplant "The People's Choice;" on the contrary, it is meant to increase the people's ability to make clear and informed choices.

A second question that might be raised is why a National Goals Institute is needed now when we have progressed this far without one. The answer lies in the basic shift of emphasis that has occurred from private goods to public goods. The private sector has done such an effective job in meeting the demand for items like automobiles, television sets and radios that the most critical shortages today exist among such social goods as health, education and safety—areas in which public participation and planning are absolutely necessary.

Another question that might be raised about a National Goals Institute is whether it is possible to treat in quantitative terms all the goals of society. There obviously are many values in life that cannot be measured. The dispossessed in our society, however, have no problem in recognizing—and demanding—such basic quantitative objectives as more income, more jobs, more health care, to name just a few. These goals are important in themselves, and they provide a foundation for the achievement of such broader goals as dignity and self-respect, social harmony and cultural advancement.

Let me turn now to another part of my subject today—the task of moving effectively toward the goals we choose. Even with a clear sense of priorities and adequate funding, tremendous effort would still be needed to develop a sound and effective attack on social problems. My own experience leads me to believe, howover, that new approaches can be made to work if there is general agreement on the broad objectives of the entire community.

For example, I have devoted a great deal of time to the work of the Economic Development Corporation of greater Detroit, an organization of businessmen established to encourage and assist the development of black-owned and operated businesses in the city. There is general agreement among both whites and blacks on the desirability of minority ownership of varied kinds of business in the inner city and there is general agreement as to the kinds of assistance required—financial, technical and legal. But it is clear that these enterprises must be controlled and directed by residents of the inner city. The Economic Development Corporation is responding to requests for help from black entrepreneurs, and is making no effort to tell anyone how he must set up or run his business. This is determined by the black businessmen themselves.

Locally managed programs of this kind will add up to an effective national attack on social problems, I believe, if the local programs are conceived and implemented with clear understanding that they are only part of an overall effort to meet a problem of national dimensions.

This is why I believe so strongly in the idea of a National Goals Institute. Something of this kind is needed if we as a nation are to see our problems whole and learn to deal with them effectively. Unless we adopt a total view, we must resign ourselves to patchwork progress, and probably to eventual failure.

To make gains in one area of need while compounding problems in other areas is not real progress. For example, inner city factories would increase local employment but might at the same time add to the problems of air pollution and urban congestion. So what we must seek, actually, is a synthesis of efforts. All parts of a total program must be mutually consistent, at both the national and local levels.

The proposed National Goals Institute, unlike any existing institution, would have the following three characteristics, all of which would contribute to the successful operation of the organization.

1. *Degree of Independence.* Although the Institute should be supported by both Congress and the White House, it should not be an integral part or fully dependent on either. A quasi-independent status should make it easier to attract nationally recognized leaders on its board of directors, and qualified scholars on its staff. In turn, this would assure objectivity in the work on the Institute, and a recognition of the objectivity by the general public—both of which are essential for success.

2. *Government Support.* Congressional creation of the Institute and backing by the Executive Branch would give it the kind of support necessary for effective operation, as well as make its output more acceptable to the governmental bodies which would be the primary users. Assurance of continued financial support is essential, and this could probably best be achieved through primary reliance on Congressional appropriations. Compared to the size of the problem, the amounts required would be small indeed. I would estimate expenditures of about $2,000,000 annually would be adequate.

3. *Continuity.* The task of establishing national goals should be viewed as a continuous process, reflecting changes in the national mood as well as changes in our technology and social institutions. Continuity of employment would also aid in attracting the kind of personnel needed, and in their gaining the experience and expertise required to deal effectively with the complex issues involved.

The task of setting acceptable priorities for our society is a most difficult one. In the accomplishment of this task, the establishment of a National Goals Institute is only one small step, but, nevertheless, a vitally important and necessary one that can and should be taken now.

All the Institute can hope to accomplish is to provide a mechanism to aid in the decision making process; it can not be a substitute for leadership action itself. A specific example may help clarify this point. At the present time, leaders from practically all segments of society are calling out boldly for an end to environmental pollution, yet concrete proposals of exactly what steps should be taken are rare indeed. This should not be too surprising, when we realize that no one really knows how to define in objective terms what we mean by pure air or clean water, or what it will cost to attain these objectives. I have heard one estimate that 200 billion dollars would be required over the next decade to clean up our environment, yet no one to my knowledge has indicated where funds approaching this magnitude will come from. The real character of the problem is brought home when we remember that previously announced national efforts, like the War on Poverty and the call for an average of 2.6 million housing starts a year, are falling far short of their objectives, primarily because of a shortage of funds.

In other words, what is lacking most today is not a general recognition of what we would like to accomplish, but rather the ability to establish and communicate realistic programs. In my opinion, a National Goals Institute would help meet this need by enabling legislative bodies and sincere citizens in all walks of life to reach decisions based upon comprehensive and factual information. Hopefully, greater understanding of the true nature of problem dimension would lead to establishment of *attainable* national goals and priorities, supplanting false hopes which can only lead to discouragement, frustration and despair.

We have the ability to make significant progress toward a better life, but only if we make a determined, continuous and intelligent effort. One factor in our favor today is the widespread unrest present among almost all segments of our society. Change is possible only when we are dissatisfied with the status quo. Let us view the present unrest then as a perilous opportunity—as a challenge to build a better future; using all the vision, good will, and power at our command.

Representative REUSS (presiding). Thank you, Dean Miller.
Mr. Hayes?

STATEMENT OF FREDERICK O'R. HAYES, DIRECTOR OF THE BUDGET, CITY OF NEW YORK

Mr. HAYES. Mr. Chairman, I am directing my attention very heavily to the problems of the cities or, if you will, to the urban problems of our increasingly urban Nation—and the claims upon national product and upon Federal expenditures that a serious engagement with these problems would suggest.

My testimony builds, throughout, upon the experience of the City of New York—about which I know something—rather than upon nationwide estimates and requirements—about which I know very little. I am convinced that the New York experience is, in nearly all salient particulars, respresentative of the problems of our older central cities all over this Nation.

Our cities are in serious trouble—trouble directly related to the most significant economic role the great metropolis plays in American society. The enormous increases in productivity in the Western World over the past two centuries have been effected very largely through the attraction into metropolitan labor markets of labor from areas and sections of lower opportunity and productivity. The city has provided, first, a huge and diverse labor market; just within the City of New York there are over four million jobs, nearly all of them within reach of public transportation.

The city has, secondly, been able to provide, through its many institutions, the education and training requisite to the assimilation of the migrants and, eventually, their children, into an urban labor force and into an urban society.

This process is no longer working well, and our local governments are staggering under the burden of supporting housing, and educating an increasing population of the poor. The costs of continuing to do no more than what we are doing now are rising so much more rapidly than local revenues that, in my opinion, the very existence of local government in its present form and its present degree of independence is in serious jeopardy. Already, the poverty-related demands on municipal budgets have impaired the ability of the cities to carry on normal municipal functions such as street cleaning, the collection and disposal of garbage, and even the maintenance of parks.

We have in my opinion, no less than an emerging major crisis in the financing of local government and, to a lesser extent, of State government. This is a crisis that can be resolved only by a substantial and early shift of responsibility for financing poverty-related expenditures from State and local government to the Federal taxpayer—or by general Federal support for local government at comparable levels.

This emerging crisis threatens our ability as a society to deal with fundamental domestic needs—housing, health, welfare, education, manpower training, environmental protection.

Most of the work in these areas is the responsibility of State and local governments. Spending at the State and local level is now over $120 billion annually, increasing in recent years at an annual rate of more than 12 percent. These governments spend roughly double the domestic Federal budget, excluding social security cash transfers. The tripling of Federal grants to States and localities since 1960 still leaves Federal aid only about 15 percent of total State and local revenue and most of the increase represents the Federal share of public assistance and medical expenditures in which case, of course State and local costs have increased to pay for their share of the program cost.

Accelerating expenditures at the State and local level belie earlier projections of slowdown based upon population trends. We are now witnessing, for example, during a period of prosperity, the surprising growth of public assistance spending, especially in aid to dependent children. With the introduction of medicaid, State, and local government has made a substantial commitment of funds for health care for the poor and the medically indigent.

Much more money is being spent for compensatory and remedial education in the public schools and we are well on our way to bearing the cost of access to higher education for everyone as a right. A major crime problem—again poverty-related—has increased State and local expenditures for law enforcement activities. The collection and disposal of garbage costs more both because there is more garbage and because it is harder in an increasingly urban environment to get rid of it.

Yet, to maintain, or, perhaps, restore the livability of our central cities requires much more. The necessity of increased public spending for control and infrastructure needs is coming into alarming focus. Our housing stock in New York and in other cities is deteriorating and massive efforts must be made at rehabilitation and new construction, particularly in central cities, and particularly for poor and moderate-income families.

I have included in my prepared statement a table which shows the recent growth in local and State spending. In real terms, applying the implicit price deflator to spending for goods and services and the consumer price index to transfer payments, growth has been at a rate of 5.2 percent annually in the early 1960's, increasing to an average of 6.3 percent in the second half of the decade, nearly double the rate of real increase in GNP. Our own increases have been larger in New York.

As might be expected from the expenditure mix—personal services, for example, made up 42.7 percent of all State and local expenditures in fiscal 1968—inflation has hit hard.

The research director of this committee, James Knowles, has noted that a 1-percent increase in the total GNP price deflator is associated with a 1.7-percent increase in the cost of operating State and local services. The effect of inflation in the Vietnam period on expenditures of the city of New York is instructive, I think, particularly instructive, because inflation is a direct Federal responsibility.

Supposing that no general inflation had occurred from 1965—that we had stable prices—our 1969 budget would have been $950 million less than its total $6.1 billion. Since we have derived these figures by merely applying the overall State and local government price deflator on goods used together with general New York regional price indices, we have some reason to believe the special factors in New York makes these figures underestimates on the cost of inflation in the city.

Expenditures reflecting real growth and inflation are running up against a wall of the State and local revenue base. Personal income taxes make up 45 percent of total Federal revenues but only 8 percent of State and local revenues. It is estimated that this tax is extremely elastic, with automatic 1.5- to 1.6-percent increases, with a 1-percent increase in GNP. Overall, the tax base of State and local governments is income inelastic. The property tax, which even now represents 30 percent of total revenue for States and localities, and 41 percent of tax revenues in 1969, is usually found to be relatively unresponsive to increases in GNP; a report of the Advisory Council on Intergovernmental Relations has estimated the elasticity of the tax between 0.7 and 1.1. Inelasticity of this tax is of course a particular problem for localities who rely on it for 87 percent of their tax revenues. Even New York City, which has a sales tax, a stock transfer tax, a corporate income tax, a personal income tax, a commuter earnings tax, and virtually every other kind of tax you can think of, still receives about half of its locally generated revenue from the property tax. General sales taxes, which provide 17 percent of State and local tax revenues, have an elasticity of approximately unity, while specific sales taxes, also providing 17 percent of revenues, are much less elastic.

These governments have therefore had to increase tax rates and find new tax bases to meet expenditure needs. As a special report of the 1971 Federal budget notes, State governments in the last decade have had to increase rates on major taxes on more than 300 occasions. Public officials, big city mayors especially, believe that they've come to the end of this particular road. The "taxpayers revolt" is becoming an everyday fact of life.

Projecting recent expenditure increases, I believe State and local governments will be facing dramatic deficits. These will necessitate serious cuts in ongoing services. As a rule of thumb, I expect annual increasing costs of present programs in the city of New York to run at about 15 percent while our tax revenues will grow only by 5 percent. For the 1971 budget we now estimate a deficit of over $800 million that has to be bridged one way or another before the end of the fiscal year. Professor Otto Eckstein of Harvard in a report for Mayor Lindsay's commission on inflation, has estimated annual deficits for all State and local governments in the early 1970's of between $7 billion and $11 billion, the estimates depending on real and inflationary growth in GNP and some increases in Federal aid.

The new Federal budget does not reflect in any sense the urgency of the situation we will face very soon. The administration's revenue-sharing plan is totally inadequate. The initial disbursement of $275 million in 1971 is less than the annual increase in New York City expenditures due to extraordinary inflation. If I can underline that—the inflationary cost of the current defense effort, the Vietnam war, to our city annually is larger than the entire initial disbursement under the President's proposed revenue sharing plan as proposed to Congress. Even the eventual $4 billion transfer, envisioned for 1975, will represent only one-fourth of the increase of State and local budgets in that period.

The administration's family assistance or new welfare proposals leaves no ground for complacency. The proposed federally financed standard of $1,600 in cash assistance for a family of four presents little fiscal relief for big cities and is unfair to States where increases in public assistance payments have been most marked. Thus the assistance standard in New York State is now $3,750 for a family of four—which should be compared to the $6,100 budget for this size family considered "low" in New York City by the U.S. Department of Labor. Hence, even though for the first time Federal aid will be available for aid to the working poor, the State and the city will obtain little relief from welfare spending under the administration's plan. At present, 1,040,000 persons are receiving cash assistance in New York City. We are projecting a total welfare bill for benefits alone of $1,102.2 million in 1971, of which $311 million will be city tax levy expenditures. Nationally, in 1969 there were 10.6 million persons receiving cash assistance, an increase of 20 percent from 1965. In 1968, total program cost was $5.5 billion, of which the State and local share was $2.5 billion, or 44.6 percent. Under the administration's plan, during the first full year of its operation, the amount of fiscal relief for States and localities is estimated at $500 million. New York would receive only an estimated $80 million—and any gains would, in fact, almost certainly be lost by further inflationary pressure on allowance levels.

As a matter of fact, the increases in welfare allowances have already been announced by the State and Governor to be effective on July 1 will offset any gain that the city of New York would receive from the change in Federal legislation, were it enacted by the President and effective before July 1.

Hence the President's budget does very little to relieve the acute and dangerous pressure on local governments. Its new initiatives would, in fact, provide less new money than the amounts we are now losing by virtue of the federally generated inflation resulting largely from the expansion of military expenditures during the past 5 years. We are, in my opinion, on the verge of a crisis in local government finances of a magnitude that the Nation has not experienced since the early 1930's. I have deliberately concentrated on what seems to me to be the most pressing issue; that is, the capacity to continue to carry on the fight against urban problems that has been primarily the responsibility of local governments.

I would like to talk now very briefly about the things that go far beyond what we are doing now, the need for a vastly greater expenditure and often deliberately improved approaches if we are going to maintain and improve the quality of urban life and if we are going to make our society and our economy work. I just want to touch on a few areas.

I have added in my prepared statement an appendix that deals with some points in somewhat greater detail.

On education, all of the available measures, all of our analyses in New York, indicate we are doing no better than holding our own in the education of children from disadvantaged families and groups. The numerous remedial and compensatory programs have in our city produced no improvements measurable in terms of better educational performance by the child. The current situation suggests the need for better research and better educational models as well as more money.

University education is looking more promising, and we believe it requires chiefly the massive Federal support required to make a free university education available to every high school graduate.

I believe that the manpower training area is one where, despite the $30 million in city and $30 million in State and Federal money, it is still clear we are doing much less than necessary. It is also clear there are many problems in attempting to relate training problems to the economy and to job placement which have not been entirely resolved.

We have already experienced a huge increase in health expenditures resulting from medicare and medicaid but this has not produced comparable improvements in health care and it will not produce such improvements without the expansion and reorganization of the providers of health care.

We have stimulated, greatly stimulated, the demand for health care, and undoubtedly thereby produced a great expansion in the cost of health care. We are all—Federal, State, and local governments—really befuddled and confused by the enormous difficulty of both organizing and expanding the supply of health care in such a way that we can get from these increased expenditures the improvement in services which they should produce. I think the inattention in the early development of the program to the problems of supply of health care is responsible for this.

Water pollution control. About 75 percent of New York City's sewage is now treated and our program will be essentially complete with the construction of the new North River plant and the smaller plant in the Brooklyn Navy Yard plant and the six marginal stormwater plants to protect beaches. Federal funding is lagging and present progress has been possible only by virtue of State help. We have made our progress so far very largely by virtue of State help in the absence of adequate Federal aid.

In air pollution, the city has already reduced particulate emissions to 80 percent of 1967 levels and the sulfur dioxide levels to 50 percent of those prevailing in 1967. Continuing and expanded Federal aid is necessary but the amounts are relatively small. There are special problems, such as the problems of automobiles and airplanes, that can perhaps be dealt with more effectively on a Federal basis, and some continuing problems where Federal action would be very helpful—some relief from import restrictions on low sulfur fuel oil will be very helpful to us.

Mass transportation in the city requires an enormous additional investment, estimated at $2.8 billion over the next 5 years for new cars, new lines, and other improvements that will really meet our current standard for urban life.

This whole area, crucial to our big cities, is in our opinion still a very neglected area of Federal support.

There has been no Federal aid for the disposal of solid waste, which certainly in the cities is probably our biggest pollution problem. Our city is facing enormous difficulties just in keeping streets clean and in disposing of the mounting volume of garbage and trash. Declining land fill opportunities have necessitated a massive new $500 million incinerator program, and I might add that a very high component of that, a very expensive element, being the air pollution equipment here that has to go with the new incinerators. Some serious consideration ought to be given to Federal taxation on disposable packaging with the receipts returnable to the local governments who have the responsibility for disposing of the packaging as it ultimately hits the solid waste disposal system.

Certainly in the public's mind, rising crime rates and widespread drug addiction are the worst problems of the city. The Safe Streets Act is still providing only token support A Federal program of grants-in-aid for substantial expansion of local law enforcement activities might make substantial inroads in the problem. Federal funding of less than half a billion dollars could expand our urban police forces by about 20 percent, which in our opinion is a very, very worthwhile investment.

We have probably done more work in the analysis of our housing problems than we have done on any other in the city or than has been done anywhere in the Nation and we are very disturbed by the findings. We have clearly identified an accelerating rate of decay during the 1950's partly because the cost of maintaining buildings has gone up far more rapidly than any prospect of recovery through higher rental receipts. In New York alone, this decay will not be arrested without, in our opinion, an estimated $255 million in additional annual rent payments, most of which must be public subsidies. By that I means that two-thirds of the $255 million would have to be collected from families that are already paying in excess of 25 percent of their incomes for rent. To restore this inventory to minimum standards, according to the estimates of the New York City Rand Institute, would require $3 billion.

Even after the changes made by the Housing Act of 1969 the city will have to subsidize the construction costs of low rent and middle-income housing under Federal programs. If we are really going to do something about this problem, it will require a different approach from the various ones we have had and tried over the last 20 years. We are going to need vast increases in appropriations to be able to do it.

These are the areas I wanted to comment on just briefly. I can talk, if you have questions about it, in greater detail later and I have included, as I have mentioned, in the back of the statement more detailed information on all areas discussed with one exception.

Thank you very much.

(The prepared statement of Mr. Hayes follows:)

PREPARED STATEMENT OF FREDERICK O'R. HAYES

The Budget and the Economic Report are somber documents. They emphasize both the finite limits to our resources and the painful process of choice within these limits. We once supposed that our major domestic priorities could be met from an automatic Federal fiscal dividend coupled with what was supposed to be an equally large peace dividend once hostilities ended in Vietnam. The effect of the recent tax relief act, our continuing commitment in Vietnam, the on-going flow of major military projects, together with the projected short-term deceleration in growth of GNP all circumscribe our near future options and compel some hard analysis of goals.

The Chairman of the Committee, in his letter inviting me to appear before this Committee, asked me to discuss the economic report and the budget in terms of National priorities.

I have directed my attention to the problem of the cities or, if you will, to the urban problems of our increasingly urban nation—and the claim upon national product and upon Federal expenditures that a serious engagement with these problems would suggest.

My testimony builds, throughout, upon the experience of the City of New York—about which I know something—rather than upon nation-wide estimates and requirements—about which I know very little. I am convinced that the New York experience is, in nearly all salient particulars, representative of the problems of our older central cities all over this Nation.

Our cities are in serious trouble—trouble directly related to the most significant economic role the great metropolis plays in American society. The enormous increases in productivity in the western world over the past two centuries have been effected very largely through the attraction into metropolitan labor markets of labor from areas and sections of lower opportunity and productivity. The City has provided, first, a huge and diverse labor market; just within the City of New York there are over four million jobs, nearly all of them within reach of public transportation. The City has secondly, been able to provide through its many institutions the education and training requisite to the assimilation of the migrants and, eventually, their children, into an urban labor force.

The process is no longer working well and our local governments are staggering under the burden of supporting, housing and educating an increasing population of the poor. The costs of continuing to do no more than what we are doing now are rising so much more rapidly than local revenues that the very existence of local government in its present form is in serious jeopardy. Already, the poverty-related demands on municipal budgets have impaired the ability of the cities to carry on normal municipal functions such as street cleaning, the collection and disposal of garbage, and the maintenance of parks.

We have no less than an emerging major crisis in the financing of local government and, to a lesser extent, of State government. This is a crisis that can be resolved only by a substantial and early shift of responsibility for financing poverty-related expenditures from state and local government to the Federal taxpayer—or by general Federal support for local government at comparable levels.

This emerging crisis threatens our ability as a society to deal with fundamental domestic needs—housing, health, welfare, education, manpower training, environmental protection. Most of the work in these areas are the responsibility of State and local governments. Spending at the State and local level is now over $120 billion annually, increasing in recent years at an annual rate of more than 12 percent. These governments spend roughly double the domestic Federal budget, excluding Social Security cash transfers. While Federal grants to states and localities have more than tripled since 1960, Federal aid still represents only about 15 percent of total State and local revenue. Most of the increase in Federal aid stems from the Federal share of public assistance and Medicaid expenditures.

Accelerating expenditures at the State and local level belie earlier projections of slowdown based upon population trends. We are now witnessing, for example, the surprising growth of public assistance spending, especially in aid to dependent children. With the introduction of Medicaid, State and local government has made a substantial commitment of funds for health care for the poor and the medically indigent.

Much more money is being spent for compensatory and remedial education in the public schools and we are well on our way to bearing the cost of access to higher education for everyone as a right. A major crime problem—again poverty related—has increased State and local expenditures for law enforcement activities. The collection and disposal of garbage costs more both because there is more garbage and because it is harder in an increasingly urban environment to get rid of it.

Yet to maintain or, perhaps, restore the livability of our central cities requires much more. We are realizing the necessity of increased public spending for control and protection of the environment. Mass transportation and other infrastructure needs are coming in alarming focus. Our housing stock is deteriorating and massive efforts must be made at rehabilitation and new construction, particularly in central cities, and particularly for poor and moderate income families.

The recent growth in State and local spending is shown in the accompanying table. In real terms, applying the implicit price deflator to spending for goods and services and the consumer price index to transfer payments, growth has been at a rate of 5.2 percent annually in the early 1960's, increasing to an average of 6.8 percent in the second half of the decade, nearly double the rate of real increase in GNP.

As might be expected from the expenditure mix—personal services, for example, made up 42.7 percent of all state and local expenditures in fiscal 1968—inflation has hit hard. The Research Director of this committee, James Knowles, has noted that a one percent increase in the total GNP price deflator has led to a 1.5 or greater percentage increase in the cost of operating State and local services. The effect of inflation in the Vietnam period on expenditures of the City of New York is instructive. Supposing that no general inflation had occurred from 1965 our 1969 budget would have been $950 million less than its total $6.1 billion. Assuming that inflation had continued to take the moderate course of the early 1960's we could have provided the same services at a cost reduction of $375 million. Since our procedure was to apply the overall State and local government good and services deflator together with general New York regional price indices, there is reason to believe that these figures are underestimates of the cost of inflation to the City.

EXPENDITURE TRENDS OF STATE AND LOCAL GOVERNMENTS, 1958-68

	1958	1963	1968	Annual rates of increase in percent: 1958-63	1963-68
	(Millions of dollars)			(Percent)	
Education	15,801	23,941	43,398	8.7	12.6
Elementary and secondary	13,165	18,747	30,500	7.3	10.2
Higher	2,078	4,238	9,871	15.3	18.4
Other	558	956	3,027	11.4	25.9
Health	4,797	6,522	11,297	6.3	11.6
Welfare	4,290	6,032	11,774	7.1	14.3
Civil safety	3,156	4,384	7,186	6.8	10.4
Commerce and housing	8,901	11,389	15,980	5.1	7.0
Housing and community development	126	340	647	22.0	13.7
Agriculture and natural resources	1,624	2,454	3,734	8.7	8.8
General government, public utilities, all other	5,282	7,142	13,616	6.2	13.8
Total expenditures	43,977	62,204	107,632	7.2	11.6

Source: National Income and Product Accounts, Office of Business Economics, Department of Commerce, table 3.10. Quoted from Eckstein, Otto, "The Outlook for the Public Finances of State and Local Governments to 1975", "Commission on Inflation and Economic Welfare of the Mayor of the City of New York," 1969.

Expenditures reflecting real growth and inflation are running up against a wall of the State and local revenue base. Personal income taxes make up 45 percent of total Federal revenues but only 8 percent of State and local revenues. It is estimated that this tax is extremely elastic, with automatic 1.5 to 1.6 percent increases with a 1 percent increase in GNP. Overall the tax base of State and local governments is generally viewed as inelastic. The property tax, which even now represents 30 percent of total revenue for states and localities and 41 percent of tax revenues in 1969, is usually found to be relatively unresponsive to increases in GNP—a report of the Advisory Council on Intergovernmental Relations has estimated the elasticity of the tax between 0.7 and 1.1. Inelasticity of this tax is of course a particular problem for localities who rely on it for 87 percent of their tax revenues. Even New York City, which has instituted an income tax in 1966, still receives about half of its locally generated revenue from the property tax. General sales taxes, which provide 17 percent of State and local tax revenues have an elasticity of approximately unity, while specific sales taxes also providing 17 percent of revenues are much less elastic.

These governments have therefore had to increase tax rates and find new tax bases to meet expenditure needs. As a special report of the 1971 Federal budget notes, State governments in the last decade have had to increase rates on major taxes on more than 300 occasions. Public officials, big city mayors especially, believe that they've come to the end of this particular road. The "taxpayers revolt" is becoming an everyday fact of life.

Projecting recent expenditure increases, I believe State and local governments will be facing dramatic deficits. These will necessitate serious cuts in on-going services. As a rule of thumb, I expect annual increasing costs of present programs in the City of New York of 15 percent, which will be met by increases of only about .5% in our tax revenues. For our 1971 budget we now estimate a deficit of over $800 million. Professor Otto Eckstein of Harvard, in a report for Mayor Lindsay's Commission on Inflation, has estimated annual deficits for all State and local governments in the early 1970's of between $7 and $11 billion, the estimates depending on real and inflationary growth in GNP and the flow of Federal aid.

The new Federal Budget does not reflect in any sense the urgency of the situation we will face very soon. The administration's revenue sharing plan is totally inadequate. The initial disbursement of $275 million in 1971 is less than the annual increase in New York City expenditures due to extraordinary inflation. The eventual $4 billion transfer, envisioned for 1975, will represent only one-fourth of the increase of State and local budgets in that period.

The Administration's Family Assistance Program proposal also leaves no ground for complacency. The proposed Federally financed standard of $1,600 in cash assistance for a family of four presents little fiscal relief for big cities and states where increases in public assistance payments have been most marked. Thus the assistance standard in New York State is now $3,750 for a family of four—which should be compared to the $6,100 budget for this size family considered "low" in New York City by the U.S. Department of Labor. Hence, even though for the first time Federal aid will be available for aid to the working poor, New York City and State will have little relief from welfare spending under the Administration's plan. At present, 1,040,000 persons are receiving assistance in New York City. We are projecting a total welfare bill of $1,102.2 million in 1971, of which $311.0 million will be City tax levy expenditure. Nationally in 1969 there were 10.6 million persons receiving cash assistance, an increase of 20 percent from 1965. In 1968, total program cost was $5.5 billion, of which the State and local share was $2.5 billion or 44.6 percent. Under the Administration's plan, during the first full year of its operation the amount of fiscal relief for States and localities is estimated at $500 million. New York would receive only an estimated $80 million—and any gains would, in fact, almost certainly be lost by further inflationary pressure on allowance levels.

The President's Budget, hence, does little to relieve the acute and dangerous pressure on local governments. Its new initiatives would, in fact, provide less new money than the amounts we are now losing by virtue of the Federally-generated inflation resulting largely from the expansion of military expenditures during the past five years. We are, in my opinion, on the verge of a crisis in local government finances of a magnitude that the Nation has not experienced since the early thirties.

Beyond this, in area after area, there are needs for vastly greater expenditures and, often, greatly improved approaches if we are to maintain and improve the quality of urban life and if we are going to make our society and our economy work. Let me just touch on some of the more significant areas.

1. EDUCATION

All available measures indicate that we are doing no better than holding our ground in the education of children from disadvantaged families and groups. Numerous remedial and compensatory programs have in our city produced no improvements measurable in terms of better educational performance by the child. The current situation suggests the need for better research and better educational models as well as more money.

University education is far more promising—and requires chiefly the massive Federal support required to make a free university education available to every high school graduate.

Manpower training needs in our changing urban economics are very large. Despite over $30 million in City funds, we are still doing less than is necessary.

2. HEALTH

The huge increase in health expenditures resulting from Medicare and Medicaid has not produced comparable improvements in health care and it will not produce such improvements without the expansion and reorganization of the providers of health care.

3. WATER POLLUTION CONTROL

About 75% of the City's sewage is now treated and the program will be essentially complete with the construction of the new North River Plant, the Brooklyn Navy Yard plant, and six marginal storm water plants to protect beaches. Federal funding is lagging and present progress has been possible only by virtue of State help.

4. AIR POLLUTION CONTROL

The City has already reduced particulate emissions to 80% of 1967 levels and the sulfur dioxide levels to 50% of those prevailing in 1967. Continuing and expanded Federal aid is necessary but the amounts are relatively small.

5. TRANSPORTATION

Mass transportation in the City requires an enormous additional investment, estimated at $1.8 billion over the next 5 years. Federal funding is still manifestly inadequate—and, moreover, does not contend at all with the continuing effects of under maintenance. Crucial to our big cities, this is still a neglected area of Federal support.

6. SOLID WASTE

No Federal aid of significance is available here. Our City is facing enormous difficulties in keeping streets clean and in disposing of the mounting volume of garbage and trash. Declining land fill opportunities have necessitated a massive new $500 million incinerator program. A Federal tax on disposable packaging returned to local governments is an innovation worth considering.

7. LAW ENFORCEMENT

Certainly in the public's mind, rising crime rates and widespread drug addiction are the worst problems of the City. The Safe Streets Act is still providing only token support. A Federal program of grants-in-aid for substantial expansion of local law enforcement activities might make substantial in-roads in the problem. Federal funding of less than a billion dollars could expand our urban police forces by about 20 percent.

8. HOUSING

The accelerating rate of decay of urban housing is one of the most disturbing current phenomena. In New York alone, this decay will not be arrested without an estimated $255 million in additional annual rent payments, most of which must be public subsidies. To restore the inventory to minimum standards would require $3 billion. At the same time, rising costs are restricting new housing construction, even under public programs. Drastic changes in programs and vast increases in appropriations will be necessary if present trends are to be reversed.

I am including as appendices more detailed statement of needs and policy issues in several of the program areas I've touched upon.

APPENDIX

EDUCATION

By all standard indicators, inner city school systems are failing. As revealed by the following indices, in New York City, today's problems are being felt at every level of the school system:

—Of 530,000 pupils tested in the spring of 1969, 135,000 or 25% were reading two years below the National norm and 175,000 or 33% were reading one year below grade level.

—Attendance levels in the elementary and intermediate schools dropped from about 89% in 1965–66 to 84% last year and high school attendance has dropped from 81% to 76%.

—The dropout rate in the City's high schools has risen to 40%, a 3% increase over the previous year.

—In 14 high schools with over 75% Black and Puerto Rican enrollment, only 13% of the entering ninth and 10th grade classes survived to gain an academic diploma, while 32% received a commercial or general diploma.

—Daily average teacher absence has increased 10% over 1966–67.

The level of support provided the City's school system has been no less than they have needed in light of the serious problems they face. Including payment on capital construction bonds, we are currently spending over 1.6 billion dollars to support a system of 1,130,000 pupils. This amount, which includes approximately $110 million in Federal funds, provides an overall expenditure per pupil of close to $1400, more than double the National average. And the need to provide a wide-range of remedial and compensatory educational benefits has pushed this basic cost even higher. At the high school level, the per pupil expenditure for such programs such as College Bound and College Discovery is roughly double the standard academic high school pupil cost. In our enriched programs in the lower grades, projects like the More Effective Schools and several others, approximately 50% more is spent per pupil than is provided for regular instructional programs.

But the basic problem has yet to be attacked: research and understanding of the education production function is totally undeveloped. We simply do not know what educational programs or techniques are effective. In fact, we doubt that we have any useful indicators of success at all. Achievement test scores, which are the most consistently used criteria are often invalid and culturally biased. No concrete educational research has been done to effectively analyze the impact of teacher experience, teacher-pupil ratios, use of para-professionals, type and design of school buildings or the role of teacher and parent attitudes.

Federal guidelines in grant-in-aid programs stress public accountability on allocation of public funds but not the end results—evaluation and effectiveness. In the next few years, there must be a large scale effort on the part of the Federal government in sophisticated research and funding of a wide array of pilot projects. Performance standards should be developed so that school systems can be judged on the basis of output. Eventually federal grants could be given on an incentive basis with rewards for demonstrated productivity.

Meanwhile, we must proceed on an ad hoc basis. States and localities will require substantially greater Federal aid simply to stay afloat. Several short-term operational changes should be explored.

Where we find an effective program among the various pilots Federal funds should be made available to expand and generalize the effort throughout the school system.

Federal grants should allow greater flexibility at the local level. At present, Title I Elementary and Secondary Education funds must be spent in a school in which 30% of enrollment qualifies under income or reading criteria. This qualification seriously limits the funding of enriched programs for many underachieving pupils.

In addition, since most Federal grants go to the state in block grants for redistribution to localities, the Federal government must insure fair distribution within the state. Thus for example, although New York City has about 40% of the children eligible for vocational education funds we receive only $2 million or 13% of the total $16 million federal grant to the state. If the federal government cannot or will not provide this protection and monitoring, then all such block grants should contain the right of judicial review in the courts by the local area.

I think we must also devote substantial resources and energy to occupational training in the schools, another largely unexplored area. At present, 43% of New York City high school students fall into a so called "general track" which is neither academic nor specifically vocational and graduate with no salable skill. New York City employers are finding entry level workers increasingly unprepared and increasingly unable to follow a traditional pattern of upgrading within the firm.

Local areas are unable to expand instructional programs for handicapped and maladjusted children, which typically display per pupil costs from twice to eight times the average.

To the problems of our faltering urban school systems must be added the ballooning needs for training and education outside and beyond the public schools.

The greatest need in our City and in the Nation is for what Paul Ylvisaker has called that act of social jui-jitsu necessary to move our impoverished into the middle class in one generation rather than the two we have historically required. We believe that a free university system open to all high school graduates is an essential part of such an effort. The first step in this direction will increase the budget of the City University to $335 million—and, before the end of the decade, needs will clearly approach $1 billion annually. This is preeminently an area appropriate for massive increases in Federal help.

New York City's Regional Manpower System offers a wide range of skills training programs with different training environments to suit individual needs. Upon graduation from one of these programs, it is expected that the trainee has a useful, marketable skill and, where necessary, has developed the attitudes which will enable him to survive, if not succeed, in a regular work environment.

Optimally, these manpower training programs should be reaching, attracting and retaining the under-employed as well as the unemployed, primarily in the 20–35 year old age group. In other words, these programs must be relevant to people who, through educational or personal limitations and/or institutional barriers, have never had a meaningful place in the labor market. What is necessary here is not merely the existence of some training program; rather, it must be a program that can lead to the kind of meaningful regular employment that is an attractive alternative to the street hustle or public assistance.

In this respect, the importance of the phrase "a good job" cannot be overemphasized. A random sampling of businessmen in most urban areas would probably indicate an acute need for porters, delivery boys, dishwashers, messengers, etc. But these jobs are "dead end," with little, if any, opportunity for advancement, no medical or pension benefits and little job security. Furthermore, it is waste of public money to spend several thousand dollars to train a man if, when he is finished he can still only find employment in the $80–90 per week range. And, on the basis of our experience with institutional skills training programs, it seems clear that these programs are meaningless without adequate job placement follow-up. All too often, trainees have been graduated from these programs with the expectation that they will be able to find employment in their new skill.

In addition to City expenditures, the Federal and State governments are spending approximately $30 million annually for manpower programs in the City of New York. The City University system is also operating Urban Skills Centers and an extensive careers program in its community colleges.

Yet, the evidence is marked that all of this is not enough, that we are not providing enough effective opportunities for training and employing the underprivileged and under-educated. Here, more directly than perhaps anywhere else, we are dealing with one of the fundamental tensions of the city—the yawning gap between aspiration and current competence in the youth of the ghetto.

HEALTH

Health is a particularly troubling problem, and an elusive one. This country is relatively rich in health and medical resources, yet they are organized, or rather disorganized, in such a way that securing routine medical care has become both a cost and a logistical problem for both the poor and the middle class.

The enactment during the 1960's of the Community Mental Health Act, the Medicare program and the Title XIX Medicaid program have enormously increased the level and drastically changed the character of public support for personal health care. Medicare and Medicaid, offering the promise to large numbers of the medically indigent of freedom of choice in the selection of physicians, have in cities such as New York been grafted on to an older extensive system of charity medicine provided through municipal hospitals and public health clinics.

The effect, in New York and other States participating in the Title XIX program, has been a sky-rocketing increase in costs. The budget of the City of New York now includes over $1 billion in expenditures from Federal, State and local funds for personal health care, including mental health and dentistry. Estimating, as we do, that roughly 50% of New York City residents, or about four million people, are medically indigent by the original New York State Title XIX standards for Medicaid eligibility, we are appropriating approximately $250 per capita for the medical care of each medically indigent New Yorker. If, as we suspect, no more than three million of the medically indigent are actually receiving care through public programs, the cost per person served would be even higher—about $335 per person per year.

In a reasonably and economically organized medical care delivery system an average of $850 per year for a family of four should be sufficient to purchase prompt attention to routine problems and necessary hospitalization as measured by average incidence of need and duration. Yet, those crude measures that we do have of health and utilization indicate that this is not the case. At cost levels of $25 per outpatient visit and $100 per inpatient day, how could it be? We are buying extensive and expensive medical care for some—and none at all for others.

In planning a realistic program for Federal, State and local investment in health and medical care of the next decade, we should look carefully at the lessons that can be learned from the experience of Medicaid and Medicare. Pumping additional sums into the systems as presently structured, whether through a national health insurance plan or some other device, will only place additional strains on the present poorly structured delivery system and will not necessarily result in an expansion of those services where greater volume is desired. Any plan for financing the demand side of the health system must be accompanied by a concomitant and carefully structured investment in the supply side, and the benefits under a national health insurance scheme should be structured to reinforce the desired objectives.

What are the needs? I can suggest some of them as they have become evident during the past two years of considerable stress in the whole health and medical care field.

First, there is the need for Federal assistance in a program of capital investment to produce the ambulatory and extended care capacity needed to extend and re-focus the delivery system. The proposed Budget calls for an increased proportion of Federal construction aid for these facilities, but the $187 million projected is a relatively small sum. This assistance should be accompanied, however, by a strengthened requirement for regional planning whereby expansion is carefully related to a reorganization and consolidation of existing resources, to build a coherent system of services for a given population.

Second, there is need for Federal investment in the training of additional manpower, professional and para-professional, to staff the expanding services, in particular ambulatory care. The professional focus of modern medicine has shifted from the community and the doctors office to the hospital and the medical school. It is probably unrealistic to expect the highly trained professional to shift back. Instead, we are going to have to supply him with new personnel for support and outreach, to link him to community medicine rather than try to put him back into it.

Finally, we are going to have to use new forms of benefit payment to maintain supply and demand in reasonable balance. The comprehensive capitation payment plan suggests itself as a possible model. Research and experimentation may produce others. The Federal government is already beginning to move in these directions, but the movement is slow and halting and occasionally, as with recent changes in Medicaid, more harmful than constructive to ultimate objectives.

There is one more area which should be mentioned in connection with health, and that is the need to devise new programs and institutions to meet the health and living needs of the elderly. Medicare is proving inadequate to cover the long-term needs of the elderly, sick poor, and I understand there is a proposal being drafted to reduce Medicaid benefits for long term care. This would be disasterous in cities like New York where there is a growing proportion of elderly people with marginal income who consume large quantities of care per capita because they need it. Alternative solutions are needed for the particular problems of the elderly, many of whom now end up in hospital beds and in the medical care system because there is no where else to go.

HOUSING

When the Housing Act of 1949 was passed, the housing problem of the country was set in a relatively simple frame-work of clearance of slums, and their replacement with new housing. It was assumed that private investment would be used to rebuild the slums, while low-income families would be rehoused by public housing. This plan proved to be oversimplistic and failed to account for subsequent social, demographic, and economic trends.

New York City is currently facing a crisis in housing of which the salient features are: a shortage of housing, deterioration of the existing housing stock, building abandonment, disinvestment in housing.

The problem of decaying housing stock is no monopoly of New York City. George Sternlieb's pioneer work on *The Tenement Landlord* in Newark showed clearly that many forces were operative in creating the slum conditions of an older central city. There are strong indications that New York's current problems are representative of those of our older cities— and that the Nation faces an urban housing crisis of unprecedented magnitude.

The 1968 Housing and Vacancy Survey indicated that 450,000 of the City's dwelling units, 25% of the existing housing stock are in substandard conditions; 348,000 units are deteriorated and 92,000 are dilapidated. Not only is 25% of the housing stock in substandard condition, but the rate of deterioration and dilapidation shows no sign of abatement. Between 1960 and 1968, the inventory of substandard housing increased by 136,000 units. During the same period, there has been a 44% increase in units in dilapidated buildings and a 37% increase in units in deteriorated buildings.

Although this decay is the result of numerous interrelated factors, the underlying cause of poor housing conditions is undermaintenance which often constitutes a deliberate disinvestment policy by the owner. Over time, undermaintenance is compounded, necessitating housing rehabilitation or ultimately demolition and replacement.

As buildings continue to be undermaintained, their condition worsens, they command less rent, operating and maintenance expenditures increase as a percentage of rent, which in turn puts greater pressure on decreasing expenses and so on in a continuing spiral. Revenues inadequate to cover operating and maintenance expenditures in the existing stock foreshadow a further increase in substandard units. Thus the substandard housing stock will continue to increase unless additional cash is provided for these buildings.

The New York City Rand Institute estimates that there are about 722,000 private apartments in New York City with rental receipts inadequate to support normal building maintenance and operation on a continuing basis. The estimated aggregate annual revenue deficit on these units is estimated at about $255 million. For all practical purposes, this deficit can be satisfied only through substandard service to tenants and, more important, a continuing disinvestment in housing through undermaintenance.

If monthly rents were raised to minimum maintenance levels, 588,000 families—most of them on welfare—would need government assistance to pay the increased rent. Even with Federal and State sharing in higher welfare rent levels, approximately $108 million in City funds would be necessary for rent supplements for non-welfare families and for the City share of the higher welfare allowances.

Even if rents could be raised to levels sufficient to cover current maintenance, we would need a massive investment to rehabilitate long neglected housing. Preliminary figures from a study of rehabilitation costs indicate that the capital investment required to bring the City's deteriorated and dilapidated housing stock up to current standards of livability is on the order of $3 billion.

Rehabilitation programs to date have been manifestly $82 million of capital funds for this purpose. This has financed the rehabilitation of approximately 3400 units.

The basic problem is poverty. Too much of the City's housing is now occupied by families too poor to pay the cost of urban housing. New York and our other major cities have since the war attracted in increasing numbers the poor of the Nation. Puerto Ricans from the island and blacks from the South have come to the cities—as European immigrants before them—in search of jobs and economic opportunity. Nowhere else is there greater access to employment and to opportunity. Given the limited opportunities for housing and the limitations of a center-oriented transportation system, few are likely to settle in the suburban areas.

The net effect upon the Nation is probably salutory—in maximizing the opportunity for the economic assimilation and improvement and for the urbanization of our most deprived families. But present public programs are ill-equipped to serve poverty populations in high density, high cost urban situations. The burden in terms of money costs, and adverse effects upon neighborhood and housing quality is inequitably and infeasibly placed heavily upon a local community and tax base that is not equipped to support such a burden. And, nationally, neither our Federal housing programs nor our Federal social and poverty programs are directing any real help towards this most basic and fundamental housing problem.

Even with good maintenance of the existing housing inventory, New York and other cities need a continuing investment in new housing to replace obsolete housing and the inevitable losses from the inventory. New York City has approximately 2.85 million housing units. Were the City's 500,000 deteriorated and dilapidated units replaced over the next 15 years, 33,000 units should be constructed annually. We could use an additional 10,000–15,000 units annually merely to meet the needs of the larger number of households in largely stable population.

Total annual housing production of 45,000 units, hence, it is not an unreasonable target. Sweden, with approximately the same population as New York, calls for annual housing production of 100,000 units. Our actual production is now running at only 14,500 units and the highest five year average since the war is 45,000 units per year.

The high and still rising costs of housing construction in the City are squeezing out private housing construction in the City and making increasingly difficult the provision of publicly supported housing under various Federal programs. Even with new and higher cost limits, the City will be required to subsidize from local funds virtually all of the public and middle income housing planned to start in the current year. The costs may total as much as $80 million.

In short, Federal housing programs are not now based upon a realistic view of the urban housing crisis. The two most significant needs are: first, a statutory recognition of the real level of housing construction costs in urban areas; and second, the provision of substantial funding for the maintenance of a rapidly deteriorating inventory of existing housing.

ENVIRONMENTAL CONSERVATION

We have finally begun fully to realize that there are severe environmental costs in the conventional operation of our production and household economies. Clean air and clean water, we now recognize, are not free goods but come at a substantial price. We are beginning to take seriously such novel concepts as "noise pollution." In urban areas and big cities particularly, as is not yet generally recognized, the traditional area of refuse disposal is emerging as an alarming problem. We have developed the political awareness necessary to deal with environmental issues, and in many instances remedial technology is available—a notable exception is an inexpensive and relatively pollution free automobile.

I think the major unresolved issue is the price we are willing to pay for environmental protection and how the burden is to be placed.

Our experience in New York may provide some notion of the magnitudes and issues involved.

Water pollution

Federal standards prescribe treatment of 100% of the City's sanitary sewage at the level of 85% pollutant removal. At present only about 75% of the City's sewage is treated and the control plants remove 69% of the major pollutants from the water they treat. To meet the Federal standard, we have developed a capital program to upgrade our 12 existing plants and to construct two major new ones. We estimate the total cost at $1 billion.

Parts of New York's 6,000 mile sewer system are over 100 years old and a substantial fraction is 80–100 years old. Supposing, optimistically, a 100 year useful life for a sewer, we ought to have a sewer replacement program costing $600 million per year. This is, of course, well beyond our capacity: Our total capital budget for fiscal 1971 is $1.4 billion. We can afford only to operate on a basis of emergency repair and replacement following breakdowns. We are not alone among urban areas in requiring large-scale replacement of this infrastructure item—we are certainly not alone in requiring massive construction outlays for new sewers. Although our population has not increased over the past ten years, outlying areas of the city are undergoing rapid development and large areas remain completely unsewered. Our backlog of needed sewer construction is estimated at $2 billion.

Sufficient appropriations have not been made to meet Federal matching funding under formulas in the 1966 Clean Waters Restoration Act. Congress has appropriated $800 million for water pollution control this year, four times the sum requested by the Administration. New York State will receive only $70 million, which does not cover the Federal obligation to the State for the City's programs. Only $975,000 in Federal aid was made available to New York City for this coming fiscal year, although the Federal government is obligated to allocate nearly $200 million to match proposed State and City funding. The Administration has proposed a $10 billion five-year water pollution control program, but $6 billion of this is to be Federally assisted state and local bond revenues.

Air pollution

New York City has one of the best air pollution control programs in the Nation. We have already made some significant gains: reduction of particulate emissions to 80% of their 1967 levels.

The program has entailed installation of air pollution control devices on incinerators, shut-down of others, necessitating greater refuse collection and disposal efforts, use of low sulfur fuels and changes in space heating systems to cleaner fuels. We estimate that the total operating cost to the City and to the private sector of maintaining our air pollution control standards is approximately $100 million annually, due to the higher cost of relatively pollution free fuels, operation of pollution control devises and more indirect program expenses.

Aside from aditional funding support—the Federal government provides $1 million in aid—there are a variety of steps that could be taken at the Federal level which would dramatically reduce the burden of urban pollution control. Thus, for example, were import restrictions on low-sulfur Arabian oil relaxed the cost of the pollution control effort in New York City could be reduced by 60%.

Solid waste disposal

Federal concern with solid waste has been confined to a small research program in disposal methods, but sanitation is becoming a major inner city problem. Although population has remained roughly constant in the last 10 years, household refuse generation in New York City has increased by over 40%. This means 5,500,000 more pounds to be collected every day, and twice as many bulky items such as beds and refrigerators. The incidence of abandoned automobiles, a particularly tough problem, has increased 17 fold. Over the next ten years we are projecting an increase of 63% in household refuse, requiring a collection of 12,000,000 extra pounds per day.

The collection problem is a relatively tractable one. We are in the process of applying efficient new techniques—plastic bags rather than heavy garbage cans, larger and compactor trucks, and various types of containerization for industry and households. Some ways off we can see centralized collection for several blocks of apartment buildings, using refuse chutes shredding and compacting devices. Better technology will allow us to meet our collection needs with only 1,300 extra men over the next ten years, a 9% increase over the current force.

The question of disposal poses much more severe problems. Although disposal costs are only 10% of the costs of solid waste management, future spending could mount rapidly. We and many other cities are running out of traditional disposal capacity. We have been burying refuse for a long time in New York. Thirty-seven square miles, or roughly 11% of the City has been created from some type of fill material. There are few new places to turn. Incineration offers an alternative. New high temperature incinerators with advanced air pollution control equipment reduce the volume of material requiring ultimate disposal by more than 90%. The problem is cost: incineration costs $6.50 per ton, while disposal by sanitary landfill costs only $1.65 per ton. We must find different technologies. We have looked into rail transport and searched for other landfill possibilities within the metropolitan region. Among the most promising possibilities is shredding and massive compaction possibly with eventual disposal at sea.

Aside from greater research efforts and planning for regional coordination of landfill disposal, the Federal government has responsibility to guide growth in the national economy in a way which takes account of environmental costs of production. To handle the increasing problem of solid waste management the Federal government should consider establishment of a user charge which could be levied on packaging, varying according to the costs of collection and disposal of the discarded materials. This would apprise producers and consumers of the full cost of their activity and should have beneficial motivational effect to reduce production of the most obnoxious kinds of packaging such as nonreturnable bottles and cans. The user charge could be a means of raising revenue to cope with the situation. The charge would be most easily instituted at the Federal level but revenues should revert to local governments for operating expenses for solid waste management. A user charge averaging a penny a pound for packaging would have increased New York City's resources for sanitation by $20 million this year.

MASS TRANSPORTATION

Funds needed for adequate development and operation of mass transportation facilities far exceed available resources.

In New York City, over half the employment—over 2 million jobs—are concentrated in the Central Business District, less than 9 square miles of Manhattan south of 60th Street. Over 80 percent of these workers use mass transportation for some part of their journey to work, and less than 10 percent actually enter the CBD by private automobile. Clearly, there is no alternative to mass transportation for commuting in the New York City area; if everyone tried to commute by car, traffic would come to a virtual halt.

Mass transit in New York City is essential not only for commuting, but also for travel for other purposes. Automobile ownership in New York City is much lower than elsewhere in the State: there is one car for every three persons in the state and only one car for every five persons in the City. There are simply not enough streets in the City—1 mile of streets for every 1,300 residents—to accommodate automobile travel for everyone.

Capital requirements

Solely to make capital improvements to maintain the existing system, we will need $105 million in 1971, an amount which will rise to $135 million by 1975 because of rising costs and the particular timing of necessary outlays. The total amount required in the next five years is $550 million. This spending is only for such items as the replacement of over-age buses and subway cars, modernization of signal systems, replacement of worn-out subway tracks, and so on. It does include some limited improvements to meet new standards of comfort, safety, or efficiency, such as the installation of air-conditioned subway cars and buses and the replacement of obsolete manned power substations with larger automated ones.

The figure does not, however, make any allowance for expansion of transit service to areas, which, because of growth in employment or population, are now inedaquately served. No new subway lines have been built since 1940. Since that time, areas of the City, primarily outlying sections of Brooklyn, Queens and Staten Island, have increased greatly in population and now require subway service. Employment in the CBD has increased by almost 10 percent in the past decade requiring additional rapid transit capacity for home-to-work travel. Employers report that crowded, inadequate subways are a major reason why they have difficulty hiring and retaining workers.

To meet these needs the City has embarked on a 50 mile expansion of the rapid transit system. The total cost of this expansion with current rates of cost escalation is estimated at between $1.8 and $2.0 billion. Approximaely $900 million will be required in the next five years.

In utilizing resources for these two functions—maintaining the existing system and responding to existing needs—the City is essentially adopting a passive role towards mass transit and the role of mass transportation in influencing development. Transportation facilities have traditionally been used to stimulate new development rather than to respond to existing needs. The first subway lines in New York City were frequently built with the explicit intent that development would take place around the new stations. The results of this policy can be noted for example in the Bronx, where apartment development is concentrated in lines running along the rapid transit routes.

There are numerous opportunities for development of new residential, commercial and industrial areas in New York City which are not being realized because of the lack of transportation facilities. Much of the vacant land in Staten Island, outlying areas of Brooklyn, Queens and The Bronx could be developed without relocation to ease the City's critical shortage of housing units. With new transportation facilities making the area more accessible to the CBD, new housing in the Lower East Side to replace existing badly deteriorated stock could be fostered. We estimate that there are approximately $700 mililon worth of development-oriented transportation projects on which the City should start planning immediately, with $300 million of this spent in the next five years.

The total needs for capital funds for mass transportation facilities in New York City adds up to the considerable sum of $1.75 billion over the next five years. Where is this money going to come from?

The City's own capital resources are limited by various legal constraints, and beyond these, by the City's ability to borrow. Given these constraints and the needs in other areas the City will not be able to devote more than one-sixth of its capital resources to mass tranportation, and even this is a very large amount compared to what other municipalities provide. We expect to be able to provide from our own funds a total of $560 million in the coming five-year period.

Limited additional funds will be available from the State, which has passed a $2.5 billion transportation bond issue. Of this $600 million will be available for mass transportation projects in New York City. The bond issue is a one-shot infusion, implying no ongoing commitment to mass transit capital needs by the State.

The picture is discouraging. Available resources fall short of needs by a staggering total of $775 million over the next five years. Without new revenue sources about 45 percent of the mass transit needs of the City will go unmet. When we turn to the Federal government, we find that the commitment, both to date and in the proposed Urban Mass Transportation Act, is inadequate. Under the new proposed bill a total of $465 million will be available over the next five years for New York State as a whole, with a major portion of that amount going to New York City. It is clear that a reasonable approach to the mass transportation needs of the country will demand a far more extensive commitment of Federal funds.

Operating expenses

Operating deficits of mass transit systems are as serious as the difficulties on the capital side. The operating cost problem is particularly serious because in most systems these costs must be covered by fare box revenues. Increasing operating costs are translated into higher fares, which in turn, drive still more riders to automobiles, further compounding the financial problem. Moreover, higher fares work a particular hardship on the poor who have no alternative to mass transportation.

Operating costs of mass transit systems have been rising at between 6 to 10 percent per year across the nation in the past five years, and fares have been going up commensurately. In New York City, the basic subway-bus fare was raised by 5 cents in 1966 and by 10 cents in 1970. We expect the fare to go up by an additional 5 cents every two years to meet anticipated increases in operating costs of $50 to $60 million annually. In order to have avoided the 10 cent fare rise of January 1970, an outlay of $230 million in calendar 1970 and an equally large expenditure in 1971 would have been necessary.

Rising mass transportation costs and fares are largely a reflection of general increases in the price level, and a reduction in the general level of inflation would be the most important single factor in limiting future increases in operating costs and fares. But, given the particular importance of mass transit to the lower income segment of the population, we may, as a matter of public policy, wish to consider government operating subsidies to mass transit as a means of keeping fares down and increasing the mobility of the poor. Since local governments are generally even more strapped for operating funds than for capital resources, a Federal commitment would again have to be considered for this purpose.

Representative Reuss (presiding). Thank you, Mr. Hayes.

Mr. Warnke?

STATEMENT OF PAUL C. WARNKE, ATTORNEY AT LAW

Mr. Warnke. Mr. Chairman, I think I will take advantage of your invitation not to read my statement but just to comment on some of the points that I think are worth, perhaps, some further elaboration.

I would like to start by saying that it is always a temptation for an advocate to try to bolster his own argument by showing that the other side's argument is totally without value. So, from that standpoint, I suppose that I could start off by saying that our defense budget is absurdly high. I don't' think that we can talk of it usefully in those kinds of absolute terms. It seems to me that when we are dealing with the question of national priorities we are no longer dealing with absolutes; we are dealing with issues of relative value, and that from that standpoint our defense budget today is too high. The problem is one of a relative assignment of priorities among our national needs.

As proposed for 1971, the expenditures for national defense would be $73.6 billion out of approximately $200 billion. This represents, as the President has pointed out, a reduction of some $5.8 billion in defense expenditures. This, in my opinion, is a step in the right direction but, as I have suggested in my prepared statement, I think it is too small a step, and that we have to find additional money out of the defense budget to meet the other needs that are intrinsic to our national security.

In considering the national security of the United States, we should constantly update our preception as to where the real risks lie, and today we should ask ourselves whether the greater threat is one of external aggression or whether basically it is one of internal decay.

Are we really in a position today where we can afford to spend $73.6 billion, something like 37 percent of the total budget, on the hardware, the manpower, the means of implementing American military power? I believe that we are not, and that at least something like $5 billion out of that $73.6 billion deserves relatively low priority in view of some of the compelling needs that have been outlined by my colleagues here today.

I think we have reason to recognize from our experience during the past decade that the uses of American military power are relatively limited and that basically all it can do is to cope with military threats. It seems to me also that looking at the situation as we face it today, we have a military threat from only one power, which is obviously the Soviet Union.

Now, from the standpoint of our military planners, we can not fairly blame them for budgeting for contingencies that are on the whole improbable. That is their job. But it is the job of the American people, and primarily it is the job of the American Congress, to assess the relative likelihood of the basic threats to our national security.

At one point, and it wasn't too far back, I think we tended to feel that we could fund for whatever level of national defense we elected to view as being within the realm of even improbability. That is no longer the case today. Because, as I think that the work of Senator Proxmire has illustrated very dramatically, the costs today of military hardware are almost inconceivably high. Even if we were successful in eliminating all of the waste and all of the redundancy it would still no longer be possible for us to fund for all those things in the area of national defense that have become technologically possible.

I think one figure illustrates what I have in mind. The unit cost of aircraft has gone up so fantastically that, in our current budget, although the number of planes is down something like 24 percent, the cost of the aircraft is down only something like 2 percent.

My present colleague and former boss in the Defense Department, Secretary Clifford, used to say that perhaps the best hope for peace was that war was pricing itself out of the market. Now, one of the risks, of course, is that we will continue to pay the price even though we do have more compelling demands on the limited budgetary funds which are available to us.

The President, in his economic report, states that "We have to think carefully about how to choose the claims upon the national output that will be met since we cannot meet them all." I think that this is an extremely sound statement. But I don't believe that the current portion of the Federal budget devoted to national defense constitutes a sound choice in the light of the needs with which American society is faced at the present time.

There has been a lot of debate about just how you go about designing a realistic establishment, as to whether you should abandon the concept of two and a half wars, and go to some concept as one and a half wars.

I think that either concept is relatively futile because it doesn't really tell us anything about how to go about designing the overall defense system. I believe that, in the emergency situation with which we are presented at the present time, we have to consider what is the minimum defense posture that can meet the most likely needs of the United States for the utilization of military power.

As I stated previously, our experience in the past decade has shown that the uses of military power are relatively limited. I was quite intrigued by the report recently released by the Department of State in which it is pointed out that the suspension of military aid has had very little, if any, impact on influencing the activities of foreign governments. But the report did not draw from that fact the conclusion which seems to me to be inescapable. Not only does suspension of military aid have very little impact in influencing political judgments, but the necessary corollary is that the granting of military aid, similarly, is a somewhat inept weapon for American foreign policy implementation.

I would suggest that we have to regard our national security today as a total seamless fabric and that our national security is more threatened today by our inability to meet the needs of the citizens of the United States, and to fulfill their rightful expectations, than it is by any external threat.

We have an abundant nuclear deterrent capacity, which holds in check any effort on the part of the Soviet Union to influence our conduct by the threat of military violence. We can speculate as to what might happen in 20 years as far as the Red Chinese are concerned. But it seems to me that it is imprudent to budget against that sort of a threat at the present time. We have more immediate threats, we have undeniable threats, and certainly looking some 25 years back we find that our military threats then were from the Germans and from the Japanese. Today a major effort on our part is to prod the Japanese and the Germans away from their selfish preoccupation with a peaceful economy and toward a greater military effort.

As has been said repeatedly, we don't have permanent enemies and we don't have permanent friends in the field of foreign policy. We have permanent interests. The permanent interests of the United States are to preserve our own independence and our territorial integrity.

It is also in the interests of the United States to preserve the kind of a viable, lively society in which we can really enjoy the fruits of our independence. And I believe that the statements that have been made by my colleagues on the panel here today indicate that we are not today meeting those needs, and that some serious reordering of our priorities is essential if we are ever to meet those needs.

Thank you sir.

(The prepared statement of Mr. Warnke follows:)

PREPARED STATEMENT OF PAUL C. WARNKE

Mr. Chairman and members of the committee, in your invitation to testify before this Committee, I was asked to focus on the issue of national priorities. This is, of course, the key and continuing issue confronting the Congress and the people of the United States today. I can claim no special qualifications to suggest either the appropriate order in which we should deal with the compelling needs of American society or even a procedure for resolving competing claims for priority of attention. Nonetheless, I am grateful for the opportunity to share with you a few scattered and probably somewhat primitive thoughts on the context in which such consideration should take place.

First, as I see it, top priority must always be given to the national security. At the same time, the major threats to this national security are subject to frequent change and a responsible ordering of our national priorities should reflect a realistic and current assessment of these threats.

Traditionally, as reflected in our Federal budget, we have assumed that the principal threat to our national security lay in the danger of military aggression by foreign powers. Accordingly, our military outlays in recent years have consistently ranged in the area of 7 to 9% of our gross national product and have accounted for by far the largest single share of the total Federal budget. I see no purpose in seeking to reassess history in an effort to determine whether this was in the past a misallocation of funds. Certainly in the past we have had good reason to believe that we faced a genuine military threat to vital American interests. Foreign powers obviously have not renounced the use of military force and we must continue to support a substantial U.S. military capability. But the demands of national defense can no longer be treated as absolutes.

In the past, many of our present pressing domestic needs were both less urgent and less susceptible of solution by expenditure of Federal funds. Today, I believe there can be no serious question of the fact that grave threats to our national security are being created by our failure to meet and to master a series of domestic crises. This failure cannot, in my opinion, be attributed to any lack of appropriate mechanisms in the form of statutory authority. What is lacking is the needed primacy of national attention and the allocation of the necessary financial resources.

In the final analysis, our national security rests on the ability of our society to provide for our citizens a quality of life that meets their needs and aspirations. Basic to this quality of life are decent housing, a wholesome environment, opportunities for education and remunerative employment. It requires, certainly, reasonable safety of person and property. Absent such essentials, at least on a minimal level, our society will become increasingly dissatisfied and unstable. If these fundamental human expectations cannot be satisfied, we may in the long run have nothing foreign powers will covet and nothing our own people will want to protect.

There is, as I have suggested, no absence of means to cope with these real and present dangers to our national security. Legislation enacted during the past several years provides the mechanisms for a massive effort. We possess both the human and the material resources to provide a decent home in a decent neighborhood for every American family. We can see only too clearly the appalling consequences of a failure to provide for the least privileged Americans a chance for adequate educational and employment opportunities. Our society cannot afford the loss of yet another generation who, condemned by an impoverished environment to a life of futility and frustration, will only continue to poison American life for even the most privileged of our citizens.

The budget for 1971 proposes to reduce spending for national defense by \$5.8 billion. I am convinced that this is a step in the right direction. But, given present budgetary restraints, I also believe that it is too small and too uncertain a step. A sound weighting of our priority needs would require that we devote at a minimum an additional \$5 billion to meet critical problems in the area of crime, dope addiction, urban blight, deficient housing and pollution of our environment. As Chairman Burns of the Federal Reserve Board has observed to this Committee, additional funds for Federal programs would require either a reordering of priorities or an increase in taxes. If the necessary financing is to be found within the budget figure presently proposed, it can come only from reduction in outlays for military defense.

As I see it, sufficient reduction can never be achieved simply by seeking to prove that particular weapons systems are worthless. They are neither designed nor proposed by incompetents. But I think that we can reallocate very substantial amounts now proposed for military expenditures, even though recognizing that this may mean the loss of some incremental margin of military security. If we are to cope with our current crises by reordering national priorities, we must ask whether our security can best be served by dealing with today's dope-driven crime wave or by budgeting for tomorrow's "greater-than-expected" enemy threat. If we are to seek the impossible goal of total military security, the amount we can devote to national defense is literally limitless. Since we can't avoid all risks, and can't even afford to try, we are entitled, and even required, to insist that the less probable be deleted from our defense planning.

Marginal increases in military strength might perhaps be justified when the alternative is a return to private uses of any reduction in military spending. For the man—or the society—that has everything, extravagance is not synonymous with folly. But the family that can't afford a college education for a talented son certainly can't afford a second car.

When Congress comes to consider the appropriation of funds for the Phase II of the Safeguard antiballistic missile system, therefore, I would hope that debate would not focus primarily on whether it will work or even exclusively on whether it will advance or retard strategic arms limitations talks with the Soviet Union. In terms of national priorities, we might ask instead whether our national security can really be best advanced by budgeting against the specter of deranged Chinese leaders who might be bent in the 1980's on mutual nuclear destruction? Might not $1.5 billion be better used to dispel some of today's waking dreads rather than tomorrow's nightmares? Is the arguable erosion of the land-based segment of our nuclear deterrent more or less risky than the undeniable deterioration of the air and water that support our life? Similar question might be asked about the budget for general purpose forces. Will, for example, a fleet of nuclear attack carriers show the flag more proudly than well-financed public schools with competent teachers and interested pupils?

There was a time, perhaps even in the recent past, when any savings in defense expenditures would not in fact have been utilized for other Federal programs. Today, however, I think we are virtually at the point of a dollar-for-dollar trade off. Today our defense expenditures are directly competitive with other and crucial national programs. Under these circumstances, it may well be characterized as imprudent to continue to budget for remote external threats and improbable military contingencies.

Representative Reuss (presiding). Thank you. Mr. Warnke.

Mr. Hayes, you have painted a very stark and alarming picture, and I don't think you have overdrawn the crisis, this is your phrase, which faces New York City and so many other cities. I would like to relate that to the current economic policies that our country seems to be following based on our week or more of hearings.

The two main methods of the administration for fighting inflation seem to be very high interest rates, the highest interest rates in about 100 years, and an enforced slowdown in growth of the economy, coupled with increased unemployment. Now, both of those things are very tough for New York City, are they not? High interest rates mean that your borrowing costs, and you do have to borrow, become intolerable, and the slowdown in growth means that there isn't any appreciable peace or growth dividend. Hence your programs across the board are vastly underfunded as far as Federal aid is concerned. Would that be a fair statement?

Mr. Hayes. I think it is a fair statement. That the high cost of interest, I think, has a surprisingly pervasive effect throughout the whole structure, means that, for example, not only is it far more difficult to continue new housing construction but loans for rehabilitation of existing housing become almost unavailable under current conditions, even in the few instances where our building owners can pay them, and the effect upon the city is a very dramatic one.

After submitting a balanced budget last July on the basis of the best estimates we could get of costs during the current year, we are facing a deficit in the current year that we are trying to cure of about $60 million. About $20 million of that is directly due to an increase in the cost of interest on temporary debt of the city. This is a massive addition on any municipal budget in that kind of period of time.

I would say I am as disturbed as your witnesses yesterday, particularly Mr. Lewis, about the possible effects of a slowdown in growth upon the problems of the city. We have had many problems even with a rather buoyant rate of growth in the city and what would happen with a slowdown and with the continuation in the short run of many inflationary pressures is very hard to say. I think we are in a quandary in economic policy and I think some serious consideration has to be given to direct control on wages and prices.

We have not during the entire postwar period, to my knowledge, gone through price and wage increases at the rate we have experienced in the last 2 years without direct controls. Having gone as far as we have with many of the policies we have tried, it may well be that the only effective solution to our difficulties without damaging effect at this stage is direct controls.

Representative REUSS. I have at these hearings characterized the administration's concentration on the two methods I have described—very high interest rates and a slowdown in growth and increasing unemployment—and its refusal to fight inflation by either wage-price guideposts and a price freeze, on the one hand, or by controls over credit and lending, on the other hand, as a disaster.

Do you think that characterization is proper?

Mr. HAYES. I think so. You know it is a prediction. We all can be wrong on predictions, but I don't think the prospects are good. I think they are very, very bad.

Representative REUSS. I didn't hear you.

Mr. HAYES. I say I don't think that the prospects under current policy are good. I think they look very bad in the short run. I might add, that with all the attention that the President has given the effect of domestic spending upon inflation, it seems to me that Mr. Warnke's testimony on where the reductions might be made in Federal expenditures is a far more appropriate one. Even if it has some adverse effects upon growth, at least the distributional effects are far superior to that obtained by cutting education aid appropriations.

Representative REUSS. Let me turn to Mr. Warnke, who has made what I think is a devastating priority analysis of spending a billion and a half on the ABM versus spending that billion and a half on eduction, health, the environments, the problems of our cities.

You point out, I think, that the chances of a Chinese nuclear attack in the 1980's against the people of North Dakota, Montana, and Wyoming, to you seem less of a danger to this country than the clear and present danger of refusing to do anything about the problem of the city of New York, for example, as described by Mr. Hayes. Would that be a correct recapitulation of your weighing of those alternatives?

Mr. WARNKE. That certainly is my view, Mr. Chairman; yes.

It seems to me that the arguments for spending something like a billion and a half dollars for a Safeguard system just are not anywhere near as compelling as the arguments for spending a billion dollars for example on dealing with the problem of drug addiction for funding, as Mr. Hayes has pointed out, by $500 million, a 20-percent increase in our urban police forces. It seems to me that we have an immediate need for that sort of funding, and we have a highly conjectural need for a Safeguard system that will be operative against the hypothetical Chinese attack in the 1980's.

Now, the people of the United States could conclude that they want both. If they want both, however, the answer is an increase in taxes, to raise the amount of Federal funds that can be expended. The choice should be between higher taxes and Safeguard, not between Safeguard and safe streets.

Representative REUSS. The problem, of course, is a political problem, and let's look at the realities of that. Safeguard is made largely by Western Electric, which is a subsidiary of American Telephone & Telegraph, which has a large and powerful lobby in every Congressional district. This is one fact which makes the ordering of national priorities very, very difficult. Let me ask you this: Segments of the arms and space industries are now experiencing a little unemployment in various areas. Instead of poor-mouthing and bellyaching, as many of them do, wouldn't it be a glorious thing for the Republic if the defense and space industries developed an interest in our problems of air pollution, water pollution, solid waste disposal, low-cost industrialized housing, mass transit, drug addiction, and so on. Wouldn't it be glorious if these firms displayed the same energy at conning the public into believing that a massive attack on those problems was necessary as they have in their military and space efforts? If they displayed the same remorseless lobbying activity with Congress on these domestic goals as they have on military and space activities, would we not then be likely to get a reordering of our national priorities?

Mr. WARNKE. Well, with all respect, Mr. Chairman, I would say that I think that the order of action has to be exactly the opposite. I think that the reordering of national priorities through the work of the U.S. Congress would have to precede any reordering of priorities by American industry. At the present time the defense and space industry has been entitled, I believe, to rely on the fact that the Congress would appropriate large amounts of money which would go into military hardware, and they were geared up to anticipate that sort of priority allocation by Congress.

I don't think that in a private enterprise system we can anticipate that American industry is going to react before Congress reacts. I don't think that they are going to reorient their industrial capacity on the chance that Congress may reorder the way in which it allocates the Federal budget. So with all due respect, sir; I think that it is going to have to be your move first.

Representative REUSS. Well, I feel that we would move a lot faster if we weren't locked into a situation such that once a conglomerate, for example, has an interest in 218 congressional districts, it may then own the United States. I personally think that the best opportunity to make progress would come about if Congress could lead the reordering of national priorities, in contrast to the current majority which doesn't' believe in a reordering, and if American industry would take a bit of a lead too. I am not suggesting industry build plants for nonexistent mass transit orders. But these businessmen are very good at lobbying and I would like to see them lobby for some of the programs we are talking about. Having persuaded Congress—because, after all, it is these industries which wield so much power in a majority of Congressional districts—then having persuaded Congress, let them build their plants to meet the new 1970 editions of what were the military and space programs of 1960. Maybe there is room for both sides to act.

Mr. WARNKE. I would certainly agree with that, sir; as an objective, and I think there is no question of the fact that American industry can help a great deal in advancing what I regard as being a sound reordering of priorities.

I would certainly like to see the talents of American industry and American ingenuity turn toward trying to deal with the urgent problems we have in the way of housing, in the way of pollution, and the various other problems that have been described here today, and I think that this is the sort of adjustment that can be made by American industry. After all, most of our large defense contractors have a very large nondefense portion of their business, so they would not be getting into a total alien field, and I think that many of the same talents could very well be turned to this type of peaceful use, certainly to the betterment of our entire environment.

Representative REUSS (presiding). Senator Jordan?

Senator JORDAN. Thank you, Mr. Chairman.

Mr. Miller, you have a very broad background in industry and economics, and now in higher education, and I was intrigued by your statement, by your suggestion for a National Goals Institute and I think it has some merit. I wanted to explore it a little further with you.

As I understand it you would set up an independent agency that would assess the national goals that we should achieve, and then assess likewise our ability to meet those goals. Is that essentially what you were saying here?

Mr. MILLER. Yes, sir.

Senator JORDAN. This process of assessing national goals, cumbersome as it is. is that at present it is pretty much decentralized, is it not, and vested in the Congress of the United States and in the executive branch of the United States and the numerous legislatures and governorships of the several States and even in the courts.

Do you believe that a centralization of that authority or that into a new body would be desirable and productive?

Mr. MILLER. Senator Jordan, I think we need to make a clear distinction between the centralization of information-gathering, on the one hand; and decisionmaking, on the other. In my opinion, the first function can and should be centralized, but not the latter. Such a centralization of data would provide well-meaning and sincere citizens, in and out of legislative bodies, a way to look at the total picture, and evaluate one claim against another. I can see a quasi-independent organization fulfilling a needed function in setting forth once a year data on what our economy is capable of producing, as well as the total claims against that production.

In the conversation that has taken place here this morning, for example, I was pleased to hear the chairman emphasize the importance of supply side. In projecting what our economy is capable of producing, we should identify the bottlenecks that are holding back output in various areas, such as health care and building.

Senator JORDAN. And it would function like the Council of Economic Advisers?

Mr. MILLER. Yes, sir, I think that would be a very good pattern. The council of economic advisers was a big step forward at the time it was established, with emphasis on maximum production, employment and purchasing power. In my opinion, however, the goals today have gone beyond that. In the conversation here today we have identified the need for a better environment, for safety, for health and other objectives that go beyond production itself. So I believe it is time to reconsider what our national goals should be.

Senator JORDAN. It is well enough to define them, it is well enough to catalog our resources but how do we give implementation to the findings of such an institute?

Mr. MILLER. It is not an easy problem, sir. I believe, however, that better data would lead to better choices. We could then make better judgments as to the kind of incentives that would be required to "turn on" the resources of the private sector toward meeting our objectives. For example, we heard this morning from Mr. Hayes of the need for housing. Well, the private industry is in a position to make a contribution in the housing market. You can't expect business to meet the need for low-income housing at the present time, however, because the people that need the low-income housing simply don't have the money. Congress must provide the incentive, be it in terms of subsidized interest, be it in terms of rent supplements, be it in terms of a new secondary mortgage market, or what have you. Proper incentives would permit private industry to pursue "public goods" goals in the future in the same way that they have been pursuing narrower "private goods" objectives in the past.

Senator JORDAN. Thank you.

Mr. Hayes, you paint a grim picture of the big cities, the hardcore cities of the United States and frankly, I don't see much prospect for any immediate relief. The migration to the cities over the past several years has been substantial, out of the rural areas, has it not?

Mr. HAYES. It has. There are signs of some slackening off but the movement has been so great that the natural increase in the population that had migrated in urban areas in the fifties and in the early sixties is now very substantial.

Senator JORDAN. Yes, it is and you say it is slackening off but population projections indicate we might have another 100 million people in the United States by the turn of the century, that is only 30 years away and if it follows the pattern of the last 20 years, most of that additional 100 million is going to be in the hardcore cities, is it not?

Mr. HAYES. It is going to be in the metropolitan areas not necessarily in the cities and the pressures created over the last 20 years on the cities is redistributional within the metropolitan area with the cities getting more of the poor and with the outward migration from the city into the suburban areas of both a substantial part of the white population and the middle class population.

The thing that disturbs me about this perhaps more than anything else is that I find it hard to see how this process of upward economic and social mobility—which has really worked so well in the United States throughout its history—how this can function without the effective functioning of the labor markets in cities like New York, Chicago, Milwaukee, and Los Angeles. These are the places, perhaps the only places in the country, where the Mississippi sharecropper or the Puerto Rican coffee farmer in substantial numbers can, in fact, be assimilated in the mainstream in American life and go from productivity levels of $500 to $1,000 a year to $5,000 to $10,000. It is a system that has worked historically, and it is the very guts of the way that the American system functions, and functions effectively. We are at the point where we ought to feel a little bit shaky about how the process is working. What is happening in New York is of extraordinary importance to the Nation just as what is happening in other large cities. It is not an isolated problem; it is a national problem and it is one that has to work for the country. It has to work and work well.

Senator JORDAN. I agree it is a problem because as you so aptly stated in your statement, that while the Federal Government relies on the income tax for as much as 45 percent of the revenue State and local governments rely on only to the extent of 8 percent, meaning the other 92 percent of the income of States and local governments is fairly inflexible. Ad valorem taxes and excise taxes and sales taxes generally do not follow the increase in the cost of goods and services that are required by State and local governments, is that a fair statement?

Mr. HAYES. That is a fair statement.

Senator JORDAN. That being the case, and, as you state that the revenue-sharing proposals that have been advanced are entirely inadequate, tell us what do you regard as being the dimension of the need of New York City. Let's take the categories that you indicated here, first, education and, second, health. In education alone, what is the dimension of the need of outside help for education to New York City?

Mr. HAYES. Let me make just a couple of points on that. In all of these service areas, the costs have gone up astronomically. We are confronted at the same time with some real crises of means and ends relationships. For example, do we really know what we can do to educate faster, say, the children of the black sharecropper from Mississippi, or the Appalachian white, and many other people who come into the cities? But in attempting to solve the problem we are now at the point where our education runs at a cost of something in excess of $1,400 on the average per pupil per year.

On health care in the city, the budget of the city of New York now, on personal health care includes expenditures of $1 billion a year. There is an estimate that the medically indigent population of the city is 4 million. I estimate we are probably serving no more than three-quarters of that or probably 3 million people. This would mean the cost of personal health care is running at about $335 per capita per year for the indigent population. If you take the whole 4 million, the per capita costs come to $250. These fantastic amounts are fantastic because we are not getting the full performance, because we are not dealing with the problem on the supply side.

Our big problem is that we are carrying a burden which is now too heavy for our tax base even though there is in both health and education, particularly in the health area, substantial State and Federal aid. Despite our effort, the system is not producing what it ought to produce.

The burden on the municipality and on the State as well is such that I expect the continuing attrition of eligibility standards. Medicaid eligibility 3 years ago was $6,000 for a family of four. It was cut to $5,300 by the legislature 2 years ago, to $5,000 by the legislature last year, and, in the meantime, by the income comparable to $6,000 in 1966 is in excess of $7,000 a year. This increases the strain on our so-called charity medicine institutions, our 21 municipal hospitals, 150 odd public health clinics that are now bearing the burden of people who are too poor to afford health care and too rich for medicaid. I know I am not giving you a straight and easy answer to it. I am talking about areas in which the city is already spending in grand total something in the vicinity of $2.6 billion a year, and a $2.6 billion a year that obviously gets further inflated by the continuing upward movement of costs——

Senator JORDAN. Well, I have a signal, Mr. Hayes, that my time is up. Could you wrap this up with an answer of how much Federal aid do you calculate is needed for the State of New York in these eight categories that you have mentioned, education, health, water pollution, air pollution, mass transportation, solid wastes disposal, law enforcement, and housing, could you give us one figure?

Mr. HAYES. I could give you one estimate. If, in fact, we are going to maintain any kind of fiscal sense in the city at all, I think that we are going to have to recognize a city budget that over the next 5 years is going to have to go up by something between $3 and $4 billion. Our capacity to produce funding against that is probably no greater than another billion or a billion and a half in growth. We are going to need something in the vicinity of $2 to $3 billion a year in additional State and Federal aid if we are going to make a go of it by the time the incumbent mayor's term ends or the subsequent year after and that is primarily to carry out the services you mention.

Senator JORDAN. What prospect is there of getting a share of that from the State and how much?

Mr. HAYES. We have many complaints against the State on their sharing in the costs of services. Still I would have to say, fairly, that given the levels of personal income tax in the State—a top bracket of 14 percent—and corporate income taxation—we have a 5½ percent city corporate income tax, the state has 7½, for a grand total of 13 percent—that the State is hard pressed. I use those two taxes because I think the Governor is citing them in terms of the problems of competitive position. At the same time, perhaps the State has the capacity for producing another half billion for us just out of growth and some reallocations, but their problems are painful ones, too, and they are painful ones simply because of the fact that State taxation has to be considered competitively with that of other adjacent States.

Senator JORDAN. And net Federal cost then of around $2 billion?

Mr. HAYES. Yes.

Senator JORDAN. Thank you.

Mr. HAYES. That is for one city, Senator.

Senator JORDAN. One city, 1 year?

Mr. HAYES. Yes.

Representative REUSS (presiding). Senator Proxmire?

Senator PROXMIRE. Gentlemen, I want to thank all of you for your statements. I think this is a most important hearing we are having this morning and I intend to have a series of hearings by the Subcommittee on Economy in Government on our national priorities and I think it is a most important contribution this panel is making. I think it is dramatized by what you are telling us this morning.

Mr. Miller, you tell us that the National Planning Association in 1965 projected a gap of $150 billion if we are going to meet our social needs, and you say that is too conservative now in view of inflation and in view of our better realization of what our needs are.

The administration gave us a chart, I didn't think it was as helpful as it should have been. It was on page 71 of the Economic Report of this year in which they project the gross national product at a rate of real growth of 4.3 percent, which is highly optimistic, it would be a greater rate of growth than we have had in the sixties or we have had throughout the years, and that would provide a $1.2 trillion GNP by 1975.

It points out that the claims on that GNP on the basis of just present programs, would leave only $12 billion for new programs, almost nothing, very, very little and, as I say, these are highly optimistic assumptions with regard to the real growth of the economy.

Yet, also it would not provide anything like the 26 million housing starts we have to have in the next few years.

Now, the conclusion that I draw from this is that we simply are not going to be able to meet these needs, we aren't going to be able to do it. The needs are there but we just kid ourselves by indicating this is something we have to do and are not going to do, we are not going to do it. I think if we imposed greater taxes to do it we are going to retard our economy in other ways, that just cannot be done. What we have to do is decide there are some things we must do and some things we simply cannot do. These are tough decisions to make. They are decisions that Members of Congress and politicians hate to make because you make enemies when you make them.

But is your conclusion, Mr. Miller, contrary to that? Do you think we can do this and somehow we have the will if we are willing to tax ourselves, if we are willing to make tough choices on priorities that we can go ahead with a program that you indicate that we should to meet our social needs.

Mr. MILLER. Senator Proxmire, my answer is yes. Look at it this way. We have just so much in total resources to go around, so these hard choices must be made in any event. The only question is how they are going to be made. Are they going to be made intelligently based on comprehensive overall objective information, or are they going to be made piecemeal based on inadequate data? It seems to me that if I were in your position and had to make these tough choices, I would insist on having better information at my command.

I know, for example, from my background as president of Ford Motor Co. that we had to plan ahead and make choices, and although our programs were much simpler than you gentlemen are facing, we had far more data, and far more complete information on the alternatives open to us.

Senator PROXMIRE. This is very, very helpful, Mr. Miller. You see one of the things that I tried to get from the administration, and they refused to give us, is what the projections amounted to, how much is going to the defense sector, and how much is going into health and so forth. I feel unless we have those specific projections we cannot intelligibly debate and discuss these programs and come to a conclusion in determining our priorities intelligently.

Mr. MILLER. I agree 100 percent with your statement. I think you need to know by fairly detailed classifications what the total costs would be out over a period of years, with clear indication of how much future income is preempted by programs currently enacted—such as medicare, medicaid, and veterans expenditures.

The reason I think it is appropriate to have calculations made by a quasi-independent organization, supported both by Government and the private sector, is that talking of Federal priorities alone is not enough. Implicit in your earlier statement was an understanding you have that there should be a proper balance between public and private spending. We can produce just so much in total, so if taxes go up, there is going to be less for private housing, for private investment, and for private consumption.

In my judgment, therefore, we should consider the needs of all segments of our society in deciding the appropriate division of expenditures between the public and private sectors. Consideration should then be given to the breakdown within each sector. The laws that you gentlemen pass have an impact on the breakdown of expenditures within the private as well as the public areas. For example, the 7-percent investment credit for investments in machinery encouraged our productive capacity. I think that is the right track. I think our best answer is growth so we will have a larger pie to cut.

Senator PROXMIRE. Good.

I would now like to proceed into a couple of the areas you have indicated in your statement. One is, and you have indicated one device of trying to get more production or more productivity in our economy, get this 4.3-percent growth up. I think it is highly optimistic, I hope we can do that well or better, but I am skeptical.

Right now we face a dramatic problem because the administration has deliberately been slowing down the economy for understandable reasons as their way of coping with inflation. They project an unemployment average of 4.3 percent in the coming year. They admitted to this committee they expected it to be as high as 5 percent sometime during the year.

As Chairman Reuss pointed out this means 700,000 or 800,000 Americans out of work who are working now. We now are operating at about 81.9 percent of our capacity in our plants. We obviously are not producing as much as we could produce.

It would seem if we pursue present policies for very long, and it seems we may have to pursue them for a year or two to get inflation under control, then we are not going to have the production to meet these, priorities that we are setting here, our goals. What is the answer to that?

Mr. MILLER. Well, there isn't any easy answer. We are always going to live in an economy of scarcity. There is really no such thing as an affluent society. When we use terms like this we are only kidding ourselves.

Senator PROXMIRE. We only make it more scarce when we slow down the economy.

Mr. MILLER. Yes, sir.

Senator PROXMIRE. Isn't there a better way to do it? Do Japan and Germany point a way of doing it without having a socialized or completely controlled economy?

Mr. MILLER. Well, I certainly don't favor a socialized or a completely controlled economy. But I do think that plans to expand the growth through time of our economy can be made in better fashion than they are now.

Senator PROXMIRE. In the recent past we have had a series of ad hoc goals institutes including the National Commission on Technology, Automation, and Economic Progress, the President's Commission on Law Enforcement and Administration of Justice, the Kerner Commission, the Eisenhower Commission, all of which defined areas of critical social and economic needs that are being neglected and made recommendations for in effect a reordering of national priorities. Each of the reports of these Commissions were well accepted and widely acclaimed and yet nothing happened. Practically none of the recommendations were acted upon. They were ignored by the White House and by Congress.

What makes you think a National Goals Institute would have a greater impact?

Mr. MILLER. I would like to try to answer that question.

First let me say that coming as I do out of a background of 23 years in private enterprise, it is with considerable reluctance I have come to the conclusion that we need one more Federal organization. But as I examine the organizations that you have mentioned—and I could run off a longer list I have here before me—none of them had all three characteristics I mentioned in my paper which I think are absolutely essential for success.

First of all, previous attempts were, as you say, ad hoc, temporary affairs that arose and then disappeared. Whereas the nature of the problem isn't that kind of a problem at all. The problem of establishing national priorities is a continuous one and, therefore, requires a permanent organization.

In addition, an effective National Goals Institute must have a certain degree of independence, as well as Government support. It cannot be wholly subordinate to this body, although Congress should play a primary role. It should not be primarily subordinate to the executive branch. As I said earlier, I think it also needs private support. With an appropriate degree of independence and assured continuous support, the Institute would be free of the charge, whether justified or not, of playing politics in preparing the information that would be made available.

I believe that such an organization could attract national leaders on its board of directors, and qualified scholars on its staff that would be there long enough to acquire the expertise and experience needed to deal with the complex issues involved.

Senator PROXMIRE. My time is up, I will be back.

Representative REUSS (presiding). Mr. Brown?

Representative BROWN. Mr. Warnke, what is your personal background of expertise that qualifies you as an expert witness in the field you commented on?

Mr. WARNKE. I am not sure, Mr. Brown, that I can claim to have any. I served for a period of time as general counsel of the Department of Defense.

Representative BROWN. When was that?

Mr. WARNKE. That was from 1966 until July of 1967. And thereafter as an Assistant Secretary of Defense for International Security Affairs, which job I maintained until February 15, 1969.

Representative BROWN. You suggested that we would need increased taxes if we want both the ABM system and the social systems that you would like to see us undertake as a society. When we had the increased, but under-financed, social programs put on the books up the 88th and 89th Congresses and were continuing our effort to reach the moon and outer space and, then, escalated the war in Vietnam, what were your views then about increasing taxes and funding those programs? Can I find them any place in the public record?

Mr. WARNKE. You would not be able to find them in the public record, Mr. Brown; no, sir. I might say that my views at that stage probably were consonant with the views of the majority of the American public, and I think that we probably underestimated the urgency of our domestic problems at that period of time.

Representative BROWN. So you are viewing our present problems from your current viewpoint?

Mr. WARNKE. That is correct, sir.

Representative BROWN. But you are looking at the past problems from hindsight, is that correct?

Mr. WARNKE. That is absolutely correct, sir.

Representative BROWN. So I would assume if you are right in your present viewpoint, with reference to the necessity of defense against possible attack from Russia and China, that your conclusion would necessarily be correct, but if you are wrong then we might be making an error, is that correct?

Mr. WARNKE. Mr. Brown, there is always the possibility that we are making an error in our Federal allocation of priorities.

Representative BROWN. Just as there may have been some years ago, when you were in the position of responsibility and didn't ask for the increased taxes to pay the bills as we went. Is that right?

Mr. WARNKE. As I have indicated, sir, from my report of my job experience, that was not my responsibility at that period of time. I am happy to say it was not because I have no assurance that I would have done better than the incumbents did during that period of time. But what I am saying, sir, is that we have to view our current situation from the standpoint of our current perception of priorities.

Representative BROWN. I am pleased that you are acting on your feeling of public responsibility somewhat more aggressively now than then by commenting on these matters of economic priority. I think they are important now. But I think they were just as important then and it seems to me that if we had some proper decisions then we might not be in the bind economically that we are in now. In other words, if we had paid for the programs as we undertook them or, barring that, if we had set priorities then, we might be a good deal better off now.

Let me ask you about one other thing you mentioned, the effort to fund a practical way to control drug traffic. Some of us were concerned 4 or 5 years ago about the drug traffic when it was much less a problem than it is now, and still manageable. Were you vocal on the drug traffic problem then as you are now?

Mr. WARNKE. I would say 5 years ago, sir, I was not in the U.S. Government. At that point I was quite active in civic affairs. I am happy to say I shared your concern at that period of time. I share your concern today.

Representative BROWN. Well, I am glad. I wish you had been more vocal then or had achieved a good deal more attention—as you will undoubtedly achieve now by appearing before this committee—because we certainly needed some attention to the problem then as we do now.

Let me turn to you, Mr. Miller, about the program you proposed on the priorities institute. Can you give me some indication, without a long dissertation, on how you cost out the factors that are involved in maintaining peace? Because I would assume that maintaining peace would be a relatively high priority, since whether we have peace or war certainly has some impact on whether we can accomplish some of the other priorities for our society.

Mr. MILLER. I think you should start, sir, with a statement of what the foreign policy of the United States is, and then come up with the resources required to accomplish those objectives.

Representative BROWN. Where would you get the expertise for this institute on U.S. foreign policy and its various inputs?

Mr. MILLER. The institute should rely to the maximum extent on available documents. The foreign policy is the prerogative of the governmental branch. The institute would evaluate, for example, the foreign policy statement recently sent over to Congress by the President. It would draw, sir, on available information instead of determining itself what particular things should be done. It is a mechanism, not a decisionmaking body.

Representative BROWN. So you would engage private citizens in the industrial and educational fields to take the President's basic statements on foreign policy and extrapolate from that to what our foreign policy should be?

Mr. MILLER. No. The foreign policy statement would be the basic document from which the defense organization would determine the kind of resources required to implement that policy, and then the cost would be derived from the estimates prepared by the Defense Department.

Representative BROWN. How about Mr. Warnke's concern as to whether we need an ABM system? You would take the President's statement on foreign policy and figure a percentage on our likelihood of getting involved in war, like you figure a batting average or something, and then determine what would be our investment in defense mechanisms military hardware from that?

Mr. MILLER. It is always easier to explain a point by using a specific example, Congressman Brown. I am, therefore, glad you brought up the ABM because I can clearly indicate how the institue would work.

It would simply say if you had this kind of ABM system it would cost so and so dollars. This cost would be a claim against national resources along with all the other claims, such as education, housing, and cleaning up the air. Then this group, or some other group in Congress, could see when we add up all of these claims they totaled, say, $300 billion more than our economy is capable of producing, so we have to give up something if we are going to have the ABM. So the institute would only provide the financial facts on which to make a hard choice.

Representative BROWN. Who sets the priorities, though?

Mr. MILLER. That would not be the role of the institute.

Representative BROWN. So the institute is just an economic assessment area.

Mr. MILLER. Yes, sir.

Representative BROWN. To tell you how much it would cost?

Mr. MILLER. Yes, sir.

Representative BROWN. Well, now, aren't there variables that go into the cost factor? For instance, in housing, wouldn't it depend on who does the job—the Federal Government or private industry—and what method is used, and the building codes and zoning practices around the country?

Mr. MILLER. Yes, sir.

Representative BROWN. How would you take that into account?

Mr. MILLER. That is why I said in my prepared statement there would have to be ranges of costs in many cases. In housing, for example, there would be a very clear statement that the average desired number of housing starts for this country is 2.6 million a year, based on Government reports. The next step would be to estimate the costs. The institute would say that if we did it on the basis of present technology, it would cost x dollars. If we were able to use modern production techniques, such as moduler housing, it would go down by x percent. If we were able to change building codes and zoning practices, housing costs would go down another x percent. And so forth.

Representative BROWN. A lot of the work is done by the staff members of such committees as this and by the various Members of Congress themselves.

Mr. MILLER. Yes.

Representative BROWN. Do you think your system is better, preferable to this?

Mr. MILLER. It is not a substitute but a complement. There are lots of bits and pieces of very good information around, including much valuable work done by this particular committee, but there is no place where everything is brought together so that you can make an overall appraisal of it, and see exactly what the total story is. The institute would take existing estimates and put them together in a comprehensive, more useful form.

Representative BROWN. Incidentally, the President also delivered to us his message on the state of the world, so that is one resource that is commonly available to us. There may be others that are not, but I am not aware of any that are available to private sources but not available to us.

The comment was made that the people of Montana, Wyoming, and North Dakota might not have a certain viewpoint about something. It occurs to me that the people of Montana, Wyoming, and North Dakota might just find it more desirable at a billion and a half dollars to defend the country against a possible Russian or Chinese missile attack than to spend $2 billion to lower the interest rates in the city of New York.

Now, how does that input get translated in the institute of priorities that you are proposing?

Mr. MILLER. I think——

Representative BROWN. No goals, excuse me.

Mr. MILLER. I think the report of the National Goals Institute to this group and others would indicate that a small ABM system would cost x billion, a larger one would cost x billion; and offset against this would be all the competing domestic claims. Then you would have to make the determination here as to what you were going to spend and what you were going to cut out.

Representative BROWN. You would still leave it to the people——

Mr. MILLER. Yes, sir; absolutely.

Representative BROWN (continuing). And to the Congressmen who represent those people in Wyoming, Montana, and North Dakota.

Mr. MILLER. Yes, by all means. I would like to emphasize the clear distinction between providing the data needed to make a good decision, and the decisionmaking process itself. The decisionmaking process itself must always be a political process.

Representative BROWN. I would like to ask some more questions.

Representative REUSS (presiding). I have one question for anyone on the panel who cares to answer or all of you if you care to.

The question is, Do not certain Federal policies actually distort priority allocations? For example, there has been for some years a Federal trust fund for the building of interstate highways. This has meant that the amount of money available for this one purpose has been guaranteed and it has also meant that other public transportation systems such as mass transit, have not had the benefit of the steady and sure source of revenue.

Do any of you have a feeling that the Federal Government sometimes distorts local priorities and state priorities?

Mr. HAYES. I would say that is definitely true. Perhaps sometimes advantageously and sometimes not. But there is no question about the fact that State and local governments, largely due to the Interstate Highway Act of 1956, do have money for highways. They don't have money for mass transportation or they haven't had it until recently after a 10-year gap in reaching even minimum requirements.

There is also a tendency to have through legislation money available for only, say, for certain types of housing needs. There is very little, for example, that Federal housing now can do in terms of the kinds of contribution we need in the maintenance of the existing stock, because Federal housing legislation has not dealt with that kind of a problem.

You have all kinds of things buried in Federal legislation which, because they don't afford maximum flexibility, raise problems of this kind. In fairness, on the other hand, they do permit an emphasis on some things that State and local governments probably would not have done without Federal assistance going in that direction.

Mr. MILLER. I might say, Mr. Chairman, that I think you are unkind on yourself when you use the word "distort." I prefer the word "influence." In my opinion, governmental bodies should influence total expenditures. May I add this comment: As we look ahead, it is going to become increasingly true that a smaller share of our national product will be spent for private goods. I think it was something in the order of 82 percent two decades ago. But as we move down the road and make more social progress, and as private industry does a better job in meeting the private demand for automobiles, radios, TV, what have you, then relatively greater needs will arise in the social area—areas like education, clean air, clean water and safety. These are collective goods, the private mechanism cannot meet them effectively, and what we need is a political process to determine what public goods to produce. We need to "balance off" one claim against another, because we are not going to do all of one and none of the other. "Trade-off" is the term used these days to describe this process. What we need, therefore, more than ever before is a mechanism to enable legislative bodies to make intelligent "trade-offs" between the private and public sectors on the one hand, and within the public sector on the other.

Representative REUSS. Included in the administration's program for this year is a proposal that the Federal Government set up a financing authority to aid local governments in providing antipollution facilities. Now, I think that antipollution facilities are a very fine thing for localities but I wonder whether this may not be a case in which the Federal Government is unduly distorting local government financing patterns. For example, while it is great to have New York City get some help in building a new sewage disposal plant, New York City may equally need to build a new school, a new firehouse, a new police station, any number of other municipal needs.

Therefore, I guess I will ask this question of Mr. Hayes. Wouldn't it make much more sense if the Federal Government were to set up an authority to help in the financing of local borrowing needs generally rather than just one function of local government, however important that function may be?

Mr. HAYES. I think probably so, Congressman. But, just picking up from Dean Miller's comment before, if the Government is really making a considered decision that it has established a very high priority——

Representative REUSS. Could you speak a little more closely to the mike?

Mr. HAYES. I say if the Government has established a position where what it really wants to do is to place the antipollution program in a very, very high priority position, quite clearly the measures that help antipollution efforts relatively to other efforts are going to advance it.

In my opinion, the great difficulty is the gap between Washington and the places where things occur, and we are all familiar with it. I think any of us who have had experience in this town, and the kind of experience that all of you here have at the other end is that there are different views of reality.

I would say, on the antipollution point, that perhaps one of the things that happened in New York State as a result of the Governor's very strong push on the so-called clean waters program of half a dozen years ago is that incentives have been provided for the construction of water pollution control plants, and at the same time, the cities' efforts in the whole problem of solid waste disposal and anti-air pollution really languished.

I feel that we are taking steps now, for example, on disposal of solid wastes that should have gone into planning in 1960 and 1961. At the time there was heavy State concern and extension of debt limit for water pollution control. I would argue it was not bad to have a priority except the priority was not broadly enough considered.

Representative REUSS (presiding). Thank you.

Senator Fulbright, are you ready to ask questions?

Senator FULBRIGHT. You go ahead because having just come in I don't know what has been asked so I would rather you proceed because you are familiar with what has gone before.

Representative REUSS. Any time you are ready.

I will recognize Senator Proxmire.

Senator PROXMIRE. I will just ask one other question of you, Mr. Miller. You have talked about the institute which has a lot of merit but once again, I don't mean to be too skeptical about it, but these other commissions created, the Eisenhower, the Kerner Commission had a very capable staff, headed by people with great national prestige and yet as I say nothing has been done and yet you say something would be done here because your institute would be permanent, it would be permanently staffed and they would persist in asking the questions.

We still have—the main point of my question though is, How do we get these things implemented? How do you get the Congress and the President to really take them seriously enough to act on them?

Mr. MILLER. Let me just go back to the Eisenhower Commission on National Goals which, as I recall, was appointed in 1960. It had highly qualified people on it and made a report, but didn't attempt to put any dollar signs in that report.

The National Planning Association, which is a nonprofit organization located here in Washington, D.C., took the report of the Eisenhower Commission and put dollar signs on the goals. The NPA report indicated that in 1975 the Eisenhower goals would cost $150 billion more than our available resources. These were 1962 dollars. Inflation would increase this "gap" in 1969 dollars to well over $200 billion. I would estimate that adding in new goals like environmental improvement would now increase the "gap" to well over $300 billion.

In my judgment, the NPA report was a very important milestone, but lacked impact because it was a one-shot thing and not continued. I was very pleased to see the 1970 Economic and Budget Reports contain for the first time projections that looked forward to 1975. I would like to see this concept continued and expanded, so that this committee could receive each year a much more detailed report indicating what the gap would be 5 or 10 years out. Unlike separate estimates now available, this report would be based on a consistent set of underlying assumptions; that is, degree of inflation and productivity increase.

This annual report would provide a rational overall approach, so that when you exercised your judgment to vote for or against the ABM you would know that you were voting against or for a subsidy of welfare in New York and other cities, or for or against education, et cetera.

I would like to comment on one more point implicit in the statements that Congressman Reuss made earlier. After we determine national priorities, there is still a major question of how local programs "mesh" with Federal programs. In my judgment, the Federal Government is the best money raiser. Through the Federal income tax, funds can be raised that can be passed back to State and local subdivisions. More emphasis should be attached to revenue sharing or block grants, so that local people can make the determination as to what their most needful priorities are.

In these determinations, I hope we go all the way to the grassroots and get input from the local communities themselves. If there is anything we are learning in this society it is that the day is gone when people on the top can make all the decisions and impose them all the way down to the bottom. We must have an input from the bottom, but it is wrong, and fruitless and frustrating to make these local programs if they don't tie in and are supported by Federal programs.

Senator PROXMIRE. Certainly one element of deciding whether to go ahead with a program, whether it is ABM or C-5A or a domestic program is whether or not the program is worthwhile.

We have had in the Defense Department, Office of the Secretary of Defense, a program analysis group which, as you know, makes studies of programs, and they made two studies of the C-5A, and whether or not it was not feasible to buy another squadron, and both studies concluded it was not; yet the Secretary recommended we go ahead with it. I asked to have copies of the study and the Secretary understandably refused to give them to me although he had a man brief me on the study.

He said at that time, Secretary Laird did, "You ought to have your own office or your own staff to be able to make a cost-effectiveness study on these studies. Congress ought to have it." He said, "If I give you everything that we work up here it is going to mean I am not going to be able to tell this office that is under me to make a study without compromising our position if I happen to disagree with it or the President disagrees with it," and, of course, the Secretary or President ought to make a decision, not the technicians, so he said we ought to have that kind of an office.

With that in mind I made a speech last year saying the Joint Economic Committee ought to have this kind of an office in order to make a cost-effectiveness study and I am hoping we can push that through and I think it would be a useful supplement to the institute that you are talking about. Would you agree? Would you think this would be useful to us in giving us a little more understanding and intelligence as to whether we ought to go ahead with some of these programs?

Mr. MILLER. I would agree, Senator Proxmire, and I think this also agrees with the testimony that Mr. Charles Schultze of the Brookings Institute made before your Subcommittee on Economy in Government in which he indicates that an appropriate institution should be created within Congress to do some of the very things you mentioned.

Senator PROXMIRE. With a yes or no, Mr. Warnke or Mr. Hayes, would you agree we should try to do that up here or not?

Mr. WARNKE. I would certainly agree, Senator Proxmire, this would be a very useful adjunct.

Mr. HAYES. I should think so.

Senator PROXMIRE. I should like to ask Mr. Warnke where I have difficulty with your recommendation, and you made a very fine statement and I am very grateful from your background that you can give us this kind of an understanding view of putting defense spending in its proper priority. Our difficulty is the manner in which Congress is supposed to evaluate the merits of defense programs versus other priorities. As you see it, we are not to focus on the technical aspects of ABM, or on whether it will affect our strategic talks with the Soviet Union, which is a very appropriate question. You think what we ought to do is to ask whether national security is best advanced by spending funds preventing a potential nuclear attack or to move against domestic problems such as air pollution? How does Congress proceed to make such an evaluation without inquiring into the technical aspects? It seems to me regardless of anything else if you are convinced, as I was, that the ABM wouldn't work, and the experts that I relied on said it wouldn't work, that is enough for me regardless of any other consideration.

Are you saying we ought to make some kind of general decision that domestic problems need to be dealt with—they cost money—and the money should come out of the defense budget? Isn't there some better way to proceed through analysis on both the civilian and military sides of the budget?

Mr. WARNKE. First, let me say, Senator Proxmire, that I did not mean that these were to be exclusive criteria. Obviously, with respect to any weapons system the question of whether or not it will function is a very valid question and a threshold question. Similarly, I would not mean to suggest that, with respect to the debate with regard to the Safeguard system, the Congress should ignore its views as to what impact that might have on strategic arms limitation talks with the Soviets.

What I intended to illustrate is that in many instances you can reach a conclusion as to the ordering of your priorities based on accepting the argument which is made for the desirability of a weapons system. Thus, with respect to the Safeguard system, you might assume that it works, you might assume that it has no impact on the strategic arms talks, but you might still conclude that it should take a far lower priority than some of our compelling domestic needs. If that is the case you can avoid the kind of technological debate or the kind of debate with respect to negotiating tactics which can lead to no clear conclusion and perhaps still determine that that $1½ billion could be better spent in the interests of our national security by dealing with some of our domestic problems. But certainly——

Senator PROXMIRE. The difficulty, of course, is that I think all of us agree that we have to spend whatever money and make whatever sacrifices are necessary to be able to defend the country, and if we accept the conclusions of the Secretary of Defense that we are being threatened with a first strike, if we accept his conclusion that the ABM will go a long way toward preventing that first strike or making it unfeasible and the Russians will recognize that, if we accept that, it seems very, very hard not to vote for that system regardless of what else we need to have.

Mr. WARNKE. I would say that would be true, sir, if you were to accept the argument as being an absolute.

Senator FULBRIGHT. Being what?

Senator PROXMIRE. As being absolute.

Mr. WARNKE. If you were to accept the argument made by the Department of Defense as being an absolute.

It seems to me the function of the Congress of the United States just as the function of any governmental body, is to make decisions and to make choices, and that we can no longer accept the principle that every incremental increase in our physical security has to take priority over any other of our domestic needs.

Now, in this instance you can argue either pro or con the question as to whether this is some incremental increase to our physical security. I am not persuaded by the argument that it is an increase, but some reasonable men, I concede, could differ on those points.

All that I would like to bring out with respect to it is that you are dealing with speculation as to what the world situation may be a decade into the future, that you are speculating with respect to what the state of the art might be at that point, you are speculating as to whether or not such things as penetration aids and the increase in the penetrability of offensive missile systems is going to far outstrip today's technology with respect to antimissile defenses.

In addition to that, sir, I think you have to recognize that with regard to any weapons system there is the Defense Department's principle of redundancy.

Now, obviously, sir, I am speaking to an expert when I speak to you with respect to this question. But the Department of Defense has the role, and discharges the role very well, of doing everything that it can to improve the physical security of the United States. The Department of Defense cannot be expected to assume the role of making choices as between physical defense and some of the other demands on the Federal budgetary dollar. As a consequence, it seems to me that the Congress of the United States has to evaluate the argument for the ABM system in terms of what it knows about the other compelling demands on the budgetary dollar.

It is exactly that sort of information that is the virtue of Dean Miller's suggestion. It would provide data that would enable you to make a more deliberate, a more conscious choice, even accepting as I say the arguments for the validity and the value of a particular weapons system.

Senator PROXMIRE. My time is up.

Representative REUSS (presiding). Senator Fulbright?

Senator FULBRIGHT. Mr. Chairman, this subject, of course, interests me very much indeed. The view of Mr. Warnke, of course, is familiar with the debate last year.

It struck me in a most dramatic way and also a very frustrating and discouraging way that in that debate, and as a consequence of the hearings of this committee and other hearings, that nearly all of the independent scientists of this country, especially those who have been chosen by the predecessors in the White House, or I would say nearly all of those not in the employ of the Pentagon, said that the ABM was very questionable. Those, of course, under the employ of the Pentagon said they thought it would work, especially Mr. Foster, but it seemed to me that perhaps the decisive voice was the manufacturer, Mr. Packard. His testimony, I thought, was directly contrary to Mr. Panofsky who was recognized as a great scientist, I think the preeminent scientist, especially with radar.

When Congress finally weighed it they went with the establishment, we might say, as you know.

I wonder if they will again. The resources of the Pentagon, the Government, are so much greater than this committee or the Congress has at its disposal when it comes to making the decision itself. There is something more than the arguments or just the reason involved here in this decisionmaking. I am very puzzled about it.

I was noting this morning the suggestion of the Russians who suddenly after a silence of 10 years come out and say, yes, the ABM will work. I had a very great suspicion that being aware of the difficulties of this country, economic and so on, that this was a bait, this was a false bait, that they said, they are giving certain people an opportunity to say "You see, it works, therefore we have got to have another $100 million for the ABM."

I felt very nervous about this because it doesn't take anybody very bright to see that every year at appropriation time certain reactions are always brought forward. There is always difficulty in this or that area. Last year the SS–9 suddenly emerged as a great threat to us just as we were getting into the middle of the debate on the ABM.

Now, this year the the Russians suddenly decide that the Galosh system is a great success though we have been told by the CIA and others that they were not proceeding with it, everything indicated they didn't think it was a success.

Now, this psychological warfare between the administration and the Congress bothers me very much, and they have a great advantage. They have the attention, the ear of the public, and this committee right here this morning, look at the attention here to this committee hearing and down the hall Mr. Laird is telling them about what a terrible threat, I am sure, the ABM is and all the rest of it. There are 15 television cameras and all the press in Washington down there and they report everything he says. I don't know what to do about this.

You have been an executive, and you know exactly how the Pentagon and the executive run over the—have run over the Congress for 15 years. Can't you give us some better advice as a political matter as to how to hold our own against it? You say we made a decision, you are right about it. I have heard the leaders of the Congress particularly every time we get into a debate, they say "Well if there is any doubt about it, they always said we should resolve the doubts on the side of security of the great United States," which means any weapon the Pentagon wants, any weapons.

I have heard them say that in nearly every debate or every argument we have got, in the party caucuses, party meetings, you get the Speaker of the House arguing that if there is the slightest doubt about it it always comes down to the side of the Pentagon and the establishment.

You are out of politics, you are out of the Pentagon, can't you give us some clue as to how you approach or breakdown the invulnerability of the Pentagon? The Starbird memorandum, you know all about that program, they have been brainwashing the American people. Can't you give us some defense to it?

Mr. WARNKE. I am afraid, Senator Fulbright, that I don't have either the political expertise or the ingenuity to come up with any sort of a formula that will enable you to resist the blandishments of the Pentagon.

I think all that I can say and what I have been trying to say here today is that I believe the time has passed when you can accept the argument that every incremental gain in physical security has to take precedence over anything else.

Senator FULBRIGHT. Long since passed. There is not any doubt about that but how do you deal with it?

Mr. WARNKE. I think you just have to say that that is not so. There are other things that are more important.

Senator FULBRIGHT. We said that.

Mr. WARNKE. At the present time.

Senator FULBRIGHT. We said that. About 40 Members of the Senate but we got beat and we get beat on every contest so far. Some way must be found.

Mr. WARNKE. I don't believe, sir, that you can expect that the Pentagon is going to cease to push its point of view with respect to any weapons system and, as I have said, I feel that is their job. After all that is the charter that they have been given by the U.S. Government. They are supposed to do what they can to advance the physical security of the United States. Now there are arguments sometimes of a diplomatic nature, of a foreign policy nature, that can be utilized to indicate that there are some considerations which may transcend the issue as to whether or not this is a gain in physical security. It seems to me that it is up to the Department of State, and it is up to the Congress of the United States, to come up with these other arguments.

Senator FULBRIGHT. In the ABM debate it seems to me that the great weight of evidence was against the idea that the ABM would add materially to the security of the United States. It was a false start, and the best scientists we had, Kistiakowsky, Wiesner, and York and Panofsky. these are people of the highest standing in the scientific world, said it was very questionable, and yet it made no impression. This is what I mean. How can you muster any better technical advice on the very question, does it or doesn't it add substantially to the security of the United States?

The Pentagon has been able to persuade the people that anything they propose automatically does add to the security of the United States. They assume the very question in issue, they assume it nearly every time. How many of these weapons systems they have proposed have proved to be utterly worthless and they themselves have abandoned, one after the other. There have been some 20 or 30, and yet we pay the bill anywhere from $100 million to a billion dollars or more, or $50 billion, I don't know what they all add up to. This is a question that bothers me more than any other one, how you combat this enormous bureaucracy over which nobody seems to have any control.

Mr. WARNKE. All I can suggest, Senator Fulbright, is that you have to have an equally effective lobby for the competing needs. At one point and I have said this in my statement, and I believe it, at one point there was not a clear trade off between dollars saved on defense expenditures and dollars spent for domestic programs.

I think it would have been very hard at one point to get the Congress of the United States to appropriate some of the funds to finance some of the domestic programs they are willing to finance now. I think that today we are in a position in which there is this trade off. If we save $5 billion on defense expenditures, I think that the Congress of the United States will see that those funds are put to work on some of the underfinanced domestic programs. So that I believe that the context in which the Congress is operating today is a different kind of a context than it was a decade ago or even 5 years ago, and accordingly you are in a position in which some progress is being made toward an assessment of the relative values of certain domestic programs as compared to further defense expenditures. I think that the debate last year was a wholesome debate, and a beginning of an exercise of this decisional process by the Congress of the United States with respect to weapons system procurement. I would hope that the debate this year would be equally wholesome and perhaps more successful.

Senator FULBRIGHT. I think the most successful thing was not directly, but the sort of thing that this Committee revealed about Mr. Fitzgerald. This offended, I think, many Americans, and it isn't really directed to the point but the fact that the Pentagon will fire a man interested in saving money, I think offended a lot of people and had a greater effect than proving that the C–5A was not a very useful or necessary instrument, but the ABM was a shocking thing to me where the overwhelming, I thought, independent judgment about it was against it and yet it succeeded.

You say create a lobby, a competing lobby, well, they happen to have 3½ million soldiers and they take any of them and all of them and use them as propaganda. They have unlimited funds for direct management of the news, and they do it. You know how they do it. They have the Vice President of the United States threatening any independent news agency if they don't behave. How in the world can we compete with that? We need some assistance from you gentlemen who have been on the inside and have participated in that kind of an operation. Now, that you are out of it you ought to give us some better leads than we have had. I am very frustrated about it.

Mr. WARNKE. I will keep on trying, sir.

Senator FULBRIGHT. I don't know what to do about it. I wish we could.

Lastly, my time is up, what do you think about this sudden discovery by the Russians that they have an ABM that works? Do you believe it?

Mr. WARNKE. The answer, Senator Fulbright, is that I do not believe that the Galosh system would be an effective system to counter a U.S. missile attack.

Senator FULBRIGHT. I don't either.

Mr. WARNKE. Obviously it is far behind the state of the art even of the safeguard system and consequently I think it is already functionally obsolete. As to why they may have made this statement, I have never been able successfully to conjecture about the decisionmaking process in the U.S. Government let alone the Soviet Government.

Senator FULBRIGHT. We can't therefore—you at least ought to be allowed a conjecture. It just struck me as most unusual at this particular time, the timing of it is so significant, that at this particular time they suddenly find out that they have an effective Galosh system. Nothing before in 10 years they have been working on it, they never before have made any optimistic statements. It is a very suspicious discovery.

Mr. WARNKE. If I might violate my rule and speculate about the Soviet decisionmaking process.

Senator FULBRIGHT. I wish you would.

Mr. WARNKE. I believe, sir, there has been some suggestion that the positive decision with regard to phase I of the Safeguard ABM gave us a bargaining chip with respect to the strategic arms talks. I don't, I am not very much persuaded by it, but it could be that somebody in the Soviet Government is impressed with the idea that if they hypothesize an effective antiballistic missile system this somehow will improve their bargaining position when the next talks begin in April.

Senator FULBRIGHT. I think that is a very wise observation. My time is up.

Representative REUSS (presiding). Before I recognize Congressman Brown, I would say to Senator Fulbright that earlier I was worrying with Mr. Warnke about the same problem that concerned you—what do we do about the ABM? I threw out the suggestion that maybe we could get up a new consumerism movement. After all everybody pays a telephone bill every month in this country, and it is Western Electric, an A.T. & T. subsidiary which makes the ABM. Therefore, if a lot of payers of their telephone bills would just enclose a little note saying that as far as they were concerned, they wish A.T. & T. would get busy on some programs for meeting our mass transit needs, our antiair and water pollution needs, or provide better rural telephones, perhaps A.T. & T. would do a little shifting of its priorities. After all, this is a lobby, you know, in every congressional district of this country, and since we don't seem to be able to change the Pentagon and since Congress, despite your and Senator Proxmire's efforts and the efforts of others, seems to be rather locked in on its present course, maybe the consumer can help. This I should say in defense of Mr. Warnke, did not appeal to him as a solution either. I won't ask you.

I will recognize Congressman Brown.

Representative BROWN. Mr. Chairman, Mr. Warnke observed that the time had passed when he could accept the argument of the Pentagon and the executive about military expenditures. Apparently that time passed between the time he was in the Pentagon, when he accepted the escalating of the $30 billion war deficit financed under the previous administration, and the present time, when he does not accept a billion and a half ABM system—somewhat more modest than the previous administration proposed—under a balanced budget system.

I think our priorities are being reordered, to the extent that in the first 2 years of the new administration the proposal has been to cut in excess of $10 billion out of our defense spending, to balance the budget—which is one restriction I would put into your recommendation about the reordering of priorities; I think that is a high priority—and then to provide for a shift in emphasis to more pressing domestic matters, as you describe them.

Mr. Hayes, I have done a little pencil work here on your $2 billion estimate of annual needs for New York. How many people have you got in New York City?

Mr. HAYES. Probably just under 8 million, Congressman.

Representative BROWN. I didn't figure right; I estimated 10. I guess I was figuring the metropolitan area. But if we assume 70 percent of the people in the United States, or 140 million, live in urban areas, and that for every 10 million we need $2 billion from the Federal Government, that makes about $28 billion which the other 60 million people in the country are going to have to pay to tackle the problems of the cities or help finance the treatment of those problems.

Now, my figures bring that down to $433 a year per person or $1,733 a year per family of four.

If, on the other hand, that $2 billion is paid for by the 8 million people in New York that makes $250 a year per person. Can you comment on that bit of mathematical effusion? Why is it better to have a per person cost of $433 for people not in the metropolitan centers as opposed to $250 cost for those who live in the metropolitan centers to help resolve their own problems?

Mr. HAYES. Well, Congressman, if you are going to use that kind of arithmetic you really ought to start giving us a few credits for the $16 billion you are already taking in Federal taxation out of the city of New York.

Representative BROWN. Presumably these other people pay taxes too.

Mr. HAYES. That is right, but I don't think the burden of doing things for the cities is something that is going to be borne by the rest of the taxpayers in the country exclusively of urban areas.

Representative BROWN. You are talking about taking Federal taxes from the city of New York.

Mr. HAYES. That is right.

What I am talking about are Federal taxes taken from the city of New York.

Representative BROWN. I fall in the same category, being a Member of Congress from Ohio. Ohio pays more money in Federal taxes than it receives in Federal finances from Government.

Mr. HAYES. That is correct.

Representative BROWN. If we assume that system is unsound, then I guess we have to start over with some altogether different base.

Mr. HAYES I think clearly the case of fiscal Federal policy ought to be a tax system which is an equitable one in terms of the income of the country and makes sense in terms of the problems we have.

Representative BROWN. Am I wrong in thinking that the per capita income in New York City is rather high by comparison to the average across the country?

Mr. HAYES. Yes.

The per capita income of New York City is approximately the same as the per capita income of the State as a whole, which is high.

Representative BROWN. Can't we forget about money that the Federal Government takes out of New York and go back to my figures?

Mr. HAYES. No.

Congressman, the money that the Federal Government takes out of New York has something to do with the higher income and price structure which has, on the other hand, something to do with level of expenditures. For example, your extrapolation of the urban problems to $27 or $30 billion on a national scale from our $2 billion is probably not a bad estimate. I would discount it somewhat simply because of the fact I think there is a direct association with the problem depending upon density. It is still a very, very sizable amount of money, let's say the kind of thing I am talking about if we took it nationwide, would not be that $25 or $30 billion but quite clearly in 1975–76 would be on the order of $10 or $15 billion.

Representative BROWN. Then your comment to Senator Jordan did not mean that it would be $2 billion per 8 million people across the board? You said there are a lot of cities in the country and I assumed you meant all the cities had a similar need.

Mr. HAYES. No, I think cities do have similar needs but I do think the cost is higher in places like New York. As a matter of fact some studies have been done that indicate the higher the density and the higher the concentration the greater the level of costs. I am just talking about the proportion.

Representative BROWN. Let's talk about that for a minute. We heard a lot today about the quality of life in the country and what we are trying to produce for the average American citizen. I assume this applies to people who live in Puerto Rico as well as people who live in New York. Can you compare for me the quality of life of a $500-a-year Puerto Rican sugar worker and a $3,000-a-year Puerto Rican dishwasher in New York City?

Mr. HAYES. I think it is almost impossible.

Representative BROWN. Is there any relationship at all? We are talking about curing the environmental problem, and the necessity of giving up some of the technological comfort we have developed to return to a more simple life, perhaps, which is not as polluted as this highly mechanized industrial community in which we live.

Where is this guy better off and what are the relative cost factors? For instance, you mentioned $1,400 as the average education cost in the city of New York a year. What would be the education cost of that man if we were still in Puerto Rico?

Mr. HAYES. Obviously substantially less, and I don't think there is any question.

Representative BROWN. Where is he better off? That is my question, because this involves what has developed as a matter of Federal policy. Perhaps we do not want to continue to encourage the centralization of vast metropolitan centers such as New York if, indeed, as you suggest, the cost of citizens' services in a community like that, for whatever the reasons, is sufficiently high to be uneconomic.

Mr. HAYES. I find it hard to see. I think there are a few alternatives but it really means I think a deliberate Federal policy of creating or encouraging the expansion of some existing smaller centers in the country. But I don't think that we can expect really anything in terms of productivity and progress by figuring that the Puerto

Rican coffee worker can stay there. Some of them can but in fact the big problem in areas of that kind is the inability of agriculture to handle the growing numbers of people who, just because of natural growth, continue to be there, and that continues to be a problem.

Representative BROWN. It occurs to me that it might be more economic for the United States to spend the $2 billion that you would like to have us spend on New York in Puerto Rico, to keep the Puerto Ricans from trying to get to New York and impacting the situation there. And whatever that figure—whether it is 15, 17, 28, as I figured out, or $30 billion—to cure the problems of the cities, perhaps it would be better to solve them indirectly simply by encouraging the development of the less developed areas in this country and removing, perhaps even from New York, some of this industry which impacts the price structure in New York, and which makes New York yield up to the Federal Government a higher tax rate than it gets in return. Is there any logic in that, do you think? Is it possible?

Mr. HAYES. I think the theoretical logic of it is impeccable, and the effect, in actual practice, has been very limited.

Representative BROWN. We haven't tried it, have we?

Mr. HAYES. We have in Puerto Rico, for example. Since the Revenue Act of 1948 we have provided a form of tax exemption in Puerto Rico for encouragement of industry which has established substantial expansion of employment in Puerto Rico. I think the best that you can say about it is that it has made it possible for the Commonwealth to hold its own. At this stage of the game, talking about $2 billion going to Puerto Rico instead of to New York City, is 10 years too late. We already have the repercussions of the population shift.

Representative BROWN. I only speak to the specific in order to illustrate the general principle. I am not suggesting that we spend the $2 billion in Puerto Rico. There may be some possibility here that the Government, the Congress, the sociologists and others had not fully looked at—that should be explored from an economic standpoint as to where the best economic benefit lies.

Mr. Warnke, I'd like to return to you. Senator Proxmire noted if we had 4.3 percent unemployed that would mean 700,000 to 800,000 Americans out of work. I assume that would be generalized across the country and in a number of different industries; but in fact, it seems to have hit certain industries more than others, such as the housing industry, because of the economic circumstances we find ourselves in as a result of some of the decisions that were made a few years ago.

But if we sharply reduced spending of the Federal Government in the defense industries, do you think we could very quickly absorb in the areas of need in this country those employees who would be laid off in the defense industry? In other words, can we take the Lockheed worker who has been working on a C-5A and put him into education or health care or the water and air pollution problem or law enforcement or housing? Is that what you are suggesting we do with the economic balance of the country, and if so, can we accomplish that without any significant unemployment factor?

Mr. WARNKE. Congressman Brown, I have never really been impressed by the argument that our defense expenditures are needed to make work for the purpose of bolstering an economy that otherwise might fail. I have great confidence in the ingenuity of American industry, and in its resiliency, in its ability to convert to more peaceful products than military hardware.

As I have suggested earlier, many of our large defense contractors are really companies that have a relatively small defense side. It is true of Western Electric, it is certainly true of General Electric. So that many of these companies are already primarily involved in producing products other than defense hardware.

I believe that something like a $5 billion cut in the 1971 defense budget could be absorbed by American industry with no substantial dislocations.

Representative BROWN. I am sorry; I didn't get the last part.

Mr. WARNKE. With no substantial dislocation in terms of unemployment.

Representative BROWN. No substantial decrease in employment?

Mr. WARNKE. No, sir.

Representative BROWN. How many people would that involve?

Mr. WARNKE. I have absolutely no formula that I could apply.

Representative BROWN. Do you know how many are involved in the defense industry, the so-called military-industrial complex? There are some 3 million, as I understand, or in excess of 3 million in uniform, and the administration plans to cut some 200,000 out of that. Those people, I assume, would be absorbed unless we are going to have increased unemployment in some other areas. Isn't that correct?

Mr. WARNKE. That is correct, sir.

Representative BROWN. How many in the defense production industry?

Mr. WARNKE. I have no idea.

Representative BROWN. You don't know.

Let me just make one other observation, if I may, since my time is up again. It seems to me, Dr. Miller, that perhaps if the job you suggest is not to be done by Congress—where, incidentally, along with Senator Proxmire I think it should be done—then it might be done by some foundation in the country sponsored in the hope of eliminating political influence in the assigning of these economic cost figures, if we can assume that foundations are amenable to influence. It occurs to me that it might be called a national costs, rather than national priorities, institute since it would have no hand in formulating goals. Finally, I would simply observe that when any of us in the Congress vote for anything we are by indirection voting against everything else, unless you can assume that we are in favor of increasing taxes to pay for this and everything else that might come along.

The game is played, as I am sure you are aware, by many of the Members of the Congress who will vote for certain programs but pick one to vote against. In other words, the program we don't want to finance at all by voting for the appropriation bill might be space. We vote against that and then go back and tell our constituents we wouldn't be $3 billion in debt if everybody had voted to end the space program. There wouldn't be any appropriation at all. That is the rub, it seems to me. The administration has to set these priorities, and they do in their budget. I think one of the problems the Congress has is that it has no functioning committee or vehicle within itself to set the goals and the priorities and live within some kind of a budget, and do that as a whole Congress. Maybe what we ought to do, along with full disclosure of our incomes and some of the other things that have been proposed for individual Members of Congress, is make every Member of Congress individually establish his own personal Federal budget every year after the President announces it. Then our constituents would have a chance to compare our viewpoints to the President's, and presumably we could defend our positions rationally against the President's.

Mr. MILLER. I would like, if I may, to make two observations. First, you said when a Congressman votes for one program he, in effect, votes against others. I agree, but I think it would help to make this choice more explicit. I don't believe you have the information now to know what the totals are.

Secondly, the costing out of national goals and resources has already been tried by a foundation. This is what the National Planning Association did in 1965. It didn't have the visibility and support an important effort of this kind should have. Maybe it is psychological, but I think when you pay for something you attach more importance to it. I would like to see Congress put up a big part of the money, which might be supplemented by foundations. If you pay for something, you are more apt to use it than if you get it for nothing.

Representative REUSS (presiding). I have just one question for the panel.

Dean Miller, I believe it was you who testified that the present allocation between private and public needs, between consumer goods, on the one hand, and public goods—such as education, health, the environment—will shortly have to be shifted toward the public side. I guess this means more taxes in order to finance these public needs. Do I interpret you correctly?

Mr. MILLER. Yes, sir.

At the present time, about 30 percent of the gross national product is taken by taxes. This is by all levels of government. If you go back two decades the amount is 18 percent. I believe it is appropriate that this upward trend continue as our goals shift more out of the private into the public area.

Representative REUSS. I would like to ask Mr. Hayes and Mr. Warnke respectively whether they also share this general philosophical view?

Mr. HAYES. I think, Congressman, to be a little more philosophical, we are in a situation where the demands of the public sector, in almost any reasonable man's view of the civilian side of it; seem to me to be bound to expand more rapidly than the gross national product. One can see this in a comprehensive municipal budget like New York's in the budget just in relationship to personal income in the city. This is not a fair measure of burden because personal income is not as comprehensive as the GNP concept, and we cannot estimate a GNP for the city of New York very easily. Also because the budget itself includes State and Federal financing as well as local. But we see over a period of the last decade or so, this budget up from something under 10 percent of the personal income of the city to something now where it is approaching 20 percent, and this is as you know, a fantastic figure. Part of it comes out of our cost inflation. A lot of it comes out of the whole character of changing of service demands, the fight against water and air pollution, the fact that we now have 32,000 policemen, where 18,000 existed 15 years ago, and many other factors of this kind. Still, we are not scratching the surface on many of the big problems.

Representaivte REUSS (presiding). Mr. Warnke?

Mr. WARNKE. I would say, Mr. Chairman, that the best I can do and the intelligent thing I can say is to agree totally with my fellow panelists, which I do.

Representative REUSS (presiding). Dean Miller?

Mr. MILLER. I would like to add a postscript. I think recognizing there will be a greater emphasis on public goods does not necessarily imply there will be less reliance on the private sector, because the private sector itself can work in tandem with the Government in attaining established objectives. For example, I have mentioned low-income housing as an area that needs Federal money to provide incentives to encourage private construction. I believe the Post Office would be run more efficiently under a quasi-private organization like Comsat. The private sector can innovate more and change more. The problems we now confront are such that there must be a more effective partnership between the public and private sectors.

Representative REUSS. Gentlemen, you have been extraordinarily helpful. I have a rollcall vote over in the House. Senator Proxmire, who went to answer a Senate rollcall a few minutes ago told me most particularly that he does have another question or two to address to the panel. If you would be kind enough, therefore, I would like to declare a recess of a few minutes in which you can relax. Are you able to stay for a few more minutes?

Mr. MILLER. Yes.

Representative REUSS. He will be right back, we will reconvene and then with my thanks I am going to take leave. Let me say to Mr. Warnke, who was under a little indictment from Congressman Brown a moment ago, that as far as I can see it consisted of two counts: One, the advice you have been giving the Nixon Administration about reordering national priorities is no good. Two, they have taken it.

We won't have to go into that recess because I see Senator Proxmire returning, and again my great thanks to you three gentlemen.

Senator PROXMIRE (now presiding). I want to apologize. Thank you so much for waiting. I do have some questions I was very anxious to ask, and I won't detain you gentlemen too long, you have been very patient.

Mr. Warnke, I can't agree with your belief that weapons systems, and I am quoting you now, "Are neither designed nor proposed by incompetents," surely you must agree somebody made significant inputs of incompetence in such failures as the C-5A, F-111, Cheyenne and Main battle tank, and a number of other battle systems.

You mean to say Congress should not exercise a great deal more scrutiny over the major weapons systems which invariably cost a million dollars or more, do you think it is possible to contain the defense budget without dealing with individual weapons systems?

Mr. WARNKE. I would say the answer to both of those questions, Senator Proxmire, is no. I don't believe that Congress can control the defense budget without looking into individual weapons systems. What I intended by my statement, and what I believe very firmly, is that this should not be the end of the inquiry. In many instances, you will find that there are valid arguments for a particular weapons system, and the weapons system although it may not come up totally to specifications and initial design nonetheless is a functional bit of hardware. But it is still a question of whether, given the total context in which we are determining priorities, it is worth the amount of money that is expended.

Now, I think in many instances what has occurred is that the defense establishment has tried too hard. What they have tried to do is get ahead of the state of the art in the effort to advance the physical security of the United States. You have to recognize, sir, that as Congressman Brown has pointed out, I have to count as a biased witness. I spent several years in the Department of Defense, I thought very highly of my colleagues. And I continue to think very highly of their competence and their integrity.

Now, there is unquestionably, as you yourself have been able to document, mistakes made in the procurement process——

Senator PROXMIRE. They are so consistent.

Mr. WARNKE. And mistakes made in design.

Senator PROXMIRE. So serious before they go ahead. You are familiar with the study made by a senior member of the Budget Bureau of the major electronics weapons systems we have had in this decade in which he pointed out there have been 11 costing $40 billion only two of which were able to meet their standard specifications, six of which, the majority, failed to meet even 25 percent of the standards specified. He pointed out on the average they cost 100 to 200 percent more than they were supposed to cost, they were delivered more than a year late, and it is a record which it seems to me indicates that Congress, unfortunately, although we do have great limitations in this area, simply has to challenge and raise questions about the technical capacity of these weapons systems we are asked to authorize as enormous sums for——

Mr. WARNKE. I agree with that very much indeed, Senator Proxmire.

What I would like still to highlight, however, is that I don't believe the inquiry can stop there. Even if you were to perfect defense procurement practices, and if you were to perfect the way in which these systems are designed and constructed, nonethless you would still have a defense budget which is disproportionate in terms of the other compelling demands on the budgetary dollar.

Senator PROXMIRE. The Comptroller General, along that same line, has pointed out on the basis of his investigation there is a very strong tendency to try what you indicated to try to proceed too fast too hard with systems before they have done adequate research on it, go into prototype and into production long before they should.

I would like to ask about a fascinating article that was in this morning's New York Times that was very appropriate. I wonder if you gentlemen read it—it is entitled "The 'National Priorities' Problem." It is written by Max Frankel who is, of course, a very able reporter, and the subtitle is "Solution Is Linked to End of Secrecy in Military Budget."

He says, and I quote "No satisfactory method will be found" [that is for more social spending for a way to sort out our priorities] "as long as complex and usually secret complications for military necessity form one side of the military equation."

Without objection I will place in the record at this point the article referred to above.

(The article referred to follows:)

The "National Priorities" Problem—Solution Is Linked to End of Secrecy in Military Budget

(By Max Frankel)

WASHINGTON, February 23.—It has become fashionable in weighty Government declarations nowadays to dwell at some length on the subjects of "national priorities" and "resource allocation." The reason is that everyone here worries about the competing claims of large military and nonmilitary programs without quite knowing how to resolve them.

President Nixon has addressed the problem in describing the state of the world, the state of the union and the state of his treasury. Budget Bureau officials, past and present, have described the difficulties of judging the rival merits of, say, another aircraft carrier as against some more low-income housing projects.

Even Defense Secretary Melvin R. Laird, in defending the military budget last week, wrote sympathetically about the need for more social spending and the lack of a system to sort out priorities.

Yet the essential conclusion of these Government statements—reinforced by the informal comments of high-ranking officials—is that no satisfactory method will be found as long as complex and usually secret calculations of military necessity form one side of the priority equation.

NIXON CONCEDES PROBLEM

The President reported with some satisfaction in his budget message last month that spending on "human resources" would soon exceed military spending for the first time in many years. But this statistic depends more on a shift of definitions than on a shift of preferences.

In his State of the World Message last week, Mr. Nixon readily conceded that "we have no precise way of measuring whether extra dollars spent for defense are more important than extra dollars spent for other needs."

That document did describe one Presidential effort to make at least a crude judgment on priorities. It said that five different strategies for nonnuclear military forces had been compared with five possible levels of domestic spending and that two of the military plans had been rejected because they would have thwarted vital domestic programs.

But as described by officials, even this rudimentary exercise began with the Defense Department's own definition of "irreducible" military outlays. The same will be true in more refined discussions of priorities in the future, officials said, and there is no plan to arrange for the direct confrontation of competing claimants.

TENDENCY TO OVER-REQUEST

This year's priority exercise was conducted in the National Security Council after an exchange of papers with the Government's domestic departments. Yet even Mr. Laird doubts that this is the proper arena for a fair contest.

"Since studies within the N.S.C. and the Department of Defense focus on requirements," he wrote in his military posture report last Friday, "there is a built-in tendency to request more resources than are available."

Only the President and Congress should be expected to make the final priority decisions, Mr. Laird said, conceding that there was no "appropriate mechanism for weighing one Federal program against others within the context of the budget as a whole or in an appropriate time frame."

Mr. Laird, admittedly afraid that the pressure for more domestic spending would result in arbitrary and injurious cuts in military spending, came close to deploring the tax cuts that the Congress and Mr. Nixon approved for the next few years. Tax cuts are in fact expenditures, he pointed out, and "tax spending should meet the same criteria for resource allocation as direct spending, but we have no mechanism for considering them together."

SOME STRONGER CRITICISM

With this statement, the Secretary came close to endorsing the much more outspoken criticism of Government procedures recently heard in Congress and among liberal economists, notably two alumni of the Johnson Administration—Arthur M. Okun, the former chairman of the Council of Economic Advisers, and Charles L. Schultze, former budget director.

Here is how Mr. Okun describes the problem in a review of his years in the White House, "The Political Economy of Prosperity":

"The absurd battle between defense and the cities arises because we insist on rather stable tax rates and hence on a relatively constant Federal share of our national product. Thus defense and nondefense programs are plunged into a direct tug-of-war for a fixed volume of budgetary resources. This is surely the greatest paradox of resource allocations in our Society.

"Defense spending—with its 9 per cent of G.N.P. [Gross National Products]—is pitted against nondefense Federal, state and local expenditures—with their 14 per cent of G.N.P.—while the big 77 per cent of our G.N.P. that goes into private spending remains a bystander. And because controllable Federal civilian spending is concentrated in aid to cities and the poor, the bulk of the pressure is exerted on about 5 per cent of our G.N.P.

"When defense goes down efforts to assist the cities and the poor can go up. When defense goes up, we seem to expect the belt-tightening to be concentrated in these social programs."

NOT REALLY 'VILLAINS'

Politically, Mr. Okun writes, this tug-of-war forces civil rights leaders and others working for social programs to lead the assault on military spending and wrongly casts military planners as the "villains" who bar social progress.

He believes that the either-or contest between defense and nondefense spending must be abolished by earmarking future revenues resulting from economic growth for public civilian use. Thereafter, he would reduce taxes only to the extent that savings could be found in the military budget and he would raise taxes to the extent that increases in military spending were deemed necessary.

Mr. Okun implies that this would compel the Government to arrange the kind of private and public review of military assumptions and plans that Mr. Schultze has found lacking in his review of procedures. The changes in the budget and other review procedures that Mr. Nixon has ordered so far will not get at the basic problem, Mr. Schultze believes.

In the winter issue of the quarterly, The Public Interest, Mr. Schultze wrote: "Do not think that once a decision has been made on commitments, that the appropriate contingencies we must prepare against are obvious and need no outside review; or that once we have stipulated the contingencies, that the necessary force levels are automatically determined and can be left solely to the military for decision; or that once force levels are given, decisions about appropriate weapons systems can be dismissed as self-evident. There is a great deal of slippage and room for judgment and priority debate in the connection between any two steps in the process."

POSITIVE FIGURES URGED

Mr. Schultze would require the Defense Department to provide explicit estimates of the future costs of projected commitments to manpower and weapons. He has also asked Congress to create procedures to weigh the priority decisions embedded in Government policies and requests.

Yet the men supervising national security planning insist that the complexity and necessary secrecy of their work makes full-scale public review of their assumptions extremely difficult, if not impossible. And even simpler proposals for reform of the Congressional committee system and appropriation procedure have gone nowhere in recent years.

It is conceded here on all sides that the public's sense of domestic as well as foreign danger has finally focused attention on the priority problem. Social planners feel frustrated by the shortage of funds for new initiatives in the foreseeable future and defense planners are afraid that "expediency"—in Mr. Laird's word—will lead to arbitrary cutbacks at the Pentagon.

But no one has yet demonstrated that recognition of the problem has led to effective measures to resolve it.

Senator PROXMIRE (presiding). I wonder if we are outgunned to deal sensibly with the priorities question because of the monopoly of information held by the military establishment.

Mr. WARNKE. I don't believe, Senator Proxmire, that the Congress is overly handicapped by secrecy at the present time. I think that in many instances the classification rationale is used to disguise an absence of a basis for a particular recommendation.

Senator PROXMIRE. How about a refusal even to give us the overall projections? Mr. Miller and I too, have indicated that I am happy they made some projections but they won't even break out the total military projection for 1975. Of course, it makes an immense difference in our debate on our priorities if they can do this. This is part of the secrecy. There is no reason why they can't do that. There is no reason why they can't tell us the cost of the Vietnam war now. They refused to do that. They told us last year.

Mr. WARNKE. Yes, sir.

Senator PROXMIRE. But this year they refused to tell us.

Mr. WARNKE. I can see no basis for the refusal.

Senator PROXMIRE. Unless we have that figure there is no basis of knowing where the peace dividend is. They are deescalating in Vietnam on the basis of previous statements by Secretary Laird, there should be a $13 billion initial dividend being made at least and they are only cutting defense spending by a little over $5 billion putting most of this back into weapons systems so we don't know because they won't tell us.

Mr. WARNKE. I certainly agree, Senator Proxmire, that it is impossible to evaluate these projections unless you get more of a breakdown than you have at the present time. For example, as I understand it they project something like $22 billion surplus for 1975. But that figure is hard to understand or to deal with unless you have some basis for knowing what sort of a defense budget they project for 1975 and there has been nothing that I have seen that gives any estimate as to whether the defense budget in 1975 would be $75 billion or $55 billion.

Senator PROXMIRE. If you will notice they have what would seem on the basis of all our recent experience, a most unrealistic assumption that the Federal Government purchases will be lower in 1975 than in 1971 and far lower than in 1970. The Federal Government purchases in 1970, $93 billion, 1975, $86 billion. Unless there is a big cut in military spending that is an incredible figure, if there is going to be a big cut we would like to know where it will be, and it would help us in many ways.

Mr. WARNKE. I would certainly hope that is what those figures signify.

Senator PROXMIRE. Mr. Frankel goes on to quote Secretary Laird and say there was "No appropriate mechanism for weighing one Federal program against others within the context of the budget as a whole or in an appropriate time frame." He points out there is just no realistic way of comparing, as we all know, an aircraft carrier with low-income housing. One of you gentlemen did that in your statement this morning. Could you comment on whether this statement sounds accurate with your own experience in Government and what an appropriate mechanism for weighing military and civilian programs might consist of.

Mr. WARNKE. I would say that certainly it is consistent with my experience, Senator Proxmire. I think that the most useful suggestion that I have heard along those lines is the one that has been made today by Dean Miller. If there is some sort of an information assembling system that can present on an authoritative basis the key factors for the evaluation of the Congress, this would be a distinct step forward.

Senator PROXMIRE. Would you have anything else to add to that, Mr. Miller?

Mr. MILLER. Well, I thank you for those kind words and again I would like to refer to what Charles Schultze said in this report he made before the Subcommittee on Economy in Government. Mr. Schultze, as you recall, was a former director of the Budget and a most competent individual.

Senator PROXMIRE. I remember that, I was the chairman of that subcommittee.

Mr. MILLER. Just two sentences:

> The Defense posture statement should incorporate a 5-year protection of the future expenditures, consequences of current and proposed military force levels, procurement and so forth. Not only should this sum be given in total but it should be broken into meaningful components.

Senator PROXMIRE. And you support that?

Mr. MILLER. Yes, sir. I don't see how you can make intelligent judgments until you have facts on which to base those judgments, sir.

Senator PROXMIRE. Very good.

One other question, Mr. Warnke, you state that the proposed $5.8 billion defense cut is a step in the right direction, but too small and too uncertain a step. Of course, you are an authority on our national defense needs and given your background and recent experience how much do you believe ought to be cut out of the defense budget in the next few years and how can Congress make the necessary determination? It would be helpful if you could start with this year.

Mr. WARNKE. What I have suggested, Senator Proxmire, is that I believe at least $5 billion in the current budget should take relatively low priority. I mean it should yield to other competing needs in the domestic programs.

I can claim no particular basis for electing a $5 billion figure. But it seems to me clear that the reduction of $5.8 billion is in itself only a partial reflection of the reduced costs of Vietnam, and as a consequence this budget as it now stands does not reflect any reordering of priorities.

Now, I also base my suggestion of a minimum of $5 billion on the thesis that there is no need to catch up because of any programs that have been stinted during the Vietnam war. My own view—and again I can't document it—is that there has been no stinting and no lack of adequate modernization but that instead, quite on the contrary, the very existence of the Vietnam war has enabled the services to update their various resources. Accordingly, in the light of the various demands that we have of a domestic nature, something like a $5 billion cut this year as a starter would be an appropriate reordering of priorities. Over a period of time, of course, in determining what your overall defense budget should be, it has to reflect your assessment of your foreign policy interests and a determination as to which of these interests can be implemented by military force. This should be a continuing study in which I would certainly hope that the Congress of the United States would participate. That is what I mean by saying that you can't do it just on the basis of whether we should equip for 2½ wars or 1½ wars. You have to determine it on the basis of the instances in which military force can effectively implement American foreign policy objectives. I submit that they are more limited than the instances for which we are currently budgeting and that, therefore, we should be able to effect quite substantial reductions in the defense budget over a period of the next 5 years.

Now, whether that would be something in the nature of $10 or $15 billion is something, sir, on which I have no basis at the present time for making a judgment.

Senator PROXMIRE. Mr. Miller, would you like to give your educated guess on the level of the defense budget for this coming year?

Mr. MILLER. Your question permits me to make the point that talking about priorities and calling for priorities should not be an excuse for inaction. We have to operate the store and modernize the store at the same time. Obviously, as a concerned citizen in this country, I have views now, based upon information available to me, as to what future goals should be. I would like to see the Government at this time, based on what I now know, go further in reducing military and space expenditures, and putting more resources into our domestic problems.

There are three areas that I think in particular require attention at this time, none of which are very costly. First would be research on air and water objectives to determine exactly what we mean by clean air and clean water. I know from my experience in the automobile industry we were flying blind because we didn't know exactly what contaminants were harmful. At first California identified only unburned hydrocarbons, then carbon monoxides were added, then oxides of nitrogen, and now the Federal Government is adding particulate matter. I think it is terribly important that the Federal Government complete the research on what ultimate environmental standards should be, so that private industry and everyone else will know what we are aiming for, so that nobody is flying blind.

Senator PROXMIRE. Can you give me a figure or not?

Mr. MILLER. I would really prefer not to, based on what I now know.

Senator PROXMIRE. At any rate it should be reduced but you don't want to give a dollar suggestion.

Mr. MILLER. Yes; defense expenditures should be cut further. Just to finish this quickly. Second, I would like to see more research done on urban planning and evaluation. This lets me make a statement supporting the work of the Urban Institute, which is a quasi-independent organization here in Washington doing very valuable work in planning what future cities should be.

Lastly, I think that we should devote more Federal support to the training of public managers. In my view, management is our scarcest resource. I am enough of an optimist to think that at some future date we will get the mechanism established to aid in the making of priority judgments. Some day we will be out of Vietnam, and we will have a fiscal dividend, so there will be funds available for the public goods area. When we reach that time, where will the people come from to manage the complex organizations required to reach our new goals? I think managers can be taught, and I would like to see us get on with that job now.

Senator PROXMIRE. You are very helpful. You are certainly doing your best to develop that management at Stanford.

Mr. MILLER. I certainly enjoy it.

Senator PROXMIRE. I have a question for you, Mr. Hayes, and I would appreciate it if you would permit me to give you this question before I have to run to a rollcall.

What I would like for you to do because I am very concerned about the waste I have seen in Medicare ways and others there has been a lot of testimony that even appropriations for such useful purposes as higher education have been wasted to a considerable extent.

I would like you to answer because obviously we are not going to be able to do most of these things even if we made the most startling progress in cutting military expenditures, even if we make great progress we are not going to meet these needs. In education there seems to me there are areas where we can do a better job and what dramatized this to me, I am chairman of the District of Columbia Subcommittee, is that we spend more money per pupil than any school board in the country except New York City, and these are two of the least effective school systems. I talked to a young Negro man last night who had two sons in school here. He says he is going to take them out and send them back to South Carolina because the discipline is better there, the discipline is better and they don't have the terrible problem, this was a black man, they don't have the terrible problem of having their children beaten and robbed, and no opportunity for the teachers to really exercise effective discipline. In the health area, water pollution control area, I have a proposal in to provide an effluent charge to raise $1½ billion by an effluent charge on the polluter, it worked very well in West Germany and in Cincinnati, Ohio. This would be a way of getting funds from those who use the products in effect that are uninvolved in pollution.

In all of these areas, I think it would be helpful if you could make any suggestions you would like to make, water pollution control, air pollution, transportation, solid waste, solid wastes, law enforcement and housing, where you think there may be opportunities for reducing the cost or achieving efficiencies, things we can do other than providing funds that might be helpful. I know it is a tough question. It is a question you have asked yourself.

It seems to me we ought to be able to indicate we are doing our best here if we are going to be able to raise that kind of money we need.

Mr. Hayes. I am not sure I am going to be much help on it. This is my business as a professional but it is a tough area. In the whole question of cost reallocation to polluters, I think there are a good many things we could do. But underlying this are many, many questions of means—relationships that, 5 or a half dozen years ago or 10 years ago, we assume existed and where now there is a good deal of evidence that these relationships do not exist.

On education for instance, I find it bewildering that we don't really have good experience out of the remedial and compensatory programs. On the other hand, I believe you are wrong on the New York City school system. What New York has done is taken a greater percentage of disadvantaged. There has been a lot of money put in over the last 10 years and has made it possible to stay even. But the performance hasn't gotten any worse.

Senator Proxmire (presiding). I appreciate that. I want to thank you gentlemen very much for most helpful testimony, and the committee will stand in recess until tomorrow morning at 10 o'clock and we will hear from a panel consisting of Mr. Robert Weintraub, Mr. Eli Shapiro, Mr. Arthur M. Okun, and Mr. Robert V. Roosa in room G-308, in the auditorium downstairs.

(Whereupon, at 1 p.m., the hearing was recessed to reconvene, Wednesday, February 25, 1970, at 10 a.m.)

APPENDIX

(The following paper was submitted for the record of the hearings in the context of the discussion on national priorities:)

THE CHANGING FORM AND STATUS OF LABOR

By IRVING H. SIEGEL *and* A. HARVEY BELITSKY *

I. A SKETCH OF DIRECTIONS

In the spirit of the title of the 1969 AFEE Program, this paper attempts a forward look with acceptance of the obvious attendant risks of vagueness, generality, and error. It is grounded, however, in research that the authors have conducted during the past three years for a book on *The Future of Employment*. Its object is to outline some of the plausible directions of future evolution of "labor," a term interpretable in four senses: work (as a category of human activity), employment (e.g., in an industry or occupation), manpower supply (or labor force), and unions (i.e., "organized labor").

A sketch of "plausible directions of future evolution" is not a forecast of status for any particular date.[1] It does not offer flat predictions or prophecies. It refers to longer-run, rather than near-term, prospects—say, a decade or so ahead. It attempts, by generality, to avoid critical dependence on the political coloration of future federal leadership. It does not pretend to an impossible completeness, either in scope or in detail. The exercise requires (*a*) identification of leading influences that specifically condition the outlook for labor and (*b*) adoption of a few fundamental assumptions regarding the larger future context or climate of a labor forecast. The composite statement that emerges is intended to be self-consistent as well as compatible with these key premises and conditioning factors.

II. KEY ASSUMPTIONS

The broad general assumptions that we make about the future setting for a discussion of the labor outlook really amount to forecasts also, although we do not focus chief attention upon them. They are made of necessity and for convenience, as well as in the hope that they will prove correct.

One inevitable premise for a sketch of labor prospects is that our society will avoid extensive and irreversible breakdown under serious strains of the kinds already recorded. As a forecast itself, this assumption seems plausible enough. If it were not plausible, however, the opposite assumption would leave us with too little to say about the future of work. Still worse, the opposite assumption would prove a more interesting subject for a paper.

The second assumption also has inherent plausibility, though less than the first: No new wars of significant scale or duration will engage or engulf us in the next decade or so. The usefulness of this assumption is as obvious as is the element of wishful thinking. The experience of Vietnam will certainly induce caution, perhaps excessive caution, even with regard to "little wars."

Although the third assumption helps to keep the discussion within manageable bounds, it could prove a poor forecast. Our nation, we assume, will be able to continue with impunity to acknowledge only casually or grudgingly the hankering of overpopulated and relatively unindustrialized countries for eco-

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*A paper presented at the annual meeting of the Association for Evolutionary Economics, December 29, 1969, in New York. The authors are on the staff of the W. E. Upjohn Institute for Employment Research, which shares no responsibility for the views here expressed.

[1] For additional remarks on forecasting, see I. H. Siegel, ed., *Manpower Tomorrow*, Augustus M. Kelley, New York, 1967, pp. 8–14.

nomic improvement. To the extent that this assumption proves untrue because of hostile or impatient initiatives from abroad, the second assumption might also be placed in jeopardy.

III. Some Conditioning Factors

Throughout the industrial area, the role, variety, and apportionment of work have proved attractive topics for speculation, debate, legislation, and political and social action; and some recent circumstances and relatively firm prospects have charged these topics with new interest. Four conditioning influences that merit special notice in current discussions and agenda respecting the future of labor are: the Vietnam conflict, the "automation" bogey, egregious defects in the quality of living, and continuing substantial population increase.

VIETNAM'S SIGNIFICANCE

The undeclared, drawn-out war in Vietnam constitutes a most powerful contemporary stimulus to the reappraisal of dominant life styles, traditional values, and implicit national economic priorities. No hint of the longer-range significance of this war was contained in so recent an official document as the 1968 *Economic Report of the President*, which dealt extensively with inflation but hardly conceded the underlying military cause. In a rare reference to Vietnam, the *Report* spoke too lightly of the conflict (p. 27) as "a burden a wealthy people can bear," a burden "costing us 3 percent of our total productiton" or "less than one year's growth in our total output." Such a narrow economic assessment ignored the lack of popular enthusiasm; and it overlooked the war's serious implications, social as well as economic, for the nation's future.

One of the neglected serious implications of Vietnam is the accentuation of the "generation gap." Millions of our better-educated young people have been profoundly disturbed by the requirement to order their lives around the possibility of a reluctant military service. Idealistic doubts normally stirred by a reading of the great books at an impressionable age have been strengthened and prolonged. Youths have been motivated to question anxiously the structure and functioning of existing society, the wisdom of implicit and explicit public and private decisions on the allocation of financial and material resources, and even the necessity of a link between work and income. Too long the military draft went unnoticed as a source of disaffection, despair, and open rage on the nation's campuses.

Another major fact ignored in the 1968 *Economic Report* is the restlessness of millions of adults. This restlessness may likewise be traced in good part to the casual escalation, the stubbornness, the visible costs, and the sensed hazards of the conflict in Asia. It is also traceable to the multiplying concomitant evidences of domestic disarray. Already a principal concern of politicians of all parties, it is inexorably, if only silently, influencing the nature and timetable of the settlement of the conflict. Indeed, the "silent majority," if it exists, also is a generally sullen one; it "accepts" Vietnam, inflation, and foregone alternative uses of people and public funds as disagreeable realities. While few members of such a majority may fear that low-grade warfare will be institutionalized as a permanent federal activity, or may regard Vietnam as the fruit of a military-industrial conspiracy, most have become sensitive to the Veblenian "wastes" and perversities in our economic system, particularly the public sector. The space exploits that they applaud now highlight, rather than conceal from them, the distortions of policy, resource use, and prices that adversely affect their daily lives.

"AUTOMATION"

A protracted "automation" scare seems to have waned recently, but it has left psychological scars and a legacy of legislation and language testifying to its great impact. "Automation" at first had narrow meanings; but it soon became a variously defined monster, its name generally conjuring up visions, among young and old, of sophisticated labor-saving technology. A more or less continual interdisciplinary game of predicting extensive unemployment "due to automation" was inaugurated by Professor Norbert Wiener's influential books on *Cybernetics* (1948) and *The Human Use of Beings* (1950). Our information and communicatitons media, including official and professional publications, tended to amplify the rumors of a new Apocalypse. What had become technically feasible was trumpeted as inevitable, as already economic, as imminently pervasive. The gloomy propaganda and the inaccurate pejorative forecasts of many journalists, union representatives, government officials, and scholars transformed a common historical fear of "technological unemployment" into an uncommon hysteria.

The scare weakened as doom-dates passed uneventfully and as the federal income-tax cut of 1964 took constructive effect. It seems finally, and with surprising suddenness, to have been displaced by Vietnam as the main source of national jitters. Ironically, it is being muted also by mounting concerns over pollution and other problems associated with the success of "conventional" technology, with continuing urbanization and crowding, and with continuing population increase.

The "automation" scare illustrates the maxim that what people believe may be much more important sociologically than what is probably, objectively, or demonstrably true. The scare contributed to an atmosphere favorable to a more energetic interpretation of the Employment Act of 1946, the adoption of public measures to diminish regional distress and to counter poverty, the increase of statutory minimum wages and the expansion of their coverage, the proliferation of schemes for guaranteeing basic incomes without the disparagement of work, the introduction of large-scale federal training and retraining programs, federal aid to primary and secondary education, and deliberate (though selective) control of new technology in accord with promised net benefits (social as well as private).

QUALITY OF LIVING AND POPULATION GROWTH

The cumulative degradation of the natural environment is finally being recognized by the nation's opinion-makers and political leaders as a significant neglected cost that offsets in some measure the better-advertised benefits of our enterprise system. Pollution by automobile fumes, industrial gases and effluents, urban wastes, pesticides, detergents, and noise has become too noxious or obnoxious to ignore. Many wonder chemicals and pharmaceuticals of the 1950's became regarded as poisons of the 1960's. Even the development of nuclear power must now proceed uncertainly in the face of rising anxiety over unwanted radioactivity and thermal effects. The reversibility of ecological damage already done—and still to be done as population expands sharply—is no longer being debated only by scientists.

Dysfunctions of the man-made environment, especially the city, also claim more urgent and wider attention than ever. Racial tensions, hard-core and teenage joblessness, crime, drug addiction, malnutrition, poverty, filth, illiteracy, and slum housing are being regarded more generally (and especially by the new generation) as species of pollution too; and they impose costs that become heavier and harder to escape. We should also note that the frustrating experience of Vietnam is helping to extend this broader concept of pollution to war itself—and to inflation.

Finally, numerous demographic projections have warned, as did a Presidential Message of July 1969, of a huge population increase during the next 30 years. To accommodate a total of some 300 million inhabitants, it will be necessary to build many sizable new cities and to crowd existing urban centers that are already overstrained.[2] It is difficult to imagine the adoption of, and persistence in, future national policies to (*a*) support the added population at a level of material welfare below today's average; and (*b*) to ignore the further degradation of the physical and man-made environments entailed by economic expansion and population growth.

IV. SOME DIRECTIONS OF FUTURE CHANGE

The four conditioning factors and three basic assumptions outlined above guide the comments made in the rest of this paper on directions of future change and the status and form of labor. What has already been said and what is to follow suggest that we shall not soon emerge from the long corridor of familiar experience into either a shining Utopia or a shining Cockaigne. Although the designation of our evolving future as an "age of discontinuity" has ear-catching advantages, the unsensational opposite, an "age of continuity," is at least as correct and operationally more helpful. This alternative emphasizes that the present base of the future is large and viscous, if not solid; that very much of this base will remain recognizable and functionally relevant in the world of to-

[2] On the population outlook, see, for example, J. J. Spengler, "Some Determinants of the Manpower Prospect: 1966–1985," *ibid.*, pp. 87–112.

morrow; that, in an important sense, the idea that "man makes himself" is still valid, even though the handles for deliberate change are not easily discerned and grasped in a complex society.

WORK, EMPLOYMENT, AND THE LABOR FORCE

Several unstartling prospects emerge from our study:

1. As a category of human activity, work is not likely to go out of style soon—for psychological, social, and political reasons as well as economic ones.

2. The concentration of individuals on work will continue to diminish with the reduction of physical demands, annual hours of employment, and age at retirement; with the improvement of public and private provisions for income maintenance and supplementation; and with the rise of the average level of education, including education for its own sake.

3. Preoccupation of management with conditions of work will intensify in behalf of productivity standards.

4. A plenitude of significant peaceful needs, old-style as well as new, will offer sufficient job opportunities to engage a growing, diversified, and trainable labor force.

5. Unions will find new challenges in foreign economic competition, the pressure of new domestic underclasses, and the changing structure of large companies.

6. The state, instead of withering away, will greatly extend its economic, managerial, monitorial, and balancing roles.

The economic dropout rate may prove somewhat high for today's educated youngsters, but work will remain focal in the lives of most people. Unless the fabric of civilization is torn, a society is bound to demand economic and political "dues" in the form of work from its able-bodied and able-minded citizens. The worker, in turn, will generally continue to derive psychological and other benefits from this "communal" activity. Marx, like Freud, was sufficiently bourgeois to recognize the human importance of work, although both may have exaggerated its degree of centrality in the individual's life as the productive system evolves. Neither for the person nor society can work become merely a Puritan hangover. Nevertheless, it can be rendered less time-demanding and arduous, be made more attractive, and become better integrated with the leisure and the opportunities for consumption that an efficient productive sysem also allows.

The machine, even the computer, is not yet ready to banish Adam to a boresome Eden—to validate the slogan of nihilistic dropouts and the lurid visions of contributors to Sunday supplements. Although the advance of "automation" or other process technology does restrict the volume of new blue-collar job opportunities and of some non-factory openings also, the service industries and construction should not languish. Indeed, the greater output sought through such advance itself tends to engender an expansion of activity in office work, warehousing, sales, finance, transportation, communication, and electrical utilities. Despite the belief of many futurologists, the additional jobs are economically "productive" in the same sense that jobs in manufacturing are. Even increases in leisure exert a counterpressure for more work to supply various goods, structures, and services. Increasing per capita wealth, furthermore, necessitates a growth of repair services; and, if such services are not forthcoming on an adequate scale, the inevitable alternative for our kind of society is an expansion of replacement manufacture and construction. That "premature" replacement cost is "a burden a wealthy people can bear" is less arguable today than the willingness of Americans to remain indefinitely at war in Southeast Asia.

A great new frontier of employment beckons to satisfy environmental needs already widely regarded as underfinanced. The resource requirements of Vietnam have impeded a proper address of these needs; and the eventual shift of emphasis is likely to mean the modification of, rather than any intentional retreat from, customary living scales. The dimensions of our economy, of the economic space in which we operate, will continue to increase as the composition of the national product undergoes new major change.

The huge gain projected in our population for the next few decades will itself entail a significant demand for additional workers—in commodity production as well as in construction and in the service industries. On the whole, these jobs will require familiar, rather than exotic, skills, education, and training. Besides, the preparation of workers for jobs and the adjustment of jobs to the available labor supply are typical problems of the society in which we already live.

Improvement of the physical and man-made environments and accommodation of the expected population growth will also involve a substantial expansion of government—federal, state, and local. More will be said about this particular "service" expansion in the next subsection.

In short, a seasoned, modern, industrial (or, for those who prefer, "post-modern" or "post-industrial") society should be able to retain its demonstrated flexibility and adaptiveness over a wide range of new circumstances. A society such as ours is unlikely, for example, to lose its market governors suddenly and to persist thereafter in the manufacture of familiar hard goods for fun, just because automatic tools and computer control will make redundancy and unprofitable operations technically easier. Quantitative responsiveness to the challenge of supplying homes, goods, and services for a growing population would seem to pose no special difficulty. The challenge, however, is also qualitative, and the entailed racial, environmental, and other problems cannot easily be resolved. Nevertheless, unless we postulate extensive and irreversible breakdown, the complications are bound to be addressed sooner or later and in one fashion or another. Social invention is much more common than is ordinarily supposed, and clumsy compromise is typical in human affairs and in going concerns. A long-lived spirit of enterprise could, instead of sudenly dying in a system that otherwise survives, migrate from private bodies to public ones or to hybrids. If private initiative becomes inappropriate for the accomplishment of the urgent real tasks of the future, the state can be modified instrumentally and the ruling ideology reinterpreted accordingly.

Instead of limited job prospects that tax the capacity of people, the key problem in the future of employment would seem to be the opposite: to keep a large mass of workers sufficiently interested in the tachable tasks that they are required to perform. Data-processing as well as the more usual sorts of mechanical equipment will become increasingly available to the average employee, whose level of education will meanwhile be rising. Furthermore, education will be offered over a longer period of a person's life for self-development as well as far preparation of the "human resources" that society needs for economic processes. Can the average employee of the future be engaged at a sufficient level of his native ability and education for enough of his worktime to optimize his productivity, his economic and social "dues"? (We should not, incidentally, overlook the huge labor-intensive task of even conferring literacy on all pupils, a challenge the federal government would like to see met by 1980.) To satisfy the requirements of service industries, can skills for dealing with people or data be taught as explicitly and effectively as skills for dealing with things? Can the worker be kept from borèdom by a proper definition of his job to include both discretionary and prescribed functions, to include an agreeable mix of things-data-people operations? Can organizational theory and job design and redesign be continually applied on behalf of piquant diversity? The tribe of interdisciplinary consultants—the Argyrises, Herzbergs, Likerts, Maslows, *et al.*—will surely increase. Indeed, counseling, psychiatry, and vocational and on-the-job training will become substantially larger service industries in the private realm.[3]

Perennial intellectual criticism of work in modern industrial society as "dehumanized" and "meaningless" may well attract a larger following in the future, but an old-fashioned "systems approach" that has intuitively appealed to workers will prove difficult to undermine. In a commonsense way, workers focus on the net results of employment, on the expected yield of net benefits. While they are hardly indifferent to the details of the work process, they prize above all the opportunities for consumption and leisure that are afforded by mandatory productive activity. Future managers will seek to reduce discontents, build motivation into the work itself, and continue in other ways to strive for the optimal productivity and profitability achievable with a declining manhour input per employee. The pressure for greater productivity will be maintained, not only by union demands for reduction of work hours and for higher pay, but also by the rising social standard of income transfer (e.g., in the form of guarantees for the

[3] On the potential of private vocational institutions, see A. H. Belitsky, *Private Vocational Schools and Their Students: Limited Objectives, Unlimited Opportunities*, Schenkman, Cambridge, 1969.

non-working poor). The employee will concentrate on the size of his probable dividend, on his probable command over goods, services, and leisure. For him, the chief aim of work is not self-development or direct self-expression, although such incidental objectives cannot, and will not, be neglected in the social pursuit of greater productive efficiency. The primary interest of the worker is likely to remain the acquisition of greater economic means to do his very own thing in his very own way *off the job.*

GOVERNMENT AS EMPLOYER OF FIRST RESORT

The most significant change that we expect is the emergence of government—federal, state, and local—as a dominant *employer of first resort* (not "last resort") in meeting critical and social needs. Government is the natural medium for improving the quality of living on behalf of society at large. It is the logical agent of the people for the performance of tasks that would not normally attract private firms. Such tasks may lack clear profitability, or require large capital outlays for long periods, or demand a coordination of opposing interests. Indeed, government could collaborate with private companies in setting up joint ventures of appropriate structure, power, and scope for the achievement of public objectives. Precedents already exist that offer suitable incentives for private participation. Collaborative public ventures that involve more than one governmental jurisdiction are also familiar, and their proliferation could be encouraged by the adoption of various revenue-sharing schemes. Incidentally, although we say "employer of first resort," we do not mean the term to exclude related roles of governmental leadership—e.g., as financier or guarantor.[4]

In seeking amenities for themselves through government, majorities would also improve the quality of living for others—and significantly strengthen the sense of community in additional ways. In particular, majorities would be opening up realistic paths for the incorporation of the disadvantaged into the larger economic, social, and political life. Thus, the pursuit of comprehensive, non-crash programs to improve air and water supplies, to revive cities, to make adequate health care widely available, and so forth would incidentally provide "meaningful" training situations and career ladders for the less educated members of the labor force. These special opportunities could not be prestigmatized as low-grade since government would be functioning as the instrument of first resort for meeting widely recognized problems endowed with new high priority. The corrective programs, furthermore, would entail the definition of jobs and the hiring of employees over a wide spectrum of skills, occupations, and salaries. Educated social dropouts and volunteers could be accommodated, in addition to the disadvantaged, in work having clear social importance. Furthermore, many initial volunteer tasks could be supplemented with ladders to subprofessional and professional employment; the provision of pay could help assure a sufficient supply of personnel. The new respectability of the entire public enterprise would spread to all the parts.

In principle, at least, any major gap in national economic activity threatened by a phase-out of hostilities in Vietnam could be filled pertinently by a frontal address of side-tracked domestic problems. A growing belief that industrial—or "post-industrial"—man is at bay, that he is fighting for survival close to home and in civilian clothing, will presumably provide a modern—or "post-modern"—moral equivalent to the fervor that used to be associated with bloody war in faraway places.

Even as active warfare or a swollen defense establishment seems redunant for future full employment, a vast expansion for foreign aid is not essential for our economic vigor after Vietnam. This statement does not, of course, mean that such expansion is unwarranted according to other criteria, selfish as well as altruistic. Within the framework of assumptions adopted for this paper, however, we wish to shift attention briefly to the prospect of intensified competition in trade among *developed* nations in a largely peaceable world.

Foreign competition will make resort to the federal government for relief more common. Unions and firms will appeal not only for quotas and tariffs but also for tax incentives to export and for compensation against "injury" from imports. Overpriced domestic manufactures will become more numerous as wage-productivity ratios (i.e., unit labor costs) decline elsewhere in comparison to ours in a growing list of industries. Other nations do not just compete success-

[4] This extended meaning was assigned when the term was introduced in *Manpower Tomorrow* (footnote 1), pp. 16–18.

fully; they 'imitate" our technology, and they "dump" goods made by "underpaid" workers. Often, the injury attributed to them could also be ascribed to, say, "excessive" wage settlements in the United States; and the unemployment blamed on them might a few years ago have been traced instead to domestic "automation." In any case, it will seem increasingly desirable in the future to spur the advance of living standards of foreign workers toward our own—e.g., by means of television, inducements to visit, and truly international organization of labor.[5]

OUTLOOK FOR UNIONS

Organized labor will affect, as well as be affected by, other prospects already outlined. It will remain a strong vested interest, despite any future splintering (such as the establishment of the Alliance for Labor Action), the challenges raised by an insistent new racial underclass and by new corporate configurations, and the occasional adverse action of government. The young idealistic intellectuals of today will surely exert some influence on union attitudes and behavior toward this underclass, especially through their contributions to the ideology and agenda of organized racial groups and to the programs of government. They are even less likely than Veblen's imagined "guild of engineers,"[6] however, to become an independent and effective force in the confrontations of labor and management.

Veblen noted that the labor unions of his time were clearly outside the cultural pattern, that they did not fit into the "natural-rights scheme of right and honest living" and had to strive crudely for acceptance.[7] Now it is the turn of organized racial groups to seek legitimacy.

These groups search for improved economic and social status not only through conventional political action but also through threats against tangible public and private property and against the legal and customary rights of others. In their quest for greater access to apprenticeship training and for better job opportunities in general, they treat the unions as a part of the "power structure" or "establishment." They resort to techniques of controlled violence and purposeful lawlessness that the unions themselves have helped to develop and occasionally still use with impunity. Unions will, of course, try to contain the challenge without giving up too much. They will attempt, as in the creation of the AFL–CIO Human Resources Development Institute and the Alliance for Labor Action, to enlarge minority membership, to provide leadership, and to channel racial protest along "constructive" paths. They will cooperate with business and government, as well as with racial bodies, in the expansion of training, work, and upgrading opportunities within the framework of collective bargaining. The very expansion of our nation's economic space and the growth of population will help organized labor adopt a more generous posture than otherwise.

Like any other organizations, unions will continue to grapple with problems of governance of members and responsibility of leaders, and the public will be as concerned a bystander as it is now. Since members differ in age, sex, occupation, skill level, seniority, and location, they are bound to differ also in their primary concerns, and they need not feel equally satisfied with their leaders' conduct of negotiations, bargaining settlements, and positions on national affairs. (Women, for example, will become more insistent in demanding equality of opportunity in employment. Since members tend to share many of the prejudices of their communities, they will give far less than unanimous endorsement to the stances of national leaders on issues of racial accommodation. As work becomes less arduous or less engaging and as the standards of living, education, and income maintenance continue to rise, the strike may be used with increasing frequency as an instrument of self-expression and dissent and as a socially accepted ritual for breaking monotony. Unions, like other institutions, may indeed be afflicted with increasing alienation; and this phenomenon could find expression in the corruption of leaders, and in their political misuse of union funds as well as, say, in the frequent rejection of negotiated settlements by members and in spontaneous walkouts. The inconvenienced or disturbed public would probably like the strike to remain an ultimate weapon of infrequent resort and will accordingly want

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[5] A nongovernment contribution to the improvement of our future trade balance is suggested by a recent report (*Wall Street Journal*, December 23 and 29, 1969) that the United Steel Workers is exporting to the Japanese steel union its know-how for closing blast and open-hearth furnaces without damage in preparation for strikes.

[6] Thorstein Veblen, *The Engineer and the Price System*, B. W. Huebsch, New York, 1921, p. 76.

[7] Thorstein Veblen, "The Cultural Incidence of the Machine Process," reprinted in W. C. Mitchell, ed., *What Veblen Taught*, Augustus M. Kelley, New York, 1964, p. 333.

machinery of arbitration and mediation more generally incorporated into the collective bargaining system. It may also insist on still closer surveillance of union treasuries and on occasionally stricter adherence to laws already governing political activity.

The changing size of companies and the proliferation of their activities will make bargaining increasingly difficult for unions that cannot respond adequately to the structural evolution of their adversaries. Coalition bargaining—the collaboration of different international unions for more effective negotiation with multi-plant and multi-industry firms—is sure to develop, especially since unions lack flexibility for changing their jurisdictions. The Industrial Union Department of AFL–CIO was established to assist coordination. Merger activities leading to giant conglomerates and to multi-national companies present unions with accomplished facts; and the responses made on the side of worker representation may be too little as well as come too late.[8]

The AFL–CIO Conference on Transportation Trades, comprising 27 unions with 4.5 million transportation workers, adopted a resolution in 1969 conceding the threat posed by mergers. Apart from its broad implications for "monopoly," the merger movement presents a special hazard to organized labor since "the more diverse a company's business interests the less pressure unions are able to bring in the collective bargaining process." [9]

The labor movement has always felt required to expand its coverage of the labor force, and additional areas of significant opportunity for expansion beckon. Among these areas are government (all levels), agriculture, public entertainment (ranging from opera companies and symphony orchestras to spectator sports), the private service industries, and professional employment in general. Two Executive Orders that deal with labor-management relations at the federal level, No. 10988 (January 1962) and No. 11491 (October 1969), have given prestige and impetus to government unionism in general and may enhance the respectability of white-collar organization also.

Numerous complexities remain, however, in the public area; they involve, for example, the right to strike, the significance of governmental "sovereignity," and the roles of advisory and binding arbitration, fact-finding, and mediation. Furthermore, the difficulty that established unions have in structural realignment to match the conglomerates and multi-national firms has a counterpart in dealings with a "monolithic" government. Thus, unions that represent teachers, firemen, policemen, nurses, sanitation workers, and so forth may not be able to set up a common front for most effective bargaining with a municipality's management. Additional frustrations may arise because a "monolithic" executive branch is often unable to speak for a parsimonious legislature.

To promote a climate favorable to steady improvement of real wages, hours, and fringe benefits, labor leaders commit the rank and file to support of a widening variety of economic and social measures. In the future, we may expect a strong union interest in proposals for establishing and raising minimum annual incomes, not only of welfare recipients but of families in general. The assumption of federal responsibility, or its extension, will continue to be urged in provinces once regarded as proper to state and municipal governments (e.g., health, education, and welfare). In addition to demanding greater Social Security and Unemployment Compensation benefits, higher statutory minimum wage and wider coverage, extensive training and retraining of workers, and more public construction, union spokesmen will, as they already do, formulate positions on broader issues of policy.[10] The Employment Act of 1946 provides a handy framework for the definition of comprehensive labor postures. We have already suggested that the temptation to engage in directed political action for the furtherance of union proposals will be hard for leaders to resist, despite legislation intended to control such allocation of employees' dues.

LABOR AS A NON-COMMODITY

The expanding scope and sophistication of organized labor's participation in the nation's life reflect the degree to which the spirit of the Clayton Act has prevailed. This Act did not merely assert that labor is not a commodity; it also made clear that unions are not combinations or conspiracies in restraint of

[8] See W. N. Chernish, *Coalition Bargaining: A Study of Union Tactics and Public Policy*, University of Pennsylvania, Philadelphia, 1969.

[9] *AFL–CIO News*, November 8, 1969.

[10] See editorial in *AFL–CIO News*, December 13, 1969 on the book by J. A. Beirne, *Challenge to Labor*.

trade within the meaning of the antitrust laws. In retrospect, one could well decide that this Act was either redundant or irrelevant, but Gompers had good enough reason, from his vantage point and in his own time, to hail the legislation as "labor's Magna Charta." The Marxian focus on the sale of "labor power" was being repudiated in favor of a more typical, though poorly advertised, "American" view that Commons and Perlman well understood: the pragmatic blending of political, legal, and other considerations with economic motivation.

Over the years, we have seen the "law of supply and demand" reinterpreted for an increasing variety of labor markets to allow ever more subtle restrictions on competition among workers and on the magnitude of the supply. This trend has been confirmed by Supreme Court decisions (e.g., in the Apex Hosiery and Hutcheson cases) and additional legislation (especially the Norris-La Guardia Act).[11] We have also seen the "marginal productivity theory" of wage determination downgraded to, or never upgraded beyond, an attractive mathematical theorem for econometric purposes and pedagogy. This theorem is a simpler device than any general theory of bargaining can be, and it also yields numbers—seemingly satisfactory ones too at the aggregate level. The measurement of output, however, is typically dogged by conceptual difficulties, which worsen with the growth of service industries, including government; and the growth of these service industries also augments the uneasiness felt in the combination of different occupations and skill levels into a "volume" of labor input.

It is no wonder, in short, that the Declaration of Philadelphia, which marked the twenty-fifth anniversary of the International Labor Organization in 1944, paid tribute to the Clayton Act. At the very beginning, the Declaration reaffirmed the fundamental principle that "labor is not a commodity."

EMPLOYMENT AND STABILIZATION POLICIES [12]

As government becomes an increasingly important employer of first resort, it will have to (*a*) recognize more responsibly its own potential for destabilizing wages and prices and (*b*) explore and develop more fully the variety of its anti-inflationary powers. In the future, the Employment Act of 1946, which tortuously states a resolve but offers a minimum of machinery, could be amended, extended, and coordinated more explicitly with the older Federal Reserve Act to serve as the focus of a total public policy "to promote maximum employment, production, and purchasing power"—the last term interpreted to mean reasonable price stability and a progressive income distribution.

With respect to the first point, it should be noted that the conventional script of inflation is badly written or poorly applied. Labor unions are typically assigned a disproportionate—sometimes, the unique—blame for upward price pressures. The suspicion that the timing and magnitude of many price increases are subject to private discretion, even in a competitive setting, tends to be confirmed by the few Presidential adventures in "jawboning." Especially important, however, are the contributions by government itself to the initiation and aggravation of inflationary cycles. Apart from failures to enact timely tax increases or expenditure reductions of appropriate amount, the federal government may strangely take leadership in guaranteeing supra-productivity pay increases that set targets for the private sector.

With regard to our second point, the ruling current monetary and fiscal notions for achieving and maintaining high-level employment with reasonable price stability hardly exhaust the list of federal options. As already indicated, government salary policy may set an unfortunate pattern for the private sector. Accordingly, consideration should be given to the design of salary-deferment bonds for the public sector that are redeemable at public convenience. The idea might appropriately be extended to include wage-deferment bonds of guaranteed purchasing power for the private sector. For a peacetime setting, government might consider the encouragement of "profit-sharing" schemes in industry and "syndicalist" arrangements with labor and business. Far less speculative is the development of two underutilized potentials of government: (*a*) as a monopsonist (e.g., in the purchase of financing of bulk health services) and (*b*) as a direct or indirect trainer of scarce manpower required for implementing public policies. Finally, even in the exercise of monetary controls, the federal government might well consider the plugging of egregious gaps—e.g., the sterilization

[11] See O. O. Gregory, *Labor and the Law*, W. W. Norton, New York, 1961, pp. 255 ff. and pp. 269 ff.

[12] Based in part on I. H. Siegel, *Fuller Employment With Less Inflation*, The W. E. Upjohn Institute for Employment Research, Kalamazoo, 1969.

of repatriable dollars that inopportunely swell the money supply and the recapture for public use of "excess profits" derived by financial institutions from distorted interest rates.

The next decade or so may witness the emergence of a post-post-Keynosiunism and a new-new economics more finely attuned to the challenge of improving the quality of living for a growing population. The state of stabilization art, it is to be hoped, will soon progress beyond the prescription of hemlock, tourniquets, and leeches for contrivance of higher unemployment "in the public interest."

(The following letter to Chairman Patman from Mr. Barrett was subsequently supplied for the record:)

BARRETT, BARRETT & MCNAGNY, LAWYERS,
Fort Wayne, Ind., March 19, 1970.

Hon. WRIGHT PATMAN,
Chairman, Joint Economic Committee, Congress of the United States, New Senate Office Building, Washington, D.C.

DEAR SIR: Dean Arjay Miller of the Graduate School of Business of Stanford University has sent me a copy of his testimony before your committee on February 24 of this year, in response to my inquiry concerning the shift in economic emphasis which environmental problems is forcing upon us.

I am so impressed with the reasonableness of Dean Miller's proposal, and of the urgency of its implementation, that I want to lend my approval to what he says.

Although my primary interest is in the field of conservation, it is abundantly clear that we have many more problems than we know how to solve and that, as he testified, there are many conflicting claims but few concrete proposals for action.

To his suggestion of an overall approach that would do two things, namely, tell us what our economy is capable of producing and project the cost of present and contemplated national programs, I would add a third, which I think is at least of equal importance, that is, the assessment of the social costs of our not redressing existing problems. This type of assessment, which is exceedingly difficult in the area of the impact of our economic system on the natural world and the processes within it which are necessary for survival and a desirable standard of living (as well as many other social problems), is most essential to the establishment of necessary national goals and priorities.

As Dean Miller also states, it is imperative that objective, unbiased information be available from a national organization which is, and is seen by the public as being, truly independent and not grinding somebody else's axe, public or private. Our form of government is premised, in part, on the belief that people, if rightly informed, will make more wise choices than foolish ones. However, with the exceeding complexity of life today, the need for information becomes greater, but it becomes more difficult to acquire.

While I agree with Dean Miller that today there are obviously many values that cannot be measured, I think that we must attempt to find ways to measure them, for in reality they are evaluated in the marketplace, although quite unknowingly in most cases. I believe that this is one area in which a national goals institute can be most beneficial. Such measurements are essential in setting goals and priorities.

If the record of the hearings on this matter is still open, I would appreciate your making this letter a part of the record. I would also appreciate your sending me a copy of the record of the hearings or, if one is not available, of testimony by others which may be available bearing on the problem of measuring and accounting for social costs.

Very truly yours,

JAMES M. BARRETT III.

THE 1970 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 25, 1970

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

The Joint Economic Committee met, pursuant to recess, at 10 a.m., in room G-308, New Senate Office Building, Hon. William Proxmire (vice chairman of the joint committee) presiding.

Present: Senators Proxmire and Javits; and Representatives Brown and Reuss.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Loughlin F. McHugh, senior economist; and Douglas C. Frechtling and George D. Krumbhaar, economists for the minority.

Senator PROXMIRE (presiding). The committee will come to order.

I would like to welcome our distinguished panel this morning and tell you gentlemen that unfortunately I will have to leave briefly, but I will be back. I have to leave about 25 after 10 to go to the floor to put in a bill to provide that the Federal Reserve authorities can lend from the discount window on home mortgages.

This is the last of the hearings on the President's Economic Report and the state of the economy.

Our subject is "A Balanced Policy Mix." We will hear from four distinguished economists. Mr. Arthur Okun of the Brookings Institution, former chairman of the President's Council of Economic Advisers, is well known to all of us. He has been extremely helpful to the committee, both in and out of office, and we are always pleased to hear from him.

Dr. Robert Roosa is a partner in Brown Bros. Harriman. Dr. Roosa, your coming here on such short notice, with all of your private demands, and your continuing to advise on Government problems, is deeply appreciated. Dr. Roosa was formerly Under Secretary of the Treasury and he, too, has been helpful to this committee on many occasions.

Dr. Eli Shapiro is professor of economics at the School of Business, Harvard University. Dr. Shapiro, I want to congratulate you on your recent appointment to the special chair of Coleman Professorship of Financial Management at Harvard. Your work as Director of Research on the Commission on Money and Credit is very well known to all of us. You have long been a wise and trusted adviser to Government and private policymakers.

Dr. Robert Weintraub went over to the House temporarily. He is on his way back and will be here in a moment. He is professor of economics at the University of California at Santa Barbara.

He is the author of the newly published "Introduction to Monetary Economics" which we all hope to read. He has been a staff adviser to the House Banking Committee and is an active contributor to thinking on monetary economics.

Gentlemen, we are delighted to have you with us.

Mr. Roosa, I understand because of the fact you have been back in the country for a brief time you have not had a chance to prepare a statement in detail and have it typed and mimeographed, but if you will proceed, we will be happy to hear from you.

STATEMENT OF ROBERT ROOSA, BROWN BROS. HARRIMAN & CO.

Mr. ROOSA. Fine.

Mr. Chairman, I certainly appreciate the opportunity to be here, and your indulgence in permitting me to make an introductory statement extemporaneously without the usual submission of a manuscript. I have been impressed with the thorough analysis you have already received of the immediate issues that are confronting the country today. If I can be so presumptious, I would like to commend the committee for its continuing insistence, as well, on taking the long view and for trying to pull from the immediate experience the implications that are going to be with us even after, in some miraculous way, the problems of the present disappear.

In that spirit, I want to offer three or four suggestions this morning, which we may find some opportunity among the panel to elaborate on later. What I would like to suggest is that in the current crisis of inflation, unfortunate as it has been to undergo, we have had the opportunity to see rise to the surface several strands of influence on economic behavior which I think call for, if anything, even greater attention from this committee, the Congress and the Federal Government, over the years ahead.

For one, it seems to me that in the area of budget policy we are fortunate that in the decade of the 1960's there has been increased focus, and this committee has had a great deal to do with that, on the role of fiscal policy, both the spending and the taxing sides, and in an incidental way, on the role of debt management. Going back even earlier to the 1950's, your emphasis was more heavily on monetary policy, but what has evolved through the 1950's and the 1960's is an emphasis on the blend, the mix, that I think has been most important in permitting this country to help lead the way toward the combined use of monetary and fiscal policies in a manner that gives some prospect, when properly exercised, of containing the inflationary strains.

But I also feel that what we are now facing for the long run is, I hope, the prospect of being continuously confronted with the risk of renewed outbreak of inflation. With some temerity, I say "I hope" because I trust that the main thrust of this committee's work, and much that has gone before in governmental influence on the economy, is going to maintain effectively and successfully a pace of growth in the economy that will keep us continuously so close to full employment that there will be renewed and repeated risks, undesirable but also probably unavoidable, that the pressure of excess demand will break through, will pull out price increases more than we want to tolerate for the long run, and will create an environment in which the upward push of costs will continually harass us.

Perhaps what we want to be thinking about for the long run are the ways in which these tools, monetary and fiscal policy, can be even further developed to meet this kind of problem.

It is not useful now to go over past history, except to recognize, I think, that we did move too slowly in directing the mix of fiscal and monetary policy toward restraint as excesses deriving from the Vietnam escalation and other pressures were spreading through the economy. But Vietnam aside, we are going to, I hope, for many causes, have these kinds of pressures in an expanding, growing, fully employed economy through the years ahead.

I think one thing that we ought to work more explicitly into our analysis from now on—although Chairman Okun always had this fully in mind—is the recognition that one of the targets to be included in the planning of fiscal policy should be a specific target for either a surplus or a deficit in any given year.

I think still these are regarded as residuals. There is often a tendency on the part of administrations, and certainly the present one, to assume that you can never get a surplus, so therefore you never strive for one. The present modest surpluses I regard as only the plus or minus around zero that is within the range of error in any budgetary forecast.

I would suggest as the first of the four recommendations I would like to make for the long run, that it is going to be important in the future that we definitely consider as a major item among the elements which have to be taken into account in fiscal policy planning, the calculating of how large a surplus or how large a deficit is needed to go alongside the current monetary policy.

The reason, in my view, that monetary policy has pushed us to extremes of high interest rates that everyone of us, and this includes most bankers that I know, have found unnerving, if not upsetting, is in large part that we did not have the parallel reinforcement on the budgetary side in terms of a surplus that we needed. We need a surplus to retire debt, to put additional funds into the savings stream through this type of forced saving. When we do not get the requisite surplus we find ourselves instead left with the alternative of forced savings imposed by inflation.

I think in the future we need even more emphasis, therefore, on the concept of net savings from debt retirement, or net spending through debt enlargement as an active instrument on the fiscal side of the blend of fiscal and monetary policy that we have been evolving over the past decade or so.

Secondly, allow me to turn to the balance of payments area, an area which is currently neglected because of the euphoria set off both by a strong dollar in the international exchanges and the confusion set off by contradictory measures of the deficit.

In the present euphoria, I think we have let the balance of payments slip out of focus a bit. That may be all right for the moment, but for the long run we are going to have a continuous balance of payments problem, in addition to a potential inflation problem, with our fully employed continually expanding economy.

I think we will have to examine further the ways in which those Government spending programs which flow across international exchanges can be manipulated, altered from year to year, as offsets to other forces that affect the aggregate of flows across the exchanges and lead to a surplus or deficit in our foreign position.

There is need, I think, for much more than the interest in jiggling exchange rates that we have seen come to the fore recently. I do not mean to digress on this at the moment; it is just that I do feel there is an enormous range for positive influence through the deliberate variation from year to year in the way Government payments cross the exchanges. I have just been reviewing some data for the last several years for most of the OECD countries, in which the surprising fact emerges that the changes on trade account can explain with only one or two exceptions, no more than a third to a half of what happened, either plus or minus, in the overall balance of payments position of any of the OECD countries. It was capital movements, increasingly important to all developed OECD countries, and government transfers that accounted for the other half to two-thirds.

I think we are going to find that balance of payments adjustment, important as it is, cannot be confined to the focus we have emphasized in the past on the trade account or even the current account. We are going to have to continue to find ways to use the influence, from time to time, of the Government directly on capital flows as we have done and are doing, and even more directly to vary the Government's own flow of current payments.

Now, that is a broad subject and I am just touching on it, but I would very much stress its importance, for the long run, in the fully employed economy that I know we intend to have as soon as the present aberration can be overcome.

Third, I think we owe a tremendous debt to all of those who are now unemployed and those increasing numbers who may be unemployed before the present episode is over, a debt to see to it that never again do we, in any period, suffer from the lack of the fundamental data for dealing with this most critical human and economic problem of any modern economy aiming at full employment. By that I mean we regrettably do not in this country have an enumerated census of the unemployed, and we do not have a continuing record of job vacancies.

The regular compilation and availability of such information has been resisted or opposed or modified or qualified through the years for one good or bad reason after another. But the European countries which have maintained much lower levels of unemployment and a much greater degree, admittedly in smaller areas of labor mobility, have found that it is possible to maintain such information—not just a statistical series based on sampling, but an actual head count by name of those who are unemployed, and an actual listing of those positions that are vacant.

It should not be beyond the capability of a Federal Government spending $75 billion on defense to spend the half billion dollars that would be needed for this task, including the cost for the computers that would be needed to implement it.

So I think we need a direct census of the actual individuals unemployed and their skills, along with a continuous cataloging of the vacancies that exist, if we are going to have a chance of both obtaining the information and removing the barriers to mobility that account for some of the unemployment that results whenever the economy has to be damped down. And so long as any economy moves ahead rapidly it will sometimes spurt ahead faster than can be sustained and have to be damped down in the interest of stability.

But now finally, and fourth, I do not want to come to what I think is the crux of the major effort that is going to be needed over the years ahead, and I know Chairman Okun can certainly speak much more authoritatively and emphatically than I on this. It seems to me that we are trying to put all the policies of Government on a two-legged stool, and that is one more important reason that we have been tipping from side to side over the past several months, even years.

I think the fundamentals of policy have to have three legs. There has to be a monetary policy, a fiscal policy, and an incomes policy. I would hope that just as in the 1950's this committee led in the further articulation of the meaningful approach to monetary policy and in the 1960's to that in fiscal policy—the monetary earlier, the fiscal later—that the 1970's will see this committee leading the way toward the evolution for a full employment economy of a genuine and effective incomes policy.

I know it is easy to scoff at this; the administration has been denigrating it with the jawbone epithet, which I think is most misleading and deceptive. I think it ignores the fundamental role of Government in any economy to set up a framework of new boundaries—as evolution results in new conditions—within which the forces of the market can operate. And I certainly do not believe that there is any inconsistency between fundamental reliance on the principles of a market economy and some form of incomes policy.

Antitrust policy is aimed at maintaining the conditions of competition that will check price increases, and where that cannot be done in monopoly situations, we impose direct regulation; we see no conflict between that and adherence to a market system, and we should not. I think something more needs to be done on the price front.

Parallelling that, I think something more is needed on the side of costs, particularly. In periods of full employment there will be the continuous risk of overshooting in wage demands. And hopefully every laborer will have a semimonopoly situation, because he knows there are more jobs than there are people. That is the condition we ought to be in.

Yet we have to develop ways of keeping that kind of an environment from tearing itself to pieces. I do not mean to say that I am proposing the direct regulation of wages by any Government fiat, not at all. There is a fragmenting of labor not a monopoly—two-thirds of the labor force are not members of unions now, and those that are unionized are in any case not monolithic. I think, however, that there is a role for more self-regulation on the part of those that are represented through the unions. But it is impossible for any one union to take the lead without appearing ridiculous. There has to be a norm proposed by Government and given the dignity of government stature representing public support.

In this sense I identify Government and public interest. And this, I think, provides a base on which it does become possible to evolve some reasonable relationships, some limiting in the growth in wage costs to the average growth of productivity, and some holding of average price increases to very nominal figures. Of course, theoretically there should be no rise in average prices at all, but I am prepared to grant that the world will never be that perfect.

I think that labor can begin to consider self-regulation, once there is a widely recognized norm that has the force of strong public opinion and the commitment of Government behind it. This administration is not yet prepared to give that kind of leadership. Since a psychological climate of acceptance is all important, the administration's indifference condemns my suggestion to failure until there has been a change, I am afraid, in either the administration's attitude, or in administrations.

But I am recommending this for the long run—a long run that may not be too far away.

The other condition that I would suggest in this connection is that I think we do need an advisory tribunal. It would have only an advisory role. But either party in a wage dispute, or any party concerned about a price increase, in any given field where they are involved, should be able to turn to this body and appeal for a finding. It must be a group of experts competent to make findings. It could be a public body representing business and industry, labor, finance, as well as Government. Or it could be composed entirely of civil servants. I do not pretend to have the answer here, but I hope this is an area to which this committee will be able to devote considerably more effort over the months and years ahead.

It does seem to me this is the crucial challenge of the 1970's in this country, in every country which seeks full employment—to design an incomes policy that can work harmoniously, even though imperfectly, with monetary and fiscal policies that will be aimed, hopefully, in about the right direction.

Thank you, Mr. Chairman.

Senator Proxmire (presiding). Thank you very much, Mr. Roosa. Mr. Okun?

STATEMENT OF ARTHUR M. OKUN, SENIOR FELLOW, BROOKINGS INSTITUTION

Mr. Okun. Thank you, Mr. Chairman.

This is the sixth consecutive year that I have had the privilege of testifying before the Joint Economic Committee in its review of the reports of the President and the Council of Economic Advisers.

This is the first time in that series, however, that I appear here as a private citizen rather than as a co-author of the documents. Surely that must explain why I feel somewhat more relaxed today. Unfortunately, the state of the economy provides no cause for relaxation. Compared to my five earlier experiences, prices are rising more rapidly than ever before and the state of demand has never been more perilous.

Economic policies will be subjected to stringent tests this year. The President's Council of Economic Advisers has provided an able and lucid presentation of how the administration views these tests and how it proposes to meet them. I am pleased generally to second CEA's judgment of the current outlook, the appropriate targets for the economy, and the indicated fiscal-monetary strategy. Specifically, I agree that:

1. A gross national product for 1970 in the 1980's seems likely, reflecting a pause in the first half of this year, followed by a moderate renewed advance of economic activity in the second half.

2. Such a pattern also seems appropriate—a much larger advance would jeopardize the important objective of slowing prices down, while a much smaller increase in GNP would mean an unacceptably large sacrifice of employment, real income, and output.

3. A balanced but moderating combination of fiscal-monetary restraint is called for to promote the desired result. CEA espouses a prudent belt-and-suspenders approach to the fiscal-monetary mix—given our uncertainties, it would be unwise to plan a large or abrupt shift in either of our major policy instruments while trying to offset it with the other. Because the monetary belt is so tight today, an easing there has first priority in shifting toward less restrictive policy.

4. The economic slowdown should produce some deceleration of prices during 1970, but it will be only the beginning of the return voyage to price stability. CEA is admirably realistic in not promising too much or too prompt a relief from the nagging problem of inflation.

Beyond expressing my satisfaction that so much of modern economics in nonpartisan or bipartisan in character, I need not spell out these broad and important agreements in detail. Instead, I shall devote the remainder of my statement to three areas: (*a*) The unbalanced risks of the current economic situation; (*b*) an assessment of current fiscal and monetary policies; (*c*) the need for structural anti-inflationary policies.

DOWNSIDE RISKS

Any prospective or targeted path of economic activity is surrounded by risks. In the present situation, the risks are predominantly on the downside. It is hard to visualize a dangerous new boom of private demand in the near future. It is not hard to envision the possibility—although I emphasize not the probability—of a progressive and costly decline in economic activity.

To some extent, the present imbalance of risks is an unavoidable result of a prolonged slowdown. A prosperity pattern of economic activity is predicated on growth—on the expansion of markets, job opportunities, business earnings, and consumer living standards. The economy has been growing at a relatively slow rate—below our potential—for more than a year, and not at all since autumn. In this environment, there is a risk of retrenchment in business spending on inventories, plant and equipment, and of a retreat in spending by consumers associated with insecurity about jobs and real incomes.

These risks have intensified in the past month since the CEA report was issued. Statistical data on economic activity in January were dismal. Consumer buying, homebuilding, job opportunities, and industrial production all retreated. The January figures sound an alert, but not an alarm. They may well turn out to be misleading straws in the wintry winds.

As I read it, the balance of evidence still points toward pause rather than cumulative decline.

First, the last readings on plant and equipment spending were still strong and, if these are confirmed in the important survey results that Commerce-SEC will soon compile, this sector could provide important antirecession insurance for the economy in the first half of 1970. It is ironic that, after hoping for more than a year that plant and equipment spending would level off, we must now hope that it retains some of its recent vigor.

Second, consumers may have already discounted the worst and, when they find that the worst is not occurring, their spending should respond again to continuing—though modest—gains in earned income and to the extra bonuses coming from the reduction in the tax surcharge and the prospective increase in social security benefits.

Third, although the relationship of inventories to sales has deteriorated, it does not seem generally so worrisome as in the situations that developed into our past recessions.

The jury is still out on whether the policy strategy succeeds in limiting the slowdown to a pause.

The big issue is not whether our real gross national product falls by a fraction of 1 percent or rises by such an amount in the next few quarters. Nor is it whether the National Bureau of Economic Research will ultimately define the experience of 1970 as a recession. The kind of cumulative decline we experienced in 1953–54, 1957–58, and even 1960–61, is a qualitatively different experience from the administration's scenario for 1970.

It does not take a dictionary or a microscope to recognize the difference. The pause scenario might involve a rise in unemployment of roughly one percentage point, a decline in industrial production from its peak of last summer by perhaps 4 or 5 percent, a shortfall of actual output below our potential of perhaps 3 percent, and a decline in corporate before-tax earnings of 5 or even 10 percent.

Such a pattern of developments could be a tolerable sacrifice for eliminating inflation. But our postwar recessions involved a jump of 2 or 3 percentage points in the unemployment rate, a shortfall of 6 to 10 percent in our national output below potential, a drop in industrial production of 8 to 15 percent, and a decline in corporate earnings of 20 to 30 percent. This is the important difference between a cold and pneumonia in our economy.

In stressing the dangers of pneumonia, I should warn that an abrupt shift to stimulus in stabilization policy could threaten an excessively rapid rebound later this year or in 1971. The balance could shift too far. What we need now is to bring the downside risk and upside risk into better balance. It is necessary to ask how the risks can be brought into better balance today. To quote the Council:

"In these circumstances, policy must be cautious and tentative and feel its way along."

MONETARY POLICY

The first item on the agenda to improve the balance of risks is a shift in monetary policy. As I read the many criteria of monetary policy, no significant reduction in monetary restraint has taken place to date. The monetary brakes are still pressed to the floorboard.

The Federal Reserve deserves our commendation for its courage in pursuing a very tight monetary policy during most of 1969. It deserves our understanding of its reluctance to let up on the monetary brakes in any visible way until the boom was clearly halted, although economists of varying political and methodological views generally have been urging such a moderating move for several months. The boom is now unquestionably dead. Although its heritage of rising prices is regrettably still alive, a further squeeze on demand cannot appreciably shorten that lag.

The desirable shift in monetary policy should be prompt and distinct; it should not be panicky or abrupt. I have no simple rules or formulas to recommend to the distinguished new Chairman of the Federal Reserve and his able, experienced colleagues. They have a challenging assignment that demands all their wisdom. I may, however, offer a few comments.

1. I see no appreciable risk today that a visible relaxation of monetary restraint might alter business and financial psychology so as to trigger off a new boom. Since last fall, when that risk was a relevant concern, the attitudes of private decisionmakers have changed dramatically. Monetary policy has nothing to hide in shifting to a less restrictive position.

2. Because a decline in interest rates might reflect merely a weakening of private demands for funds or a diminution of inflationary expectations, such a decline cannot in itself be read as a demonstration of appropriate momentary relaxation.

3. After a year of monetary restraint, the Nation's stock of liquidity today is considerably below normal in relation to our GNP. There has been an unprecedented degree of economizing on money and near money assets. Under these circumstances, a very slow growth of money and liquidity—even though it marked an upward movement from the recent plateau—would nonetheless widen the shortfall below the normal liquidity requirements of a growing high-employment economy.

4. At some time in the next few years, it should become appropriate for the Federal Reserve to restore gradually a more normal and more adequate level of liquidity in relation to our potential output. Indeed, that will be necessary if we are to resume growth with less pressure on credit markets and less reliance on monetary restraint.

If economic activity should weaken in the months ahead, this could prove to be an appropriate period for such a catchup. In short, there is substantial room for an easing of monetary policy if conditions should warrant. This is one important safeguard against a prolonged cumulative decline in activity. And it reduces the likelihood that a stimulative shift in fiscal policy will become desirable for stabilization purposes in 1970.

FISCAL POLICY

The Federal Reserve could relax its restraints with greater confidence and decisiveness if it had prompt and clear assurance from the Congress that fiscal policy would not be significantly more stimulative than the budget recommended by the President. As I read the President's budget, it provides for an appropriate continued and moderate use of the fiscal brakes. The budget is more restrictive than it appears at a superficial glance.

The revenues projected in the budget reflect the recent and prospective slowdown in corporate and individual incomes.

That part of the revenue slowdown should be properly recognized as an automatic stabilizer—a cushion under the economy rather than a stimulus. If we correct for that, the surplus that the budget would yield along a steady full-employment path rises moderately from fiscal 1969 to fiscal 1970 and again to fiscal 1971. Also of some economic significance is the prospective change in the composition of the budget, with high-powered purchases of goods and services slated to fall and the relatively low-powered temporary corporate surcharge expiring.

It is regrettable, in my view, that so much emphasis has been placed—pro and con—on the $1.3 billion surplus projected for fiscal 1971. It would be an unfortunate retreat from a decade of progress in fiscal understanding if an actual surplus of any size under any economic circumstances were to be equated with a responsible anti-inflationary budget—or any and all deficits with an inflationary fiscal policy.

If the economy runs modestly below the target path drawn by the administration, the budget will, on that account alone, wind up in red ink. And it ought to be in red ink under those conditions. Surely no one should wish to reduce expenditures below currently projected levels in order to avoid a deficit that reflected a weaker economy.

It seems very important to me to distinguish what the Congress does to the budget through expenditure decisions and tax legislation from what the state of the economy does to the budget by swelling or shrinking the revenue base. I would urge the Congress to hold its decisions within the bounds set forth by the President.

Of course, the Congress would wish to reach its own decisions on specific recommendations. If, for example, it should decide against postponing the pay increase for Federal workers, then some alternative restraint should be sought.

A careful monitoring of any new developments affecting uncontrollable expenditures could also prove valuable. Elbow room in the budget for top priority social efforts should be sought by a stringent review of defense spending, other outlays, and our tax laws—it should not be allowed to increase fiscal stimulus.

The record of recent years has underlined the need for a rationally determined and effectively controlled fiscal posture. It will be a gratifying display of American democracy in action at its best if the Congress and the administration can work together to achieve that result.

STRUCTURAL ANTI-INFLATIONARY POLICIES

I want to turn finally and briefly to one area where I cannot agree with the posture of current policy, or more accurately with the absence of current policy. We need to broaden the base of anti-inflationary policies, and to use all the tools that can appropriately improve our price-cost performance. We need to look at the trees of prices as well as the forest of aggregate demand. Exclusive reliance on fiscal and monetary techniques might prove to be a two-legged stool, if I may echo the metaphor used by Mr. Roosa.

The immediate need for measures to reinforce the anti-inflationary effect of our economic slowdown is underlined with each disappointing monthly report on our price performance.

The longer run need was dramatized to me by CEA's projections for the period to 1975. In an especially constructive and innovative section of its report, the Council sets its sights on some laudably ambitious targets: a return to a high-employment growth path with a 3.8-percent unemployment rate and a 4.3-percent trend rate of real growth. CEA's illustrative pattern of catching up after the current slowdown involves an advance of real output in 1972 of about 6 percent. If we are to follow that path and avoid a new wave of inflation, we must achieve significant improvements in our price-wage institutions.

First, we need to enlist the active cooperation of big business and big labor in exercising price-cost restraint. The record of 1969 testifies to the cost of inaction. The industries which had been responsive to White House appeals for restraint in 1966–68 showed a widespread and especially marked acceleration of prices in 1969, as I have pointed out in some detail previously. The administration has demonstrated its own commitment to fiscal-monetary restraint, and is now in an excellent position to seek the help of private decision makers in the battle and we all share in order to achieve noninflationary prosperity.

Voluntary cooperation is just one plank of a broad platform to deal with specific prices and costs. We need a new sense of urgency in reviewing some old questions.

With farm and food prices continuing to rise at an extremely rapid rate, how can Government policies be reshaped to relieve this burden on the American consumer?

Can the forthcoming decision on oil imports be accelerated and shaped to promote the cause of price stability as well as economic efficiency?

Can HUD's Operation Breakthrough and other efforts to stabilize construction costs be placed on the front burner?

Could this be the year for a comprehensive congressional review of fair trade legislation, regulatory policy in transportation, and other Government programs that may add to costs and prices?

How can manpower programs be best used to increase the mobility and adaptability of our work force?

Some good answers could help to realize CEA's admirable goals for 1970 and 1975.

Thank you.

(The following paper was supplied for the record by Mr. Okun:)

THE CONTROLLED EXPERIMENT OF 1969

By ARTHUR M. OKUN, *Senior Fellow, Brookings Institution,* January 19, 1970*

[To be published as an appendix to "Inflation: The Problems and Prospects Before Us," Charles C. Moskowitz Lecture, by the New York University Press.]

In January 1969, President Nixon made clear his intention not to attempt to influence particular price (and wage) decisions in the private economy. This pronouncement represented a discreet shift from the policies of the Johnson

*The views expressed are my own and are not necessarily those of the officers, trustees, or other staff members of the Brookings Institution.

administration. During 1969, a very marked acceleration of prices took place in those industries which had been responsive to Government appeals and criticism during 1966–68. According to the evidence set forth below, somewhere between ½ and 1 percent of extra inflation in the industrial wholesale price index may be attributed to the shift in policy. Since the index of industrial wholesale prices rose 4.0 percent during 1969 as compared with 2.5 percent during 1968, that extra price increase represents between one-third and two-thirds of the *acceleration.*

In the table, I have listed those published components of the wholesale industrial price index which I believe were directly responsive to administration persuasion in one or more specific instances during 1966–68. Obviously, some judgment was required to compile that list, but inclusion or exclusion of borderline cases does not change the results appreciably. The big items—steel, copper, aluminum, petroleum, automobiles—are not on the borderline. Specific instances of White House appeals for restraint to these industries and several others are on the public record. Naturally, I was aware that 1969 price performance was not an appropriate criterion for inclusion. Nonetheless, I wish I had formulated the list (and had it notarized!) in January 1969. For lack of a better term, I shall call these "responsive prices"—i.e., responsive to White House persuasion during 1966–68.

The list of responsive prices is confined to "jawbone" cases; it excludes such items as lumber and hides where prices were influenced, in my judgment, by other structural policies. Finally, the list is limited to the product prices that were responsive in a fairly direct manner. For example, I did not include machinerv made of steel, although its price is affected indirectly by steel prices.

The responsive list accounted in December 1968 for 22½ percent of the total weight in the index of *industrial* wholesale prices, or 16½ percent of the comprehensive wholesale price index (which includes farm, food, and feed products as well as industrials). The relative importance of the listed items varies greatly—passenger cars get 100 times the weight of alloyed aluminum ingot.

During 1961–65, prices of the responsive group were especially stable. Between December 1960 and December 1965, the index for the responsive group rose only 0.1 percent a year, on average, while the index for all other (i.e., nonlisted) industrials crept up at an average annual rate of 0.5 percent. No clear inference about the impact of price guideposts can be drawn directly from this differential in overall price performance.[1] The responsive group is not a typical or random selection of industrial products in any sense; and their prices, as a group, cannot be expected to behave exactly like other industrials. During the early sixties, some of the listed products displayed exceptional productivity advances, which could account for the better price record. The appeals from the Government during the period were broad rather than pinpointed, apart from the celebrated episode of April 1962 involving steel prices.

During the inflation of the next three years, 1966–68, the price index of the responsive group rose at an annual rate of 1.7 percent; meanwhile all other industrials advanced at an annual rate of 2.3 percent. In each of those three years, the percentage increase of the price index of the responsive group was no more than that of all other industrials, even though demand grew especially strongly for many of the listed items. Again, the overall differential cannot be reliably attributed to Government appeals for restraint, although several specific rollbacks and reversals of announced price increases provided evidence of some stabilizing impact.

The events of 1969 provide a much better basis for making a judgment. The distinct shift in White House posture produced a situation about as close to a controlled experiment as we are ever likely to find in observing the inherently complex relationship between private decisions on prices and the attitudes of Government officials. In light of the three—indeed eight—previous years of experience, anyone who believed that the responsive prices, as a group, had not been influenced by White House persuasion should have expected them to rise no more rapidly than other industrials in 1969.

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[1] In the case of wage behavior, however, the strong evidence of a guidepost influence during the 1962–65 period is presented by George L. Perry, "Wages and the Guideposts," *American Economic Review*, Vol. 57 (September 1967), pp. 897–904.

However, during 1969, they advanced 6 percent, substantially faster than the 3.5 percent average increase of all other industrials. The acceleration of prices for the responsive group was 4.3 percent over the average of 1966–68, while that for all other industrials was only 1.2 percent. To put it another way, the index of responsive prices rose 3½ times as rapidly during 1969 as during 1966–68, while the index for other industrials increased 1½ times as fast as previously. And the pattern of marked acceleration was widespread, extending to petroleum, steel, copper, aluminum, passenger cars, glass containers, cigarettes, newsprint, photographic supplies, and paperboard. The exceptions were sulfur products, tires, tin cans, and laundry equipment. There were exceedingly few new wage settlements that could have accounted for any acceleration. To be sure, special supply forces encouraged price rises in some areas—just as they generated a major decline in sulfur. But the pronounced and pervasive pattern cannot be reasonably explained as resulting from "bad breaks."

I have heard it conjectured that moral suasion was beginning to lose its grip in any event before the change of administration. The facts of 1968 do not fit that conjecture. During 1968, the differential between the responsive group and other industrials was especially wide: the former rose 1.0 percent while the latter advanced 2.9 percent. Surely, the 1968 result was atypical—benefiting particularly from price declines in important petroleum and copper products, when supply eased. But any reading of the 1968 record will reveal no emerging tendency for the price performance of the responsive group to deteriorate relative to other industrial products.

Indeed, in light of the facts of 1968, skeptics may be tempted to embrace an alternative hypothesis, which I have never heard so far. It would conjecture that 1968 was an unusually "lucky" year in the price performance of the responsive group, and that the 1969 acceleration represented an unwinding of favorable transitory factors. But on that hypothesis, the acceleration in 1969 should have been concentrated in those commodities whose price performance had been especially favorable in 1968. It was not.

I conclude that the shift in Government policy is central and crucial to the explanation of the especially large speedup of the responsive prices during 1969.[2]

It is exceedingly difficult—and yet essential—to convert this judgment into an estimate of the effect on the overall level of industrial prices. Obviously, the issue is whether and how much overall inflation was stimulated by the shift in policy. Paul McCracken has said: "We are concerned with restraining the average level of prices, and restraining even a significant number of individual prices and wages may not restrain the average level but may only divert inflationary pressure and make other wages and prices rise more." [3]

One can, indeed, conceive of full diversion of inflationary pressure as an extreme possibility. But I suggest that *no* diversion of inflationary pressure is a much more realistic working assumption.

First of all, *no* spillover of spending will occur unless, as a result of price restraint for some items, fewer dollars are spent on those products (and hence some part of a given total of spending is diverted elsewhere). Fewer dollars will be spent on the items with restrained prices only if either (*a*) the price restraint makes it unprofitable for suppliers to meet demands; or (*b*) demand is price-inelastic so that quantities demanded respond less than proportionately to lower prices of the listed items. Copper and sulfur were the only ones, to the best of my knowledge, which fit condition (*a*)—they showed excess demand at times in recent years. Elsewhere suppliers continued to meet and greet all demands for their products, indicating that prices still exceeded costs on the margin. Hence, sales and output were stimulated because prices were held down.

Cigarettes are the one item on the list where I am aware of statistical research demonstrating that (*b*) applies, i.e., demand is price-inelastic. It would be most

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[2] Of course, the especially inflationary performance of the responsive group during 1969 may not be typical of the longer run. The abandonment of the jawbone may have unloosed a particular flurry of price increases that had been contained by persuasion. That would merely demonstrate the effectiveness of the persuasion, so long as it was maintained.

[3] Statement of Paul W. McCracken, Chairman, Council of Economic Advisers, before the Executive and Legislative Reorganization Subcommittee of the Committee on Government Operations, House of Representatives, September 23, 1969.

hazardous to judge that the listed items have, on the average, price-inelastic demands. And only on such a judgment would there be a presumption that *any* spillover of spending occurs.

Even if some spending spilled over onto other industries, that diverted spending would add to output and employment as well as to prices in those areas, so long as firms were not operating at an absolute ceiling of their productive capacity. The full benefit of the restraint would then be split between some favorable net movement in overall prices and some more favorable path of output and employment.

Finally and most important, any undesired spillover can, in principle, be mopped up by fiscal-monetary action. Whatever the ideal criteria for monetary policy may be in a period of gradual disinflation, an effective program of restraining some prices allows the Federal Reserve to aim for a slightly lower level of aggregate dollar spending than otherwise, without any greater sacrifice of output and employment. A selective program of restraint will generate a "tradeoff dividend"; just how that dividend is divided between lower prices and more output depends on monetary-fiscal decisions.

An assessment of the overall effect must take into account several forces which tend to magnify or multiply the direct benefits of restraint on the responsive prices. As I noted above, many industries not on my list use steel, copper, aluminum, and other responsive items as inputs; their costs, and presumably their average prices, would have been lower if the responsive prices had been restrained. Similarly, because wage increases are influenced by the cost of living, restraint on selected prices will tend to hold down average wage costs, and hence other prices. Furthermore, a policy of seeking restraint in price decisions can be accompanied by, and reinforced by, an effort to restrain wage settlements. Finally, concern with public opinion and with the public interest may exert a deterrent effect on the pricing decisions of some industries which are never identified as responsive to appeals. I am prepared to judge that, if the responsive prices had been restrained, the other industrial prices would probably have risen somewhat less than they actually did during 1969.

In summary, while I would not hazard a pinpointed estimate of the overall cost of the policy change, I can reasonably offer a plausible lower and upper limit. To get the lower end of the range, let me suppose that, if the policy of Government persuasion had continued:

(*a*) The nonlisted prices would not have been affected at all during 1969—even though I believe they would have been favorably affected, on balance; and

(*b*) Prices in the responsive group would have matched the pace of other industrials—even though they had consistently risen less rapidly prior to 1969.

Under those conditions, the industrial wholesale price index would have risen 3.5 percent (rather than 4.0 percent) during 1969, reflecting a 3.5 percent rise of nonlisted prices (as actually occurred) and a matching 3.5 percent advance of the responsive group (rather than 6.0 percent).

I regard this half of a percent as a reasonable lower limit. It seems equally plausible on the higher side that a continued policy of persuasion might have held down the rise in the industrial wholesale price index by a full percentage point; a 3.0 percent advance would have resulted if—

(*a*) Prices in the nonlisted group had increased 3.2 percent, improving by 0.3 percent as a result of somewhat lower material and wage costs and some deterrent influence, and

(*b*) Responsive prices had risen 2.4 percent, maintaining their average 1966–68 relationship to the increases in other industrial prices.

Whether the better estimate is 0.5 or 1.0 percent or something in between, it represents a significant handicap in our vital national effort to achieve non-inflationary prosperity. And that handicap is continuing and influencing prices and wages generally as 1970 begins.

CHANGES IN WHOLESALE PRICES OF SELECTED INDUSTRIAL COMMODITIES—1969 COMPARED WITH PRIOR PERIODS

	Relative importance [1] (percent)	(Annual rate) percent change [2]					
		1969	1966-68	1968	1967	1966	1961-65
Selected petroleum products:							
Gasoline	2,772	3.5	−0.6	−0.9	−3.6	2.8	−0.9
Crude	.843	4.8	1.0	.7	.9	1.2	−.1
Middle distillate	1.053	3.7	2.0	−1.3	5.9	1.6	.4
Sulfur products:							
Sulfur	.104	−33.3	18.1	7.7	39.3	9.8	1.6
Sulfuric acid	.085	0	9.9	3.7	21.0	6.0	1.7
Tires and tubes	1.221	2.2	3.0	1.7	4.2	3.1	−.2
Paperboard	.669	5.0	−1.8	−2.8	−3.3	.7	−.1
Glass containers	.375	5.3	3.3	9.1	0	1.1	.6
Cigarettes	.890	6.6	3.6	1.6	5.0	4.2	.8
Newsprint, standard	.426	3.3	2.2	0	2.1	4.6	−.3
Photographic supplies	.346	3.4	2.2	2.0	5.1	−.5	.8
Passenger cars	5.818	1.9	1.2	1.2	1.9	.3	−.7
Tin cans	.301	2.7	2.3	3.0	4.1	0	2.3
Laundry equipment	.242	1.2	1.7	2.4	2.8	−.1	−1.3
Selected steel products:							
Finished	4.247	6.8	1.6	2.2	1.3	1.3	.4
Semifinished	.272	5.7	1.4	.3	2.9	1.0	.3
Selected nonferrous metals:							
Aluminum ingot	.143	8.7	1.7	3.0	2.0	0	−1.2
Aluminum ingot, alloyed	.058	7.2	2.5	4.6	1.9	1.0	
Aluminum shapes	.660	6.7	1.2	2.4	1.1	.2	−2.5
Copper wirebar	.386	24.3	5.3	10.2	5.9	0	3.7
Copper and brass shapes	.743	27.9	4.1	−4.2	5.7	11.5	3.6
Wire and cable	.809	22.2	1.7	−3.8	2.3	7.0	3.5
Listed items	22.463	6.0	1.7	1.0	1.9	2.1	.1
All other (nonlisted) industrials	77.537	3.5	2.3	2.9	1.9	2.3	.5
All industrials	100.0	4.0	2.2	2.5	1.9	2.2	.4

[1] Fraction of "industrial" wholesale price index in December 1968 accounted for by commodity.
[2] Year figure represents change "during" year—for example, 1969 is period from December 1968 to December 1969. 1966–68 is thus December 1965 to December 1968.

Representative REUSS (now presiding). Thank you, Mr. Okun. Mr. Shapiro?

STATEMENT OF ELI SHAPIRO, SYLVAN C. COLEMAN PROFESSOR OF FINANCIAL MANAGEMENT, GRADUATE SCHOOL OF BUSINESS ADMINISTRATION, HARVARD UNIVERSITY

Mr. SHAPIRO. It is a great pleasure to have this opportunity to participate in the hearings before this august body on the state of the economy and the economic report of the President. This committee has earned the virtually unanimous praise of economists—a group not known for their ability to reach unanimous conclusions—as one of the great economic seminars on public policy we in the United States have experienced.

Because of its well-deserved reputation as a model adult educational venture, I shall try to frame my testimony in the best of the academic tradition; namely, looking back to history—not to have my feet mired in the concrete of the past—but to bring forward from the past, lessons which are relevant to the formulation and implementation of public policies in the immediate present and hopefully which may be even more useful in implementing public policies in the uncertain future of our great country.

In examining the past to draw inferences for the present and for the future, I am led to remind you that while it may not be elegant or indeed flattering, I am nevertheless impressed by the fact that "philosophers—or doctors of philosophy—like vegetables are profoundly affected by their environment." I cite as evidence of this proposition the following: Who among us 15 years ago would have believed that fiscal policy as a stabilization instrument would be under growing attack with increasing uncertainty as to its effectiveness? Who among us would have believed that even central bankers, never mind subcommittees on international payments of the Joint Economic Committee, would be advocating some departures from fixed exchange rates? And who among us would have believed that the liberal Democrats in the Congress would have supported proposals, if not for fixed rates of increase in the money supply, at least placing bands within which appropriate increases in money supply should be supplied? And if these rates of increase exceeded or fell short of the target, it would require detailed explanations to the Congress from the Federal Reserve authorities.

A time when the established truths are being questioned is a rare opportunity for education. True education—destroying our confidence in established beliefs—is painful for obvious reasons. But it also is an opportunity to look anew on old problems which obviously have not solved themselves. When the great Employment Act was passed by the Congress in 1946, I venture to suggest that the widespread view of both professional economists and our citizens was that the private economy was substantially unstable and it was therefore critical that the Congress and the executive branch of the Government should engage in direct actions to compensate for this instability in order to achieve high employment in our economy. An examination of the behavior of the private economy in the postwar period demonstrates to me that the private economy has shown a great deal of stability. I make haste to assure you that I have no doubt that this stability has arisen from the assurances that the fiscal and monetary authorities would not permit the economy to dip into deep or prolonged recession. As I see it, much of the instability we have experienced since World War II has arisen from fluctuations in Government expenditures, largely thought not exclusively expenditure increases induced by the conflicts in Vietnam and Korea. In addition, instability in the economy has arisen from sharp alterations in the course of monetary policy.

The primary conclusion which I think should be drawn from this history is that for the future, the Federal Government and the monetary authority should continue to strive to create an economic environment free from substantial instability. Our knowledge of how fiscal and monetary policies influence the economy and our political willingness to use this knowledge are such that we can set reasonably high objectives for ourselves in this regard. However, a major lesson of the past is that both the Federal Government and the monetary authority should give more attention to assuring that they themselves do not take actions which generate short-term fluctuations in the economy.

In attempting to organize fiscal policy so that it will best achieve our social and economic objectives, there are two critical choices that face us. One relates to the size of Federal public spending relative to private expenditures. When the economy is at high levels of employment, increases in public spending can come only if they are matched by equal reductions in private expenditures. If there is a proposal to increase public spending by say $5 billion, the Congress must determine the hints of private spending which will have to be foregone and to weigh the costs of these reductions against the benefits of the proposed increases in public spending. Similarly, if it is proposed to reduce public spending by say $5 billion, Congress must decide in which areas of public spending these reductions would be least detrimental to the achievement of its objectives. It must then weigh the cost of reducing these programs against the benefits of the increased private spending.

These are bound to be difficult judgments to make. However, proposals to increase or decrease public and private spending must be evaluated in terms of their merits using this kind of reasoning and cannot be judged simply in terms of historical patterns or political slogans.

This analysis would argue that as our national priorities change and the need for new Federal programs becomes apparent, two evaluations must be made. There will be resources for the new areas of spending only if some areas of public spending are reduced or if some areas of private spending are reduced. The new items can be called high priority items only if we can find some area of existing public spending or some area of private spending which is less important.

If the less important area of spending lies in the public sector there should be a reallocation of the existing Federal budget and no increase in total public spending. If the less important spending lies in the private sector, taxes must be raised to free the necessary resources from that sector to allow the increased spending on the public project.

Another critical choice in fiscal policy is that of the structure of the tax system which frees the resources necessary for public spending. In its simplest terms, the tax structure must balance the pressures to raise revenue in an equitable fashion against the pressures to design a tax system which provides sufficient incentives to work, invest and assume risks.

A third critical choice in budget policy is the desired balance between revenues and expenditures. The influence of the Federal budget on the economy is best summarized in the concept of the high employment budget surplus, deficit or balance. Pending final resolution of the ideal size of the high employment budget surplus or deficit, a substantial full employment surplus would on the one hand promote faster economic growth by increasing national saving, bringing interest rates down, and hence encouraging investment at the expense of current consumption. But on the other hand, the lower interest rates associated with a full employment surplus might cause balance of payments problems by adversely affecting the capital account. In my view, until new evidence is in, the safest course is to adopt the goal of approximate balance in the full employment budget.

Furthermore, because of administrative difficulties as well as uncertainties as to the short-run effects of tax rate and expenditure changes, the high employment budget ought not to be changed to accomplish short-run "fine-tuning" of the economy. Given the lags in the way the economy responds to fiscal policy and the uncertainty of the economy's response to small and/or frequent changes in tax rates and spending levels, we should pursue discretionary counter cyclical fiscal policies only if the prospective disturbance is of an extent and has a likely duration sufficient to warrant their use.

Pursuit of this budget policy will assure that changes in the expected level of public spending will have to be matched by corresponding changes in the projected high employment tax yield. Proposals for changes in spending levels would be considered in combination with proposals to change tax rates, and vice versa. Furthermore, changes in the balance in the high employment budget would be made only if the problems were of such magnitudes and duration as to cause one to be reasonably confident that the fiscal policies would achieve their objectives.

For the longer run, there has been much discussion of the appropriate approach to the use of fiscal policy for stabilization purposes. The first approach is to set the goal of policy so as to achieve a desirable budgetary situation (balance, surplus, or deficit as the case may be) at full employment, and to rely on the so-called built-in stabilizing properties of the budget to be the principal mechanism by which the fiscal machinery helps to stabilize the economy in the short run.

For a given high employment budget balance, surplus, or deficit, our tax and expenditure system operates to dampen fluctuations as they arise. Since most Federal expenditures do not vary as the level of total income varies, whereas rising incomes produce a built-in automatic growth in revenues, the Government's budget position automatically moves towards surplus and therefore toward restraint as total income rises. Similarly, falling incomes result in an automatic decline in revenues relative to expenditures and make the Government's budget position more expansionary. Moreover, certain Federal expenditures such as transfer payments in the form of unemployment compensation increase during periods when the actual growth of the economy falls short of the expansion of its potential and decrease in periods of excess demand. The effect is to reinforce the influences just noted and thereby contribute further to stabilization.

The second approach incorporates the idea of conscious changes in fiscal policy from time to time, that is, discretionary changes in expenditures or tax rates, or both, for the purpose of promoting stability at full employment.

Rather than be dogmatic about one or the other of these approaches to fiscal policy, I tend to be pragmatic in my approach to the subject to the following caveats about the employment of discretionary fiscal policy. The first is that if discretionary fiscal policy is utilized, it should be directed to correct changes which are believed to be enduring; that is, more than a year. By this I mean that fiscal policy changes are too cumbersome to be an effective instrument of short-run stabilization policy. They cannot plausibly be changed each quarter or half year, not only for administrative reasons but also because income tax changes that are known to be temporary are unlikely to have a significant influence on private-sector spending in the same period. Fiscal moves should therefore be avoided except where it is judged that they will have validity for a period of 1 to 2 years at the minimum.

The second caveat is that the experience of the last 6 years shows that the legislative lag in the enactment of fiscal measures considerably limits their effectiveness. Delays of 1 to 2 years after executive recommendation characterized both the 1964 tax cut and the 1968 income tax surcharge. Therefore, if discretionary fiscal policy is to be used an an important stabilization device, I feel that limited executive authority to alter tax rates—with a provision for congressional veto—would add significantly to the power of implementing discretionary fiscal policy.

Turning to a monetary policy for high employment with stable prices, the Federal Reserve authorities should place primary emphasis as a guide to monetary policy on the growth rate of the monetary base which largely determines the trend growth of the money supply. An appropriate and relatively stable rate of expansion in the monetary base which is closely under the control of the Federal Reserve authorities is indispensable to any program aimed at stable and noninflationary economic growth. This guide to monetary policy actions should not be displaced by efforts to facilitate Treasury finances, to stabilize interest rates, to "protect" the flow of mortgage credit and so forth. It is important to avoid large swings in the growth rate of money and credit which set up destabilizing forces in the economy and themselves become a source of economic instability.

Looking at the behavior of monetary policy since World War II, I would conclude that we have been too dependent upon monetary policy to offset inappropriate levels of Federal spending and tax rates. Differential lags in these two instruments of policy lead to poorly synchronized results.

If monetary policy works slowly and its effects last for a long time while the effects of fiscal policy are more immediate, it is difficult to use one policy to offset another. Further, if a too expensive fiscal policy with substantial budgetary deficits generates a large volume of financing requirements by the Government, any attempt to pursue a truly restrictive monetary policy will be impeded by the fear that chaotic conditions may develop in the financial markets in which the Government must borrow. The need to avoid undue strains on financial markets at such times can prevent the monetary authorities from pursuing an appropriately restrictive monetary policy.

Recent experience has made it quite clear that other difficulties can arise from trying to substitute monetary for fiscal policy. There is a tendency for the impact of changes in monetary measures to be stronger on some sectors of the economy than on others—a tendency arising out of the network of regulation of interest rates, both on claims issued by financial institutions and on maximum rates payable on loans (especially mortgages), as well as regulations affecting the freedom of financial institutions to invest their funds in the assests of their choice. The impact of monetary policy on the housing and State and local government sectors has been particularly heavy. The social importance attached to expenditures in these areas has made the Federal Reserve reluctant to pursue monetary policies which are sufficiently restrictive to maintain price stability in the face of an excessively expansive fiscal policy.

The inferences which I have drawn from an examination of our past record would suggest that it is possible to frame monetary and fiscal policies which hopefully would seriously reduce the probability that the Government would have to face the unpleasant choices that are now before it as it attempts to reduce the rate of inflation. However, these issues are before us and must be dealt with now.

The current U.S. inflation is the result of excessive total spending for goods and services by Government and by the private sector. For much of the period since 1965, the very period when Government expenditures have risen sharply, the Federal Reserve has exacerbated the inflation by pursuing an overly expansionary monetary policy which, in turn, has led to a corresponding sharp increase in private sector expenditures as well.

Stemming the inflation depends primarily on slowing down the rise in the sum of Government and private sector spending. Unfortunately, the process will entail some rise in unemployment. The reason is found in the distinction between expected and actual rates of inflation.

When the actual rate of inflation is equal to that which is built into the expectations of the economy, there will tend to be a level of unemployment which, for want of a better term, I will define as "normal." The "normal" level of unemployment is the result of seasonal, frictional, and structural unemployment under a given framework of legal and economic institutions, including barriers to employment. Because this framework can be modified by public policy, it is possible to reduce the "normal" level of unemployment.

One of the most important immediate tasks for economic policy should be to improve the functioning of the labor market so that we may soon enjoy "normal" unemployment levels at least as low as the actual levels now prevailing. An intensive study of structural improvements to remove barriers to employment, improve labor mobility, increase the efficiency of job search, and upgrade the skills of disadvantaged workers must be begun immediately and should be pressed into action as quickly as possible.

If for some period of time demand grows so rapidly that the price level rises by more than has generally been expected, profits tend to rise, unemployment may decline, and some expansion in physical output may occur. As long as the price increases are thought to be temporary and the wage gains look real to workers, some additional workers will enter the labor force. Similarly, as long as the expansion in demand seems real, businessmen will add employees to meet the newly perceived demands. Thus when an increase in total demand causes prices to rise and the inflation exceeds that which had been anticipated, unemployment tends to fall below the "normal" level.

For a time, inflation may reduce unemployment, but during that period economic changes take place tending to return unemployment to its "normal" level. Responding to rising prices, business, workers, and consumers come to change their anticipations of the future prices and wages. Employers revise upwards their estimates of the wage increases necessary to acquire and retain labor; employees revise upwards the annual wage increases they require to stay in their present jobs; unions push harder merely to retain the same real gains; producers revise upwards, their estimates of the price increases they can make while still keeping competitive; customers revise upwards their estimates of the price increases they will pay without shopping elsewhere; and borrowers and lenders include the expected inflation in the rate of interest they agree upon. As these expectations come to approximate actual inflation, employment gains evaporate, unemployment rises, and tends to return to its "normal" level. Thus, while an unexpected rise in the price level generates a temporary increase in employment, a steady increase in the price level—at any specified rate—is unlikely to bring about a lasting expansion in employment.

It is unlikely that there is any long-run tradeoff between unemployment and the price level in the sense that some permanent increase in employment can be bought or "traded-off" against some increase in the rate of change in the price level. The price level increases that are capable of altering the level of employment are unexpected price level increases. A policy to reduce unemployment by accepting price inflation would require for its success that the price level continually accelerate faster than labor and business expected. Such a policy is socially unacceptable and may not be attainable.

Thus, while a temporary increase in employment can be obtained by expanding demand and thereby letting the actual rate-of-price increase exceed the expected rate, the growth in employment is temporary. Any steady increase in the price level does not bring about a lasting increase is employment. For long-run economic policy, inflation, when anticipated, will provide no more employment than a stable price level when it, too, is fully anticipated.

Moderating the inflation depends primarily on slowing down the rise in the total of Government and private spending. When total demand turns out to be lower than had been anticipated and planned for, business firms react to the volume of sales being less than had been projected by restricting employment—not so much by discharging personnel as by limiting the hiring of new or additional employees and by eliminating overtime and reducing the workweek. Thus, earnings of many employed people fall and job opportunities for new entrants and others are restricted. In deciding how to reduce the use of labor, employers also will tend to lay off low-skilled employees with limited seniority and others who are more readily replaceable at low cost and in whom less must be invested for training and adaptation to available jobs. These employee characteristics cover a large number of young, black, and low-wage low-skill employees whose employment opportunities are already more limited than those of the labor force as a whole. In fact, many of these same people are now doomed to structural unemployment except when the economy is temporary subject to undesirably high and rising inflationary pressure.

The initial effects of anti-inflationary policy are likely to involve cutbacks in output and employment in many industries; only at a later stage will price increases be moderated or reversed. Thus, as has been anticipated, part of the difficult process of slowing the inflation entails a transition period where there are many examples of falling output and rising prices, the worst of both worlds.

After the economy has experienced inflation, the difficulties of readjustment should affect the manner in which the stabilization authorities attempt to move the inflationary economy toward price stability. The stabilization policies which are used should minimize the risk of a substantial increase in unemployment. The stabilization authorities should not attempt to end the inflation immediately, since the temporary increase in unemployment resulting from the unexpectedly large reduction in demand and deceleration in wages and prices might be unnecessarily high. The interim target for demand should be a gradual but continued reduction of its increase until it is within the country's capacity to produce at stable prices. This target for demand will cause a deceleration in the rate of growth of prices and minimize the level of unemployment required to restore price stability.

Because a policy of disinflating the economy is politically difficult, one obvious lesson to be learned is that we should strive valiantly to avoid the inflation in the first place. Thus, in a period of unemployment, the stabilization authorities should not move to expand demand by such large amounts over short periods of time that they cause prices to rise as a result of the pace of the expansion in demand. They must be careful to expand demand to achieve high employment gradually and thereby preserve price stability in order to gain the assurance that the employment increase will be permanent. The fact that too rapid expansion of demand in 1965–1968 generated much of our current difficulties may afford small solace to the administration currently. But it is critical that at some later date the country does not make the same mistake.

There are several important lessons to be learned from recent flaws in stabilization policy. The inflationary impact of the Federal deficits could have been mitigated through different monetary and debt management policies. One serious error was to accelerate the growth of bank reserves and the money supply in order to facilitate Treasury financing at the very time the Federal deficit was rising. The Federal Reserve and the Treasury were overly concerned with avoiding "failures" of Government financings at interest rates predetermined by the Treasury. Hence, the use of monetary policy as an anti-inflation tool was immobilized for a large part of each of the past 4 years by the Federal Reserve's "even keel" operations during periods of Treasury financings. In practice, the "even keel" policy turned out to be a form of monetizing the increase in the Federal debt, thereby multiplying its inflation potential.

The alternative and noninflationary approach would have been to finance the mounting Federal deficits without this recourse to Federal Reserve credit, thus avoiding an excessive growth in bank credit and the money supply. Admittedly, this would have had the stabilizing feature of moderating the rise in private investment and consumption thus tending to offset, at least, in part, the effects of larger Federal spending.

In retrospect, the policy actions of the Federal Reserve in 1967 and 1968 seem to have been aimed at controlling the rise in interest rates in a period of strong expansion in the economy. Such actions were apparently undertaken not only because of considerations relating to the financing needs of the U.S. Treasury but also because of those relating to the homebuilding industry, State and local government financing, and mutual thrift institutions—that is, mutual savings banks and savings and loan associations. These institutions, which are among the principal sources of home mortgage credit, are particularly vulnerable to rising interest rates, since the interest paid to their depositors tends to rise faster than the average yield on their portfolio of assets, which have long-term maturities and hence turn over slowly.

Thus, in the short run, monetary actions designed to hold down interest rates may seem to protect the solvency of mortgage-lending institutions and to assure an adequate flow of home mortgage credit and financing for State and local governments. However, over a longer span of time, such as the past several years, efforts to hold down interest rates in the short run necessitated such an increase in the monetary base and in the money supply that a strong inflationary process was set in motion and interest rates rose even higher, in my judgment, than would have been the case in the absence of such actions.

As 1969 came to a close, the fundamental irony stemming from Federal Reserve policy of the past several years was that, in addition to the sharpest rise of prices since the Korean war period, the economy also experienced the highest levels of interest rates seen in this century. Thus, the effort to hold down interest rates through an expansionary monetary policy was a strategic failure.

In fiscal 1965 the high employment budget was in surplus by approximately $2.7 billion. From the middle of 1966 to the middle of 1968 the high employment budget moved to a substantial deficit peaking at approximately $15 billion in mid-1968. Passage of the surtax in mid-1968 quickly eliminated this deficit so that in calendar 1969 the high employment budget surplus varied between $7 and $11 billion. For calendar 1970 the outlook is for the surplus in the high employment budget to average $11 billion. Given the outlook for the levels of private demand and the goal of maintaining levels of demand which are consistent with a reduction in the rate of increase in prices, it is critical for the current year that control over Federal expenditures is carefully exercised in order to make certain that this prospective surplus does not dwindle too abruptly. In the event that Congress views expenditure increases beyond those proposed by the President as truly in the public interest, I would hope that tax increases would be voted to raise the necessary revenue to preserve a moderate surplus in the high employment budget. Such a course of action would insure that movement toward a less restrictive monetary policy could be pursued by the monetary authorities.

The fact is that the high employment budget surplus in 1970 is estimated at between $9 and $13 billion. I would remind you that when high employment budget surplus was about that order of magnitude in 1961–62, the problem that faced the Congress to which it ultimately reacted was to respond to fiscal drag by enacting a tax cut to reduce the size of that high employment budget surplus.

Now, it seems to me fiscal drag is not mentioned at all in connection with the current high employment budget surplus. I would submit that the fiscal drag is not as large now as it was then, but that is because the level of private demands is very much higher now than it was then.

Nevertheless, I would argue that on the basis of the high employment budget surplus anticipated for 1970, that the budget posture of the Federal Government is deflationary.

There appears to be a campaign being mounted to move to wage and price guidelines as an instrument of stabilization policy. In my view these guidelines do not work, are no substitute for appropriate monetary and fiscal policy and serve no real purpose except to divert attention from the difficult budget choices, monetary actions, and labor and product market improvements which are required.

Among the vanguard of advocates of such policies are the advocates of fine tuning—who believe the Government can control our vast and cumbersome economic machine—and in some ways are responsible for our present plight. If I interpret them correctly, they now say we do not have the same capability of controlling inflation through the use of classical stabilization tools as we had the capability to bring the economy to high levels of employment.

The approach to guideposts requires that (1) the Government state a standard of price and wage behavior and (2) business and labor must adhere to this standard with minimum compulsion by Government.

It is not easy to specify a standard for wage-price behavior. You may recall that in January 1962, the President's Economic Report specified a productivity standard. Hourly wages must rise in line with average gain in output per worker. Prices should be stable—declining in lines where productivity rose more than the average and rising where gains in productivity were less than the average.

This seems like a simple and clear standard. Yet it had become increasingly clear with the passage of time that exceptions were needed. Exceptions to wage increases were justified in industries where wages lagged behind; exceptions could also be made where workers were needed in geographical areas or in particular occupations. Exceptions to price behavior were also added: if capital needed to be attracted, higher prices could be posted; also if costs other than labor rose, price increases were permissible. While these and many other exceptions were mentioned no specific quantitative content was or could have been given to them.

The second problem with guideposts is how do we enforce non-quantitative standards? The experience between 1962–66 is replete with instances where the Federal Government actively intervened in labor negotiations and price decisions—steel, automobiles, aluminum, et cetera.

Now we come to the crux of the policy debate. While it is true that during this period prices were quite stable, it does not follow that this price stability is attributable to the existence of guidelines as many learned studies have attempted to prove incontrovertibly. Alternatively, equally careful studies have shown that without guidelines we would have achieved a similar record of price stability. Unutilized plant capacity, relatively high unemployment rates, relatively stable monetary and fiscal policies would have yielded growing real output and stable prices. In my view the latter studies are more convincing than the former ones.

The difficulties associated with reducing inflation while still fostering expenditures in certain sectors of the economy have caused some to propose the introduction of selective association of credit. So strong was this feeling that the Congress of the United States granted the President the power to allocate credit. The power to impose selective credit controls was embodied in general legislation imposing ceilings on interest rates; according to newspaper accounts the President reluctantly signed the bill though he has publicly stated he does not choose and will not choose to utilize the credit allocation powers contained therein. The basic reason for the use of the selective credit controls is to prevent the allegedly perverse effects of general monetary restraints, particularly on housing. In my judgment these controls are difficult, if not impossible to administer. Moreover, selective controls discriminate against the poor who have no assets to draw upon to pay cash while the wealthy can do so.

Inflations can be controlled but not through the use of specific controls on arbitrarily selected goods or services. The solutions to inflation lies in the adoption and maintenance of appropriate monetary and fiscal policies which attack the cause of inflation. They require an appropriate rate of growth in the stock of money and the attainment of appropriate budget surpluses.

This represents my testimony, Mr. Chairman.

Senator PROXMIRE (now presiding). Thank you.

Mr. Weintraub?

STATEMENT OF ROBERT WEINTRAUB, UNIVERSITY OF CALIFORNIA, SANTA BARBARA

Mr. WEINTRAUB. Thank you, Mr. Chairman. I will read a shortened version of my full statement.

I take for granted that our near term domestic macroeconomic goals are to end or at least substantially moderate the ongoing inflation without generating a significant slide in employment and business activity. It is easy to subscribe to these goals.

The hard questions—the ones in dispute—concern the kinds and timing of actions to achieve these goals. There is plenty of choice. Most important, the appropriate mix of fiscal and monetary actions must be delineated. Also, I will comment briefly on the advisability of developing strategies involving price-and-wage guideposts, price-and-wage controls, and modification of domestic market structures and the terms on which we trade with the rest of the world.

To begin, I strongly urge the Congress to initiate actions to remove existing barriers to our international trade. Definitely such actions would operate to decrease domestic prices. Unhappily, it also is true that such actions would require adjusting domestic employment patterns. But this prospect should not deter us. As the Council of Economic Advisers observed, "By providing temporary adjustment assistance, the Government can help those who must adapt to changing patterns of world trade, and improve the capability of our market economy to take full advantage of the benefits of international trade and investment."

I also strongly urge initiating steps to constrain combinations in restraint of domestic trade, including in labor markets. Along the choice spectrum such actions have unique potential; for they would operate both to decrease prices and increase output and employment. Because attempts to constrain business and labor monopolies are certain to evoke resistance by those who benefit from excluding other economic agents from their markets, no one can be sanguine about implementing a program designed to increase the free flow of goods and resources in our economy.

But I would be remiss not to urge that such a program be designed and implemented.

Third, concerning the efficacy of direct wage and price controls, conceivably, net benefits would derive from this strategy in a hyperinflation. In such case it might be worth the costs to buy time to implement appropriate fiscal and monetary policies and allow for the lags in their effects. But we are not now confronted with hyperinflation. Hence we must be mindful of the costs that are associated with direct controls.

Rationing problems will arise, illegal transactions will have to be policed, and perhaps most importantly, we will fail to allocate sufficient resources to uses and places where demand is growing.

Opposition to direct controls does not, however, imply opposition to wage and price guideposts. In the current situation—and I emphasize the word "current"—a balanced policy mix should include guideposts. Specifically, wage and price guidelines for the near term future should be developed by the CEA consistent with their expectation for success in moderating inflation.

There would, however, be no need for selective "jawboning" by the President in cases where the guidelines are exceeded. Guidelines are guides, not rules.

Hopefully the guidelines would act to decrease the size of upward wage and price adjustments, adjustments that we currently are experiencing because of past, present, and expected inflation. I want to stress the importance of retraining these adjustments. In particular, unless adjustments now being made in anticipation of further inflation can be discouraged, we will be unable to stop inflation by application of restrictive macropolicies without generating substantial declines in employment and output.

Guideposts are needed to minimize the employment and output effects of restrictive macropolicies. To wage negotiators and administrators of monopolylike pricing policies, guideposts would be a posting of the maximum upward adjustments in wages and prices that are consistent with continuity and employment and output in their sectors—assuming average productivity increments. Such knowledge should serve to temper present and future wage demands and price increases. Thereby, implementing a guidepost strategy will clear the road of wage and price distortions so that appropriate fiscal and monetary actions can achieve our twin goals of moderating inflation without generating a recession.

The question that remains is: What is the appropriate mix of fiscal and monetary actions?

Two aspects of fiscal policy must be explored. One concerns the advisability of changing present tax and expenditures policies as a means of fighting inflation. The second pertains to the effects we must expect from estimated future surpluses deriving from inherited fiscal actions.

Consider first the advisability of reviewing present tax and expenditures policies. A widely believed hypothesis about fiscal policy is that rising surpluses are deflationary. An implication of this hypothesis is that we can moderate the ongoing inflation by adopting expenditures and tax policies that produce rising fiscal surpluses.

Viewed purely as a statement of a tendency, the implication is correct. However, one difficulty with this policy decision is that it is not consonant with present fiscal realities. Using the national income accounts data, we find in fiscal year 1969, the budget surplus was $6 billion. And it is estimated at $3.6 billion for 1970, and $1.6 billion for 1971.

Though some expenditures programs doubtless contain fat, others doubtless are too lean. On the whole, the small surplus estimated for fiscal year 1971 would appear to define the maximum surplus obtainable at high employment based on hard realities concerning minimum national aggregate expenditure needs and maximum tolerable tax rates.

Moreover, it would be advisable to change presently planned fiscal parameters to produce a larger surplus only if we were extremely confident that a rise in the surplus above $6 billion would be significantly disinflationary and had no other effective options for combatting inflation. But the advisability of reducing expenditures and/or raising taxes can be questioned on both grounds.

Now, first, we have disinflationary policy options. I refer to monetary policy options. More on these later. But also, we cannot be confident that a rise in the 1971 surplus above $6 billion would be a significant disinflationary force. The validity of the underlying economic hypothesis depends crucially on the insensitivity of the public's demand for money. If money demand is totally insensitive to interest rate changes, fiscal policy will have no effect on the national income aggregates, including prices. I submit that occasionally we may have to contend with a situation resembling this extreme.

We would have to do so if, as seems perfectly plausible, the public's demand for money with respect to interest rates is such that money holding becomes less and less sensitive to interest rates as the level of interest rates rises.

Given this behavior, then at the high interest rates prevailing today, we cannot expect to exert a significant dampening effect on aggregate demand, or as a corollary on prices by acting to increase the 1971 fiscal surplus above $6 billion.

A further important question that arises about fiscal policy pertains to the effects we can expect from the fiscal actions now in force.

It is widely believed that simply because we now are running a fiscal surplus we have an effective disinflationary fiscal policy and therefore the Fed need not worry about inflation. Unhappily this is not the case. Though this may seem paradoxical, the impact of a fiscal surplus that emerges from inherited fiscal policies—and I underscore the word "inherited"—is likely to be inflationary. This follows from consideration that the disinflationary force of the policy actions that caused the surplus is soon fully accumulated and we are left with the effects deriving from continuous retirement of the Federal debt which results from the surplus. These effects are inflationary in the same way that Federal Reserve open market purchases of Government securities are. It does not matter whether the public's holdings of Government securities is reduced by debt retirement by the Treasury, or open market purchases by the Fed. In both cases there emerges a tendency for yields on securities to fall and prices of existing real capital to rise.

In turn, because the prices of real capital rise; investment rises, and this, of course, is inflationary.

Thus, we cannot be sanguine about the disinflationary force emanating from inherited fiscal policies. If we are to moderate the ongoing inflation we will have to do so by monetary actions.

Monetary policy means different things to different people. Broadly speaking, one school of thought would have the Fed operate on aggregate demand via intervention of credit variables; more specifically through interest rates and free reserves.

A second school urges using some money supply measure as the intermediate target of monetary policy.

I belong to the second school, and more specifically to that branch which would use the conventionally defined money stock, currency plus demand deposits, as the target of monetary actions.

I reject using interest rates or free reserves as the target variables because they are deceptive indicators. For example, in the context of inflation, the Fed is supposed to act to dampen aggregate demand by raising interest rates and lowering free reserves. But the effect of rising prices and profits is precisely to pull up interest rates and push down free reserves. Thus, the Federal Reserve authorities can easily deceive themselves, if they use interest rates and free reserves to indicate the thrust of their actions, into thinking they have pursued a tight policy when in fact they have taken no actions to moderate economic activity and in fact may have acted to fuel the boom.

On the other hand, there is no chance that the monetary authorities will think that they have taken disinflationary actions when they have not if money supply is their target. This is because the natural tendency in inflation is for accelerated growth of the money stock and the impulse we want the Fed to transmit to the quantity of money in inflation is to moderate its growth.

For the record, the money stock also satisfies the other requirements of a viable monetary policy target. It is subject to close control by existing instruments; for example, open-market powers. Second, we have a reasonably well articulated and empirically validated theory connecting money supply changes to changes in economic activity.

I come now to the penultimate question. What is the optimal money supply target for 1970? And I underscore "for 1970." Based on events of the past few years it would appear judicious and prudent as well for the Fed to use its open-market powers to cause the money stock to grow between 2 and 3 percent this year.

Any substantially higher growth rate would court renewed inflation. A lower rate would expose the economy to a severe recession. A brief look at the recent record is instructive.

Between August 1965 and mid-1966, the money stock grew at an annual rate of 7.1 percent. This compared to increases of about 4 percent per annum in the 1963–65 period. Since our economy was operating at near full employment in the fall of 1965, the effect of the increased rate of growth of the money stock, in the fall of 1965-summer of 1966, was to accelerate the rate of inflation from 1 to 3 percent per year.

In the second half of 1966, the money stock actually declined about half a percent. This was the period of the "money crunch" and as a result of the crunch we experienced a short-lived minirecession in the winter and spring of 1966–67.

The money stock again grew at an accelerated pace in 1967 and 1968, averaging 7.3 percent per annum. The effect of this second round accelerated monetary growth was to accelerate the advance of prices to more than 5 percent per year. The record thus clearly suggests the need to restrain monetary growth if we are to avoid price inflation. I would stress, too, that today's high interest rates also are part of the inheritance of the monetary mismanagement of 1967 and 1968; for nominal interest rates always reflect inflationary expectations, and these in turn are shaped by past inflationary experiences.

Consider now the ultimate question. Will controlling monetary growth in the 2 to 3 percent per annum band moderate the ongoing inflation without causing substantial unemployment and falloff in output? My answer is a hesitant yes. I cannot be supremely confident, however, because the available evidence indicates that money supply changes affect prices only by changing output and unemployment.

But the history that provides this dismal evidence was marked by monetary actions that produced sudden sharp changes in money supply. It may be reasonably urged that in the past moderation of inflation has been associated with increased unemployment primarily because the monetary growth rate has been caused or allowed to fall below 2 to 3 percent per annum.

I want to emphasize that 2–3 percent per annum money supply growth is recommended by way of attempting to avoid severe recession as well as to modify the on-going inflation. In this connection cognizance should be taken that whether by accident or design, monthly money supply growth, though averaging 2.6 percent per annum in 1969, was less than 1 percent per annum in the second half of 1969.

The effects of this truly tight policy are now becoming apparent. In the financial sector interest rates already high because of the pull of inflation on credit demand, have been pushed even higher. In the real sector there has been a cutback in output and unemployment now is exhibiting a tendency to rise.

To prevent development of a full-fledged recession, it is essential that the Fed take the actions required to raise monetary growth back to the 2–3 percent per year rate. Whether money supply now grows at 2–3 percent per year or not at all, disinflation will manifest itself shortly, perhaps by spring, certainly by next fall.

There is no reason whatever to think disinflation will emerge sooner if monetary growth continues to be held between 0 and 1 percent per annum over the near term future than if the Fed now raises monetary growth back to last year's 2.6 percent per annum average.

Furthermore, long-term price level stability as an operational goal of Government probably would be undermined by our experiencing a severe recession over the near term future, since there would be a natural tendency to renew inflationary monetary growth in order to quickly end any such episode.

In summary, prescription of a 2–3 percent per annum money supply growth for 1970 is designed to attain the best possible of not very nice choices. It is intended to avoid severe recession and at the same time it is aimed at moderating—but only moderating and only gradually—the on-going inflation.

This committee has already done much to help achieve our twin goals of moderating inflation without causing a full-fledged recession by requiring explanations of excessively high or low monetary growth. I hope it will continue, both to publicize the need for moderate growth in the money stock and to insist on explanations of departures from its guidelines.

Two points are stressed in closing. One is doleful, the other cheerful. On the sad side, we must expect some rise in unemployment as inflation abates because of wage and price increases now being contracted and otherwise programed to become effective in the months ahead.

But this development can be minimized by a judicious guidepost policy, and in any case it definitely should not be aggravated by excessive monetary restraint.

On the happy side, I believe we can expect interest rates to fall sharply shortly after disinflation takes hold, a development I expect this spring, and no later than the fall. With the members of this committee I look forward to the time when once again interest rates are devoid of any inflationary additive and reflect solely the real rate of return on capital. This will be one of the finer byproducts of breaking the on-going inflation.

A prudent 2–3 percent money supply policy for 1970 thus will be midwife to the low interest rates all of us ardently desire.

Thank you, Mr. Chairman.

Senator PROXMIRE (presiding). Thank you, gentlemen, very much.

Mr. Roosa, you dropped a bomb in December at the American Economic Association when you suggested there be a 6 months' freeze on prices and wages.

Mr. ROOSA. Yes.

Senator PROXMIRE. At that time there was a great deal of interest in that and still is in the Congress. A number of Members of Congress have told me that they agree with you, and a very large proportion of people whom I have talked to in my State seem to think something like this should be done.

Could you give us a picture of how you think this could be implemented and how you meet the arguments of so many of the experts and economists who disagree with you? Because everything I have heard from the economists argues that we cannot do it now because there is no popular war on, it is very hard to make it effective, maybe something could have been done before, but this is not the time.

How would you meet all of those problems?

Mr. ROOSA. First, I think the most difficult problem to meet is that a freeze, being a psychological move in its impact, must have the support, the massive wide-ranging support of the administration and the President. The fact that he and his spokesmen have so clearly not only turned this suggestion aside, which I so greatly regret, but also have dug themsleves into so deep a hole in opposition that they would have a very hard time ever reversing themselves, makes me feel that the country has missed the chance.

To repeat, I think it is a psychological move. It depends therefore on commitment of the full force of the President's own conviction and of all his powers of publicity and of persuasion. And lacking that, I am quite discouraged.

Now, I would be quite happy, though, to pursue this suggestion further in terms of what would happen if the President had, instead, simply sidestepped the issue for now. The position could be quite different if the President had said that perhaps it would be relevant later; that he did not want it at the moment, but had kept it open as a possibility. Then there would be a chance of his being prepared to throw himself into this with a conviction that I would devoutly hope he might find.

It seems to me that the notion of a freeze arises from the fact that we have been caught up in a spiral which has become a chase. And I am very much afraid, even though the fiscal and monetary framework that we have been talking about is going to be maintained somewhat along the lines that are described here today, I am very much afraid that we have not only a built-in lag effect, as everyone has said, that is going to lead to somewhat greater unemployment over the next few months, but there is another lag effect. That is that the pressure for additional wage increases, based on the price increases already behind us, is also going to be great and quite understandable.

I think it is this chase—higher prices leading to higher wages, and following the wage increases prices then going up further—that has taken on a force of its own. The spiral has generated an inflation mentality that has an inner driving capability beyond that of the mere economic aggregates. Expectations become dominant.

That is why I thought that a psychological move to break that chain, that really vicious chain, was important and should have been initiated. In my judgment, in terms of the state of the mentality as it still exists, such a freeze would be relevant today.

Senator PROXMIRE. Wouldn't you have a great deal of trouble enforcing this? The price increases, by and large, have been in the service sector and areas where you have small units operating; it really has not been organized labor as much, or big corporations. It has been all along the line, and thus to enforce a freeze under these circumstances would be difficult, plus the fact you do not have the psychological support of a popular war during which it is unpatriotic to increase prices.

Under these circumstances you would not have that.

Mr. ROOSA. Surely, I would distinguish, first of all, between a freeze which is imposed and one which is voluntary. Whatever they think about Vietnam, the public—they have not caught up with my colleagues here—is still worried about inflation, and this is an overriding, prevading, corroding concern. And because of that, I think you could do something about the mentality of inflation if the action were in the nature of a short-term freeze.

Senator PROXMIRE. Doesn't the short-term nature of it make it difficult—because you say 6 months and then the lid is off and you build up a pressure and then you get your explosion after that?

Mr. ROOSA. Yes. I would like to distinguish my suggestion from the arguments I know Chairman Burns used here. He is right to say that we do not have the atmosphere of patriotic war that would justify taking this sort of action. I believe that is valid if we are talking about applying a mantel of direct controls. I would not propose that now. That is why I tried to find some middle ground. And the middle ground, as I see it, is to use the power of the presidency to appeal for the freeze on the grounds that this is entirely voluntary, that you are not enforcing anything, that you are asking every American to stand still because inflation is the overriding challenge.

Senator PROXMIRE. You say it is entirely voluntary?

Mr. ROOSA. Yes. I did not propose legal enforcement of the freeze at all.

Senator PROXMIRE. Then it would not mean anything, would it?

Mr. ROOSA. I think it would. That is why I leave it at 6 months, a period consistent with the sort of tolerances that a voluntary program might have.

Senator PROXMIRE. The whole trouble with this kind of a voluntary appeal is that those who are responsive and those who feel that this is something you should do in the national interest are penalized.

Mr. ROOSA. I realize that.

Senator PROXMIRE. While unions and business people, and those who are not, go ahead, and therefore it would be an intense demand to require that the Government enforce this.

Mr. ROOSA. Yes. So the second stage that I would hope for is that this 6-month interval would have been used to develop the facilities for the kind of approach to longer run incomes policy that I outlined. We would slide from the freeze into the revival of the guideline approach. But I think the freeze—obviously to try to enforce it would be impossible. And that is why I suggested——

Senator PROXMIRE. I can understand why any President—I am a Democrat and President Nixon is a Republican—if I were advising a President, I must say I would be very reluctant to appeal for a voluntary freeze which so many people would be likely not to abide by, and then the President would look pretty ridiculous.

Mr. ROOSA. For a brief period I think you could get it. That is why I made the period in my suggestion as brief as this.

Now, of course, this requires using all the panoply of public influence that the Presidency can command. There will be deviations, but what I suggested in proposing the freeze was that for every buyer there is a seller—and there are two sides to every contract—and if it is just being stressed every day that the President, the administration, has appeared for a standstill on prices and wages for a brief period until a fresh approach in overall policy has evolved, I think the majority of the American people will respond, and for that brief period.

Now, I can realize all the hesitation one would have in recommending this, and it certainly requires very careful preparation and the enlistment of business groups and labor groups in support.

Unless you found some evidence of a readiness to go along, any President would hesitate. But I think the evidence is there. I think we heard it from Mr. Meany in some of the things he said within the last week, as I read them in the paper, and I certainly know it exists in much of the business community. I was a little fearful when I dropped what you called a bombshell that there might be some reaction that would embarrass my partners. It did not embarrass me. I was amazed and gratified to see that there has been none whatsoever, that almost every businessman we have contacted has said, well, it is a shame something has not been done to get at the psychology of inflation.

Senator PROXMIRE. I find that, too. I find great widespread public support for some kind of price control, although I do not know that they understand you proposed simply a voluntary one.

Mr. ROOSA. I also proposed the voluntary freeze on the other ground you suggested, that the legal enforcement of controls over so many separate items would be impossible. That is particularly so because the price increases have occurred in the areas where you do not have single decisionmakers, who can just say this is it, and then determine large sectors of the whole economy, either in the consumer or labor or price sector. The main increases have occurred in the fragmented parts of the economy. That is why the enforcement has to be based on an appeal that reaches individuals, where we could not possibly set up adequate administrative procedures.

Senator PROXMIRE. Is there any precedent for this, either in this country or any other country where this has been tried and has been at all successful?

Mr. ROOSA. Yes. It is hard to say how successful it has been, but, of course, in the initial phase of the British effort leading to the Wages and Incomes Board they did call for a freeze, and they actually did introduce the Prices and Incomes Board, I guess they call it. People can argue a long time as to whether or not that has been successful.

Senator PROXMIRE. Do you feel it was?

Mr. ROOSA. I am not trying to——

Senator PROXMIRE. Pardon me, do you feel it was successful, reasonably successful?

Mr. ROOSA. I do, yes, on balance.

Senator PROXMIRE. What was the period?

Mr. ROOSA. It is still underway. I cannot remember precisely the beginning—it would have been late 1965, but just exactly when I'm not sure. The duration was probably 3 months rather than 6. But it was during this period that they were preparing to introduce the Board.

Now, there was also an earlier period, it might have been 1961 or 1962, because there was an earlier attempt when by law they declared a freeze, which extended also to dividends, as I also proposed.

I think there has to be restraint on all sides——

Senator PROXMIRE. Rent?

Mr. ROOSA. Yes.

Senator PROXMIRE (presiding). My time is up.

Senator Javits?

Senator JAVITS. I think I would like just to listen, Mr. Chairman. I have another hearing.

Senator PROXMIRE (presiding). Congressman Brown?

Representative BROWN. Mr. Roosa, what is wrong with the unemployment figures which you suggest we should take a census of? Is there a wrong presumption built in to the employment figures?

Mr. ROOSA. I am no expert on these, sir, and I do not mean to try to present that side of it. I think there are differences in conceit. We have been up and down this road statistically for years.

The point I want to stress is not that I am criticizing the figure. I am arguing for a different concept, not just a number as to how many are unemployed. I am saying we should have what I would hope would be a Federal employment register, located in every key city and area—the name of the person unemployed and what his skills are.

We need a labor bank to be matched against a job bank. It is this gap which, it seems to me, is such a glaring inadequacy in the matching of the unemployed with the jobs that are available.

This is done on a regional labor exchange basis in the United Kingdom. It has been done in Sweden, I think, for 20 years. They know by name who is unemployed. Then they know what his capabilities are. And as jobs become available, the contact is made.

So the fact that there is a tremendous lack of knowledge in the labor market here is, I think, a serious impediment to reducing unemployment.

Representative BROWN. Let me suggest two concerns which I am not sure how to fold into the economic circumstances we find ourselves in today.

One, it has been estimated that as high as 40 percent of the unemployed currently are 16 to 19 years old, and that this group, because of the war in Vietnam, and the imminence or possibility of draft, should not be considered as having as much impact on the employment market as if they were 35 to 40.

The other concern is what to do about the imbalance in the total figures from specific kinds of unemployment such as in the homebuilding market, or the rapid removal from the Federal military service of, say, 200,000 people?

Mr. ROOSA. Well, insofar as this is a statistical problem in measuring unemployment, there is a continuing issue faced by the people that put these data together as to who is in the labor force. And they will be resolving that in ad hoc ways from month to month, always. We will never feel that they have it exactly right.

I do believe that in terms of the nature of the unemployment that has arisen thus far, that there are relatively fewer who represent the kind of classic case of ablebodied heads of household who are laid off. But there are certainly many of those, too, who are genuinely employable—adult males, most of them family men, who are now unemployed through no fault of their own—and they represent the typical problem.

But so far as the teenagers are concerned, this is a pretty critical problem, too, even though they are either waiting to be drafted or just uncertain as to what is going to happen and therefore standing by—the fact that there is not employment for them is a pretty serious impairment of their own morale and of the Nation's well-being.

Representative BROWN. I did not mean to discount that in any way. I am just wondering what it does to our picture of the total problem.

Perhaps I should ask Mr. Shapiro to comment on this since he mentioned the unemployment of the young, black male as the particular problem currently.

Mr. SHAPIRO. Well, my argument is that we increase unemployment by our present disinflationary policy. My argument, further, is we ought to move slowly on the disinflationary policy and I suppose this is what sort of causes skepticism about our ability to combat inflation. Although heaven knows, the evidence is everywhere present about the effect of this program in terms of real output, not for the first quarter of 1970, but simply all through the four quarters of 1969.

Thirdly, I would argue that these people who are unemployed, ought not to be put outside on the streets; there ought to be some form of income maintenance available for them, which income maintenance ought to be associated with training. For the fact of the matter is I feel a lot of them would be unemployed except as we have inflation, and let us make them productive members of our society by increasing their skills.

Representative BROWN. Is that a family assistance plan that has been proposed?

Mr. SHAPIRO. Well, it is a pitch for the Manpower Training Act as much as anything else.

And it is associated with the fact that most Americans are concerned about the fact that unemployed persons ought not to be without income.

So I think we can accomplish all three things, one affecting the immediate shortrun stability problem vis-a-vis the price level, but more important, that we are adding to our productive labor force a group of people who are more capable to adding to the productivity, hence to our GNP in the future.

Representative BROWN. I appreciate that comment.

If I might get off that point in order to complete another one:

As I understand, Mr. Weintraub, you suggested a 2- or 3-percent money supply increase; and Mr. Shapiro, I think your recommendation was a 4½-percent money supply increase over the next 3 or 4 months, and then at the same rate as productivity increased.

Mr. SHAPIRO. Output increase which would be approximately the same as Mr. Weintraub's.

Representative BROWN. What is implied in the difference in those figures? Or is there a difference? Are you, in effect, saying the same thing? I gather that you would increase the money supply somewhat more sharply at first, and Mr. Weintraub would even it out a little more; but are you both assuming the total output increase would be 2 to 3 percent?

Mr. SHAPIRO. Mr. Brown, if I may, I think the sort of essential difference on shortrun strategy between Mr. Weintraub and myself is that we have had a long record in 1969 where the money supply was substantially unchanged. It was flat. And therefore, as Mr. Okun points out, our liquidity generally has dried it out. And therefore I wish to move a little faster in the intervening 6-month period to overcome the deficiencies of our monetary policy in 1969, and therefore when we get there, we will assume a steady state.

Representative BROWN. Mr. Weintraub?

Mr. WEINTRAUB. I think I probably just put a little more danger on inflation than Mr. Shapiro does and therefore would not want to go above 3 percent. But I share with him the concern that monetary policy in the 6 months just ended has been very restrictive.

Senator JAVITS. Has been very what?

Mr. WEINTRAUB. Restrictive.

Senator JAVITS. Would the whole panel agree with that? Would you agree with that, Bob?

Mr. ROOSA. No, I would not. I would not have more than a 1 percent increase for the rest of this half year, at any rate. Then wait and see what happened. And I would regard anything more than that as dangerous because I feel, different from the others, that the inflation mentality is still running strong.

I suspect I see more businessmen week in and week out than they do, and I know very few who are not going to take the evidence of an immediate change in monetary policy as the grounds for leaping ahead. I am just afraid we would find the boom that everyone here fears recurring much more rapidly than they suspect.

We may have a dip of some magnitude in between but not very long. This is a strong economy and the businessmen in this country are looking across that valley right now. I think the Federal deficit is itself much looser than we have given evidence of here, that we are getting much of the ease that may be needed and appropriate at this time from that source. I would not go along with what he said.

Senator JAVITS. Congressman, may I ask Mr. Okun? I yield to you.

Representative BROWN. Yes, I would like to have his answer.

Mr. SHAPIRO. May I call to the attention of the Congress that Mr. Roosa is suggesting a policy which is adverse to the Joint Economic Committee's recommendation about money supply, which as I understand it is 2 to 6. I just wish to say that.

Mr. ROOSA. I have often been in disagreement with this committee and I am sure they appreciate wholesome disagreement.

Senator JAVITS. May I ask, Mr. Chairman, to yield my time to Congressman Brown?

Senator PROXMIRE (presiding). Yes. We go back and forth. Normally, though, Henry would be next, but——

Senator JAVITS. Congressman, would you mind?

Representative REUSS. Surely.

Mr. OKUN. I do not think I could be constructive to this committee or to the Federal Reserve by offering any particular numerical rule for growth of the money supply or any other aggregate.

I think that would have to be determined in light of much more thorough analysis of sources and uses of funds prospectively for the rest of 1970. We saw in 1969 how difficult it was to anchor on any particular monetary variable. We could find, as interest rates go down, that we get a very sharp rebound of time deposits, which would have some impact on the liquidity of the economy.

But my qualitative feelings are more like those of Professor Shapiro and Professor Weintraub than those of Mr. Roosa, perhaps an unusual circumstance. I am impressed by how much the level of demand in the economy has weakened in recent months.

I am aware of the fact that there remains very substantial inflationary expectations. I would be prudent and moderate in the light of that.

I think moderation now calls for resuming a growth of liquidity of about normal, which is about what Mr. Shapiro and Mr. Weintraub are suggesting. I would not want to catch up with the shortfall under present circumstances, but I do think that the balance of risk at this point are on the downside and that there is a danger that inadequate growth of liquidity could turn the highly commendable and desirable policy strategy of a slowdown into a cumulative and costly drain.

Senator JAVITS. May I just ask one question, Congressman?

Are any of your views tied to a reversion of some kind of guidelines?

Mr. OKUN. Tied?

Senator JAVITS. In other words, does what you say about this modest increase and the monetary base relate also to the feeling that we ought to revert to guidelines of some kind on wages and prices?

Mr. ROOSA. Well, I feel we should, but I take the administration at their word that they will not, and it is partly for that reason that I feel we should stay longer with relatively tight money policy.

Senator JAVITS. Any other comment?

Mr. WEINTRAUB. The monetary policy I recommend is not tied to a resumption of guidelines. On the other hand, as I stated, I do favor, in the current situation, publishing guideposts as a warning to wage negotiations and price administrators in monopoly industries, including those in service industries, of the maximum upward adjustments they can expect in the future consistent with continuity of employment and output for industries experiencing average productivity gains.

Senator JAVITS. Thank you.

Mr. SHAPIRO. May I say for the record, then, there are really three people who have advocated guidelines in one form or another. I find myself in the uncomfortable position of being in the minority.

Representative BROWN. Mr. Shapiro set a schedule for adjustment in the monetary supply which, as I understand, calls for fairly prompt action——

Mr. WEINTRAUB. Right.

Representative BROWN. Mr. Roosa?

Mr. ROOSA. I am the equivalent of just moving sideways from where they are, and when I say 1 percent, I do not disagree with anything Arthur said about the difficulty of all of this. I was trying to respond in a symbolic way.

Representative BROWN. When do you think we should?

Mr. OKUN. As soon as possible. I have been advocating some kind of moderating move for monetary policy for four months. I think it could have been done more gradually had it been done earlier. Given the understandable fact the Federal Reserve was reluctant to make any visible display of easing until it was clear that the boom is dead, there is a call for a prompt and distinct move now.

Representative BROWN. Maybe we should call Dr. Burns this afternoon and advise him that you have averaged out about 2.7.

Senator PROXMIRE (presiding). Congressman Reuss?

Senator JAVITS. I want to thank the Congressman for the time.

Senator PROXMIRE (presiding). I want to thank him, too, for this unusual procedure, and he has been very patient.

Representative REUSS. Mr. Okun, as you know, at least Senator Proxmire and myself are very concerned about the fate of the economy and the administration's proposed method of dealing with it. We do not see much diminution in inflationary price increases, we are distressed at the highest interest rate in 100 years, and we are most unhappy about the notion that some 700,000 people who otherwise could have jobs are going to have to be unemployed, apparently in order to fulfill the administration's economic policies.

I thought, Mr. Okun, you were quite charitable in your paper where you complimented the Council of Economic Advisers for espousing a prudent belt and suspenders approach to keeping the economy's pants up. Wouldn't a more accurate metaphor, for keeping the economy's pants up, be requiring that the top button on the pants be buttoned to about the middle buttonhole on the vest, thus creating an arthritic condition which can be quite uncomfortable before we are through?

Mr. OKUN. That might be an uncharitable way of putting it, Mr. Reuss.

Representative REUSS. You are being tremendously helpful to us, and since Senator Proxmire and I are Democrats, and since Mr. Roosa and Mr. Okun, I think, fall into that category, the obligation is on us, it seems to me, to either approve of what the administration is doing or suggest some improvement. And that is why I think Chairman Proxmire pursued with Mr. Roosa his suggestion of a temporary freeze.

I think it was an interesting colloquy, because it gave Mr. Roosa a chance to give the setting for that freeze. I think you would probably agree, Mr. Roosa, that just having a freeze for 6 months and then forgetting about it would do more harm than good.

And I think you were trying to relate your freeze idea to a longer term incomes policy. Is that it?

Mr. ROOSA. That is it, that is certainly right. Yes, indeed.

Representative REUSS. Let me perhaps ask Mr. Okun to enter the discussion, too. Mr. Okun has made both today and in the past the suggestion, with which I heartily agree, that the wage-price guideposts should be revived and reinvigorated, and be arrived at in consultation with management and labor and other great segments of the public interest, and that their administration, such as it is, should be entrusted not to the Council of Economic Advisers, but to some new border agency, perhaps quite informal in nature, which would try to focus public attention on wage-price increases of an inflationary nature.

As Mr. Okun knows, I completely agree with his suggestion. I think it is too bad that we are not adopting it. It is a fact, Mr. Okun, is it not, that if the administration should start agreeing with you and me tomorrow, it would take some time to evolve and put into effect such guideposts? I think if we are going to do it right, you could not do that in a week. Would you agree?

Mr. OKUN. Yes. And I think one could perhaps mold Mr. Roosa's proposal of a freeze a bit.

Representative REUSS. You are answering my next question, so please go ahead.

Mr. OKUN. One could launch a decision to develop a long term and viable incomes policy, with an appeal by the President for the utmost of restraint during the period in which these things were being evolved.

I think businessmen and labor leaders would be very responsive to that kind of an appeal. They certainly would not want to seem to be in the position of jumping the gun on any kind of rules of the game that they might subsequently agree to.

I hesitate, for some of the reasons that Senator Proxmire pointed out, to suggest to any President that he put himself in a position where he was bound to be a loser, and he would be a loser if he asked for a general freeze.

We have commodity markets which will continue to operate, presumably produce some increases in prices in freely traded commodities, and those have to be reflected to some extent in manufactured goods. We had some already scheduled wage contracts, not new negotiations but second round increases.

I do not think you could maintain an equitable position of saying that none of these should take place, even though they were decided upon long ago.

Representative REUSS. I will put this to Mr. Roosa in a minute, but why not?

Mr. OKUN. By spelling out to some degree what he had in mind by asking for the utmost of restraint during a transition period, in which a more comprehensive, more equitable, more viable incomes policy, such as you and I agree on, could be developed. I think that would work.

Conditions have changed. I hope the administration does not feel that it has to close its mind on these things because of anything it said in the past. There were reasons to feel a year ago that the Government, that a new administration had to show its commitment to doing its part of the job, and I am not being just charitable, I am being honest in saying I think the administration has made an able and vigorous effort to use fiscal monetary tools appropriately in a very difficult situation.

They have demonstrated this——

Representative REUSS. What you are saying, though, that however admirable it is not enough, and we are concerned with how to make the thing work.

Mr. OKUN. We want that third leg on our two-legged stool, and I think the administration is in a position now to say we need some help, the Government cannot do this all by itself, it needs the cooperation of business and labor. And I think business and labor recognize that this is not the Government's battle, it is the Nation's battle for noninflationary prosperity.

Our past record is not very encouraging on getting a very prompt deceleration of prices in the short run or of maintaining the kind of high employment goals we would like for the long run without some major reforms of our institutions.

Representative REUSS. Let me, before putting this to Mr. Roosa, see whether our minds are still tracking. You have said that what you would like to see is one, any announcement that the wage-price guideposts will be reconstructed and revitalized; two, that in the roughly 6 months that it may take to do that, you think the President could well call on the American people to exercise restraint and to give a little more content to that. Would you buy the following formulation?—by restraint, I suggest the President should say that price be held generally firm, that there be no price increase, and that wage earners restrict their wage increase demands to a general figure which will not cause the piercing of that price standstill request.

The only point I disagree with Mr. Roosa—and I will turn to you in just a minute—I think he is unwittingly a little inequitable in asking for a total wage freeze during this period.

I think it is inequitable, because a total wage freeze I do not think is necessary to achieve the overall objective. But first let me ask Mr. Okun whether there is anything in my formulation which bothers him particularly.

Mr. OKUN. No; that kind of thing obviously would be worked over, and perhaps even prior to that announcement you would want to make some initial approaches to business and labor for reactions.

Incidentally, I would not even want to suggest that this administration revive the label "guideposts." I think they ought to have the right to put their own label on their package.

Representative REUSS. Operation Private Enterprise?

Mr. OKUN. Anything we suggest would be untenable for the very reason that we suggested it, Mr. Reuss.

Representative REUSS. Mr. Roosa?

Mr. ROOSA. I just want to say that in this proposal I am not trying to be dogmatic. I did also consider, I think, all of the reservations that Mr. Okun has mentioned, including the fact that the commodity markets will function; the world is not going to stand still while we do this. There will be a number of things that have to go on.

That is one reason why the short period is also relevant. I do think what I am suggesting does make sense, that there may be a chance—I know this has some aspects that will be inequitable—it will be inequitable to a lot of people if they adhere to it.

Even if you could impose the guidepost today, everyone who observes the guideposts from today onward is, for the time being, suffering an inequity against everybody who got a 15-percent per annum wage increase last week. You cannot escape that when you are getting out of inflation. I think it is a matter of trying to minimize the inequities.

I wonder, Mr. Chairman—I was a little timid, I guess—could I introduce for the record the paper I gave in December?

Senator PROXMIRE (presiding). I wish you would. That would be very helpful. Your paper will be printed in the record.

It will be included in your colloquy with Mr. Reuss.

(The paper follows:)

CONTROLLING INFLATION AND THE INFLATIONARY MENTALITY*

When Walter Hoadley, many months ago, gave me this opportunity for a return engagement at this luncheon, he hinted that there might well be something to talk about, by the year end, on the balance of payments and international finances. He was right. There is. Yet, dear as those subjects are to me, I have accepted the license he offered and am ranging into other territory. This is not to imply that I am complacent about the balance of payments; nor that I do not yearn to give you my version of the paradox that the dollar is presently very strong abroad, while the balance of payments deficit as recorded this year will be the worst ever, by twice. But I feel that the course of both of these, in the years ahead, depends upon what the United States does about inflation in 1970. So I want to use these precious minutes to consider some of the costs of controlling the inflation—an inflation that will vividly thrust itself upon you when you pay your hotel bill after these meetings.

During the past year, inflation in the United States has, it seems to me, been transposed from an economic phenomenon into a corroding force affecting the entire human condition. As economists, we share a heavy responsibility for having permitted this degenerative process to get underway, and to gain momentum. To be sure, the influence of this country's commitment in Viet-Nam pervades this inflationary process, as it does all other aspects of American life today. Yet at the pace of advance which the United States' economy was experiencing in the early sixties, an ultimate collision between inflation and full employment would almost certainly have arrived before the end of the decade, in the same way that it has in so many other countries, even without Viet-Nam.

Underneath the corrosive influence of Viet-Nam, the insidious characteristics of inflation *per se* are also now becoming unmistakeable: the loss of reliable standards of value; the protectionist scramble by individuals, and firms, and labor unions, and the Government itself; the shoddiness of deteriorating quality in goods and in performance; and the debasement of personal integrity. These go beyond mere economics to produce a deterioration in ethics, as well as in prudence

*Address by Robert V. Roosa, partner, Brown Brothers Harriman & Co., before the joint luncheon of the American Economic Association and the American Finance Association, New York City, December 29, 1969.

of judgment, which may not be simply reversed by a formalistic return to reasonable stability in costs and prices. The legacy of the inflation that the United States has already suffered will undoubtedly blight the potentials of the next decade even if that stability could be rendered today. Yet, despite protestations against inflation by practically everyone, the rate of inflation in prices and costs has actually been increasing up to the present month.

Wholesale prices, year to year, are up nearly 5 per cent; consumer prices, nearly 6 per cent; and labor costs, apparently over 6 per cent. Anyone in this room can probably suggest specific instances where the figures are twice that size, or larger.

While checking inflation, and restoration of the damage and distortion it leaves behind, are not tasks for economists alone, ours is certainly a key responsibility for diagnosis and prescription, both in terms of the shortcomings in what actually is being done, as well as in terms of what still needs to be done. Faced with that responsibility, we have never before, at least in my experience, been as resoundingly contradictory in our professional counsels. Our only full agreement, to my naked eye, is that inflation of the degree and dimensions now prevailing is not permanently sustainable within the American economy. In agreeing that this inflation must be brought under control, many, but not all, of us also go on to agree that the economy should not have to undergo either recession or depression as a cost of achieving control. But from there on, within the spheres of our own presumed competence, we are almost ludicrously divided, or perhaps more accurately fragmented.

This disarray is not, I suggest, for lack of a general consensus as to what initially went wrong, or what the principal early mistake was. Indeed the nature of the originating cause is as old as the history of warfare among developed societies. It was the Government's attempt to superimpose the costs of the escalation of the Viet-Nam war upon an economy already approaching virtual full employment—without incurring the opposition that would have been aroused by an appropriate and early increase in taxes. A succession of other miscalculations came afterwad, at various times, on the part of the Administration, the Federal Reserve, and both the employing and the employed within the private sector.

I suspect none of us would agree fully on which were the more critical episodes, after the early failure to match enlarged Government spending with larger revenues, but at this stage that scarcely matters. While a careful study of the entire sequence is important, for the guidance it may provide another time, the passing around of blame or grievances is not, I submit, particularly relevant for the diagnosis of where to go from here. That is where, I believe, Walter Reuther's December 18 letter to all of us economists misses the point. It does not matter now, for what lies immediately ahead, whether or not he is right in asserting that profits or prices, rather than wages, "triggered" the initial inflationary impulse. We are, I submit, in a new phase of the inflation, for which the capacity of our analysis is frighteningly inadequate.

A very crucial element seems to me to be missing from most of the prescriptions which now abound. In the effort to shift blame or disclaim responsibility, each of the various sectors of the economy, and their spokesmen among our profession, fail to recognize that when an inflation has become as rapid and pervasive as that in the United States, it takes on a character of its own. Everyone now has a share in the perpetuation of inflation, and not merely as victims. We all—as consumers, savers, investors, businessmen, workmen, or Government officials—have come to inject a new dimension into our decisions or demands: we assume that prices or wages or interest rates will be so much higher next year that every claim or every purchase we can make must be crowded into today or tomorrow.

As economists, you have knowingly recognized all of this, of course, as the "inflation mentality." But as economists, we have not yet sufficiently recognized, I believe, that we may need new methods or additional methods, to cope with the kind of inflationary pattern that occurs after that mentality has taken over. We cannot then get reliable guides to action out of our forecasting equations, no matter how high-powered the formulations, or the computers. As essential as model building has become for understanding the interrelationship among all economic processes, any adequate diagnosis and prescription in our present circumstances must also find some way of modifying the inflationary mentality itself.

How else can we begin to explain for example, wages and benefits that are currently being negotiated for annual increases of 10 percent or more, when every party to such contracts knows that the economy, as vast as its potentialities are, can never support increases of that proportion, nor probably of even half that proportion, out of annual increases in real output? Or how can anyone explain the persistent evidence that corporate capital expenditures are planned at ever-rising levels, with increases of a 10 percent magnitude scheduled for 1970, despite the tightest restraints on money availabilities that this economy has ever seen, short of the conditions of comprehensive wartime controls? Or how else can anyone explain the fact that prices across the board, wholesale and retail, are currently rising at the highest rates we have seen since the early months of the Korean War, despite overall monetary controls and a shift in the Federal budgetary position that have already applied restraints so severe that the rise in the real volume output has shrunk to the lowest rate in a decade?

Nor do I see any reason for reassurance simply because this slackening in the real advance in the economy has occurred; that, unless it reaches the disastrous scale of depression, can scarcely be expected to change anyone's inflation mentality. Indeed I see a rather sad perversity in the approach of many of our colleagues who express great satisfaction over what appear to be sidewise movements in some of the key indicators of real ouptut and who seem to regard a rise of unemployment as evidence of success in the anti-inflation program. I am even more bewildered by those who are so gratified by this odd kind of success as to argue that the time has already arrived for an easing of whatever restraints are still at work.

Some slowdown in employment and production may prove to be part of the unwanted cost of the effort to contain inflation, but these surely are not the objectives of the effort. The most fundamental way to defeat inflation is to produce more, not less.

I suggest that we have for too long taken as given the supposed inevitability of a rather rigid tradeoff between inflation and employment. To be sure, there will be some zone of reduced unemployment, as the figure drops into the 2 or 3 percent range, in which there is a high potential for price increases. And to reconcile, as in common sense we must, the superficial conflict this seems to imply between high employment and price stability is no doubt the overriding issue confronting economists in every developed country across the world. But the necessary reconciliation will not occur so long as we retreat into the grooves of any pre-ordained Phillips Curve. Over the longer-run, surely our most arresting challenge is to find ways in which both the shape and the position of that Curve can be changed. Such an effort, I feel sure, underlies the effort being promoted by the present Administration to improve the state of knowledge and mobility in the labor markets—through development of comprehensive data on job vacancies, and the centralization of personnel data on all who are involuntarily unemployed.

As important as all these and similar measures are, they cannot be ready for use on a comprehensive nationwide scale in time to help reduce any implications for employment of attempts to meet the inflationary menace that threatens in 1970. The nation will surely need, as promptly as possible, everything that can be put in place to improve the flexibility of the labor market and help assure the maintenance of an optimum level of employment in the future. But for 1970, I very much fear that we will also have to rely on something else.

The concern that many economists express over the continuation of the present restraints is rooted in a well-warranted fear that these restraints may, if continued at the present intensity, produce a significant downturn in the economy—some call it "recession;" others, seeking to alarm, call it "depression." While quite properly shrinking from the prospect of induced unemployment, both of manpower and of resources, those who recommend an easing of restraints now are, in my view, giving up too soon in the effort to bring about the slower pace of price and cost advances which is consistent with the longer run viability of the American economy.

Among those who foresee depression, there are some, notably Professor Friedman and his group, who have such sublime confidence in the validity of their one-track explanation of economic phenomena that they seem to think the basis has already been laid for controlling inflation. They believe that a return to easier money, along the straight line path that they would draw across the chart of time, will eventually restore balance and avert the slump which, otherwise, they view as inevitable.

As one who has never been able to share in the mysteries of the Friedman monetary school—though I yield to one one in saluting the crucial importance, year in and year out, of monetary policy—I can only consider the current edition of Friedman as another episode in his long record of nimble escapes from reality. Because he can be reasonably assured that responsible officials will not follow the course of any "philosopher king" he can smugly ascribe any misfortune that may befall the economy to their failure to follow his prescription. Indeed his prescription seems to change just often enough to leave him and his followers the opportunity of indicating, in the unlikely event that any official policy should ever be set on a Friedman-like course, that the officials had unfortunately chosen the wrong percentage of increase in the money supply, or perhaps use the wrong definition of money.

What disturbs me most, though, is that I fail to see how any version of the Friedman prescriptions can deal effectively with the inflationary mentality which, if I am right, has now become a force in itself. This is one of the shortcomings, I feel sure, that gravely troubles many others among our economist colleagues, including a number from whom I was privileged to learn much in past Administrations, and for whose views I have the highest regard. Even so, however, several of them have become at least mildly concerned that monetary policy has been too tight for too long. They are understandably apprehensive that any further application of the brakes to only the monetary wheel of the economic machine will send the economy skidding sideways into the ditch. To avoid that, they suggest, albeit in very modest terms, that some lessening of the monetary restraint will soon have to occur.

In all their comments, the Hellers and Ackleys and Okuns recognize that many of the forces of inflation are still running strong, and they propose other ways to counter them. They mention measures which aim at both twisting and shifting the Phillips Curve, for example, as well as urging a refreshing of competitive forces in the resource sectors as well as the manpower sectors of the economy. All of these I believe the country must have, over the longer run, if there is to be an effective reconciliation between the need for high employment and for reasonable price stability. Nor do I see any visible evidence of fundamentally different views on the part of the present Chairman of the Council of Economic Advisers, though he is also properly careful to avoid explicit urging of an easier monetary policy right away.

To me, it seems that their prescriptions for the kinds of positive action which should be introduced are quite convincing—though admittedly I have mangled them somewhat in this shorthand reference to them. But I am disturbed by the feeling of some that the economy can afford gently to release the brakes after having already gone so far, and crossed into so much new ground at very high cost, in the effort to check the upthrust of inflation.

Neither the economists of the previous Administrations, nor those of the present one, however, neglect the crucial importance of maintaining restraint on the fiscal side. But I am much afraid that the rapid slippage of the budgetary position, after making a swing of more than $25 billion from heavy deficit to small surplus a year ago, is already producing a dangerous new kind of stimulus. For with the current fiscal year now apparently headed for a slight deficit, and the next an even greater one, this country will be spinning the fiscal wheel of its economic machine while braking the monetary one. And that imbalance could be catastrophic, leading to a "bust" of the old-fashined variety. When inflation has already reached the psychotic stage, the prospect of the Federal budget slipping back into deficit, which now so clearly confronts us, simply must not be accepted.

With a restoration of fiscal discipline, there might well be grounds for some relaxation of the extreme strains now necessarily being imposed by monetary policy. But relaxation, on the basis of expected fiscal change, as 1968's experience will bear witness, can only be attempted at peril. It seems to me there can be on safe ground for relaxing the monetary grip until the fact of Federal budgetary surplus is assured. My own prescription is virtually the same as it was a year ago: to have a $10–$15 billion surplus.

Behind the bulwark of a sizeable surplus, the Federal Government could become a source of new funds, releasing these "forced savings" into the capital markets through repayment of some of its outstanding debt. The pressures on interest rates resulting from the long-imposed scarcity of available funds could be materially relieved. The convulsive changes in interest rates which, if long continued, threaten to disrupt the orderely pattern of relationships among the various kinds of financial assets—and among the various forms of debt for housing and municipal projects and corporate expansion—could gradually be replaced by patterns that can be sustained over time. Moreover, should any evidence develop that the net impact of the surplus and debt retirement were causing a serious slowdown of the economy, instead of simply making possible greater investment as an offset to inflationary demand, then the Federal Reserve could readily and safely relax, to avert a downward spiral of economic activity.

All of this requires, to be sure, a degree of harmonization between fiscal and monetary policy that depends not only upon congenial relations between the Administration and the Federal Reserve, but also upon a degree of skillful expertise, on both sides, which cannot always be presumed. Nonetheless, should this scenario be realized. I believe it would still be possible in another year or so, perhaps at the cost of a relatively mild recession, to dispose of the inflationary mentality. The American economy could then set out confidently on the longer run course of reconciling employment and price stability, freed from the distorting influences of the inflationary state of mind, and could take full advantage of the several newer approaches already mentioned (as well as one more, to be mentioned below).

That is the most hopeful among possible outcomes. Another, very much to be feared, now that the inflationary psychosis has become so powerful, is that the economy might slip into recession without producing any material change in the broad pattern of price, wage, and other cost increases. I think we owe it to ourselves, as economists, to face the possibility that the United States might over the months ahead get the worst of both worlds—a continuing, perhaps intensifying, inflation, as the inflationary mentality persists, while at the same time suffering the personal hardship and the losses of production that come inevitably with recession. Because this possibility exists, I think we have a professional responsibility to consider in cost-benefit terms another course of action—one which would not remove the need for fiscal discipline nor for monetary restraint, but which would introduce a transitional arrangement for dissipating the inflation mentality.

What I am asking is that we rethink the possible place of a wage-price-profit freeze, while all effort also goes forward to prepare adequately for the orderly reconciling of the nation's price and employment objectives once the economy emerges from this transition phase. To be sure, today's circumstances are not the wartime conditions that would either permit or require a full mantle of direct contols. And I hasten to make abundantly clear that this is not what I am suggesting that we appraise. Instead, I think the schizophrenia that most Americans now share—concern over the costs of inflation on the one side, and concern to seek out the best ways of protecting ourselves individually on the other—has become so disconcerting for nearly everyone that the country might take in stride a Presidential appeal to maintain all pieces and wages and dividends unchanged at present levels for a period of, say, six months.

The initial shock effect of such a Presidential request might in itself begin to tranquilize the inflationary psychosis. Although legal enforcement could probably not even be attempted, the fact that each transaction has two sides—the buyer as well as the seller—and that Americans do have a fairly reliable sense of fair play (if not pressed for too long) might assure a reasonable degree of self-enforcement for a relatively brief period. The same self-policing, within the terms of a general Presidential appeal, should also be able to accommodate, without the need for detailed Governmental guidance, those necessary fluctuations in particular prices from day to day or through the seasons that customarily reflect the inherent nature of certain commodities or services.

There are, of course, more objections to this kind of suggestion than I could possibly field if each of you were to begin tossing them up to me as I stand here this afternoon. Perhaps, on further and more careful reflection, we might all agree that the notion is not worth pursuing. All I am asking is whether—in our laudable desire to avoid a proliferation of controls and to sustain the principles of a market economy—we may be cutting ourselves off from systematic appraisal of a very limited and special form of control which may have a very limited and special relevance. At least it may prove to have such relevance at a time when inflation has been allowed to go on too long, and has become too powerful to be reached effectively by the existing general controls, in the manner in which these are presently being applied.

No doubt the case if any, for a freeze could completely disappear if a determined effort to gain a large Government surplus were to be made promptly and resolutely, in a manner that would persuade everyone that the Government would succeed in limiting inflation. But as scientists of a sort, we can scarcely be blamed if we do not take the certainty of such a substantial surplus for granted.

A temporary truce would not, in any event, remove the serious confrontation among the objectives of high growth, high employment, and reasonable price stability with which so many of us are concerned for the long run. If the truce were to be meaningful in establishing a conviction among most Americans that Government is irrevocably determined to use its powers in the future to prevent another recurrence of what the economy is now going through, the experiment might be worthwhile. Certainly a major turnaround from the present Christmas-tree version of the tax reform to a broadside increase in some form of taxes could do the same job. But whether that would be feasible before the country had suffered the cold douche of a freeze might be considered doubtful.

Somehow, people must be able to believe that prices can be reasonably stable again, that interest rates can settle at more nearly tolerable levels, and that wage increases can produce gains in real income rather than be totally dissipated through offsetting price increases. Then, and only then, can there be an assured prospect for the orderly resumption of the optimum use of all the unparalleled potentials of this economy. If that kind of conviction is to be developed over the longer run, I suspect there will have to be one more major addition to the tools of policy maintained by Government, as part of its effort to assure the continued effective functioning of the market economy—an incomes policy.

Few Americans are likely to have their inflationary convictions altered merely by an assurance that, following the freeze, there would be more effective harmonization of fiscal and monetary policy, to avoid any recurrence of such excesses as those the country is now experiencing. Perhaps such assurances would be enough eventually, I hope so. But at least until then, whenever a dissipation of the inflationary mentality permits the country to resume its efforts toward maintaining high employment, optimum growth, and reasonable price stability, I suspect there will have to be a reincarnation under some new guise of the ill-fated guideposts of the earlier 1960's. Those failed because they were relied upon as substitutes for responsible fiscal policy and were considered a basis for urging the Federal Reserve to avoid restrictive monetary measures, at times when the economy began bursting ahead at unsustainable rates. Certainly the appropriate use for any guideposts, whatever they may be called when the rebirth occurs, must be that of providing only marginal guidance. Without some helpful intermediation, however, the contest of power between employers and the employed, or between buyer and seller, might escape the impact of controls long enough to build up a chain reaction of disruptive consequences on the side of costs. We cannot forget that all of the other general controls are geared to impose limits on an overall demand pull. There should be some place, I would think, for a mediating influence upon factors of the cost-push variety, within a framework of general controls consisting primarily of fiscal policy, monetary policy, and in some limited degree the debt management policy of the Federal Government and its many Agencies.

I had occasion to urge the same approach when delivering the Per Jacobsson lecture in Washington on October 1, 1965, and I think the same words bear repeating here:

"... so long as monetary and fiscal policies are being directed to maintain an appropriate environment of expansion without inflation, thereby narrowing the open area over which certain key business decisions can be expected to range, the final patterns of such decisions can become reasonably responsive to a voluntary effort. The success of economic policy over recent years in maintaining price stability . . . has created an environment in which guideposts for overall wage increases have at times been crucially useful in avoiding settlements that otherwise could have caused an outbreak of cost inflation. At any rate, in my own view, effort along these lines offers much more promise, and less ultimate risk to the sustained functioning of a market economy, than the mere enjoining of management and labor to be 'responsible'—which has so often led only to debilitating industrial strife, partly for lack of a clear indication as to the meaning of 'responsible' from the public interest point of view. In these terms, the 'guidelines' sectors of economic policy may become a vital part of the useful influences which Government can exert from time to time upon the framework within which a market economy can flourish."

Those hopes were a little premature. But I would indeed urge, as you think through afresh the conditions for non-inflationary growth over the next decade and beyond, that you review again the case for what some of us a few years ago considered the three-legged stool of public economic policy for growth with price stability—fiscal policy, monetary policy, and the guideposts, otherwise known as incomes policy. And as you do so, in the context of other changes that may be under way in the sphere of general economic policy to improve the flexibility and mobility of labor and resources, perhaps some of you could also explore—with a thoroughness conspicuously lacking in these remarks—the pros and the cons of imposing a temporary price freeze to break the momentum generated by an inflationary mentality—in an economy where the infection has spread from the body to the mind.

Representative REUSS. May I suggest to Mr. Roosa and Mr. Okun, whose views I find very close to each other and very close to my own, may I suggest this to you, gentlemen, Chairman Proxmire was concerned before about whether the public would really pay much attention to such a patriotic request by the President, and there was some reference to history. Is it not a fact the reason OPA controls got to be unpopular toward the end of World War II was that those controls included not just price restrictions, but rationing of a great many commodities that were in short supply—sugar, automobiles, tires, and so on—which were very offensive to a lot of people and impinged on a great many people?

Is it not a further fact that we are not faced, happily, with that kind of hyperinflation or that kind of shortages now, and the imposition of a 6-month standstill therefore would not involve rationing or short-supply items, and thus the chance of such a patriotic request's being well received would be a good deal better than people might think?

Would you comment on that?

Mr. ROOSA. I obviously agree, so I leave that to Mr. Okun.

Mr. OKUN. I think one crucial element would be an absolute assurance that such an appeal would not be prolonged, but there would have to be some opportunies for the market to adjust subsequently, and this would put heavy emphasis on developing reasonable rules of the game and maintaining appropriate fiscal and monetary policies during the interim period, as well as thereafter.

I think there are a great many areas of administered prices today, where there would not need to be a fear of shortages, bare shelves, quality deterioration, and the like, which normally would accompany a comprehensive set of price and wage controls of a mandatory character.

I do continue to be concerned about the need for markets which are either public markets or more or less automatic in their carrying of supply and demand, to function effectively, so that we do not try to frustrate cases where the market is signaling for some adjustment in prices in either direction.

Representative REUSS. My time is up. You gentlemen are quite pessimistic about the chances of this proposal appealing to the President. But I would remind you that when I was at the OPA 25 years ago, two of the most dedicated controllers of prices that we had were Mr. and Mrs. Nixon, who then worked with us. So who knows; they might review some history themselves and come to adopt your views.

Mr. OKUN. Some of the people I know who feel the strongest opposition to any formal pricing wage controls are precisely the people who worked in OPA.

But I do think there is a big difference between the appeal for utmost restraint, even a standstill, as a transition to a more durable set of arrangements, during the period when cost push and not excess demand is driving the economy from one of establishing any kind of mandatory and formal controls on prices and wages.

Representative REUSS. Thank you.

Senator PROXMIRE (presiding). You gentlemen have all given us some very useful projections on your preferences for monetary policy. In fact, you have given us figures—increases in the money supply in the coming year.

One of the things this committee did in 1968 was to request the Federal Reserve Board to give us a report every year indicating financial flows paralleling the President's economic projections. And we thought this monetary information would be very useful coming from the most authoritative source and a very expert source. Chairman Martin understandably objected and said this would be giving away their stategy and this would be providing information which might be misinterpreted, and he was objecting for a number of reasons. But he did agree he would give us a staff estimate on financial flows.

Now, Dr. Burns in appearing before us shortly after he was named chairman, objected even to that, said that what they predicted, he took a look at what they predicted last year, and he said they were all wrong. All they did was provide us information. He said it was a fine staff but even the staff could not estimate what money flows would be.

We are in the position, where if we are going to make intelligent decisions and advise the Congress on economic policy, we ought to know as much as we can about this important monetary policy instrument and we cannot know it if we do not get some kind of useful advice.

I suggested just today—I have written Chairman Burns, and I sympathize with his position, because he also points out that he feels that people would make money if they were very alert to what was going on, would take this and in the short range if the Fed authorities said they were going to have a more expansive monetary policy, then you have a boom in the stock market, that it would reflect that for a few days.

I propose that we have a series of alternative projections, maybe three or four, in which they indicate what monetary policy would be if they have a substantial expansion in the economy, what it would be if it were more moderate, what it would be if the economy were level, what it would be if the economy leveled off somewhat. Then at least we would have some understanding of what the thinking is and what we can expect in terms of adjustment without providing any great rigidity in the monetary policy. We want them to do anything they feel would permit them to follow a flexible policy.

This is a tough question. You gentlemen are experts in the area and I would be grateful if you would give me your reaction to this.

Mr. Roosa?

Mr. ROOSA. I think reviewing three or four schematic approaches could very well be useful. I would agree with the implication of Chairman Martin's view, as I understand it, that the Board in carrying out its authority must avoid tipping its hand in advance. The financial markets are geared to anticipations. At this very moment and over the past couple of weeks anyone who was alert to it could have made a fortune in any of the long-term bond markets, because of the way in which interest rates on municipal bonds and long-term bonds have come down as much as 1 full percentage point. If he had a 20-year bond, that drop in interest rates might be equal to as much as 7 points in his price. And corporate bonds have behaved in the same way. If you had known ahead and bought those on margin, you could very well have taken care of your needs for the rest of your life.

And all this has been based upon the expectation—starting with the President's remark at his press conference the day before Mr. Burns was sworn in, and then his remark at the time of the swearing in, that the administration wanted more money and lower interest rates and viewed Mr. Burns' appointment as meaning that.

The market reaction which followed this—a market hungry for change, eager for relief of restraint—has been enormous.

Now, if at any time during this period there had been an occasion where Chairman Burns had to tip his hand to indicate to what extent he was actually fulfilling this wish—and every President has this wish, I am not criticizing the President, it is inevitable the Federal Reserve should be in the buffer position to some extent resisting such wishes—but if there had been any exposure here where that expectation could have been in any sense validated, the change in market rates, the anticipation, the way the market speculates and exaggerates at any given move, could have been twice as great. We have had an enormous move in the Treasury bill market—although the capital gain there is much smaller.

But all of this has occurred since the evening of January 30. These are enormous potentials for gain by a few. I think it absolutely important that, while people can make guesses, no one should have a way of knowing what the Federal Reserve intends to do at a given moment.

Senator PROXMIRE (presiding). Mr. Okun?

Mr. OKUN. I think there is obviously a conflict or trade off problem here between the maximum information and maximum security. There is a very real problem of security about Federal Reserve decisions and intentions, which Mr. Roosa outlined very effectively.

Perhaps some kind of alternative seminar such as you have indicated might be a way of having to cover a broader range of contingencies, and might be less subject to abuse as a violation of security or tipping of hands to the private market.

I think there is another danger in the release of information, that the Federal Reserve cannot and should not put itself in the position of locking itself into any kind of promises, that it should feel its way, it should not set its sight on any various specific target for any monetary magnitude.

I think, knowing Arthur Burns, he is the last man in the world to turn over the job of Chairmanship of the Federal Reserve to a computer that makes instantaneous calculations of the money supply. You want to look at all of the facts in the economy, and as I said in my statement, one of the uncertainties of the Federal Reserve is what fiscal policy is doing. I wonder whether there isn't some way of making the exchange of information and the exchange of intentions more reciprocal in providing the Federal Reserve with some clear understanding that this committee, perhaps other committees of the Congress, does have the firm intent of maintaining a properly disciplined posture in the fiscal policy decisions, which will be made during the coming year.

This is something which always plagues the Fed. They sit and ask what is the budget going to do, what is Congress going to do about expenditure and tax decisions. Often they have to ask how their actions may influence congressional decisions, and that was a terribly important problem in 1967–68, in which the Fed has received much less sympathy and understanding than it deserves. It recognized the emergence of a boom, but it also recognized that if it countered the boom with a tight money policy, it would undermine the economic and political case for the tax bill.

Senator PROXMIRE. There you had a situation where we had this terrific deficit in fiscal 1968, $25 billion followed by a surplus, a small surplus in 1969, about as sudden and powerful a fiscal turn-around as you could get and apparently it was rendered completely ineffective by monetary policies and other things because prices continued to rise and rose more rapidly than before. Fiscal policy did not seem to have impact and I cannot think of any fiscal policy that was more dramatic, that much of a shift in a short time. It did not seem to do anything.

Mr. OKUN. We did get a very progressive and gradual slowing of the economy after mid-1968.

Senator PROXMIRE. It did slow, but in terms of the price response.

Mr. OKUN. The prices and wages did not respond and that was very disappointing. There was no question about it. It took a combination of both fiscal and monetary tools ultimately to bring the boom to a halt.

Senator PROXMIRE (presiding). Mr. Shapiro?

Mr. SHAPIRO. All I can say in response to your question is I applaud the efforts of the Joint Economic Committee in your work on the Federal Reserve System. Moreover, I would applaud you even more if you amended the Federal Reserve Act to restrict the degrees of freedom open to the Federal Reserve Board to keep the money supply within the 2 to 6 percent band while we get some experience on how a more stable monetary policy would stabilize generally.

Senator PROXMIRE. You say we should amend the Federal Reserve Act?

Mr. SHAPIRO. Precisely.

Senator PROXMIRE. What we do now is simply have them to report to us and they agreed to do that. I think this is some progress, they do so when the money supplies fails to increase as much as 2 percent annual rate or exceeds 6 percent. They are free to go below 2 percent or above 6 percent but we think they ought to tell us why after they have done it.

Mr. SHAPIRO. All I am saying, I would go further than the Joint Economic Committee by imposing degrees of restriction to freedom now open to the Federal Reserve authorities, for I believe this would have the effect of avoiding the sort of stop-go monetary policies that we have experienced which have had adverse effects upon economic activity. Just as I think there was long and learned debate for the extremist arguments about a freely floating exchange rate versus a fixed exchange rate, and I applaud the general progress, both from the Joint Economic Committee and even among some central bankers, who introduced some degrees of flexibility in the exchange rate which does not get you into the problem of using either of these polar extremes. So all I can say, Senator, is I would wish you could amend the Federal Reserve Act.

Senator PROXMIRE (presiding). Mr. Weintraub?

Mr. WEINTRAUB. First, I would associate myself with Mr. Shapiro's remarks completely. Second, I would like to comment briefly on Mr. Roosa's concern about the Fed tipping its hand. I want to know what the Fed would tip its hand about.

Those who say the Fed should announce a near term money supply target are not asking the Fed to give away anything that would help money market speculators. Go back to mid-1968; suppose Chairman Martin announced that money supply would grow at the annual rate of 6 to 7 percent during the second half of the year. What good would this information have done money market speculators? Most people in money and capital markets believed the Fed would follow an "easy money" policy after the surtax was passed, and as a corollary that interest rates would fall. In fact, measured by money supply the Fed followed an easy policy in the second half of 1968. But yields generally were higher in December than at mid-year.

Consider the situation today. Suppose the Fed announced it would follow Mr. Shapiro's recommendation and increase the money stock at 4½ percent per annum for the near term future. Given this information, what bet will people make about interest rates? The answer is that some people will bet bond prices will rise and others that they will fall; different speculators will make different bets. There would be no tipping of the hand about the future course of interest rates.

I think that if the Fed were required to confine money supply movements within this committee's 2- to 6-percent per annum guideline the major effect would be to purge nominal interest rates of the inflationary and deflationary additives that have caused past wide swings in nominal yields. Speculators no longer would have to bet on whether inflation or deflation lies ahead. This would have a salutory effect on money and capital markets. It would allow full attention to be paid to the relative merits of individual securities and to long-term trends in real returns to capital.

Senator PROXMIRE (presiding). Mr. Brown?

Representative BROWN. I think perhaps there is no real political difference that reflects itself in the professional views of the Congress. But I would like to start at the other end of the table to ask everyone to comment on this question.

The indication is we have made some fiscal and, particularly, monetary errors in 1967–68. Dr. Burns suggested when he was before this committee that those were not errors of heart but, perhaps, errors of head, or accidental errors.

How do these errors occur? Were the signs being incorrectly interpreted at that time, or was the interpretation accurate but the circumstances were such that the expected results did not occur?

Mr. WEINTRAUB. I would like to begin by saying the following. The errors, in my mind, in monetary policy over the past few years, maybe the past decade, perhaps even since 1914, have occurred primarily because the Federal Reserve focuses on the wrong intermediate target variable. The Fed focuses on credit variables, on interest rates and free reserves. Our monetary authorities therefore get misleading indications of what their actions are doing. In the period we have just been through, for example, they have applauded themselves for being tight, when they were extremely easy, in my opinion. They said, "look, free reserves have fallen and interest rates have risen. See how tight we have been; banks and credit markets are starved." But in fact the money supply was rising at historically very rapid rates, more than 7 percent per year, for the near full employment economy we have had. Money supply grew rapidly because the Fed was sure its interest rate and free reserve targets were right and it used its open market and other powers to hit these targets and this involved rapid expansion of the monetary base and money supply.

What some of us wanted the Fed to do was to focus only on money supply and bring the annual rate of increase down below 6 percent. They finally have done this. Now let us hope they do not go too far in the opposite direction. Unhappily, past experience suggests it is naive and romantic to think they will not go too far in the opposition direction. I think therefore this committee must keep a very close watch on what the Fed does to the money supply in the next few months. There is a danger it will allow the rate of increase to fall below zero and that would be a disaster. I think that this committee should continue to request from Dr. Burns explanations of any shortfall in the rate of increase of money supply below 2 percent per annum.

Mr. SHAPIRO. I think in general I would agree with Mr. Weintraub and I am sure he meant to say it, but let me just add one point to his response. I do mean to impugn the Federal Reserve authority in terms of its intention, I think one can understand why they did what they did in the sense that they are not convinced as Mr. Weintraub is, that the money supply is an important variable. And under the circumstances, they looked at other variables, which gave them different signals, which both of us think were correct ones. The Fed was honorable and unconvinced of the wisdom of our suggestion.

Representative BROWN. You are suggesting, then, that they did not really take into account the money supply, as such, in their considerations, or did not place proper emphasis on it?

Mr. SHAPIRO. I think they tend to underestimate the money supply as a policy variable. That is right.

Representative BROWN. Dr. Okun?

Mr. OKUN. I think the Federal Reserve, first of all, deserves congratulations for one of the most outstanding successes in the history of stabilization policy in the 18-month period following the beginning of 1966. It single-handedly halted an inflationary boom, and it single-handedly prevented the subsequent slowdown from turning into a recession. I see no evidence that it could have accomplished that goal if it had been hogtied to a rigid set of rules or any monetary aggregate.

You can call the first half of 1967 minirecession, but calling it that name does not detract from the fact that it represented a practically painless transition to a state where the economy had an excellent second chance to get off the path of noninflationary prosperity in the summer of 1967.

Representative BROWN. But in fact, is that what happened? Didn't we go from that into a rather sharp inflation?

Mr. OKUN. No one can tell you exactly what would have happened if Congress had acted promptly when the President made his all out try for fiscal restraint in the summer of 1967. As you know, it did not. At that time prices were rising at a rate of about 2¼ percent a year. Subsequent to that, for the next year, monetary policy was conditioned, not by a concern about the interest rates on the Federal debt, but the Federal Reserve knew it was running much too accommodative a monetary policy in terms of any overall stabilization objectives. It felt strongly that monetary policy would not once again do the same job at the expense of housing, at the expense of financial markets. It was really a matter partly of equity and partly of political judgment, which turned out to be a losing bet, that the way to get appropriate mix of moderate amounts of fiscal and monetary restraint, which were indicated, was to stand back and help make the political and economic case for the fiscal restraint program.

Representative BROWN. Are you suggesting that there was an attempt to substitute fiscal restraint for monetary restraint which failed politically, because it did not get the action out of the Congress that the administration, or those in charge of our economic policy, hoped that they could get?

Mr. OKUN. Precisely.

Representative BROWN. And are you contending that it could have worked economically? I gather there is some difference of opinion because fiscal policy is regarded as an imprecise tool which doesn't lend itself to making fine adjustments in the economy.

Isn't that the difference that I detect in your positions?

Mr. SHAPIRO. It is also a difference in the interpretation of what in fact occurred. That is to say, this splendid golden era Okun talks about was an error when housing starts fell to an 800,000 rate, thereby causing a shortage of housing, thereby causing rents to go up, thereby causing the consumer price index to be raised by that particular element.

Moreover, I would remind you in 1966 you then had newspaper items about the collapse of the financial markets in August of 1966. Moreover, the level of interest rates was then the highest that we had ever experienced in our history since the Civil War.

So there is a question of how good it was, in addition to which it did cause a minirecession or at least I think it did, although other people may differ.

Mr. OKUN. I do hope we get out of our current slowdown with no bigger minirecession than the one Federal Reserve had in 1967. If we do, the administration would have had a remarkable success in economic policy.

Mr. SHAPIRO. That is quite right, and the probabilities of that are very small indeed because you had a 7-percent increase in the money supply in 1968.

Representative BROWN. I gather the consensus is that we are still experiencing now the results of policies undertaken then.

Mr. OKUN. It does seem to me it is a little like attributing the evils of the world to the incident between the serpent and Eve in the Garden of Eden, to believe that our entire inflationary problem today dates from a period of 3 to 5 months in the summer of 1968, when the Federal Reserve was admittedly way off course and basing its policy on an economic forecast, which I shared and which a great many economists shared, and which turned out to be dead wrong. It was wrong at that time.

There has since been a very substantial period in which a reasonable degree of monetary restraint had been applied, and a period of near 10 months in which there has been extreme monetary restraint.

I think you have to look deeper into the economic situation than to point to a short spurt in the money supply during the summer of 1968 to explain today's acute problem of price inflation.

Mr. WEINTRAUB. I would like to point out it was not a short spurt in the money supply in the summer of 1968. There was an ongoing increase in the money supply throughout 1967 and 1968, through and until the end of 1968, at an annual rate exceeding 7 percent. This is the type of thing that causes inflation, when you begin with high employment as we did.

I would also further point out that the percent monetary restraint did not become severe in 1969 until the second half. And I think that we should take into account, as we come out of the present inflation, this committee should take into account, what the past experience was and not permit the Federal Reserve to again resume policies that increase the money supply at annual rates of 6 and 7 percent. If they do, we will get renewed inflation.

Representative BROWN. Mr. Roosa?

Mr. ROOSA. The score is two and two. I would agree with everything Mr. Okun said. I think, in an imperfect world, the record of the Reserve policy over this period has been remarkable. And I think, as he says, that this economy would have suffered if we had been strapped to a single money supply target for Federal Reserve policy; it would have been something which would take a lot more to explain or to live through than anything we have experienced.

So I feel that, as you have observed, economists have differences. They also have phases and fads, and there is a fad now on the money supply. I had it back in 1936–37, and I outgrew it, and I have been back to it once some years ago. I suppose I may be back in it again, but I am out of it now, and so do not take these things all that seriously.

I think there were mistakes made. There will always be in manmade institutions. I think the Federal Reserve has learned a lesson insofar as the 1968 episode—the summer and autumn of 1968—are concerned. But insofar as the notion of following a single money supply target is concerned, and how we could have avoided all of the difficulty that followed in 1968 and 1969—I just cannot understand it. I do not agree with it, but I respect the difference of view. I think that is where we have to leave it.

Mr. SHAPIRO. Mr. Brown, may I say two things. In the first place, in response to Art Okun, I do not propose to go back to the Garden of Eden for history, and I would simply remind you that the Joint Economic Committee held some hearings in 1959 under the guidance of Senator Paul Douglas, an old colleague of mine, where the same sort of issues that you are now addressing yourselves to—namely, inflation—were the issue.

In my judgment, what happened was that the initial reaction of the Federal Reserve Board at least in 1953 was to respond with great slowness to the decline in the economic activity for the very understandable reason that they were not convinced the recession was present. In 1954, it took no evidence to convince them for it was right there before them. They responded with great alacrity and great dispatch to inflate the economy with excess liquidity which subsequently led to the sort of investment booms that finally led to the hearings on employment, growth, and price levels.

So I do not have to go back to the Garden of Eden for this particular historical event.

With respect to what Bob Roosa says, I would simply indicate to you—for I am sure he must have misspoken at least in terms of my admonition to Senator Proxmire—it is not that we have perfect knowledge, nor is it that I was asking for a fixed target date of increase in the money supply, I was simply asking that the Fed be bounded in its discretion, which is a quite substantive difference from a fixed rate of money supply increase, which I have not advocated.

Representative BROWN. Well, Mr. Chairman, my time has long since expired, but I do have some questions. I think it is particularly significant during our current economic situation to know what happened and whether there was an error and—if an error, what kind and what the causes were—a couple of years ago which set off what we are experiencing now.

I have some other questions, Mr. Chairman, which I would like to address individually or collectively to the panel. And, if I may, I would like to write them and get a response for the record. I am particularly fascinated by Mr. Weintraub's discussion with reference to the trade policy and the current situation. There are conflicting opinions on that. I do hope my last question has not prevented you from going to lunch together and continuing your discussion.

Senator PROXMIRE (presiding). I am not through with you gentlemen quite yet. France will have to do without my presence.

I would like to ask you, gentlemen, and Mr. Okun, you might lead off on this. We are very concerned about what the budget surplus really is. We have been told by some people it is an expansionary budget, that the $1.3 billion surplus is tenuous. It is going to disappear. Congressman Mahon pointed out that if it were reported on an administrative basis it would be a $7 billion deficit, and many people have pointed to various proposals in the budget that are unlikely to be carried out—cutting school milk, impact aid—administration itself seemed to be unsure about whether they are going to go ahead and sell $3.6 billion of mortgage assets. If they did, it would have a further depressing effect on housing. So that the budget may end up in a deficit.

At the same time, we have here from the Federal Reserve Bank of St. Louis, precisely the opposite interpretation in terms of the impact on the economy. They point out that this is a budget posited on the assumption of 4.3 percent unemployment. But if you assume employment at a higher level, that is with unemployment between 3½ and 4 percent, in other words a high employment budget, you would have a surplus for 1971 of $17.9 billion, according to the Federal Reserve Bank of St. Louis.

What is the Joint Economic Committee to assume based on these somewhat contradictory views of what kind of a budget we have? Is it expansionary or restrained?

Mr. OKUN. I think it is restraining, and I think the St. Louis bank is looking at it in the right way, although I have some difficulty tracking their numbers. I think their number is substantially too high for what they are trying to measure. But basically, that is the right way to look at the budget, and I think this came through in a number of the statements. We see it in terms of what it does to the economy and abstracting from what a change in the state of the economy does to the budget.

The 1970 and 1971 budgets reflect a current and prospective slowdown in income, which represents a short fall in Federal revenue.

Quite honestly, I am rather suprised that the administration did not develop that point in detail itself.

Senator PROXMIRE. I am surprised, too. We asked them and challenged them on the point the budget seemed to be—I did not have the St. Louis figures before me and frankly I did not pay as much attention as I should to the high employment concept—but we challenged them on the notion that this really is not going to be a surplus. It may be in deficit, but it is still a restraining budget.

Mr. OKUN. I think there is a good and valid case for arguing that the budget in terms of the expenditures and the revenue action it proposes is an appropriately moderately restraining budget. That case cannot be made by looking at the rates or the $1.3 billion surplus which is compounded.

Senator PROXMIRE. The question is if the figure is right, it is a $17.1 billion surplus which would be the biggest, I understand, since 1963. Anyway, the biggest in a long time.

Mr. OKUN. If I believed that figure, I might be concerned it was too restrictive, but I really do find it somewhat implausible. It implies that the revenue shortfall below full employment is something on the order of $15 billion, and there is nothing I know to suggest a number more than half that size. But still, one can reach the qualitated conclusion that this budget is doing its job of providing restraint.

Now, the question of how Congress responds to the President's recommendations and whether it adds to the budget and whether it decides as it did last year that tax cuts are appropriate, those questions are still to be resolved. They are in the hands of you and your colleagues now.

Senator PROXMIRE. I take it all of you gentlemen would agree we should in terms of the impact on the economy evaluate this in terms of full employment. If we do that, we have a concept that is going to be very hard to get across in Congress because not many people in the Congress or the public appreciate—I think maybe I am wrong—the full implications of a high employment surplus, which is relatively new among economists.

Mr. SHAPIRO. Mr. Proxmire, may I simply——

Senator PROXMIRE. I think it is a good direction. You all agree with Mr. Okun that this is a restraining budget in that sense?

Mr. SHAPIRO. I wish to congratulate you on having arrived at a consensus, I think, among the four people present in the first instance.

But if I may, and you will permit me, I can understand the difficulty in terms of conveying this information to your colleagues. A simple pedagogic device that I offer you simply because I think it is important to the national welfare, is to point out that the tax cut in 1964 was predicated on the high employment surplus that was then prevailing, which was preventing us from achieving high employment. And it may be you can make points with your colleagues in terms of their action and response to a similar budget number that was very effective in getting us a tax cut when it did.

Senator PROXMIRE. As Mr. Okun points out, this is a surplus in high employment terms, but it is very hard for any Member of Congress to convince his colleagues. They say we are going to end up with a deficit which we probably will.

Mr. SHAPIRO. All I hope, that leadership is exercised in various branches of the Government.

Mr. ROOSA. I just want to agree that the full employment budget concept is the appropriate one.

To footnote, however, I also stress that there will be times when the scheduling of cash surpluses has relevance in the total appraisal of the condition of financial markets. People who concentrate on the money supply do not pay as much attention to the total condition of financial markets, but I would put the emphasis there at times.

Then I would just put one final caveat, while I think it is extremely important that everyone understand the high employment budget concept, it is equally important that it be properly measured. I think in the St. Louis case it has not been properly measured. I have not been able to figure out what they have done to get that figure. It does certainly require an estimate of cash revenue far below anything that I can understand. So that along with understanding the concept, it is important that the numbers put into it are nearly accurate as the existing budget formulation permits.

Senator PROXMIRE. Are you gentlemen concerned about the adequacy of the supply of savings over the next few years in terms of this budget and monetary policy?

Mr. OKUN. I am concerned about the adequacy of savings. That is an argument for believing that most of the time we will want some significant, although not enormous surplus in the budget measured at high employment conditions, in order to relieve the burden on monetary restraint, to provide some Government saving in debt retirement to lubricate our financial markets, and in particular, to lubricate the flow of funds toward the essential homebuilding sector.

Senator PROXMIRE. Let me ask you, Mr. Okun, yesterday there was a very interesting article on our priorities in the New York Times by Max Frankel. He quoted you at some length and one of the things—maybe I misinterpreted the article—but one of the things seemed to be that you favored the setting of our domestic priorities and that they were vital to us and we should go ahead with them and stick to them and then vary the tax load to accommodate our military needs.

There was a fascinating proposal, because just yesterday we had some witnesses who argued that we ought to organize some political pressure balance to counteract the Pentagon, which has this enormous influence on the Hill, and this might be a very good way to do it. The taxpayers have a lot of potency and the Defense Department has a lot of potency which they should have. Is that correct?

Mr. OKUN. That is an accurate statement of my feeling. We ought to begin to make it clearer to the taxpayers that the appropriate way to pay the cost of national security is through taxes and not through squeezing nondefense social programs. Basically, we ought to be willing to trade some private butter for any guns we feel we must have, rather than putting all of the pressures downward on public butter.

Senator PROXMIRE. If we put something like that into effect now, there would be a tendency to say we are reducing the Vietnam war expenditures, defense expenditures. Military expenditures generally are diminishing, and therefore we would have a further tax ease.

Mr. OKUN. We have taken that tax cut in advance, it seems to me, Senator Proxmire, by eliminating the surcharge before the extra military expenditures the surcharge was designed to finance had been phased out. The quotation from me was written when the surcharge was still in effect. What I was proposing then was that the surcharge be phased out as defense purchases fell below $80 billion, in such a way that it would be phased out entirely when defense purchases fell to $68 billion. We are still a considerable margin above that defense expenditure and we have already phased out the surcharge, at least it is firmly scheduled for July 1.

So we start out with a debit balance on the side of our social priority expenditures, as I view it.

Senator PROXMIRE. You have had experiences as Chairman of the Council of Economic Advisers and this committee, several members of the committee criticized your report last year for a dearth of analysis of the economic impact of military spending. You did have some analysis but it was quite limited.

This year the new Council did worse. They had no analysis at all of military spending, zero. One of the reasons given was they do not have the staff to go into this in any detail. None of the expertise. If they do not have expertise in the area of economic impact, who does?

I agree they do not have expertise to tell us we ought to move ahead with procurement in certain areas, ABM or whether our military manpower is excessive, but at least they can tell us what the impact is and it is enormous.

In your judgment, is the staff sufficient, should we do our best to encourage them to increase the staff?

Mr. OKUN. I think it would be entirely appropriate to have a professional position on Council staff devoted to an analysis of the economic impact of defense.

Senator PROXMIRE. You need staff capability for this or do you think they have it?

Mr. OKUN. I am really in no position to appraise that.

Senator PROXMIRE. You were Chairman. Did you have staff capability when you were Chairman?

Mr. OKUN. It was not as good as it might have been in that particular area. It is a hard job to find a good economist with the intimate knowledge of the procurement area and of the defense impact to do the job. I think it deserves some priority and I would guess it would require some staffing by the council in that area.

I do see that Chairman McCracken serves on a defensive review priority committee and that in itself would undoubtedly increase his requirement for staff backup. I am sure he is alert to that need.

Senator PROXMIRE. Incidentally, I have a note saying the reduction from $30 billion to $17 billion by June 30, 1971, beginning fiscal year 1971, which is what Mr. Laird said in October would be the spending in Vietnam. The $30 billion in 1968 is going to $17 billion beginning fiscal 1970, and that parallels exactly what we lose in repealing the surtax.

Mr. Shapiro, you have competition between large established programs—defense, space, veterans, social security—and new programs aimed at curing our social ills, so that business feels it can count indefinitely on high government spending and instead of contracting to make room for these new programs, it goes full speed ahead adding to inflation. Does this fit with your appraisal?

There seems to be a ridiculous increase in plant equpiment this year, they are operating at less than 82 percent of capacity in the last quarter, they are probably down below 80 now. At least they are very low. Is this expansion in the face of vacant capacity because of the feeling that government is just going to continue to expand these programs regardless of administration statements of restraint?

Mr. SHAPIRO. I do not really think so. Unfortunately, I am not in a position to characterize a private expenditure with private money as ridiculous. The presumption is these people——

Senator PROXMIRE. I said it was ridiculous. I just think it is ridiculous in terms of looking at a situation where you do have vacant plants and capacity and yet you have a situation where they are expanding at a rapid rate. It would seem maybe a very good business judgment to assume they would have to pay much more for this if they wait 5 years. Maybe twice as much if they wait 5 or 10 years. Isn't there inflationary psychology behind that?

Mr. SHAPIRO. There may be some inflationary psychology behind it. I would say if we cool off the economy by the appropriate monetary and fiscal means, very shortly you will find the profits deteriorating even more. A most heartening sign in terms of anti-inflationary programs to me, at least, came with the report of the second quarter of 1969, pretax profits. If indeed plant equipment expenditures continue to rise, the presumption is that the total of demands is excessive and therefore these people anticipate that it is a wise business judgment.

I think the Congress of the United States and the Federal Reserve authorities can in fact control those particular expenditures by simply providing an environment in which the expectations about sales will be more bearish than they currently are. So I think the problem will solve itself in terms of the appropriate budget and monetary policy.

Senator PROXMIRE. You see, meanwhile you have a period of great misallocation of our resources. Because every indication seems to me we should have more resources in housing. We have unemployment in the construction trades growing rapidly, we have the worst housing shortage in 20 years, yet we have this dedication of so much of our resources to plant and equipment where we do not need more for the time being, certainly.

Mr. SHAPIRO. I am not at all sure who is to make the judgment on need. It seems to me that there are opportunities to pay 10-percent rate of interest, and housing will attract sources of funds that now go into Treasury bills. The need is the function of what people are willing to pay for this acute shortage of housing. The presumption is they are not willing to pay more, so their needs are not as pressing.

Senator PROXMIRE. Yes, but look at this from the standpoint of the home buyers. The person whose income is below $10,000 a year, according to every expert we can find, simply cannot buy a new home. So 70 percent of the people in the country are taken out of the home buying market. They need the homes. They want the homes, but they cannot buy the homes. And why? Because of the high level of interest rates.

You take the cost of the $20,000 home, you buy it with an 8-percent mortgage for 30 years and the cost of the house, the labor, the site, the lumber, everything in it, is $20,000 and the cost of the money is $33,000. This is what is preventing these people from getting homes.

Meanwhile, you have a situation in which resources move out of housing. One analysis showed 70 percent of the impact of the credit crunch of 1966 was in housing; 3½ percent of the gross national product got 70 percent of the impact. And you have something like it going on right now. This is not right. We ought to be able to somehow reorder our resources without interfering with people's freedom.

Mr. SHAPIRO. Mr. Proxmire, if indeed we wished to increase the availability of housing, I would certainly say that you put that then very high on your priorities, which means that you then have to free resources to go into the housing field. If indeed you feel that investment is excessive relative to the productivity of an input into the housing field, you can, it seems to be, by appropriate tax policy discourage plant and equipment expenditures.

Moreover, if we feel that other Government expenditures are too high, and hence are absorbing the resources, we can in fact by appropriation policy decrease the demand for resources in the Government expenditure side.

Senator PROXMIRE. Well, fine. That is why I get back to the bill I just ran over the floor to put in and I did not mean to say Arthur Burns approved the bill. He did not say anything like that. He did say he approved the principle of permitting mortgages to be discounted at the Federal Reserve window the same way the banks can borrow at six percent. The homebuyers' intermediaries could borrow at 6 percent. And the homebuyers at 6½.

I put a bill in to do this for people with income less than $10,000. It has a lot of cosponsorship in the Senate. It will not increase the money supply, provided you have complimentary open market operations by the Federal Reserve. If they put $3 billion in housing, they take $3 billion out elsewhere by selling their securities. What is wrong with that?

Mr. SHAPIRO. If the equal offset takes place, the results will be precisely as you specified. It will not in fact increase the money supply.

Senator PROXMIRE (presiding). This does not inhibit them from doing that. It is up to the Federal Reserve. If they decide to increase the money supply by 3 percent, put it all into housing this way, they can do that. If they do not, they can adjust the open market operations accordingly.

Gentlemen I want to thank you very much. I do apologize for keeping you so long, but this was a marvelous panel and you have contributed greatly to my understanding. I am sure the record is going to be most useful to members of this committee and members of Congress.

Thank you very much. This concludes our hearings on the President's Economic Report. The record will remain open for 10 days.

(Whereupon, at 1:07 p.m., the committee adjourned.)

APPENDIX

(The following additional questions asked by Representative Brown and answers thereto were subsequently supplied for the record by Mr. Roosa:)

Question 1. Last week, Dr. Arthur Burns, Chairman of the Federal Reserve Board recommended that Congress set a spending ceiling "with no escape hatches" for controllable or uncontrollable expenditures, the Administration or Congress. Do you think a comprehensive ceiling on Fiscal 1971 expenditures would be wise given the projected state of the economy? How would you view a proposal that Congress appropriate as much as it sees fit, with no mandatory spending requirements, and allow the President to determine what is a proper level of spending during a fiscal year?

Answer. An expenditure ceiling makes much more sense as a budgetary discipline that the debt ceiling which Congress has used for so long. Any hard and fast rule will encounter some need for exceptions, but even the authority for permitting exceptions should be carefully limited. I do think that a comprehensive ceiling on fiscal 1971 expenditures would be wise. To the extent that "built-in flexibility" is appropriate, that can best be provided in the short run through the effect of declining revenues, rather than by increasing expenditures. I do not think that Congress should appropriate money for projects without regard for the resulting overall total of all expenditures. It should attempt to establish priorities in order to fit the sum of all expenditures within an overall fixed ceiling. However, because the executive branch has responsibility for actually making expenditures, the President should have authority for deciding whether, or how much, to use any scope which Congress specifies for deviating from the ceiling.

Question 2. Dr. Shapiro indicated that the presently projected "razor-thin" 1970 budget surplus is appropriate because it is based upon a slowing economy, and if a recession begins to set in, the budget deficit that would quickly result would be properly counter-cyclical. However, will this budget be appropriately restrictive if the economy booms or grows faster than the Administration currently expects? Should Congress and the Administration focus more of their attention on insuring all federal budgets are balanced at high employment?

Answer. As I said in my oral response, the so called "full employment budget" is an appropriate concept for gauging the broad economic impact of budgetary decisions. In general, the full employment budget should provide for a substantial surplus when even full employment prevails. That will make possible, in effect, an enforced collection of additional savings through the budgetary process at full employment, with the proceeds used to retire Government debt and thus increase the flow of funds in the capital market. This kind of forced saving at full employment is far preferable to the alternative form that would otherwise be brought about through the inequitable and disruptive process of inflation.

So long as the data used in computing the full employment budget are reasonably accurate, there will be ample scope for the built-in flexibility which can make fiscal policy an active instrument of economic stability. This would imply that a "razor-thin" surplus or deficit would appear under conditions somewhat below full employment. If economic activity contracts further, a larger and larger deficit should be expected. This, at least conceptually, is what I would consider a properly counter-cyclical approach to fiscal policy. In present circumstances, I would think an actual budget surplus of several billion dollars would still be appropriate. This should make possible a moderate easing in monetary policy.

(The following additional questions asked by Representative Brown and answers thereto were subsequently supplied for the record by Mr. Okun:)

Question 1. During the fourth quarter of 1969, factory operating rates were at a 7-year low, profits were declining and the cost of money reached historical highs. Recently, we have found that industrial production, the gain in personal income and business sales are all declining, indicating to some that we are entering a recessionary period. However, a Department of Commerce-SEC survey conducted in November and December of last year indicates that business plans to increase capital spending in 1970 by 9.7 percent. Yesterday, it was reported that Pierre Rinfret expects capital spending to rise 12 percent in 1970, based on a survey of major manufacturing firms. And today the paper quotes the economic and investment counseling firm of Lionel D. Edie & Co. as saying business investment will rise 10 percent in 1970, compared to the 7 percent forecast last September.

How do you reconcile such a strong advance in business investment with the growing evidences of a real economic slowdown? Where does the business sector expect to obtain the money to finance this investment, given the tight money situation and the decline in funds generated internally? Given this generally forecast strength in business investment, do you think the fiscal policy currently projected will be adequate? Will there be any opportunity for monetary policy to ease?

Answer. The continuing vigor of business investment spending may in part reflect the momentum of an upsurge which began more than a year ago and which generated many new projects now moving into the stage of major expenditure. It also reflects, in part, the special needs for added capacity in public utilities, airlines, and communications industries. Investment in manufacturing is not surging ahead. As you suggest, these projected capital budgets would require a vast amount of external financing, and that need may indeed contribute to some shortfall in actual investment below the anticipations.

Actually, it will be reassuring if the forthcoming Commerce-SEC survey points to substantial continuing gains in business capital investment during the first half of 1970. In the present circumstances, precisely because other areas of the economy are temporarily tilting downward, the stimulus of investment helps to maintain the balance. On the other hand, for the second half of the year, a levelling off of investment plans would be desirable, and the indicators on appropriations and orders suggest that that may indeed be forthcoming. In that event, it would be most appropriate for monetary policy to focus on the second-half horizon and to make the prompt and distinct move toward ease that I have urged in my statement.

Question 2. Last week, Dr. Arthur Burns, Chairman of the Federal Reserve Board recommended that Congress set a spending ceiling "with no escape hatches" for controllable or uncontrollable expenditures, the Administration or Congress. Do you think a comprehensive ceiling on Fiscal 1971 expenditures would be wise given the projected state of the economy? How would you view a proposal that Congress appropriate as much as it sees fit, with no mandatory spending requirements, and allow the President to determine what is a proper level of spending during a fiscal year?

Answer. The unpredictability of Federal expenditures is one of the most serious complicating factors in the determination of Federal Reserve policy. Undoubtedly, a very firm ceiling on Federal spending would make the awesome task of formulating monetary policy a little easier. At the same time, if the Congress enacted a rigid ceiling, it would be retreating from its responsibilities for determining the allocation of Federal expenditures. In implementing such a ceiling, the President would have to be given the authority to determine the proper level of spending for a great many programs during a fiscal year. If the appropriations total is clearly inconsistent with the level of the expenditures ceiling, then the legislative appropriations process would become a mere formality.

On the other hand, a rigid spending ceiling that was reasonably consistent with the appropriations total would have little economic effect and could have significant adverse impacts on priority areas. If, for example, agricultural price support payments—which are largely uncontrollable in the shortrun—should bulge $500 million above the budgeted level, I would personally rather see the overall budget contain that modest overrun, rather than witness a compensatory $500 million slash in manpower or education programs. If the Congress carefully adds up the totals in the appropriations process and diligently monitors new developments in uncontrollable areas, an expenditure ceiling would be unnecessary on economic grounds and would be counterproductive on social priority grounds.

Question 3. Dr. Shapiro indicated that the presently projected "razor-thin" 1970 budget surplus is appropriate because it is based upon a slowing economy, and if a recession begins to set in, the budget deficit that would quickly result would be properly counter-cyclical. However, will this budget be appropriately restrictive if the economy booms or grows faster than the Administration currently expects? Should Congress and the Administration focus more of their attention on insuring all federal budgets are balanced at high employment?

Answer. In the highly unlikely event that the economy should significantly exceed the path predicted by the Administration, the budget would be inadequately restrictive and consideration of added fiscal restraint would become appropriate.

In general, I heartily agree that both the Congress and the Administration should focus more attention on the balance of the Federal budget at high employment. Under normal circumstances, a significant—although not enormous—surplus at high employment will be desirable; only under circumstances where private demand was faltering or monetary policy was unusually tight would one wish a budget that would be in deficit even at high employment.

This is an area which is very close to my heart and I would like to take the liberty of quoting my own proposal in this regard:

"Experience suggests that, to promote a balance between overall supply and demand without inflation and without monetary restraint, the federal budget should normally generate a small surplus under conditions of full employment. Each presidential budget should focus on the full employment surplus that is being recommended as the key decision variable of fiscal policy. It should explicitly state that the full employment surplus is being increased in order to provide restraint on aggregate demand (or more room for monetary ease); that it is being reduced for the reverse reasons; or that it is being held constant. That decision can be defended only on the basis of a forecast of aggregate demand, prices, and monetary and credit conditions. Such a procedure would not freeze the full employment surplus or search for a magic number; but it would place on the President the burden of proof for any shift in fiscal impact he would advocate.

"Once the budget is submitted, Congress should review the proposed fiscal impact explicitly, approving or modifying the President's recommendation. Subsequent actions taken by the Congress to modify the President's budget program should be monitored for their effect on the full employment surplus."

(The following additional questions asked by Representative Brown and answers thereto were subsequently supplied for the record by Mr. Shapiro with a supplementary statement:)

Question 1. Last week, Dr. Arthur Burns, Chairman of the Federal Reserve Board recommended that Congress set a spending ceiling "with no escape hatches" for controllable or uncontrollable expenditures, the Administration or Congress. Do you think a comprehensive ceiling on Fiscal 1971 expenditures would be wise given the projected state of the economy? How would you view a proposal that Congress appropriate as much as it see fit, with no mandatory spending requirements, and allow the President to determine what is a proper level of spending during a fiscal year?

Answer. Until we have a more effective mechanism for evaluating alternative Federal expenditures, the use of a ceiling on expenditures will have the salutary effect of requiring careful Congressional evaluation of one kind of expenditure relative to another. Clearly I am not fearful that a major recession is imminent. Hence the specific limitation on Federal expenditures will not magnify the hoped for slowup in total expenditures both public and private.

Question 2. You indicated that the presently projected "razor-thin" 1970 budget surplus is appropriate because it is based upon a slowing economy, and if a recession begins to set in, the budget deficit that would quickly result would be properly counter-cyclical. However, will this budget be appropriately restrictive if the economy booms or grows faster than the Administration currently expects? Should Congress and the Administration focus more of their attention to insuring all federal budgets are balanced at high employment?

Answer. There are many measures used to assess the impact of Federal fiscal policies. As I have indicated in my testimony, the most useful measure is the balance (balance, surplus or deficit) in the national income and product account budget which would occur if the economy were operating at high employment—the so-called high employment budget.

This budget gives a much clearer picture of Federal fiscal policy than does the balance in the *actual* national income and product account budget. The magnitude of the *actual* balance depends upon the level of Federal spending on the one hand and on tax rates and the level of income on the other. As income levels vary from the high employment level, the *actual* surplus or deficit will differ from the high employment budget position.

To get a measure of how the impact of the Federal budget position is changing in its influence on the economy, *it is important to separate the effects of the budget on the economy from the effects of the economy on the budget.* The high employment national income budget measures these effects on the economy while the *actual budget balance* does not. Therefore, when assessing the impact of the budget on the economy, the Congress should center its attention on the high employment budget.

As I said in my testimony, given the outlook for the level of private demands and the goal of maintaining levels of demand which are consistent with a reduction in the rate of increase in prices, the high employment budget surplus of some $11 billion anticipated for calendar 1970 suggests that the budget position of the Federal government is deflationary. This may be desirable currently because of my earlier references to the necessity for a more expansive monetary and credit policy to be made effective immediately.

Question 3. You say, "The current U.S. Inflation is the result of excessive total spending for goods and services by government and by the private sector." On Monday, private economists told this Committe that low rates of industrial capacity utilization, as indicated by capacity indexes, and an unemployment rate continually high by world standards indicate that at no recent time has the economy been pressing against its productive capacity. How could total spending have been excessive if this were the case? Would you agree we have not seen the economy reach the limits of its supply capability, "but for a few quarters in 1966"?

Answer. The U.S. economy has been experiencing levels of actual output at or slightly above its potential (at stable prices) as measured by the Council of Economic Advisors until very recently. This fact, together with the behavior of prices, is the evidence I consider relevant to the issue of inflation. Therefore I do not accept the proposition that the economy has been operating below its supply capability since late 1966.

Contrasting measures of unemployment in the U.S. with those abroad is irrelevant since these figures are derived very differently. What is evident is that the unemployment rate in the U.S. for most of the period since Viet Nam has been substantially below the level that is normally regarded as high employment and it has been achieved at the cost of inflation.

The behavior of business firms in their investment decisions suggests that while the rates of capacity utilization may be lower than was true earlier, there is still considerable incentive to add to the stock of capital. Investment expenditures which have persisted at a high level in spite of lower levels of capacity utilization suggest a high level of total demand is anticipated by business.

Supplementary Statement

There were numerous historical references to wage and price guidelines, incomes policy and jawboning. I observed with interest that there was no precise definition of these terms. It is, therefore, difficult to evaluate their historical record, for presumably each of these "instruments" has unique characteristics. Because of the resort to history in attempt to solve a current problem, I am pleased to enter my remarks pertaining to these devices in the record.

One defense of wage and price guidelines was given by Mr. Roosa. In effect, he argued that wage and price guidelines are as I would put it "as American as apple pie" since we have a long history of regulating the prices that utilities may charge. This statement is misleading on two counts. First, while I am not asserting that the deterioration of the services furnished by the regulated industries currently is caused by the price regulation and its inadequacies, it is at least a possibility that inadequate price regulation has been responsible for the deterioration of services provided by the utilities. Far more important, however, is my feeling that the analogy between price control measures and regulation of the prices of utilities is extremely misleading. We grant by law monopoly power to utilities hence we must regulate their prices. Since there is no free entry in the utility business it would be tragic if indeed having granted monopoly power to a firm that we did not regulate prices. However, the irrelevance of this analogy to wage and price guidelines clearly is underscored by the fact that entry is not regulated or restricted for nonutilities in the economy. In fact, we have a public policy which is enforced by the Department of Justice to insure that entry is free and we depend upon competition to set prices. If it were not for free entry and competition there would be no justification for the present market system at all. Hence the presence of competition and the government granting monopoly power in the utility field are two quite different animals. Hence one can not argue by analogy the desirability or the justification for wage and price controls for the economy from the experience of price regulation in the monopoly situation of utilities.

In his discussion Mr. Roosa cites the two experiences with incomes policy in the United Kingdom. I think these citations are extremely revealing. He admits, as does everyone else, that the first experience with incomes policy broke down. He asserts that the second experience was more effective. This is not to argue that it was effective but surely by contrast with the first experience with incomes policy in the UK it must be characterized as more effective. Granting this fact it is noteworthy that a deflationary fiscal and monetary policy was not pursued in the first experience with incomes policy in the UK and hence that system broke down. While it is not at all clear that the second experience with incomes policy in the UK was a tribute to incomes policy, it is more evident that the second experience with incomes policy was associated with an extremely deflationary fiscal policy as well as a restrictive monetary policy. Thus, at the very worst I would argue that incomes policy without a stabilizing fiscal and monetary policy will not work at all. I would further argue, though I cannot prove it, that with an effective stabilization policy, i.e., a deflationary fiscal and monetary policy, an incomes policy would have been unnecessary.

Thus I conclude that if we have two stools, i.e., fiscal and monetary policy as referred to by Mr. Okun and Mr. Roosa, and these are used correctly, it is unnecessary to have the third stool—incomes policy—as they assert. The UK experience does not demonstrate the need for the third stool at all.

Mr. Reuss in his nostalgia talked about the effectiveness of price stabilization during World War II when we had an Office of Price Administration. It is not without interest that he indicated that, in his judgment, the important element which made for the effectiveness of price controls during World War II was that they were tied to a rationing system. I could interpret this, and I believe he implied, that the price control system would not have worked in view of the expansive monetary policy during World War II and the fact that our budget was substantially unbalanced. The expansive monetary and fiscal policy provided purchasing power to the public which would have led to a breakdown of the price control system. The rationing system was in effect a short-run capital levy on people. They were not able to use their purchasing power, for red points and blue points were substituted for money as the means to acquire goods and services. Thus the analogy to the success of price controls during World War II was that you had an effective monetary and fiscal policy through the use of a capital levy and the provision of blue points and red points were substitutes for money. I would therefore argue that if price control was effective during World War II—and I am one of the people who believe it was—it was because of the substitution of a new form of stabilization instrument which was a substitute for fiscal policy and monetary policy.

I would remind you of what I said in my testimony which runs as follows. The approach to guideposts requires that (1) the government state a standard of wage and price behavior and (2) business and labor must adhere to this standard with minimum compulsion by government.

It is not easy to specify a standard for wage-price behavior. You may recall that in January, 1962, the President's Economic Report specified a productivity standard. Hourly wages must rise in line with average gains in output per worker. Prices should be stable—declining in lines where productivity rose more than the average, and rising where gains in productivity were less than the average.

This seems like a simple and clear standard. Yet it became increasingly clear with the passage of time that exceptions were needed. Exceptions to wage increases were justified in industries where wages lagged behind; exceptions could also be made where workers were needed in geographical areas or in particular occupations. Exceptions to price behavior were also added: if capital needed to be attracted, higher prices could be posted; also if costs other than labor rose, price increases were permissible. While these and many exceptions were mentioned no specific quantitative content was or could have been given to them.

This gives rise to the major problem with guideposts. The problem is how do we enforce nonquantitative standards. The experience between 1962–1966 is replete with instances where the federal government actively intervened in labor negotiations and price decisions (steel, automobiles, aluminum, etc.).

There was some discussion about historical experience with wage-price freezes. It is not without interest that in the middle of January the Canadian government had asked industry for a two-month nationwide moratorium on price increases. As Mr. Roosa suggested in his testimony about U.S. business favorable attitude toward wage-price control, business in Canada was favorable to this proposal. The Canadian Manufacturers Association said that it would support the government's anti-inflationary program. The Prices and Incomes Commission has campaigned unsuccessfully for several months to get business and labor leaders to agree on guidelines for wage and price restraints. The two largest unions in Canada rejected voluntary restraints in what amounted to a major setback for the Commission late in 1969. Currently the Commission has tentatively set a meeting with business leaders to pledge support for price restraints.

I would ask the members of the Legislature who are thinking of wage-price freezes to ask themselves if they would be in a position, or anybody they know would be in a position, to police the following recommendations as announced by the Canadian Manufacturers Association when it agreed to support the incomes policy. Mr. L. S. Wills, the President of the Canadian Manufacturers Association, said that members would be guided by the following recommendations:

"A firm would be justified in raising a domestic price or prices only if it finds that without such an increase or increases its . . . net profit on its entire sales anticipated for the year 1970 would show decline compared to that of some appropriate base period or that the return on capital invested would otherwise be inadequate by any reasonable standard of comparison.

"A firm would be expected to reduce a domestic price or prices in cases where its present net profit on its entire sales anticipated for the year 1970 would otherwise increase as a result of declines in costs and where at the same time the rate of return on capital invested is already adequate by any reasonable standard of comparison.

"Where requested to do so firms would keep the Prices and Incomes Commission informed of major changes in their pricing policies and would cooperate with the Commission in price reviews which it finds desirable to initiate."

(The following additional questions asked by Representative Brown and answers thereto were subsequently supplied for the record by Mr. Weintraub:)

Question 1. Last week, Dr. Arthur Burns, Chairman of the Federal Reserve Board, recommended that Congress set a spending ceiling "with no escape hatches" for controllable or uncontrollable expenditures, the Administration or Congress. Do you think a comprehensive ceiling on Fiscal 1971 expenditures would be wise given the projected state of the economy? How would you view a proposal that Congress appropriate as much as it sees fit, with no mandatory spending requirements, and allow the President to determine what is a proper level of spending during a fiscal year?

Answer. (*a*) I am against putting a "no escape" ceiling on Fiscal 1971 expenditures, as was suggested by Chairman Burns. (I assume any such ceiling would be set in the neighborhood of presently contemplated spending for Fiscal 1971.) To begin with, any such ceiling would have to allow the Government to provide funds for unforeseen expenditures to which we now are committed under historic programs, such as unemployment compensation, which link spending to economic trends. Furthermore, even aside from these loopholes, any such ceiling would, I believe, prove not be escape-proof because the costs imposed by taking it seriously would turn out to be unacceptable.

Expenditures must be tractable to permit deciding rationally whether to provide funds to meet emergencies that develop in particular programs. Lockheed's request, as reported in the newspapers on March 6, 1970, for $600 million to enable that company to continue working on four ongoing defense projects is an example. If there now was a no-escape spending ceiling, the Administration could not subject Lockheed's request to some rational cost-benefit analysis. Since such a constraint would surely be unacceptable any overall spending ceiling would have to be waived to allow the Administration to determine rationally whether to meet emerging contingencies in particular programs. The ceiling would therefore prove, I believe, about as meaningful as the continuing attempt to put a ceiling on the debt has proven.

But moreover, it is difficult for me to see what benefits would derive from imposing a spending ceiling which could not be obtained otherwise. Over the long run budgetary prudence requires only that the Congress carefully screen and prune expenditures requests, especially those that involve projects that start out small but commit us contractually to large expenditures in future years. However, it is in the context of the short run that a no-escape expenditures ceiling must be viewed.

For the short run, the aim of Dr. Burns' proposal would appear to be to combat the present inflation. But, as I pointed out in my testimony, fiscal policy changes are not likely to have much impact during inflationary periods when money demand is insensitive to interest rate changes. Furthermore inflation can be controlled, though only slowly and not without generating some unemployment, by appropriate monetary actions; specifically by limiting growth of our circulating media in 1970 to 2–3% per annum.

Finally, I would add that my opposition to a budgetary ceiling does not require (as a mater of logic) that I also must oppose a money supply growth rule. Budgets sum expenditures for particular purposes. It is unwise to restrict the total because the particulars have independent significance and it is difficult if not impossible to plan ahead for particular contingencies. Projects in process often prove more costly than expected. Also entirely unforseen spending purposes arise year after year because of natural and man-made crises both home and abroad. Thus flexibility is required in the spending process. On the other hand, the elements of the nation's money stock are of no importance in themselves but rather have significance only as they affect the total quantity of money. Thus, unlike in the case of budget expenditures, a rule for growth of the total money stock can be designed without worrying about the behavior of its individual parts.

(*b*) I also am against the proposal "that Congress appropriate as much as it sees fit, with no mandatory spending requirements, and allow the President to determine what is a proper level of spending during a fiscal year." My opposition to this reflects a philosophical preference for continuing Congressional control over the allocation of federal tax receipts and other expenditures sources. This allocation is, I believe, currently responsive to a broad spectum of needs (or at least demands) primarily because small groups without a national political base can express themselves openly and forcefully; as they now can through individual members of the Congress. Personally, I like this sort of responsivity.

Question 2. You maintain in your statement, "nominal interest rates always reflect inflationary expectations, and these in turn are shaped by past inflationary experiences." Do you think it is possible to effectively reduce interest rates without moderating the rate of inflation? You say you look forward to the time when interest rates again are "devoid of any inflationary additive and reflect solely the real rate of return on capital." To what levels would you expect to see long and short term rates fall once inflation and inflationary expectations are eliminated?

Answer. I do not believe that interest rates can be reduced without moderating the rate of inflation. As I indicated in my testimony, in equilibrium nominal interest rates are the sum of real returns to capital plus the expected per annum percentage rate of inflation. I see no practical way of reducing real returns to capital over the near term future. (Over the long run population control would have this effect by increasing the capital-labor ratio.) Thus, to reduce interest rates over the near term future, the public's current inflationary expectations must be broken. Since these expectations "are shaped by past inflationary experiences" it is essential that the ongoing inflation be ended if we are to reduce interest rates.

In a time without inflation, I would expect to see both long and short term yields on U.S. Treasury securities to recede to the 4–4¼% level. Such were the prevailing interest rates in the first half of 1965, just prior to the emergence of the first stage of the present inflation. But we won't see interest rates at this level until the public is convinced that the current inflationary problem has been licked, and this will take one to three and perhaps even five years of the sort of price behavior we had in the first half of 1965.

Question 3. Dr. Shapiro indicated that the presently projected "razor-thin" 1970 budget surplus is appropriate because it is based upon a slowing economy, and if a recession begins to set in, the budget deficit that would quickly result would be properly countercyclical. However, will this budget be appropriately restrictive if the economy booms or grows faster than the Administration currently expects? Should Congress and the Administration focus more of their attention on insuring all federal budgets are balanced at high employment?

Answer. (*a*) To most economists the 1970 budget would not "be appropriately restrictive if the economy booms." However, as stated in my testimony, I would not expect policies designed to increase the surplus (e.g., expenditures cuts or delays, reimposition of the surtax, *et al.*) to halt a 1970 boom if one should develop. Once again, my reason stems from my belief that money demand is interest insensitive when interest rates contain an inflationary additive, and if money demand is interest insensitive the standard macro model implies that adoption of tight fiscal policies will have no effect on economic activity. Moreover, I think that today most economists, fiscalists as well as monetarists, share the view that the boom that began in the early 1960's (I would put its conception in the fall of 1962 and its emergence six months or a year later) is over. The problem now is to avoid recession while the inflation abates. For the world, then, that now is emerging the 1970 budget is, as Dr. Shapiro indicated, "appropriate . . . properly counter-cyclical."

(*b*) Concerning the second part of this question, I would favor a continuing attempt, year after year, to program policies designed to balance federal expenditures and receipts at high employment, say 3 1/2–4%. A possible defect in this strategy is that under it the Treasury could not itself retire debt. Debt retirement would however take place in the real sense, that is in the sense of reducing the associated tax burden. This burden would fall as the Federal Reserve exchanged base money (currency and reserves) for Treasury securities held by the public and banks in carrying out open market operations designed to increase the money supply consonant with real growth. Both fiscal and monetary policy formulation would benefit, I think, if this obvious by-product of the money supply process was recognized formally, as could be done simply by consolidating the accounts of the Federal Reserve and the Treasury. The fact is that Federal Reserve holdings of Treasury securities are not part of the Federal debt in any real sense, and failure to recognize this only obscures the interrelationship between fiscal and monetary processes.

Question 4. You suggest that reductions of barriers to international trade would have an important effect in stimulating competition and reducing inflationary pressures in this country. This sounds like a particularly appropriate policy during times of tight labor markets and substantial price and wage pressures. Were the GATT reductions in tariff restrictions on international trade in the early 1960's suitable for the economy that prevailed at that time? Isn't your recommendation really of a longer range nature than other policies proposed to reduce inflation over the next 12 to 18 months? Do you feel your recommendation might be politically less popular than other measures, given the effect that reductions of import restrictions might have on employment in certain domestic industries?

Answer. Reductions to barriers to international trade are beneficial whether we are trying to dampen an inflation or to stimulate recovery from recession. I would agree that the policy is especially appropriate "during times of tight labor markets and substantial price and wage pressures." But I believe also that it is beneficial in recession and recovery periods. Viewed in terms of money demand theory, the imports of more goods at lower prices increases the public's holdings of real cash balances and this in turn stimulates spending on domestic goods and services. Any production fall-off in sectors competing with the now lower priced imports is thus overwhelmed in the economy in-the-large.

The point that needs to be stressed in this matter is that reductions to barriers to trade (domestic as well as international) operate to increase aggregate real income and also to decrease prices in sectors where trade restrictions have been removed. For the economy in-the-large both effects are beneficial regardless of whether the prevailing trend is inflationary or recessionary. But for the sectors directly impacted by reduction of the barriers, costs are imposed. Such costs should not however deter us from reducing existing barriers to trade. The government can provide adjustment assistance to those who must adapt by moving, whether labor or capital.

The recommendation to further reduce barriers to trade should therefore be viewed as timeless. Such reductions will however operate to reduce the present inflation. Clearly from the economic standpoint now is as good a time as later to reduce trade barriers. From a political standpoint opposition to reductions in trade barriers is sure to be vigorous because, unlike in the cases of other policies, those harmed by such reductions can readily see the cause of their problem. But the opposition to reductions of barriers to trade will organize no matter when they are put into effect. Thus, from the political standpoint now also is as good a time as later to put them into effect.

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