461

THE FEDERAL BUDGET, INFLATION, AND FULL EMPLOYMENT

HEARINGS

BEFORE THE

SUBCOMMITTEE ON FISCAL POLICY

OF THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

NINETY-FIRST CONGRESS

FIRST SESSION

OCTOBER 7, 8, 9, 13, 14, 22, AND 23, 1969

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

37-795 WASHINGTON : 1970

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price $1.50

JOINT ECONOMIC COMMITTEE

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

WRIGHT PATMAN, Texas, *Chairman*

WILLIAM PROXMIRE, Wisconsin, *Vice Chairman*

HOUSE OF REPRESENTATIVES

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

SENATE

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

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

ECONOMISTS

LOUGHLIN F. MCHUGH
JOHN R. KARLIK
RICHARD F. KAUFMAN
COURTENAY M. SLATER

Minority: DOUGLAS C. FRECHTLING
GEORGE D. KRUMBHAAR

SUBCOMMITTEE ON FISCAL POLICY

MARTHA W. GRIFFITHS, Michigan, *Chairman*

HOUSE OF REPRESENTATIVES

HALE BOGGS, Louisiana
WILLIAM S. MOORHEAD, Pennsylvania
WILLIAM B. WIDNALL, New Jersey
BARBER B. CONABLE, Jr., New York

SENATE

WILLIAM PROXMIRE, Wisconsin
HERMAN E. TALMADGE, Georgia
STUART SYMINGTON, Missouri
JACOB K. JAVITS, New York
JACK MILLER, Iowa
CHARLES H. PERCY, Illinois

CONTENTS

WITNESSES AND STATEMENTS

TUESDAY, OCTOBER 7, 1969

SUBMISSIONS

THE FEDERAL BUDGET, INFLATION, AND FULL EMPLOYMENT

TUESDAY, OCTOBER 7, 1969

Congress of the United States,
Subcommittee on Fiscal Policy,
Joint Economic Committee,
Washington, D.C.

The Subcommittee on Fiscal Policy met, pursuant to notice, at 10:05 a.m., in room S–407, the Capitol, Hon. Martha W. Griffiths, chairman of the subcommittee, presiding.

Present: Representatives Griffiths, Windall, Conable; and Senators Proxmire, Symington, Javits, and Percy; and Representative Brown of Ohio, guest.

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

Chairman Griffiths. The committee will come to order, please. I would like to begin by telling you, Mr. Secretary, that this morning we are going to discuss inflation. The labor market is already so tight that this committee has just hired a woman economist.

Mr. Kennedy. Good.

Chairman Griffiths. This morning the Subcommittee on Fiscal Policy begins an examination of the Federal budget and other broad economic policies as they concern ending the present inflation and insuring a climate favorable to the attainment of full employment with stable prices in a continuously growing economy.

Our first and immediate interest in these hearings is to develop a basis for conclusions and recommendations on Federal economic policies in the months immediately ahead. As Chairman Patman pointed out in his request to the subcommittee to hold these hearings, this is a matter of very considerable concern to us all. I think it is also obvious that recent experience suggests the need for exploration as to directions to be taken in the longer run so that economic policies, both private and public, will prevent these regular reoccurring cycles of inflation and recession. This will be our second major objective.

Before proceeding with this morning's witnesses, I wish to stress two points.

First, I cannot understand at all the continuing suggestions from some quarters—particularly from the economists—that the administration and the Congress must make some sort of trade-off between inflation and unemployment. The technicians mention some quite mystic device known as the Phillips' curve. I find it incomprehensible that anyone would even suggest that we can afford to buy a stable price level at the expense of misery for millions of unemployed working people. Such a situation would not only bring misery to those unemployed, but it would also reduce profits for businessmen, produce budget deficits for Federal, State, and local governments, cause bankruptcy for countless small enterprises, and no one knows how many other horrible consequences there would be. Nor, on the other hand, can I understand how we can be expected to purchase full employment at the expense of a continuous inflation which would bring disaster to over 70,000 State and local governments, to the homebuilding industry, to many small businesses, to many millions of retired individuals, and which, just incidentally, appears from historical record to be good insurance that the real wages of the working classes would cease to rise.

Section 2 of the Employment Act of 1946 has always been interpreted by the Joint Economic Committee as calling for the simultaneous attainment of full employment and stable prices. From the very origin of this committee it has protested compromises that seemed likely to produce departures from this standard. There must be no compromise at this late date. Experience suggests that sharply altering Federal expenditures, without an adjustment of taxes, leads either to inflation, as in the past 5 years, or to a recession as happened on other occasions, notably 1954.

Second, much has been made in the last year of the idea that the Congress and the last administration had applied the fiscal brakes via imposing the surtax and a limit on expenditures—actions shifting the Federal budget from a high deficit to a modest surplus. The critics then point to the continued rapid increases in prices as evidence that fiscal policy is no good—that it cannot stop inflation.

I confess to being puzzled as to how a bare balance or a surplus of $2 or $3 billion in the Federal budget is to instantly—or even in a year—bring to a halt an inflation that has been fueled by a Federal deficit which ran to over $20 billion per year.

I am puzzled also as to why the 1970 budget is touted as an anti-inflationary budget. The current estimate of Federal surplus for fiscal 1970 is $5.9 billion, of which about two-thirds represents the effect upon the budget of prospective legislation which has not yet passed the Congress. All that we are really sure of now is a surplus of $2 billion or less which is hardly more than the average error in estimating Federal receipts and expenditures. One of the paramount questions before this subcommittee, therefore, is: How do we arrive at an anti-inflationary budget?

With these preliminary remarks, I wish to welcome to these hearings the Honorable David M. Kennedy. Mr. Secretary, it is really a great pleasure for me to have you here, also the Honorable Robert P. Mayo, Director of the Bureau of the Budget. We greatly appreciate your taking time out of your busy schedules to be with us to discuss the budget this morning. We will hear from each of you. Then we will proceed with the questioning.

Mr. Secretary, you may proceed in your own way.

STATEMENT OF HON. DAVID M. KENNEDY, SECRETARY OF THE TREASURY; ACCOMPANIED BY ROBERT P. MAYO, DIRECTOR OF THE BUREAU OF THE BUDGET; MURRAY WEIDENBAUM, ASSISTANT SECRETARY OF THE TREASURY; MAURICE MANN, ASSISTANT DIRECTOR, BUREAU OF THE BUDGET; AND DALE McOMBER, DEPUTY ASSISTANT DIRECTOR FOR BUDGET REVIEW, BUERAU OF THE BUDGET

Mr. KENNEDY. Thank you, Madam Chairman, members of the subcommittee.

It is a pleasure to have this opportunity to appear before you for an examination of the budget outlook and an assessment of our efforts to control inflation. This subcommittee has made an important contribution in serving both the Congress and the executive branch as a respected forum for discussion and review of economic policy. In the tradition of reasoned analysis which has characterized the deliberations of the subcommittee, it is appropriate to review the conduct of fiscal policy by the Nixon administration during its first 8½ months in office.

Director Mayo will give you the budget outlook for the current fiscal year. The projected surplus of nearly $6 billion is essential in the present economic environment. In its report on the January 1969 Economic Report of the President, the Joint Economic Committee argued persuasively for a significant surplus, and we are in complete agreement with that position. Our determination to restrain Federal spending and to maintain sufficient revenues to adequately cover expenditures supports the objective which we all share—to preserve a positive role for fiscal policy in the maintenance of economic stability. The failure in recent years to make prompt and timely use of fiscal policy to counteract impending inflationary tendencies has been a source of considerable disruption and inequity in the economy.

The American people understand the falseness of an inflated prosperity, and I know many of them have communicated this understanding to their elected representatives in Washington; many have also expressed their concern to me personally. The real wages of the average manufacturing worker are only $1.45 a week higher today than they were in 1966—despite higher and higher wage settlements. Inflationary excesses create hardships for all segments of our society. Monetary values are eroded, purchasing power is diminished, decisionmaking is distorted, and interest rates are disproportionally inflated.

The control of inflation is more than a matter of domestic concern. Last week I met with the financial representatives of over 100 countries. They impressed upon me their own deep concern over inflation in the United States. The American economy is so large and its influence so widespread, especially because the dollar is a key currency, that the excesses of either inflation or recession affect the entire world economy. It is important that we improve our competitive position in foreign markets and maintain international confidence in the dollar. The current inflation is unhealthy for both America and the rest of the world, and its control is, therefore, both a domestic and an international necessity.

Since assuming office last January, this administration has moved quickly and firmly to bring the policies of the Federal Government in line with the country's most urgent economic priority—to halt the spiral of rising prices. Our basic strategy has been to restore stability through the coordinated application of fiscal, debt management, and (with the cooperation of the Federal Reserve Board) monetary policies designed to moderate aggregate demand pressures.

In April the President proposed two major actions to increase tax revenues: (1) Extension of the income tax surcharge at 10 percent for the first half of fiscal 1970 and at 5 percent level for the second half of fiscal 1970; and (2) repeal of the investment tax credit. The Congress has approved extension of the full surcharge through this calendar year, but action to continue the surcharge at its reduced rate and to repeal the investment tax credit remains to be taken in the Senate. I want to emphasize again that these measures are essential to our overall strategy, and require the earliest possible action. They are in complete agreement with the recommendations made by the Joint Economic Committee last spring.

Enactment of these two tax proposals will produce an estimated $3.3 billion in revenues. Including the requested extension of present excise tax rates and the proposed imposition of new user charges, a total of $4 billion of necessary revenues depends on favorable legislative consideration. Without positive congressional action, fiscal policy will not be exerting the measure of restraint appropriate for effective inflation control.

Assuming favorable action on these revenue-raising proposals, total budget receipts for fiscal 1970 are now estimated at $198.8 billion, or $0.4 billion below the May 20 estimate. This relatively small change in total receipts is primarily due to a $0.5 billion reduction in estimated corporate income tax receipts, reflecting our lower estimate for 1969 corporate profits. The economic assumptions underlying these latest estimates are the following: Changes since May 20 largely resulted from revisions in national income account data by the Commerce Department. The May 20 estimate of gross national product was $927 billion, with a current estimate of $932 billion. Personal income in May was estimated at $739 billion. The current estimate is $745 billion. Corporate profits before taxes, $97 billion in May, against $94½ billion currently.

On the expenditure side, the President has demonstrated his determination to regain Executive control over Federal outlays by his commitment to hold expenditures below the congressionally authorized limit. Total outlays for fiscal 1970 are estimated to be $192.9 billion, the same figure used for the May 20th estimate. Director Mayo will discuss budget expenditures in greater detail.

The net result of these fiscal actions will be the generation of sufficient revenues to more than cover substantially trimmed outlays. The Federal budget will be contributing importantly to the control of inflation.

Nine months ago, we knew that this would be an arduous and lengthy task. Aggregate spending was under strong upward momentum, and inflationary expectations were well entrenched. It has been our deliberate policy to restore economic stability through the careful application of restrictive fiscal and monetary measures. The evidence that this policy is being effectively applied is beginning to mount:

Real economic growth is well below the basic trend rate of capacity growth;

The September unemployment rate was reported at 4 percent;

The combined index of leading business indicators has slowly declined for 3 consecutive months;

Industrial production registered a small monthly decline in August; and

Consumer surveys indicate a significant decline in buying sentiment.

While there is ample evidence that real growth has been declining in recent months, the desired abatement of price level increases has not yet become evident in the statistical indicators. This is not unexpected, since prices invariably tend to lag behind changes in the underlying market conditions. But regardless of the source of inflationary pressure, whether from excess demand or from rising costs, the absence of sufficient demand to clear markets at inflated prices must result in inventory accumulation and inevitably lead to price reductions. Investment and production decisions reached under the assumption of a continuation in current rates of inflation will come to be sorely regretted.

We are encouraged that our strategy is beginning to show results. The difficulty of pursuing this task must not be underestimated, however, and cooperation from the Congress is vitally important to our maintaining appropriate fiscal restraint. The revenue-raising measures proposed by the administration must be enacted to continue the desired budgetary effects.

Only last month, a distinguished former Secretary of the Treasury told a Senate committee that both the executive and legislative branches had committed a serious policy error by failing to control the budget during the 1965–66 period. As a result, fiscal policy came to exert a completely undesired influence on an overinflated economy during the fiscal year 1968. Madam Chairman, it is my hope, and I am certain this most important subcommittee shares my concern, that we can maintain fiscal policy in its proper role of contributing to economic stability. That, I believe, is the purpose for these hearings; and that is why I am pleased to be here for a discussion of this important issue with you.

Thank you very much.

Chairman GRIFFITHS. Thank you very much, Mr. Secretary.

Mr. Mayo?

Mr. MAYO. Thank you, Madam Chairman and members of the subcommittee. Revised estimates of the Federal budget for fiscal year 1970 were issued on September 17 in our summer review of the 1970 budget. At that time, congressional action had not been completed on any of the regular appropriations bills, so our estimates were necessarily tentative. They remain so today, although one appropriation bill has been signed into law and other appropriations bills and a major user charge proposal have progressed within the Congress since mid-September.

Our estimated budget totals are unchanged from those in the summer review:

Receipts, as the Secretary indicated, $198.8 billion; outlays, $192.9 billion; and surplus, $5.9 billion.

While the current budget surplus estimate is down slightly from last spring's $6.3 billion, it is $2.8 billion higher than the actual fiscal year 1969 surplus. The change of $0.4 billion since last spring has resulted from a lower estimate of receipts. In an inflationary environment this is a modest surplus indeed, amounting to 3 percent of Federal outlays. Estimated outlays remain at $192.9 billion, reflecting the President's determination to control the level of Federal spending.

When our administration took office in January, the prospective economic environment—one in which demand would continue to exceed supply—made fiscal restraint the appropriate policy. The forces that threatened our economic health were moving strongly toward increased inflation. These forces had too much momentum to be left unrestrained. Accordingly, a restrictive fiscal policy was adopted and has been maintained ever since. During the same period, the Federal Reserve System has maintained a complementary policy of firm monetary restraint.

The momentum of inflationary forces shows encouraging but still only scattered signs of slackening in response to these policy actions. Nevertheless, prudence requires that fiscal restraint be continued. After a strong rise from mid-1967 to late 1968, the index of leading economic indicators reached a high plateau that has now developed a slight downward slope. In the past, such a pattern has usually been followed, after a timelag, by a similar movement in the measures of economic growth and—perhaps after a further lag—by a slowing down in consumer price increases.

We know from past experience that stubborn cost and price inflation can be effectively minimized only after a long period of adjustment. We also know from the experience of 1967 that if we relax too soon and inflation and inflationary expectations are not reduced, we will have to fight the anti-inflation battle all over again when the economy resumes a more rapid rate of growth. Under these circumstances, and given continued price increases, a significant 1970 budget surplus is a necessary element of our fiscal policy. To this end the President has:

Urged extension of the income tax surcharge at 5 percent for the first 6 months of calendar year 1970;

Taken firm administrative action to hold 1970 budget outlays to $192.9 billion; and

Directed a deferral of 75 percent of all new contracts for direct Federal construction and strongly urged State and local governments and business firms to cut back their own construction plans.

We expect that the President's determination to hold 1970 spending within a total of $192.9 billion will result in compliance with the statutory limitation on 1970 outlays enacted in July in the Second Supplemental Appropriations Act, 1969 (Public Law 91-47). The limit established by the Congress at $191.9 billion is subject to adjustment in two ways. First, the net effect of congressional action or inaction on the budget proposals adjusts the ceiling automatically, except for the first $1 billion of net reductions. Second, the President may adjust the ceiling for certain administratively uncontrollable items specified in the law, up to an increase of $2 billion. As of August 31, the President specified in his report to the Congress, upward revisions of $1.5 billion under the latter provision, so that the statutory ceiling now stands at $193.4 billion.

The seriousness of the President's determination to continue a policy of restraint on Federal spending was evident in his statement on July 22 that, even if congressional action permitted a higher level of spending, he still intended to hold the total to $192.9 billion administratively. As the summer review stated, there has been a substantial worsening since April 15 in the outlook for 1970 budget outlays. Current estimates for uncontrollable items such as interest on the public debt, medicare, civil service retirement benefits, public assistance, and veterans' benefits are more than $2.5 billion higher, including the $1.5 billion noted above that qualify under the expenditure ceiling exception.

The summer review also assumes that congressional action or inaction—as in the case of the postal revenue bill—would add about $1 billion to 1970 outlays. But the actions or inactions to date by various congressional committees or the House or the Senate individually would add much more than that. For example, possible spending increases not reflected in our summer review include:

$1.5 billion for military and civilian pay raises, under H.R. 13000;

$0.5 billion in 1970 outlays for the $1 billion House-approved Labor-Health, Education, and Welfare appropriation bill, in excess of what the President recommended;

$0.6 billion in the food stamp authorization approved by the Senate;

$0.3 billion if no postal rate increase is enacted effective January 1, 1970 (we already allowed in the earlier figures for the fact that it could not possibly be made retroactive to July 1, 1969, which was assumed as an effective date in the April estimate);

$0.4 billion for veterans' and Farmers Home Administration loans, unless the Congress enacts legislation to permit the disposal of loan paper at interest rates that are competitive with commercial rates;

$0.5 billion for a new GI bill for Vietnam veterans and other veterans bills; and

$0.1 billion for additional school aid in federally impacted areas.

I stress that these are possible. They are not yet probable because congressional action has not been completed on any of them. But the size of these possible increases in a clear measure of the need for congressional cooperation if the Nation is to have a responsible fiscal policy in the crucial period immediately ahead.

The President has already directed that the $2.5 billion of the increase for uncontrollable items and for the $1 billion of potential congressional add-ons he foresaw in July will be offset by reductions of an equal amount—$3 billion from military programs and $0.5 billion (net) from other programs. Taking into account both the budget reductions announced on April 15th and the reductions now planned, this administration will be cutting $7.5 billion from the program levels implicit in the January budget of the prior administration:

$4.1 billion from military programs, and
$3.4 billion (net) from other programs.

Without these cuts, budget spending in 1970 would be in excess of $200 billion. These cuts have not been easy to achieve. I am sure I need not remind any Member of the Congress of the great popularity of even the most marginal Federal program.

Under either the tax bill passed by the House or the administration's tax proposals to the Senate, budget receipts in fiscal 1970 are now expected to be $198.8 billion. If no tax legislation is enacted in this session of the Congress, however, 1970 receipts will be reduced by $4 billion, as you have already pointed out, Madam Chairman, and as has the Secretary. Thus, if the Congress does not enact the proposed tax legislation, the presently estimated surplus would be reduced by two-thirds, and urgently needed fiscal restraint would be lost.

Excessive buoyancy in the economy during the second half of 1968 resulted, in large part, from an easing of monetary policy after the income tax surcharge went into effect late in June of that year. Monetary policy was eased—as the "consensus forecasts" advised—because of an underestimate of (1) the great momentum of the underlying forces of expansion, and (2) the potency of inflationary expectations that had been fed by a massive $25 billion deficit at the culmination of more than 7 years of continuous economic expansion. The easing of monetary policy encouraged widespread expectations that demands for credit would be accommodated, and that, despite the tax surcharge, inflation would continue to be a dominant force in economic activity.

Most responsible short-term economic forecasts made late last year predicted a slowing of economic expansion in the first half of 1969 and a quickening of the pace of expansion in the second half, the current period. But this pattern did not develop; we are not capable of estimating lags quite that well. Rather, an unhealthy rate of price increase continued through the second half of 1968 and into 1969. This development led to the adoption of a restrictive monetary policy at the end of the year and continued restrictive fiscal policy in the first half of 1969 as the new administration recommended reductions in the programs proposed in the January budget. Nonetheless, prices continued to rise at too fast a clip.

The slowdown in the rate of growth of gross national product originally expected by most forecasters to occur in the first half of 1969 is now expected to occur late in the year and to extend into 1970. In view of the fact that excessive cost and price increases can be shaken out of the structure of the economy only after a period of adjustment, it is imperative that fiscal policy for the immediate future be one of continued restraint.

We must be careful not to overreact in either direction. The economy must be allowed to experience a sufficient period of slower growth to remove the excessive cost and price increases that are built into it now. In doing so, however, we must be careful not to force a quicker deescalation of economic activity than is desirable or than now seems likely to occur. I want to say just a word, if I may, about the outlook for 1971.

There is nothing in the present environment to suggest that tight restraint on budget outlays can be relaxed in the fiscal year 1971. The major determinant of the need for such restraint is the outlook for a substantial decline in the growth of revenue.

Federal receipts increased by $34 billion from fiscal year 1968 to 1969 as a result of the tax rate increases, including the 10 percent income tax surcharge that was in effect throughout fiscal 1969, economic growth, and, of course, excessive price increases. The 1969 to 1970 increase in revenues is expected to be only about $10 billion, given passage of the tax bill now before the Congress or only $6 billion if for some reason that should fail. The increase would be larger but for the projected decrease in the surcharge from 10 percent in calendar 1969 to 5 percent in the first 6 months of 1970. With the surcharge removed completely in fiscal year 1971, there is likely to be only a small increase in receipts—even assuming enactment of the administration's proposed tax program.

Budget outlays on the other hand, have no such automatic governor. Indeed, mandatory increases under existing law for higher interest costs on the public debt, social security benefits, other retirement benefits, veterans' benefits, medicare and medicaid, housing commitments, and other programs will command additional billions of dollars. We are working on those figures right now, as you all know. New initiatives already announced by our administration, including revenue sharing, the family assistance program, and social security benefit increases, will require several billion dollars also in fiscal year 1971. Other desirable programs, even though more controllable, have powerful built-in pressures for expansion. And Federal pay increases comparable to those currently being received in private industry could add billions more.

Therefore, our task for 1971 is to find enough budget reductions to offset the excess of these outlay increases over available resources. We have yet to determine precisely the administration's fiscal policy goals for fiscal 1971, but given the constraint imposed by revenues, it is clear that we must find ways to limit severely the growth in outlays. Thus, the outlook is for a further decline in fiscal 1971 in the share of the gross national product attributable to Federal spending.

Underlying all our planning for the coming year is an explicit recognition of and support for the goals of the Employment Act of 1946; "to promote maximum employment, production, and purchasing power." Our difficult task immediately ahead is to negotiate successfully the transition from an overheated economy to a stable, noninflationary growth path—without suffering a period of significant disruption. We believe that our current policy of fiscal restraint will be a major factor in making the transition successfully.

Thank you, Madam Chairman.

Chairman GRIFFITHS. Thank you very much. In spite of the dreams of this committee, may I ask both of you, do you really believe that we can stop inflation without increasing unemployment?

Mr. KENNEDY. I think that the efforts that we have made demonstrate our concern over unemployment because we have taken the approach of trying to slow the economy without too much pressure on unemployment. There is no question but that as you slow the economy, there will be changes in employment patterns and some increase in unemployment. It is a question of doing it with the least impact and to get the maximum result. It is not an easy task, as you well know. I think if we could succeed in our training of the hard core unemployed, those who are not skilled, bring them into the labor force, you would have an anti-inflation measure that would let us get along with less restrictive policies. But that takes a lot of time and it is not an easy task. It is one that we are working on but one on which we are not making the progress that I would like to see made.

Chairman GRIFFITHS. As a matter of fact, when we reach down and pick up the unemployables and employ them, and give them more money than they are getting on welfare, is it really anti-inflationary or is it inflationary?

Mr. KENNEDY. As they come into productive capacity, they produce more than they consume and to me it would be anti-inflationary.

Because we have moved almost away from hand labor in our economy, one of the current pressures we face, is that of technology and technicians. We had not only full employment there but in many cases over-full employment, with overtime. This has put pressure on our wage-price structure beyond, I think, what it would have done if we had been in the more labor intensive kinds of business.

Chairman GRIFFITHS. Yesterday it was reported that the rate of unemployment had jumped abruptly in September to 4 percent, from 3.5 in August. Professor Friedman in testimony before our Subcommittee on Economy in Government seemed to interpret this as a harbinger of recession with even higher unemployment ahead as a result of recent tight money policies. I take it from your statements, that neither of you agrees with Mr. Friedman's forecast. Why do you think he is wrong?

Mr. KENNEDY. If I may comment, Professor Friedman is putting great emphasis on the reduction in the increase in the money supply. We have been effective in reducing through the action of the Federal Reserve. That is having an effect. I do not think there is any question about it. And it will have an effect over a period of time.

It is a question of that in connection with fiscal policy. I happen to believe that fiscal policy, including Government expenditures, have a very important bearing on our overall economic activity. I, for one, would feel that, given the leading indicators and the surveys that I referred to in my statement, now would not be the time to change our policy. We must be sure that these efforts are taking effect before we start to reverse our policies. We must not make the same mistakes that were made before, when we had a restrictive fiscal policy at the same time that we had a very easy monetary policy.

It is a matter of balance.

Chairman GRIFFITHS. Mr. Mayo, did you have something you wanted to say?

Mr. MAYO. I would like to add two things, Madam Chairman.

In the first place, with all due respect to the finest statistics in the world, I do not think we should put too much store in the data for one particular month. We have all sorts of factors, as your committee is aware of, perhaps more than any other in the Congress, that indicate that 1 month does not necessarily make a pattern.

I would also, in support of what Secretary Kennedy has just said, point out that money supply is very important, but not all-important. For example, I believe if we go back to the fall of 1966, we will find that many of those who felt that money was all-important became seriously concerned about the possibility of a serious recession in 1967. At that time, I believe they had great influence on policy, when the money supply was eased too soon.

Chairman GRIFFITHS. If the tax bill fails, and I do not think it looks in too strong a condition, what is your second line of defense?

Mr. KENNEDY. Well, I would not give up on the tax bill at this point. I think we must get the Congress to act. It is important. There is a demand for tax reform. The public wants it. Surely if you are going to reduce one person's taxes you have to tax someone else. So, I would feel that these pressures that we are getting from various groups should not be given too much weight.

I think that the Congress should act promptly. We must eliminate the investment tax credit and extend the surtax or we will have a loss of projected revenue. I think if we do not get them, we will have to take another look. There are only a few areas that we can go to. One is to cut budget expenditures further. Mr. Mayo has, I think, done an outstanding job with the departments in reducing governmental expenditures in a short period of time very substantially.

You cannot turn expenditures around quickly. It has been working. I will be putting more pressure on Mr. Mayo if we do not get elimination of the investment tax credit along with extension of the surtax. But I do not think that this will be the case.

Monetary policy will have to carry a much heavier load. But then you have the distortions that Mr. Friedman does not like.

Chairman GRIFFITHS. Has the Government in the last 7 months, fewer employees, or more employees, or about the same?

Mr. MAYO. We have, I would say, a pretty level record of Federal employment in the last year or so. I would like to make a quite important point that has received very little publicity. Our present plans for the level of full-time permanent Federal employment on June 30, 1970, call for a reduction of 100,000 positions below the level proposed in the January budget of the outgoing administration.

We are working very hard at keeping Federal employment to the necessary minimum. We have attacked the problem in terms of specific areas, such as overseas employment, and with particular objectives in mind, as well as being fairly tight on the general employment picture. We feel we owe this to the Congress as well as to the American people because the Congress did accept our recommendation to repeal section 201 of the Revenue and Expenditure Act. As you know section 201 established three out of four rule, that is, the executive branch could only fill three out of four vacancies, a system which worked rather unfairly and arbitrarily among the agencies.

We think we can manage more effectively with our present flexible approach, and still cut Federal employment.

Chairman GRIFFITHS. What has been the effect of the anticipated repeal of the investment credit on capital expenditures?

Mr. KENNEDY. I think it has had some effect in planning because the date was fixed in the bill. The Senate also acted to present the bill to the leadership, and it is being pigeonholed and not acted upon. So, I think business generally expected that the investment tax credit would be ended. I am confident that in forward planning they would take that into account.

On the actual expenditure side, it has made very little difference up to this point because most of the expenditures are on the basis of plans previously made over a long period of time.

Chairman GRIFFITHS. Senator Javits?

Senator JAVITS. Thank you, Madam Chairman. I want to welcome the Secretary and the Budget Director and their associates to the committee. I am very deeply interested in their testimony.

Mr. Secretary, as I see it, the administration is sailing between the Scylla of galloping inflation and the Charybdis of a recession.

You say in your statement, "the desired abatement of price level increases has not yet become evident in the statistical indicators."

Do you not think you are getting perilously close to piling up on the rocks of recession without any real effects on inflation?

Mr. KENNEDY. I think we are seeing signs, Senator, that we are having some success in the program. As I indicated in my statement, there are various areas that look as though they are now turning the corner. There is always a lag, according to the analysis of previous times, before prices start to react. However, price increases have been less than they have been. So, there has been some slight effect on prices.

In answer to the previous question, I indicated that I think that we can go through these shoals without causing the trouble that you and I are concerned about. We have got to react to the indexes and the forces that are showing a downward trend. But I think it would be a serious error at this time to make a shift in policy.

Mrs. Griffiths asked the question about what would happen if the Congress does not pass these bills. Then we would unleash forces going the other way and very strongly so. There is an uncertainty, an uncertainty as to our revenue side. The figures we gave you are very tentative because we have not seen the action of the Congress on the revenue side.

Senator JAVITS. Would you say affirmatively, then, that the Congress would be performing a serious disservice to the Nation if it did not pass the tax bill which at least gave us the bulge of the surtax without penalizing us in more reduction in the tax reform bill?

Mr. KENNEDY. I would say that unequivocally, categorically.

Senator JAVITS. Now, coming back to the Scylla and Charybdis reference, is it not a fact that you have realized a very, rather serious bulge in unemployment considering the fact that seasonably the unemployment rate goes down in September and you have not realized but the barest fractional result in a reduction of the price level?

Mr. KENNEDY. There was a shift in the figures that were just released up to 4 percent from the 3½ percent level. That is the rate which prevailed during the high employment situation just prior to the Vietnam expansion. That rate of unemployment is one that used to be looked at as a goal that we were trying to achieve. As we have gotten into an inflationary economy, we have successfully pulled that rate below 4 percent.

Senator JAVITS. The administration has always told us that it wishes to effect the slow down in inflation "without an unacceptable degree of unemployment."

Now, is this 4 percent acceptable or unacceptable?

Mr. KENNEDY. In the present circumstances it is acceptable.

Senator JAVITS. What would be an unacceptable rate? What is the red light?

Mr. KENNEDY. I could not give you a percentage figure. I think it would be a mistake.

Senator JAVITS. Does the administration have one?

Mr. KENNEDY. No, I think not. We would be taking into account all of the factors. What are the chances of fiscal policy working? What are the problems in the monetary side? You cannot very well give a figure.

Senator JAVITS. But does the administration have any standards which will guide it in deciding that it is in such danger of a recession that it is going to ease up a bit on the anti-inflationary front?

Mr. KENNEDY. I do not think there is any magic figure or magic number anywhere. What you look at is all the indexes, each one of them, and see their general impact. It is not an exact science, as you well know, Senator. It is really an art. The Federal Reserve is in charge of the monetary area, and that is their responsibility. Right now the money markets are very tight. Financing requirements are being met with difficulty. We found in our last offering of the Treasury that we had to pay 8 percent interest. Some indicated to me that was probably too high a rate and that we might have been giving something away. Actually, considering the results that took place, and it was an exchange offering—the holder had to present the security to get the new security—we had an above normal level of attrition, even with the high rates that we were paying. So we do have areas where pressures are building up.

On the other side, we still have very strong forces going in the other direction. It will be a balance between all of these that the Federal Reserve and the administration will have to take into account.

Senator JAVITS. I think we would all agree that an 8 percent rate for the U.S. Government is pretty shocking, and as far as the people are concerned, I think the one area of real irritation and difficulty in the actions of the administration is the very high interest rates. Right now as you know, loans are being offered at a minimum of 10 percent considering maintained balances, and probably around 12 percent, which is unheard of in this country. Do you not think that is a case for wage and price controls under these conditions rather than the effort to kind of nudge it along which we have been making?

Mr. KENNEDY. Well, we have been using fiscal and monetary policy in tandem so as to influence the fundamental factors in order to bring into balance the underlying economic forces. I deplore as you do, the high rates. I am a borrower now, not a lender, and I want that to be clear for the record. So, when I see these rates, they concern me very much. But, I think that it is a price that we are having to pay in order to get over the pressures we have. The guidelines, and so on, that have been talked about did not work well as you well know. They were almost useless even in a period when we had better balance between supply and demand. When you get into a period such as we have now, it would be very, very difficult to administer such guidelines.

Senator JAVITS. Well, nonetheless, Mr. Secretary, there is some feeling that the administration ought to try to exercise an influence to bring about a far greater degree of restraint in wages and in prices than it is doing, whether it is guidelines or controls or something else. There is a general feeling that that would help materially. You yourself must feel this too. I think the figures on the cost to the United States of money illustrate the problem as well. In 1969, 1970, and anticipated for 1971, it almost looks as if you are just exchanging peas for bananas and whatever you cut out of your budget you are paying back in interest. Is that not true?

Mr. KENNEDY. It is quite a factor. It is one of the big uncontrollable items that Mr. Mayo is referring to. In the Government, we are doing our part by reducing Government expenditures, maintaining the surtax, and by the action we have taken to restrict Government contracts. Reducing the new contracts will reduce demand at least. I think that we are quite firm about getting our own house in order. Those who are looking ahead, building more plants, using more money than is needed and pushing interest rates up perhaps more than needed, will have a hard time validating that unless inflation is not under control. It is our dedication to bring it under control.

Senator JAVITS. Mr. Secretary, if one Senator may just give you an opinion, and I will close on this note, I think the administration has to do some very hard thinking about a more direct impact of the President's standing and prestige on the wage and price structure. I think that is the lead point. We are trying to do it all indirectly through fiscal and monetary policy and I think it is exacting a burden which may not be all that necessary.

I knew a general in Hollandia when I served in World War II who insisted on having his headquarters in a sea of mud instead of like General MacArthur up on a hill where it was nice and cool because he thought that would really season his officers. Well, it depressed them.

I just suggest that to the administration, that this is something you can perhaps learn from us. We are close to the people and this is bearing in very hard and very heavily, and right now I would judge the public of America thinks you are more likely to have a recession than to control inflation.

I close on that note. I want the administration to succeed and I commend to the administration some real hard thinking about what to do about wages and prices if it really wants to make this go without bearing so heavily in on the people that they will change your policy for you—perhaps unwisely—because they just will not have it this way.

Thank you, Madam Chairman.

Chairman GRIFFITHS. Senator Proxmire?

Senator PROXMIRE. Gentlemen, I would like to follow up along the same line that Senator Javits has pursued so very well. I seem to get Mr. Mayo, from you the impression that what you intend to do is to prevent the economy from moving ahead too fast and to continue a period of slower growth, is the way you put it, for some time, at least, until as you say we can get costs and prices under control.

Mr. MAYO. That is our immediate goal, yes.

Senator PROXMIRE. Can you give us any idea at all on how long this period is likely to take? I would call to your attention the fact that back in 1957 and 1958 we had over 4 percent unemployment for a couple of years and the administration then was trying to restrain inflation. We went to 6.8 percent average unemployment throughout 1958 and during that period, as you know, it was a long hard effort to get prices under control. At least, the price rise under control. We still had inflation.

My question is, are we going to have to go through the same kind of thing again? Will it take a couple of years, in your view?

Mr. MAYO. We have no specific time period in mind, Senator Proxmire, as to how long it would take. This is not an area where we feel we can be precise. This is a stubborn inflation, I think we will all agree. I would hope that a basic adjustment, at least to turn the rate of inflation around so that it declines to a more historic 2 percent, or perhaps less, will be achieved fairly soon now.

Senator PROXMIRE. Do you have anything in mind, either you or Mr. Kennedy, any figure beyond which you just will not go? Can you tell us you will do everything you can to prevent unemployment exceeding, say 5 percent? Can you give this committee and the Nation assurance that under those circumstances you would not pursue a slowdown policy?

Mr. KENNEDY. Surely, we will give you a commitment that we are sensitive to unemployment. Our objective and aim is to control inflation without having an unacceptable level of unemployment.

Senator PROXMIRE. What is unacceptable?

Mr. KENNEDY. I cannot give you figures, as I indicated before, because that would be touted all over the housetops. That would be one that would cause us complete embarrassment, and I have none in mind. I think you have to take into account the factors you work with and any one unemployed person over the present level is very difficult for me to face.

Senator PROXMIRE. Well, you have a very, very difficult position and I do not mean to indicate that you do not, but I would hope that you do have in mind, whether you tell us or not, I do hope you have in mind a figure beyond which you will not go because I feel very strongly that as the chairman indicated earlier, we simply cannot permit unemployment to go higher than 5 percent. In fact, I would hope it does not go, as all of us hope, will not go higher than the present 4 percent, but I would hope you would have some figure of that kind in mind.

Mr. KENNEDY. I would like to say this, that we will strive to keep unemployment at the lowest possible level consistent with price stability.

Senator PROXMIRE. Then, we come to the other topic—interest rates. Senator Javits pointed out interest rates are higher than they had been in 100 years and certainly unacceptably high. Again, are you going to tell us on this, too, that you do not have a position beyond which you are not going to let them go? It would seem to me if we had sat here a couple of years ago that it would have been easy to say we are not going to let the prime rate go above 8½ percent, not going to have the Federal Government pay more than 8 percent on Treasury bills, and so forth. Now, it seems we may go even higher than that.

Mr. KENNEDY. My judgment, for whatever it is worth in this field, is that with the factors changing as they are and as they appear in the indexes that I see, I think interest rates are peaking out at this level and the next movement will be down. But there again, there is no magic in a situation of that kind.

Senator PROXMIRE. Well, we have been hoping that for a long time, month after month, ever since you have been in, but it has not been that way.

Mr. KENNEDY. But we have not seen the figures coming through that we are now seeing in the business community.

Senator PROXMIRE. Let me ask, Mr. Kennedy and Mr. Mayo, if you can tell us what should be the reaction to the budget? What should be the reaction both in terms of revenue and in terms of expenditures in the event you are convinced that inflation is coming under control and unemployment is becoming the most serious problem? What kind of action would you take and recommend to the Congress?

Mr. KENNEDY. Well, on the budget side I think that, Mr. Mayo can comment on this in more detail, and would continue to push for the levels that we now have in mind which look consistent with any pattern that I can foresee coming. I think the change would come in monetary policy rather than in budgetary policy at this point. I think he would have to continue to work on reduction in budget expenditures.

Senator PROXMIRE. Monetary policy really is outside of your control.

Mr. KENNEDY. Yes.

Senator PROXMIRE. At least, outside of your full control.

Mr. KENNEDY. Yes.

Senator PROXMIRE. The Federal Reserve Board has the real——

Mr. KENNEDY. It is within the Government but it is outside of our control.

Senator PROXMIRE. So, you do not have any kind of action in mind in the event that we get into a situation in which unemployment becomes a more serious problem than inflation even in the view of the administration.

Mr. Mayo?

Mr. MAYO. I would just introduce one more qualification. On the expenditure side of the budget, the President announced on the 4th of September a 75 percent cut back of new starts in direct Federal construction, a cutback which, incidentally, was on a base already lower than it had been for several years, because the preceding Administration also exercised quite a bit of muscle in cutting back on public works. I would suggest that this is one area where the President has already announced——

Senator PROXMIRE. How much real leeway is there there, Mr. Mayo? I have seen estimates that the actual effect of this so-called 75-percent cutback is to reduce about $300 million, which is a lot of money but a very, very tiny percent of the Federal budget and GNP and the effect on inflation or jobs should be almost invisible.

Mr. MAYO. There are three effects, I think, of the construction cutback, Senator Proxmire. In the first place, there is an important psychological effect in demonstrating a determination to do something about the construction problem. This was combined, as you know, with other things, notably, manpower training and vocational education to achieve a major increase in needed skilled labor. It was not just a budget proposal.

Second, the actual cutting back on the award of contracts has some deflationary effect on the construction industry.

And third, the cutback involves new contracts estimated at about a billion six hundred million dollars. You are correct——

Senator PROXMIRE. How long——

Mr. MAYO. You are correct, though, that the effect on budget outlays would only be $300 million in this fiscal year. Much of your effect, therefore, in terms of the actual cash flow through the economy, would be in fiscal 1971. This points up again one of the lags that——

Senator PROXMIRE. That means——

Mr. MAYO. Let me just finish.

Senator PROXMIRE. I am sorry.

Mr. MAYO. This lag may be a little more predictable than some of the other lags in the economy, but one which means that expenditure policy is not very flexible. If this policy were to be reversed, let us say, next June—just to pick an arbitrary date—there would still be an important economic effect in 1971.

Senator PROXMIRE. Exactly. So that the effect of this is going to be perhaps 9 months or a year from now at a time when we might very well need stimulation in the economy rather than a slowdown.

Mr. MAYO. Yes, except that there is a current effect that has economic significance, not just psychological.

Senator PROXMIRE. How about the military cutback? We were told by Secretary Laird there would be a cutback up to $3 billion and I understand the actual cutback when you consider all that is actually done, it is closer to $1.3 billion, and if you throw in research and development it will come to $2 billion but far below the $3 billion we were assured, and even the $3 billion, I would remind you, is a great deal less than many called for.

At the Senate Banking Committee hearing a week ago Chairman Martin of the Federal Reserve Board recommended $10 to $15 billion. So, is there really a significant cutback?

Mr. MAYO. Yes. Are you casting doubt on the $3 billion?

Senator PROXMIRE. Yes, I am.

Mr. MAYO. Cutting the defense budget is not easy to do, but I have been assured by Secretary Laird that he will achieve the $3 billion this fiscal year.

Senator PROXMIRE. Well, I hope he will, but the best information we can get is that he is below it and what Secretary Laird did say was that he would cut up to $3 billion. So, he can cut $2 billion and still meet that up to $3 billion pledge.

Mr. MAYO. He has used the $3 billion target quite a bit.

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

Chairman GRIFFITHS. Mr. Widnall?

Representative WIDNALL. Thank you, Madam Chairman.

Mr. Mayo, do you know if the administration will be cutting $7½ billion from the budget by the previous administration in January, including $4.1 million military.

Mr. MAYO. Yes, sir.

Representative WIDNALL. This is somewhat along the line of the questions asked by Senator Proxmire. Are they really cutting expenditures or primarily postponements of certain programs which will have to be reinstated at a later time?

Mr. MAYO. I would consider, Mr. Widnall, that these are true savings in expenditures. There will be some instances in which the cuts might look like just a postponement. For instance, the President in his cutback announcement on construction, indicated that there should be no expectation that when the public works deferment expired some day in the future, everything would be made well, so to speak, after the public works deferment expired. There is such a thing as a more or less permanent postponement, I think, in the world in which we live, where a project or a program can be developed more slowly than was originally scheduled. You never have a final totaling of the books, so to speak, in an instance like this. So, I think there are real savings here, not just a damming up of expenditures that will suddenly flood out at some later time.

Representative WIDNALL. I think it is an extremely important question because it influences the post-Vietnam military budget and we ought to be fully aware of what we are doing. Will we find that after the war is ended we will have to defer some of the funds spent on the war to finance programs that were postponed earlier to help fight inflation?

Mr. MAYO. I am sure that——

Representative WIDNALL. I am not talking about military now.

Mr. MAYO. Yes; I understand. Yes. There will be some military programs in the list of claimants on whatever, if we may use the common term, peace dividend there is after Vietnam.

Representative WIDNALL. Do you have any estimate as to the amounts that will be involved?

Mr. MAYO. No. I think the estimate is highly speculative at this point. Figures have been bandied about, but I think it is just too soon to try to make an evaluation until we know a little more of the shape of the post-Vietnam period. Post-Vietnam may not be just something that suddenly occurs as of a given date. There may be a transition period, and you can draw all sorts of curves on how you get there. Until we have some more positive indication of the way in which the Vietnam problem will be ended, I think we should keep our estimates fairly flexible.

Representative WIDNALL. I would like to come back to some questions that our chairman, Mrs. Griffiths, asked. You mentioned, Secretary Kennedy, that congressional enactment of the continuation of the tax surcharge, repeal of the investment tax credit, extension of the present excise tax rates and the proposed imposition of new user charges will produce $4 billion of necessary revenues. You go on to say without positive congressional action, fiscal policy will not exert the necessary restraints for effective inflation control.

How do you propose to deal with inflation if these fiscal measures are not enacted?

Mr. KENNEDY. We would have to pursue, I suppose, stronger policy on monetary restraint which would be very restrictive and very difficult to handle. To me it is unthinkable that the Congress would not provide the necessary tools to control this inflation. I think that the Congress must act on these measures.

Now, if it does not act, we will have to go back to what we were talking about before, Congressman Widnall. That is, we will have to go back to more budget action on the part of Mr. Mayo, maybe moving into the field of controls of some kind. It is not a very pleasant thought we are facing up to—lack of fiscal responsibility in the present circumstances.

Mr. MAYO. Mr. Widnall, I might add that I hope I made it clear in my prepared testimony how seriously we are committed to $192.9 billion of outlays, and also how difficult it may be to achieve that particular figure, partly because of the uncertain fate of proposals now before the Congress.

Beyond that, the President becomes increasingly limited in what he can do on the budget side as the year progresses. If it is required that he do more because, say, of a failure to pass the tax bill, as each month passes it becomes increasingly difficult to achieve a given dollar cut simply because we are dealing with, first, two-thirds of a year, then only half a year, and then only a quarter of a year, and it is far, far harder to achieve a billion dollar cut in, say, February, than it is a $2 billion cut right now.

Representative WIDNALL. That is all. Thank you.

Chairman GRIFFITHS. Senator Symington?

Senator SYMINGTON. Thank you, Madam Chairman.

Secretary Kennedy, Director Mayo, it is a privilege to see you this morning.

I have three basic questions, perhaps some additional questions behind them, I would ask this morning.

First, why some months ago did this administration decide to recommend a cut in the surtax from 10 percent to 5 percent come next January, for the last 6 months of this fiscal year?

Mr. KENNEDY. The answer to that question, Senator, is, that in formulating the overall tax program, we recommended the elimination of investment tax credit in lieu of continuation of the surtax at the 10 percent rate from January to June. So, that recommendation was a balancing factor revenuewise. We came out with more revenue than we would if we had carried it the other way.

Senator SYMINGTON. Now, the staff tells me that this surtax, if passed, will take in a total in those 6 months of $2 billion. We know the debt of the United States is some $365 billion. And has been estimated as being $57 billion more than the debts of all the other countries in the world combined.

I figured out yesterday just as a matter of interest, that the surtax will bring us in around $100 a second but the Vietnam war alone today is costing us over $900 a second. Why, therefore, as this war goes on do you not recommend, if not increasing, at least continuing, the surtax at its present level?

Mr. KENNEDY. Hopefully, we are trying to bring the Vietnam war to an end and——

Senator SYMINGTON. Yes, but we have a great deal of testimony in other committees that even if it does end, for a long period there will be no substantial reduction in our defense costs.

Mr. KENNEDY. Our objective, Senator, is to have a budget surplus in which total receipts exceed total expenditures. The estimates that we had, provided the Congress acts, would produce about the surplus that we felt was the right medicine for this year.

Now, that does not answer the question of what you do with Vietnam or other war expenditures. It seems to me that is a separate question. It does mean taxes, of course, and I think it was a serious mistake that we had the expenditures at that level without having the revenue to pay for them. So that the program that we now have at least would be a surplus program, and I think that is what is required.

Senator SYMINGTON. Well, you say a surplus program. You emphasize the importance of gross national product which, with all due respect, is in a sense, another way of expressing the growing inflation. Regardless of the surplus, the truth is, however, that the larger the debt, the less your ability to control the national budget. Is that not a fair statement?

Mr. KENNEDY. Well——

Senator SYMINGTON. Because of charges that you cannot change?

Mr. KENNEDY. It is difficult to, in effect, make changes in the budget. I think in the defense area, where you are interested, you have commented to the effect that our efforts have not been satisfactory or large enough from your standpoint. But these efforts have at least made a significant cut in defense spending.

Senator SYMINGTON. Well, let the record show that I am impressed with the efforts made by Secretary Laird to reduce the defense budget, but that has nothing to do with the political decision as to what we are going to do about this war. Regardless of the saving of a billion dollars here or a half billion dollars there, the fact that we are spending $80 million a day in Vietnam is, in my opinion, occasion for your problems and much of ours as representatives of the people.

Interest rates to business are at an unprecedented high level and, according to my constituents, some relatively small businesses are actually now being destroyed by the tight money situation. The problem is particularly acute in the housing industry. As I understand it, the savings and loan associations, have some $180 billion. They are getting into trouble and they cannot lend money to promote the housing business. One of the leaders in this field told me the other day that if they really got in trouble they could not pay out 3 percent.

So, we can estimate the theory of a balanced budget; but at the same time, as our chairman, Mrs. Griffiths, pointed out, we are having growing unemployment; growing failures in business; unprecedentedly high interest rates; and a steadily increasing inflation. I think it is fair to say that the primary reason for this is the continuation of the tragedy in Vietnam.

Now, I do not mean to criticize present officials on the basis of the past. I do not think I have ever criticized this administration about it. But I am intrigued by your testimony that there does not seem to be any financial way out if we continue with these tremendous expenses abroad.

On that premise, I would ask this question. Are we planning for a recession as a way to handle our inflation?

Mr. KENNEDY. No. We are trying to reduce the inflationary pressures without causing the imbalance that would force us into a recession. The problem now, of course, will be to watch these indexes, to watch the timing of this in order to make sure that that does not happen. Fortunately we do have many kinds of measures that are built into the structure—the automatic features of our budget. We also have measures that can be taken budgetwise if that should happen on monetary policy. But I think the real test will be to carry forward this program to eliminate inflationary pressures and not push us into a recession.

Senator SYMINGTON. Could I ask one more question? Are you satisfied with the development of the SDR's under the International Monetary Fund?

Mr. KENNEDY. I think that was a major step forward, Senator. I think a lot of work was done by the previous administration, so I take no credit in that respect. We did move forward with it and we were able to get a volume sufficient, I think, to take care of the monetary needs for a period of time. I was pleased with the amount and the early activation. So, I think that we will have more stability in the international monetary markets now.

Senator SYMINGTON. Thank you, Mr. Secretary. Thank you, Madam Chairman.

Chairman GRIFFITHS. Senator Percy?

Senator PERCY. I am sorry to report to my colleague from Missouri that as a result of the football games a week ago the balance of payments between the senior Senator from Illinois and the senior Senator from Missouri is badly tipped in favor of Missouri. But I hope I will recover.

I am always happy to follow my former fellow businessman and though I am tempted to get into Vietnam, I will try to restrain the feeling.

I would like to congratulate the administration first, on this budget review. It is exceedingly helpful to have these periodic reviews and I think having dealt with budgets most of my life, there is a remarkable correlation between current estimates and your original forecasts with slight shadings and changes. But it has been a result of very hard work and determined effort; and I believe it is exceedingly helpful to point out to the Congress the dependence that you have and reliance you have on restraints by Congress in certain areas in order that you will be able to meet these figures and clearly point out the areas where we can possibly exceed estimates, such as in the hunger program which I participated in and contributed somewhat to your problem in that area.

I think particularly the cutback of $3½ billion in the military has been hard but I think exceedingly wise and necessary.

I would like to ask this question, looking to the rather large picture that Senator Symington pointed to on Vietnam. I am just wondering whether with minor bites we are going to be able to solve this gap between the domestic needs that we face which are tremendous in the future and our expected revenue if we do not look at the underlying premise behind our whole commitment program abroad—the defense of the free world and the much discussed capability that we are supposed to have of waging two major and one minor war simultaneously.

If we could reduce that to one major war and one minor war you might talk in terms of reducing our Armed Forces by 750,000 men or a million men and that might be $10 billion to $12 billion in savings right there.

Is there thought being given inside the administration to appraising our overall commitments that require this $80 billion military defense level?

Mr. MAYO. Yes. This, Senator Percy, is undergoing very deep thought at the present time within the administration, not just in the Defense Department but in the context of a much broader look at the entire environment in which we are operating as a nation.

Senator PERCY. I have talked informally to members of the Armed Services Committee about this overall commitment we have. I find some of them deeply concerned about it, particularly in the area of the number of men we are maintaining under arms, because that just automatically requires all the heavy support behind it. And if we can just take the big bite rather than these little nibbles, cutting small programs or parts of programs out here and there which never really get to the heart of it, I would certainly feel there would be a tremendous amount of support in the Congress for your giving us a re-analysis of what our commitments around the world should be and what we should try to undertake in view of the nation-building job we have here at home.

Could you give us a feeling on housing, where we are going here? We are caught between the necessity to reduce construction, of course, and we are doing that at the Federal level. I think the 75-percent deferral is a fine, wise program and necessary probably now. But to cut back in domestic housing as much as we are and come down almost to a level of a million homes when we are going to need 2½ million on average for the next 10 years to meet our basic needs, is very tough.

What do you see is the outlook for housing? Have we reached a low point and can that be one of the first industries to respond after we get some of these other things under control?

Mr. MAYO. Well, there are several points that could be made on the housing front. I am not prepared to say we have reached the low point on new starts, Senator Percy. They might still sag a bit more. I think in part this is a reflection of a fact that we all know so well, that housing is one of the areas that is more sensitive to tight money and one where an increase of 1 percent in the interest rate makes a big difference because it involves long-term borrowing.

I might add—I must add, I should say—that as I look at the Federal budget in terms of what we are doing in housing programs, I find that, almost to the same extent that the increases in interest are uncontrollable, we have some rather significant uncontrollable items. Even if I were to suggest to Secretary Romney that we have to cut back in budget spending on housing, he might be unable to do very much. In many of these areas, his budget will go up by a figure well in excess of a half billion dollars for housing aids in fiscal 1971 without lifting a finger or making a new commitment, just on the basis of what is already outstanding.

Although this gives me some pain as Budget Director, it does, on the other hand, represent a national commitment to housing that is an important factor in our allocation of resources.

Senator PERCY. Secretary Kennedy——

Mr. KENNEDY. Could I just add, Senator Percy, one thought in answer to the second part of your question? When things turn around and the money does become available, housing will be one area that will move very fast, based on past experience, to step into the breach. It is quite a strengthening factor in the economy. It is very strong in every community, not only in the urban but the rural areas.

Mr. MAYO. I think we also have to keep in mind that one of the greatest beneficiaries of inflation control can be the person who is going to buy a new house. He is plagued now with a realization that even if he has the money for a downpayment, and he is paying very high prices for things in general, as all of us are, he is paying even more when he is buying a new house because of high interest rates that will affect his payments for the duration of the mortgage. We want to do everything we can on the general inflation front to help him.

Senator PERCY. Secretary Kennedy, I agree with you that it is crucial that we extend this 5-percent surtax. We simply must do it. It is, as you know, tied up in politics and it is tied up in tax reform.

I strongly support a tax reform bill. I think we have some gross inequities. But I must say I am going to testify before the Senator Finance Committee tomorrow and say stop, look, and listen at one aspect of the tax reform that is in the House bill that I think can severely damage and begin to destroy a part of the genius of the American system. It can initiate a shift into Government sector, what we are now doing which is the envy of the world in the private sector, and I am talking about the changes affecting private philanthropy, foundations, educational institutions, and personal giving which is personal giving to treasure as well as time and energy. This can hardly be calculated as to the amount of voluntary contribution of effort and energy that presently goes to our social and charitable institutions.

Secretary Finch has given the only really dramatic and positive position paper on this particular point. I realize these provisions are not a part of the administration bill, other than to the extent that you have supported a 2 percent tax to cover the cost of auditing. I think that will not cost you nearly that much to audit and I hope we can get that figure down some more. But would you and Mr. Mayo care to clarify what your feeling is on this matter. I think it is terribly important to the Senate Finance Committee now and the entire Senate to have the administration's position made as clear as possible as to how you do look at anything that will undercut private philanthropy, will undercut the voluntary nature of American society and life which I do consider is real genius. DeTocqueville was the man who discovered that and what he said in 1832 is just as true today. If we start to erode that, we have really cut in at the heart of America and how we conduct our philanthropy as well as our business and everything is going to end up down in Washington, I am afraid.

Mr. KENNEDY. I would make this comment, Senator, that I would agree completely with you that we need to continue preference for charitable giving. Foundations, and so on, have done a tremendous amount of good in our country, and I would not want to see a tax bill that would do damage.

On the other hand, there are some changes that can and should be made as you, I am sure, would agree. It would be the task of the Senate Finance Committee to make what changes are necessary in the House bill in order to keep that bill from causing the damage that you foresee. And those changes are not too difficult to make and they would not impair the value of tax reform. I happen to have received Secretary Finch's letter and we answered his letter. In general we agreed with it. As the House bill works its way through the Finance Committee, I am sure that those changes will be considered and your testimony should be appreciated there.

Now, we need tax reform. We must act promptly on it. We do not want to get into the delaying tactics of keeping the investment tax credit and the 5 percent extension because that will cut revenues. They are badly needed. And I would hope that whatever political considerations there are, and that is in your field, not mine, that that would be worked out and we would get some prompt action. It can be done. And I would like to see the Senate move forthwith.

Senator PERCY. Well, I would be willing to eat Christmas dinner in Washington as much as that might interfere with our family plans if it would help finish a tax bill.

Mr. KENNEDY. I will join you. We will have dinner together.

Senator PERCY. We have got to know where we stand on this and we have got to let the American public and the business community know where we are, both from the standpoint of what we are going to appropriate and also what our tax structure is. But I realize we have got a big job and I hope we will try to do it as expeditiously as possible with your guidance and help.

Thank you.

Mr. KENNEDY. I would like to make one further comment, Senator, on that tax bill with respect to reform. It should be balanced out. It should not be a tax reduction bill in the light of the inflationary difficulties we are discussing here. And that is the real danger and this is where we have got to have statesmanship all the way through. Because in the economic climate that I see, I think it would be very bad to have that as a tax reduction bill.

Senator PERCY. Thank you.

Chairman GRIFFITHS. Mr. Conable?

Representative CONABLE. Thank you, Madam Chairman. Sitting down at the end of the line, of course, most of the obvious questions have been asked.

I have been sitting here and musing a little philosophically about Senator Javits analogy to a Scylla of recession and Charybdis of inflation, and I was thinking that you gentlemen must have an awful lot of back seat drivers as you trace this perilous course, not just in the Congress, of which this committee is probably a microcosm, but also in the business community. I sympathize with you. It would be a tough enough job if you had complete control of the ship. Here you have all the economic crosscurrents that are imperiling the voyage and you also do not have complete control of the crew.

With all this back seat driving, you two gentlemen are responsible in very large degree for the adoption of the unified budget concept. Although it was adopted during the Johnson administration, you both worked on it and strongly supported it. Then you were thinking as economists as you were both deeply involved in financial circles.

Now you have to think politcially, also. I wonder if you ever sometimes regret that we have a unified budget concept and are now talking about a surplus and trying to maintain a surplus rather than holding down the deficit that we would be talking about if we still were talking in terms of the administrative budget? It seems to me that politically you are in a very strange position to be talking about surpluses and I would like to report, if you do not know it, and I am sure you do, that the discovery that we had a greater budget surplus—under the unified concept, that is—than was originally anticipated, had a major impact on the fiscal restraint that the administration was asking for with respect to the education bill in the House.

So that political considerations certainly are now something that you are having to deal with in the psychology of fiscal restraint as it applies to the unified budget concept.

Do you have any comments to make about that, Mr. Secretary?

Mr. KENNEDY. Yes, I do. I think that the effort of the unified budget was a very productive one and that it——

Representative CONABLE. Certainly in economic terms, I agree.

Mr. KENNEDY. In economic terms and in giving the figures so that they could be understood. I think that the word surplus or deficit is where we probably have our real problems. One problem in understanding arises when there is a surplus at the same time the debt is increased. This problem keeps coming back from congressional members and that is the one I think you allude to. But at the same time, a problem in understanding arises when the budget figure shows a surplus while the debt is going up. That is a hard one to answer.

The figures are all in the budget. Perhaps we have been hit by at least the congressional end on the basis that, with their preference, the old administrative budget, which they understood, would be more effective in selling programs. I have not discussed this with Mr. Mayo. I had a long discussion on it yesterday. As a matter of fact, it was on the same question that you are giving me.

Representative CONABLE. I notice in your statement the word "surplus" appears many times and——

Mr. KENNEDY. Well, that is probably where we might have to change terminology or something. From an economic standpoint it is the impact of Government programs on the economy. Trust accounts are also involved in this.

I will ask Mr. Mayo to comment on that. He has more of a problem than I do.

Mr. MAYO. I have no regrets about what we came up with in the Budget Commission, Mr. Conable. I think we recommended the right thing and I think it is just as right today as it was then.

I recognize that, as the Secretary mentioned, there is a difficulty in explaining why the debt subject to limitation goes up, the way we define this debt, at the same time there is a budget surplus. The point, I think, is that we should be careful how we define debt. We went through all that earlier this year and failed to convince the Congress that we should define debt as debt. Involved, I think, is, as the Secretary suggested, the economic concept of the unified budget as a measure of the impact of Government activities on the economy.

Perhaps as important is that the whole point of the budget commission and the whole point of coming up with a unified budget was to eliminate, insofar as it was possible, the confusion caused by three different budget concepts that existed before. In January of 1967, for example, the Associated Press reported in terms of the administrative budget; the United Press carried the story based not on the administrative budget but on the cash budget; and the Washington Post and New York Times emphasized the budget based on the national income account. So, depending on which paper you picked up, you could draw different conclusions.

I think this was creating undue confusion in an area that is by definition somewhat confusing anyway. So, I feel very strongly, not just because of my association with the budget commission, but also in my present capacity, that the unified budget is the best way to present these figures, and I say that with no intention of disguising the fact that if you were to take out the trust fund surplus from the 1970 estimates, you would have a substantial deficit in the budget this year. You would have had a deficit last year. You would have had an even bigger deficit in 1968 than the $25 billion that we experienced.

So, I feel again that from a budget standpoint we are talking about resource allocation and the best way to allocate is on the basic of as comprehensive a definition of the Federal budget as we can get.

I feel it is important to look beyond the mere technical distinction between trust funds and Federal funds.

Representative CONABLE. I am not quarreling with the economic rationale and I hope the confusion we have over the unified budget is a temporary one. I am thinking about the psychology of fiscal restraint.

Mr. KENNEDY. Selling the taxpayer.

Representative CONABLE. You gentlemen have a real problem with back seat drivers who say, "The No. 1 domestic problem is inflation and do something but you do not do anything that will have any consequences." That is the problem that you are faced with. It is a psychological and political problem. I would like to tell you that here is one member that feels that tough measures are in order for the administration and I will support tough measures. I acknowledge the fact that you cannot make an omelet without breaking eggs. I do think that inflation is the No. 1 problem and I want to compliment the administration on what it has been doing to fight inflation generally. I think we have got to quit pussyfooting about the probability that there may be some discomfiture in the course of trying to get inflation under control, I want to see it under control sooner rather than later because I do not want prices stabilizing at the higher level that they will achieve at if we wait.

I think we have got to move fairly vigorously and toughly in this field.

Let me ask you—Senator Percy discussed the problem of the homebuilders to a certain extent. Are there ways in which we can mitigate the hardship in this particular industry? Homebuilders are not being discriminated against because they will benefit, of course, from getting inflation under control as you pointed out so well, but which, of course, has got to be the point of the fight against inflation as long as monetary policy is a very substantial part of that fight. I am sure that this is something that you have been concerning yourself with and I know the homebuilders descended on Washington last week and had all sorts of suggestions, some of which were somewhat inflationary themselves.

I wonder if you, Mr. Secretary, have any suggestions of ways in which we can mitigate their plight while not changing the basic course of the fight against inflation.

Mr. KENNEDY. We have been discussing various problems facing the housing industry with the homebuiders and the other groups. We have no answer that will remedy the situation at the moment. There are piecemeal actions that might be taken into account. I think in the last financing we were quite aware and quite concerned about causing disintermediation which would take even the short supply of funds out of the savings institutions. And there are proposals being discussed to solve this problem, but we have no answer at the moment.

Representative CONABLE. That is all, Madam Chairman.

Chairman GRIFFITHS. I understand that the technicians consider as a rough rule of thumb that when the general price level goes up 1 percent, the cost of running the Federal, State, and local governments goes up between 1½ to 2 percent.

Since prices have been rising recently between 5 and 6 percent per year, this suggests that the cost of running the Government is up somewhere between 7½ to 10 percent. This amounts in dollars to between $15 and $20 billion in the Federal budget. Yet, the increase in expenditures in fiscal 1969 to fiscal 1970 is only $8.6 billion.

Does this imply that we have to face an exceptionally large increase, perhaps $20 or $30 billion, in the next fiscal year to catch up with expenditures not allowed in the current fiscal budget or does it mean in real terms we are passing on the burdens of inflation to the beneficiaries of Government programs, including the aged, those on welfare, and the States and localities whose budgets are already allocated? To me the figures imply that somebody is paying a high cost for inflation through reduced Government benefits and what I want to know is who is paying?

Mr. MAYO. Well, that is quite a large order, Madam Chairman. In the first place, I am not familiar with the rule of thumb you stated. Also I am by nature, I guess, very cautious about rules of thumb.

But to get down to the specifics, your point is well taken, that there is a substantial increase in Government spending as a result of the inflation. I would not pretend to measure it precisely. We know that the very inflation we are talking about is the reason why pay comparability of Federal employees, for instance, requires us to spend nearly $3 billion in pay raises for this fiscal year that were not in last year's figures.

We know that the erosion of buying power due to inflation is the reason why President Nixon has asked for a 10-percent increase in social security effective April 1.

We know that the civil service retirement fund has an automatic escalator for benefits that are tied to the cost of living. And we know that procurement and many other things go up not only in the Federal sector but in other areas.

So, your point is well taken, and I would illustrate the point even further. If you take the relationship of total Government spending to the gross national product, it is shrinking somewhat at the present time despite the costs of the Vietnam conflict. We estimate for fiscal 1970 that the budget outlays will be 20.2 percent of GNP as against 21.6 just 2 years ago, fiscal 1968. This is a manifestation of the same sort of thing you are talking about.

I would also add that national defense purchases of goods and services—and this is something that is surprising to many people—are declining. They have declined from 9.1 percent of GNP in 1966–67, to less than 8½ percent at the present time, both figures being substantially less than, say the 10 to 13 percent we spent on national defense in the 1950's. I bring that in just as a footnote to some of the earlier discussions here.

In terms of overall Government spending, I think the point is very clear that each program in turn must be reevaluated in terms of increases that occur because inflation has forced higher costs on those programs. We are doing that as a regular process in the budget reviews which are going on right now for fiscal 1971.

Chairman GRIFFITHS. In the summer review of the 1970 budget the surplus is currently estimated at $5.9 billion compared——

Mr. MAYO. Yes.

Chairman GRIFFITHS. To $3.1 billion actually for fiscal 1969; is that not right?

Mr. MAYO. Yes, that is correct.

Chairman GRIFFITHS. Superficially this looks like a more restrictive budget but two-thirds of the more than $5.9 billion is contingent on legislation, is it not?

Mr. MAYO. That is correct.

Chairman GRIFFITHS. Does not this mean that there is considerable uncertainty as to whether the fiscal 1970 budget shows any improvement as far as surplus is concerned?

Mr. MAYO. Well, there is certainly uncertainty among businessmen, among citizens, among financial markets—where it is perhaps the most obvious—as to where not only the tax bill but where the appropriations bills are going as they wend their way through the congressional process. And I would say that not only is it terribly important for fiscal responsibility that these uncertainties be resolved in a favorable way, but that this be done as soon as possible because uncertainty is not really the way to achieve optimum economic growth.

Chairman GRIFFITHS. Actually, if you had the $5.9 billion surplus is not it really less restrictive than the last budget?

Mr. MAYO. Than the $3.1 billion? No, I do not think so, although I would join you in the point that each dollar does not necessarily have the same anti-inflationary or inflationary impact. You would have to look at individual programs and individual taxes to come to a firm conclusion on that.

Chairman GRIFFITHS. If you were to prorate the 1970 budget over the fiscal year, is it not true that the seasonally adjusted balance in the budget would show a declining surplus?

Mr. MAYO. I am not sure that our figures are too good on the seasonal adjustment factors to point that out, but I would like to, if I may, take a look at that, and maybe insert something in the record on seasonally adjusted.

Chairman GRIFFITHS. Without objection.

(The information referred to and subsequently submitted, follows:)

Monthly and quarterly data on the unified budget basis are available only for the fiscal years beginning with 1968. This is too short a period to permit the development of reliable seasonal adjustment factors.

If the seasonal patterns of fiscal years 1968 and 1969 are repeated in fiscal year 1970, except insofar as proposed changes in tax laws would affect the pattern, the unadjusted quarterly budget receipts, outlays and surplus (or deficit) in fiscal year 1970 will be:

[In billions of dollars]

	Receipts	Outlays	Surplus or deficit (−)
First quarter	47.9	50.4	−2.5
Second quarter	43.2	47.2	−4.0
Third quarter	45.5	47.1	−1.6
Fourth quarter	62.2	48.2	14.0
Total for year	198.8	192.9	5.9

Mr. MAYO. We, of course, pay attention to the seasonal adjustment but our business is basically the dollars themselves with reference to the way that our books are kept, if you want to put it that way; that is, without seasonal adjustment. The seasonal adjustment is done as a separate economic exercise.

Chairman GRIFFITHS. But the real truth is that the Government is largely responsible for the inflation and I sort of go along with the theory that it is. The 1970 budget is really not as restrictive as it probably should be to stop inflation, is that not true?

Mr. MAYO. Well, we are trying to tread this narrow path that Senator Javits was referring to and I am loath to suggest that a surplus of $9 billion or $11 billion or $2 billion would be a precisely better or worse surplus than the six. The surplus is a temperature gage but only one of a whole list of temperature gages.

Chairman GRIFFITHS. If the tax bill were actually passed as the House wrote it with the reductions in it, since I understand that there is no estimate made or an allowance made for economic growth or inflation, can you tell me or give me any inkling of what the loss in revenue would be over the next 10 years?

Mr. MAYO. I do not have such figures. I am not sure if the Secretary or Mr. Weidenbaum do. I was not even aware that such estimates as I have seen did not have a growth factor in them.

Chairman GRIFFITHS. I would like to ask you one more thing. We were discussing the decrease of Government employees. Is it true that more Government work is now being contracted out?

Mr. MAYO. Any effort to keep severe restrictions on the number of full-time permanent Federal employees may possibly elicit certain responses from a person managing a program. If you are in the Defense Department you may scratch your head and see if you cannot get a sergeant to do the job rather than a civilian employee of comparable grade. In certain cases you may be able to get more temporary employees, rather than permanent employees. In still other cases, you may try to resort to contracting out.

We have fairly stiff regulations on contracting out in the Budget Bureau. We are the first to admit that even with those stiff regulations, there is pressure in this direction and we are working very hard at controlling it.

Chairman GRIFFITHS. Well, will you answer in the record, then, whether or not you consider this more expensive than in hiring the employees by the Government?

Mr. MAYO. Yes; I will be glad to put something in the record.

(The following statement was submitted by the Bureau of the Budget:)

CONTRACTING OUT

Bureau of the Budget Circular A-76 dated August 30, 1967, sets forth the basic policies to be followed by the executive agencies in determining whether commercial and industrial products and services used by the Government are to be provided by private suppliers or by the Government itself.

Contracting out to avoid personnel ceilings is clearly prohibited by the Circular, the pertinent paragraph of which reads as follows:

"4. *Scope.* This Circular is applicable to commercial and industrial products and services used by executive agencies, except that it:

"a. Will not be used as authority to enter into contracts if such authority does not otherwise exist nor will it be used to justify departure from any law or regulation, including regulations of the Civil Service Commission or other appropriate authority, *nor will it be used for the purpose of avoiding established salary or personnel limitations.*" (Emphasis supplied.)

Budget Circular No. A-64 on the subject of position management and employment ceilings also provides a clear directive on this matter in section 4d:

"d. Any decision to substitute the use of service contracts for direct employment, or to change the proportionate use of full-time (permanent or temporary), part-time, or intermittent employment must be based on considerations of effectiveness and economy in administering Federal programs, and must not be used as a device to avoid compliance with the ceilings."

On the matter of relative costs, in-house vs. contracting out, the Circular is also clear. Paragraph 5.e. provides that:

"A government commercial activity may be authorized if a comparative cost analysis prepared as authorized in the Circular, indicates that the Government can provide or is providing a product or service at a cost lower than if the product or service were obtained from commercial sources."

Paragraph 6. of the Circular provides:

"Commercial sources should be relied upon without incurring the delay and expense of conducting cost comparison studies for products or services estimated to cost the Government less than $50,000 per year. However, if there is reason to believe that inadequate competition or other factors are causing commercial prices to be unreasonable, a cost comparison study will be directed by the agency head or by his designee even if it is estimated that the Government will spend less than $50,000 per year for the product or service. A Government activity should not be authorized on the basis of such a comparison study, however, unless reasonable efforts to obtain satisfactory prices from existing commercial sources or to develop other commercial sources are unsuccessful."

"Cost comparison studies also should be made before deciding to rely upon a commercial source when terms of contracts will cause the Government to finance directly or indirectly more than $50,000 for cost of facilities and equipment to be constructed to Government specifications. Cost comparison studies should also be made in other cases if there is reason to believe that savings can be realized by the Government providing for its own needs. Such studies will not be made, however, if in-house provision of the product or service, or commercial procurement thereof, is clearly justified in accordance with other provisions of this Circular."

I believe that these directives are unequivocally clear in setting forth the policy to be followed by the agencies of the Executive branch in determining activities to be performed in-house and/or by private enterprise.

The intent of these directives is to make contracting out no more expensive than direct hiring by the Government and to prohibit the use of contracting out to avoid personnel ceilings.

Chairman GRIFFITHS. Thank you.

Senator Proxmire?

Senator PROXMIRE. I would like to join in congratulating you gentlemen on being the principal movers in providing our unified budget. I think that was a great contribution and Mr. Kennedy, you were the chairman, as I understand it, and Mr. Mayo was the executive director and certainly most responsible——

Chairman GRIFFITHS. Pardon me, Senator Proxmire. Representative Brown, who is a member of our full committee, has just come in. We welcome your presence, Mr. Brown.

Representative BROWN. I arrived to discover the same people but discovered it was not my subcommittee. However, with your indulgence, there is one question I would like to ask just for your comments on what can be done about the problem.

Chairman GRIFFITHS. Without objection, the committee invites you to ask any questions you like.

Representative BROWN. Thank you, Madam Chairman, and members of the subcommittee, I appreciate your hospitality.

Have you had any rethinking, Mr. Secretary, on the wisdom of the total budgetary limitation that the Congress has passed which limits the President in what he can spend but does not limit the members of Congress on the appropriations for which they can vote, and, therefore, finds the President in a political whipsaw which provides the opportunity for members, all of us, to beat their breasts and view with alarm over any reductions proposed in certain areas and vote over the budget for appropriations in other areas and yet know that the President is faced with the necessity of restricting total spending to $192.9 billion?

Mr. KENNEDY. I am sure I do have concern and Mr. Mayo has double concern. Would you like to comment on that?

Mr. MAYO. Well, as you know, Mr. Brown, the administration preferred just as it did on the personnel side, that the Congress recognize the President's firm intention to keep budget spending at $192.9 billion and not impose a limit itself. The limit that was enacted was $191.9 billion plus a $2 billion kitty, if you please, for uncontrollables, most of which has now been used up. So the legal limit is already above the President's own ceiling, which he is determined not to exceed.

But we feel much as you suggested, that it is a very difficult sort of situation where an overall limit is imposed by the Congress, yet appropriation bills are passed which, when the expenditure effects are added up, exceed, perhaps significantly, the total ceiling. This gives us a responsibility which we are glad to have but we hope to share more with the Congress.

We continue to urge the Congress, therefore, in specific appropriation bill testimony, that the President's budget requests be adhered to. If they are not, then we may be forced into the very awkward position of reserving funds for specific programs and making further cuts in order to keep within the limits.

Representative BROWN. In a happier day or perhaps a day with a different set of problems, at least, Congress used to suspect that the various departments and the administration totally padded their budget requests in order to make allowance for the fact that the Congress was in those years inclined to cut budgetary requests when the Congress approved appropriations. Have you given any thought to the possibility that you might hew a little hunk of bone off here and there in the thought that the Congress is probably going to add to the allowances that you have made when they get into the appropriation procedure on your budget requests?

Mr. MAYO. I thought your line of questioning was going to go in a little different way, that you would suggest that maybe we should pad the budget to give you folks some place to cut so you would feel better about it.

Representative BROWN. That is the way it used to be done. It used to go in the other direction in other days. We have reversed our roles in this procedure, however, in recent years, and I wondered if you thought of reversing your role to the extent of recommending in your budget less than maybe the minimum so that the Congress could take the credit with their constituents for putting that back in and then we could all still live within the budget and everybody would be happy economically and politically, too.

Mr. MAYO. Well, I am not sure it would work out that way. My policies have been to submit the very best budget estimate that I know how to make and not attempt to play games with padding the estimates on the one hand or making cuts that we had good reason to believe would be restored on the other. I think the Congress is entitled to our best judgment. Otherwise, the whole process becomes a loss.

Representative BROWN. And then if they do not follow your advice it becomes the responsibility of the Congress, I suppose.

Mr. MAYO. Yes.

Representative BROWN. That would be your attitude. Except that we managed to put this total limit on which now adds another dimension to the thing. I wonder if at any place along the line anybody is going to point out how much more Congress appropriated in total than the President allowed and how much had to be cut by the administration?

Mr. MAYO. I think it will become clear as we go through the year. We are talking, of course, on the basis of only one appropriation bill having passed the Congress. Only the Treasury-Post Office bill, has been enacted, so all the returns are not in. But as I indicated in my statement, the possibilities at this stage are not particularly encouraging.

Representative BROWN. Maybe what you ought to do or somebody ought to do, some unbiased observer like the press ought to keep a box score on every Member of Congress to see if his individual voting with reference to appropriations matters kept within the budget or was irresponsible with reference to the budget and that would at least entitle us to talk out of one side of our mouths on the legislative side and just as it may keep the administrative side talking out of one side of its mouth, too.

This is the extent of my questioning, Madam Chairman, and again I thank you all very much for your kindness.

Chairman GRIFFITHS. You are quite welcome, Mr. Brown. Senator Proxmire, you are again recognized.

Senator PROXMIRE. Having congratulated you on the unified budget, Mr. Mayo, now I would like to say it is not very reassuring when the only reaction the administration has in the event that unemployment increases very sharply is that you would reverse this construction cutback which, as we pointed out, has had a very minute effect, $200 million, equal to 4 days of the Vietnam war. Obviously, it is not going to do much to provide the kind of jobs that we would need in the event unemployment rises. And you see what concerns me about it, and I think it should concern the administration very much, that if we felt confident, more confident than we do, that the administration would act decisively and effectively in the event unemployment starts rising sharply, I think you would get more support for your revenue measures and your expenditure measures designed to overcome inflation.

I suspect that the really great difficulty you are going to have with the tax bill in the Senate will depend on what happens to unemployment figures in the next month or two, and if there is no feeling the administration has any program to deal with this effectively in a big and sharp and decisive way, it would seem to me that it is going to be difficult to expect the Senate to go along on what could be construed as a deflationary recommendation.

Mr. MAYO. Senator Proxmire, I might say that just because I mentioned the Federal construction cutback as an example, it is not necessarily the only——

Senator PROXMIRE. What else is there?

Mr. MAYO. Well, of course, there are some automatic stabilizers as we all know. Unemployment compensation is one case in point. I would also mention that although we have not constructed a specific set of plans as to what we would do if the economic indicators begin to exhibit certain patterns, it is quite obvious that our approach would change. For instance, certain manpower programs could quite logically be expanded, and training programs could be speeded up somewhat.

Senator PROXMIRE. I would certainly like to see a specific series of plans. For example, I think the last administration started working on a program to meet the economic problems to develop after Vietnam and I presume you are carrying on in that area.

Mr. MAYO. Yes.

Senator PROXMIRE. But it has been quiet, anonymous. We have not heard very much about it and it seems to me something like this might be useful and helpful. We hope that the Vietnam war is going to wind down and, of course, the President does, too.

Mr. MAYO. To continue with my previous comment for a moment, we have some options on the construction side, too. Not only would the reversal of the 75-percent cutback have some significance, but, as I indicated earlier, Senator Proxmire, the policies of the preceding administration on Corps of Engineers and on reclamation were restrictive in earlier years. Changes there could add buoyancy to the economy, if necessary.

I want to emphasize, however, that we are not planning for a recession at this point. We feel that the economic adjustments will be sufficiently gradual that we can cope with them as they come along.

Senator PROXMIRE. Now, one of the reasons why I am concerned about this, the distinguished gentleman on your right, Secretary Kennedy, is Mr. Murray Weidenbaum, who we know well, an extraordinarily able economist who has testified before this committee before. He made a speech yesterday in which he said this:

> September results on the job situation, just released this morning, indicate that we may be returning from overheated, overemployed condition to more sustainable employment levels. The unemployment rates in September reached 4 percent.

Now, this seems to indicate that the administration feels that 4 percent, 4½ percent, this area, may be sustainable and may be the kind of level with which we are going to have to live for a long time. Does not the administration have a program for cracking into the structural elements that seem to give us serious inflation when we get below 4 percent, something which we have confidence in, some way we can move toward getting our unemployment rates below their present level without inflation? Four to 4½ percent means a lot of very, very unhappy Americans. Three million of them, including many members of the minority groups.

Mr. KENNEDY. If I may make one comment and then I will turn the microphone over to the man who caused this question to be raised, I think you stated a very important point. We must somehow provide the answer by qualifying a large number of people for gainful employment. These training programs and the efforts in our cities should move forward very quickly.

That is one area that is being considered when things start to change where you should move very quickly and carefully to increase your efforts. They are spending as much as they can now with the budget situation as it is. But you might want to talk about the unemployment rate, Mr. Weidenbaum.

Mr. WEIDENBAUM. It is always a pleasure to discuss economics with the Joint Economic Committee. I should caution the committee, of course, not to read too much into the speech that I gave yesterday. My main point there in that part of the speech you recited, Senator, dealt with the fact that as we examine the American economic history, a 4-percent unemployment rate compared to a 3½-percent unemployment rate, has generally been associated with periods of greater price stability. As the Secretary indicated, we are not engaged in recession planning, in good measure because that is not our expectation.

However, consistent with that I should like to point out that the administration has taken a number of steps, some of which require congressional action, to strengthen the ability of the American economy automatically to adjust to softening in economic activity.

Senator PROXMIRE. Let me come to that in a minute, but first, let me point out that you refer to a more sustainable rate in the employment situation just prior to the Vietnam expansion. I want to know what you mean by just prior but in 1963 we had 5.7-percent unemployment; 1964, 5.2; 1965, 4.5.

Now, those were perhaps acceptable at that time but in view of developments since then, to go back to this area of 4½ to 5, 5½ percent, it seems to me, would be really cruel and something we simply cannot accept.

Mr. WEIDENBAUM. Senator, I certainly did not have in mind an extrapolation of the rate. My statement was—please keep in mind the basic speech was on tax policy and in a sense this was an aside.

Senator PROXMIRE. I did not mean to pick on your but it is so hard for us to get hard figures and I do not blame you gentlemen for shying away from them. Here we have a figure that is fairly hard, so I am trying to find out if this is apparently the attitude of the administration, it seems to be that we can go along with this 4 to 5 percent unemployment perhaps because that is necessary if we are going to have stable prices. Is that an unfair statement?

Mr. WEIDENBAUM. That is not quite the way I would put it, Senator. My point was a far smaller one and that is that as I examine

American economic history in recent decades, I find that a 4 percent unemployment rate is usually associated with a less inflationary condition than a rate such as 3½ percent.

Senator PROXMIRE. All right. Now, Mr. Kennedy, let me move into what the administration really has done that is new. Back in the 1950's we had much higher unemployment. The Eisenhower administration had great trouble coping with it. They did a fine job in many respects, but in this respect I think many of us felt it was not adequate, and even in the 1950's, as I pointed out, unemployment was high.

Now, what new program is there that the administration has that can really change this situation? Senator Javits properly pointed out, and I would have if he had not, that we no longer have wage-price guidelines, no longer jaw boning by the President, no longer this kind of effort to hold down prices to the administrative price area or put pressure on unions to settle for more reasonable wage levels. Under these circumstances, it seems to me fairly clear that we are likely to get a higher level of unemployment and a steeper rise in prices than we would have if we had that kind of effort by the administration.

Mr. KENNEDY. Senator, in connection with your point on programs, the tax bill itself maximizes receipts over the period where inflation, not deflation or recession, appears to be our very serious threat. In other words, with the ending, as we recommended, of the surcharge next June, extension of 5 percent to June and then terminaton of the surcharge provided in the tax reform bill as it passed by the House, the revenue holding measures come into immediate play like the investment tax credit. The phasing out of many of them would be coming in a period when the economy would have turned the corner and it would have a stimulating rather than a deflationary effect as would the enactment of the family assistance program in the reform of our welfare system.

Senator PROXMIRE. The President recommended family assistance go into effect January first, 1971?

Mr. KENNEDY. That is right. That is the time when it would be going into effect. Then there are other areas. The enactment of the proposals to modernize the Federal-State unemployment insurance system would provide some automatic stabilization.

Senator PROXMIRE. Well, automatic stabilization but that automatic stabilization will only work to the extent that we have a deficit, to the extent that we have—I mean, very largely to the extent that we have a deficit. After all, if you are going to spend $4 billion that is the recommended addition to the family assistance program, this would tend to unbalance the budget?

Mr. KENNEDY. If you——

Senator PROXMIRE. Unless you cut out——

Mr. KENNEDY. If you are talking about a turn in the economy, Senator, you will have a fairly quick imbalance in the budget because tax revenue falls off very fast and expenditures escalate on the automatic expenditure side. So, there is a built-in, as you well know——

Senator PROXMIRE. Well, that is right.

Mr. KENNEDY. That is already there.

Senator PROXMIRE. I understand that. But you see the difficulty is that the administration seems to be relying on these automatic factors with very little dynamic action on their own part. They are relying on kind of a passive acceptance of the stabilizing effect of unemployment compensation. You do have this new family assistance program that will go into effect at a fairly modest level more than a year from now. But by and large, it is hard to see anything that really is going to cope effectively with the kind of rise in unemployment we may be experiencing, especially if the Vietnam war cools off as all of us hope and pray it will.

Mr. KENNEDY. The way I see the economic situation is just the reverse from the kind of a picture you are painting. You are talking about contingency planning and I agree.

Senator PROXMIRE. I think we ought to be prepared for everything——

Mr. KENNEDY. My view is that moving as fast as we are with technology and the pending demand that everyone has in our economy as well as worldwide, demand for almost everything imaginable, change in monetary policy in this kind of a climate can push economic activity up very, very fast. It is an entirely different situation than one you have over a longer period of time.

Senator PROXMIRE. You know the famous reaction that Chairman Martin had to this kind of thing when he was asked why he did not rely more on monetary policies to stimulate a sluggish economy. He said, you cannot push a string. In other words, monetary policy is pretty effective—supposed to be pretty effective—in holding down an expanding economy but when you——

Mr. KENNEDY. I was thinking that, given the needs for worldwide markets to satisfy the expectations of people in every walk of life, it would move much faster than when he was talking about the string.

Senator PROXMIRE. Thank you, gentlemen, very much. I just want to conclude by saying I would hope that you would give some really serious consideration to working up a program, a comprehensive program to meet the possibility of a serious unemployment problem arising. I am somewhat surprised and unhappy that the administration does not have that kind of thing in mind and thought out rather carefully.

Chairman GRIFFITHS. I would like to thank you very much for coming here and helping us. You have been very kind and quite responsive.

This committee will now adjourn until in the morning at which time we will hear Mr. Moore, Commissioner of the Bureau of Labor Statistics, and Mr. Fabricant, Director of Research for the National Bureau of Economic Research.

(Whereupon, at 12:30 p.m., the committee was adjourned, to reconvene Wednesday, October 8, 1969.)

THE FEDERAL BUDGET, INFLATION, AND FULL EMPLOYMENT

WEDNESDAY, OCTOBER 8, 1969

Congress of the United States,
Subcommittee on Fiscal Policy,
Joint Economic Committee,
Washington, D.C.

The Subcommittee on Fiscal Policy met, pursuant to recess, at 10:05 a.m., in room G–308, New Senate Office Building, Hon. Martha W. Griffiths, chairman of the subcommittee, presiding.

Present: Representative Griffiths and Senator Proxmire.

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

Chairman Griffiths. The committee will be in order.

Gentlemen, I would like to welcome both of you. I am very happy to have you here.

This morning the subcommittee continues its study of the budget, inflation, and full employment by inquiring into the anatomy of inflation.

We shall be concerned not with the movement of some single price index but with how the process of inflation moves through the complex network of thousands of prices, wage rates, profits, unit costs, and other economic factors. We shall be concerned with whom inflation affects; in what sequence do various prices, say, of raw materials, semifinished goods, finished products, or services begin to move; and, if we succeed in moving toward more stable prices, how will we detect success.

We have today two outstanding experts to help us comprehend the processes of inflation. Our first witness is Dr. Geoffrey H. Moore, Commissioner of the Bureau of Labor Statistics, Department of Labor, who is both a distinguished economist and statistician, and who was the recent president of the American Statistical Association. Our second witness is Dr. Solomon Fabricant, Director of Research at the National Bureau of Economic Research, an outstanding economist and student of economic processes. Both of our witnesses this morning are well known to this committee, and we welcome them.

Gentlemen, we will first hear from you in an opening statement and then proceed with the questions.

Dr. Moore, will you please lead off?

Dr. Moore. Thank you, Madam Chairman.

I have prepared a statement of some length, and I would like, with your permission, to put it in the record and just briefly summarize it.

Chairman GRIFFITHS. Please feel free to do so.
Mr. MOORE. Thank you.
(The prepared statement submitted by Dr. Moore appears following his oral testimony. See p. 44.)

STATEMENT OF DR. GEOFFREY H. MOORE, COMMISSIONER OF LABOR STATISTICS, U.S. DEPARTMENT OF LABOR

Mr. MOORE. Madame Chairman, Senator Proxmire, I am pleased to appear before you today.

As you have indicated, it has become fairly common in this country to discuss inflation in terms of a single index, namely, the Consumer Price Index. But really the term "inflation" covers a much wider realm of prices and costs: retail and wholesale prices of commodities, retail prices of services, wages and other factor prices, and asset values such as land or common stocks—all the things that people buy and sell. It is in the context of all these prices that I want to discuss some aspects of the anatomy of inflation.

I think the chief characteristic of inflation is a persistent and widespread rise in the price structure, plus a general expectation on the part of the public that this rise will continue.

The role of expectations deserves a good deal of stress and probably has received less attention than it deserves, in my judgment. The reason is that when people think prices are going to continue to increase at a rapid pace, the decisions they make reflect those expectations. A decision to buy an automobile or to build a house at a considerably higher price is likely to be influenced by whether or not the buyer expects prices to continue to rise rapidly. Borrowers become willing to pay interest rates at a higher level if they figure that they may have to face still higher rates if they postpone a decision or if they figure that the price level will keep on rising at a fairly rapid rate and make the loan easier to repay later on.

Inflationary expectations lead to higher wage demands because workers feel they must get a substantial wage increase to cover the rise in the cost of living or what they expect the rise in cost of living to be.

And there are a lot of decisions in the securities and money markets, both here and abroad, that are generated by expectations regarding the value of the dollar.

These expectations, at least for some time, help feed the inflation that brought them about but at the same time there is a possibility at a later stage for disappointment of widely held expectations. This can be a powerful factor, reversing decisions to buy or borrow or to hold or sell. It is for this reason, in considering this whole problem, I shall try to deal as best I can not only with the actual course of prices but with some evidence on expectations as well.

Now, we must use a number of statistical techniques in considering the inflationary process. One technique that I have tried to concentrate upon in this testimony is the rate of change in prices, and a good many of my statistics will bear on the rate of increase rather than the level of prices.

To understand the difference, please turn to chart 1–A (p. 46), which pertains to the Consumer Price Index. The top line on the chart shows the level of that index in each month since 1948, with the base 1957–59 as 100. The top line is the level of the index, and the line below, which is much more jagged in its appearance, is the rate of change in that index over 6-month intervals but put at annual rates. Recently, for example, the rate is somewhat over 5 percent.

In addition to considering rates of change, we must also bear in mind that there are seasonal fluctuations in prices—or at least in some prices. Prices of cars, for example, are generally higher at the beginning of a model year than they are later in that year. In other words, there is a gradual decline as the year goes on. Food prices also have a seasonal component.

In order to look at the longer run drifts and get a better fix on just where we are, I think it is desirable wherever there are these seasonal variations which simply repeat themselves every year, to eliminate them—and statistically we can do that. In the materials I have presented we have eliminated seasonal variations where they seem to persist.

In addition to considering the rate of increase in prices, I think one needs to look at the scope of price increases, that is, how widespread the price changes are. As I indicated at the beginning, I think an inflationary period is one in which price increases are general and we can, statistically, measure how general price increases are. We do that in terms of what we call a diffusion index, which simply measures, for any group of prices, how many of them are rising at any given time. If a large proportion are rising we can say that the inflation is widespread, and if only a small proportion are rising, it is less widespread.

I also want to treat the sequence in price changes, and for this purpose we have attempted to identify peaks and troughs in the rates of change in the various price indexes.

Now, let me refer briefly to the chart that I mentioned earlier on the rate of change in the Consumer Price Index and pick out a few of its features over the period since 1948.

Right after World War II, there was a very rapid increase in the price index through about the end of 1946. During 1947 it began to subside, and we pick up the movements in the chart in 1948 where you see a decline extending through most of 1948 and then into early 1949. That is, although the Consumer Price Index was still rising until the end of 1948, it was rising at a declining rate, and the decline in the bottom line of the chart shows that.

Then, early in 1949, the rate of decline began to diminish, and shortly before the middle of 1950, it crossed the zero line and began actually to increase again. So that was the period, through most of 1949, when the Consumer Price Index was declining and the rate of change was negative.

During the Korean war the rate of increase rose to as much as 14 percent per year at the beginning of 1951. Then it dropped off very sharply, and while the index kept on rising, the rate of increase was relatively low and reached its lowest point in the next cycle at the end of 1954.

Then, there was a rise again, into 1956, and an irregular decline thereafter that was interrupted early in 1958 by a sharp rise in the rate of increase. Then it dropped toward the end of 1958. The rate of increase picked up again in 1959, began dropping slightly in 1960, and still more in 1961.

Then, there came a long interval with relatively small rates of increase in the Consumer Price Index until 1965 and early 1966, when the rate of increase began to rise rapidly, reaching about a 4 percent rate. It dropped off in 1967 very briefly to about 2 percent, and since then has been rising fairly steadily until recently. I will come back to the recent changes in a moment.

Well, I think this history of rate of change in the Consumer Price Index reveals that the rate has varied over a very wide range in the last 25 years and that the very high rates of increase have not persisted for very long.

Another observation is that the declines from the highest rates of increase have occurred prior to business recessions. The peak rates in 1946–47, in 1951, in 1956–57, and in 1959 all occurred well in advance of the onset of recession. One inference that I would draw from that is that a recession is not necessary to bring about a decline in the rate of increase in the Consumer Price Index.

Moreover, there was at least one occasion, very recently, that is, 1966 and 1967, when there was a significant decline in the rate of increase of the Consumer Price Index, and no recession that is generally recognized as such occurred.

Now, in tables 1 and 2 (pp. 47, 48), we have tried to identify the peaks and troughs in the various measures of prices and costs and show what their sequence has been on different occasions when the Consumer Price Index rate of increase reached its peak or trough. In all cases, I am talking about the rates of change and not the levels of the indexes.

I have summarized in my testimony the conclusions I draw from that table. One is that stock prices have led at every turn in the Consumer Price Index, but by widely varying numbers of months averaging about a year at peaks and a half year at troughs. The prices of industrial materials traded on commodity markets have also tended to precede turns in the rate of change in the CPI and, to a lesser degree, so do prices of industrial commodities in wholesale markets generally.

On the other hand, looking at the components of the Consumer Price Index itself, it is clear that the service prices that are included in it, such as rents or utility charges, lag in relation to the total index as well as in relation to its commodity price component. Some of these prices lag because they are fixed by contract, by regulation or simply by custom.

Turning to the comprehensive measures of wages and their rates of increase, I read from the table that their movements are approximately coincident with the rates of increase in consumer prices while the rates of increase in labor costs per unit of output usually lag behind both the compensation rates and prices.

Finally, a record of selling price expectations held by business enterprises and compiled by Dun & Bradstreet suggest that these expectations also lag behind actual price changes. Similar data on consumer expectations compiled by the University of Michigan Survey Research Center reveal a similar type of lag.

In chart 1, I have put together some measure of what, for this purpose, I have called indexes of demand pressures, because they throw some light on the kinds of factors that have influenced the rate of change in the Consumer Price Index or in prices in general. They are called indexes of demand pressures because they represent, for the most part, types of economic data that have a forward-looking and early-moving element and pertain to the pressure of demand against supply.

The first line in that chart is called capital investment commitments, and these include such things as new orders for durable goods, contracts for construction, permits for new housing, and formation of new business enterprises. These represent commitments for future activity and usually rise when the demand for such capital investment is rising, and putting pressure on the capital goods markets.

The next line is inventory investment and purchasing. The components include such things as the change in business inventories, the change in unfilled orders, purchasing activities of purchasing agents, and, again, from the standpoint of looking at the demand and supply situation, these types of activities put pressure on markets for commodities.

Sensitive financial flows, the third line of the chart, include the rate of change in the money supply which can be looked at as the net increase in funds created by banks relative to the amounts which they absorb, and some rather cyclically moving types of credit flows: consumer installment credit, mortgage credit, and business loans. All these are in the form of a net flow, that is, the amounts of credit or money that are created on net balances each month. These, of course, provide the wherewithal for the purchases in the capital markets as well as the commodity markets.

Profitability, line four, is included because one of the most sensitive and early ways in which the pressure of demand on supply gets indicated is through profits.

The fifth line, marginal employment adjustments, includes activities such as the change in the average workweek, new hiring or layoffs, and initial claims for unemployment insurance, all of which represent initial reactions in the labor market to a change in the demand and supply relationships.

The sixth line, a composite of elements of all five preceding ones, in a sense sums them up, and I think you can see a good deal of similarity among the five elements themselves in their short-term movements, so the composite index is a fairly representative summary.

Finally, the rate of change in the Consumer Price Index, is the same series that I showed you on the preceding chart.

Now, looking at these indexes of demand pressures and the rate of change in the CPI, I think you can see a modest relationship between the two. It is not by any means close. Sometimes, as in 1950–51, there was a clear and almost coincidental relationship between them, and, again, in 1966–67, the demand pressures and the rate of change in the CPI moved down together. At other times, there seems to be more of a lag in the rate of price increase behind the demand pressure indexes. Nevertheless, there is some correspondence if you take the lag into account.

In the next collection of charts 2, 3, 4, and 5, we put together some measures of the kind of thing that I mentioned earlier, but pertaining to fairly recent periods.

Chart 2 includes the different types of prices that I mentioned earlier, to show something of their sequence in the last 4 or 5 years.

Chart 3 measures the rate of inflation in terms of the Consumer Price Index on the first page, the GNP inflator at the bottom of the page, the wholesale industrial price at the top of the next page, labor costs per unit of output, and labor compensation and output per man-hour. All of these measures are interms of annual rates of increase or decrease, as the case may be.

The fourth chart includes measures of what I have called the diffusion or scope of inflation and shows on the top line what percentage of a group of wholesale price indexes are rising at any given time. The second and third lines show what manufacturers and retailers say they think is happening to their own prices in any given quarter, whether they are rising or falling.

Finally, in chart 5, there are three indexes of inflationary expectations which record how wide the belief is that the prices will continue to rise over the next 6 to 12 months.

Let me summarize the findings that I think these charts enable us to come up with.

First, the current inflation developed gradually over the past 4 years, becoming more and more pervasive. The rise in the price level began to accelerate in 1965, and acceleration continued during most of the period since 1965. Expectations that prices would continue to rise became more and more widely held.

There was a significant but short-lived interruption to this process during 1966–67. During that period of about a year, every one of the demand-pressure indexes declined, and the rate of increase in the Consumer Price Index fell from 4 percent to 2 percent. But unfortunately that interruption in the rate of increase was short and came to an end very soon. By the end of 1967 the rate of increase was back to where it had been the year before. The acceleration has continued through 1968 and early 1969.

In the last few months, all of the indexes of demand pressures, with the possible exception of inventory investment and purchasing, have begun to weaken, and I have reported in my prepared statement the months where they reached their highest point. The earliest month in that group is December 1968, when the sensitive financial flow index reached its high point, and the rest ranged through April and May, with the latest one reaching a high point in July. The composite index of all of them reached its highest point to date in April. While all of them have weakened, this weakening has not generally carried as far as it did in 1966–67.

Well, besides this weakening in the demand pressure indexes, we can see some decline in the rates of increases in some of the early moving price indexes. In stock prices, the rate of increase not only began to decline late last year, but, of course, the actual level has been declining for some months.

In industrial materials prices, the sensitive commodity market index, the rate of increase has been gradually declining in recent months. But it certainly has not dropped in its level.

The rate of increase in the Consumer Price Index has been relatively stable for several months. It is too early to say that a decline has set in, but the highest rates to date were reached last spring or summer, at about the same time or a bit later than the highs in the demand-pressure indexes.

The rates of increases in wages may also have begun to stabilize, though at a much higher level than the rates of increase in output per man-hour. The discrepancy between the two produced very sharp increases in unit labor costs the first half of this year.

Expectations of further price increases are more widely held, according to the indexes I have shown, than at anytime since the 1950's, but, as I pointed out, such expectations have generally lagged behind events.

The way I sum up this situation is that the developments that have occurred in recent months are similar to those which have usually occurred when an inflationary period has been drawing to a close. This does not mean that the general price level will not advance further. It is virtually certain to do so. But the acceleration that we have been observing over the past 4 years has, in my judgment, been stopped, and the next development that I look for is a reduction in the rate of price increase which I believe could be expected to follow from the relatively mild reduction in demand pressures that have already occurred.

I would like to conclude, Madam Chairman, by mentioning three statistical improvements that I think we ought to be making, and I just put them before you.

One is that whereas we have a widely accepted measure of the general price level on a monthly basis, we do not have a similar widely accepted index of the general wage level. I have used in this presentation the most comprehensive index of labor compensation per man-hour that is available, but there are many defects in it from a statistical point of view in its coverage and in its availability. I think we should attempt to construct a better general wage index.

Secondly, there are some specific needs for improvement in the price statistics, particularly with respect to the comparison of U.S. prices with prices in other countries. There are also some deficiencies in our wholesale price indexes that could be remedied by further work.

Finally, there is a need for statistics to be presented currently, as clearly and conveniently as possible on inflation, the rate of inflation and inflationary expectations, the demand pressures that I have mentioned, and so on. On the whole, from my experience, I see a lag in the recognition of inflationary pressures, and there may well be a lag in the recognition of the cessation of those inflationary pressures. By making a better statistical presentation available to the public, we could reduce those lags.

In these various ways, our knowledge of the anatomy of inflation can be expanded and made more precise, that is, with the additional statistical improvements that I mentioned. The toll of human misery and economic waste that inflation leaves in its path surely justifies this effort.

Thank you.

(Dr. Moore's prepared statement follows:)

PREPARED STATEMENT OF DR. GEOFFREY H. MOORE

THE ANATOMY OF INFLATION

1. INTRODUCTION

(a) Inflation

Although it has become customary to measure the degree of inflation in this country on the basis of a single index, notably the Consumer Price Index, the term *inflation* is really descriptive of the state of the whole price and cost structure. The anatomy of inflation should be viewed through the complicated network of commodity and service prices, wages and other factor prices, and asset values. All of these move constantly in relation to one another as changes occur in cost and supply conditions, consumers' and businessmen's expectations, fiscal and monetary policy, consumers' incomes and tastes, and foreign as well as domestic competitive conditions. As a result of these changing conditions some prices fall and others rise, but the chief characteristic of an inflation is a persistent and widespread rise in prices, plus a general expectation on the part of the public that this rise will continue.

Expectations play a very important role in how the price structure behaves, and in what the consequences are. The reason is that when people think prices are going to continue to increase at a rapid pace, the decisions they make reflect those expectations. A decision to buy an automobile or to build a house at a considerably higher price is likely to be influenced by whether or not the prospective buyer expects prices to continue to rise rapidly. Borrowers become willing to pay interest rates of seven, eight, or nine percent if they figure that interest rates may go still higher or the price level will keep rising three or four percent per year, making the loan easier to repay at a latter date. Inflationary expectations also lead to higher wage demands. Workers feel that they must get a substantial wage increase just to cover the rise in the cost of living. But rapid wage increases raise costs of production and influence decisions to raise prices or to avoid price cuts. Finally, many types of decisions in both foreign and domestic money and securities markets are generated by expectations regarding the future value of the dollar.

Decisions that are influenced by the state of expectations often help to feed the inflation that brought them about. This constitutes a self-generating process that promotes price and cost increases and, at least for a time, verifies the expectations themselves. By the same token, disappointment of widely held expectations can be a powerful factor reversing decisions to buy or to borrow, to hold or to sell. For these reasons, in considering the anatomy of inflation I shall deal not only with the actual course of prices but with some evidence on expectations as well.

(b) The level of prices versus the rate of change

In analyzing the inflationary process we must employ a number of statistical techniques. We must concern ourselves not only with the level of prices but also with the rate at which the price level is changing. There are many ways in which the rate of change can be measured. What we have done is measure the rate of change in a price index over different lengths of time, such as one, three, six, and twelve months. The rate of increase over each of these spans is then converted to an annual rate. Two principles can be observed from this method of measuring the rate of change. If you use the rate of change over a very short span such as one month or one quarter you may be able to recognize a change in the trend sooner than if you used a longer span. To be aware of current developments you must concentrate on short-run movements.

On the other hand, there is generally a great deal of erratic movement in month-to-month or quarter-to-quarter changes and consequently, if you look at every wiggle, you are bound to be wrong about what is happening to the general trend a good deal of the time. The longer the span the smoother the rate of change. But one pays a price for smoothing away the wiggles, namely, tardy recognition of a change in trend. We have found no ideal answer to this dilemma, but resolve it by providing a variety of measures and making some arbitrary compromises.

In working with rates of change one must consider not only the irregular and cyclical aspects of a price index but also its seasonal behavior. Some prices go up quite regularly in certain months and go down just as regularly in other months. Quite often a price index will appear to have very little seasonal movement in terms of its general level. This is true of the Consumer Price Index and the Wholesale Price Index. However, in terms of rates of change over short periods such as three or six months the seasonal factor can be quite significant. As a rule, we will use seasonally adjusted data in this analysis, since we are interested in the persistent movements in prices, not the ups and downs that occur regularly every year. To show what the adjustment does, I have included an analysis of seasonal movements in the Consumer Price Index in Appendix A.

(*c*) *Scope of inflation*

The rate of increase in prices is not the only attribute of inflation that requires measurement. The scope of inflation is also important. The seriousness of the inflation depends on whether prices are advancing in most sectors or just a bare majority, whether prices of most types of commodities, services, or factors are advancing, and whether a large or small fraction of the population expects the rate of advance to continue. Furthermore, the end of a period of inflation may be heralded by a reduction in the scope of price increases. Diffusion indexes provide a useful means of looking at this aspect of the anatomy of inflation. For any group of prices, a diffusion index shows what percentage are rising at any given time. We shall, therefore, want to observe closely a few of the more important diffusion indexes available.

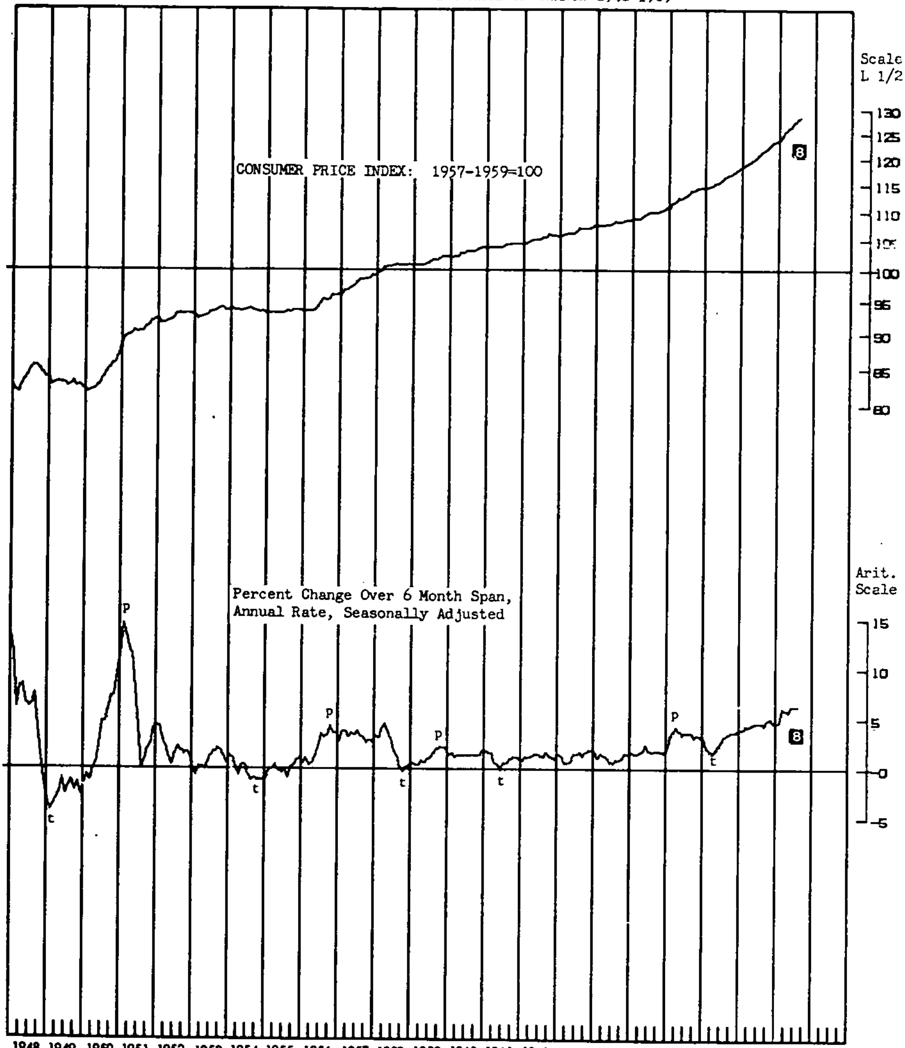
(*d*) *Sequence in price change*

The condition of inflation means a general, or widely diffused, rise in prices, but at the beginning and again at the end of such a period, price increases are less common. In part, this is due to the existence of more or less regular sequences in the movement of different prices. The prices in some markets almost always begin to rise more promptly than in other markets. Similarly, some prices typically begin to fall sooner than others. In order to observe these sequences we have identified peaks and troughs in the rates of change of various price indexes and other series, and have measured leads and lags between these high and low points. The methods used are the same as those used for many years at the National Bureau of Economic Research in identifying leading indicators. For the present purpose we have measured leads and lags with reference to the rate of change in the Consumer Price Index. By determining the historical relationship of other series to the rate of increase in the Consumer Price Index, we hope to illuminate the current situation and near-term prospects.

2. LEADS AND LAGS IN THE PRICE SYSTEM

Before taking up the subject of leads and lags in the price system let me review briefly the history of changes in the rate of increase in the Consumer Price Index since World War II (see Chart 1–A).

CHART 1A
CONSUMER PRICE INDEX AND ITS RATE OF CHANGE 1948-1969



Source: U. S. Department of Labor, Bureau of Labor Statistics

Shortly after the war ended the price index began rising at a very rapid pace, reaching a rate in the neighborhood of 30 percent on an annual basis at the end of 1946. Early in 1947 the rate of increase began to subside, but it was still as high as 12 percent at the end of 1947. A further decline occurred in 1948 and by the end of the year the price level actually began to fall—i.e., the rate of change became negative. The sharpest rate of decline occurred early in 1949. With the outbreak of the Korean conflict in June 1950 the index shot up, and its rate of increase reached the spectacular level of about 15 percent per year early in 1951. Fortunately this rate did not persist. By the end of 1951 it was down to about 4 percent, and it fell further during 1952, 1953, and 1954. The bottom was reached at the end of 1954, when another climb began. By the autumn of 1956 a rate of increase of more than 4 percent was being registered. An irregular decline followed, interrupted by a sharp rise early in 1958, after which the rate of change dropped to zero towards the close of the year. The year 1959 saw some acceleration, but only up to a rate of increase of 2 percent, following which another irregular decline occurred, with a zero level recorded in mid-1961. For the next three years the index rose at rates in the neighborhood of 1½ percent, but in 1965 a 2 percent rate became prevalent and early in 1966 a 4 percent rate was reached. A year later the rate had dropped to 2 percent again, but it didn't stay there long. A rather steady acceleration in the rate began in the spring of 1967 and continued during 1968 and early 1969.

This brief history of the rate of change in the Consumer Price Index reveals several things. First, the rate of increase has varied over a wide range during the past quarter-century. Second, high rates of increase have not persisted very long. Third, declines from the highest rates have occurred prior to business recessions. The peak rates—1946–47, 1951, 1956–57, and 1959—all occurred well in advance of the onset of recession, from which I infer that a recession is not necessary to bring about a decline in the rate of increase in the Consumer Price Index. Moreover, since some declines in the rate of price increase occurred when no recession ensued—the most recent example is 1966–67—recessions are not a necessary consequence of a decline in the rate of increase in the Consumer Price Index. The one can occur without the other.

Tables 1 and 2 utilize the chronology of peaks and troughs in the rate of increase in the Consumer Price Index to look into the question whether other prices, wage rates, costs, and price expectations tend to move sooner or later than the CPI. We reach the following conclusions, all with respect to rates of increase in these indexes.

TABLE 1.—CYCLICAL PEAKS IN RATE OF CHANGE IN SELECTED PRICES, WAGES, COSTS, AND PRICE EXPECTATIONS

Series	Peaks				Median at peaks
1. Consumer Price Index, total.	February 1951	October 1956	November 1959	April 1966	
2. 500 common stock prices [1]	January 1951	September 1955	January 1959	April 1963	
3. Industrial material prices	November 1950	December 1955	November 1958	November 1964	
4. WPI, industrials [2]	January 1951	November 1955	May 1959	July 1966	
5. GNP deflator	February 1951	August 1956	(3)	August 1966	
6. CPI, services	(4)	June 1957	September 1959	September 1966	
7. Selling prices, manufacturing and trade:					
Actual	February 1951	November 1956	August 1959	August 1966	
Anticipated	May 1951	February 1957	November 1959	February 1967	
8. Compensation per man-hour.	November 1950	August 1956	February 1960	May 1966	
9. Unit labor cost [5]	February 1951	February 1956	August 1960	August 1966	
	Lead (−) or lag (+) at peaks in CPI, total, in months				
2. 500 common stock prices [1]	−1	−13	−10	−36	−12
3. Industrial material prices	−3	−10	−12	−17	−11
4. WPI, industrials [2]	−1	−11	−6	+3	−4
5. GNP deflator	0	−2	(3)	+4	0
6. CPI, services	(4)	+8	−2	+5	+5
7. Selling prices, manufacturing and trade:					
Actual	0	+1	−3	+4	+1
Anticipated	+3	+4	0	+10	+4
8. Compensation per man-hour.[5]	−3	−2	+3	+1	−1
9. Unit labor cost [5]	0	−8	+9	+4	+2

[1] Additional peaks occurred in April 1961, April 1967, and September 1968.
[2] Additional peak occurred in July 1953.
[3] No timing comparison.
[4] Not available.
[5] Private nonfarm, all persons.

Note: Rates are computed over 6-month spans except series 5 (2-quarter span) and 7 (4-quarter span), are datedat end of span, and are annual rates based on seasonally adjusted data except series 2, 3, 6, 7. Series 7 is a diffusion index. For further indentification of series, see app. B.

TABLE 2.—CYCLICAL TROUGHS IN RATES OF CHANGE IN SELECTED PRICES, WAGES, COSTS, AND PRICE EXPECTATIONS

Series	Troughs					Median at troughs
1. Consumer price index, total	February 1949	December 1954	October 1958	June 1961	April 1967	
2. 500 common stock prices [1]	December 1948	September 1953	January 1958	February 1960	October 1966	
3. Industrial material prices	June 1949	August 1951	do	July 1962	do	
4. WPI, industrials [2]	May 1949	January 1954	February 1958	December 1960	July 1967	
5. GNP deflator	do	November 1953	No timing comparison.	August 1961	May 1967	
6. CPI, services	Not available	Not available	December 1958	do	August 1967	
7. Selling prices, manufacturing and trade:						
Actual	do	May 1954	May 1958	May 1961	May 1967	
Anticipated	do	August 1954	August 1958	February 1963	August 1967	
8. Compensation per man-hour [3]	November 1949	February 1955	May 1958	February 1961	May 1967	
9. Unit labor cost [3]	August 1949	do	August 1958	August 1961	August 1967	
	Lead (−) or lag (+) at trough in CPI, total, in months					
2. 500 common stock prices [1]	−2	−3	−9	−18	−6	−6
3. Industrial material prices	+4	−40	−9	+13	−6	−6
4. WPI, industrials [2]	+3	−11	−8	−6	+3	−6
5. GNP deflator	+3	+13	No timing comparison.	+2	+1	+3
6. CPI, services	Not available	Not available	+2	+2	+4	+2
7. Selling prices, manufacturing and trade:						
Actual	do	−7	−5	−1	+1	−3
Anticipated	do	−4	−2	+20	+4	+1
8. Compensation per man-hour [3]	+9	+2	−5	−4	+1	+1
9. Unit labor cost [3]	+6	+2	−2	+2	+4	+2

[1] Additional troughs occurred in June 1962 and March 1968.
[2] Additional trough occurred in November 1951.
[3] Private nonfarm, all persons.

Note: Rates are computed over 6-month spans except series 5 (2-quarter span) and 7 (4-quarter span), are dated at end of span, and are annual rates based on seasonally adjusted data except series 2, 3, 6, 7. Series 7 is a diffusion index. For further identification of series, see appendix B.

1. Common stock prices, as measured by Standard and Poor's 500 stock index, have led at every turn in the CPI. The leads have averaged about a year at peaks and a half-year at troughs. However, the leads have varied greatly in length and there have been some swings in stock prices—for example, in 1961–62—that are not matched by corresponding swings in the CPI. Stock prices are, of course, especially sensitive to investors' appraisals of domestic and international events, many of which have little to do with the factors that determine the prices that consumers pay. But some factors influence both stock prices and consumer prices, causing them to move in a rough correspondence, but with the effects showing up much earlier in stock prices, and of course greatly magnified in degree.

2. The prices of industrial materials traded on commodity markets also tend to lead the turns in the CPI. To a lesser extent, so do the prices of industrial commodities in the wholesale markets generally. Price changes in these markets are generally passed on, with a lag, to the retail markets. The processing that the industrial materials and components undergo as they enter into finished goods for sale to consumers adds a cost element which itself generally lags behind these prices.

3. The Consumer Price Index includes services as well as commodities, and the prices of these services lag behind the total index as well as its commodity price component. Some of these service prices, such as rents or utility charges, lag as a consequence of being fixed by contract or by regulation, or simply by custom.

4. Rates of increase in labor compensation per manhour appear to move in roughly coincident fashion with rates of increase in consumer prices, while rates of increase in labor costs per unit of output usually lag behind both the compensation rates and the prices.

5. Records of selling price expectations held by manufacturers, wholesalers and retailers, compiled by Dun and Bradstreet, Inc., suggest that such expectations lag behind actual price changes. Similar data on consumers' expectations, compiled by the University of Michigan Survey Research Center, reveal a similar pattern.

3. DEMAND PRESSURES AND THE PRICE SYSTEM

The leads and lags within the price system tell us something about the inflationary process and how it develops. But we need to know more about the underlying conditions of demand and supply, and how these relate to the inflation of prices. One way to observe these conditions, which seems to have particular merit from the standpoint of current analysis of forecasting, is to pick out aspects of demand, or of demand-supply relationships, that have a forward-looking, early-moving element. I shall call them indexes of demand pressures, and some five different types are portrayed in Chart 1, which shows their course month by month since 1948, together with a composite of all five (line 6 in the chart) and the rate of increase in the Consumer Price Index (line 7).

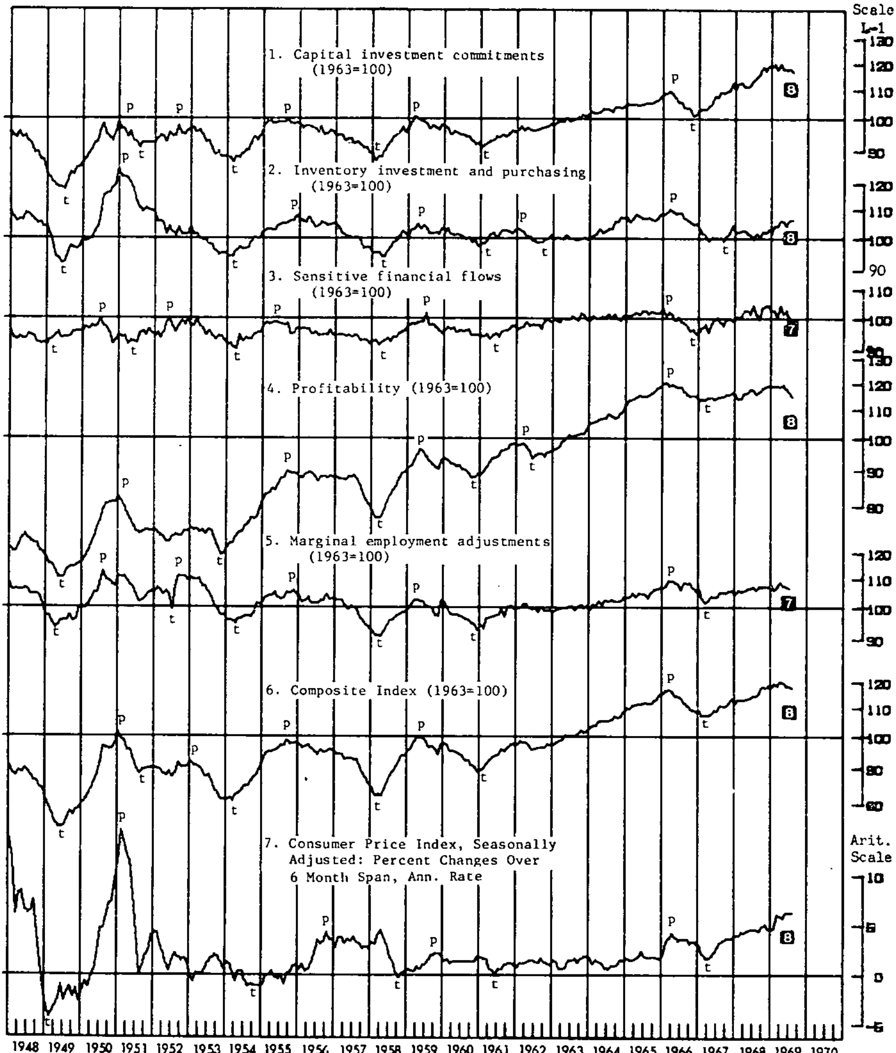
The top line, *capital investment commitments*, includes orders for durable consumer goods and durable producer goods, orders and contracts for plant and equipment, building permits for new housing, and an index of the formation of new business enterprises. Each of these represents a commitment for future activity, and such commitments not only have effects on the level of future activity as and when they are fulfilled, but also are likely to be highly sensitive to appraisals of future demand-supply, or price-cost relationships.

The second line, *inventory investment and purchasing*, includes the change in manufacturing and trade inventories, which is a measure of the difference in the rate of flow of goods delivered to business enterprises and goods sold by the enterprises. It includes also the change in unfilled orders for durable goods, which can be viewed as a measure of the excess of new orders placed over goods delivered. A measure of the activities of purchasing agents in adding to their inventories is also included, and finally the index of industrial materials prices, which in turn is sensitive to the demand created by attempts to maintain or expand inventories. All of these measures are, like the capital commitments, sensitive to appraisals of the future price-cost situation.

Line 3, *sensitive financial flows*, includes the rate of change in the money supply and three of the more cyclically volatile elements in the new flow of credit, namely, the change in consumer instalment credit, mortgage credit, and business loans of commercial banks. These funds provide the wherewithal for capital investment, inventory investment, and other transactions, and represent corresponding financial commitments by borrowers and lenders.

CHART 1

INDEXES OF DEMAND PRESSURES AND THE RATE OF CHANGE IN THE CONSUMER PRICE INDEX, 1948-1969



Source: U.S. Department of Commerce, Bureau of the Census, series 1 through 6.
U.S. Department of Labor, Bureau of Labor Statistics, Series 7.

Line 4, *profitability*, includes corporate profits, a ratio of prices to unit labor costs in manufacturing, and an index of stock prices. These components reflect, each in its own way, the element on which changes in demand and supply usually impinge first and most directly, namely, profits.

Line 5, entitled *marginal employment adjustments*, includes the average workweek, accession and layoff rates, and initial claims for unemployment insurance.

All of these represent types of activities with respect to the employment of labor that are intitial responses to demand-supply changes. They can be expected to reflect promptly in easing in the demand for labor.

The sixth line is a *composite index*, based on elements of all five of the preceding indexes. It is, in fact, an index of twelve "leading indicators." Since the movements of the five sub-indexes are fairly similar to one another, the composite index provides a fair summary of them all.

Clearly, the relation between these indexes of demand pressures, on the one hand, and the rate of change in the Consurmer Price Index on the other, (the bottom line on the chart) is far from perfect. Sometimes, as in 1950–51 and 1966–67, the movements correspond closely. At other times, as in 1954–55, the CPI appears to lag well behind the upward surge of the demand pressures. Further refinement of these measures, which were really developed without this particular use in mind, and hence are not precisely suited to the purpose of analyzing inflation, might clarify these divergencies. Yet by and large it seems to me that the indexes do have a good deal to say about the factors underlying the inflationary episodes since World War II.

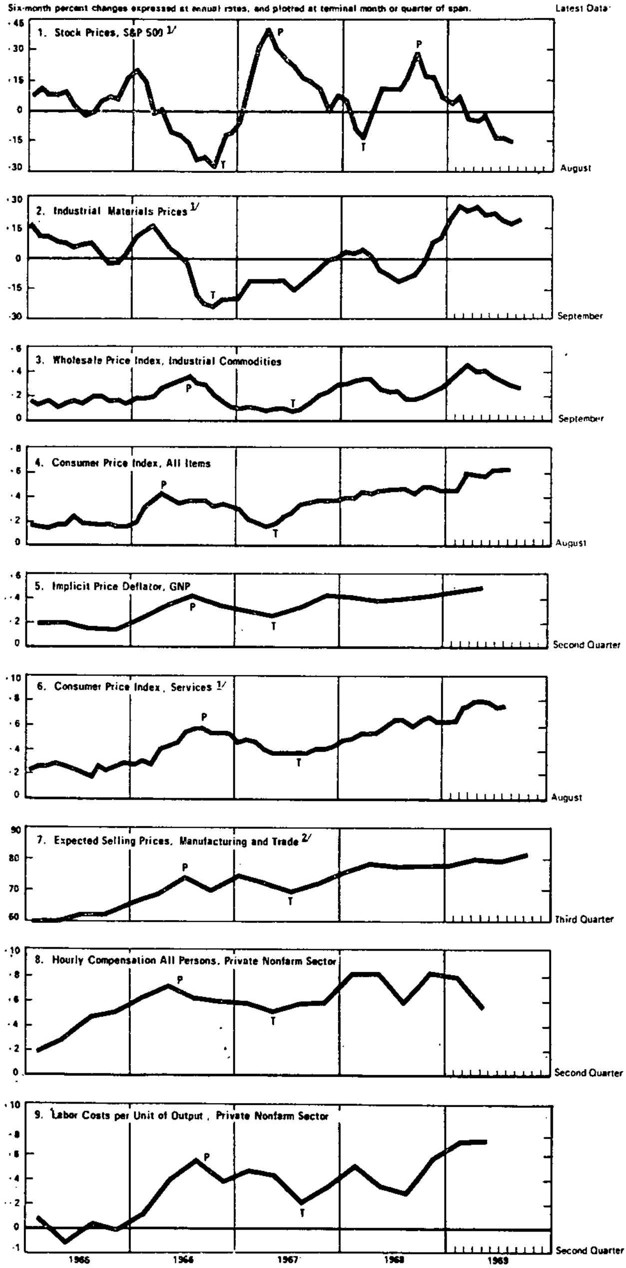
4. THE CURRENT INFLATION

What do our measures of the rate of price change, of the scope of price increases, of expectations regarding price change, of sequences among price changes, and of demand pressures, tell us about the current inflation? Let me enumerate some principal points that I believe are supported by the charts already presented and those that follow (Charts 2, 3, 4, 5).

Chart 2.

Rates of Change in Prices, Costs, and Price Expectations

(Seasonally adjusted except where indicated)



1/ Not seasonally adjusted

2/ Diffusion Index. Percent of respondents expecting an increase in their prices from a year earlier for the period roughly 6 months ahead. This series copyright by Dun and Bradstreet. Used by permission. May not be reproduced without written permission from the source.

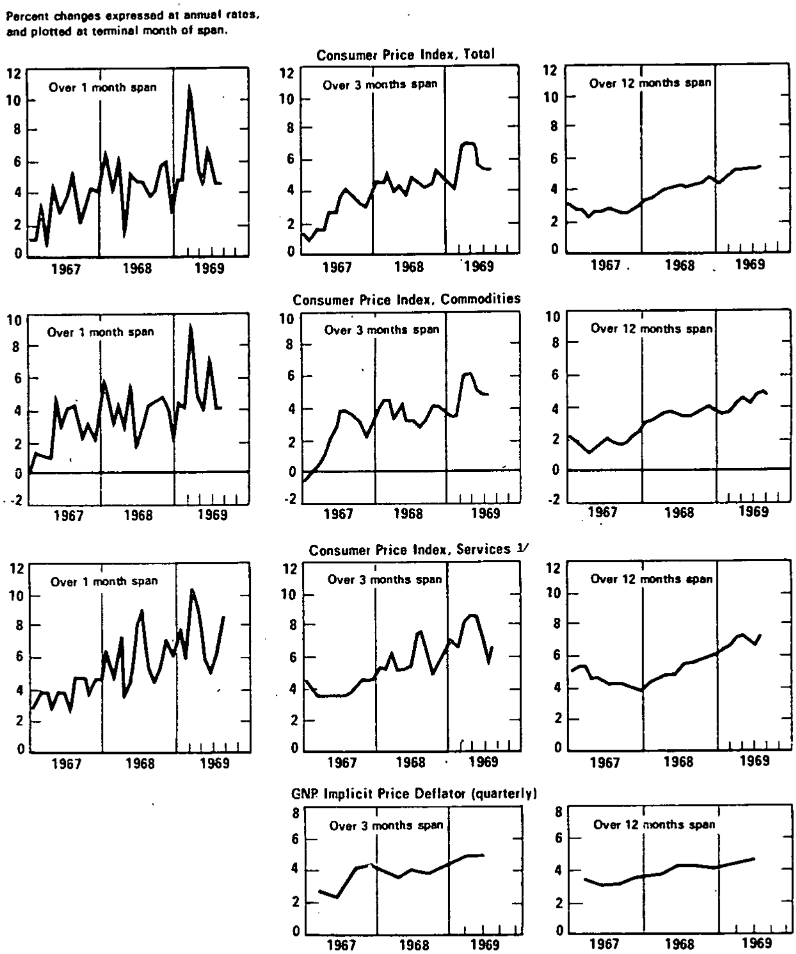
P-Peak
T-Trough

UNITED STATES DEPARTMENT OF LABOR
BUREAU OF LABOR STATISTICS

Chart 3.

Measures of the Rate of Inflation

(Seasonally Adjusted Series)



UNITED STATES DEPARTMENT OF LABOR
BUREAU OF LABOR STATISTICS

Latest Data: August (monthly plotting) and 2nd Quarter.

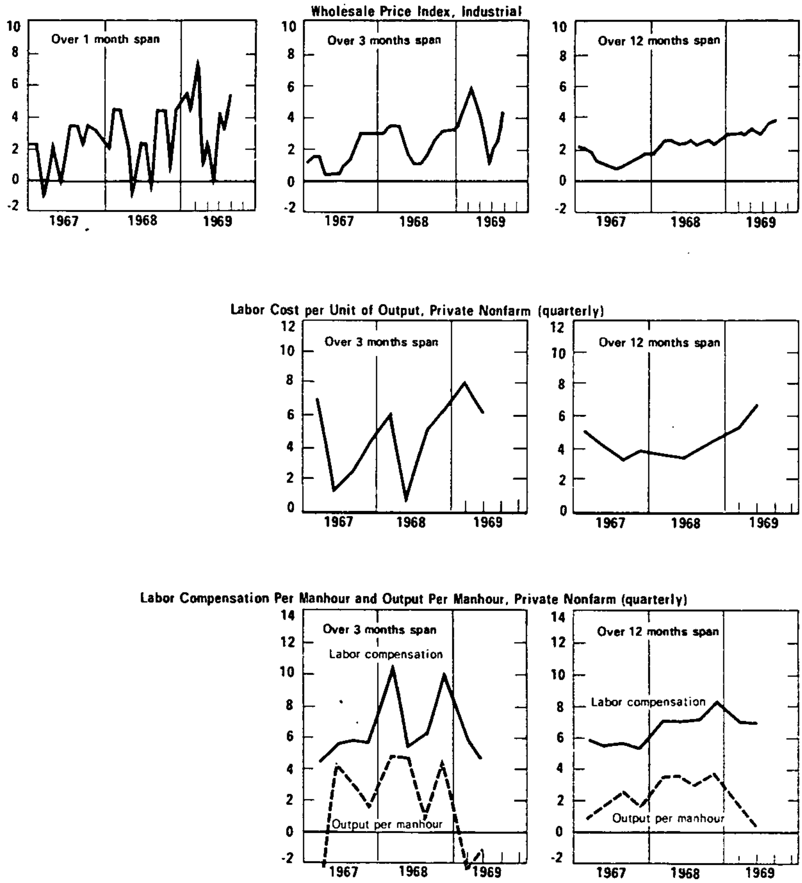
1/ Not seasonally adjusted

Chart 3. (Continued)

Measures of the Rate of Inflation

(Seasonally Adjusted Series)

Percent changes expressed at annual rates, and plotted at terminal month of span.



UNITED STATES DEPARTMENT OF LABOR
BUREAU OF LABOR STATISTICS

Latest Data: September (monthly plotting) and 2nd Quarter.

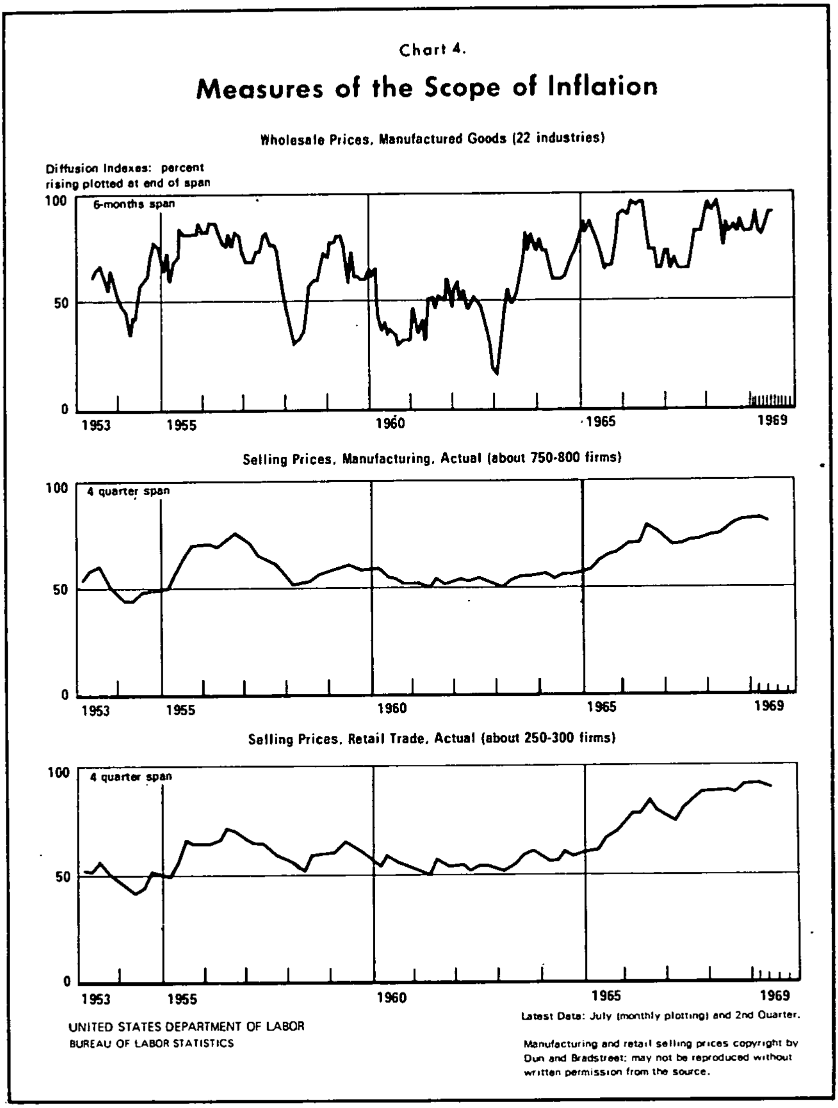
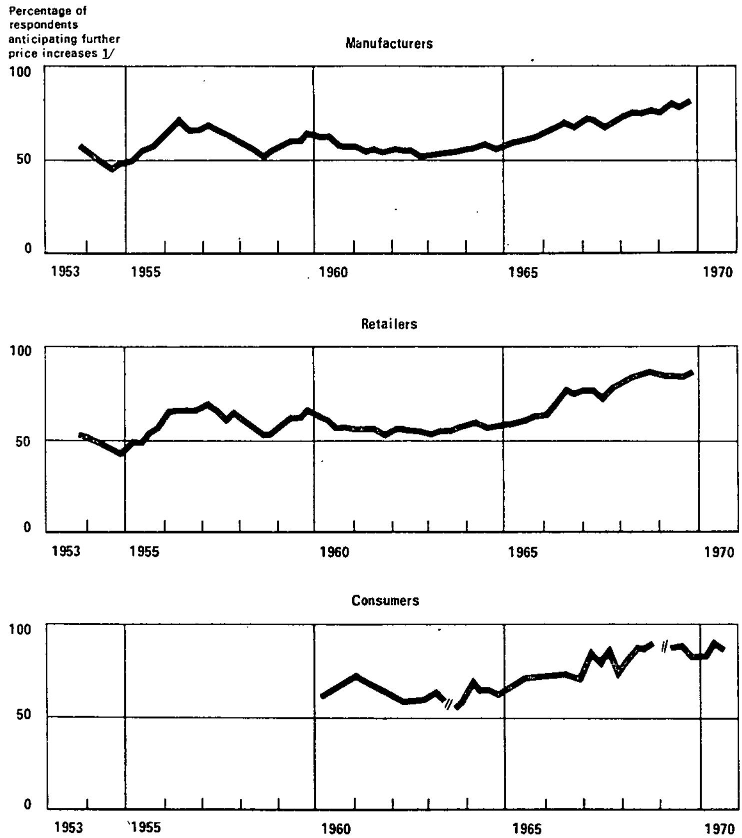


Chart 4.
Measures of the Scope of Inflation
Wholesale Prices, Manufactured Goods (22 industries)
Diffusion Indexes: percent rising plotted at end of span
100
50
0
6-months span
1953
1955
1960
1965
1969
Selling Prices, Manufacturing, Actual (about 750-800 firms)
4 quarter span
Selling Prices, Retail Trade, Actual (about 250-300 firms)
4 quarter span
Latest Data: July (monthly plotting) and 2nd Quarter.
UNITED STATES DEPARTMENT OF LABOR
BUREAU OF LABOR STATISTICS
Manufacturing and retail selling prices copyright by Dun and Bradstreet; may not be reproduced without written permission from the source.

Chart 5.

Measures of Inflationary Expectations



Latest Data: 2nd Quarter

1/ Four-quarter span, plotted at final quarter.

Sources: Manufacturers and Retailers, copyright by Dun and Bradstreet. Used by permission. These series may not be reproduced without written permission from the source.
Consumers, University of Michigan Consumer Survey.

UNITED STATES DEPARTMENT OF LABOR
BUREAU OF LABOR STATISTICS

1. The current inflation developed gradually over the past four years, becoming more and more pervasive. The rise in the price level began to accelerate in 1965, and acceleration continued during most of the period since 1965. Expectations that prices would continue to rise became more and more widely held.

2. There was a significant but short-lived interruption to this process during 1966. Every one of the demand-pressure indexes declined, and the rate of increase in the Consumer Price Index fell from 4 percent to 2 percent. But early in 1967 the inflationary process resumed its course. By the end of the year it had made up for lost ground, and it continued to accelerate through 1968 and early 1969.

3. All of the indexes of demand pressures, with the possible exception of inventory investment and purchasing, have begun to weaken in the past few months. The high points to date (using the latest available data through August) were reached in the following months:

(a) Sensitive financial flows, December 1968.
(b) Capital investment commitments, April 1969.
(c) Marginal employment adjustments, April 1969.
(d) Profitability, May 1969.
(e) Inventory investment and purchasing, July 1969.
(f) Composite index, April 1969.

This weakening has, in general, not carried as far as it did in 1966–67.

4. The rates of increase in some of the early moving price indexes—stock prices and industrial materials prices—have been declining for several months. In stock prices the decline has been much sharper than in materials prices, since the decline in rate of increase has been succeeded by a decline in level.

5. The rate of increase in the Consumer Price Index has been relatively stable for several months. It is too early to say that a decline has set in, but the highest rates to date were reached last spring or summer, at about the same time as or a bit later than the highs in the demand-pressure indexes.

6. Rates of increase in wages may also have begun to stabilize, though at a much higher level than rates of increase in output per manhour. The discrepancy, which was especially large in the first half of this year, produced sharp increases in unit labor costs.

7. Expectations of further price increases are more widely held than at any time since the 1950's, but such expectations have generally lagged behind events.

8. In short, we seem to be able to observe much the same sequence of developments occurring in recent months as that which has usually occurred when an inflationary period has been drawing to a close. This does not mean that the general price level will not advance further. It is virtually certain to do so. But it seems reasonable to say that the first essential objective, namely, to stop its acceleration, has been successfully accomplished. It also seems reasonable to expect, in my judgment, that the next objective, a gradual reduction in the rate of price increase, will follow from the relatively mild reduction in demand pressures that has already occurred.

5. SOME NEEDED IMPROVEMENTS IN STATISTICS ON INFLATION

I should like to conclude this statement with some recommendations for improvements in our statistical arsenal for dealing with the problem of inflation.

First, although a widely accepted measure of the general price level is available promptly every month, we do not have a similar, widely accepted index of the general wage level. We have used in our presentation the most comprehensive index of labor compensation per manhour that is available. But its statistical basis, particularly in coverage of salaried employees, is weak, and the earnings of government employees are not included at all. Moreover, it is available only quarterly, and one unfortunate result is that at the present time the latest figure we have is for the second quarter, which ended more than three months ago. If we turn to monthly data, the most comprehensive figures have other shortcomings. Besides omitting farm and government employees, they also omit most salaried workers, and they fail to include fringe benefits. They are superior to the quarterly data in that they can be broken down by industry, but inferior in that comparable data on output per manhour and labor cost per unit of output are not available.

An ideal general wage index would cover all employees and include all forms of compensation. It would be so constructed as not to be affected by fluctuations in overtime, by shifts in employment from one industry to another, or by changes in the mix of occupations. It should also be possible to break down the general index to provide comparable data for different groups of workers, different industries and areas, union and nonunion situations, and to show separately the various components of compensation for all classifications. With such a measure, we should all be in a better position than we are today to know how effectively and how equitably policies designed to meet the problem of inflation are working.

Second, there are some specific needs for improvement in price statistics. I said nothing in my statement about how U.S. prices compare with prices in other countries, either with respect to level or rate of increase. The relevance of foreign prices during a period of domestic inflation, especially with respect to our balance of payments and trade position, is obvious. My excuse is that statistics that would enable us to compare foreign and domestic prices for many of the products we export are sadly lacking. Another deficiency in price statistics is that our wholesale price indexes fail to cover adequately the products sold by many industries, and in some instances they fail to measure adequately the actual transaction prices that prevail in the marketplace. Improvements are also needed in the weekly industrial materials price index, which as I have shown, provides some early warning signals both on the upside and on the downside.

Finally, I believe there is need for greater emphasis on statistics pertaining to inflation in current statistical reports. The data we have brought together and presented today on the rate of inflation, on inflationary expectations, on the scope of inflation, and on demand-pressures should be made publicly available in current reports. Conveniently arranged charts and tables, released on a prompt publication schedule, can create an awareness of an emerging problem. whether it be inflation or deflation. The lags in expectations that I have referred to, and the unfortunate consequences that ensue when anticipated developments fail to materialize, can be at least partly overcome by an improved information system.

In these various ways, our knowledge of the anatomy of inflation can be expanded and made more precise. The toll of human misery and economic waste that inflation leaves in its path surely justifies this effort.

Appendix A

SEASONAL MOVEMENTS IN THE CONSUMER PRICE INDEX

Seasonal movements in components of the Consumer Price Index are most noticeable in food, fuel, auto, and apparel prices. Very little of this seasonality is apparent in the all-items index, especially in recent years. Earlier the seasonal movement was larger. This is probably due in part to the increased importance of services in the index, since prices of services exhibit little or no seasonal. For 1968 seasonal factors for the all-items index derived from the Bureau's computer program vary between 99.8 and 100.1. (See Table A-1.)

TABLE A-1.—SEASONAL FACTORS FOR CPI, ALL ITEMS, 1968

	Seasonal factor	1-month change (annual rate)	3-month change (annual rate)	6-month change (annual rate)
anuary	99.9	−1.2	−0.8	−0.4
February	99.9	0	−.4	−.4
March	99.8	−1.2	−.8	−.4
April	100.0	2.4	.4	−.2
May	99.9	−1.2	0	−.2
June	100.0	1.2	.8	0
July	100.1	1.2	.4	.4
August	100.1	0	.8	.4
September	100.0	−1.2	0	.4
October	100.1	1.2	0	.2
November	100.0	−1.2	−.4	.2
December	100.0	0	0	0

The entries in the first column tell us that the level of the CPI would be raised at most by 0.2 percent and lowered at most by 0.1 percent after seasonal adjustment. These differences seem small enough to be neglected. In terms of rates of change over short intervals, however, the situation is quite different. As an example, consider the rates of change from month to month during 1969 in Table A-2.

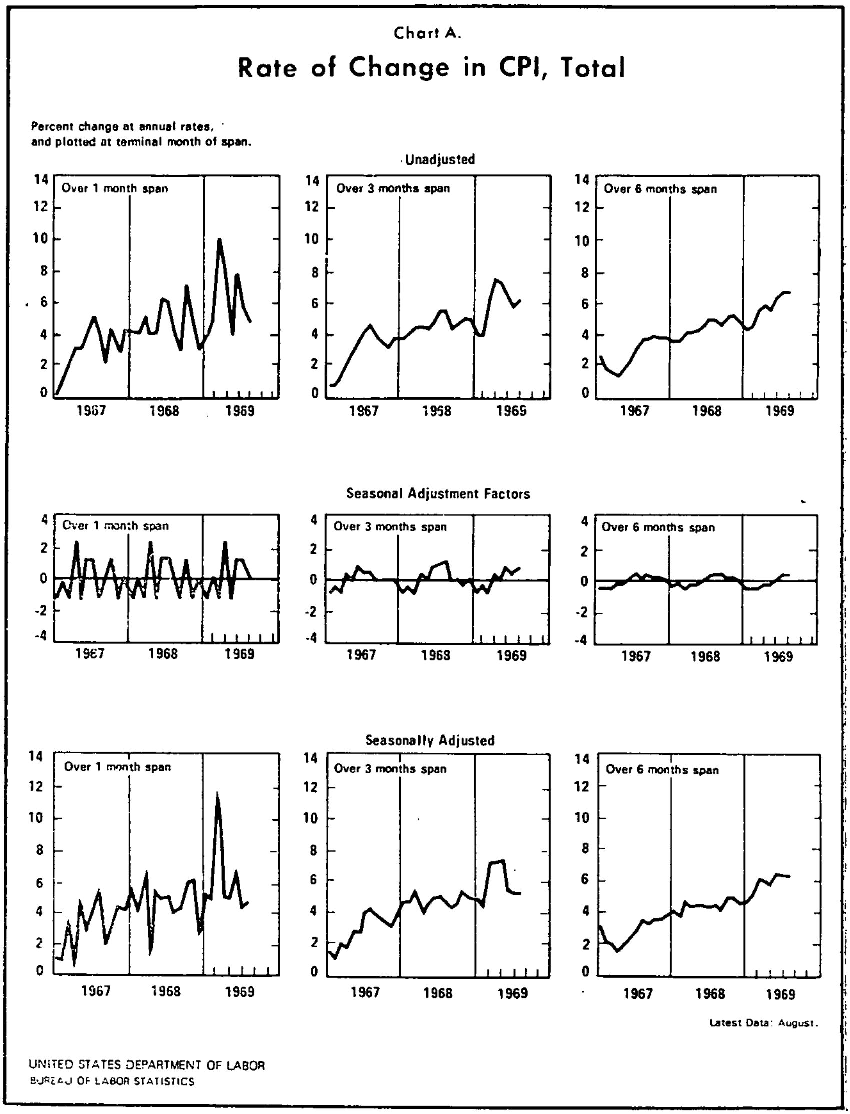
TABLE A-2.—RATE OF CHANGE IN CPI, ALL ITEMS, OVER 1-MONTH SPAN, SEASONALLY ADJUSTED AND UNADJUSTED, 1969

Months	Percent change, unadjusted	Percent change at annual rate		
		Unadjusted	Adjusted	Difference
December to January	0.32	3.8	5.0	−1.2
January to February	.40	4.8	4.8	0
February to March	.80	9.6	10.9	−1.2
March to April	.64	7.7	5.3	+2.4
April to May	.32	3.8	5.0	−1.2
May to June	.63	7.6	6.4	1.2
June to July	.47	5.6	4.4	1.2
July to August	.39	4.7	4.7	0

Several observations can be made about the above figures. The unadjusted data indicate the rate of increase accelerated in February but it was all due to seasonality. In May the unadjusted rate of increase dropped sharply but not on a seasonally adjusted basis. Although the March increase was greater on an adjusted basis than unadjusted, the adjustment makes its exceptional and isolated character plainer. Indeed, in six of the past eight months the adjusted rate of increase was close to five percent. This stability does not show up as plainly in the unadjusted rates.

37-795—70——5

The chart which follows presents similar rates of change for the past few years on a one-, three-, and six-month basis. These results clearly show the importance of seasonal adjustment in interpreting short-run developments.



Appendix B

TITLES AND SOURCES OF DATA

[Q=quarterly series; M=monthly series]

A. *Department of Labor, Bureau of Labor Statistics*
1. Consumer price index (M).
2. Consumer price index, commodities (M).
3. Consumer price index, services (M).
4. Wholesale price index, industrial commodities (M).

5. Index of industrial material prices (M).
6. Compensation per manhour, total private nonfarm, all persons (Q). Compensation from Dept. of Commerce, Office of Business Economics.
7. Output per manhour, total private nonfarm, all persons (Q). Output from Department of Commerce, Office of Business Economics.
8. Labor cost per unit of output, total private nonfarm, all persons (Q). Based on data from Department of Commerce, Office of Business Economics.
9. Diffusion index, wholesale price index, manufactured goods, twenty-two industries, six-month span (M). Department of Labor, Bureau of Labor Statistics and Department of Commerce, Bureau of the Census.

B. *Other titles and sources of data*

1. Index of stock prices, 500 common stocks (M), Standard and Poor's Corporation.
2. Implicit price deflator, gross national product (Q). Department of Commerce, Office of Business Economics.
3. Composite index of twelve leading indicators without reverse trend adjustment (M). Department of Commerce, Bureau of the Census.
4. Index of capital investment commitments (M). Department of Commerce, Bureau of the Census.
5. Index of inventory investment and purchasing (M). Department of Commerce, Bureau of the Census.
6. Index of sensitive financial flows (M). Department of Commerce, Bureau of the Census.
7. Index of profitability (M). Department of Commerce, Bureau of the Census.
8. Index of marginal employment adjustment (M). Department of Commerce, Bureau of the Census.
9. Diffusion index, anticipated and actual selling prices, manufacturers, wholesalers, and retailers, four-quarter span (Q). Copyrighted by Dun and Bradstreet, Inc. Firms are asked whether their prices were higher, lower, or unchanged in the previous quarter compared with a year earlier and whether they expect prices to be higher, lower, or unchanged in the coming quarter compared with a year earlier. These series may not be reproduced without written permission from source.
10. Diffusion index, consumer price expectations (Q). University of Michigan, Survey Research Center. Consumers are asked whether they expect prices to be high, lower, or unchanged during the coming year.

(The following materials were subsequently furnished for the record by Dr. Moore:)

U.S. DEPARTMENT OF LABOR,
BUREAU OF LABOR STATISTICS,
Washington, D.C., October 15, 1969.

Hon. MARTHA W. GRIFFITHS,
Chairman, Subcommittee on Fiscal Policy, Joint Economic Committee, Congress of the United States, Washington, D.C.

DEAR MRS. GRIFFITHS: Thank you very much for the privilege of appearing last week before your Subcommittee. Since that time I have had an opportunity to examine some additional information on expectations held by the public. As you know, when I appeared before the Subcommittee, I stressed the importance of expectations regarding prices because of the effects they have on consumers' decisions to buy. Data compiled by the Survey Research Center at the University of Michigan indicate that there has been a deterioration in consumer attitudes in recent months.

Although there are a number of factors underlying the deterioration, I believe the impact of tight credit conditions and high interest rates is particularly interesting. More and more people believe the next twelve months will be a bad time to buy large household goods, automobiles, and homes because of tight credit and high interest rates. A year ago this factor was much less important than it is today. The enclosed table summarizes some of the factors underlying expectations and changes which have occurred over the past year. The impact of tight credit and high interest rates, on attitudes towards home buying during the past year is particularly great, but the effect also shows up on attitudes towards purchases of autos and large household goods.

Of course, as I pointed out in my testimony, a large majority of consumers continue to think that prices are going up. But more of them are beginning to believe that this makes it a bad time to buy rather than a good time to buy, because they are giving more weight to the possibility that prices will fall later. For example, of all those who thought prices would go higher, the following percentages thought it was a bad time to buy:

	August 1968	August-September 1969
Autos	43	56
Large household goods	34	49
Houses	57	64

Please call on me if I can be of help in any other way.

Sincerely yours,

GEOFFREY H. MOORE,
Commissioner.

SELECTED REASONS FOR OPINIONS ABOUT MARKET CONDITIONS

[In percent]

	November 1965	August 1968	August-September 1969
CARS			
Good time to buy because—			
Prices are low; good buys available	20	6	9
Prices are going higher; won't come down	12	26	19
Bad time to buy because—			
Prices are high; going up; may fall later	9	20	24
Credit is tight; interest rates high	0	2	11
Uncertain, other reasons, or no answer	59	46	37
Total	100	100	100
LARGE HOUSEHOLD GOODS			
Good time to buy because—			
Prices are low; good buys available	20	12	12
Prices are going higher; won't come down	14	25	20
Bad time to buy because—			
Prices are high; may fall later	9	13	19
Credit is tight; interest rates high	0	4	11
Uncertain, other reasons, or no answer	57	46	38
Total	100	100	100
HOMES			
Good time to buy because—			
Prices are low; good buys available	14	4	1
Prices are going higher; won't come down	15	20	15
Bad time to buy because:			
Prices are high; may fall later	15	26	27
Credit is tight; interest rates high	1	23	45
Uncertain, other reasons, or no answer	55	27	12
Total	100	100	100

Source: Survey Research Center, University of Michigan.

OCTOBER 17, 1969.

Hon. GEOFFREY H. MOORE,
Commissioner, Bureau of Labor Statistics,
Department of Labor, Washington, D.C.

DEAR MR. COMMISSIONER: Thank you very much for your letter of October 15 containing information on expectations regarding prices, also for the table giving selected reasons for opinions about market conditions. These materials are most helpful, and we have decided to include them at the end of your testimony in our printed hearings.

We do appreciate your taking time from your busy schedule to be with the Subcommittee in our current hearings and we are grateful for your valuable contribution.

Sincerely,

MARTHA W. GRIFFITHS,
Chairman, Subcommittee on Fiscal Policy.

Chairman GRIFFITHS. Thank you very much, Dr. Moore.
Mr. Fabricant?

STATEMENT OF SOLOMON FABRICANT, PROFESSOR OF ECONOMICS, NEW YORK UNIVERSITY, AND FORMERLY DIRECTOR OF RESEARCH, NATIONAL BUREAU OF ECONOMIC RESEARCH

Mr. FABRICANT. I cannot say that it is a pleasure for me to be here. No one finds it pleasant to be faced with a problem as serious and difficult as inflation. I wish the problem were not here to trouble us and the rest of the country. However, inflation is here, and I do want to say that I am grateful for this opportunity to assist the Congress and the people, as well as I can, to understand what we are up against.

Let me start with a capsule summary of my main points:

(*a*) The inflation problem is serious. It is also difficult. It is not going to be solved quickly.

(*b*) Current anti-inflation policy, which, of course, embraces monetary as well as fiscal policy, has not yet had any very obvious effects on the price level or on its rate of growth. This is not because the policy is weak. Rather it is because time—considerable time—is generally required before these effects manifest themselves.

(*c*) What is happening in the economy today, and what may be expected to happen in the future, depends only in part on current Government policy. The path traced out by aggregate production, employment, and the price level depends also on outside forces (the military and political situation here and abroad, for example), on the policies—good or bad—of the Government in the past, and, what is too often forgotten, on the cumulation of restrictive forces generated by the expansion that has led up to the present boom period.

(*d*) In viewing the present situation, and considering the prospects ahead, allowance needs to be made for the restrictive forces developed by the boom, for these intensify the danger of recession in 1969 or 1970. Allowance needs to be made also for the lag I mentioned. When these are taken into account, we will come to realize that there is a very real danger that the present policy to fight inflation is now too restrictive. It is my opinion that monetary policy, though not fiscal policy, should be relaxed somewhat—which does not mean it should be abandoned.

(*e*) Relaxation of the present very tight monetary policy would help lessen the probability of a serious recession. On the other hand, it would also mean less pressure on the inflationary spiral. But it is too much to expect that we will succeed in stabilizing the price level this year, or even by 1970 or 1971. This could be done only at the cost of an intolerably high level of unemployment and the loss of a large volume of production. We may reasonably expect, however, as we look ahead, that further acceleration of the price change will be stopped soon—and it is just possible that this has already happened, to judge from some of the figures that Commissioner Moore cited—and that the rate of increase in the price level will be brought down in the next couple of years, to a level closer to what it was over the decade that ended 5 years ago, and that this will be done without paying too high a price in unemployment and production.

(*f*) It is important to intensify efforts to improve the structure of our economy, improvements that can lessen the cost, in terms of employment and production, of a reasonably stable price level. To make the required structural changes is a big job, but if we tackle it vigorously and imaginatively we can be more optimistic about attaining our economic goal of prosperity without inflation—not, to be sure, in the period immediately ahead, but eventually.

(*g*) It would be a waste of time to return to the guideposts policy, and a serious mistake to go on to the much more drastic policy of price and wage fixing, even on a limited basis. These policies cannot accomplish what is needed. If we try hard to make them work, we will not succeed and we will find ourselves saddled with a large bureaucracy, troubled with black markets, and paying a very high price in terms of economic growth, efficiency, and freedom.

Now, let me say a bit more about these points:

One. That the inflation problem is serious is indicated by the rise in the Consumer Price Index over the past 12 months by as much as 5.6 percent. But perhaps even more important is the fact that the present high price level is the latest in a series that began accelerating about 5 years ago, after a decade of relative modest increase. Few people feel they have been able to adjust to the price increases that have already taken place. Few people are not worrying about what the future might bring in the way of further increases.

All this is well known. Not so well understood is an implication of the fact that the Consumer Price Index tells us the average change in the price level. Precisely because it is an average, the CPI understates the drain on the pocketbooks of about half the families of the United States. It is little comfort to the families that have suffered a rise of more than 5.6 percent in the prices they pay to be told that there is another half that has suffered a lesser rise. Those especially hard hit are the families, particularly the younger families, that are just now buying—or trying to buy—their first home, or renting and furnishing their first apartment. Also older families that need to move into larger quarters, or make major alterations and repairs on the quarters they now occupy, or pay extraordinary medical and hospital and dental bills, are in the same difficult position.

Further, inflation has pushed money incomes into higher tax brackets more rapidly than would otherwise have been the case. Inflation has also reduced the real value of exemptions. As a result, the fraction of a given amount of real income going for taxes has been raised, apart from any changes in the tax rates themselves. Families with real income formerly too small to be burdened with income taxes—some even below the so-called "poverty line"—now have to pay these taxes.

While average money income has also gone up as a result of inflation, as I have just said, the rise has not been enough to keep average disposable real income growing in recent years at anything like the rate that our people have come to expect. Over the past 12 or 15 months, in fact, average per capita disposable personal income—in constant prices, of course—has shown virtually no rise. Although there is some tendency on the part of the public to put all the blame for the slowdown in the growth of real income on inflation or on the efforts to control inflation, more than just this is behind the slowdown. I will say something about the other factors in a moment. The point I want to stress now, however, is that with average real income virtually constant, there must be some families that were hit by more than the average increase in the prices of the things they buy at the very same time that their money incomes failed to grow or even declined. I do not know how big this group is, but I do not believe that we can dismiss it as negligible. And I would add to Commissioner Moore's list of statistical jobs that might be undertaken, the acquiring of more information on this particular point.

There are, of course, still other reasons to worry about inflation—the problem of the balance of payments, for example—but these are well known, and I will not stop to list them.

That the problem of inflation is not only serious but difficult is also evident. The studies of economists and the discussions among them—and the strong differences of opinion expressed during these discussions—make clear that even we experts, whose particular job it is to know about such matters, know less than laymen think we do. I should mention here that this is one reason why whatever I am saying here is entirely my personal opinion and that it is not to be counted as the responsibility of the National Bureau of Economic Research, with which I am connected; and the same, of course, goes for the New York University with which I also have the pleasure of being associated.

I also ought to add that I retired recently as Director of Research at the National Bureau, so I am now former Director of Research, and just a working member of the research staff, and a hard-working member I hope.

Our citizens recognize that the Federal Government, including the monetary authorities, are making efforts to arrest the inflation of prices. The public has been lectured on the need for and the nature of these policies, and has experienced them directly in the form of postponed tax reductions, cuts in Government programs, and tighter money. But with the experts often differing, with the news from other countries on efforts to restrain inflation abroad rather less than encouraging, and with the price level here still rising, it is natural for people to wonder: When, if ever, will the price level stop rising or at least stop rising so fast? Should or should not stronger or different policy be pressed? What might be the consequences of anti-inflationary action, not only on prices but also on production and employment?

These doubts and fears reflect fundamental issues on the causes, process, effects and control of inflation. In the time allotted, let me concentrate on a few of the points on which something reasonably factual can be said, an which have at the same time often been neglected or misunderstood. I list these points briefly, but I hope not too cryptically, as a basis for questions by the committee and discussion by the panel.

Two. The failure of the CPI to decline or even level off—it might have stopped accelerating, to judge from some of the figures Commissioner Moore mentioned—has been explained by a lag between actions taken to stem inflation and the effects of such actions on the price level.

One fact to keep in mind, when thinking about this lag, is that the antiinflationary actions taken are mostly of rather recent vintage. The shift from a Federal deficit to a surplus, measured on the national accounts basis, began around mid-1967, two years ago, but the first surplus was not actually attained until the first quarter of 1969. The decline in the rate of growth of the money supply, narrowly defined to cover demand deposits and currency, did not begin until mid-1968, a little over a year ago, and did not fall below, say, about 5 percent per year, allowing as best as we can for erractic fluctuations, until the spring of this year, 1969. The decline in the rate of growth of the money supply, broadly defined to include also time deposits, did not begin until late in 1968, or about a year ago; but it proceeded much more rapidly and has reached very low levels. The most recent figure on its rate of change in this money supply, July to August, is minus 10 percent on an annual basis, well below what has been seen in many years.

Is the length of the lag so far—we have not yet seen a general decline in the price level—within the realm of experience?

Tested knowledge, in contrast to just speculation, on the effects of deliberate shifts in fiscal and monetary policy is rather scarce. The cause and effect relationship must be inferred from records of the past, during which many other factors affected price levels, and, of course, the economy has changed in many ways. Also, until recently, changes in the Federal surplus and in the rate of change in money supply were more often passive responses to changes in business conditions than the result of deliberate efforts to influence business conditions. For these and other reasons, economists differ with regard to the inferences they draw from the record and with regard to the degree of confidence they put in their conclusions.

Without going into the details, let me simply mention a few objective facts, about which there can be little question. These relate, to begin with, to the timing of changes in the Federal surplus or deficit, and in the rate of change in the money supply, relative to peaks in general business. This is information similar to that which Commissioner Moore was presenting a few moments ago. We know, first, that the Federal cash surplus, on which information has been available for a long time, has more often led turns in general business than it has lagged. But the timing has been rather irregular and the average lead is therefore not very meaningful. Also, with a few exceptions, over most of the prewar period the Federal surplus was relatively small and therefore could be only a minor factor in the economy as a whole. The available statistical information on the Federal surplus on the national accounts basis, which is the basis favored by economists, is limited to the postwar period. But this is when the Federal budget was large, and this recent experience may be more to the point. The lead in this series is much more consistent. There is a clear tendency for turns in the Federal surplus so defined to lead business cycle peaks. The average lead is some 14 months.

As for the historical experience with changes in the money supply, these—whether defined narrowly or broadly—have almost always led turns in general business, on the average. In case of peaks, the lead was by as much as 20 months.

The historical relation between consumer price changes and changes in general business is not easy to describe briefly. It must suffice to say that turns in the level of the consumer price index usually came after a peak in general business, on those occasions when the index did in fact turn down. The average lag was 2 to 3 months. Sometimes, however, and this has been often the case since the war, the CPI failed to turn down at all. On these occasions, the index sometimes simply stopped rising for a while, or rose at a less rapid rate. But sometimes there was no obvious conformity to the turn in general business, which, of course, was essentially what Commissioner Moore was saying a while ago.

It seems fair to conclude this much: Turns in the price level and even in the rate of change in the price level, have tended generally to come some considerable time after changes in the Federal surplus and in the rate of change in the money supply. If one assumes a cause and effect relationship, one may say that the reaction of price levels to changes in the Federal surplus and rate of change in money supply has been quite slow, as a rule. The fact, then, that the price level has not yet stopped rising does not mean that anti-inflationary policy is not working. Indeed, as I have mentioned, there is a hint in the recent figures that the rate of change in the consumer price level and also in the wholesale price level—we saw this in Commissioner Moore's charts—has stopped rising and may even have begun to fall.

Three. The fact that historical periods have differed considerably in the length of the lead of changes in the Federal budget and the rates of increase in the money supply, on the one hand, over the changes in the level of prices or its rates of change, on the other, has important implications. It means that—in the short run, at least—other factors play a part in determining the behavior of price levels and price trends besides current fiscal and monetary policy, and that these other factors can be important. I want particularly at this time to draw attention to the factors effecting the price level, and production and employment as well, that are generated by developments in the private sector. These are the developments that economists have in mind when they speak of business cycles, or—in the terms perhaps more appropriate to the world of today—of periods of speedup and slowdown.

A couple of years ago, it is true, a conference of economists was held on the question whether the business cycle is obsolete. I could not be there, but I was not surprised to learn that a colleague of mine at the National Bureau of Economic Research had said that "the question posed by this conference may be obsolete, the problem of booms and recessions is not."

If economists were able to fool themselves enough to pose the question, it is not surprising that the public seems to have forgotten—if it was ever really learned—a very important fact. An economic expansion during which aggregate activity increases in volume, unemployment declines to low levels, and prices and wages rise, develops—to use the words of another former colleague of mine at the National Bureau of Economic Research—"restrictive forces that gradually but insistently come into play as a result of the expansion process itself." This conclusion is based on a vast amount of carefully analyzed data which I can only mention here. Let me merely list, by way of illustration and in the most summary way, some of the restrictive forces that are ultimately developed by the very process of expansion: One is the narrowing of the scope and reduction in the pace of expansion. Another is the rise in costs, which sooner or later exceeds the rise in selling prices and reduces profits per unit of sales and then, also often, aggregate profits. A third is the increase in construction costs and interest rates, which soon depresses home building, dampens State and local government construction plans, and—coupled with the slowdown in expected profits—eventually leads also, and on a widening front, to the postponement of investment in new business plant and equipment. A fourth is the depressant effect of these developments on the stock market, the declines in which become, in turn, another restrictive force on business investment, home building, and the purchase of large items of durable consumer goods. In time, these and other developments, which I have not been able to mention in the time we have, lead to retardation in the growth, if not actual decline, of aggregate production and to a widening gap between a growing number in the labor force and a stable or declining number employed, that is, to rising unemployment.

It would be foolhardy, I think, to ignore the possibility—no, let me say, the fact—that these restrictive forces have been gathering strength, for some time in our economy, and not only because of the relatively recent restrictive policies of the Federal Government. We may expect that even by themselves, were policy neutral, they could cause the decline in the rate of growth of aggregate output which has already been evident for some time, the decline in profits, which have been falling in real terms—and also sooner or later a decline in production, a rise in unemployment, and eventually a slowdown in the rate of inflation. This is all the more likely a prospect as we look ahead, because fiscal and monetary policy is now pushing in the same direction, in contrast with the situation a year or two ago.

Four. If the boom is itself generating restrictive forces on a widening front, and these forces are growing in strength, it may be wise to begin to lighten the pressure of anti-inflationary policy.

This may be all the more necessary at this time because of the longish lag between policy and its effects. We may be heaping more wood on the fire, to use another figure of speech, when what is needed is to give the wood already there a chance to catch fire.

I might mention here that John Maynard Keynes, whose name sometimes comes up in this room, has an even more interesting analogy, and I might recall it, if it is not too close to lunch——

Chairman GRIFFITHS. Yes.

Mr. FABRICANT. A lessening of pressure does not necessarily require a reversal in both fiscal policy and monetary policy. There are good reasons, apart from the desire to stabilize the economy, for establishing and continuing a policy of Federal surpluses when unemployment is low. But the very tight monetary policy now in force could be relaxed without interfering with these long-term goals.

What I have been saying is, in substantial degree, consistent with the idea expressed in the so-called Phillips curve. This specifies the "payoff" between inflation and unemployment, that is, the cost in increased unemployment of a given reduction in the rate of price increase. There is evidence, however, that the relationship is subject to change as the structure of the economy is altered. These structural changes need not be a result of chance. They can be planned, and when planned, a deliberate effort can be made to design them to favor reduction in the unemployment cost of a reasonably stable price level.

It would take at least another session to list the kinds of improvements in economic organization and structure that might do this. An obvious example is an improved and widened program of training or retaining. The possibilities now being worked on and others in sight are many, and more can be discovered if we devote the resources to the task. Some can be instituted fairly quickly, in addition to those already in existence. Some will require much experimentation and discussion and time before practical difficulties can be overcome and differences in sectional interests reconciled. It is not too soon to expand and intensify the work that is already going on.

In the meantime, we may have to rest content with halting the acceleration in prices, and then reducing the rate of price increase to something at least a bit closer to what it was during the decade that ended 5 years ago. If we can do this much without paying an inordinately heavy price in unemployment and lowered output, we should count ourselves lucky.

Five. Let me conclude: One solution that is often put forward for stabilizing the price level without raising unemployment involves fixing by Government, in a formal or informal way, all individual prices and wages or only those which are set in imperfectly competitive markets. This is the sort of thing that the guidepost policy of 1962–66 tried to do, or the more formal incomes policy such as they have in Europe, or even an unlimited or limited OPA-type policy. Much has been said in criticism of this solution in other congressional hearings, and I need not take the time to explain why I believe it to be a costly and ineffective way of dealing with the problem of inflation. I bring it up because subsequent public sessions of this committee will focus on some of the individual categories of prices that have risen more rapidly than the average. There is a tendency, when one focuses on individual price increases, to argue that the way to keep the general price level down is somehow to restrain these individual prices.

Thank you.

Chairman GRIFFITHS. Thank you very much, Mr. Fabricant.

I am surprised, Dr. Moore, that you did not put in your indicators the length of women's skirts, because they seem to be a pretty true indicator. I mean, they are going down to your ankles, as precedes, I think, a depression.

Mr. MOORE. I have heard of that as an indicator, but I have never given it a close examination.

Chairman GRIFFITHS. Well, you try it for this century.

May I ask you: Has inflation ever been stopped without increasing unemployment?

Mr. MOORE. Well, the rate of price increase has declined on some occasions without an increase in unemployment or without an appreciable increase in unemployment.

The most recent occasion was in 1966–67, when, as I mentioned, the rate of increase in the Consumer Price Index dropped from around 4 percent to 2 percent, while the rate of unemployment remained slightly below 4 percent during that whole period, with the exception, I think, of 1 or 2 months when it got a fraction of a percent above 4 percent. Now, that is a substantial drop in the rate of increase, but, as I mentioned, it did not persist.

Chairman GRIFFITHS. In your judgment, can this inflation be stopped without increasing unemployment?

Mr. MOORE. Well, that is my hope and expectation, yes. I think the policy that the administration adopted, of a gradual reduction in inflationary pressures, was calculated to do that, and I have every hope that it will.

Chairman GRIFFITHS. Do you think so, Dr. Fabricant?

Mr. FABRICANT. Well, I think that inflation can be stopped—Do I think that inflation can be stopped without causing a rise in unemployment? If by stopping inflation, you mean the consumer price level would level off essentially, my answer is "no." I have tried to indicate some of the reasons why I think so. I would agree, I think, with Commissioner Moore, that it is possible—there have been historical episodes—and he mentioned one—in which the rate of increase in consumer price level has been reduced without any obvious effect on unemployment. To that statement, I would add that one must make an allowance that sometimes the consumer price index stops rising because something has happened to food prices which may reflect farm conditions, weather, and things of that sort, and it is sometimes, therefore, better to look at the nonfood part of the Consumer Price Index, and I suspect that might not show exactly the same picture.

It is also the fact that the rate of change in any of these indexes, including the Consumer Price Index, is rather erratic, so it depends on whether you are looking at a very short period during which you may get an erratic declining rate of growth or a longer period in which case you would smooth out the erratic changes.

To return to the basic question, I do not think that in the United States, or in any other country, there has even been—I know of no case in which an actual reduction in the Consumer Price Index, or even a leveling off when it has been rising very rapidly, has ever occurred without a rise in unemployment.

Chairman GRIFFITHS. What percentage increase in unemployment do you think we would have to have to make an appreciable stop in the rise of prices?

Mr. FABRICANT. Well, by "appreciable", if you mean something close to zero, I would say more than the American people are willing to pay, or that any of us would want to pay. I tried to indicate that in my statement. I think, however, we can, and ought to, reduce the rate of growth of the consumer price index to something close to what it was 5 years ago. It was not zero 5 years ago; it was going up at the rate of 1, 1½, or 2 percent per annum. I think we ought to try to get back to something closer to that, let us say 3—to pull one out of the hat—and I think it would be worth paying the price of some unemployment for that. There is a trade-off also between unemployment now and unemployment in the future. If we let the private level get out of hand, let acceleration continue, let prices march up at a very rapid rate, I think the burden on various groups of the population would be such that there would be a terrific outcry, "Stop it at any cost," and if we stop it at any cost at a later time we would have a lot more unemployment than we would if we tried to stop it gradually in a succession of efforts.

Chairman GRIFFITHS. Well, now, if prices were rising between 1½ to 3 percent and we had about a 5 or 6 percent unemployment rate, do you think that we can tolerate that today?

Mr. FABRICANT. I would not think so, no, not 5 or 6.

Chairman GRIFFITHS. No, I do not think we can either.

May I ask you: Do you think that the surcharge was anti-inflationary, or inflationary, or neutral—the surcharge, the 10 percent surcharge?

Mr. FABRICANT. Well, I think that most of the Congress would say that it was anti-inflationary.

Chairman GRIFFITHS. Well, I think that is what we intended to be, but do you really believe that it was anti-inflationary? As a matter of fact, at that exact moment, the UAW—before it went into effect, the UAW and the steel unions and all the big unions were negotiating contracts. Did they not allow for that surcharge in their negotiations?

Mr. FABRICANT. Well, I really do not know the details of the negotiations.

Chairman GRIFFITHS. I think they did.

Mr. FABRICANT. It is quite possible. I think the answer to the question you are raising is rather complicated, because the effect of the surcharge or any other change in the Federal budget depends also to what is happening to the rate of change in the money supply and what, of course, has happened to prices in the past. If, when a trade union is negotiating with an employer for a wage increase, they are in a position of trying to catch up on changes in the consumer price index that have taken place since the preceding contract and, therefore, the fact that prices conceivably might not rise or rise as rapidly in the future is not something that is going to hold them back from trying to recoup some of the loss they have suffered. There have been a number of such contracts. I think, to judge from what I have seen in the papers—Well, maybe I had better not get into any particular case. But there have been such contracts signed without escalator clauses, and after a time this obviously turned out to be a mistake.

Chairman GRIFFITHS. Well, when I came on this committee, one of the matters that was being considered was the use of the tax structure to fuel a boom or to stop inflation. In the light of the years that have passed since we have actually tried to use it, do you believe that it is a successful method of stopping inflation or fueling a boom?

Mr. MOORE. Well, if I may say one point on that—but let me preface this by saying, too, that I really do not feel that I should enter into a discussion of Government policy. The reason I say that is because I am the head of a statistical agency.

Chairman GRIFFITHS. Yes, I understand.

Mr. MOORE. And I believe that agency ought to be kept out of policy pronouncements, at least in public. But the point that I was going to make is that I do think that we have to consider the effect of any policy on expectations of the public and the businessmen and how they act in the light of expectations. If the policy is pursued in a restrictive direction consistently, whether it is fiscal, monetary or any other kind, it has some effect on people's expectations, and that, in turn, has an effect on inflation, itself.

Chairman GRIFFITHS. Would you care to comment?

Mr. FABRICANT. Well, I would agree with what I think is in your own mind, namely, that our efforts in recent years to use fiscal policies as a flexible stabilization tool have not been very successful. And, I suppose the executive branch can always blame the Congress for that, for not listening to what the executive wanted, and, perhaps, the Congress might blame the executive, too. But it has not, in fact, been very successful.

I might add this, that in a world in which information and communication has improved enormously, people have become much more sensitive to changes in fiscal policy and prices. It is quite possible that reaction to a given change in taxes or Government expenditures may not be the same today that it used to be in the olden days. People are sometimes told "This is only a temporary rise in taxes," and they may adjust their levels of consumption and expenditures to take account of the fact that it is just temporary. They may go ahead and buy that house or that car, borrowing if necessary, or drawing on some of their savings, because next year the tax will be reduced. I think there is some evidence that this has taken place in the United Kingdom. I remember reading a very interesting article about the experiences in the United Kingdom in their efforts to control inflation as well as to increase productivity, and the remark was made in one of these discussions to the effect that there is a continuous dialog between the public and the Government and the public is always trying to anticipate what the Government will do in the future. If the Government says explicitly "this is temporary," whatever it is, the public is naturally going to take that into account.

I might add also that if the Government does not do what it says it is going to do, the public will begin to take that into account.

Chairman GRIFFITHS. Thank you very much.

Senator Proxmire?

Senator PROXMIRE. Mr. Moore, you say that all of the indexes of demand pressure were up, foreshadowing an easing of price increases, that is, a slowing rate of inflation. Can you give us any idea of a rough timetable on this? When can we expect the rate of inflation to ease?

Mr. MOORE. Well, looking at the past relationship between these indexes of demand and pressure and the rate of increase in the CPI, on the whole they have occurred roughly at the same time.

Senator PROXMIRE. What does that mean?

Mr. MOORE. Within a few months of each other.

Senator PROXMIRE. So, you are telling us that within a few months we can expect the rate of price increase to moderate?

Mr. MOORE. Well, I would judge that to be a reasonable prospect from the way these demand indexes are moving.

Senator PROXMIRE. In view of the fact we already have, according to your indexes—the composite index, showing a definite turning point in April, I would think that by now, this being October, that we should have this. Do you feel we already have statistical evidence that the rate of inflation is easing?

Mr. MOORE. Well, the problem is that if it has eased, it has not eased very much—that is, the rate of inflation.

Senator PROXMIRE. But you would expect that easing——

Mr. MOORE. If we had another year's worth of data and were looking back, we might be able to say that last spring was the peak rate of increase in the CPI, which it was in terms of its monthly rate of change. But, as of now, since it has not declined very much from that level, I cannot say that with any assurance.

Senator PROXMIRE. Now, let me give you some hypotheses and ask you to tell us how this will work out:

Supposing the Congress does not extend the surtax—the 5 percent surtax. Will that have a significant effect, in your view, on the slow down of inflation?

Mr. MOORE. Well, I think——

Senator PROXMIRE. That is, the 5 percent surtax, after January 1 until next June.

Mr. MOORE. As I told Mrs. Griffiths, I would rather not, if I may, decline enter into a discussion of Government policy. I am head of a statistical agency, and we are——

Senator PROXMIRE. Well, I am not asking you for your judgment on whether this would be wise or not. I am just asking you for your professional opinion as an expert as to what effect this is likely to have. Is this going to be significant?

As I understand, there would be a reduction in revenue of $2 billion to $3 billion over a 6-month period.

Mr. MOORE. Well, I think I just cannot answer that.

Senator PROXMIRE. You cannot give us a professional opinion of whether a reduction of $2 billion to $3 billion would be significant or not?

Well, let me ask Mr. Fabricant. Can you tell me what your view is on this?

Mr. FABRICANT. Well, I indicated a moment ago, what the Government does in taxes or expenditures may not bring the response that the old-type theory would lead us to believe. My own feeling, however, is that a reduction in the surtax and an easing of taxes would not be a good thing at this time, because we do want to maintain some pressure on the inflationary spiral.

Senator PROXMIRE. Supposing that is accompanied by a spending hold-down including an easing in Vietnam, and we have every reason to expect in the coming year instead of spending the $25 billion to $30 billion we are now spending in Vietnam it will be reduced by some amount. It may not be by a great deal, but certainly enough to compensate for a $3 billion loss in the surtax.

Mr. FABRICANT. Yes. It depends on your timing. If you begin to talk about and actually reduce the surtax now and make it appear that it will be reduced before the expenditures would have been reduced, I do not think it would be good from the point of view of inflation. I think a better way to reduce the pressure—we want to maintain pressure, but not quite as much pressure on inflation—is to reduce or bring back the money supply rate of growth to something that makes more sense than the present level.

Senator PROXMIRE. Well, that is supposed to be within Congress's purview, but we have about as much control over that as King Canute had over the tides. Our creature, the Federal Reserve Board, determines monetary policy, and it is supposed to be our creature and they tell us it is our creature, but they never respond to anything we suggest.

Can you tell us, Mr. Moore, what does this recent economic history tell us about how high unemployment is likely to get to slow annual inflation rate down to say 3 percent?

Mr. MOORE. Well, I do not think that recent economic history tells you much about that particular question. I would like, though—and I think it is illuminating—to recall our 1966–67 experience, and I do not think it really can be explained in the way Dr. Fabricant suggested. I do not believe that it was an aberration in food prices or some special factor. If you look on my chart No. 2 which contains a number of different price and cost indexes, and most particularly look at that period of 1966–67, the GNP implicit price deflator, which is one of the broadest price indexes that we have, declined—its rate of increase declined—as well as the prices of services in the CPI. Even wage rate increases were reduced by a small amount, as well as labor costs and output per man-hour.

Senator PROXMIRE. You are talking about 1966 and 1967?

Mr. MOORE. Yes, 1966–67. Well, now, as I have mentioned before, the rate of unemployment through that period was slightly below 4 percent, with the exception of 2 months when it got a little bit above 4 percent.

Senator PROXMIRE. Well, you gentlemen seem to feel that that is a good precedent. I disagree very vigorously on that. I think 1966–1967 is something that we are not likely to get, and I am not sure we should for several reasons: No. 1, it did not result in getting inflation under control. It was a temporary easing of inflationary pressures, and the prices did not rise for a month or two or three or four, but then they resumed their rise. No. 2, we had a near panic in the financial market. No. 3, we had devastation in housing. We went down to an annual rate of 800,000 housing starts a year, and, of course, that is a depression level. It just seems to me that this is not a satisfactory way to handle it or to expect that this is going to give us the kind of results that would be adequate to cope with inflation.

Mr. FABRICANT. Mr. Proxmire, if I could add a word?

Senator PROXMIRE. Yes.

Mr. FABRICANT. The decline which occurred in the rate of growth of Consumer Price Index between 1966 and 1967 followed a period in which it was going up, and going up at a very modest rate. I think one of the troubles right now is that the consumer price index has been rising much more rapidly than it was at that time, and for a longer period than at that time, so that to reduce the rate of growth of the price level by a significant amount, say 2 or 3 percent, would, I think, require much more in the way of increase in unemployment than was the case at that time.

Senator PROXMIRE. I think that is a proper observation. Many of us in Congress—and I think Mrs. Griffiths is one of them, and I am certainly one—feel that we cannot and will not pay for inflation control the price of substantial increases in unemployment. We have to find another way, even if it is controls, and I know that you gentlemen do not like controls. And I am inclined to feel that this is a better solution than to permit the unemployment level to rise, say, above 5 percent. How significant to future inflation, Mr. Moore, is the increase in labor costs to which you referred?

I think the labor cost increased in 1967 rather sharply. Can you translate that into what this means for the future prices of 1969?

Mr. MOORE. Well, I think basically it puts a sort of floor, at least temporarily, under price, under the rate of price increase. But, of course, labor costs have been brought down, as I think they were in 1967; and they can be brought down again if there is a sufficiently large increase in productivity.

Senator PROXMIRE. That really takes a long time, does it not?

Mr. MOORE. Well, that is another point that I would like to make. I think what Mr. Fabricant was saying about unemployment depends partly on how long the process of getting inflation under control takes. If you allow a sufficiently long time and have a persistent policy of gradually reducing pressure, it seems to me that you are more likely to change people's expectations about price increases, and this then will be brought to bear on the actual price increases themselves because of the decisions that they will be making. If you try to do it all next month or within the next 2 or 3 months, you can have a catastrophe.

Senator PROXMIRE. I have a couple of more questions, but my time is up.

Chairman GRIFFITHS. I would like to go a little bit more closely into this expectation business.

The University of Michigan survey shows that the upper-income people are now deciding to cease buying. How does this fit in with expectations? Do they believe prices are going to fall?

Mr. MOORE. Well, I do not know. They may believe that the prices are high and that they are just as well off, or better off, by not paying these high prices, and they are simply making decisions postponing buying. But I do not know the real details of that survey.

(Dr. Moore subsequently furnished the following:)

The Michigan survey obtains answers to the questions why people believe it is a good or bad time to buy. In recent months two significant trends have shown up in these data (see table).

1. The proportion believing it is a bad time to buy because credit is tight and interest rates high has risen sharply. This applies not only to houses but also, to a lesser extent, to autos and large household goods.

2. Of those believing prices will continue to rise, a larger proportion now think it is a bad time to buy, apparently because they think prices may fall later.

SELECTED REASONS FOR OPINIONS ABOUT MARKET CONDITIONS

[In percent]

Commodity	November 1965	May to June 1967	February 1968	August 1968	November to December 1968	February 1969	May to June 1969	August to September 1969
CARS								
Good time to buy because—								
Prices are low; good buys available	20	17	9	6	5	12	13	9
Prices are going higher; won't come down	12	14	22	26	20	20	22	19
Bad time to buy because—								
Prices are high; going up; may fall later	9	16	17	20	16	16	18	24
Credit is tight; interest rates high	(1)	1	3	2	3	7	10	11
LARGE HOUSEHOLD GOODS								
Good time to buy because—								
Prices are low; good buys available	20	21	16	12	11	16	15	12
Prices are going higher; won't come down	14	19	21	25	20	22	26	20
Bad time to buy because—								
Prices are high; may fall later	9	10	11	13	14	14	15	19
Credit is tight; interest rates high	(1)	2	2	4	3	6	8	11

Footnotes at end of Table, p. 76.

37-795—70——6

SELECTED REASONS FOR OPINIONS ABOUT MARKET CONDITIONS—Continued

[In percent]

Commodity	November 1965	May to June 1967	February 1968	August 1968	November to December 1968	February 1969	May to June 1969	August to September 1969
HOUSES								
Good time to buy because—								
Prices are low; good buys available	14	12	(2)	4	2	3	3	1
Prices are going higher; won't come down	15	21	(2)	20	18	20	20	15
Credit will be tighter later; interest rates will go up	(2)	(2)	(2)	(2)	(2)	(2)	10	4
Bad time to buy because—								
Prices are high; may fall later	15	19	(2)	26	22	22	26	27
Credit is tight; interest rates high	1	13	(2)	23	19	24	36	45

[1] Less than ½ of 1 percent.
[2] Not available.

Note: Responses to the query, "Why do you say so?" following each of these 3 questions: (1) "Speaking now of the automobile market—do you think the next 12 months or so will be a good time or a bad time to buy a car? (2) About the things people buy for their house—I mean furniture, house furnishings, refrigerator, stove, television, and things like that. In general, do you think now is a good or a bad time to buy such large household items? (3) Generally speaking, do you think now is a good time or a bad time to buy a house?

Source: Survey Research Center, University of Michigan.

Chairman GRIFFITHS. Well, now, would consumer buying actually fit in with expectations anyhow? Let's go back to these dresses. Any woman would be a fool today—or extremely wealthy—to invest any real amount of money in a short skirt or a wardrobe filled with short skirts, because she knows that next year they are going to be long. So, it has nothing really to do with the price, it is a change in the design.

Mr. MOORE. Oh, yes.

Chairman GRIFFITHS. Well, would that not be true?

Mr. MOORE. That would certainly be true of a lot of things that people buy.

Chairman GRIFFITHS. Well, now, I was on a TV program the other night where we were arguing doing away with the internal combustion engine, and I think that is what they use in cars. Of course, this is treason in Detroit. But suppose that laws were passed that brought back the Stanley steamer. The effect would be immediate upon the automobile market, would it not?

It would stop right then?

For instance, the prices of cars have remained relatively stable throughout this whole rising price level. Now, they have gone up. What, in your judgment, will be the effect on the automobile market?

Will people stop buying, or will they all buy immediately because they may go up again?

Mr. MOORE. Well, I really cannot predict that. I do think that whatever the price expectations people do hold, particularly on durable goods like automobiles, that does affect their tendency to buy. If they change their expectations, as I rather hope they will, to the effect that price increases in the future are not going to be as large as they have been recently, they may hold off.

Now, the example you gave of the dress is not a good example to express this idea. Let me give you the example of a coat which you do not, I would think, buy every year. You decide to buy one this year, or you might postpone that purchase until next year thinking that coat prices will be lower, and you can postpone that type of purchase I think much more sensibly on the basis of expectation than you can postpone others.

Chairman GRIFFITHS. But there are some very large elements of purchase that would not have as much to do with the price as they have to do with the design.

For instance, you can use only a conventional refrigerator, but if you have, suddenly, a refrigerator that defrosts itself and does a lot of other things automatically, you buy, not because the price may go up but because the cost of cleaning ladies goes up, and it is easier to have a defrostable refrigerator. So, it does not actually work every time, and it seems to me that it would be in a large sector purchases that price has relatively little to do with, as to whether you buy or whether you do not.

Mr. MOORE. Well, I think that is true. There are simply thousands of factors influencing decisions to buy, the design and style, and a great many other factors. But I do not think that many of those factors can be pointed to as influences on the general trend of prices. They behave in all sorts of ways, in different directions at different times, and what I was addressing myself to was the general trend of prices and not to any specifics.

Chairman GRIFFITHS. But clothing is a significant factor in the cost of living, and you can assume that as the months go on short skirts are going to go down in price very rapidly or are going to be dumped completely.

Mr. MOORE. Well, I am glad my wife is in the audience and I hope she is paying attention.

Chairman GRIFFITHS. And someone said to me that if she was lucky she was going to be able to dress next year from the attic. You can just go upstairs and find all of those clothes that you threw away in the 20's and wear them.

Your testimony contains little reference to the wholesale price index or the GNP deflator. We often hear it said that the wholesale price index is a better indicator of underlying price trends than the consumer price index. Is this true?

Mr. MOORE. Well, it is better and it is worse. The GNP deflator has the advantage of covering a great deal more of the total amount of goods that are sold; it includes producers goods, equipment, commercial buildings, costs of construction, and other services that are produced and sold by businesses, so it is more comprehensive.

On the other hand, it is available only quarterly, and I believe at the present moment the last published quarterly figure is for the second quarter, whereas the CPI is available through August. Its statistical basis for measuring these other prices, the prices of business equipment, the prices of construction, and so on, is considerably weaker, I believe, than that of the Consumer Price Index. So, you have to assess the two indexes on the basis of those considerations, and I really do not like to make a choice myself. I look at both.

Chairman GRIFFITHS. The preliminary September estimate of the index for wholesale industrial commodities shows that they are continuing to advance at an annual rate of about 5 percent. Is that not a rather discouraging sign?

Mr. MOORE. I would much rather have it advancing at a lower rate, yes.

Chairman GRIFFITHS. But it is still not too good?

Mr. MOORE. No.

Chairman GRIFFITHS. Just what is included in the indicator you call industrial materials traded on commodity markets?

Mr. MOORE. Well, there are some 13 commodities in that index.

Chairman GRIFFITHS. Is lumber one of them?

Mr. MOORE. I do not believe so.

Chairman GRIFFITHS. It is not.

Is copper and aluminum?

Mr. MOORE. I know copper is, and scrap steel, rubber, hides, but I do not believe aluminum is.

Chairman GRIFFITHS. Turning from price statistics to employment statistics. We are interested in the September unemployment figure. Just how much significance should we attach to this extraordinary jump in the unemployment rate?

Is it a statistical aberration, or is it a continuation of a trend which, for some reason, failed to show up fully in the August figures? Or is it the beginning of a really major rise in unemployment?

Mr. MOORE. Well, the way I would characterize this is that there has been a gradual rise in unemployment, in the unemployment rate. I think there were some special factors connnected with the unemployment rate in September, and one of them I would put this way: There was a rather substantial decline in agricultural employment between August and September. It was unusually large. The rate of increase in nonagricultural employment was lower than it had been recently, but it was still an increase and not unusually small or large, one way or the other. There was, however, a drop in agricultural employment, and it seems to me that one needs to pay attention when considering the size of the increase in unemployment to what the sources were in terms of the decline and increase. I am merely pointing to the fact that agricultural employment in that 1 month took a rather substantial drop.

Chairman GRIFFITHS. What else have you found?

Mr. MOORE. Well, there was a rather substantial increase in the unemployment of people who had not previously been in the labor force. They were entering the labor force. So that, if you look at the unemployment of people who were not previously employed, either because they were newly seeking a job or reentering the labor force, there was an increase in unemployment. But so far as I can judge from the data we have there was no perceptible increase in the number of people who lost their jobs. That remained essentially the same in both August and September.

Chairman GRIFFITHS. Is unemployment now larger with Negroes and women?

Mr. MOORE. Larger than what?

Chairman GRIFFITHS. Than it has been?

Are they the people who have borne the brunt of it?

Mr. MOORE. No, there was no significant increase in the unemployment rate of Negroes.

Chairman GRIFFITHS. Of the Negro. But what about women?

Mr. MOORE. I am afraid I cannot answer that question. I do not recall.

Chairman GRIFFITHS. Will you supply the answer?

Mr. MOORE. I certainly will.

(The information requested and later supplied, follows:)

Unemployment rates (seasonally adjusted) for major groups in the labor force in August and September 1969, and the averages for the first three quarters of 1969 were as follows:

	August	September	Quarterly averages: January to March	April to June	July to September
Total	3.5	4.0	3.3	3.5	3.7
Men, 20 years and over	2.1	2.4	1.9	2.0	2.2
Women, 20 years and over	3.8	4.2	3.5	3.7	3.9
Both sexes, 16 to 19 years	12.5	13.2	12.1	12.3	12.6
White	3.2	3.6	3.0	3.1	3.3
Negro and other races	6.5	6.8	5.9	6.8	6.6

Unemployment rates for all the above groups have risen since last winter. The rate for teenagers has risen relatively less than for adults. Unemployment of Negroes went up sharply in the second quarter and has not increased since (the change in their rate from August to September is too small to be statistically significant).

Chairman GRIFFITHS. You mentioned the need for a better wage index. What is the primary obstacle involved in such an index?

Mr. MOORE. Well, I think it is the inadequacy of the present statistical surveys in covering the wages or salaries of salaried employees and the fringe benefits that both salaried and nonsalaried employees obtain. We have a good monthly series on the average hourly earnings of so-called production workers, but this does not include many of the salaried workers, or it does not include the fringe benefits of anyone.

Chairman GRIFFITHS. Have you ever requested funds to begin the construction of such an index?

Mr. MOORE. No, we have not requested funds yet.

Chairman GRIFFITHS. Senator?

Senator PROXMIRE. Mr. Fabricant, yesterday we heard Mr. Mayo and Mr. Kennedy, and they made it clear that the administration has no comprehensive or effective program for dealing with the sharp increase in unemployment. They just do not think it is going to happen, and, consequently, they are not prepared to do anything about it. You speak here about trying to work hard to overcome some of the obstacles in the way of structural resistance to reducing the level of unemployment consistent with price stability. Is there anything else you think the Government can do promptly in the event this unemployment increase that we had last month turns out to be something that goes on and increases over the next 3 to 4 months?

Mr. FABRICANT. Well, yes. I was a little surprised to read in the newspaper the statement to which you referred, and I think, to express my own opinion, that the Government or anyone in a responsible position, should prepare for the contingencies unless they absolutely, have a probability of zero, which I do not think is the case here.

I have already said, because I do not want to see too much increase in unemployment, and I do not think the American people want to see much increase in unemployment, that the very tight monetary policy which is now being applied should be eased up on, and if that is not done I think there is a good chance we will get much more unemployment than we want. And, when we do get that, if that you fear does happen, then if we have not already lifted the tight money supply, we ought to take strong action to do so promptly. There are, of course, still other things that might be done if that is not sufficient, and this is the old list, which is still, I think, one that is worth looking at. We might reduce taxes. I think that might be a very proper time to do it, and we might increase Federal expenditures.

Senator PROXMIRE. You see, one of the difficulties in relying on monetary policy is that we had that experience in 1966 and 1967 which seemed to disillusion the Federal Reserve Board with what they might term a quick turnaround. They do not want to ease upon inflation until they get it under control, and Mr. Martin and some of the other members of the Federal Reserve Board have made it very clear that they think this is our No. 1 economic problem by all odds, and I think it is unrealistic to expect them to ease up on their restraint very much over the next few months.

Mr. FABRICANT. But if there is a lag, which I think most economists would agree there is, between action taken by the monetary and other authorities and the effect visible in the price index, one should allow for the lag and one should begin to ease up before you actually get the decline that is hoped for in the rate of increase in prices. I think that this is now the time in which to begin to ease up. I do not mean for you to take your foot off the brakes, but to ease up on the brakes, to go a little easier in repressing inflation.

Senator PROXMIRE. Why are you so emphatic about wage price guidelines or about jawboning—I feel that the President should use the power of his office to try to persuade unions, for example, to settle at a moderate level in their wage demands, and the power of his office, especially, this President, to persuade business to be as moderate as they can in their price increases, and he can have some effect.

President Johnson and President Kennedy did have effect. We all know that. It was not a very happy reception on the part of business, but it seemed to work, at least in specific instances; and the wage price guidelines, the statistical evidence is that it helped to hold down wage costs for a period of 3 or 4 years.

Mr. FABRICANT. Well, there are two points to be made on that. There is some question as to whether it worked. Economists have been trying to measure the extent to which the guidelines really have had any appreciable effect except on a very few prices. What we are concerned with is the general price level, or at least the price level on manufactured goods. There is a question about that.

Senator PROXMIRE. Is it not true, however, that steel, for example, is a commodity that does affect the price of others?

Mr. FABRICANT. Every price affects every other price, but that does not mean that it affects it to a sufficient extent to make any really important difference.

I think there is another point, namely, that a certain large number of prices, and wages as well, are out of line with the present price level. They have lagged for any number of reasons. The very obvious cases are those, of course, of wage contracts which might have been signed 5 years ago without an escalator clause, to which I referred earlier. It could be a rent, for example, which has been held down by a long-term contract and now needs to be lifted. And there are any number of such prices, wages, and interest rates that have lagged. I think if you impose a ceiling, fix wages and prices, you prevent that adjustment. It's inequitable. Let me add further that if the guidelines did manage to help a bit say between 1962 and a few years later, I doubt very much if they would help as much now, because the people are much more aware of the fact that there are a lot of other factors that affect the price level.

Senator PROXMIRE. It may be, but was there not a perfectly proper principle behind the guidelines, that we would have wage increases that parallel productivity increases without an increase in wage cost, and, therefore, without inflationary pressures, and to the extent you exceeded that, you would have inflationary pressures? The extent that you are consistent with it, prices do not have to go up, and there is not the same kind of pressure, overall, for industrial prices to rise. Once that concept is understood, it seems to me you have achieved a very great deal.

Mr. FABRICANT. I think there is a great deal of common sense and economic sense, theoretical sense, in that concept. However, there are two important points that need to be made there. One is that while it is true in the long run, that wages, real wages, move up with productivity and will not move up more or less rapidly by and large, this is not necessarily the case in the short run. If wages have moved ahead too fast over a few years, as has been the case sometimes, they might move up more slowly than productivity now. If they moved up less rapidly than productivity over a few years, they should move up more rapidly now. This is something that can be said about the general wage level.

Further, when you come to look at individual wages, you are back to the problem I mentioned; namely, individual wages, here and there, maybe are far too high and ought not to move ahead with productivity, or they are far too low and ought to move more rapidly than productivity. In order to find out which of these wages are to be the exception to the productivity guidepost, you have got to do more than just make a few speeches; you have got to set up a big bureaucracy that will be investigating wages, prices, productivity in all of the industries of the United States, and I do not think the American people will tolerate either the cost or the nuisance of it.

Senator PROXMIRE. Well, I think we had an experience in 1962, 1963, 1964, and 1965 that we should not reject.

Let me ask Mr. Moore. Your chart 3, Mr. Moore, indicates something that seems to me to be very alarming about the prospect of inflation in the near future, and that is that it shows that output per man-hour from the beginning of 1969 actually was negative; not only did not increase, it was negative, and under the circumstances, when your output is negative, it seems to me you have a tremendous inflationary pressure even with a modest wage settlement when you have the kind of wage settlements that we have had, the effect on wage costs can be very great.

You show, for example, in one of your charts here, that over a 12 months' span, the wage costs are now increasing at an annual rate of about 7 percent.

Why will this not translate or is not likely to translate either into diminished profits which can have, of course, an adverse effect on the economy, or into a terrific pressure on the prices, in pushing prices up, an inflationary effect?

Mr. MOORE. Well, I think it is likely to have both such effects, and historically it certainly has, that is, tending to dimnish profits—and in fact there was some reduction in total corporate profits in the second quarter—and also tending to raise prices or put a floor under their decrease. Well, I regard it, too, as a very disturbing phenomena to see a decline in output per man-hour. I found it, frankly, a little hard to believe. It is very likely true there has been some reduction in the rate of increase in output per man-hour, but that there has actually been a decline certainly was surprising to me.

Senator PROXMIRE. My time is up. Thank you, gentlemen, very, very much. Both of you.

Chairman GRIFFITHS. Mr. Fabricant, you suggest relaxation of the monetary policy now. Suppose the Fed adopted this policy and then the fiscal policy was also relaxed by not extending the surtax and by the Congress voting to increase expenditures? Now, we have already, in the House, moved the appropriations up from the President's request for water appropriations from $214 million to $600 million, and they are going to make an attempt this afternoon to move it up to a billion. Supposing this goes along and we do not extend the surcharge, and the Fed relaxes the monetary policy, what, in your judgment, would be the effect?

Mr. FABRICANT. Well, it is a matter of degree when you talk about the Fed relaxing. What I suggested was a modest relaxation and without any changing of the surtax at this time. If you had a very considerable relaxation on the part of monetary policy and a reduction in the surtax or an elimination of the surtax, I think we would be confirming the expectations in the minds of many people that we are in an inflationary era, and by gosh, no wage negotiation, no contract, no nothing, should fail to take proper account of the fact that 5½ percent which was the rise in the cost of living index, the consumer price index, last year, is something that is going to persist or be exceeded in the years ahead. I do not think we should do that. I think it would be a bad mistake. We have got a very careful line to tread here between lifting all of the pressure on inflationary and pressing too hard. And what I am saying is that this time, it seems to me, we should relax the pressure a bit but not lift it entirely. That would be a disaster.

Chairman GRIFFITHS. Mr. Moore, in your closing paragraph, you speak of the human misery and economic waste that inflation leaves.

Now, one of the things that I really am the most interested in finding out is who gets hurt by inflation and who profits by it? What kind of statistics do you have on this?

Mr. MOORE. Well, I am not so sure that in the Bureau of Labor Statistics that we have very much to help on that. I think, as Mr. Fabricant indicated, we do need statistics on the distribution of income.

Chairman GRIFFITHS. That is right.

Mr. MOORE. And how it changes over a time, how the income of individuals change over time in relation to the prices that they pay. The Bureau of Labor Statistics has a great deal of information on prices, but it does not collect information on income. We do collect information on wages but not in a way which I think would throw very much light on this.

Well, let me expand a little bit on that. Maybe I should take part of that back.

From our wage statistics, of which we have a very great number, I should think it would be possible to apply price indexes, as we do on an overall basis, to a great many of the component wage data classified by industry—primarily by industry—and arrive at some idea as to the distribution of real wage changes over time and how they altered during this inflationary period.

(Dr. Moore later supplied the following information:)

The following table shows that workers in some industries have had smaller increases in real weekly earnings over the past four years of more rapid price increases than have workers in other industries.

AVERAGE WEEKLY EARNINGS, IN JULY 1965 DOLLARS

	Average weekly earnings		Percent change July 1965–69
	July 1965	July 1969 [1]	
Total private	$95.80	$99.59	4.0
Major industries:			
Contract construction	140.89	158.13	12.2
Mining	123.25	132.67	7.6
Wholesale trade	106.60	111.93	5.0
Finance, insurance, and real estate	88.77	92.83	4.6
Manufacturing	107.01	111.09	3.8
Retail trade	68.25	69.61	2.0
Manufacturing industries:			
Tobacco manufactures	82.72	89.79	8.5
Petroleum and coal products	139.53	151.45	8.5
Apparel and other textile products	66.43	70.69	6.4
Textile mill products	77.64	82.24	5.9
Paper and allied products	114.65	120.53	5.1
Transportation equipment	133.46	139.86	4.8
Lumber and wood products	89.35	93.53	4.7
Chemicals and allied products	120.22	125.13	4.1
Food and kindred products	101.40	105.21	3.8
Printing and publishing	117.12	121.50	3.7
Furniture and fixtures	86.51	89.43	3.4
Stone, clay and glass products	110.83	114.57	3.4
Miscellaneous manufacturing	84.32	87.17	3.4
Fabricated metal products	114.68	117.61	2.6
Electrical equipment	103.57	105.74	2.1
Machinery, except electrical	125.83	127.59	1.4
Instruments and related products	107.94	109.35	1.3
Primary metal industries	135.26	135.56	0.2
Rubber and plastic products, n.e.c.	109.52	108.04	−1.4
Leather and leather products	79.75	75.25	−5.6
Ordnance and accessories	132.51	117.72	−11.2

[1] Adjusted for change in Consumer Price Index since July 1965 (16.3 percent).

Chairman GRIFFITHS. And what the effect of investments would be, other income besides wages, and assets.

Mr. MOORE. Well, again, we would have to turn to other sources, like the Department of Commerce.

Chairman GRIFFITHS. And the method of living.

For instance, I noticed that both of you assumed that old people are hurt by inflation. I would assume that in a large city this is not necessarily so. I would assume that the people who are most hurt in a large city by the increase in cost of houses—if they are moving into the suburbs, it is not because they need a larger house but because they buy a different house. They sell a house maybe at a higher price than they paid for it, but in order to replace that house in the suburbs, they are having to pay two and a half to three times the price for it; whereas, an older person may not replace it with a house. He may sell his house for twice what he paid for it and move into an apartment or reduce his living so that he may not really be hurt at all. He may have been helped by inflation, contrary to the general theory.

Mr. FABRICANT. Well, I would agree with that, but we must not forget that there are a lot of old people who do not own houses.

Chairman GRIFFITHS. Yes.

Mr. FABRICANT. And they will be hurt because they will not get the profit on the old house.

Chairman GRIFFITHS. That is right, of course.

Mr. FABRICANT. And we have to worry about that part of the population. On the average, for the country as a whole, one could argue that nobody—that on the average there is no gain or loss, that it goes from one pocket to another. But there are people from whose pocket it was taken; you see.

Chairman GRIFFITHS. Well, I think it would really be helpful if we had the kind of statistics that we could use to tell who really gets hurt in an inflationary situation and publish it; let everybody know who is being hurt.

I think you would bring up some real public understanding.

Mr. MOORE. Well, I would certainly agree on that.

Chairman GRIFFITHS. I noticed in one of the papers I was reading where some elderly people wrote in and said: "Well, we are not being hurt at all." They were in their 80's. They gave their menus everyday, and they told exactly what they did. It was very interesting. They did not go to the football game; they watched it on television. They were having quite a good time. They sounded quite sensible and not a bit senile. Now, maybe they were not being hurt, but I assume there are a lot of other old people who really were being hurt.

What are the specific deficiencies of our statistics in preparing price trends of goods traded internationally?

Mr. MOORE. Well, the problem is if you compare wholesale price indexes for commodities in the international markets, you are faced with the problem that they really are not comparable, that they are not pricing the same thing, and not knowing exactly how comparable they are, you are faced with uncertainties as to what they mean. That is one alternative.

The second alternative is to use what are called unit value indexes for export prices and for import prices, and these are measures of the average value per ton or per pound or per unit of things that we export or import. Well, if there is a great change in the mix of commodities that are exported or imported, more valuable things per pound being exported than at other times, this so-called unit value index is just meaningless as a price index.

So, what we would like to do at the Bureau of Labor Statistics is to begin to collect—and we have been doing some experimental work along these lines—actual transaction prices for goods that we buy and sell in foreign markets, and get a good statistical basis for knowing exactly what our price position is in those markets.

Chairman GRIFFITHS. In your judgment, will this help to determine when the balance of trade is going to begin to go against us or with us?

Mr. MOORE. Well, I do not know how important or how useful it will be in forecasting that. I think it will be important in interpreting why it is that the balance of trade is going against us or in favor of us, as the case may be, whether it is a price matter or whether it is something else.

Chairman GRIFFITHS. What is our present situation with respect to labor productivity?

Has productivity actually been declining in recent months?

Mr. MOORE. Well, I indicated to Mr. Proxmire that the statistics, the gross national product statistics, do indicate a decline in the first quarter and also in the second quarter and that I was surprised to see those figures. Now, I do not have any direct information to say that they are wrong. I am just a bit skeptical about whether there was such a decline or that it was of that magnitude.

Chairman GRIFFITHS. What measures do we have of increases in prices of goods and services purchased by the Government?

Mr. MOORE. I think that is one of the large deficiencies in our price collection effort. We do not have very much information on that at all.

Chairman GRIFFITHS. Do you not think it would be a very great idea to have that information?

Mr. MOORE. I do.

Chairman GRIFFITHS. Believe me, if you get it, you will be the first person who has it, because the Defense Department does not. Do the prices paid by Government tend to rise faster than the general price level?

Mr. MOORE. Well, if I had the information you just referred to, I could answer that question, but I do not have it, and I really do not know.

Chairman GRIFFITHS. Inflation creates problems for State and local governments. What statistical measures do you have for the intensity of this problem?

Mr. MOORE. Well, there, again, there is a deficiency, and we have made a recommendation in our budget that it be remedied by the collection of wage data on the State and local government employees. We simply do not have adequate data on their wages at the present time, and, hence, we are at a loss to say just what the situation is. But I think that is an area that can be and should be remedied.

Chairman GRIFFITHS. It would be a tremendous help.

Mr. MOORE. I agree.

Chairman GRIFFITHS. And if you can get these prices for these things bought by the Government, then I think a computer and two or three people can keep track of everything. The Defense Department people think you have to build the Pentagon over again, but I do not think so. I think that any industry knows exactly the price it pays for every item it buys, and it knows whether it is cheaper to buy or cheaper to build it, and I think that it would not hurt for the Defense Department to know that, and I think it would reduce the prices we are paying for things.

Is there any evidence which tells us whether the rise in unit labor cost is biased upwards by the fact that in an inflationary period an upgrading of labor occurs?

You do have to promote people, do you not?

Mr. MOORE. Yes. There is some evidence of that sort, but I am really not sufficiently familiar with it to answer your question. I would like to supply an answer for the record, if I may.

Chairman GRIFFITHS. Please do.

(The information referred to and subsequently supplied, follows:)

Available data on occupational employment do not permit a precise answer to the question of upgrading over the course of the business cycle. There is evidence, however, that during the period since 1965 there has either been occupational upgrading or many more individual wage adjustments. Since 1960, wage drift in manufacturing has been about 3 percent, almost all of it occurring since 1965. We cannot be sure whether this represents real occupational upgrading, simply a change in job titles, or more frequent individual wage adjustments.

CHANGES IN EARNINGS, GENERAL WAGE CHANGES, AND WAGE DRIFT, 1960-68, MANUFACTURING

Year	Average hourly earnings adjusted for industry shifts and overtime (December)	Mean effective general wage adjustment	Wage drift
1960	100.0	100.0	100.0
1961	102.8	102.5	100.3
1962	105.1	104.7	100.4
1963	108.0	107.5	100.5
1964	110.3	109.7	100.5
1965	113.6	113.1	100.4
1966	118.1	117.0	100.9
1967	124.1	122.0	101.7
1968	132.4	128.5	103.0

Chairman GRIFFITHS. Have all of the service prices gone up at about the same pace or has there been as much dispersion among service prices as among prices of goods?

Mr. MOORE. Well, I think there has been a very considerable dispersion among service prices. Again, let me supply for the record, if I might—some statistics for the record.

Chairman GRIFFITHS. Would you identify those that have gone up the most rapidly and those that have moved up the least rapidly?

Mr. MOORE. Yes, certainly.

(The following material was later furnished by Mr. Moore:)

Most service prices have increased considerably during the past year. However, there have been substantial differences in individual rates of increase (see table). The largest increases have been concentrated mainly in medical care and household services less rent. Rising mortgage interest rates and costs of home maintenance and repair services contributed significantly to the 8.4 percent rise in household services less rent from August 1968 to August 1969. Some other service costs associated with home ownership have increased by much less, such as residential gas and electricity rates, telephone service charges, property insurance rates, and property taxes. Most types of medical care prices have also increased considerably. The largest increases were recorded for hospital service charges for private, semiprivate, and operating rooms. Physicians' and dentists' fees have risen by somewhat smaller percentages.

Transportation costs have risen less than medical care and household services less rent. Local transit and airplane fares, and automobile insurance rates registered larger increases than taxicab and intercity bus fares.

Other service prices, such as recreation, apparel, and personal care, increased considerably less than medical care and household services less rent. The largest increases in this group were for movie admissions, legal fees and tailoring charges.

RATE OF CHANGE IN CONSUMER PRICE INDEX, SERVICES

[In percent]

	12 months ending—				
	August 1965	August 1966	August 1967	August 1968	August 1969
All services	2.2	4.3	4.2	5.7	7.0
Medical care	3.2	5.5	8.9	7.1	8.9
Household services less rent	1.4	5.0	4.2	7.2	8.4
Transportation	4.0	4.8	2.8	3.7	7.1
Rent	1.0	1.5	1.8	2.5	3.4
Other services	4.1	4.1	3.8	5.9	4.9

Chairman GRIFFITHS. Once again, I want to go back to this expectation matter and point out something that I think probably changes it besides the price. In the last few months, I would say, there has been—and I am going to ask the people that appear—a large increase in carpeting sales, in indoor-outdoor carpeting. Now, the reason you have, I think, such an increase is not because anybody thinks they are buying at a bargain price. You really are not. Though maybe it will not go up, some people, I assume, probably think it will go down in price. But they are buying because it is so much easier for housewives to clean that carpeting than it is to get down on her hands and knees and clean the floor or hire somebody to do it for her. You cannot do it all. So, I think these are not small things for a kitchen. It might be $750 to $1,300 to cover a kitchen. They are not really insignificant. But I would assume that something besides the expectation of prices is affecting a lot of consumer-price sales.

Mr. FABRICANT. May I come back to that question?

You were raising this earlier, too, and it seems to me that there are other factors that affect purchases by consumers beside the prices. You have just mentioned quality improvements which I think are important. You have mentioned fashion, which can be important for particular items. There may be other reasons, however, that we ought not to neglect. Particularly, with regard to consumer durable goods as a whole—there may be exceptions and perhaps carpeting is one. But with regard to consumer durable goods as a whole and particularly automobiles, the stock market may be a factor. I rather suspect that the decline in the stock market has tended to depress the buying power, the feeling that they have got money to spend, on the part of people, and this may account for some of the decline that is suggested by the Ann Arbor, Mich. survey. Also, of course, the rise in interest rates, the stiffening of credit terms—although many people are not aware of these things. They just sign on the dotted line and do not ask too much about credit terms. Nevertheless, there are a considerable number of people who are aware of it, and, certainly, anybody buying a house is aware of it, or the person making the loan himself is directly aware of it, and with its credit terms.

Although people may expect prices to continue higher, even rise, very stiff credit terms may be a factor which would help to account for a reduction in buying. Still another, of course, is that people may, in many cases, feel that they have stocked up on whatever it is. You know, they have got the automobile. They have hurried to buy it because they thought prices might rise, whatever it is. But after all, prices are going to have to gallop as far as expectations are concerned before they begin to stock up on autos as a speculative commodity.

So, I think there are a lot of factors that could account for the reduction of expectations in buying, in addition to those that you have mentioned.

Chairman GRIFFITHS. Investment buying certainly must be affected really just by price, largely by price. Also the sales to consumers amounts to billions of dollars, and it must be affected by other things than your price. I wonder if the truth-in-lending bill has any effect upon people in delaying their purchases?

This was predicted, that once they knew what they were really paying in interest that they would change their ways. I do not think that is quite right, but maybe it did have some effect.

I want to thank both of you for being here. It was very kind of you, and what I want is some statistics that show us who gets hurt in inflation, and I think, also, it would be tremendously helpful to know why it is that people buy products abroad—or the effect, if we could work past the effect, of increased purchases from abroad.

Now, the Ways and Means Committee would be very interested in that, I am sure.

Thank you very much.

Mr. FABRICANT. Thank you.

Mr. MOORE. Thank you very much.

Chairman GRIFFITHS. The subcommittee will adjourn until tomorrow morning at 10 o'clock.

(Whereupon, at 12:05 p.m., a recess was taken until 10 a.m., Thursday, October 9, 1969.)

THE FEDERAL BUDGET, INFLATION, AND FULL EMPLOYMENT

THURSDAY, OCTOBER 9, 1969

Congress of the United States,
Subcommittee on Fiscal Policy,
Joint Economic Committee,
Washington, D.C.

The Subcommittee on Fiscal Policy met, pursuant to recess, at 10 a.m., in room G–308, New Senate Office Building, Hon. Martha W. Griffiths (chairman of the subcommittee) presiding.

Present: Representative Griffiths and Senator Javits.

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

Chairman Griffiths. I would like to welcome you gentlemen to this committee this morning, and thank you for coming here and testifying.

I have been particularly anxious, myself, that we hear some specifics on inflation, just what it is that causes this and who gets hurt.

This morning, of course, we continue with the review of the relation of Government policy to inflation and full employment by considering price and cost trends in construction, the first of the specific fields we shall be concerned with. The other two will be medical costs and food prices. In recent years the construction of various types of structures, both public and private, appear to have accounted for about 10 percent of the Nation's gross national product in current prices. In the last 2 or 3 years the rapid increases in prices have been accompanied by a slowing in real terms, so that the ratio of construction to GNP in real terms has fallen.

The committee's concern in this specific area of construction is in seeking answers to three questions:

(1) What has happened to costs in this sector compared to those in the rest of the economy?

(2) Why have these costs behaved the way they have?

(3) What can be done to reduce the degree of inflation in this specific sector?

This morning we have three witnesses. We have asked Dr. George Christie, chief economist at McGraw-Hill Information Systems Co. to deal with nonresidential building; Dr. Sidney Goldstein, Deputy Director, Office of Policy Planning, Federal Highway Administration, to deal with highway construction costs; and Dr. Michael Sumichrast to analyze residential building costs.

Gentlemen, we are grateful to you for being with us this morning. We will hear from each of you in an opening statement, and then proceed with the questions.

Dr. Christie, will you please lead off in your own way?

STATEMENT OF GEORGE A. CHRISTIE, CHIEF ECONOMIST, McGRAW-HILL INFORMATION SYSTEMS CO.

Mr. CHRISTIE. Madam Chairman and members of the subcommittee:

Each year at about this time, my company issues an analysis and outlook for the Nation's construction markets. This year's analysis—which will be released in another week or so—begins and ends with an expression of concern about the special impact that inflation is having on the construction industry. The general problem of inflation which is affecting all goods and services has been especially troublesome in the construction industry where costs are currently advancing at more than 7 percent. That's roughly one and one-half times the rate of inflation for the economy as a whole.

Because of the size and scope of the construction industry and its conspicuous cost problems, I think it is especially worthwhile that the subcommittee has set this day aside to consider what can be done to limit these fast-rising building costs.

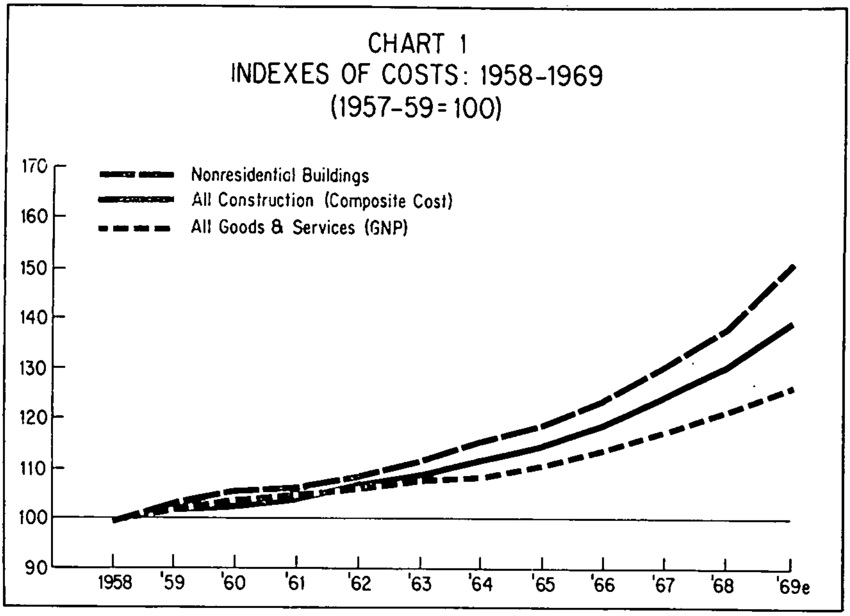
In the next few minutes, I would like to establish the severity of the problem of inflation in construction, to highlight some of its basic causes, and to suggest some possible steps that could alleviate some of the industry's underlying inflationary pressures.

I will be directing my remarks—as much as possible—to the nonresidential building sector of the construction market, since the other two participants in this morning's hearing will deal primarily with housing and construction other than buildings.

In that way, we will cover the whole field. To the extent that there are special problems peculiar to the nonresidential building sector, I will try to isolate them, but for the most part, the forces that lead to worse than average inflation in construction generally, affect individual types of building in pretty much the same way.

I would now like to refer you to a set of charts which will quickly and easily show the extent of the problem we are dealing with.

Chart 1 compares two measures of construction costs with the basic index of costs for all goods and services—the one used by the Commerce Department to adjust its gross national product statistics for price changes—the well known GNP deflator.



The two construction cost indexes—one for all construction and one just for nonresidential buildings—measure the cost of on-site work only, and do not include the price of land, or the costs of designing or financing a construction project.

Since on-site construction work is essentially a process of assembling parts, construction cost indexes are heavily weighed by wage rates and building materials prices. Here is what these indexes show:

Over the past 10 years, construction costs have persistently risen faster than the costs of all goods and services in the economy.

Within the construction industry, inflation has been more severe in nonresidential building—schools and hospitals, industrial and commercial buildings, and public administration buildings—than for the average of all construction.

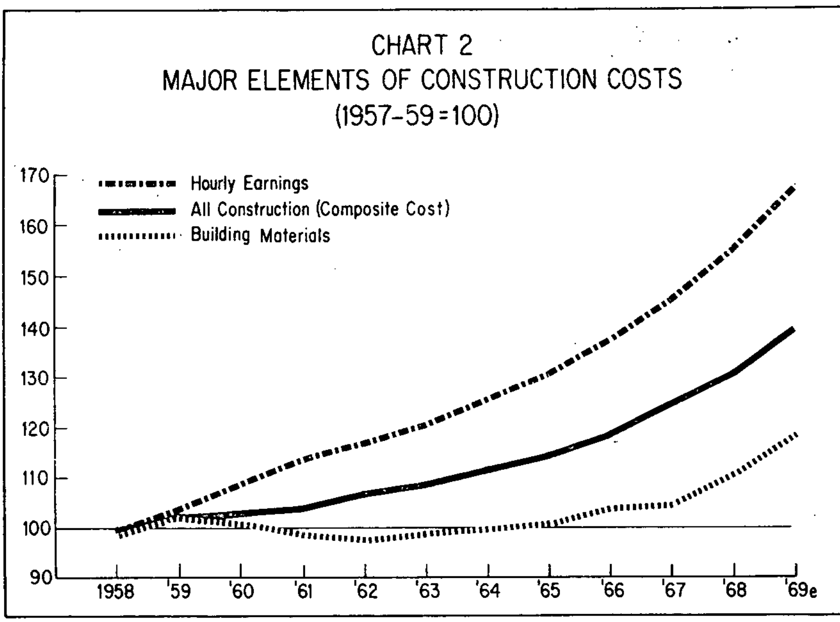
Concentrating on the period since 1965, when inflation began to accelerate rapidly throughout the entire economy, we see that the spread between construction costs and the general price level has increased. Let me cite a few useful comparisons.

Prior to 1965, in what we will call a period of mild inflation—since the overall index of prices was rising at an annual rate of about 1½ percent—total construction costs were advancing at a little over 2 percent, and nonresidential building costs were rising at 2½ percent.

In the recent period of much more severe inflation—since 1965—with general inflation averaging 3½ percent, total construction costs have gone up 5 percent a year, and nonresidential building costs have risen more than 6 percent annually—nearly double the general rate of inflation.

This year, 1969, with the overall price level rising at 4½ percent, construction costs are up 7 percent in the aggregate and nonresidential building costs are up even more, about 8½ percent.

Now, if you will turn to the second chart, you will see what is behind the sharp rise in construction costs. The heavy line in the center is the same composite construction index shown in the first chart; the other lines show the pattern of the two principal elements of that cost; wages and materials.



From this chart it is quite apparent that for most of the past decade, that is, up to 1965, wage costs have been responsible for a very large part of the increase in total construction costs.

Materials prices were unsually steady during that earlier period, and if anything, served to hold down the total rise in building costs.

Since 1965, however, both wages and materials prices have been rising sharply. Hourly earnings in the building trades have risen about 25 percent in the past 4 years, and materials prices have gone up nearly 20 percent.

These are some of the important dimensions of inflation in the construction industry. The charts merely serve to establish what we already know—inflation is even more of a problem in construction than it is in the economy at large. But cost indexes are only symptoms of the problem. From the point of view of policy, which must treat causes rather than symptoms, it is important to distinguish between two types of inflationary problems in construction.

One concerns the very rapid rise in costs in just the past few years; the other is the problem of why construction cost indexes are persistently higher than the general price level of economies as a whole over the long run. These are separate problems. They require different remedies.

Economists recognize two basic types of inflation—one sometimes called cost-push inflation, and the other, demand-pull.

The former, a sort of "hard-core" inflation, stems from a set of built-in conditions . . . rigidities within a particular industry—or in the entire economic system, for that matter—which prevent the competitive forces of the marketplace from doing their job of promoting efficiency and passing improvements in productivity along to the buyer in the form of lower prices.

The other kind of inflation, demand-pull, is usually the result of a temporary imbalance in the market—an excess of demand in relation to the capacity to meet it.

This situation is usually self-correcting, since higher prices can be expected to encourage the addition of capacity, which in turn, restores balance. Right now, both types of inflationary forces, cost-push and demand-pull, are at work in the construction industry.

The rigidities that are built into the construction industry, resulting in its long-term, higher-than-average pricing structure, are well-known.

In the interest of saving time I will mention some of the critical ones:

1. Restraint on the growth of the construction labor force, by limitation of membership in the building trades unions and by long apprenticeship programs.

2. Restraint of technological advance, by union work rules, and by local building codes.

3. Low productivity, owing to a low ratio of capital equipment per worker. Where there are exceptions, such as highway construction, the cost experience has been generally favorable.

4. Lack of standardization in buildings themselves. Again, the outstanding exception to individual design in construction, tract building of lower-cost, one-family housing, shows more favorable cost experience.

5. Seasonality of construction, which results in excessive overtime and high labor turnover, both of which tend to boost costs.

6. The local nature of construction, which, along with the immobility of labor, results in pockets of labor surplus and scarcity.

7. The high failure rate of building contractors.

These obstacles to efficiency make themselves felt through high construction costs in good times and bad. Collectively, they represent a formidable obstacle to achieving many of the Nation's goals in the decade ahead.

From time to time, however—and this is certainly one of these times—this cumbersome structure is further aggravated as demand for the industry's output temporarily outruns the capacity to meet it.

In this way, demand-pull affects construction just like any other sector of the economy: It accelerates an already existing tendency toward inflation.

There is little question that the demand for construction has been strong this year, though it is harder to speak with precision about the industry's capacity to meet it.

Perhaps it helps to note that while spending for construction of all kinds is up 9 percent so far this year, all but 2 percent of that again has been simply inflation.

The real increase in the industry's output has been only 2 percent.

If any excess capacity exists in construction, it can only be in the one-family housing sector where credit restraint is currently depressing output.

The present situation boils down to this: The construction industry's inefficient market structure which leads to a built-in tendency toward high cost operation is now being aggravated by especially strong demand for its output. The result is severe inflation. The question is what to do about it.

A simple answer, perhaps the simplest, is to reduce construction demand by withholding public construction funds. And to the extent that excess demand is the most urgent problem we face, some withholding of Federal construction money—as the President has ordered—may be helpful. But this is at best a stopgap measure, and fails to come to grips with either the general imbalance of demand and capacity in the economy as a whole, or with the special underlying problems causing inflation in construction.

What is more, it looks as though we will soon be getting some relief from the sereve pressures due to excess demand—particularly in nonresidential building.

During 1969, there has been a shift in the trend of contracting for new work—largely in the previously booming area of industrial and commercial building—and our 1970 forceast anticipates a decline in the total of such construction, perhaps 5 to 10 percent less, in the year ahead.

This should take some of the heat off construction costs—though I remind you this relief is still much ahead of us.

For the time being, a fiscal policy designed to treat inflation in the economy as a whole is superior to selective measures which attack it in one sector, only to have it pop out somewhere else.

In the short run, the broad guidelines of restrictions on public spending of all kinds, supplemented by an extension of the surtax beyond December 31, in order to produce as large a budget surplus as possible, seem as appropriate and necessary now as they did earlier this year. Any interim adjustments that might become necessary to prevent restraint from turning into recession can be made by relaxing our extremely tight monetary policy.

In a slightly longer-run sense, however, such a restrictive policy whose object is to stifle demand soon becomes self-defeating.

Taxation for the purpose of reducing spending power is also a deterrent to economic growth.

The deliberate underfunding of existing programs for social development is clearly contrary to the goals and priorities of the Nation as Congress has expressed them in the Housing and Urban Development Act, the recent Transportation Act, the Hill-Burton Act for the development of medical facilities, the various programs for educational facilities, and many others—all of which have been seriously underfunded for several years now.

One has to question the process that provides funds for the ABM, the C5A and the SST while cutting the heart out of the model cities program.

This Nation desperately needs schools and hospitals, highways and airports, water supply and pollution control—and most of all adequate housing for low-income families.

Withholding appropriations in the interest of controlling inflation is not going to solve these broader issues. And paradoxically enough, neither will it produce any lasting relief from inflation in the construction industry because it does not get at the roots of the problem there.

I mean, of course, the existing barriers to the expansion of the construction labor force, and the factors that limit the productivity of all construction workers.

There is a great deal more to be gained from a positive concept of "creative" spending of Federal construction funds than can ever be derived from the negative act of withholding them.

By creative spending I mean spending in a way that achieves the dual purpose of correcting some of this industry's basic defects at the same time it helps satisfy the urgent need for public facilities.

Examples are not hard to find. On a very simple level, the release of public money timed in a way that avoids the normal seasonal peaks, and fills in the seasonal gaps of the construction year would help to ease rather than accentuate cost pressures.

In a similar way, the release of public construction money with an eye to local market conditions, stepping up the flow in labor surplus areas and holding back in labor shortage areas, would also help hold down costs.

This kind of continuing mangement of public spending would certainly be an improvement over the recent across-the-board cutback approach.

On a more significant level, the "Philadelphia plan", requiring compliance with minority hiring guidelines on Federally-assisted construction work, is an excellent example of creative spending.

This principle could be the key to providing much of the needed expansion in the supply of construction workers over the next decade. And without such an increase in the labor force, construction costs will go out of sight.

This same approach also has potential application in the problem area of building codes. As a condition to the allocation of public funds for local construction projects, Federal agencies might require communities to show progress in bringing their codes up to the standard of a modern and uniform national code. This could remove one of the single biggest barriers to the improvement of productivity in construction.

Over the decade ahead, the strong demand for construction of all kinds will be a continuing source of potential inflation. The best way to head off this situation is with an equivalent expansion in our capacity to meet future demand as it develops.

But unless the construction industry's two biggest problems—limitation of the growth of the labor supply, and restrictive building codes that stand in the way of technological advance—are solved, future demand will make itself felt as much in rising costs as in additional construction put in place.

Government agencies can help control these inflationary tendencies by spending their construction appropriations in ways that encourage necessary structural changes in the building industry.

Chairman GRIFFITHS. Thank you very much. I particularly appreciate your statement. I have always been impressed by McGraw-Hill's work.

Mr. CHRISTIE. Thank you.

Chairman GRIFFITHS. Mr. Goldstein?

STATEMENT OF SIDNEY GOLDSTEIN, OFFICE OF POLICY PLANNING, FEDERAL HIGHWAY ADMINISTRATION, DEPARTMENT OF TRANSPORTATION

Mr. GOLDSTEIN. Madam Chairman, highway officials are deeply concerned with increasing costs in highway construction within recent years. Not only do such cost increases lengthen the completion time of highway programs, but they result in foregone and postponed tangible and intangible advantages that accrue from highway transportation.

Stability in the relationship of highway costs and highway productivity would enable the transportation requirements of the Nation to be more effectively met. Presently, highway transportation is the backbone of our surface transport system.

The Federal-aid highway construction program is carried out through the individual State highway departments. The States plan, design and build the highway projects subject to Federal guidance and approval.

Federal-aid highway construction programs consist of two major components:

The ABC program or the primary, secondary and urban connector systems requiring 50 percent State matching funds, and the national system of interstate and defense highways which require 10 percent State matching.

In addition, there are some Federally financed programs for highways on public lands and forests. These latter programs were authorized at a $50 million level in fiscal 1969. Detailed engineering estimates developed in 1956 projected a cost of approximately $41 billion to complete a 41,000-mile interstate highway system.

In 1968 that estimate had increased to approximately $57 billion because of changes in design standards, added safety features, landscaping, land costs and unit construction costs increments.

To be sure, the subject of increasing highway costs is very much in our minds, and we support the President's formation of a National Commission on Construction Labor to reduce these cost pressures.

Federal-aid highway funds authorized by Congress are apportioned among the States by the Secretary of Transportation. The apportioned funds are then available to the States for obligation, in advance of appropriations, with a commitment on the part of the Federal Government to pay its share of the work as it progresses.

Federal-aid highway programs are financed from a highway trust fund establish in 1956. The trust fund is the repository for revenues from Federal motor fuel taxes and certain other Federal taxes levied on highway users. These funds are apportioned among the States on the basis of statutory formulae.

Relevant data on obligations and disbursements in the Federal-aid highway activity for fiscal 1957 through fiscal 1969 are described in table I.

TABLE I.—HIGHWAY TRUST FUND, FEDERAL-AID HIGHWAY PROGRAMS FINANCED

[In millions of dollars]

Fiscal year	Authorizations: Date apportioned	Regular ABC	Other	Inter-state	Total	Obligations	Disbursements	Revenue, present law	Balance
Balance [1]	June 30, 1956	$1,633	$32	$315	$1,980	$1,160			
1957	June 29, 1956	125	4	1,000	1,129	2,227	$966	$1,482	$516
1958	Aug. 1, 1956	850	9	1,700	2,559	2,945	1,511	2,044	1,049
1959	Aug. 1, 1957	875	503	2,200	3,578	3,509	2,613	2,087	523
1960	Aug. 1, 1958	900	6	2,500	3,406	2,610	2,940	2,536	119
1961	Oct. 8, 1959	874	4	1,800	2,678	3,187	2,619	2,799	299
1962	Aug. 1, 1960	874	9	2,200	3,083	3,034	2,784	2,956	471
1963	Aug. 17, 1961	925	4	2,400	3,329	3,927	3,017	3,293	747
1964	Sept. 21, 1962	950	24	2,600	3,574	4,165	3,645	3,539	641
1965	July 8, 1963	975	82	2,700	3,757	4,022	4,026	3,670	285
1966	Aug. 18, 1964	1,000	23	2,800	3,823	4,048	3,965	3,924	244
1967	Aug. 30, 1965	1,000	30	3,000	4,030	3,782	3,974	4,455	725
1968	Oct. 7, 1966	1,000	30	3,400	4,430	4,232	4,171	4,428	982
1969	Aug. 29, 1967	1,000	30	3,800	4,830	4,658	4,149	4,689	1,522

[1] Unpaid balance of prior authorizations.

Federal-aid highway construction expenditures have constituted a declining portion of the gross national product in current prices in recent years due to the more rapid output and price expansion of other sectors in the economy. For example, Federal-aid highway expenditures in 1960 amounted to 0.6 of 1 percent of the gross national product; by 1969 these disbursements had declined to 0.4 of 1 percent.

Thus, while Federal-aid highway expenditures had increased by some two-fifths during this period—from $2.9 to $4.1 billion—their relative share in the economy had been reduced substantially.

It should be pointed out that employment in highway and street construction and maintenance in the United States, according to the Census of Construction of 1967, amounts to approximately 300,000 workers or about 10 percent of the employment in contract construction as a whole.

The share attributed to Federal-aid has been estimated at approximately half of the this number. Thus, the number of employees in this sector of the highway construction industry is rather minimal in relation to a total civilian labor force of 80 million.

The highway construction employees are dispersed among all the States. However, highway employment in the less industrialized States has considerable economic importance for these areas.

We have examined the most recent data available regarding prices, labor costs and productivity in the highway construction industry and have drawn some conclusions regarding their relationship to the economy in general and to other construction activities. (See tables II, III, and IV.)

TABLE II.—AVERAGE HOURLY EARNINGS (CURRENT PRICES)

Period	Total non-agricultural (private)	Manufacturing	Contract construction	Heavy construction
1960	$2.09	$2.26	$3.08	$2.84
1961	2.14	2.32	3.20	2.98
1962	2.22	2.39	3.31	3.02
1963	2.28	2.46	3.41	3.11
1964	2.36	2.53	3.55	3.23
1965	2.45	2.61	3.70	3.38
1966	2.56	2.72	3.89	3.55
1967	2.68	2.83	4.11	3.75
1968	2.85	3.01	4.40	4.07
June 1969	3.02	3.17	4.70	4.40

Source: "Employment and Earnings," August 1969, Bureau of Labor Statistics, U.S. Department of Labor; "Construction Review," August 1969, U.S. Department of Commerce.

TABLE III.—PRODUCTIVITY COMPARISONS

[In percent]

Year	Labor productivity changes in Federal-aid highway activities [1]	Index of output per man-hour of private economy on establishment basis [2]
1960–61	+3.8	+3.4
1961–62	+3.5	+4.8
1962–63	+3.9	+3.6
1963–64	+1.4	+3.9
1964–65	+.3	+3.1
1965–66	+1.8	+3.8
1966–67	−.4	+1.6
1967–68	−1.1	+3.5

[1] Bureau of Public Roads.
[2] Bureau of Labor Statistics.

TABLE IV.—THE CONSUMER PRICE INDEX AND SELECTED CONSTRUCTION COST INDEXES (1966 TO JUNE 1969)

	Consumer Price Index	Composite Federal-aid-highway price index	Department of Commerce composition construction cost index	Engineering-News record construction cost index
1966 average	113.1	113	119	134.3
1967 average	116.3	117.6	125	141.4
1968 average	121.2	121.6	131	151.9
March 1969	125.6	123.5	138	162.9
June 1969	127.6	130.3	141	169.1

Sources: Survey of Current Business, September 1968, June 1969, Construction Review, August 1969.

The Bureau of Public Roads publishes a composite highway bid-price index which describes the price movements in excavation, structures, structural steel, and other components of Federal-aid highway construction to be put in place. According to this index, highway bid-prices have tended to increase at about the same rate as the Consumer Price Index during the past 2 years. (See table V.)

Table V

U.S. DEPARTMENT OF TRANSPORTATION

FEDERAL HIGHWAY ADMINISTRATION

BUREAU OF PUBLIC ROADS

PRICE TRENDS for FEDERAL-AID HIGHWAY CONSTRUCTION

1957–59 BASE

SECOND QUARTER 1969

This index is composed of six indicator items and is based on total quantities used during the 1957–59 period. These items are common excavation, to indicate the price trend for all roadway excavation; portland cement concrete pavement and bituminous concrete pavement, to indicate the price trend for all surfacing types; and reinforcing steel, structural steel, and structural concrete, to indicate the the price trend for structures.

Development of the index is discussed in some detail in an article in Public Roads Magazine, volume 31, No. 10, October 1961.

Office of Engineering and Operations

Construction and Maintenance Division

FOR OFFICIAL DISTRIBUTION

Table V

PRICE TRENDS FOR FEDERAL-AID HIGHWAY CONSTRUCTION

1957–59 Base[1]

Year	Common excavation		Surfacing: Portland cement concrete		Surfacing: Bituminous concrete		Surfacing	Structures: Reinforcing steel		Structures: Structural steel		Structures: Structural concrete		Structures	Composite index
	Average contract price (cu. yd.)	Index	Average contract price (sq. yd.)	Index	Average contract price (ton)	Index	Surfacing Index	Average contract price (lb.)	Index	Average contract price (lb.)	Index	Average contract price (cu. yd.)	Index	Structures index	
1922	$0.40	102.5	$2.28	56.9	--------	--------	56.9	$0.050	38.1	$0.074	37.3	$20.18	36.6	37.2	63.2
1923	.47	119.3	2.43	60.6	--------	--------	60.6	.057	43.4	.078	39.4	23.37	42.4	42.5	70.4
1924	.43	109.4	2.40	59.9	--------	--------	59.9	.057	43.4	.077	38.8	22.91	41.6	41.9	67.6
1925	.39	98.5	2.36	58.9	--------	--------	58.9	.056	42.6	.067	33.8	22.53	40.9	40.6	64.2
1926	.36	92.3	2.29	57.1	--------	--------	57.1	.053	40.3	.074	37.3	22.76	41.3	40.6	61.8
1927	.35	89.8	2.29	57.1	--------	--------	57.1	.051	38.8	.071	35.8	22.65	41.1	39.7	60.9
1928	.34	85.9	2.10	52.4	--------	--------	52.4	.049	37.3	.067	33.8	21.22	38.5	37.6	56.9
1929	.32	80.0	2.05	51.1	--------	--------	51.1	.048	36.5	.059	29.8	21.58	39.2	37.2	55.0
1930	.30	77.3	1.86	46.4	--------	--------	46.4	.045	34.2	.061	30.8	20.08	36.4	35.0	51.2
1931	.27	69.5	1.68	41.9	--------	--------	41.9	.040	30.4	.054	27.2	18.02	32.7	31.3	45.9
1932	.18	49.2	1.44	35.9	--------	--------	35.9	.034	25.9	.046	23.2	15.33	27.8	26.6	36.4
1933	.26	66.2	1.67	41.6	--------	--------	41.6	.038	28.0	.046	23.2	16.15	29.3	28.2	45.8
1934	.29	74.6	1.90	47.4	--------	--------	47.4	.043	32.7	.053	26.7	17.73	32.2	31.6	50.2
1935	.26	65.6	1.90	47.4	--------	--------	47.4	.044	33.5	.052	26.2	17.78	32.3	31.9	48.1
1936	.26	67.0	1.91	47.6	--------	--------	47.6	.046	35.0	.060	30.3	20.25	36.8	35.2	49.5
1937	.24	61.8	1.89	47.1	--------	--------	47.1	.048	36.5	.066	33.3	19.76	35.9	35.8	47.4
1938	.21	53.5	1.72	42.9	--------	--------	42.9	.045	34.2	.063	31.8	19.06	34.6	34.1	43.5
1939	.21	53.5	1.73	43.1	--------	--------	43.1	.044	33.5	.059	29.8	19.13	34.7	33.6	43.4
1940	.21	53.0	1.68	41.9	--------	--------	41.9	.045	34.2	.063	31.8	19.17	34.8	34.3	42.5
1941	.24	62.0	1.87	46.6	--------	--------	46.6	.054	41.1	.076	38.3	21.44	38.9	39.4	48.6
1942	.37	93.2	2.39	59.6	--------	--------	59.6	.065	49.5	.090	45.4	26.16	47.5	47.8	65.0
1943	.44	111.0	2.71	67.6	--------	--------	67.6	.067	51.0	.095	47.9	30.19	54.8	52.6	74.6
1944	.37	95.4	2.45	61.1	--------	--------	61.1	.064	48.7	.089	44.9	31.94	58.0	53.4	67.6
1945	.36	91.0	2.38	59.4	--------	--------	59.4	.062	47.2	.077	38.8	31.62	57.4	51.8	65.1
1946	.35	88.7	2.65	66.1	--------	--------	66.1	.075	57.1	.113	57.0	38.79	70.4	64.4	71.1
1947	.38	97.0	3.01	75.1	--------	--------	75.1	.093	70.8	.132	66.6	45.84	83.2	77.0	80.6
1948	.42	106.8	3.37	84.0	--------	--------	84.0	.108	82.2	.158	79.7	51.00	92.6	87.6	90.3
1949	.38	96.2	3.40	84.8	--------	--------	84.8	.104	79.1	.146	73.7	47.36	86.0	82.3	87.1
1950	.33	84.6	3.32	82.8	--------	--------	82.8	.100	76.1	.139	70.1	44.62	81.0	78.0	82.3
1950	.32	75.7	3.62	82.7	$5.89	58.5	85.7	.099	76.2	.129	66.1	42.62	78.7	74.2	78.3
1951	.40	96.2	3.92	89.6	7.33	110.1	100.3	.119	92.0	.176	90.4	50.72	93.6	92.3	96.1
1952	.43	102.4	4.19	95.7	6.98	104.8	100.5	.119	92.4	.178	91.3	52.24	96.4	94.1	98.9
1953	.40	96.2	4.07	93.0	6.53	98.1	95.6	.121	93.8	.172	88.6	52.82	97.5	94.0	95.3
1954	.38	91.4	3.98	90.9	5.97	89.7	90.3	.112	86.7	.159	81.5	50.15	92.6	88.0	89.9
1955	.35	84.0	3.96	90.5	6.07	91.2	90.8	.110	85.2	.157	80.9	50.01	92.3	87.4	87.3
1956	.40	96.0	4.26	97.3	6.58	98.8	98.1	.127	97.9	.212	108.9	53.74	99.2	102.0	98.8
1957	.42	100.7	4.34	99.2	6.75	101.4	100.3	.134	104.0	.228	117.0	55.98	103.3	107.8	103.1
1958	.43	102.9	4.41	100.8	6.67	100.2	100.5	.129	99.9	.186	95.7	54.10	99.9	98.5	100.0
1959	.40	95.7	4.40	100.5	6.58	98.8	99.6	.126	97.2	.169	86.8	53.00	97.8	94.2	96.4
1960	.39	93.8	4.33	98.9	6.37	95.7	97.2	.119	92.1	.167	85.6	51.72	95.5	91.7	94.1
1961	.41	96.7	4.20	96.0	6.35	95.4	95.7	.115	88.9	.165	84.8	53.38	98.5	92.4	94.9
1962	.45	106.2	4.28	97.8	6.28	94.3	96.0	.113	87.1	.166	85.5	54.62	100.8	93.5	98.6
1963	.45	106.4	4.32	98.6	6.45	96.9	97.7	.113	87.8	.181	93.2	57.44	106.0	98.6	101.0
1964	.46	109.0	4.25	97.0	6.24	93.8	95.3	.112	86.7	.193	98.9	58.32	107.6	101.1	102.0
1965	.47	112.1	4.43	101.3	6.37	95.7	98.3	.123	95.3	.200	102.6	60.63	111.9	106.0	105.7
1966	.52	124.3	4.61	105.4	6.36	95.5	100.2	.127	98.3	.224	114.9	64.11	118.3	113.6	113.0
1967:															
First quarter	.50	119.5	4.43	101.3	6.34	95.2	98.1	.124	95.7	.254	130.7	66.74	123.2	120.6	113.2
Second quarter	.50	118.1	4.43	101.1	6.15	92.3	96.5	.127	98.0	.252	129.7	67.07	123.8	121.0	112.3
Third quarter	.60	143.1	4.65	106.1	6.58	98.8	102.3	.133	102.6	.237	121.9	70.10	129.4	122.2	123.0
Fourth quarter	.52	122.9	4.61	105.4	6.59	99.0	102.1	.137	106.0	.244	125.5	77.77	143.6	131.0	119.2
Average	.54	128.1	4.53	103.5	6.42	96.4	99.8	.130	100.5	.246	126.4	70.26	129.7	123.4	117.6
1968:															
First quarter	.54	127.4	4.78	109.3	6.66	100.1	104.5	.133	102.7	.252	129.4	74.34	137.2	128.5	120.6
Second quarter	.57	135.2	4.86	111.0	6.73	101.1	105.8	.130	100.8	.233	119.8	70.48	130.1	121.5	121.2
Third quarter	.52	124.8	4.83	110.4	6.61	99.3	104.6	.129	99.8	.260	133.4	72.67	134.1	127.7	119.5
Fourth quarter	.66	157.6	5.16	117.9	6.75	101.4	109.3	.133	102.7	.249	128.2	74.71	137.9	128.4	132.3
Average	.55	131.9	4.86	111.1	6.68	100.3	105.4	.131	101.3	.249	127.9	72.70	134.2	126.2	121.6
1969:															
First quarter	.57	134.5	4.44	101.3	6.78	101.9	101.6	.134	103.8	.268	137.8	75.67	139.7	132.6	123.5
Second quarter	.61	144.5	4.65	106.3	7.13	107.0	106.7	.135	104.3	.276	142.0	79.03	145.9	137.1	130.1
Third quarter															
Fourth quarter															
Average															
1957–59 base	0.42	100.0	4.38	100.0	6.66	100.0	100.0	0.129	100.0	0.195	100.0	54.18	100.0	100.0	100.0

PREVIOUS QUARTER BASE—Index for each quarter as compared with 100.0 for each preceding quarter.

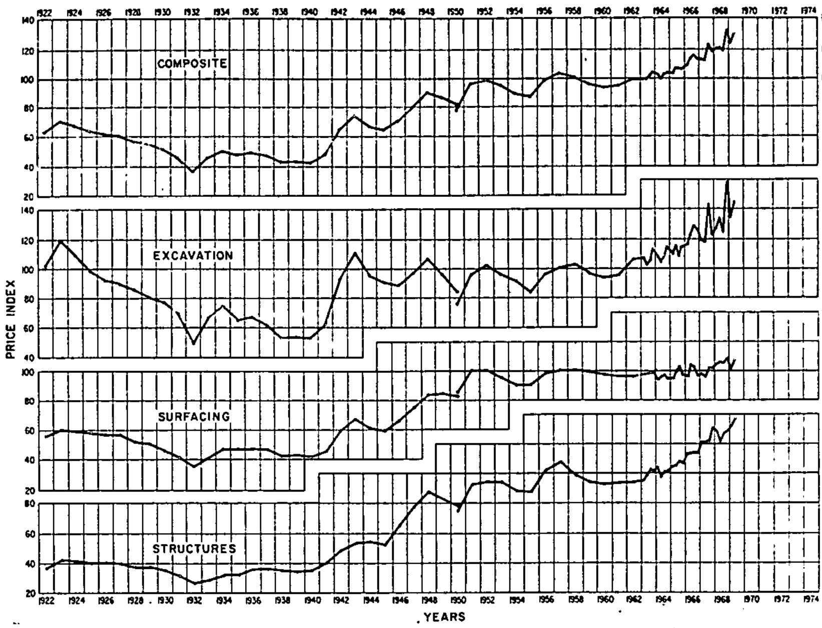
Year	Common excavation price	Index	PCC price	Index	Bituminous price	Index	Surfacing Index	Reinforcing steel price	Index	Structural steel price	Index	Structural concrete price	Index	Structures index	Composite index
1968:															
First quarter	--------	103.7	--------	103.8	--------	101.0	102.4	--------	96.9	--------	103.2	--------	95.6	98.1	101.2
Second quarter	--------	106.2	--------	101.5	--------	101.0	101.3	--------	98.1	--------	92.5	--------	94.8	94.6	100.5
Third quarter	--------	92.3	--------	99.5	--------	98.3	98.9	--------	99.1	--------	111.3	--------	103.1	105.1	98.6
Fourth quarter	--------	126.3	--------	106.8	--------	102.1	104.5	--------	102.9	--------	96.1	--------	102.8	100.6	110.7
1969:															
First quarter	--------	85.3	--------	85.9	--------	100.5	93.0	--------	101.1	--------	107.5	--------	101.3	103.2	93.4
Second quarter	--------	107.4	--------	104.9	--------	105.0	105.0	--------	100.5	--------	103.1	--------	104.4	103.4	105.3
Third quarter	--------		--------		--------			--------		--------		--------			
Fourth quarter	--------		--------		--------			--------		--------		--------			

[1]Base for composite index, 1957–59, involves 3,641,885,000 cubic yards of roadway excavation 154,953,000 square yards of portland cement concrete surfacing with an average thickness of 9.1 inches, 111,516,000 tons of bituminous concrete surfacing, 2,206,879,000 pounds of reinforcing steel for structures, 2,581,462,000 pounds of structural steel and 14,583,000 cubic yards of structural concrete.

Index figures for 1922 through 1950 are simple mathematical conversions from the 1925–29 base to the 1957–59 base. They were derived from the previously computed figures, using 1925–29 base quantities and prices, and dividing the figures for each year by the average of the figures for the years 1957, 1958, and 1959. Revisions for 1950 and figures subsequent thereto are computed from 1957–59 base quantities and prices. The breaks in the curves indicate indexes for 1950 computed by both methods. Prices for portland cement concrete surfacing reflect adjustments to base period thickness in each State and do not include costs for reinforcing steel and joints.

NOTE: Several prices and index figures for the first quarter of 1969 differ from those in the previous issue due to minor corrections.

PRICE TRENDS FOR FEDERAL-AID HIGHWAY CONSTRUCTION
1957-1959=100



Total output in the economy is being diluted by price increases so that little real gain has been evident in the economy recently.

The estimate of the gross national product for the second quarter of 1969, for example, amounted to an annual rate of $925 billion, an increase of $22 billion, over the first quarter but the "real" gain was less than $4 billion.

Consumer prices have increased from an index of 113.1 to 127.6 in the period from 1966 through June 1969, or approximately 13 percent.

During this same period the bid-price index for Federal-aid highway construction activities increased at almost the same rate, 15 percent.

Yet, if we look at the period between 1966 and March 1969, highway prices increased only 9 percent compared with a consumer price increase of 11 percent.

The latest highway bid-price data for the second quarter 1969 moved upward by more than 5 percent from the first quarter of 1969.

However, with no adjustments for seasonal and other changes comparisons of individual quarters are not meaningful and may be misleading.

A more valid comparison is the highway price changes between the second quarters of 1968 and 1969, which indicates a 7 percent increase in line with price increases in general.

Furthermore, comparison of highway bid-price changes with those of all construction activities during the past 2½ years show that changes in general construction prices are larger than changes in highway construction.

For example, the Department of Commerce composite construction cost index increased by 18 percent; the index of construction of the Engineering News-Record by 26 percent during this same period.

Thus, general construction prices have increased more rapidly than highway prices in the most recent period.

Labor Costs and Productivity

Skilled labor costs in the construction industry have been increasing at a faster rate than that indicated in the average hourly earnings figures for highways and heavy construction. This is particularly noticeable in construction activities such as housing and hospitals, which have higher proportions of skilled and urban labor than prevalent in highway construction.

While skilled labor in highways has been estimated at about 39 percent of the total work force in housing and hospital construction, skilled workers constitute 70 percent of the work force. In Federal-aid highway construction, labor costs account for 25 percent of production costs.

During the period from 1960 through 1968, average hourly earnings for heavy construction activities, including highway and street construction and heavy construction, increased from $2.84 an hour to $4.07 an hour, or approximately 43 percent.

Wages in manufacturing activities increased an almost identical 40 percent, or 4 percent annually.

Recently, however, hourly earnings have been increasing at a substantial rate in heavy construction, averaging 7 percent annually, in the past 2 calendar years, and 9 percent in the last year.

While in past periods, increases in highway productivity, as measured in total man-hours required per million dollars of Federal-aid highway construction in constant prices, have been sufficient to make up for cost increases, this has not been the case within the 2 recent years.

Highway productivity has fallen considerably, as has output per man-hour trends in the economy as a whole.

Thus, "real" product in highway construction is not maintaining its pace. Because of these relationships, there is an inflationary impact of wage and other cost increases.

Analysis of the productivity relationships in the economy with those in highway construction in recent decades shows that productivity in the economy increased at a slower rate than in highway construction in the period from 1950 through 1964.

However, since 1964 productivity increases have slowed somewhat in highway construction relative to the economy generally.

Within the two most recent years, most relevant for their inflationary implications, productivity declines of 0.4 percent and 1.1 percent in 1967 and 1968, respectively, were estimated for highway construction.

In the economy as a whole such negative change in productivity was first evident in the first and second quarters of 1969.

Hence, declines in output per man-hour are characteristic of highway construction, as well as of the economy as a whole, during the most recent period.

There is a need to increase highway productivity to counter such gains in costs. It may be unlikely that the large productivity gains characteristic of the earlier years of the interstate highway program can be restored to counter large cost increases in labor, materials and credit.

The implications of changes in the highway mix to include more urban highway mileage may negatively affect the cost-productivity relationship.

Hopefully, new advancements in highway technology and management techniques and applications of present knowledge may eventually restore the cost-productivity relationships achieved in prior years.

Stability in highway costs is essential to meet effectively the transportation requirements of the Nation and to prevent further erosion of highway construction activity. If wages in highway construction continue to increase at about current annual rates, there is little chance that they can be offset by productivity gains.

The President's statement of September 4 directed cutbacks in Federal construction programs and urged voluntary reductions by State and local agencies in their construction activities.

Consistent with this statement, the Federal Highway Administration has requested that the Governors and State highway departments make substantial project deferrals during the remainder of the fiscal year to result in significant reductions in the programs in order to counter the pressures on construction wages and other costs.

In addition, the Governors have been requested to reduce corollary expenditures to the greatest extent possible.

While immediate short-run anti-inflationary impacts are less likely to ensue from highway program adjustments because of the nature of the industry and the long lag of 6 months to 2 years to fully work out the effects of changes in Federal-aid obligation levels, there is little doubt that cutbacks result in restraints on the part of the construction industry and a change in their expectations. These have consequent deflationary effects.

However, it should be understood that most current Federal outlays for highway construction represent outlays against obligations already incurred in prior years under contract authorization.

The Federal Government is already indebted to the States for this amount. Claims in any year already have a potential for reimbursement in excess of any established outlay ceiling. Controls on obligations must be quite severe in order to effect Federal-aid expenditures within the same year. Less than one-fifth of the obligations incurred throughout a year can be expected to be translated to expenditures within that year with the balance claimed over a 2-year period. A greater anti-inflationary impact would, of course, occur if the obligations were not spread to this extent throughout the year.

There are, of course, differences between highway construction and general construction performance and labor force, a long lag that exists from apportionment to obligation to expenditure of Federal-aid highway funds, and program start-up difficulties that engender additional costs.

Because of these differences from other construction programs, reductions in the highway program though anti-inflationary, as is any reduction in a sizable governmental program, may differ in its microeconomic effects.

There have been three curtailments of highway construction program levels within the past 2 years as an aspect of economic stabilization activities. As inflationary pressures arose, controls on obligations were imposed a number of times. From fiscal 1967–1969, there was a total decline in obligations of $1.5 billion.

In 1967, at the request of the Department of Transportation, an estimate was made by the Bureau of Labor Statistics of employment impact of a reduction in highway trust fund expenditures of $2.4 billion.

This cutback was estimated as affecting 218,000 jobs, of which 108,000 would be onsite and 110,000 throughout the rest of the economy.

These calculations therefore show that each $1 billion of highway expenditures affects about 80,000 employees within the year, but as already pointed out there is a considerable leadtime required to obtain any economic effect on income and spending. Thus, the effects may be spread over a relatively long period.

The BLS study also indicated that the industries most dependent upon highway construction are: The highway construction industry itself, the stone, clay, glass products, mining and manufacturing industries, and the fabricated steel manufacturing industries.

The jobs affected directly and indirectly in these industries would total 136,000.

Highway activities also affect particular industrial suppliers. Over 40 percent of highway construction purchases are concentrated in structural metal, mining, and stone, clay and glass products.

Because of the widespread nature of the Federal-aid highway program, it affects all States and many localities. Hence, the regional implications may be particularly significant.

In conclusion, we expect that the curtailments described in the President's September 4 memorandum and requested by the Federal Highway Administrator will account for reduction of highway labor and other price pressures in the industry and we believe that the President's recently announced formation of a National Commission on Construction Labor is a forward step in the longer range process of the abatement of construction cost pressures.

Chairman GRIFFITHS. Thank you very much.

Mr. Sumichrast?

STATEMENT OF DR. MICHAEL SUMICHRAST, CHIEF ECONOMIST, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. SUMICHRAST. Madam Chairman, Mr. Javits, for a quarter of a century it has been quite apparent that the sensitivity of residential construction to changes in credit conditions has helped the Federal Reserve make a contribution to our overall stabilization objectives. It has been argued that while producing general overall stability, no inequities have occurred to consumers; there was no significant loss in housing output. When all factors are added up, the argument goes on, the stabilization objectives derived from countercyclical variability in the supply of mortgage credit did not impose a net burden on the residential sector.

This argument loses its validity during any period of rapidly rising prices.

I am not questioning the ability of the Federal Reserve Board to dictate what volume of housing start the residential construction industry produced. This is fairly obvious. The simplicity of the relationship between overall credit and volume of mortgage credit is one of the fundamental reasons why it is used so often in the past.

Examining the past trend in the cost relationship of housing makes it clear that under conditions of rapidly increasing prices there are no cost benefits derived to either the consumer or industry from this stabilization process. Neither the consumer, the builder, the laborer, nor financial institutions supplying the bulk of the mortgage money benefit.

Let us first examine what the costs are. For the sake of simplicity, I will use a typical single-family house built for sale. (Cost breakdown is included in table 1.)

TABLE 1.—BREAKDOWN OF SOME MAJOR COMPONENTS OF A TYPICAL SINGLE FAMILY HOUSE [1]

Item	Cost	Percentage of total
Land cost	$2,620.00	10.16
Land improvement:		
Financing	49.40	
Bonding fees	36.40	
Land planning	176.80	
Engineering	140.40	
Rough grading	140.40	
Street grading	296.40	
Street paving	413.20	
Curbs and gutters	213.20	
Sidewalls	150.00	
Storm sewer and drainage	210.00	
Major drainage ditches	220.00	
Sanitary sewers	355.00	
Mains and water supply lines	350.00	
Water connection charges	85.80	
Gas	13.00	
Subtotal	2,850.00	11.05
Total, land	5,470.00	21.20
Structure:		
Preparation:		
Permits and fees	70.00	
Engineering	91.00	
Site work	99.00	
Utility connections	559.00	
Footing and foundations	1,037.00	
Total	1,856.00	7.19
Rough structure:		
Structural steel	75.00	
Framing	2,852.00	
Concrete	780.00	
Rough sheet metal	70.00	
Rough electrical	226.00	
Rough plumbing	536.00	
Rough heating	169.00	
Others	476.00	
Total	5,184.00	20.09
Full enclosure:		
Roofing	190.00	
Masonry	1,200.00	
Windows and doors	257.00	
Insulation	155.00	
Exterior trim	271.00	
Exterior paint	213.00	
Stairs	21.00	
Structure—Continued		
Full enclosure—Continued		
Others	68.00	
Total	2,375.00	9.21
Finish trades:		
Drywall and plaster	707.00	
Tile	88.00	
Finish trim	1,035.00	
Flooring and covering	655.00	
Cabinets and vanities	263.00	
Interior decoration	361.00	
Finish electrical	221.00	
Finish plumbing	540.00	
Finish heat	168.00	
Finish metal	99.00	
Appliances	283.00	
Total	4,420.00	17.13
Completion and inspection:		
Cleanup	140.00	
Landscaping	304.00	
Final inspection	70.00	
Others	195.00	
Total	709.00	2.75
Overhead, profit and sales expense:		
Overhead	970.00	
Profit	1,274.00	
Sales expense	900.00	
Total	3,144.00	12.19
Financing expenses:		
Interim financing	689.00	
Fees and appraisals	221.00	
Inspections	62.00	
Title and recordings	39.00	
Fees—commitment	200.00	
Interest on notes	70.00	
Discount on mortgage	1,200.00	
Closing cost paid for customer	140.00	
Hazard or builder's risk insurance	21.00	
Total	2,642.00	10.24
Selling price	25,800.00	100.00

[1] For illustration purposes only since there is no such thing as a "typical" house. Cost was derived from the NAHB Metropolitan Cost of Homebuilding, being developed as a quarterly reporting of cost for several metropolitan areas. The sales price was derived from current median sales price as published by thr Bureau of Census in their C-25 series. Discounts are based on current FNMA prices of FHA loans; assumed 20-percent downpayment and 25-year loan. The disclosure of discounts among financial charges is only to illustrate the impact of this direct payment on total cost. Up to now discounts are not allowed to be included in the overall cost of the unit by the FHA, although they are unquestionably a part of the total cost and cannot be ignored.

If you group the total costs as they are presented in table 1 into a few major categories you will get a better picture and understanding of the total components as they changed over the last 20 years (table 2).

TABLE 2.—SUMMARY OF COST 1949 AND 1969

Item	1949 (percent)	1959 (percent)
Structure	70	56
On-site labor	33	18
Materials	36	38
Land	11	21
Overhead and profit	15	13
Financing	5	10
Average price	$9,780	$20,534

Source: Bureau of Labor Statistics and NAHB Economic Department.

There are three major changes apparent from this table:

One is the doubling of the share needed to finance construction.

The second is the substantial increase in the share of land as a portion of the final product.

Third is the reduction of onsite labor from about 33 percent to 18 percent in the last 20 years.

Let us look at the major components now, financing costs, first.

Financing Cost

Looking at the problem of financing costs as it reflects itself under the impact of monetary and fiscal policy in the last 3 years, the following can be concluded:

One, cost of financing has been the single largest individual item responsible for the increase in total cost.

Since 1966, the financial charges connected with construction of residential units have more than doubled. The effective interest rate on construction loans alone in August was 11 percent, up from 8.57 percent just a year ago (tables 3, 3a, and 3b). To this interest rate has to be added discounts, fees and other financial charges. In the area of multifamily units the situation is even worse. There are dozens of "equity" participations tied to the borrowing of money.

TABLE 3.—CONSTRUCTION LOANS

[75 percent, 6 months loan]

	June 1968	July 21, 1969	Aug. 11, 1969
Loan required	$18,750.00	$19,012.50	$19,106.25
Interest rate (percent)	6.97	8.50	8.40
Discounts (points)	0.80	1.09	1.30
6-month interest charge	$653.43	$808.03	$802.46
Discounts	150.00	207.24	248.84
Total financial charge	803.43	1,105.27	1,050.84
Effective interest rate (percent)	8.57	10.68	11.00
Increase in financial charge (percent)		26.40	3.50

Source: NAHB Economics Department, Builders Economic Council weekly Survey, August 1969.

TABLE 3a.—MORTGAGE DISCOUNTS PAID BY BUILDER

	June 1968	July 21, 1969	Aug. 11, 1969
Discount rate	0.77 points	1.12 points	1.39 points.
Discount paid	$154	$283.92	$354.10.
Increase in discount rate		45.00 percent	24.10 percent.
Increase in discount paid		84.40 percent	24.70 percent.

Source: NAHB Economics Department, Builders Economic Council Weekly Survey, August 1969.

TABLE 3b.—CONVENTIONAL MORTAGE, 25 YEARS 20 PERCENT DOWN

	June, 1968	July 21, 1969	Aug. 11, 1969
Selling price of house	$25, 000	$25, 350	$25, 475
Downpayment	5, 000	5, 070	5, 095
Amount of loan	20, 000	20, 280	20, 380
Interest rate (percent)	6. 87	7. 98	8. 02
Monthly payments, principal, and interest	$139. 80	$156. 16	$156. 96
Taxes	35. 50	39. 65	41. 51
Insurance	5. 70	5. 78	5. 81
Additional annual expense		247. 08	32. 28
Annual income needed:			
PITIX60	10, 860, 00	12, 095. 40	12, 256. 80
Required additional		1, 235. 40	161. 40

Note: Increased costs due to financial charges: June 1968–July 21, 1969, 1-time increase equals $341.76; monthly payment increases $20.59. July 21, 1969–Aug. 11, 1969, 1-time increase equals $105.75; monthly payment increases $2.69.

Source: NAHB Economics Department, Builders Economic Council weekly survey, August 1969.

The financing cost is the most inequitable cost in terms of the ultimate consumer. It brings no benefit either in size, luxury, better equipment, or any other facilities, to the final product. All it does is increase the cost of the housing.

An example, perhaps will better illustrate this point: The Kaiser Committee in its studies found that the total mechanical/electrical costs, which includes plumbing, heating, air conditioning, and electrical work, accounted for 11.4 percent of the total price. This is about the same price you pay for the privilege of borrowing the money to construct the house.

The total inside work, consisting of tile, linoleum, painting, appliances, and cleanup accounted only for 7.3 percent.

Two, financial charges for permanent mortgages also have imposed a tremendous burden on the prospective buyer. Since early 1966, the average mortgage interest rate has increased from a 6-percent level to about 8.5 percent.

Senator JAVITS. Madam Chairman?

Mr. SUMICHRAST. It is very well illustrated in the charts which I have attached to the testimony.

Senator JAVITS. Would the witness allow me to have just one word?

Mr. SUMICHRAST. Yes.

Senator JAVITS. Madam Chairman, I must go and make quorum on the Committee on Public Labor and Welfare. I came especially this morning because I believe the witnesses are touching on one of the most critical problems in the American economy. That is: the rigidity of the building construction industry and the new factor in this rigidity produced by very high money rates which fall with equal severity upon those who can, and those who can't, afford it. I say this in the sense that large corporations are able to bear and able to mark up their prices according to the cost of money, whereas individuals suffer and have no protection.

I would like to assure the witnesses, Madam Chairman, that I will read the documentation with the greatest interest. I am sure the Chair will ask you all the appropriate questions. If it is any satisfaction to them, as one Senator I will do my utmost to try to bring about some of the reforms which are recommended.

Chairman GRIFFITHS. Thank you very much for your kindness, Senator Javits.

Senator JAVITS. I hope the witness doesn't mind the interruption.

Mr. SUMICHRAST. Not at all, sir. To resume, what such in increase means in relation to the consumer is illustrated in table 4.

TABLE 4.—MONTHLY PAYMENTS FOR INTEREST AND PRINCIPAL AT VARIOUS INTEREST RATES AND WHAT A $100 MORTGAGE WILL BUY AT THESE RATES[1]

	Percent						
	5.5	6	6½	7	7½	89	9
Monthly payment at $1,000	6,140875	6,443014	6,752072	7,067792	7,389912	7,718162	8,391964
Monthly payment ($20,000 loan)	$122.96	$128.86	$135.04	$141.35	$147.79	$154.36	$167.84
Annual payments	$1,475.52	$1,546.32	$1,620.48	$1,646.20	$1,773.40	$1,853.32	$2,014.08
What will a $100 monthly mortgage payment buy? (25-year mortgage)	$16,280.00	$15,520.00	$14,810.00	$14,148.00	$13,532.00	$12,956.00	$11,916.00
Change from—							
5.5 to 8 percent						25.5	
6 to 8 percent						19.8	
Change in price of house $100 will buy:							
5.5 to 8 percent						−20.42	
6 to 8 percent						−16.52	

[1] The same monthly payments today at 8.5 percent interest rate will buy only a $20,200 house (with $16,000 mortgage as compared to $26,000 priced house (with 20,800) mortgage at 6 percent in 1966.

Source: Monthly Payment Direct Reduction Loan Amortization Schedule; Financial Publishing Co., Boston, Mass.

The table shows that for the same monthly payment today at 8.5 percent interest rate, a buyer can purchase only a $20,200 house as compared to a $26,000 house at 6 percent in 1966.

To put it another way, the increase in the mortgage rate alone means that for the same monthly payment, the consumer can buy today 363 square feet of finished living area less than three years ago.

Third, the financial charges for mortgages include only the payments of principal and interest. To obtain monthly fixed obligation, there must be added several other charges. One part of this fixed obligation, real estate taxes, has increased by 50.3 percent from 1963 through the second quarter of 1969 on new houses, or 8.3 percent annually (table 5).

TABLE 5.—MONTHLY REAL ESTATE TAXES ON FHA 203B HOMES

Year	Median monthly taxes	
	New	Existing
1963	18.07	18.81
1964	19.20	19.80
1965	19.49	21.11
1966	20.66	21.72
1967	21.23	23.39
1968	24.77	24.54
1967:		
1st quarter	21.45	22.30
2d quarter	20.35	22.95
3d quarter	21.77	24.16
4th quarter	24.35	24.26
1968:		
1st quarter	24.40	24.46
2d quarter	24.44	24.34
3d quarter	25.90	24.72
4th quarter	25.48	24.74
1969:		
1st quarter	27.08	24.75
2d quarter	27.16	24.09
Percent change:		
1963–68	37.1	30.5
1963 to 2d quarter 1969	50.3	28.1
1st quarter 1967 to 1st quarter 1968	13.8	9.7
1st quarter 1968 to 1st quarter 1969	11.0	1.2
1st quarter 1967 to 1st quarter 1969	26.2	11.0
2d quarter 1967 to 2d quarter 1968	20.1	6.1
2d quarter 1968 to 2d quarter 1969	11.1	−1.0
2d quarter 1967 to 2d quarter 1969	33.5	5.0
Average annual percent change 1963–68	6.2	4.7

Source: 1963–66, "Series Data Handbook" a supplement to "FHA Trends" covering section 203b, home mortgage characteristics, Department of Housing and Urban Development, Federal Housing Administration, Division of Research and Statistics, Statistics Section; 1967 to 2d quarter 1969, FHA Trends of home mortgage characteristics Department of Housing and Urban Development Federal Housing Administration, Division of Research and Statistics, Statistics Section, June 16, 1969.

Total monthly fixed obligations increased during the same period by 61 percent (table 6 and 6a).

TABLE 6.—TOTAL FIXED MONTHLY OBLIGATIONS, PERCENT OF AVERAGE MONTHLY GROSS EARNINGS

	Average monthly gross earnings		Median total monthly fixed obligations, FHA[2]	Earnings as percent of fixed obligations	
	U.S. production workers	FHA purchaser[1]		Production workers	FHA purchaser
1962	$418.43	$641.24	$189.32	45.2	29.5
1963	430.65	666.50	200.13	46.5	30.0
1964	446.20	676.66	210.68	47.2	31.1
1965	465.96	696.15	219.63	47.1	31.5
1966	486.81	749.36	243.14	49.9	32.4
1967	497.90	820.20	266.20	53.5	32.5
1968	530.88	869.56	282.81	53.3	32.5
1967:					
1st quarter	487.47	807.21	263.69	54.1	32.7
2d quarter	491.56	816.52	264.78	53.9	32.4
3d quarter	497.94	831.87	269.15	54.1	32.4
4th quarter	509.63	852.21	271.92	53.4	31.9
1968:					
1st quarter	515.47	855.55	277.05	53.7	32.4
2d quarter	525.08	866.30	279.49	53.2	32.3
3d quarter	532.65	897.31	295.78	55.5	33.0
4th quarter	547.83	897.24	297.31	54.3	33.1
1969:					
1st quarter	545.93	921.39	307.89	56.4	33.4
2d quarter	556.90	950.74	323.20	58.0	34.0
Percentage changes:					
1962–1968	26.9	35.6	49.4		
1962–2d quarter, 1969	33.1	48.3	70.7		
1st quarter, 1967–1st quarter, 1968	5.7	6.0	5.1		
1st quarter, 1968–1st quarter, 1969	5.9	7.7	11.1		
1st quarter, 1967–1st quarter, 1969	12.0	14.1	16.8		
2d quarter, 1967–2d quarter, 1968	6.8	6.1	5.6		
2d quarter, 1968–2d quarter, 1969	6.1	9.7	15.6		
2d quarter, 1967–2d quarter, 1969	13.3	16.4	22.1		
Average annual percent change, 1962–2d quarter, 1969					

[1] Average effective monthly income.

[2] Includes monthly housing expense, State income tax, life insurance policy premium, compulsory contribution to retirement fund, payments on installment accounts, mortgage payments on other real estate, payments on other loans and accounts, and similar items.

Source: Col. 1, Survey of Current Business, U.S. Department of Commerce, Office of Business Economics, Labor Force Employment and Earnings, Weekly and Hourly Earnings, Manufacturing Establishments; cols. 2 and 3, 1962–66 Series Data Handbook, a supplement to FHA Trends, DHUD, FHA, Division of Research and Statistics, Statistics Section, covering sec. 203b, home mortgage characteristics; 1967–2d quarter, 1969 FHA trends of home mortgage characteristics, Department of HUD, Federal Housing Administraton, Division of Research and Statistics, Statistics Section, June 16, 1969.

TABLE 6A.—SALES PRICE, INCOME AND PAYMENT REVIEW, NEW UNITS

	Median property value	Median monthly mortgage payment	Median total fixed obligations	Median family income (total current income)
1960	$14,607	$103.81	$175.10	$7,738
1961	14,918	106.60	185.87	7,882
1962	15,151	105.20	189.32	7,899
1963	15,789	108.94	200.13	8,237
1964	16,063	111.49	210.68	8,484
1965	16,561	114.26	219.63	8,777
1966	17,163	122.41	243.14	9,226
1967	17,992	113.14	266.20	10,008
1968	18,797	143.45	282.81	10,597
1967:				
1st quarter	17,854	131.82	263.69	9,855
2d quarter	17,955	131.83	264.78	9,977
3d quarter	18,127	135.01	269.15	10,169
4th quarter	18,645	139.43	271.92	10,332
1968:				
1st quarter	18,548	139.15	277.05	10,414
2d quarter	18,808	141.36	279.49	10,580
3d quarter	19,125	152.38	295.78	10,849
4th quarter	19,349	154.66	297.31	10,813
1969:				
1st quarter	19,753	160.66	307.89	11,202
2d quarter	20,187	170.80	323.20	11,474
Percentage changed:				
1960 to 1968	28.7	38.2	61.5	37.0
1960 to 2d quarter 1969	38.2	64.5	84.6	48.4
1st quarter 1967 to 1st quarter 1968	3.3	5.6	5.1	5.7
1st quarter 1968 to 1st quarter 1969	6.5	15.5	11.1	7.6
1st quarter 1967 to 1st quarter 1969	10.6	21.9	16.8	13.7
2d quarter 1967 to 2d quarter 1968	4.8	7.2	5.6	6.0
2d quarter 1968 to 2d quarter 1969	7.3	20.8	15.6	8.4
2d quarter 1967 to 2d quarter 1969	12.4	29.6	22.1	15.0
Average annual income 1960 to 2d quarter 1969	4.0	6.8	8.9	5.1

Source: 1960–1966: "Series Data Handbook", a supplement to FHA trends. DHUD, FHA. Division of Research and Statistics, Statistics Section, covering section 203b, home mortgage characteristics; 1967 to 2d quarter 1969 FHA trends of home mortgage characteristics, Department of Housing and Urban Development Federal Housing Administration, Division of Research and Statistics, Statistics Section June 16, 1969.

In 1962, the median monthly fixed obligation of FHA purchasers amounted to $189.32. The average monthly earnings of manufacturing workers was $418.32. To meet these monthly obligations, a manufacturing worker would have to pay 45.2 percent of his income toward housing.

Today, he earns $138.47 more per month. But his monthly obligations have increased to $323.20. He would have to pay 58 percent of his income to meet these obligations. He can neither pay 45 percent as was the case in 1962, nor 58 percent as is the case today.

In the last year alone, this process has shown a dramatic increase: Wages of manufacturing workers increased by 6.1 percent but their monthly obligations increased by 15.6 percent. The implications are clear and do no need elaboration.

Chairman GRIFFITHS. His wife has to work.

Mr. SUMICHRAST. Yes.

LAND COST

Land cost has increased on the average by 16 percent per year since 1951, or nearly 300 percent in that time (table 7). The sale price of an FHA home, excluding land, increased during the same period by 87.1 percent, or 4.7 percent annually.

TABLE 7.—AVERAGE NEW-HOUSE COST PER SQUARE FOOT COMPARED WITH SALE PRICE

	Average sales price includes site	Average price of site	Sale price less site	Average calculated area, square feet	Price per square foot including site	Price per square foot less site
1951	$9,780	$1,092	$8,688	$942	$10.38	$9.22
1952	11,077	1,227	9,850	968	11.44	10.18
1953	10,515	1,291	9,224	953	11.03	9.68
1954	10,985	1,456	9,529	990	11.10	9.63
1955	12,113	1,626	10,487	1,049	11.55	10.00
1956	13,468	1,887	11,581	1,104	12.20	10.49
1957	14,541	2,148	12,393	1,146	12.69	10.81
1958	14,283	2,223	12,060	1,138	12.55	10.60
1959	14,448	2,362	12,086	1,140	12.67	10.60
1960	14,662	2,470	12,192	1,142	12.84	10.68
1961	14,894	2,594	12,300	1,141	13.05	10.78
1962	15,169	2,715	12,454	1,162	13.05	10.72
1963	15,878	2,972	12,906	1,182	13.43	10.92
1964	16,216	3,113	13,103	1,206	13.45	10.86
1965	16,825	3,427	13,398	1,228	13.70	10.91
1966	17,605	3,589	14,016	1,210	14.55	11.58
1967	18,613	3,766	14,847	1,216	15.31	12.21
1968	19,568	4,128	15,440	1,226	15.96	12.59
1967:						
1st quarter	18,444	3,725	14,719	1,218	15.14	12.08
2d quarter	18,495	3,738	14,757	1,213	15.25	12.17
3d quarter	18,825	3,815	15,010	1,217	15.47	12.33
4th quarter	19,406	4,163	15,243	1,222	15.88	12.47
1968:						
1st quarter	19,287	4,039	15,248	1,222	15.78	12.48
2d quarter	19,638	4,201	15,437	1,226	16.02	12.59
3d quarter	19,851	4,172	15,679	1,230	16.14	12.75
4th quarter	19,960	4,197	15,763	1,215	16.43	12.97
1969:						
1st quarter	20,266	4,252	16,014	1,224	16.56	13.08
2d quarter	20,534	4,319	16,215	1,219	16.84	13.30
Percentage changed:						
1951-60	49.9	126.2	40.3	21.2	23.7	15.8
1960-68	33.5	67.1	26.6	7.4	24.3	17.9
1st quarter 1967 to 1st quarter 1968	4.6	8.4	3.6	.3	4.2	3.3
1st quarter 1968 to 1st quarter 1969	5.1	5.3	5.0	.2	4.9	4.8
1st quarter 1967 to 1st quarter 1969	9.9	14.1	8.8	.5	9.4	8.3
2d quarter 1967 to 2d quarter 1968	6.2	12.4	4.6	1.1	5.0	3.5
2d quarter 1968 to 2d quarter 1969	4.6	2.8	5.0	—.6	5.1	5.6
2d quarter 1967 to 2d quarter 1969	11.0	15.5	9.9	.5	10.4	9.3
1951 to 2d quarter 1969	110.0	295.5	87.1	29.4	62.2	44.3
Average annual percent change, 1951 to 2d quarter 1969	5.9	16.0	4.7	1.6	3.4	2.4

Source: Cols. 1, 2, 4: Series Data Handbook, a supplement to FHA Trends. DHUD, FHA, Division of Research and Statistics, Statistics Section, covering sec. 203b, home mortgage characteristics; 1967–69 FHA trends of home mortgage characteristics, Department of HUD, Federal Housing Administration, Division of Research and Statistics, Statistics Section June 16, 1969; col. 3 equals col. 1 minus col. 2; col. 5 equals col. 1 divided by col. 4; col. 6 equals col. 3 divided by col. 4

The living area also increased by 30 percent from 942 square feet to 1,219 square feet, or 1.6 percent annually. The price per square foot of finished floor area excluding land increased 44 percent or 2.4 percent annually during the 18-year period.

The purchasing power of the dollar declined at a somewhat higher annual rate—2.68 percent—suggesting a most remarkable conclusion: The price per square foot of housing, excluding land, actually dropped slightly since 1951.

Labor Cost

As has been already illustrated, the portion of cost of a housing unit attributable to on-site labor has changed dramatically in the last 20 years.

It now accounts for about 18 percent as compared to about 33 percent before. Yet, the wage increases labor was able to negotiate in the last 12 months in the construction industry are well beyond the average increases in other industries—15.1 percent or 2.5 times higher than the average of all wage increases.

This 15.1 percent average wage increase in on-site labor means an additional $724 in cost to the consumer on the typical conventionally built home selling at $25,800 today as compared to a year ago.

Consider the wage increases which have been negotiated in the past few years. A plumber's hourly basic wage in San Francisco is now $10.26, compared to $6.44 in 1966.

At this rate, 50 week's work would bring in an income of $16,384. To this one must add overtime and other benefits.

A carpenter's wage increased in the same city from $4.88 to $7.81 per hour.

In Detroit, labor was able to negotiate a 70 percent increase since 1966 and a carpenter now earns $7.87 compared to $4.63 in 1966 (tables 8 and 9). Compare this annual wage to that of professionals such as teachers, or policemen, or even college professors with Ph. D.'s.

TABLE 8.—WAGE RATES OF CARPENTERS IN SELECTED CITIES

Metro area	1966	1969	Percent increase 1966–69	Percent average increase per year
Los Angeles	$4.83	$7.00	44.9	14.97
District of Columbia	3.50	4.63	32.3	10.8
Chicago	5.20	6.60	26.9	9.0
Detroit	4.63	7.87	70.0	23.3
Minneapolis	4.13	5.94	43.8	14.6
Birmingham	3.70	6.19	67.3	22.4
Dallas	3.00	4.52	50.7	16.9
Seattle	4.48	6.15	37.3	12.4
San Francisco	4.88	7.81	60.0	20.0
Total, all cities				15.87

Source: NAHB Economics Department.

TABLE 9.—INDEX OF UNION HOURLY WAGE RATES 1957–59=100

	All building trades	Percent change
Year:		
1964	126.2	
1965	131.4	4.1
1966	136.9	4.1
1967	144.6	5.6
1968	154.0	5.8
1964–68		22.0
1969 [1]	167.6	8.8

[1] Estimate.

Source: U.S. Department of Labor, Bureau of Labor Statistics Construction Review, June 1969, table E-3, p. 49.

Material Costs

The increase in materials cost was the lowest among major items going into the cost of a housing unit. While, for instance, the index of union wage rates in building trades increased by 22 percent from 1964 to 1968, the wholesale index of construction materials increased 11.5 percent. This is still somewhat higher than the increase in all industrial commodities—7.7 percent—but could be explained by the unusual increase in lumber prices late last year (table 10).

TABLE 10.—WHOLESALE PRICE INDEX 1957-59=100

	All industrial commodities	Percent change	All constructive material	Percent change
1964	101.2		99.6	
1965	102.5	+1.2	100.8	+1.2
1966	104.7	+2.1	103.9	+3.1
1967	106.3	+1.5	105.2	+1.2
1968	109.0	+6.1	111.1	+5.6
1964 to 1968		+7.7		+11.54

Source: U.S. Department of Labor, Bureau of Labor Statistics; Construction Receive, August 1969, table E-2, p. 44.

Summary

The rapid increase in costs means that it is less and less possible for a family to buy a house if only one member is working.

In 1959, 73.6 percent of all FHA homes were purchased with one income; today, only 55.9 percent. In 10 years, 20 percent more people who purchased FHA homes have to send their wives to work in order to buy an FHA house.

This trend has accelerated rapidly in the last 2 years (table II).

TABLE 11.—COMORTGAGOR INCOME

(Figures in percentage)

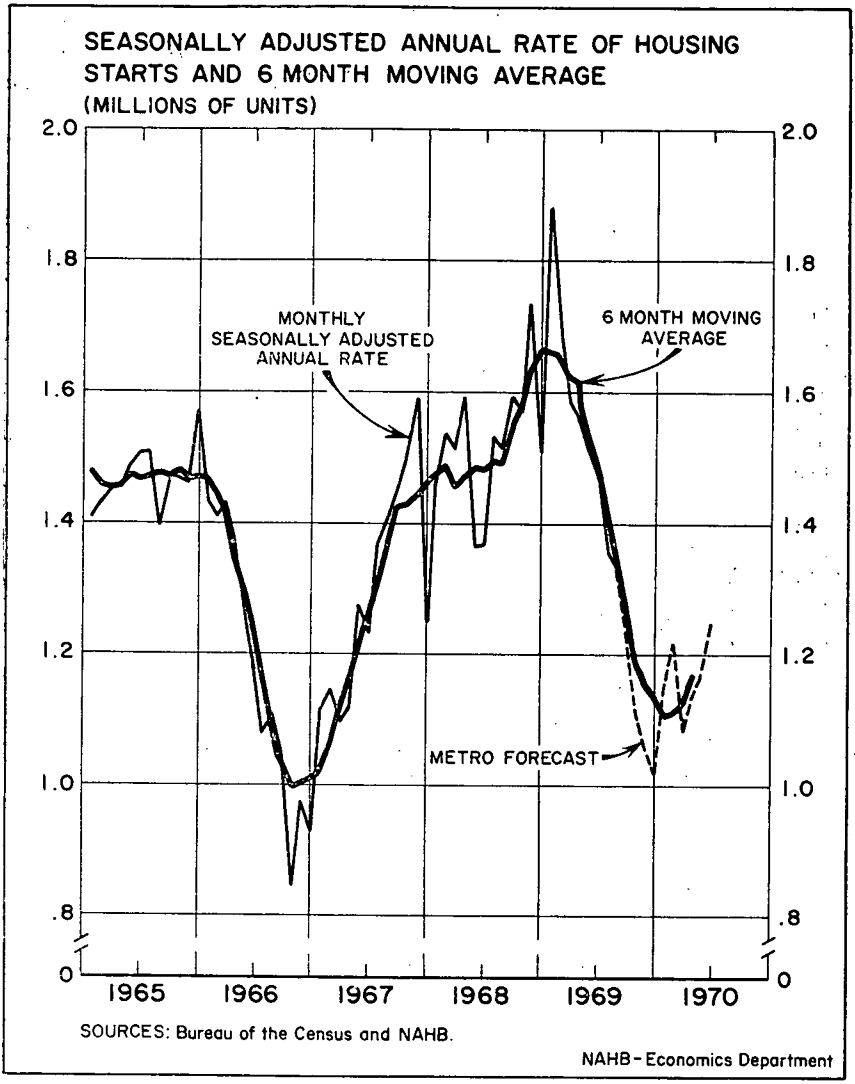
	No comortgagor income	Comortgagor income disallowed	Comortgagor income allowed
1959	73.6	9.3	17.1
1960	73.3	9.3	17.4
1961	71.6	9.6	18.8
1962	71.8	9.9	18.3
1963	70.2	10.2	19.6
1964	73.5	8.7	17.8
1965	69.4	10.9	19.7
1966	63.9	7.5	28.6
1967	60.7	5.8	33.5
1968	59.1	5.6	35.3
1967:			
1st quarter	62.4	6.2	31.4
2d quarter	57.8	6.0	36.2
3d quarter	61.7	5.3	33.0
4th quarter	60.3	5.2	34.4
1968:			
1st quarter	59.4	5.9	34.7
2d quarter	57.9	5.4	36.7
3d quarter	60.1	5.3	34.6
4th quarter	57.2	5.2	37.6
1969:			
1st quarter	56.9	5.3	37.8
2d quarter	55.9	4.5	40.5
Percentage changed:			
1959 to 1968	−19.7	−39.8	−106.4
1959 to 2d quarter 1969	−24.0	−51.6	−136.8
1st quarter 1967 to 1st quarter 1968	−4.8	−4.8	10.5
1st quarter 1968 to 1st quarter 1969	−4.2	−10.2	8.9
1st quarter 1967 to 1st quarter 1969	−8.8	−14.5	20.4
2d quarter 1967 to 2d quarter 1968	0.2	−10.0	1.4
2d quarter 1968 to 2d quarter 1969	−3.5	−16.7	10.4
2d quarter 1967 to 2d quarter 1969	−3.3	−25.0	11.9
Average annual percent change 1959 to 2d quarter 1969	−2.3	−4.9	13.0

Source: 1959–1966, "Series Data Handbooks" a supplement to "FHA Trends" covering section 203b, home mortgage characteristics, Department of Housing and Urban Development, Federal Housing Administration, Division of Research and Statistics, Statistics Section; 1967 to 2d quarter 1969, FHA Trends of home mortgage characteristics Department of Housing and Urban Development, Federal Housing Administration, Division of Research and Statistics, Statistics Section, June 16, 1969.

A conventional buyer with a typical house priced at $25,800 would need, in August 1979, nearly $1,400 more in annual income, which is an increase of 30 percent than was the case a year ago. His monthly costs increased by $23.28 or 13.5 percent since that time.

As can be seen from the accompanying chart (chart I), we expect housing starts to decline farther this year. The level of starts early next year will also be very low and recovery much slower than in 1966.

CHART I



We are moving into an era of substantial housing shortages and the basic makeup of family living is being challenged by increased costs. In the 1950's apartments accounted for less than 10 percent of starts; now, this year for the first 8 months they run at the rate of 44.2 percent.

Failures in the construction industry have accelerated rapidly since 1950, reaching a high in 1966 of 19.2 percent as a percentage of total business failures. In 1950, they accounted for only 10 percent. There is little question but that failures will increase again this year and next (table 12).

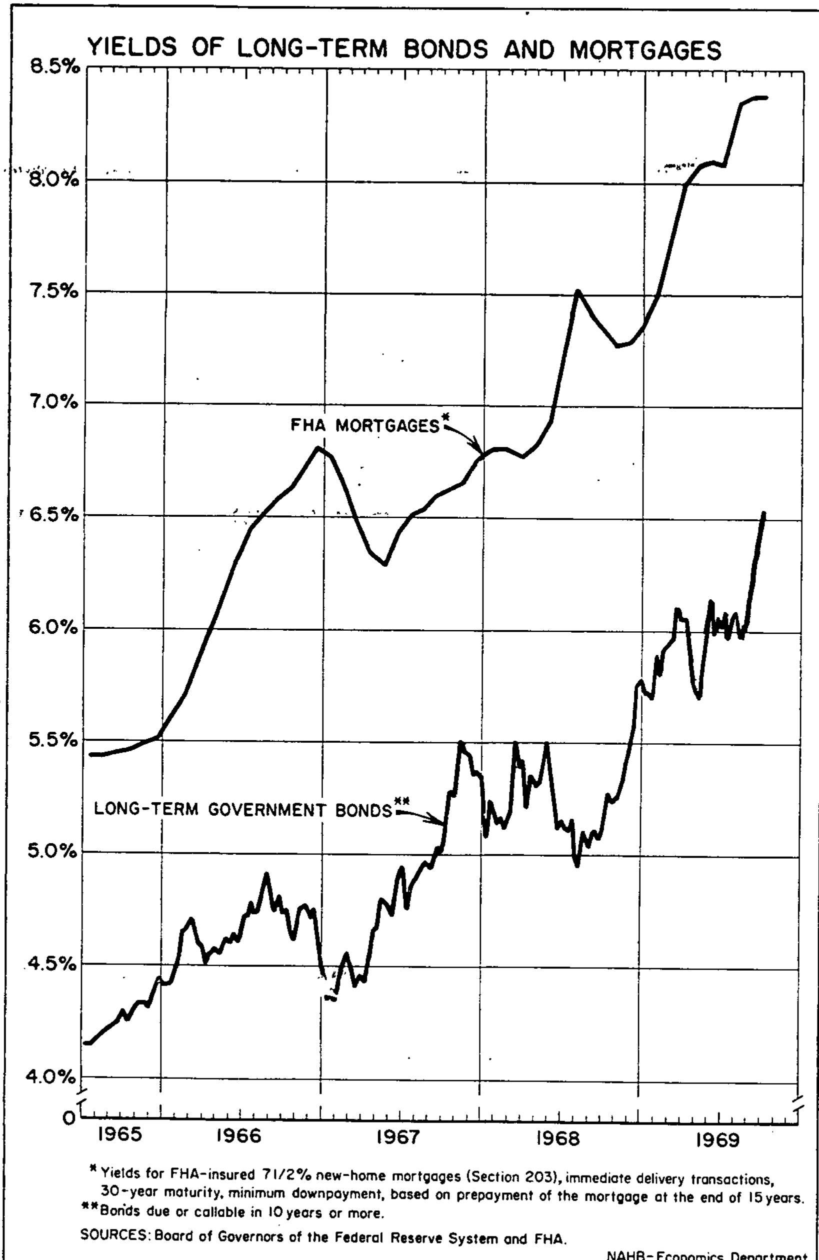
TABLE 12.—FAILURES IN CONSTRUCTION INDUSTRY

	Total construction failures	Average liabilities	Construction failures, percent of total failures
Year:			
1950	912	$2,813	10.0
1955	1,404	5,924	12.8
1960	2,607	7,724	16.9
1965	2,513	11,578	18.6
1966	2,510	13,003	19.2
1967	2,261	14,316	18.3
1968	1,670	12,722	17.3

Source: Survey of Current Business, U.S. Department of Commerce, Office of Business Economics, General Business Indicators, industrial and commercial failures.

Clearly, residential construction does not and cannot benefit from prolonged inflation. If the industry is to provide decent housing it must have stability. It must have a regular supply of mortgage money at reasonable rates. It needs fiscal responsibility with a surplus budget. The industry cannot compete with Government and large corporations for money in a period of rising prices and heavy demand for loanable funds (chart II).

CHART II



Assuming that corporate borrowing is one of the essentials for full employment, it must be Government that provides the framework of fiscal responsibility.

The many proposals dealing with this subject are clearly beyond the scope of this short statement and have been made on several occasions by NAHB.

Future fulfillment of the housing goals is indeed bleak, unless we will be able to live within our means, get some semblance of order into the money markets, and bring inflation under control.

Recommendations

We will have to find a way to insulate mortgage market from credit restrictions.

We would have to provide additional training of labor.

We would have to seriously study the problem of expanding supply of usable land.

We need to extend the surtax.

We need to have a reasonably long period of budget surplus.

Thank you.

Chairman Griffiths. Thank you. You certainly bring home the problem of housing in a very dramatic way.

As a matter of fact, some changes in the tax laws, I would assume, would help you. They certainly build a lot of new structures for business. Some type of change could do the same thing for home builders, couldn't it?

Mr. Sumichrast. Yes. the pressure is there, of course, to borrow while a certain percentage——

Chairman Griffiths. A selective increase in interest rates, that increased interest rates for some items much higher and enlarged the home building can also help you, couldn't it?

Mr. Sumichrast. I don't understand the question.

Chairman Griffiths. Supposing for putting up an office building you had to pay 14 percent for your money, but for putting up a family dwelling you had to pay 5 percent. That could help you, couldn't you heist the general increase in interest rates? The question would be for what are you going to use the money?

Mr. Sumichrast. What are you going to use for money?

Chairman Griffiths. For what would you use the money? If you put an interest rate on homebuilding that was much lower than the interest rate on other types of construction, it would certainly help the homebuilder?

Mr. Sumichrast. It certainly would—there is no question about it. But I don't think you can really do that under present conditions. There are many ways other countries are supporting a flow of savings into the institutions which deal in the mortgage markets. In Germany for instance, the mortgage bond, which could have a great potential in this country, is one of these instruments that indirectly supports the savings and loan industry. This, in turn, brings larger savings into these institutions.

The problem we have in this country is that the share of savings going into savings and loan associations and mutual savings banks has declined in the last 20 years. The savings and loan industry has permanently lost a place among the financial intermediaries as far as attracting a share of saving funds is concerned.

Now, we depend to a very large degree on these institutions. They can no longer lend more money than they do now, because the savings and loan have about 85 percent of all their assets put into mortgages, only about 1.9 percent in cash and the rest of it in Government securities.

The same situation exists at the mutual savings banks. So you can no longer get a larger portion from these two institutions into the mortgage market.

What you could do, you could enlarge the portion of savings which they could receive. There have been many suggestions by the savings and loan industry which would do this.

Then you have the problem of the basic change in attitude of savers. I think the saver is not the same saver we had 20 years ago. That is another problem: How do you make commercial construction to pay 15 percent rates and housing only 5 percent in a free economy?

To provide more money for the mortgage market a small portion you could shift into the mortgage market from existing lending institutions. I am suggesting how this could be or should be done.

I think the commercial banks were created many years ago and we should look closely not only how they function in the light of today's requirements, but they should accept some part of the social function and not be directed by only one proposition: the highest yield. We have a report of charge yielding to lenders as much as 20 percent on residential construction loans. You cannot build this kind of cost into a residential unit unless you price yourself completely out of the market.

The other institutions—such as pension funds—which do not have a large portion of their funds invested in the mortgages could transfer say 1 percent or 2 percent or their assets into mortgages, and I think we will have a lot of problems solved.

Take the pension fund assets of $235 billion. If they would change their portfolio only by 2 percent, this would bring to the mortgage market $4.7 billion.

Chairman GRIFFITHS. They will not unless they are forced into it or enticed into it. One or the other is going to have to occur.

Mr. Goldstein, what was the original cost of building a mile of highway in any major city that you care to name? What was the cost when the highway bill first went into effect?

Mr. GOLDSTEIN. The 1956 highway bill?

Chairman GRIFFITHS. Yes.

Mr. GOLDSTEIN. I don't think I could answer that question, but I can say that the original planning estimate for the total Interstate System was $27 billion for 37,700 miles, But immediately after the passage of the act there was a detailed engineering estimate made, and the cost was then developed at $41 billion.

Chairman GRIFFITHS. For 41,000 miles?

Mr. GOLDSTEIN. For 41,000 miles. But I couldn't tell you what the cost was for a mile of urban highway at that time.

Chairman GRIFFITHS. Would you supply it for the record? I would like to know the cost originally, of building a mile of highway in the city of Chicago, in the city of New York, Detroit, and Los Angeles, and the cost today.

Second, I would like to know what the land cost was in 1956 as opposed to the land cost today.

(The following information was subsequently supplied for the record by Mr. Goldstein:)

The detailed engineering estimates developed in 1958 and 1968 provide comparisons of the estimated costs of highway construction in these cities. The 1958 estimate was based on July 1, 1956 data and the 1968 estimate was as of January 1, 1967.

TOTAL COST PER MILE ON THE INTERSTATE HIGHWAY SYSTEM

[Dollars in thousands]

Area	1958 estimate		1968 estimate	
	Number miles	Cost per mile	Number miles	Cost per mile
Chicago	89	$6,881.7	143	$8,852.8
Detroit	83	5,853.0	179	5,943.6
New York	98	6,771.9	283	8,833.7
Los Angeles	197	4,273.1	230	5,569.2

The right-of-way costs developed in the 1958 estimates and in the 1968 estimates for the four cities are shown in the following table. The 1958 estimates were as of July 1, 1956 and the 1968 estimates were as of January 1, 1967.

RIGHT-OF-WAY COST PER MILE ON THE INTERSTATE HIGHWAY SYSTEM

[Dollars in thousands]

Area	1958 estimate		1968 estimate	
	Number miles	Cost per mile	Number miles	Cost per mile
Chicago	89	$1,473.0	143	$2,382.9
Detroit	83	1,774.0	179	1,492.0
New York	98	1,663.4	283	2,192.4
Los Angeles	197	1,184.7	230	2,133.3

Chairman GRIFFITHS (continuing). How many homes have been, or dwelling units have been torn down for the highway construction?

Mr. GOLDSTEIN. I can give you an estimate of this current year.

Chairman GRIFFITHS. All right.

Mr. GOLDSTEIN. Of what we would call relocation assistance, not necessarily number of homes. I believe we estimate that there will be payments made to 49,000 residents, I believe, and 7,000 businesses. These are payments.

Chairman GRIFFITHS. For a moving out of the way of the highway?

Mr. GOLDSTEIN. Yes, these are estimates for the current year, 1969.

Chairman GRIFFITHS. Why shouldn't purchasing a new home for these people be a part of the highway cost?

Mr. GOLDSTEIN. Well, under the 1968 Highway Act, they are allowed to pay additional amounts for relocation assistance, which would mean that the Federal Highway Administration can participate up to an amount above the current sales value of that house, to get them into a new home, up to I think $5,000 above the market value. This they can get.

So, in a sense, that is one of the objectives of the 1968 Highway Act.

Yes, one of the objectives of the 1968 Highway Act, relocation assistance provision, does have the particular provision you suggest.

Chairman GRIFFITHS. But it does not actually pay for a new home. It pays something about the market value?

Mr. GOLDSTEIN. It pays above the market value.

Chairman GRIFFITHS. And in many instances the market value of the old home has been run down by the mere fact that the highway is coming through, and we have just heard from the homebuilders that the price of a new home is greatly higher than the price of a home for which they have paid. So that in reality the highway building is a real disruption in home building and in American life today.

Why haven't you ever considered using any of these moneys for any other form of transportation than highways?

Mr. GOLDSTEIN. Well, actually——

Chairman GRIFFITHS. Why haven't you asked Congress for that?

Mr. GOLDSTEIN. Well, the first thing, I don't think I am in a position to answer that question.

Chairman GRIFFITHS. I see.

Mr. GOLDSTEIN. But, I think the general position that is taken is that the highway trust fund restricts the use to certain particular purposes only.

Chairman GRIFFITHS. To surface highways?

Mr. GOLDSTEIN. To surface highways. That has been our interpretation.

Chairman GRIFFITHS. But you could build highways underground. You could have subways.

Mr. GOLDSTEIN. Well, I think your question is a good one, but all I can say is that the interpretation that the Federal Highway Administration has followed is that the highway trust fund restricts it for roads for highway users and that when particular assistance to busses and so forth through construction activities can be provided so that more people can be carried, we will participate. But as far as using the funds that come in for other forms of transportation, the interpretation so far as I can give is that this has been considered outside the purview of the act.

Chairman GRIFFITHS. Why don't you have parking lots in the highway bills?

Mr. GOLDSTEIN. We do have, in the 1968 highway act the provision which allows us to participate in fringe parking lots.

Chairman GRIFFITHS. To what extent?

Mr. GOLDSTEIN. When the fringe parking lots are, as I recall, adjacent to mass transit.

Chairman GRIFFITHS. How much do you pay on it, 90 percent?

Mr. GOLDSTEIN. No, I believe it is on a 50-percent basis.

Chairman GRIFFITHS. Are the parking lots in relation to the traffic that is on the highway?

Mr. GOLDSTEIN. That would be one consideration, and I believe it also would need to be near a federally aided highway.

Chairman GRIFFITHS. How many road contractors are there in the United States that bid on Federal highways?

Mr. GOLDSTEIN. I really couldn't——

Chairman GRIFFITHS. Could you estimate it?

Mr. GOLDSTEIN. Well, I know that——

Chairman GRIFFITHS. There really aren't very many road contractors.

Mr. GOLDSTEIN. According to the census of construction for 1967, the highway and street construction industry has, as I recall, something like 14,000 establishments. Of those I think about 80 percent have 20 employees or less.

Chairman GRIFFITHS. Well, these people aren't building any of these Federal highways, are they?

Mr. GOLDSTEIN. I suppose most of the real small ones are probably maintenance contractors or subcontractors.

Chairman GRIFFITHS. So there must be a few hundred who are building the main part of the Federal highways; isn't that true?

Would you supply it for the record, exactly how many there are, because I would assume that if you have 100 it would be a lot. I know highway contractors that build in many States.

Mr. GOLDSTEIN. Probably so. The number of contractors who bid on Federal-aid construction in the year ending June 1969 amounted to 7,310.

Chairman GRIFFITHS. I would like to ask you, when do you build and when do you cut back? How do you cut back? Are you going to cut back 50 States at the same time?

Mr. GOLDSTEIN. I guess my only answer to that is that I personally am not involved in the decision for the cutback.

Chairman GRIFFITHS. Historically, have you built in all 50 States at the same time?

Mr. GOLDSTEIN. Historically the cutback has been made in each State.

Chairman GRIFFITHS. In all States?

Mr. GOLDSTEIN. Yes.

Chairman GRIFFITHS. And you have built in all States at the same time?

Mr. GOLDSTEIN. Yes.

Chairman GRIFFITHS. As a matter of fact, isn't highway labor quite mobile?

Mr. GOLDSTEIN. Well, you mean among highway projects?

Chairman GRIFFITHS. Yes.

Mr. GOLDSTEIN. Among highway projects. Well, I have had several discussions about that, and it is mobile, but again looking at the census material that I mentioned, something like 90 percent of the contractors work in the particular State only in which they report. I assume that this is true of the laborers as well. So I am not really sure how mobile they are.

Chairman GRIFFITHS. Well, I will give you some facts. I worked for a highway contractor when I was a young woman in the 1930's. There was a lot of labor. You could have gotten anybody to work. I distinctly remember that that highway contractor advertised in every State in the Union for a shovel operator. He really didn't want the shovels going out. They brought a shovel operator from several States away. I learned also, then, that those expert crews moved from State to State, from one piece of construction work to another.

The only people you hired on the spot were the manual laborers.

Now, if you are going to turn on and turn off any type of building why isn't highway construction the simplest one to go?

Mr. GOLDSTEIN. Well——

Chairman GRIFFITHS. The fact is why don't you build roads in the north in the summertime and move those crews into the south in the wintertime? I think it would be quite simple. You would get rid of this idea that they are unemployed overnight.

Mr. GOLDSTEIN. Well, actually the way the program works, it is a State highway department program. It is not——

Chairman GRIFFITHS. Well, why don't you put in some standards? You are going to cut off the money. You are supplying 90 percent of the money. You cut it off in the north in the winter and cut them off in the south in the summer.

Mr. GOLDSTEIN. Well, our current experience proves that the highway crews are rather fully occupied throughout the south throughout most of the year, and in the north, except in the very coldest weather.

Chairman GRIFFITHS. But still you do have some slowdowns in the north?

Mr. GOLDSTEIN. Yes.

Chairman GRIFFITHS. So that if there is anything that lends itself, it seems to me, to an intelligent cutback where the Government can really manage it to conserve money and to conserve labor, the highway program is that program.

Mr. GOLDSTEIN. I think, Madam Chairman, one thing should be pointed out, that about 60 percent of the people on the work force are unskilled and semiskilled, and these people are hardworking. Since a large proportion of the highway program is built in rural areas, these people are hired in the rural areas and this activity is a supplement to employment and earnings for those people.

Chairman GRIFFITHS. What equipment did highway builders have in 1960 that they didn't have in 1950 that made them more productive?

Mr. GOLDSTEIN. I think it wasn't the equipment so much as the kind of building activity. I think that we are now entering a period of additional urban building, which is more costly. The large machinery is not being used as productively as in rural areas, since the highway mix is changing.

Chairman GRIFFITHS. So that the equipment that they used in the 1950's—you pointed out that in the 1950's the cost went down.

Mr. GOLDSTEIN. Yes.

Chairman GRIFFITHS. Is that only because they were building in rural areas?

Mr. GOLDSTEIN. No, I think it is a change in the mix, the proportions that are being built. In the rural versus urban areas there are changes in the productivity relationship.

Chairman GRIFFITHS. Well, as a matter of fact, why are we building more in urban areas today; just because we have the money?

Mr. GOLDSTEIN. Well, we are building in the urban areas because we have been directed to build an interstate highway system that is supposed to connect cities of 50,000 population and over, and we are now getting to the phase of our operations that requires that particular activity.

Chairman GRIFFITHS. How many connections do you have to make? There are about four major ones already in the center of Detroit.

Mr. GOLDSTEIN. Well, I really am not an engineer, I am not qualified to answer many of these questions.

Chairman GRIFFITHS. Of course, the real question is why don't we shift our resources away from urban highways. You are causing congestion, noise, air pollution. The real question is: Hasn't the time arrived to reconsider the highway program?

Mr. GOLDSTEIN. Well, I think those of us in the highway program feel that we are considering and directing our attention at these items, and we have been researching in these areas. We believe we are helping to solve congestion in the urban areas. We are taking social factors into account in our planning, in our highway location. I believe many of us feel we are doing this.

Chairman GRIFFITHS. As you replace buildings, the truth is you are contributing to the inflation of the rest of construction?

Mr. GOLDSTEIN. Well, every public works investment has displaced buildings, and our Highway Act does have a social thrust, and I believe its relocation provisions are the most advanced social legislation of that type in public investment activities.

Chairman GRIFFITHS. Could you tell us in more detail what the functions of a National Commission on Construction Labor will be?

Mr. GOLDSTEIN. All I know of that is what I read in the newspaper, and in the releases that it would essentially be a study group to obtain voluntary compliance with results of analyses that are prepared on such factors as seasonality in the field, rigidities of different types of labor in the particular areas, open up entrance so that the supply of labor can be increased, and remove restrictions of one sort or another on labor supply—either through labor unions or through social restrictions. My impression was that it was going to be a group to study and to look at these particular areas.

Chairman GRIFFITHS. The Subcommittee on Economy in Government has been holding hearings and it has been brought out that unless a producer bears the full cost of production too much of that item will be produced. Wouldn't you believe that in principle this should apply to Government programs, as well as apply to producers?

Mr. GOLDSTEIN. In general, yes.

Chairman GRIFFITHS. Well, would you think it is possible that highway production is now one of the things that is moving toward destruction of the city?

Mr. GOLDSTEIN. No. First, as I said before, you put me in a very bad position. First, I am a technician in the Federal Highway Administration. I am not a policymaker as such, just a planner. But I think I would have to repeat what I said before, that we believe that we are attempting to improve the city and that we are trying to reduce the urban congestion, that we are trying to improve the traffic flow, that we are trying to meet the needs where relevant, of bus transportation, things of this type, in our urban transportation studies, in Detroit and elsewhere.

We do try to consider the needs of all modes and then estimate the highway mode requirements separately, afterwards, but our transportation studies do consider population factors, distribution, the economic factors, the growth patterns, residential and other land use arrangements, and this is the idea that we have of what we are attempting to do.

So that is the only way I can answer you.

Chairman GRIFFITHS. Well, let's let these other gentlemen answer, too.

Mr. SUMICHRAST. Could I comment on these other items?

I think the question you raised, of the efficiency of equipment, I think it is a very important one. I think there is no comparison to the way highway construction is built today and 20 years ago. The equipment efficiency is just unparalleled. The progress we have made in highways, it is fantastic. It is now a "science" of road building. Every yard you move is well planned. The machinery has changed tremendously in the last 20 years. I think in this area you will do injustice to the producers of larger equipment to say the equipment is the same as it was 20 years.

Chairman GRIFFITHS. Would you mind mentioning some of the equipment that is now superior to that?

Mr. SUMICHRAST. Well, the graders, for instance, that used to be pushed by bulldozers, the new Westinghouse Electric ones that run 60 miles or more an hour. The precise planning and scheduling of each trip; the placing of earth; tamping it, etc.

The new kind of bulldozers and all kinds of shovels; the graders; all of which are much superior to what they were 20 years ago.

Chairman GRIFFITHS. Has asphalt advanced?

Mr. SUMICHRAST. Yes, very much so, and so did concrete work. Building of bridges; the use of steel which combines high grade steel and low grade steel getting a better job at a cheaper price.

The other comment, the Commission on Labor which you mentioned: This is a commission pretty much the same type as that which has been in existence for many years. John Dunlop, perhaps you might know him?

Chairman GRIFFITHS. Yes.

Mr. SUMICHRAST. He has been the chairman of this committee for many years and I have been a part of it. Of course now it is on a much higher level and the new committee certainly have better chances to get something done in the ease of labor supply, and seasonality, productivity and lower cost. At least I hope so.

Seasonality. The pattern in seasonality is such—it may surprise you—but you take any trade in the construction, the seasonality pattern has not changed in the last 20 years, in spite of all the technological progress. This applies the same way, to south, north, east, and west.

Chairman GRIFFITHS. Why do we have it?

Mr. SUMICHRAST. One is, of course, of tying of the union labor to pension funds. They cannot transfer pensions from one State area to the other. So they are not so mobile as we think they should be.

Chairman GRIFFITHS. We had a committee here that looked over that, too. I happened to be one of those who thought pensions should be mobile. So when you get around that——

Mr. SUMICHRAST. The other is the pool of labor: Where I used to work, in New Jersey, Pennsylvania and Ohio, all labor used to come from West Virginia. These people traditionally work 8, 9 months and retire to the hills and take unemployment benefits. So there is not much you can do with this supply of labor. Also, it costs more money to work in wintertime.

It is still more expensive to push mud during the wintertime. The Canadians are trying to subsidize a winter employment in construction. This has been suggested by Mills and Dunlop.

So I am quite skeptical as to the possible progress since the last 20 years in spite of the greatest technological changes have been in the tooling industry and equipment industry, we have not been able to change the seasonal pattern.

So I am not so sure in the next 20 years we will be able to do a better job.

Chairman GRIFFITHS. Thank you.

Mr. CHRISTIE. I have a couple of observations I would like to make.

It is certainly true, as both of the other members of the panel pointed out, that highway construction is perhaps unique among the many types of construction in that the cost experience here has been considerably more favorable over the past decade than most other types.

Costs have risen less and this I am sure we would all have to agree is due to higher productivity, owing to better equipment and more equipment. I don't think there is much question on this point.

The point the chairman raised about how much resources we are devoting to highways relative to other uses of these funds is really the appropriate one. It is one I would like to address myself to a little more.

We are currently spending about $8 billion, give or take half a billion, roughly, for highway construction. Most of this results from the interstate highway program which began back in the early 1950's and is supported primarily out of the highway trust fund which accumulates something like $4.5 billion to $5 billion per year and is supplemented with $2.5 billion or $3 billion, of State and local money.

Now, there are two aspects of this thing which lead to some of the problems we are discussing today. Concerning the inflationary aspects of the problem, last fall President Johnson froze the highway trust fund in the final quarter of 1968 to the extent that about three-quarters of a billion, maybe $800 million, worth of work did not get done in that final quarter of the year. He really slammed the brakes on highway construction that year.

However, because of the nature of the trust fund, these funds were earmarked. They arose out of user taxes for highways. People who get the benefits are the same people paying for them through gasoline taxes and truck taxes and the like.

So these funds were special purpose funds and couldn't be used for anything else, and they were literally frozen for a time.

They were released early in 1969. The result was that three-quarters of a billion or more got jammed into the first quarter of 1969. Actually it spilled over into the first 5 months of 1969 on top of the regular flow of funds out of the trust fund.

So it meant that in the first half of 1969 compared with the last part of 1968, something between one and a half to two times as much highway construction was contracted in this period as in the previous one. That had substantial inflationary effects, since by crowding all this work in a short space of time, it put enormous pressure on the available resources to supply it.

The highway construction issue has at least two aspects—first a broader question of how much resources we want to put into highways; secondly, the severe limitations on the use of highway trust funds as far as their timing and application.

Maybe we have reached a point where the trust fund concept itself ought to be looked at. Can we in fact determine 10 or 15 years in advance, as we thought we could back in the early 1950's, that earmarking $7 or $8 billion a year would be the best and most efficient and most appropriate allocation for our resources in 1969? I rather think that if we had options on how we wanted to spend this money today we might well spend it differently—perhaps on urban renewal or low-income housing rather than highways.

I point this out largely because there is under consideration the notion of doing virtually the same thing in the area of airport construction. We are considering a trust fund approach for airports to be built over the next 10 years. Certainly we need airports. There is not much question about that.

Air traffic control, the safety aspect of this thing, undoubtedly, is very important in the growing role of aviation in our commerce and travel. I would not want to see, however, the solution of this problem take the rigid lines it did in the highway trust fund approach of the past decade. I would want to see more flexibility built into the funds provided for airport needs in the future. Anytime the concept of a trust fund approach to proving funds for airport construction comes up, the question should be asked: Can we really determine priorities that far in advance?

Chairman Griffiths. I agree. I am very much opposed to earmarked funds. I think they perpetuate themselves and people stay up trying to figure out ways to spend much the same way; at the present time, I spend a great deal of my time trying to fight off 100 Senators in the House on earmarking the remaining part of the excise tax on autos. I know they will be doing the same thing. I think it is just foolish. These things should come back year after year and ask for an appropriation, in my judgment, and this really should have been true of the highways.

I think it is time we took a look to see whether this is really what we need or what we don't need.

We had a hearing here on the overruns of the C5A which had overrun $2 billion. Now, as a matter of fact, the highways have overrun about $31 billion, haven't they?

Mr. Goldstein. If by "overrun" you mean the estimates of cost have increased over the years due to various things that the Congress itself has required us to do, which is a very substantial part of that overrun. The question of beautification, the question of fringe parking, the question of relocation assistance, the question of scenic enhancement and so forth and on and on.

The question of traffic improvements, the question of spot safety, all of these things which are now part of highway expenditures actually dilute expenditures for construction purposes, and they are social purposes. So I don't know if I can answer the question on "overrun" quite the same way as I would if I were a private corporation that had contracted to do a particular job, according to certain specifications. However, the costs are considerably higher.

Chairman GRIFFITHS. I would like to ask you: Why don't we standardize fixtures in buildings? Wouldn't this do a lot for homebuilding?

Mr. SUMICHRAST. Talking about the Operation Breakthrough I would like to add the following: I think there is a great deal of standardization in structures now. I think the study which we made for the Kaiser Committee on Industrialization of Housing in the United States shows that there has been a great deal of industrialization, but concentrated mainly on small parts.

We looked into just about all systems available at this time in U.S.A. and we found that the cheapest way—per square foot—to build was by the use of conventional methods. In other words, there was no one single system which could bring more cost benefits to the ultimate user than the conventionally built unit.

As to the Operation Breakthrough, I think something will come out of, something similar to subsystems, which will be reusable for many other units similar to what the Canadians did. In this respect the Canadians are many years ahead of us in the design of schools.

The Toronto system did a remarkable job in first setting up a philosophy of teaching. Then, going from that point of view, without detailed specification, they outlined the kind of teaching unit you ought to have. They didn't tell you what the school should look like or how many inches of concrete you should use for walls, and so forth. They did tell you: This is the kind of teaching they expected to have in their schools.

They were able to provide a substantially superior product at 10 percent less of their average cost. This is one of the most remarkable things that I have seen in the last few years.

Now, Operation Breakthrough. I don't know what the end result will be. I have my doubts about whether much will be accomplished costwise, because you are talking about, usually about one-sixth of the total cost when you talk about the structure. And this is what everybody is talking about, and the structure itself.

How much can you do with that one-sixth as a total reduction cost? I am sure you cannot reduce it by 50 percent. It is impossible. So to answer your question: there has been a great deal of standardization. There is a great deal of small parts which have been developed over the years. I think our construction industry, it is much superior to most of the industrialized nations. We get people from all over the world. We had about 80 Japanese in here last week, Germans coming in here, and all we have to do is take them out and show them how the thing is put together.

I think it is fairly obvious to me that we are not doing so badly in terms of what we provide in housing. Where we failed is in the area of low-cost housing. There is plenty of housing being built for upper middle-income and up, but the middle-income people, people completely forgotten are the middle Americans which cannot do anything because they either make $7,000, $8,000, or $9,000; for this they cannot buy new housing.

This is the problem.

Chairman GRIFFITHS. Mr. Christie?

Mr. CHRISTIE. I think we are all hoping for and expecting some pretty good things out of breakthrough. It is well to point out, though, that the freely operating homebuilding market has already achieved quite a good deal in this area over the past decade or so.

I would point out that out of about 800,000 singe-family homes built this year, approximately 250,000 of those are what we would classify as nearly or fully prefabricated, or a better term, manufactured homes. That is close to a third, somewhere between a quarter and a third of the total.

In addition, the mobile home industry is producing, on top of that 800,000, an additional 400,000 units, most of which are geared to a single-family low-cost market. So that means you take the 800,000 single-family homes of the conventional type, add 400,000 mobile homes and you have a total of 1,200,000 of which 600,000—400,000 mobiles and about 250,000 manufactured homes—or roughly half the total, represents largely off-site construction.

The point we are making is if we want to save money and lower costs in building, we should move more of the work off the site. The more you complete off-site and simply bring to its final point of application, the more you are going to achieve in the way of cost savings and efficiency.

Just the fact that the market has accomplished this in its own way seems to indicate that it is the path of progress.

I would point out, though, that almost the entire application of this principle so far has been confined to single-family housing. Multifamily application of this principle represents the next stage of the breakthrough for the future.

Chairman GRIFFITHS. That isn't the real reason that you have this type of breakthrough, mobile homes and so forth put up; isn't the reason for it that you have put up these homes in places outside the cities that had building codes?

Mr. CHRISTIE. Yes, very definitely. Codes and zoning regulations limit very greatly the places you can put these units.

Mostly their application has been in places where you can get around those codes and zoning laws.

Chairman GRIFFITHS. Don't you think it is essential that there be a better zoning regulation for the whole country and for all the areas outside a major city, either that or we are just rebuilding slums?

Mr. CHRISTIE. I think probably the single strongest recommendation that came out of Senator Douglas' investigations last year and the year before, was in the area of zoning, and perhaps next most critical was reform of building codes.

To the extent that we can use Federal funds to encourage changes in these areas, we stand to gain greatly.

Chairman GRIFFITHS. Part of this subcommittee has just returned with me from visiting new towns in Europe. One of the things that impressed me was that the towns had been built for humans. There were no streets crossing the pathways. They had rapid transportation outside of the town, and another thing that impressed me vastly is that all of the utility lines are underground, which I thought was a great help, in place of looking up at tangles of wires and so on. In addition they had built into those towns recreation areas and they had green areas, and they had trees and so forth, and so on, which is not really available here.

In one city, the Canadians set up 4,000 acres for a new town, but in any new town we are considering we have only really a few hundred, and that it not really enough, because that town will be immediately occupied by industry.

It will be rapid and everybody else will just be outside the zoning ordinances, and we won't have recreation involved in any of them.

But, is a key element in the cost reduction the time it takes to build?

Mr. SUMICHRAST. The time it takes to build, no. We used to cycle the houses in 90 days, and I don't think it really makes a bit of difference because construction costs run only about 60 percent of the total mortgage and you try to borrow as little as possible, so really that is not the problem. At least in the single-family housing it is a minor problem.

Chairman GRIFFITHS. You state that a plumber's hourly wage in San Francisco is about $10. With a 40-hour week, 50 weeks a year, this would be an annual income exceeding $20,000. Yet you give an annual income figure of $16,384. How many hours a week does a plumber work?

Mr. SUMICHRAST. I don't know, really. I think this is the question we dealt with in the seasonality. I think in the last 2 years we have had full employment in the construction industry. I don't for one moment agree with Mr. Goldstein. For practical purposes we have had full employment.

My guess would be that in the last couple of years he worked 52 weeks, not 50.

Chairman GRIFFITHS. Does the $10 include the fringe benefits?

Mr. SUMICHRAST. No, this does not. They don't.

Chairman GRIFFITHS. Aren't fringe benefits in some of these construction contracts greater than they are in any other type of contract?

Mr. SUMICHRAST. That is probably true. I don't really know.

Chairman GRIFFITHS. I observed there are two small unions in the City of Detroit with large resort areas just for their union members. One of them was on some 600 acres of land, and one on 300 acres with three lakes. I would think that is quite expensive, because I am sure that that land at the present time would sell at about $2,000 or $3,000 an acre. So it must have been very expensive for the management to have added the cost of those resort areas.

Mr. SUMICHRAST. $2,000 or $3,000 an acre but for what kind of land? What was it used for? What zoning?

Chairman GRIFFITHS. It was a private residence of a very wealthy person.

Mr. SUMICHRAST. Well——

Chairman GRIFFITHS. Three lakes, and it was bought for a very small use.

Mr. SUMICHRAST. $2,000 or $3,000 an acre is a very inexpensive piece of land.

Chairman GRIFFITHS. Well, not at the place it was, at that time. It certainly doesn't go up to $14,000 or $15,000, but——

Mr. SUMICHRAST. I would like to come back to the question you asked, the point of transportation, coming back to it.

I have been working on a book which shows how we spend money, all our money, as a percentage of total consumption. It is surprising when you look at it from the period of 1929 that we pay now as much for transportation as we pay for shelter, just to go back and forth from work. I don't know whether this adds anything to our way of life.

When you look at this line, what has happened is that the expenditure for food and clothing declined very sharply and the other expenditures for social services, medicare and so forth increased.

I am not so sure we live in a society which I can be completely happy with because of the transportation system. It is getting very difficult to find a place to park. It is very difficult to get to any place.

You can multiply this by 220 metropolitan areas in the U.S.A. and you get about the same picture.

So I think the morale of it is that I think we ought to have some other kind of transportation. We are just as guilty because we provide about $2,500 in garages just to accommodate cars. That is a pretty large chunk of money.

Chairman GRIFFITHS. I would like to ask you if you suddenly went to that, how would we pay for the price of shoes? The real truth is the economy has been largely built on that transportation, hasn't it?

Mr. CHRISTIE. In many respects this simply represents a substitution. As we move the house out into the suburbs, part of what we used to be paying for shelter now goes for transportation to get us to and from our less costly housing.

Mr. SUMICHRAST. In terms of cost they are very large increases because they are not built the way—we build roads for airplanes. Now, sometimes a city asks you to put 6 or 8 inches of concrete base plus two 1½ inch layers of asphalt. You can land a jet on it with that kind of a road. For a residential area nobody needs that kind of a road. Then add to this the curb and gutters, which are extremely expensive, extremely time-consuming and so forth, and this is the kind of thing you have to develop and consumers have to pay for. I don't know if this is really good for the consumer.

Chairman GRIFFITHS. I think some of the houses that have been built have been built to wear out. What would it cost, really, in the price of housing, to build a house, even on the same square footage, that would really last. Supposing you built a house that you assumed was going to be standing there and serviceable 75 years from today; what would be the cost?

Mr. SUMICHRAST. This is what the Canadians do: They build it in the way—total evaluation system, based on that premise. You should be able to renew this house every so often, maybe every 5 years and have the built-in—take the built-in obsolescence out of the house. Their schools, I venture to say, are going to be just as good—and just as little additional expense will be needed 50 years from today as they are now.

This is the kind of subsystem I would like to see in housing. You have to take that kind of philosophy. You have to define what is living first. Once you define a way of living—and it can be defined in many, many ways—then you can go one step further. You can say we have certain requirements and see what we can do in terms of construction.

If nothing comes out of Operation Breakthrough——

Chairman GRIFFITHS. The real truth is that you look at it in the cities of America, the thing that I think is very significant is that there has been very little real change in housing.

Mr. SUMICHRAST. Deterioration.

Chairman GRIFFITHS. I mean no protection from the winter winds, really. That is about it in a remarkable amount of housing.

Mr. SUMICHRAST. You mean the styles haven't changed?

Chairman GRIFFITHS. A house built 200 years ago in Europe and still standing might be just as valuable, you might add a little plumbing and electricity.

Mr. SUMICHRAST. This is a function of people, No. 1, and you can't change that. It is the way people live. I can take you to Baltimore and show you some houses where people don't live like human beings, and that is the way people live. I have tried to sell houses to low-income families and I have to talk to the housewives and tell them that "this is not the way to live. This is not the way you abuse your house."

The other problem is the problem of taxes. When you buy a house or when you already have an existing house and when you need improvements your real estate taxes will increase. It just happened in the last week that the tax man has been around and my wife, unfortunately, was home.

We had just finished the basement and, I guess, I will pay more taxes on my house. There is no incentive for people to maintain units because the minute they do it they will be penalized by the system.

Chairman GRIFFITHS. May I ask each of you in turn what you would do to increase the amount of labor and to bring wage increases more into line with the rest of the economy?

Mr. CHRISTIE. I will have to go back to the two points I brought out in my earlier testimony. It is largely a deliberate restriction on the available construction labor supply that causes the scarcity and high cost of labor such as we have now. Admission to the building trades has to be freer, more broad.

As I pointed out, and perhaps something like the Philadelphia plan—which will require a greater acceptance of minority group workers on federally financed construction jobs—would certainly have a positive effect in increasing the total supply of labor.

Participation by minority groups in construction trades is unusually low. So any expansion there will be a net addition to the total.

Secondly, I think in many cases, but especially in residential building, that the type of mechanic that is produced by a 4-year apprenticeship program is largely overqualified for the kind of work he does.

Perhaps this is not so true in many kinds of nonresidential building, but certainly some process by which the apprenticeship program can be shortened, perhaps turning out different classifications of workers, matching the degree of training and skill of certain kinds of work, could produce a quicker expansion in the labor supply than the present apprenticeship programs are doing.

Chairman GRIFFITHS. I noticed an article in a paper the other day by a brother tradesman that if the Rockefellers could leave their money to their children why can't I leave my job to mine? How can you explain that?

Mr. CHRISTIE. I am not sure. I hope we still believe in freedom of opportunity in this country.

Chairman GRIFFITHS. Do you have any more suggestions?

Mr. CHRISTIE. I did have one further point I wanted to make on the issue of construction costs.

Chairman GRIFFITHS. Yes.

Mr. CHRISTIE. It follows from the problem of labor scarcity. Scarcity of labor is the main problem in expanding the total volume of construction produced. If we are not successful in expanding the supply of labor, there has to be another way to increase output.

The other alternative, of course, is substitution of capital for labor. This is done in every other kind of industry and probably one of the important things that prevents this in construction is the building code structure in communities all over the country as they exist today.

To the extent that we can move work off the job-site, prefabricate is a commonly used term; systems buildings is another one, to the extent we can move work from the job-site, put it under a factory roof where it can be done with more capital equipment under conditions greater and higher productivity, generally we can get a larger volume of work done for the amount of labor available.

Mr. GOLDSTEIN. Actually, I think Mr. Christie has made my speech for me. This is what we have done. We do not use much construction labor. However, in urban areas where we impinge and compete with many other types of—particularly with the 90 percent craftsmen we use—there I fully agree that the movement of rigidities, both social and institutional, certainly would increase—assist the supply.

Mr. SUMICHRAST. I think a fundamental way you could do this is by trying to level the building cycles. In 1966 we lost literally hundreds of thousands of people who never came back.

Give more stability to construction and labor could see the next year's employment.

The other thing is I think that the incidence of Negroes in highly skilled, skilled trades, is very nominal.

So you have probably a possibility of supply of black people into construction, which of course they were unable to do. But they are not the only ones.

There are also restrictive practices of trade unions that don't let anybody get in.

Also, it takes too long for training. I think today a man who lays the roof can be trained in two weeks or maybe a month.

Chairman GRIFFITHS. Thank you very much.

I want to thank all of you for being here. I found it very interesting, and I am sure that the other members of the committee would like to ask some questions, too.

So if they submit them to you in writing, will you answer in the record, please.

(The following questions and answers were subsequently supplied:)

ANSWERS TO QUESTIONS SUBMITTED FOR THE RECORD ON BEHALF OF THE MINORITY OF THE FISCAL POLICY SUBCOMMITTEE TO GEORGE A. CHRISTIE, CHIEF ECONOMIST, MCGRAW-HILL INFORMATION SYSTEMS CO., OCTOBER 9, 1969 [1]

Question 1. On page 5 of your statement, you say that demand-pull inflation is usually self-correcting, "since higher prices can be expected to encourage the addition of capacity, which in turn restores balance".

Has this, in fact, been the tendency over the recent period? Has the construction sector as a whole and non-residential construction in particular experienced increasing capacity?

Answer. The statement that "higher prices can be expected to encourage the addition of capacity, which in turn restores balance" refers to the general way in which the price system functions to allocate resources throughout the economy. This principle has operated badly, if at all, in construction because of this industry's built-in barriers to expansion (the seven "rigidities" noted in my opening statement—restraint on growth of the labor force, restraint on technological advance by union work rules and by building codes, low productivity, lack of standardization of product, seasonality, the local nature of construction markets, and the high failure rate of contractors).

Between 1965 and 1968—the period of accelerated inflation—the number of available construction workers has remained virtually unchanged (2,710,000 in 1965; 2,754,000 in 1958) while the demand for their output, as measured by the value of construction put in place, went up 17%. Over this three-year period, *real* output of the construction industry increased only 2% as prices rose by 15%.

Question 2. You note that one of the critical rigidities built into the construction industry and producing a higher than average pricing structure is the low productivity of construction workers, resulting from a low ratio of capital equipment per worker.

Can this rigidity be corrected? How would you suggest that public policy stimulate higher labor productivity in construction?

Answer. The best way to improve productivity in construction is through the process of "industrialization". The more construction work can be standardized into sub-assemblies which are capable of being prefabricated under factory conditions (instead of custom-made on the construction site), the more there is the opportunity to reduce unit costs by the greater application of capital equipment and mass production methods. (This is the underlying principle of Operation Breakthrough, but it has application in nonresidential construction as well as housing.)

Public policy can be instrumental in stimulating higher productivity by focusing on the two key barriers to industrialized methods in construction—union work rules and local building codes. As a condition to the allocation of public funds for local construction projects, Federal agencies might require that progress be shown in modernizing building codes and work practices in much the same manner that the "Philadelphia Plan" requires compliance with minority hiring guidelines.

Question 3. You suggest on page 11 that one way to remove restraints on technological progress imposed by local building codes would be to have Federal agencies require communities to bring their local codes into line with a standard, uniform national code.

Does such a code now exist? If not, how would you suggest that one be formulated?

Answer. Four national or regional model construction codes have been available for adoption by local communities for a considerable time. They are: AIA National Building Code: ICBO Uniform Building Code: BOCA Basic Building Code: Southern Standard Building Code. In addition to these, there are several model codes for particular types of construction work—e.g., electrical, plumbing, etc. Most model codes stress performance standards rather than specifications.

In a recent survey of community acceptance of national model building codes, the National Commission on Urban Problems (Senator Paul H. Douglas, chairman) revealed the following:

1. Eighty-five percent of local governments either:
   (*a*) don't use a model code, or if they do:
   (*b*) those that do use a model code make substantial departures from it, or:
   (*c*) fail to keep it up to date.
2. Only fifteen percent of communities have codes capable of permitting efficient and economical building.

For further information on this subject, see Research Report No. 6. "Local Land and Building Regulations", National Commission on Urban Problems, Superintendent of Documents, U.S. Government Printing Office, Washington, D.C., October, 1968.

ANSWERS TO QUESTIONS SUBMITTED FOR THE RECORD ON BEHALF OF THE MINORITY OF THE FISCAL POLICY SUBCOMMITTEE TO SIDNEY GOLDSTEIN, OFFICE OF POLICY PLANNING, FEDERAL HIGHWAY ADMINISTRATION, DEPARTMENT OF TRANSPORTATION, OCTOBER 9, 1969.

Question 1. Mr. Christie notes in his statement that if any excess capacity now

Answer. It is the intent of Congress, as expressed in the Federal-aid Highway Act of 1968, that National System of Interstate and Defense Highway is to be completed as nearly as practicable in the fiscal year ending June 30, 1974. The The Act extended the period of availability of authorizations of appropriations through the same date. These authorizations were based on the 1968 Interstate Cost Estimate (House Document No. 199, 90th Congress, 2nd Session) which was based on the cost to complete the then designated 41,000 mile system. Since that estimate was made the Congress, again in the 1968 Highway Act, authorized an additional 1,500 miles to the Interstate System, a total of 42,500 miles. The Act requires the Secretary to make a revised estimate of the cost of completing the system to be submitted to the Congress in January, 1970. It is unlikely that the whole system can be completed by June 30, 1974, including the new mileage. Present projections are for completion in 1975 or 1976.

Question 1a: Is there enough capital equipment and skilled labor in the resi- ***fund when the system is complete? Has the Federal Highway Administration given any consideration to this?***

Answer. A determination as to the future of the Highway Trust Fund will have to be made before the Interstate System is completed. While funds for the Interstate System are authorized under existing law through June 30, 1974, the Highway Trust Fund, and the additional Federal taxes that were levied or increased by the Highway Revenue Act of 1956, will expire on October 1, 1972. Therefore, the Congress will first have to determine whether the life of the Highway Trust Fund should be extended to finance the presently authorized highway programs and second, whether this form of financing is to be continued to fund highway improvements after 1975. The Federal Highway Administration is giving consideration to this problem and is working on a number of possible alternative courses of action with respect to both the nature and scope of future Federal-aid highway programs and methods of financing such programs.

ANSWERS TO QUESTIONS SUBMITTED FOR THE RECORD ON BEHALF OF THE MINORITY OF THE FISCAL POLICY SUBCOMMITTEE TO MICHAEL SUMICHRAST, CHIEF ECONOMIST, NATIONAL ASSOCIATION OF HOME BUILDERS, OCTOBER 9, 1969

Question 1: Mr. Christie notes in his statement that if any excess capacity now exists in construction, it must be in the one-family housing sector. In your opinion, does there now exist substantial excess capacity in the one-family housing industry?

Answer. As of today, in general there is an excess capacity in residential construction. This is obvious from (1) The low levels of housing starts, (2) Increased unemployment rate among construction workers, (3) Decline in materials shipments for construction. We started 1969 at close to 1.9 million level (measured at seasonally adjusted annual rates). The last figure for August indicates nearly a 30% drop from that level. It is therefore, obvious that some excess capacity does exist . . . and mostly in the area of single family housing where the drop was the largest.

Question 1a: Is there enough capital equipment and skilled labor in the residential construction sector to meet our national housing goals of 26 million new and rehabilitated housing units by 1978.

Answer. If we maintained about the same portion of housing units built with what we define as "conventional" construction (which in our last national survey done in 1964 showed no change from 1959 and accounted for some 85% of all starts), then there is no question that we have enough capital equipment to build substantial portions or all of the 26 million housing units (new and rehabilitated). The process of acquiring new equipment goes hand-in-hand with increased production and is not a one-deal proposition. Nobody in this industry would venture to invest into heavy equipment at this time and gamble ten years in the future. On the other hand, there is no reason to believe that there will not be enough capital equipment used in the present construction set up and what is being used is available or can be produced in time for the enlarged demand.

But if one talks about a large (and substantially heavier investment) in large pre-fabrications such as is suggested in "Operation Breakthrough," where not only heavy equipment may be needed but a substantial investment may be required for building new factories, that is an entirely different story. I would guess that we do not have this kind of investment in capital equipment now.

As to the labor requirement, and especially skilled labor, we have suffered as a result of each cyclical movement, a heavy outflow of labor. A good example still fresh in our minds is the 1966 drop in construction. The industry lost literally thousands of workers who never returned to construction.

What the magnitude of new labor requirements is, of course, a matter of speculation. Much will depend on the degree of off-site labor and the success of industrialization. My own estimates, done some two years ago, show that due to new requirements and attrition rate, we will need some 2.8 million new workers in the construction industry. (Measured at that time from 1966 through 1975). This figure is undoubtedly low, since we have set our sights at a much higher level, namely in the residential sector alone at 26 million units. Added to this, the other improvements which go with it, and it is obvious that one of the greatest problems we are going to be facing is the labor shortage in construction.

Building Trades Employment

Building trades craftsmen comprise the largest group of skilled workers in the nation's total labor force. There were about 2.9 million such craftsmen employed in 1966—about 3 of every 10 skilled workers.[1]

Building trade craftsmen are employed mainly in the construction, maintenance, repair and alteration of homes and other types of buildings, highways, airports, and other structures, including substantial work involved in the nation's missile and space programs.

AVAILABLE: 280,000 NEW OPENINGS ANNUALLY

Building trades employment is expected to increase at about a 2% rate annually, from the 1966 level of 3,762,000 to 4,520,000 by 1975. In addition to these additional 758,000 new jobs needed in the next 10 years, more than 2 million new openings will be created through retirement, death, and the need to replace workers who will leave construction for other types of work. Therefore, there will be 2.8 million new openings available in the 10 years between 1966 and 1975.

This estimate, shown in the table is substantially different from projections done by the U.S. Labor Department recently. The Labor Department study does not include in its attrition rate the vast number of people who each year leave construction and find jobs elsewhere.[2]

NEGROES LARGELY AMONG UNSKILLED WORKERS

Negro employment in the construction industry has been estimated in 1966 at about 472,000 workers, or 12.5% of total construction employment. This is somewhat higher than overall employment of Negroes in the total labor force. It is estimated to be close to 11%

Nationally, Negro workers tend to be concentrated in the less skilled blue-collar and service occupations, 35.3% as compared to 15.8% for the white and others in 1965. The same is true in the construction industry. The Negro proportion among the skilled workers is in most cases low, while unskilled employment is high.

Highly skilled, unionized crafts, such as plumbers and electricians, are largely dominated by whites. The total number of plumbers and pipefitters is estimated at 350,000. Only about 12,000 are Negroes, just 3.4%. Of the estimated 400,000 electricians, only about 16,000 are Negroes, or only 4%.

Although information about the number of total Negro employment is somewhat imprecise, there are indications that among the skilled trades the proportion of Negroes has not changed materially in the last 25 years.

---

[1] See Table. Also separate booklets published by the Department of Labor for each occupation in building trades, Occupational Outlook Report Series, Bulletin No. 1450.

[2] Department of Labor. *Occupational Outlook Report Series,* Bulletin No. 1450 considers only openings as a result of retirement and death.

For instance, according to the Census of Population done in 1950 and 1960, the total number of electricians increased between 1950 and 1960 from 307,000 to 335,000, or by 28,000. In the same time the number of Negro electricians increased from 3,000 to 5,000. Similarly, the number of plumbers and pipefitters increased from 276,000 in 1950 to 303,000 in 1960 while the number of Negro plumbers and pipefitters was estimated to have increased from a mere 8,000 to 10,000.

But even among "freer" trades such as carpenters, Negro employment has been and still is very low, estimated to be at less than 5% of the total in 1966, or 41,000. It has changed little since 1950 when there were 35,000 Negro carpenters.

Highest employment of Negroes is to be found in unskilled occupations, such as construction labor. In 1966 there were estimated to be 230,000 workers employed in this category, or about 26% of the estimated 800,000 laborers.

EMPLOYMENT IN CONSTRUCTION INDUSTRY, 1966 TO 1975 AND PERCENTAGE OF NEGROES

	Total employment			Job openings		Negro employment, 1966		
	Actual, 1966	Projected, 1975	Net growth 10 yrars	Attrition rate	Total net openings	Total in 1966	Percent of total	Percent of each trade
1. Asbestos and insulation	22,000	26,000	4,000	10,000	14,000	1,000	0.2	4.7
2. Bricklayers	170,000	200,000	30,000	80,000	110,000	37,000	9.7	21.8
3. Carpenters	820,000	980,000	160,000	450,000	610,000	41,000	8.7	4.8
4. Cement masons	60,000	90,000	30,000	45,000	75,000	16,000	3.4	26.7
5. Construction labor	800,000	880,000	80,000	480,000	560,000	230,000	48.7	26.1
6. Electricians	400,000	480,000	80,000	220,000	300,000	16,000	3.4	4.0
7. Elevator construction	15,000	22,000	7,000	10,000	17,000	1,500	0.3	10.0
8. Floor covering	35,000	45,000	10,000	20,000	30,000	5,000	1.1	11.1
9. Glazier	8,000	12,000	4,000	10,000	45,000	500	0.1	6.3
10. Lathers	30,000	40,000	10,000	15,000	25,000	5,000	1.1	16.7
11. Marble setters	40,000	50,000	10,000	20,000	30,000	2,000	0.4	5.0
12. Operating engineers	275,000	350,000	75,000	150,000	225,000	20,000	4.2	7.2
13. Painters	450,000	530,000	80,000	250,000	330,000	35,000	7.4	7.8
14. Paperhangers	12,000	15,000	3,000	5,000	8,000	1,000	0.2	8.3
15. Plasterers	50,000	60,000	10,000	30,000	40,000	10,000	2.9	20.0
16. Plumbers and pipe fitters	350,000	450,000	100,000	150,000	250,000	12,000	2.5	3.4
17. Roofers	60,000	75,000	15,000	30,000	45,000	5,000	1.1	8.3
18. Sheet metal workers	55,000	70,000	15,000	30,000	45,000	2,000	0.4	3.6
19. Stone masons	35,000	45,000	10,000	20,000	30,000	3,000	0.6	8.8
20. Structural workers	75,000	100,000	25,000	40,000	65,000	20,000	4.2	2.7
Total	3,762,000	4,520,000	758,000	2,065,000	2,823,000	472,000	100	12.5

Note: Most of the data from above mentioned publications covers 1964 and/or 1965. It was necessary to adjust this data for 1966. Projections were based partially on Bureau of Labor Statistics publication, partly on projections by the trade groups in some of the occupations. Attrition rate was derived at by using the retirement and death annual figures as published by the Bureau of Labor Statistics as a base. Additional workers were added to the attrition rate for those who are leaving jobs for other occupations. The percentage of Negroes was derived partly from published data by the Bureau of Labor Statistics, partly from unpublished sources and partly estimated by NAHB from information supplied by some of the trade groups.

Source: Bureau of Labor Statistics, Office of Manpower and Employment Statistics, Projections of Manpower Requirements in the Building Trades, May 17, 1965. Bureau of Labor Statistics, The Negroes in the United States and Their Economic and Social Situation, Bulletin No. 1511, June 1966. Bureau of the Labor Statistics, Occupational Outlook Report Series, Bulletins No. 1450. Bureau of Labor Statistics, Changing Patterns in Employment of Nonwhite Workers, in Labor Monthly Review.

A higher proportion of Negroes is found in skilled trades which have heavy physical requirements, such as bricklayers, where Negroes account for about 22%; cement masons 27%; plasters 20%; lathers 17%, and floor covering 11%.

INSUFFICENT HELP OF GOVERNMENT IN APPRENTICE TRAINING PROGRAMS

A total of 14,700 workers have been and are—directly or indirectly—being trained by government programs on a cummulative basis from August 1962, through August 1966. Assuming continuation of these programs, this would mean that government is training only about 3,600 skilled construction workers annually.

Now, consider that the annual attrition rate in the industry is estimated to be 282,000 workers. Even allowing for about 56,000 jobs where unskilled labor could be used (construction labor) this would still leave annually, a gap of 218,000 skilled workers to be filled. To put it another way, the goverment is training annually about 1.59% of all the needed skilled jobs in the construction industry.

Of the 3,600 workers being trained annually, about 760 are Negroes, or about 21%. This is substantially lower than about 30% of Negroes being trained in all occupations.

The percentage of Negroes being trained outside government is, however, even lower. There are some indications that no more than 3–5% of total carpenter apprentices are Negroes and a lower percentage is found among plumbers or electricians.

In Detroit, for example, out of 750 carpenter apprentices, only 26 were reported to be Negroes. Out of 371 plumber apprentices, only 13 were Negroes, and among almost 100 painter apprentices, 15 were Negroes.

The actual portion of Negroes among these trades similarly showed a low count: 8 Negro plumbers, 150 Negro painters, etc.

According to the Department of Labor, Bureau of Apprenticeship and Training, there are about 16,000 new registered apprentices who complete training annually. Their distribution by craft is shown in the accompanying table.

The striking fact is not so much the low number of apprentices who annually complete their program but the fact that for each one who completes the program, more than one had cancelled for one reason or another.[3] In the last 10 years (1957–1967) there were 605,000 new apprentices registered in various programs, 287,700 completed the apprentice program, but 305,800 cancelled their training.

A similar situation occurred among consrtuction trades where in 10 years. 377,000 were newly registered, 173,500 completed training and 200,000 dropped out.

CONSTRUCTION EMPLOYMENT, CHICAGO

	Total journeymen	Total Negro	Total apprenticeship
Bricklayers	6,000	200	72 (16 Negro).
Carpenters	33,000	2,000	307 (19 Negro).
Painters	10,000	450	156 (31 Negro).
Plumbers	7,200	150	250 (20 Negro).

Source: NAHB estimates.

LABOR DEPARTMENT SPONSORED TRAINING PROGRAMS IN CONSTRUCTION INDUSTRY, AS OF AUGUST 1966

(Cumulative from August 1962 through August 1966)

	Institutional [1]		On the job [1]		Total Negroes trained
	United States	Percent of Negroes	United States	Percent of Negroes	
Total of all programs of all occupations	431,100	32	99,400	17	154,818
Construction:					
1. Asbesto and insulation	200	12	(2)	(2)	24
2. Bricklayers	1,700	40	200	23	726
3. Bricklayer apprentices	600	55	500	37	515
4. Carpenters	2,400	26	200	13	650
5. Carpenter apprentices	600	36	400	10	256
6. Electricians	600	17	(2)	(2)	102
7. Floor covering	100	14	(2)	(2)	14
8. Operating engineers	200	6	2,500	3	87
9. Painters	200	37	(2)	(2)	74
10. Plumbers	300	32	(2)	(2)	96
11. Pipe fitters	1,700	13	800	14	333
12. Sheet metal	1,300	15	200	16	227
Total construction	9,900	2,588	4,800	516	3,104
Percent		26		10	21

[1] Under the Manpower and DevelopmentTrainingPrograms, the two segments of training covers (a) Institutional setting, apprentices being trained mainly through the classroom methods, (b) On the job training where learning of skilled trades is done primarily on the job.
[2] Too small to be indicated.

Source: Department of Labor, unpublished data.

[3] Including dropouts, payoffs, discharge, out of state transfers, upgrading and suspensions for military services.

CONSTRUCTION UNEMPLOYMENT HIGH AND YET THERE IS A SHORTAGE OF LABOR

The unemployment rate among construction workers for many years has been about twice as high as that in other industries. Similarly, the unemployment rate among non-whites has been for years twice as high as that of whites. (See table). The gap between non-white and white unemployment rates persists in boom years as well as recession, but narrows substantially in an expanding economy. (See chart). The Negro unemployment in construction was at 16% in 1966 and 14.6% in 1965, while unemployment of whites was 7.4% and 7.3% respectively.

President Johnson, in remarks on June 20, 1966, stated:

"I am asking the Department of Labor to look into the question of why there are reported shortages of labor in the construction industry and yet the unemployment rate is twice as high as the average unemployment rate for all other workers."

The Labor Department with a group of outside experts has been working since then on this problem and should be shortly coming out with some conclusions.

NUMBER OF REGISTERED APPRENTICES WHO COMPLETED TRAINING PROGRAMS IN CONSTRUCTION INDUSTRY IN 1966

	Completions	Cancellations
Brick, stone, and tile workers	1,346	1,553
Carpenters	3,340	7,168
Cement masons	293	456
Electricians	3,654	3,298
Glaziers	239	132
Ironworkers	1,075	1,051
Lathers	198	295
Painters	807	2,069
Plasterers	215	296
Plumbers-pipefitters	2,736	2,298
Roofers	241	1,169
Sheet metal workers	1,568	1,628
Construction workers	640	1,094
Total	16,352	22,507

Source: Department of Labor, Bureau of Labor Statistics Bulletins Nos. 67–120 and 67–113, June 1967, "Trends In Apprentice Registrations," 1941–66

Preliminary information seems to indicate that the average higher rate of unemployment among construction workers is due to (1) seasonality, where weather interrupts the even flow of work (2) changes in location where construction is being performed (3) transfer of workers from one job to another (4) inability or unwillingness of some construction labor to leave one region or state because of the inability to transfer fringe benefits, such as pension funds (5) nature of the employment with a large number of small builders and contractors who are unable to give continued employment to workers and (6) a large amount of work being done by subcontractors on piece work basis.

It undoubtedly can be assumed that the reasons why there are twice as many non-whites unemployed as whites in the construction industry are no different from the reasons why the overall unemployment of non-whites is twice as high as the whites.

As to the question of why there are shortages of labor in construction industry, one of the answers is clearly shown in the table. There are not enough skilled workers being trained. If all the government sponsored or subsidized programs could provide less than 2% of new apprentices, the contribution must be considered too low to make any inroads into the problem of training qualified personnel.

This is especially true in considering the fact that direct public construction accounts for about one-third of all expenditures for construction activity in the United States. The value of new construction put in place in 1966 came to $74.6 billion while the value of public construction came to $23.9 billion, or 32%.

The labor shortage is also caused by the inability and unwillingness of most of the skilled trades to admit enough new members, or train an adequate amount of new people. In this area, the trade unions are responsible not only for racial discrimination but for public discrimination. By trying to protect the number of jobs available at any given time, they are aggravating the shortage of manpower, adding to the cost of housing, and being responsible for future shortages in the construction industry.

UNEMPLOYMENT RATES, BY INDUSTRY OF LAST JOB AND COLOR, 1955 AND 1965 (ANNUAL AVERAGES)

Industry group	Nonwhite		White		Ratio of nonwhite to white	
	1955[1]	1965	1955[1]	1965	1955	1965
Total[2]	7.9	8.3	3.6	4.1	2.2	2.0
Experienced unemployed	7.5	6.8	3.2	3.4	2.3	2.3
Agriculture	4.8	6.3	1.4	2.1	3.4	3.0
Nonagricultural industries	8.0	6.8	3.5	3.5	2.3	1.9
Mining, forestry, fisheries	7.7	2.5	7.7	5.3	1.0	.5
Construction	16.0	14.6	7.4	7.3	2.2	2.0
Manufacturing	7.8	6.6	3.8	3.6	2.1	1.8
Durable goods	7.2	5.9	3.6	3.2	2.0	1.8
Nondurable goods	8.6	8.0	4.0	4.2	2.2	1.9
Transportation and public utilities	8.2	4.4	3.1	2.5	2.6	1.8
Wholesale and retail trade	9.1	8.7	3.1	3.8	2.9	2.3
Service and finance	6.6	5.7	2.3	2.7	2.9	2.1
Public administration	5.5	3.8	1.4	1.6	3.9	2.4

[1] Data have not been adjusted to 1957 definitions of employment and unemployment.
[2] Includes those with no previous work experience, not shown separately.

Source: U.S. Department of Labor, Bureau of Labor Statistics, Data are from the regular monthly Current Population Survey.

Question 2: You maintain in your statement, "the ability of the Federal Reserve Board to dictate the volume of housing starts is obvious and unquestioned". Do you feel the Federal Reserve consciously pursues the objective of determining the amount of housing starts?

Answer: This does not need restating again. In the last 20 years, enough time has been spent analysing and re-analysing the role of FED and its influence on residential construction. Although I am sure that this was the objectives of FED in the 1950's (and to some extent, still is), the Governors of the Federal Reserve Board are now more cognizant as well as concerned about the immediate, and unquestionable affect of credit tightening on residential construction than ever before. There has been a better understanding, and closer cooperation between the National Association of Home Builders and FED since the last crisis and the impact on construction is on of the unfortunate by-product of monetary policies.

Although they cannot (and for that matter nobody can determine what the precise level of construction will be because consumers do behave differently, the levels of vacancies change, the expectations, the ability and willingness of consumer to pay higher interest rates, etc.) determine the actual level of starts they can virtually stop large segment of residential starts by their credit policies. This is the by-product of expansion or retraction of credit to which the residential construction is very sensitive. Governor Sherman Maisel, in one of his studies, concluded that an increase in one percentage point in the interest rate alone could be associated with a decline of some 140,000 housing starts. Whether they do it "consciously" or not is really not relevant. Of course they know what the result of their action will be within the bounds of the imperfect science of measuring the effect of credit on starts.

Question 2a: What suggestions do you have for alleviating the effects of an overall restrictive monetary policy on residential construction?

Answer: In the last two decades there were scores of suggestions made for alleviating the effect of restrictive monetary policy on residential construction. *The Study of Mortgage Credit* (Subcommittee on Housing and Urban Affairs of the Committee on Banking and Currency, U.S. Senate, May 22, 1967), makes several good and useful suggestions. The current Duesenberry Report (*Report of the Commission on Mortgage Interest Rates*) provides a more current outlook for a better supply of mortgage money.

Of course the basic problem is too much reliance on Federal Reserve Board to fight inflation and little reliance (or too little too late) on fiscal policies as was well illustrated in the last three years. Then is the question of inequities for construction to take the full brunt of credit restraint; then is the problem of changes in the preference of savers; the changing role of lending institutions, etc. There is a dire need for an overall re-examination of financial intermediaries in the light of 1970 developments: what was true early this century is no longer (or is not necessarily) true and valid today.

Question 3: You note that the wage increases labor has negotiated over the last 12 months in the construction industry was 2½ times higher than the average of all wage increases. However, if these wage increases reflect rapidly increasing labor productivity, they cannot be said to be inflationary. How have these wage increases compared with the trend of labor productivity in construction?

Answer: We know little about labor productivity in the construction industry. This is a question for the Department of Labor to answer. For some time I have been working with them to define, delineate and make some kind of conclusion as to the extent, of productivity increases. I am not sure that I know the answer. On the other hand, I do not think for one moment that the productivity has increased in the last 12 months by 15%. I am sure it did not! This industry does not and cannot make such rapid advances. And I do not think labor (skilled or unskilled) was able to produce that much more or even half as much than they did a year ago. From that point of view the 15.1%—or large part of it—is clearly inflationary.

Question 4: You mentioned during the hearings that you are deeply involved in the Housing and Urban Development Department's Operation Breakthrough. You also mentioned you have some doubts about the program. Would you elaborate on these doubts?

Answer: After studying the *History of Industrialized Housing* for the Kaiser Committee (pp. 177–179 in Volume II), it is clear that technical innovations in construction are greatly limited as the cost savings techniques. I am not so sure that large companies will be able to compete (costwise) with the established builders organizations. I think the nature of the industry is such that it lends itself to the type of organization set up as we have seen developed over the last 50 years and I do not expect any radical and immediate changes. I do not think we will be able to provide "instant housing" which will be more livable and substantially less expensive just because of technological innovations. We have to attack the whole concept of cost: land, financing, structure and all of the components which end up to be either the sale price or rent. I think we are building up too much hope for something which is hard if not impossible to achieve. One area where "Operation Breakthrough" may have the greatest benefit is the area of outdated codes. This may be its greatest contribution.

Chairman GRIFFITHS. I would like to say that one of the things I want in a house is silence. I don't want to hear from room to room or through the walls into the outside.

Thank you for being here.

This committee will stand adjourned until 10 o'clock on Monday morning, at which time we will hear Arthur M. Okun, David Meiselman, and Warren Smith. Thank you very much.

(Whereupon, at 12 noon, a recess was taken until Monday, October 13, 1969, at 10 a.m.)

THE FEDERAL BUDGET, INFLATION, AND FULL EMPLOYMENT

MONDAY, OCTOBER 13, 1969

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON FISCAL POLICY OF THE
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Subcommittee on Fiscal Policy met, pursuant to recess, at 10:05 a.m., in room G-308, New Senate Office Building, Hon. Martha W. Griffiths (chairman of the subcommittee) presiding.

Present: Representative Griffiths and Senator Proxmire.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Loughlin F. McHugh and Courtenay Slater, economists; and Douglas C. Frechtling, economist for minority.

Chairman GRIFFITHS. In the first 3 days of these hearings, we have heard what seemed to be contradictory recommendations about public and private economic policy. On the one hand, there has been the suggestion that since prices are still rising strongly we must continue a restrictive policy for some time until inflation is brought more nearly under control. In particular, it is suggested that unemployment is not yet showing signs of reaching excessive levels characteristic of a recession. On the other hand, some suggest that now is the time to begin to ease up on monetary policy even if we continue a rather restrictive fiscal policy. We also heard it asserted that the economy badly needs—particularly in the housing industry—a full employment budget that shows a substantial surplus in the next year or two.

It was suggested by one witness that one of the worst things we could do would be to consider reinstatement of the wage-price guideposts, or, what would be even worse, wage and price controls, while at the same time there was a tone in other testimony that if we could not maintain a sufficiently restrictive monetary-fiscal policy mix we would have to resort to some sort of direct controls over wages and prices.

This morning we have three of the most distinguished advisers we could call in this general policy area. We hope that they will give us some enlightenment as to the criteria by which we should decide how much fiscal and monetary restriction is needed in the present circumstances. Do we need to extend the surtax beyond January 1 at either 5 or 10 percent? Is monetary policy really restrictive at present, and if so, should it continue this way or be eased somewhat? Would any form of wage-price controls or wage price guideposts serve a useful purpose?

We will hear first from Dr. Arthur Okun, senior economist at The Brookings Institution and former Chairman of the President's Council of Economic Advisers. He will be followed by Dr. David Meiselman, professor of economics of Macalester College and Dr. Warren L. Smith, professor of economics at the University of Michigan. All of you are well known to the committee, as you have testified before. And in the case of Professor Smith, I remember you performed a very distinguished service to this committee 10 years ago in one of our major studies.

Dr. Okun, will you please lead off with your summary?

STATEMENT OF ARTHUR M. OKUN, SENIOR FELLOW, BROOKINGS INSTITUTION

Mr. OKUN. Thank you Mrs. Griffiths, it is always a pleasure to appear before a forum of the Joint Economic Committee. For a generation, the committee has been contributing to the Nation's understanding of Federal economic policy. The Subcommittee on Fiscal Policy has been particularly productive in explaining and exploring the key issues concerning Federal expenditures and taxation.

My views on the subject of today's hearing can be summarized as follows:

1. At present, fiscal policy is on track. It is restrictive, as it should be. The degree of restraint seems appropriate to the objective of curbing inflation while maintaining high-employment prosperity.

2. Looking ahead to the near future, a lessening of fiscal-monetary restraint is likely to be desirable.

3. For the long run, safeguards are needed to prevent fiscal policy from jumping the track as it did during 1966–68. Such safeguards might take various forms, but they must be based on a better understanding of budgetary economics of the public and by the Congress.

Fiscal policy has been restrictive for the past 15 months, and has been accompanied by monetary restraint for about a year. Yet, the objective of this restraint—to slow down prices and wages—has not yet begun to be accomplished. Understandably, we hear a rising chorus of doubts about the efficacy of our fiscal and monetary tools of stabilization. Economists are obliged to be humble about recent experience. The medication that was applied was too mild because the height of the patient's fever was not fully recognized—either in 1968 or in the initial months of 1969. By the time that fiscal restraint was applied in mid-1968, an inflationary boom had taken hold. The spending fever emerged subsequently everywhere in the private economy: in a decline of consumer savings, in the remarkable resistance of homebuilding to a tight mortgage market, in a new surge of business spending on capital goods. The pace of economic advance did moderate significantly after mid-1968. Our gross national product is more than $20 billion lower today than it would be if it had continued rising at the rapid rate of the first half of 1968. The growth of real output has been below the 4 percent trend rate of our potential since late in 1968. But the slowdown was less pronounced than had been desired and anticipated.

In response to the emerging ebullience of private demand, stabilization policy had to be adjusted repeatedly toward greater tightness. First, came the shift in monetary policy—which had been shaped to fit a much less buoyant outlook. Then the budget that President Johnson submitted in January was formulated to provide a continued offset by Government to the strength of private demand. In February, President Nixon's Council of Economic Advisers generally agreed with the assessment of the outlook that had been made by the Johnson administration. Subsequently, in light of the new strength revealed in business plans for capital spending and other bullish indicators of economic activity, both the forecast and program were adjusted. The Nixon administration has tightened the stabilization belt by several notches. The general shape and size of these adjustments seem entirely appropriate to me, although I would disagree with a few specific tax and expenditure decisions. I welcome the basic continuity of stabilization aims and actions. Most important, I welcome the determination to achieve reasonable price stability combined with—and not at the expense of—high-level prosperity.

This basic strategy has already slowed the growth of output and real income, and the outlook points to a further deceleration. The slowdown in economic activity is act I; it must precede act II—the deceleration of prices and wages. I believe it is a fair reading of our economic history that we have never witnessed an act I which was not followed by act II. The intermission has been disappointingly long this year, to be sure. It was a lot shorter in 1966, when an improvement in the price record was evident within 6 months of the slowing of activity. A key element in the stubborn climb of prices and wages this year has been the enormous strength of demand for labor. After years of operating in a tight labor market, businessmen have been hiring aggressively both to catch up and to get ahead; they have added far more workers to their payrolls than would have been dictated merely by shortrun needs. The result has been a sag in productivity, a substantial addition to unit labor costs, continued tightness in labor markets, and hence more inflationary pressure on both price and wages.

Employment increases have slowed down markedly since midyear. On the positive side of the ledger, this development points toward a relaxation of upward pressures on wages and of the upward push of costs on prices. It makes it possible for act II to begin at long last. I believe that some improvement in our price performance—perhaps small, shaky, and spotty at first—will become visable within the next 6 months.

On the negative side of the ledger, the slowing of employment entails a loss of jobs and job opportunities, so dramatically reflected in the jump of the unemployment rate from 3.5 percent in August to 4 percent in September. Surely, this news must make us stop, look, and listen. We should recognize that the unemployment rate is an imperfect and somewhat erratic measure of the job situation, and that September poses especially difficult problems of seasonal adjustment. With fingers crossed, I would judge that the 3-month average of the unemployment rate—3.7 percent for the third quarter as compared with 3.5 percent for the second—is a better guide to recent labor market developments than the jump from August to September. The behavior of unemployment in October and November will tell the story.

Even if the optimistic judgment about the September figure is correct, unemployment will probably rise somewhat above 4 percent during the coming winter and spring. No economist, no statesman, no one in the world, has a recipe for correcting our current price performance without some unfortunate increase in unemployment. Such a recipe would be in the same category as making omelets without breaking eggs. No economist enjoys conveying the message that there is a tradeoff between employment and price stability. But surely the Congress and the American public should be told the facts of life. President Nixon has had to face and accept this unpleasant reality, which he did not recognize a year ago when he declared that the only extra unemployment necessary to cure inflation was the unemployment of Johnson's economic advisers.

There are several things the Nation can and should do to ameliorate the "tradeoff" problem. First, we should promptly improve our unemployment compensation system to give more support to innocent victims of the economic slowdown. Second, we should recognize that, the more impatient we are about achieving a satisfactory price performance, the higher will be the toll in added unemployment and in sacrificed production and profits.

Finally, we should back up our fiscal-monetary policies with other anti-inflationary measures that do not lower demand. We could benefit from a program of voluntary restraint with speed limits on the prices and wages set by large firms and unions. Precisely because the administration and the Federal Reserve are doing their fiscal-monetary job, the President is in an excellent position to call upon labor and business to share the task. I regret the vacuum in this area of policy today.

We can also benefit from a careful coordination of the many Federal decisions that have important influences on particular prices and wages: our international trade policies, antitrust laws and their enforcement, agricultural support policies, manpower programs, Federal procurement policies and pay scales for Federal workers, the structure of taxation, ratemaking by regulatory bodies, and programs affecting key bottleneck sectors such as construction and health care.

Currently, the monetary and fiscal brakes are being applied as they should be to slow the economy. In particular, the monetary brakes are pressed to the floor. As I read the prospects for private demand, the time is approaching for a gradual relaxation of the brakes, although not a move to the accelerator. A reduction of monetary restraint should get first priority. The Federal Reserve is asking itself whether the time has arrived to start reducing restraint. An affirmative answer should be forthcoming before long.

That decision could be made sooner and more confidently by the Federal Reserve if the prospects for fiscal policy during the months ahead were clarified by the extension of the surcharge at a 5-percent rate for the first half of calendar 1970. In that event, the fiscal brakes would be kept on for the remainder of this fiscal year. The expansionary fiscal actions on the horizon—prospective increases in Federal expenditures and the reduction in the surcharge to 5 percent in January—lie within the bounds of the trend growth of Federal revenues. There would then be at least as much fiscal restraint in the second quarter of 1970 as in the second quarter of 1969—a full employment surplus of $10 billion or higher. If economic activity continues to slow down as expected, the actual surplus in the Federal sector of the national accounts will shrink over the next few quarters, but only because the budget will be doing its proper job as an automatic stabilizer. The slowdown of tax receipts associated with a slowdown of business and family incomes is a shock absorber, not a stimulus.

A gradual release of the monetary brakes—with maintained application of the fiscal brakes—looks like the right strategy for the months ahead. But surely this is no magic formula and it should be reviewed in light of new developments, using our judgment and all the knowledge available to us and making sure that we recognize the risks on both sides.

The Nation's ability to maintain an effective fiscal policy over the longer run lies in the lap of the Congress. In April 1966, your subcommittee issued an exceptionally far-seeing and constructive report, emphasizing the need for tax flexibility. You stated that ". . . a uniform percentage addition to . . . corporate and personal income tax liabilities . . . to be effective for a stated period, best satisfies criteria for shortrun stabilizing revenue changes." [1] If these recommendations had been heeded, our recent economic record would make much more pleasant reading. But they weren't heeded in 1967 or in 1968 or in 1969.

In August 1967, President Johnson asked for immediate action on a tax increase which took the form of the surcharge recommended by this subcommittee. By the time that measure was enacted 11 months later, the forces of inflation had gained enormous momentum. In January 1969, President Johnson recommended extension of the tax surcharge, and President Nixon subsequently reiterated that request in a modified form. After another unfortunate period of uncertainty, action was taken to extend the surcharge through the end of this calendar year. Still in limbo is the President's request to extend it through the first half of next year.

During 1967, the Congress wanted to see a genuine boom before it acted on taxes. It was understandably reluctant to act on the basis of imperfect economic forecasts. But, by not acting to raise taxes, it acted to generate a highly expansionary fiscal policy. Implicitly, the delay on taxes was based on the implausible forecase that a major fiscal stimulus would not produce a new burst of inflation or a new credit crunch.

In 1968, when the boom was unmistakable, the tax surcharge was held hostage to insure a reform of expenditure policy. This year it has been held hostage for the cause of tax reform. However meritorious these other objectives, an effective overall fiscal policy is also an important objective which deserves to be considered on its own merits.

In my judgment, the House of Representatives implicitly made a hazardous long-range forecast this summer. Its tax reform bill includes highly desirable and long overdue structural reforms of our tax system. But its main economic consequence for the Nation is a substantial net reduction in taxes for 1971 and 1972. It will cost about $5 billion of Federal revenues in 1972. The tax cuts may work out well—if defense spending is cut significantly in the next year or two, or if private demand sags badly in 1970. Otherwise, however, Amer-

[1] "Tax Changes for Shortrun Stabilization," a report to the Subcommittee on Fiscal Policy of the Joint Economic Committee, May 27, 1966, p. 9.

icans may pay heavily for their tax cuts through more inflation, tighter money, a squeeze on urgent Federal programs, or some unhappy combination of the three. I hope the Senate will ask whether it is safe and prudent to enact a tax cut now beyond the expiration of the surcharge. It would surely not be difficult to preserve the excellent reforms in the House bill and to eliminate the net revenue loss.

In the light of the experience of recent years, we must search for ways to improve our performance on fiscal policy. Several specific recommendations for procedural reforms have been widely discussed: Delegation to the President of some limited authority for initiating stabilizing tax changes; reform of the appropriations process to assure that the sum of the parts adds up to a desirable whole; linkage of tax and expenditure decisions.

There are many procedural roads that could lead to better fiscal policy. And no procedural reforms can substitute for enlightened attitudes in gearing fiscal impact to the economy's needs. I am afraid that I must conclude with a question to you rather than an answer. What safeguard is the Congress willing to erect in order to insure against a recurrence of the fiscal stalemate and fiscal drift of recent years? I believe this is the most important issue concerning the effective use of fiscal policy both to curb inflation and to preserve prosperity during 1970–75 period.

Chairman GRIFFITHS. Thank you very much, and I hate to convey the message to you. I think the Senate is going the other way on the tax bill. They are cutting out the reforms and adding to the tax deductions.

Thank you. You may proceed, Professor Meiselman.

STATEMENT OF DR. DAVID MEISELMAN, PROFESSOR OF ECONOMICS, MACALESTER COLLEGE, ST. PAUL, MINN.

Mr. MEISELMAN. Madam Chairman, the hearings of the Subcommittee on Fiscal Policy of the Joint Economic Committee are being held at a most appropriate time.

For at least 4 years we have had unacceptably high and rising inflation. The accelerating inflation has already hurt large numbers of our citizens, and for many years its consequences will continue to plague our best efforts to achieve stable prices and high employment. Some of the initial effects of changes in monetary and fiscal policy taken in 1969 to stem inflation are starting to surface, even though the pace of inflation itself has hardly abated.

There is a growing awareness that something has been seriously wrong with our economy in recent years, especially since the speeding up of inflation in 1965, the resumption of a destabilizing stop-go monetary policy, and the appearance of a chaotic fiscal policy. Because not all prices rise at the same rate during general inflation, it is unavoidable that we will be beset with a wide range of readjustment problems for some time as those who have lagged behind in the inflation try to catch up. This is one reason we can expect many prices and wages to rise even in the face of a fall in aggregate demand and a growing slack in business.

Anticipations of further substantial inflation have also become widespread and deeply entrenched in a wide range of economic decisions. Only the reality of an actual slowing of the inflation can change anticipations. People have come to disregard statements of intent, and who can blame their distrust of pronouncements. Proposals for further jawboning, especially after the dismal failure of exhortations, seem to presume that Americans never learn from experience.

The current inflation is the result of excessive total spending for goods and services by both Government and the private sector. Whatever may have been the merits of a cost-push explanation of other periods of inflation, there is now essentially unanimous support for the position that recent inflation has been the result of too much total demand.

For most of the period between 1965 and 1968, the very time Government expenditures were rising rapidly for both military and nonmilitary purposes, the Federal Reserve followed a highly expansionary monetary policy as evidenced by the high rate of growth of the money supply, which, in turn, led to a sharp increase in private expenditures as well. In fact, on the basis of historic norms, Federal Reserve actions alone—for example, the 7 percent to 8 percent sustained increase in the money supply, currency and demand deposits, in 1967 and 1968—would have caused inflation even if government spending had not increased so sharply or if the government spending had been matched by enough of an increase in tax rates between 1966 and 1968 to have maintained balance in the high-employment budget, instead of the $15 billion deficit that evolved by mid-1968 from rough balance in the high-employment budget 2 years earlier. As I understand it, the high-employment budget is now close to a surplus of $10 billion at an annual rate, or a massive shift of about $25 billion within a year.

Revenues from the 1968 surtax have been primarily responsible for eliminating the Federal deficit. Federal revenues increased a staggering $34.1 billion in fiscal 1969. Other factors have also entered, among them the additional cash revenues generated by the combination of real economic growth plus the effects of inflation, as well as the sharp curtailment in the growth of Federal expenditures. After a $20.4 billion increase in fiscal 1968, Federal expenditures increased a more moderate $8.0 billion in 1969, with $5.5 billion going to health and welfare and $0.8 billion to national defense.

Despite this sharp reversal in fiscal policy, the 1968 surtax must be judged a major failure both in taming inflation and in moderating interest rates. Inflation speeded up and interest rates rose to record highs after the surtax was enacted. It has not been possible to find any significant effects of the surtax on aggregate private spending or on interest rates. Rather than "fiscal overkill," the surtax bang had hardly a whimper.

Many people supported the initial proposal for the surtax in the belief that higher tax rates would contribute to significantly lower interest rates. Many have continued to support the extension of the surtax despite clear evidence of its failure out of fear that abandoning the tax would drive interest rates even higher. For some of us who predicted that the surtax would not significantly affect aggregate private demand, there was an interesting corollary to the effect that the surtax would not affect interest rates either, even though the surtax would clearly cut the Federal deficit; and thereby reduce the volume of new Treasury debt issues.

It may be helpful if I pause for a brief moment to explain several points of this analysis because the conclusions may initially strike some of you as rather bizarre. The evidence from many studies of the facts of investment behavior suggests that because outlays for capital gods depend on longrun expected profits after taxes, not current profits after taxes, a temporary rise in corporation income tax rates merely tends to lower net corporate retained earnings, that is, current corporate saving less capital outlays. Similarly, because consumer outlays depend largely on longrun expected income rather than current income after taxes, changes in income tax rates, especially when announced as temporary, can be expected to have only small dependable effects on consumption outlays. Consumer saving merely falls. People pay the higher tax, not by reducing spending, but mainly by reducing savings. Most current saving shows up as an addition to the supply of loans, however complex the network of financial intermediaries the funds pass through. Because saving falls, the supply of loan funds declines to roughly match the decline in the Treasury's borrowing needs. On balance, then, very little happens to interest rates.

These considerations are some of the reasons I have been led to question the technical feasibility of using monetary and fiscal policy or alterations in the so-called mix of monetary policy for their desired interest rate effects. Among other things, many of these effects, especially the interest rate effects of fiscal policy, are both questionable and have yet to be demonstrated by experience.

Some of these considerations, especially regarding the limited shortrun responsiveness of private spending to shortrun changes in income and in corporate profits taxes, have led me to change my view of the efficacy of several aspects of fiscal policy. First, "fine-tuning," shortrun variations in tax policy aimed at offsetting the effects of shortrun variations in public as well as in private spending, are largely ineffective because these changes in taxes have limited and undependable effects. Second, I have come to realize that there is narrower scope than I had previously believed in the ability of the Federal Government to increase its outlays significantly whenever the economy is close to full employment without, at the same time, causing inflation, even if the rise in spending is matched by a corresponding increase in taxes.

The main reason that sharply rising Government expenditures are inflationary even when matched by an increase in tax receipts is that the private sector responds sluggishly to most income tax changes. Thus, even holding aside the effects of monetary variables for the moment, a rise in Government expenditures will increase much more than private expenditures decline, leading, on balance, to a relatively large net increase in total spending—even though the Government may continue to balance the budget. As in the case of the 1968 surtax, the private sector largely pays the higher taxes by reducing its saving.

Because of the decline in saving, interest rates rise. In fact, rising interest rates are one of the principal mechanisms restricting the use of resources by the private sector to make them available for use in the public sector. I may add that these kinds of considerations are some of the factors that have led me and other economists to have serious reservations about the use of budget aggregates to assess the economic impact of fiscal policy and of Government expenditure and tax programs, especially when analyzing the shortrun economic effects of major shifts in fiscal policy.

Private expenditures most responsive to interest rate changes bear the brunt of the reallocation of resources. Housing is clearly one important class of private spending that does respond to interest rates. This suggests to me that any sharp increase in Federal spending will be at the expense of a reduction in home construction and in other kinds of private capital formation. In this sense, if Federal spending is not as productive as private capital formation, economic growth and progress are seriously impaired. Because I believe that resources are generally more productive in private use, I strongly favor a reduction in overall Government expenditures.

This mechanism helps to explain some of the inflation, the sharp rise in interest rates, and the depressed housing market we have experienced since we approached full employment in 1964 and then went on to a rapid buildup of total Federal spending starting in calendar 1965. The mechanism also suggests to me that keeping a tight lid on Federal spending would make a significant contribution both to lowering interest rates and to improving the housing market. For several years the Joint Economic Committee has been highly critical of "fine-tuning," and I share the general point of view. I also share the technical judgment of the Joint Economic Committee that a monetary rule requiring the Federal Reserve to maintain a relatively steady rate of growth of the money stock would make a major contribution to economic stability, especially since it would curb the Fed's repeated tendency to destabilize the economy with the successive shocks of a stop-go monetary policy.

In retrospect, the Joint Economic Committee's monetary rule would have resulted in a significantly lower rate of inflation in recent years than we have had. It also would have avoided the mini-recession of 1966–67 and its associated "crunch," as well as a major share of the subsequent rapid rise in interest rates. The Joint Economic Committee's monetary rule also would have prevented the Fed from shifting from an excessively restrictive policy in 1966 to an excessively expansionary policy in 1967 and in 1968, and now back to the excessively restrictive policy of the past 6 months. Since May there has been essentially no growth in the money supply. In my judgment, if the Federal Reserve does not soon reverse itself and increase the stock of money at the rate of at least 2 to 3 percent per year we will have a serious recession in 1970. Monetary growth in the 2- to 3-percent range is typically consistent with long-run growth at stable prices.

Because of the lags in the effects of changes in the stock of money, we must not wait until the current monetary restriction has important and visible effects on aggregate demand and employment to shift to the easier policy which would have been consistent with long-run stability. It will then be too late. To reverse monetary policy at that time would mean that we will again have to wait until the lag of effect of that change of policy takes hold. In the interim, unemployment will surely rise.

To avoid stop-go policies which themselves have been an independent source of economic instability requires taking a gradual approach in order to slow down the inflation without causing a serious rise in unemployment. Stepping too hard on the monetary brakes in 1969 will not eliminate from the record the poor monetary management of 1967 and 1968 nor will it undo or redress its consequences.

For the near term, then, I would hope that both monetary and fiscal policy will soon be on their high-employment and stable-price target levels. For monetary policy, I would generally take the target to be a growth of 2 to 3 percent for the narrowly defined money stock, currency, and bank deposits, 3 or 4 percent in the broader definition of money that includes all commercial bank deposits; for fiscal policy, a rough balance in the high empolyment budget when Government spending is relatively stable. On the basis of these norms, I believe monetary policy is now too tight, and that fiscal policy is close to target. On the basis of my foregoing analysis of some of the short-run effects of a sharp increase in Government spending, I believe the current modest surplus is called for to offset some of its short-run inflationary impact. Also, by maintaining tight controls on expenditures, I would hope for the projected expiration of the surtax in calendar 1970 as the beginning of a systematic program of year-by-year tax reduction.

I would also hope that we expand recent efforts to improve the performance of labor markets by increasing training opportunities, reducing barriers to entry, and, at the very least, resisting pressure for further increases in the minimum wage rate. Remediable structural defects of the labor market are a principal cause of unemployment. Improving labor market performance would lessen calls for inflation to offset problems created by poor policy in the beginning.

For the longer run, avoiding stop-go actions in a wide variety of public policies, including fiscal and monetary policy, would make a major contribution to efficiency, stability and growth. May I suggest that the Joint Economic Committee consider making a series of recommendations for instituting stabilizing fiscal, expenditure, and other policies which derive from the committee's view in recent years of the requirements for a stabilizing monetary policy.

In my view, the fiscal rules comparable to the monetary rule of a relatively stable rate of growth of the money supply include the following elements:

1. Achieve a balance in the high-employment budget and maintain it in both current and projected budgets.

2. Taxes, expenditures, and a wide range of governmental programs should be altered as predictably and as systematically as possible. Stop-go fiscal and budget policies are not more appropriate than stop-go monetary policy.

3. Modify the existing revenue system so that the Federal Government does not automatically receive a large proportion of the Nation's economic growth. To go even further in this direction, I would propose that we seriously consider initially leaving the entire growth of output in private hands by means of predetermined year-by-year tax cuts, subject, of course, to later tax "increases" to pay for additional appropriations, should they arise. Still greater tax reductions would

be possible with budget cuts. Revenues rise with economic growth and proportionately more than the rise in gross national product. Thus, the same volume of Government spending can be financed with progressively lower tax rates. I believe predetermined year-by-year reductions in tax rates are possible, and in order, both to encourage efficiency in Government and to reduce uncertainty regarding future taxes which bedevil private decisions. Because growth will reduce the need for some Government services and increase the need for others, it is not at all clear to me that total Government expenditures must rise when the intent is to maintain the same performance level. We should also be able to count on at least some modest increase in efficiency in Government operations, especially under a tight budget.

4. The constraint of a fixed or tight budget is the primary source of efficiency. It provides the solution to the dilemmas posed by a Parkinson's Law of the Fisc that expenditures always rise to meet receipts. If the Congress wishes to add a new program or enlarge an existing program it can clearly do so, but I would recommend a set of guidelines that would require that Congress then be faced with the alternative of either (1) raising tax rates to pay for the additional costs, a healthy linking of expenditures and the taxes to pay for them or (2) a reduction in some other Government spending. In this way, the necessity for having to choose among the hard alternatives, including the private use of the resources involved, itself becomes a source of efficiency. Thus, the Congress and the executive branch would be given greater incentives to lop off defunct programs and to increase operating efficiency. Moreover, in order to gain desired expenditures, the Congress, the executive branch, and the public itself would be given strong incentives to propose or to accept modifications in existing programs and to support moves for greater efficiency.

Following the schedule of predetermined tax cuts I propose would make a significant contribution to the solution of the stabilization problem posed by "fiscal drag." In fact, tax reduction on a sufficiently large scale would eliminate the problem itself, if indeed there is a problem.

For the first time in my recollection large numbers of Americans are now starting to recognize the kind of budget constraint I have in mind. Taxpayers have clearly balked at still higher taxes, and budget deficits are also politically unpopular. With taxes mounting because of the surtax, the rise in social security taxes, and the rise in effective real rates due to the inflation and the progressive rates structure of the income tax, more and more taxpayers have been questioning whether they are really getting their taxes' worth from the Federal Government, especially when compared with the uses they see for their limited incomes in meeting their personal needs, family obligations and community responsibilities.

It seems to me that these concerns underlie much of the current widespread support for tax reform and for the increasing discussions of a reordering of "national priorities," which are usually taken to be Federal budget priorities. Even holding aside the complex problems of Vietnam and military spending, many of us find it difficult to believe that the Federal budget is sufficiently tight in view of such obvious national embarrassments as the archaic Post Office Department and the wasteful operation of our agricultural programs. Moreover, there is reason to believe that these guidelines would have been a deterrent to much of our unfortunate involvement in Vietnam.

Another reason I favor a tight budget constraint for the Federal Government is that I believe our present system has a strong and inherent bias in favor of excessively large budgets. There seem to be many reasons for this growing out of the political process, the organization of Congress, the characteristics of Government bureaus, and the regretful fact that we have never found a way of permitting bankruptcy proceedings to be instituted against Government agencies, a serious shortcoming for any country with a government as big as ours. One example of the bias is the fact that recipients of the benefits of specific Government programs tend to see those benefits more distinctly than the many who pay the taxes and the other diffused costs. If people from a faraway State come to Washington to press their claims for a billion-dollar dam promising great private but dubious public benefits, it hardly is worth my while to expend great efforts in order to save the $10 or $20 it would cost me. But these $10 and $20 bills add up. A tight budget constraint, it seems to me would assist in maintaining a better balance.

(The following information was subsequently supplied by Mr. Meiselman:)

The following article summarizes much of the background for the underlying analysis in my statement. It shows why my analysis differs in several important respects from the other panelists'. The article was written in March, 1967 and updated six months later just before its publication in the November, 1967 *Financial Analysts Journal.* The updating consisted of three additional paragraphs describing monetary policy and interest rates over the six months. The additional data conformed perfectly with the original analysis. I regretfully concluded, "On the basis of this evidence . . . a quickening of the pace of inflation in 1967 and into 1968 is unavoidable."

For the most recent episode in the stop-go sequence which has regretfully characterized monetary policy in recent years, I would hope that the Federal Reserve reverses itself promptly enough to abort what, in my judgment, will otherwise be a serious recession in 1970, the consequence of their excessively restrictive policy which has resulted in essentially no growth of the stock of money since May, 1969.

[Reprinted from Financial Analysts Journal, November-December 1967—Copyright 1967]

THE NEW ECONOMICS AND MONETARY POLICY

By David Meiselman*

Discussing "The New Economics and Monetary Policy" has been made much easier by the events of the past year and a half, for no longer do we hear that money and monetary policy do not matter. The extreme Keynesian position that money and interest rates have little bearing on the level of economic activity has been so clearly refuted by the monetary and credit events of 1966 and 1967 that even so staunch a bulwark of the New Economics as the President's current Council of Economic Advisors stated in its January 1967 Economic Report, "* * * as was evident in 1966, a restrictive monetary policy can reduce aggregate demand fairly promptly and very sharply" (p. 65).

It is gratifying that the Council has finally come around to the point of view that restrictive monetary policy can reduce aggregate demand. Yet, as I shall develop a bit later, the evidence from many episodes of monetary history seems to be that the effects of money and of monetary policy on aggregate demand are

*DAVID MEISELMAN *is the F. R. Bigelow Professor of Economics, and Director, the Bureau of Economic Studies, at Macalester College, St. Paul, Minnesota. He is author of "The Term Structure of Interest Rates."*

not in any regular maner felt fairly promptly. Nor can they always be depended upon to be very sharp. Indeed, parallel to Norman Ture's discussion of fiscal policy and his criticism of what he aptly terms "instant fisc," there is no such thing as "instant monetary policy" in the sense that the lags in the effects of money can neither be ignored nor predicted with any reasonable degree of assurance, especially of the kind necessary for responsible execution of public policy.

To explain how I have come to these conclusions, I shall first turn briefly to a bit of exposition about the intellectual history of the New Economics and the role of monetary policy in it. I shall then show how in recent months the so-called New Economics has completely reversed many of its earlier views about the roles of money and of finance. I regretfully conclude that both positions are incorrect. I shall also discuss why I believe we shall soon have an acceleration of inflation.

The New Economics—which I take to be the application of early Keynesian economics, largely of the 1930's variety, to public policy—has not always afforded an important role to monetary policy. In fact, until very recently, most Keynesians paid essentially no attention to monetary policy, other than perhaps a nodding acknowledgment to its likely impact on interest rates and credit market conditions. Financial conditions were understood to have little effect on business conditions in general because private sector spending was taken to be essentially unresponsive to interest rates. This is why orthodox Keynesians believed that monetary policy had little bearing on larger questions of public policy for achieving and maintaining full employment and price stabiliy.

For a very recent example, consider Walter Heller's book, *New Dimensions in Political Economy*, published only about four months before the January, 1967 Economic Report. In the book, which describes the economic education of two presidents as seen through the eyes of their modest teacher, the quantity of money is not even mentioned once! Regarding money and credit, the central section of the book, "The New Economics at Work: 1961–1965" (pp. 70–83) mentions only the attempt to "twist" the yield curve, that is, change the relationship between short-term and long-term interest rates, not their overall level. (Despite claims to the contrary, as judged by historic standards the "twist" attempt was largely unsuccessful.) Monetary policy in the heyday of the New Economics was taken to be "accommodating," which is to say that monetary policy was passive and had no independent influence on aggregate activity.

Parenthetically, I find the chronology of the book rather interesting. The intellectual position it espouses was originally presented as a series of lectures at Harvard early in 1966, which was prior to the bulk of the very sharp rise in interest rates in mid-1966, and also before the Federal Reserve's monetary policy had changed from a sharply expansionary to a sharply contractionary one.

These pallid policy conclusions largely sprang from an interpretation of the events of the 1930's as seen through the Keynesian analysis of how money works. In the Keynesian view—which I believe is also very much the traditional banker view, too—a change in the quantity of money may effect interest rates. At this point, to avoid some possible confusion, let us be clear on what we mean by the term "money," which the economics textbooks usually define as "any commonly accepted medium of exchange." For present purposes we can consider money to be the amount of coin and currency held by the public outside the banks *plus* the public's demand deposits, their checkbook money. Some outstanding students of monetary economics believe money is better defined to include other commercial bank deposits, too—namely, commercial bank time and savings deposits. However, for most generalizations about the history of money in the United States, it makes little difference which definition is used.

The quantity of money is essentially whatever the Federal Reserve, our central bank, desires or permits it to be. The Federal Reserve can control the quantity of money within rather narrow limits as a matter of deliberate policy, even though sometimes it may not wish to do so, preferring instead to control other things, or perhaps no things at all. According to the keynesian analysis, if there is an increase in the quantity of money, people take the additional money and use it to make additional loans, buy bonds, or acquire other credit instruments, thereby lowering interest rates. At this point, it is necessary that the additional money not merely be passively held. Otherwise, not even loan rates would respond. In fact, one extreme variant of the New Economics held that interest rates would not respond to changes in the bank credit counterpart of checking accounts because it was asserted that people would passively hold the additional money, not even bothering to loan it or spend it for goods and services. This presumption of fact, never supported by the evidence, was the so-called "Liquidity Trap." Still another variant of this position held that, at least for much of the 1930's, banks themselves were in this "Liquidity Trap" because their lending did not respond to changes in their own reserve positions or in their ability to make additional loans.

If we move from this extreme position, which hardly any responsible economist believes is applicable to current circumstances, and few now believe was applicable to the 1930's, interest rates are taken to fall in response to more money. In turn, the fall in rates *may* be an incentive to more spending, especially on long-lived assets such as housing, plant and equipment, and other producer durables. If more spending does take place, this becomes the initial point where the monetary policy takes hold. With more spending for long-lived capital goods we have higher incomes, leading to more spending for other goods, and so forth, the so-called multiplier process. In other words, the sequence is from money to interest rates to capital goods to consumer goods and perhaps some additional feedback to still more capital goods, the additional spending for both capital goods and consumer goods making up the change in effective demand.

This is why the initial impact of monetary policy, and under many circumstances the intent of monetary policy, too, was largely evaluated in terms of interest rates and credit markets. With interest rates low in the 1930's, little wonder many economists and financial analysts concluded that monetary policy had been tried and had been found wanting, ineffective either to stem the onset of the Great Depression or to cure it. As we shall see, this view of interest rates was essentially incorrect. Today, a generation later, perhaps the largest single source of confusion and mischief in this area of economics and public policy remains the confounding of money and credit.

Confusion Between Money and Credit

There are several reasons for not evaluating money and the impact of monetary policy in terms of credit markets. (Incidentally, the quotation from the recent annual report of the President's Council of Economic Advisors, cited at the beginning of this discussion, was taken from a section titled "Money and Credit." There, the quantity of money *per se* is not even mentioned once! The Council's evaluation of monetary policy is largely in terms of credit markets, so that many of my comments, as well as my criticisms of the confusion between money and credit, are especially applicable to that section of the report.)

Among the reasons for not evaluating money and monetary policy solely in terms of credit market effects are the following: First, once the money gets out into the economic system it can be spent for all kinds of things, not merely bonds and credit instruments. In other words, money is both to spend and to lend. A change in the quantity of money can affect spending directly; it need not go through the credit market route. Second, the traditional analysis, which the New Economics has incorporated, has a more important flaw because it overlooks virtually all the feedback effects of the initial impact of monetary change on credit markets which tend to work in the *opposite* direction from the initial impact. Despite claims to being a dynamic analysis, the New Economics' view of the credit markets is essentially static. It takes many of the initial effects of monetary change to be the final ones. It turns out that the feedbacks, which work in the opposite direction from the initial impacts, are so great that they generally swamp the first effects of monetary change. That is why expansionary monetary policy eventually leads to higher interest rates, not lower interest rates. That is why a contractionary monetary policy leads to a fall in interest rates, even though in the very first instance monetary contraction may temporarily drive up rates.

There are two mechanisms which help to explain these interest rate feedbacks. First, consider a hypothetical example in which there is a doubling of the money stock. The increase in the quantity of money will lead to a marked increase in aggregate demand, which of course, will also cause a marked inflation. Perhaps interest rates fall initially, but once the inflation really gets under way, interest rates start to rise. As the inflation proceeds, people become more eager to borrow but clearly less willing to lend because of the depreciation in the value of their money. The rising interest rates are a consequence of the money induced inflation. Thus, for example, if you were to visit Brazil and find that market interest rates were something in the order of 30% per year, you certainly would not say that credit was expansive. Instead, simple arithmetic would lead you to conclude that credit is cheap indeed because the typical rate of inflation has been substantially in excess of the 30% per year nominal cost of borrowing, making *real* interest rates *negative*. At the same time, you probably would not be surprised to discover that the principal source of inflation in Brazil, as elsewhere, has been an excessively expansionary monetary policy. Yet, the by now traditional view of the New Economics would be that there has been a period of tight money, which is understood to be a period of rising *nominal* interest rates, even though *real* interest rates may have been negative!

Another Example

Second, consider another hypothetical example, but of a more modest monetary expansion which starts from a period when the economy has some slack. The increase in the quantity of money will ultimately lead to more spending and to higher real income. Business profits tend to rise as part of this process. In fact, profits generally rise proportionately more than output during business cycle expansions. This is one reason that the profitability (and the productivity) of capital rises as part of the expansionary process, which leads business firms to want to borrow more.

It turns out that, after a lag, the change in the demand for credit swamps the change in the supply of credit stemming from the initial increase in the money supply. Because the demand for credit increases more than supply, the rate of interest rises. If the Federal Reserve tries to keep rates from rising by once more increasing the money supply and bank credit, which they may well do if they focus attention primarily on interest rates and observe only the first scene or two in the monetary drama, interest rates will end up still higher.

In other words, easy money leads to tight credit; tight money leads to easy credit!

By emphasizing interest rates and credit conditions and essentially not inquiring why interest rates have changed, many economists, financial analysts, and Federal Reserve officials—and followers of the New Economics—are confused about what, in fact, the Federal Reserve has been doing. For example, during most of the first half of 1966 Federal Reserve policy, judged by what happens to the money supply, was highly expansionary. Indeed, the rate of monetary expansion actually speeded up after the December, 1965 hike in the rediscount rate which was announced as, and generally understood to be, a major step towards a less expansionary monetary policy. However, during the first half of 1966, interest rates tended to rise so that most analysts and New Economists sincerely, but erroneously, believed the Federal Reserve was effectively carrying out its publicly stated intent to move to a less expansionary monetary policy.

In mid-1966 there was a drastic turn in monetary policy. The quantity of money stopped rising. Interest rates rose very sharply.

By the autumn of 1966, the money supply started to fall. Monetary policy, again judged by what happens to the money supply, had become even more restrictive. During the same period interest rates also started to decline. Once more, the tight money, with a lag, had led to easy credit. The reason for the decline in interest rates in the face of the decline in the stock of money is easy to pinpoint. Business had started to taper off. By virtually everybody's theory, including the theory of the New Economics, the decline of interest rates in the face of a decrease in the money supply must have been caused by a fall in the demand for credit.

You may recall the pronouncements during the early autumn of 1966 about how the Federal Reserve had shifted to a more expansionary policy. The statement of intent did not square with the evidence, for the fact is that the Federal Reserve was then turning the monetary screws even tighter. The monetary contraction did not halt until the end of January, 1967.

In February the money supply began to rise. During the next six months it grew at an annual rate of nearly 10%. To place this figure in historic perspective, this was the fastest rate of monetary expansion in nearly 21 years, and the monetary expansion was accelerating! In the latter half of the period the rate of monetary growth averaged more than 11% per year. Typically, monetary growth of 2% to 3% per year is consistent with stability. On the basis of this evidence, plus the strong fiscal stimulus from the rapidly expanding expenditures of the Federal Government unmatched by a rise in tax rates, a quickening of the pace of inflation later in 1967 and into 1968 is unavoidable.

Whatever the political, military, and other reasons for the high and rising budget deficit and its inflation potential on the side of monetary policy, it is clear that the Federal Reserve, despite its widely heralded role as an inflation fighter, has again become an independent source of inflationary pressure. Indeed, by historic norms, this high and rising rate of monetary growth by itself would be sufficient to generate substantial inflation even if there were no deficit.

Over this six month period most interest rates have risen. Corporate bond yields reached new highs for this generation. The major exception has been some short-term rates, such as the rate on U.S. Treasury bills, but even here rates generally started to rise as the Spring and Summer wore on. Looking at interest rates alone as an indication of monetary policy would give a most confusing picture. Many people, especially those who look at long-term interest rates, erroneously believe that monetary policy has become more restrictive. Those who examine the entrails of short-term interest rates to divine the intent as well as the impact of Federal Reserve policy would probably conclude that since January monetary policy had first become easier, which is correct, and then later had become less expansionary, which is quite incorrect.

To avoid this confusion between money and credit, and for other reasons, many economists and financial analysts look to the money supply as the principal criterion of monetary policy, especially since there are some impressive regularities linking the stock of money to general economic conditions.

In summary, these are:

(1) Large swings of business and the general price level are associated with large swings of the stock of money. In fact, I can be more specific on this point. To the best of my knowledge, every large-scale inflation ever studied has been associated with a sharp increase in the quantity of money. Symmetrically, every sharp deflation which has ever been studied has been associated with a large degree of monetary restriction.

(2) The general configuration of business cycles seems to be very much like the general configuration of monetary change. Mild business cycles have typically been associated with mild monetary change and severe cycles have been associated with substantial monetary change.

(3) Money, especially when measured as the change in the growth rate of the stock of money, leads business cycle turns. However, the evidence from many episodes of monetary history is that the lead time is not the same at every business cycle peak or business cycle trough. In addition, because the growth rate of money is often very erratic, it may be very difficult to tell when an actual turn of money growth has taken place. The lack of a dependable lead of money over business conditions is one reason business analysts cannot mechanically apply this overall empirical regularity in any simple fashion to derive accurate busines forecasts. For the same kinds of reasons, policy makers cannot possibly know with any degree of assurance the precise path of future events stemming from today's monetary policy.

Thus, even if you personally could control the stock of money each remaining day of 1967, historic evidence tells us very little that we can depend on regarding the effects of money on business his year of the first quarter of 1968, or the second quarter, or even up to the third quarter of 1968 for that matter.

This is one reason, it seems to me, that monetary policy cannot be used in an effective and responsible manner to offset small changes in the economy, *even* if we were able to forecast those disturbances, which we usually cannot.

This is why a growing number of professional economists and others, including both Democratic and Republican sides of the Joint Economic Committee, in their review of the 1967 Economic Report, have concluded that frequent changes in monetary policy may well contribute an independent source of additional economic instability. (I may add, many economists have also come to believe that a free market economy tends to be highly stable in the presence of stable monetary growth. There is a growing body of evidence that the principal source of business cycle disturbance is the government, not the private sector.) The bulk of these continuous policy changes are intended to contribute to economic stabilization, yet, as with so many other government policies, results may be far different from intentions.

As an alternative, many economists have proposed that the best *possible* rule for the Federal Reserve to adopt is to have a stable rate of monetary growth. If there is need to change the rate of monetary growth, this should be done slowly in order to avoid additional disturbances to the private sector stemming from monetary policy. Many of these economists would agrue that pursuit of this rule, or rules, would permit the private sector to become relatively stable. Small fluctuations in the economy would still continue, and these would be relatively mild, but large fluctuations in demand that produce important large-scale depressions or sharp changes in the price level would be avoided. They would also assert that even this highly commendable performance was likely to be improved with the improvement in our knowledge about monetary behavior and the sources of short period economic disturbance. Further, they would claim that this performance, though far from perfect, is the best attainable, given the present state of knowledge.

Earlier Views Slowly Reversed

But let me return to more of the intellectual history of the role of money in the New Economics. In the postware period there has been a very decided shift of judgment by Keynesians regarding the role of money, in large measure the result of repeated confrontations with reality by the theory they espoused. Perhaps the most important test of the theory, especially the extreme variant of it I mentioned earlier, came at the beginning of the postwar period. Country after country was experiencing inflation. One device after another was tried to stem the rising prices. But, in country after country it was found necessary to bring the stock of money under control in order to bring prices under control, too. Thus, the cumulative evidence convinced most economists that the extreme Keynesian position that money did not matter at all was erroneous. There was a shift of judgment among Keynesian economists. Money mattered some, but its importance was subordinate to fiscal policy, the deliberate variation in government tax and expenditure policies. (Of course, it is very difficult to characterize the climate of judgment among all economists, or those economists who claim they are Keynesians. So, you will appreciate that I am trying to convey some of the flavor of the change in technical judgments that were taking place, rather than specific shifts of technical outlook shared equally by large numbers of individual analysts.)

Even though there was an emerging appreciation that money played some role in business fluctuations, followers of the New Economics, and most other economists, too, for that matter, still tended to interpret monetary policy in terms of interest rates and credit market conditions. In fact, this shift of judgment among those who followed the Keynesian analysis was probably very similar to the change of view of those who preferred to use other technical apparatus to analyze business conditions. For one thing, more attention was paid to the effects of interest rates. On a technical level, in study after study it was found that interest rates do have an important bearing on many different kinds of spending decisions. Perhaps more convincing to most people was their own experience with repeated exposure to substantial variations in interest rates of the kinds they had not known for many, many years, if at all.

Now there have emerged several more recent policy conclusions associated with the New Economics which have tended to supplant the earlier contentions that neither money nor interest rates are important. The conclusions are predicated on the view that interest rates respond to Federal Reserve action and that spending for capital goods also responds to interest rates. Therefore, not only can the Federal Reserve influence total spending and total income, but also the division of the economy's output between capital goods and consumer goods. Because the level of interest rates influences investment decisions and capital formation, monetary policy is understood to have an important bearing on long-period economic growth. In addition, there is the presumption that changes in interest rates affect different parts of the private sector differently. For example, housing is taken to be especially sensitive to interest rate changes, but outlays on consumer services or food are taken to be hardly, if at all, affected. Thus, monetary policy, here confounded with credit policy, is understood to affect both the level of output, the composition of output, and the rate of growth. There are also parallel and reciprocal effects on many kinds of financial institutions and financing activities. Deliberate use of monetary policy is thereby taken to imply an added dimension to control over a level of output, the composition of output, the rate of economic growth, and various other issues involving the allocation of both real and financial resources, as well as the welfare of particular industries and financial institutions.

Monetary and Fiscal Policy "Mix"

Although many Keynesians tend to be less concerned about the bad consequences of inflation than some non-Keynesians, Keynesians are not necessarily inflationists. One example of this is a prescription for a "mix" of monetary and fiscal policies to encourage economic growth. The rationale for the "mix" runs something like this. If more money leads to lower interest rates, and lower interest rates encourage capital formation and thereby growth, we may have so much spending for capital goods that we create an excessive boom which leads to inflation. One prescription for growth without inflation is to combine an easy monetary policy with budget surpluses, a tight fiscal policy. The expansionary monetary policy's low interest rates encourage capital formation; the tight fiscal policy's high taxes restrain the boom. This policy mix envisages public sector surpluses, not the deficits usually associated with the New Economics. In effect, private individuals are forced to consume less of their current incomes, thereby freeing resources to move into capital formation. If higher interest rates were employed to achieve the same ends, the higher interest rates would be a deterrent to private capital formation.

Note that the *combination* of monetary and fiscal policies I have just described comes down to an explicit attempt to use these powerful tools to regulate the level of interest rates without also altering the price level or overall activity. Control of the level of interest rates by this combination of policies, or by still others, may also be employed to influence the balance of payments. Here, the goal of growth may conflict with the goal of achieving balance of payments equilibrium, especially if a country wishes to eliminate a balance of payments deficit. The reason is that the high interest rates that may be helpful in lessening the balance of payments drain on capital account will tend to impair domestic capital formation and growth. Eliminating a balance of payments deficit may also interfere with the goal of full employment, but that is another sad story I cannot consider here in any detail.

Alternatively, other combinations of monetary and fiscal policy are proposed because of a concern for the allocation of resources, real and financial. For example, in the past year or two there has been much concern about Savings and Loan Associations, the effects of changes in time deposit regulations, ceilings on interest rates, and the like, notably focusing on their effects on the demand for new residential construction and on the safety of the Savings and Loan industry, particularly in California. In addition, because of the persistence of the balance of payments problem, the concern for growth, and now the additional concern for the allocative effects of interest rates, we have recently had much discussion of the trade-offs between monetary and fiscal policy, especially as they affect interest rates and resource allocation.

It is clear that there is general consensus among economists about the *direction* of effect of the main components of the policy mix when each one is considered separately. First, there is general agreement that an expansionary monetary policy leads to an increase in spending, and a contractionary monetary policy leads to a slow-down in spending. Second, there is general agreement that changes in tax rates affect spending. A rise in tax rates depresses private spending, and a cut in tax rates increases private spending. Third, there is general agreement that variations in government expenditures also tend to affect aggregate spending in the same direction, including the spending of the private sector.

Unfortunately, not only is there little reliable information about the precise consequences of using any one of these instruments separately, but there is essentially no tested knowledge of either the interim or the final effects of using combinations of instruments. For example, if we wish to change the policy mix but keep the economy stable and the level of total spending unchanged, we simply do not know how much to change tax rates to offset a given change in the stock of money, and *vice versa*. Moreover, we do not even know very much about how interest rates themselves will respond. This is why switching among instruments in the hope of achieving a trade-off consistent with economic stability or a desired level or structure of interest rates is a very dangerous game to play, especially since so little is known about lags, interactions, and feedback effects.

Along with this recent emphasis, we have had renewed interest and increased involvement in direct financial controls. The New Economics is now immersed in this murky area, and it seems to me that its reach is far beyond its effective grasp.

I therefore regard attempts to make major or frequent changes in the policy "mix" in order to help achieve the general goals of full employment and stable prices as courting serious trouble. Moreover, I regard as foolhardy attempts to make major or frequent alterations in the policy mix on the presumption that the hoped for change in interest rates will "improve" resource allocation, the balance of payments, the distribution of income, the special circumstances of selected financial institutions, or perhaps even long-term economic growth. On this score I note that whereas traditional Keynesians used to view interest rates as a potential but generally useless means for influencing general business conditions, aggregate income, and the price level, we have now come full turn, for currently we see attempts to temper general business conditions, aggregate income, and the price level in the hope these factors can influence interest rates and thereby a host of individual details of a complex economy! I can't help but be reminded of the Federal Reserve's tragic mistakes which led to the Great Depression of the 1930's, when their attempts to counter, first, stock market speculation, and later, the loss of gold, by means of restrictive monetary policy virtually destroyed the U.S. economy and paved the way, strangely enough, for the Keynesian Revolution which ironically claimed that monetary policy was essentially impotent. I may add that interest rates also fell to unprecedented lows, too, in the 1930's, largely pulled down by the calamitous economic slump.

CONCLUSION

Summing up, the New Economics has moved from a neglect, perhaps even an utter contempt, of the economic roles of money and interest rates to attempts to influence many details of the operation of the economy by means of control of money and credit. My own judgment is that much of the content of the more recent set of policy proposals which require more knowledge than we possess—and aim to achieve ends of dubious merit—are no less erroneous than the New Economics' first set of policy proposals which denied any important role at all to money. Finally, the new financial concerns and controls have led to an increase in the role and the power of government authorities over free markets and free men with all the inefficiencies and dangers this implies.

Mr. MEISELMAN. Thank you very much for your attention.

Chairman GRIFFITHS. Thank you very much, Mr. Meiselman.

Dr. Smith?

STATEMENT OF DR. WARREN L. SMITH, PROFESSOR OF ECONOMICS, UNIVERSITY OF MICHIGAN

Mr. SMITH. Thank your very much.

While these hearings are apparently directed primarly toward fiscal policy and its use in controlling inflation, I find it very difficult to discuss fiscal policy without also making references to monetary policy. In my view, fiscal and monetary policies are complementary means of influencing aggregate demand, and I believe there are important issues relating to the coordination of the two types of policy and the mix that is employed. Accordingly, my remarks today will refer to both fiscal and monetary policy.

After being excessively expansionary over a period of two and a half years, fiscal policy took on an appropriately restrictive stance somewhat over a year ago with the passage of the Revenue and Expenditure Control Act of 1968. Between the second quarter of 1968 and the second quarter of 1969, Federal expenditures—national income accounts basis, at annual rate—increased by only $9 billion, in marked contrast to the increases of $23.0 billion and $18.9 billion in the preceding 2 years.

Federal purchases of goods and services, which constitute the most directly expansionary kind of Federal spending increased by less than $2 billion and actually declined in the first half of 1969 after reaching a peak in the fourth quarter of 1968.

Tax revenues by $31.5 billion between mid-1968 and mid-1969 as a result of the imposition of the 10 percent tax surcharge, the increase in social security taxes effective January 1, 1969, and the growth of money incomes during the period. As a consequence of the restraints placed on expenditures and the rapid growth of tax revenues, the Federal Government sector of the national income accounts shifted from a deficit of $9.5 billion in the second quarter of 1968 to a surplus of $13.0 billion in the second quarter of 1969, a swing of $22.5 billion. Some portion of this swing is itself attributable to the effects of inflation in raising money incomes, but it is nevertheless true that fiscal policy has been powerfully restrictive during the past year.

Beginning in late 1968, the Federal Reserve shifted toward an actively restrictive monetary policy, and since that time fiscal and monetary policy have been working in tandem to check inflation. The discount rate has been raised in two steps from 5¼ percent to 6 percent, reserve requirements were increased in April, and open market operations have been employed to hold down the growth of member bank reserves. As a result of these measures in the face of increases in credit demands generated by continuing economic expansion in an inflationary environment, interest rates have risen sharply to unprecedented heights, while growth of the money supply and most of the related monetary aggregates has been markedly reduced.

What results have been achieved by restrictive fiscal and monetary policy during the course of the last year? The most notable result has been a persistent and marked slowdown in growth of real output. Real GNP was growing at a fantastic annual rate of 7 percent per year in the second quarter of 1968. Growth has decelerated in each quarter since then, reaching an annual rate of 2 percent in the second quarter of this year. To the surprise and discomfiture of many observers, however, this marked slowdown in real growth has actually been accompanied by an acceleration in the rate of inflation. The rates of price increase in the first half of 1969 compared with the second half of 1968, as measured by the three leading price indexes, were as follows:

RATES OF INCREASE

[Annual rate, percent]

	1968, 2d half	1969 1st half
Consumer Price Index	4.6	6.3
Wholesale Price Index	2.0	6.2
GNP deflator	4.1	5.0

I believe it is possible to pinpoint some of the reasons for this seemingly paradoxical tendency for the rate of price increase to escalate in the face of a slowing of real economic activity.

1. Total employment continued to expand in the first half of 1969—indeed, economy-wide employment expanded more rapidly than real output. Those industries experiencing substantial growth in output

continued to add workers, while sectors experiencing a deceleration of growth did not cut employment significantly. Thus, despite the slowdown, there was very little increase in unemployment. This tendency for unemployment to be slow in responding to a deceleration of economic growth is a phenomenon that has often occurred in the past—it was manifest, for example, in early 1967. One result of it is that the slowdown brought only a slight relaxation of pressures on labor markets, and wages accordingly continued to rise sharply. Indeed, wage settlements in collective bargaining negotiations ran somewhat higher in the first half of 1969 than had been the case in 1968. Furthermore, with employment growing more rapidly than output, labor productivity declined in the first half of 1969—output per manhour in the private nonfarm economy, which had risen by 3.6 percent in 1968, declined at an annual rate of 1.8 percent in the first half of 1969. With money wages still rising rapidly and productivity declining, unit labor costs rose sharply, putting upward pressure on prices.

2. Prices of many basic industrial materials have risen very sharply, reflecting strong demand not merely in the United States but in the rest of the industrialized world.

3. Price increases of the previous 2 years or so at earlier stages of production have still been working their way through the economy, raising costs at later stages of production.

4. Food prices have been increasing sharply, partly as a result of strong demand but also partly due to unfavorable supply situations.

5. The prices of services in the Consumer Price Index have risen with unusual rapidity due both to rising wages and to such special factors as the rise in mortgage interest rates which has been responsible for a sharp increase in the cost of homeownership.

Thus, while demand has been weakening, as reflected in the slowdown in real growth, a variety of forces, including those listed above, has been pushing up costs. Thus far in 1969, the upward pressures from the cost side have outweighed the downward pressures from the demand side with the result that prices have risen more rapidly than they did in 1968. However, it should be recognized that the increasing pressures from the cost side are to some extent transitory and can be expected to die out—or at least weaken—as the slowdown in real growth continues. For example, it takes a real rate of growth of 4 to 4½ percent to hold the unemployment rate constant over a period of several quarters; as growth remains below that level, the "labor hoarding" that has held the unemployment rate down in recent months is bound to come to an end.

Unemployment will rise as employment requirements are gradually adjusted to the slow growth of demand. Indeed, the sharp rise in unemployment in September is an indication that this process is now underway. Increased unemployment will reduce the pressures on labor markets and will be reflected in a slower rate of increase in money wages. Furthermore, while relatively slow growth of productivity is characteristic of a sluggish economy, the recent absolute decline in productivity should give way to a modest rate of increase as employment is more normally adjusted to output growth. These developments will moderate the upward pressures on unit labor costs and help to slow down the increase in prices.

Thus, it seems clear that if the recent slow growth of real output continues, we can in due course expect a gradual slowing down of the rate of inflation. It must be admitted, however, that the process has been considerably slower in taking hold than many economists expected at the time fiscal restraint was imposed last year. And while the deceleration of the rate of inflation can be expected to take hold with progressively greater strength once it gets under way as a slower rise in prices means a slower rise in costs and vice versa, it is extremely difficult to predict how rapidly the process will develop.

At the present time, I believe the overall degree of restraint being exerted by fiscal and monetary policy is about right, although as time passes the risks are beginning to lie on the side of excessive restraint. As far as the policy mix is concerned, I believe it would be better if fiscal policy were somewhat more restrictive than it is, enabling monetary policy to be somewhat less restrictive. As is almost always the case, most of the impact of tight monetary policy seems to be falling on homebuilding. From January through August, private nonfarm housing starts declined by nearly 30 percent, and the steady decline in the issuance of building permits presages a continuing fall in starts. The underlying demand for housing is strong, as reflected by a rapid rate of household formation, a sizable backlog of unsatisfied demand carried over from prior years, and very low vacancy rates. No doubt skyrocketing building costs are holding back construction to some extent, but clearly the main constraint is financial. The reduced rate of consumer saving, together with the sharp rise in open-market yields, has drastically curtailed the inflows of deposits to savings and loan associations. The associations have been able to increase their mortgage holdings substantially more rapidly than their deposits have increased, mainly by reducing their liquid asset holdings and borrowing from the Federal home loan banks.

But the pace of their mortgage lending has been declining recently, and their outstanding loan commitments have fallen quite sharply in recent months. Commercial banks, under heavy pressure to satisfy their other customers' credit demands, have cut back their participation in mortgage financing. Life insurance companies, faced with attractive yields on business loans and securities and with heavy demands for policy loans, have likewise retreated from the home financing field. Mortgage interest rates have risen very sharply; these high rates have certainly priced some potential buyers out of the housing market. But, even more important, the availability of mortgage funds has been severely reduced so that many persons who would be willing to pay the going rates have been unable to obtain funds. Federal support to the mortgage market through Federal home loan bank advances to the savings and loan associations and through the operations of FNMA has thus far prevented the decline in homebuilding from being as precipitous as it was in 1966, but the mortgage credit situation is getting steadily tighter.

In addition to homebuilding, the market for tax-exempt issues by State and local governments has been hit hard, partly by the withdrawal of many commercial banks from the municipal market and recently by uncertainties about the impact of the tax reform proposals on the tax-exempt status of municipal bonds. Municipal bond yields have risen especially sharply, and many potential borrowers have been unable or unwilling to market planned offerings of bonds.

It is not clear whether these financial difficulties have had much impact on the capital outlays of State and local governments. The experience of 1966 indicates that tight money has a larger effect on State and local borrowing, at least in the short run, than it does on actual capital spending, as units turn to other sources of funds for temporary financing to keep projects going. In any case, however, the precipitous rise in tax-exempt yields places a heavy burden on the budgets of hard pressed governmental units, and if it persists cannot help but cause substantial cutbacks in their spending.

The Federal Reserve has attempted to manage monetary policy in such a way as to direct the major restraining effect toward business investment, which has shown a surprisingly strong expansion so far this year. By failing to adjust the interest rate ceilings on negotiable time certificates of deposits in line with the sharply higher rates in the short-term open market, it has caused a large runoff of C/D's from the large money market banks. I have doubts regarding the effectiveness of this policy. It seems to have increased the pressure on municipal bond yields as banks have withdrawn from the municapal market—or even liquidated municipal securities to obtain funds to meet loan demands—and to have complicated the problems of the monetary authorities in Europe as the large U.S. banks have turned to the Euro-dollar market for funds to replace the C/D runoff.

It seems doubtful whether the large firms who are the dominant customers of the money market banks are much affected by reduced availability of bank credit, since they can obtain funds in the open market if they are willing to pay the price. Successive Commerce-SEC surveys have shown a scaling down of business investment plans, but it seems likely that this scaling down is attributable to the slowdown in economic growth brought about by the impact of fiscal and monetary policy on other sectors of the economy and by a growing realization that the fiscal and monetary authorities mean business in their efforts to slow the pace of inflation. That the direct effect of monetary restraint on business investment has been very great seems doubtful to me.

Since I believe we should be relying more on fiscal restraint and less on monetary restraint, I hope the Congress will soon see fit to extend the income tax surcharge at 5 percent through mid-1970 and to repeal the 7 percent investment tax credit as proposed by President Nixon. I believe it is most unfortunate that these measures having immediate fiscal policy implications have become involved in the current debate over tax reform. If these measures are adopted and President Nixon succeeds in his avowed objective of holding expenditures in the unified budget to $192.9 billion for the current fiscal year, fiscal policy will continue to exert a restraining influence during the coming months.

The more fiscal restraint we have, the less we will have to rely on monetary restriction with its disproportionate impact on housing and on municipal borrowing costs. Indeed, if we maintain a firm posture of fiscal restraint and if the continuing slowdown of economic growth begins to produce the desired deceleration of inflation, it may be possible to relax the present policy of monetary restraint somewhat in the months ahead.

This brings me to the question of the timing of the change in direction of policy that will clearly be required at some point. Here I see some serious problems. The authorities are obviously anxious to root out the inflationary expectations which are felt to be pervasive throughout the economy. I believe the concern about inflationary expectations has been somewhat overdone. If such expectations were as strong and as widespread as some of the more extreme analyses suggest, I would expect stock prices to be rising rather than falling, businessmen to be accumulating inventories at an excessive rate, and consumers to be speeding up their spending to beat anticipated price increases. None of these phenomena seems to be present. The one area where inflationary expectations appear to have had a major effect is business fixed investment.

The only explanation that seems to make sense for the recent heavy business expenditures for plant and equipment in the face of generally low operating rates, slowly growing sales, and very high costs of external funds is that businessmen foresee a continuation of the rapid increase in construction costs and prices of equipment. The successive downward revisions in business spending plans in the Commerce–SEC surveys may suggest some moderation of businessmen's expectations in this regard. In any case, whether or not inflationary expectations are as widespread as is often supposed, it seems clear that the authorities think this is a major problem. This being the case, I am afraid they will hesitate to shift to a noticeably less restrictive policy until they see a distinct moderation of the rate of inflation. Under present conditions, with a variety of upward cost pressures working on the price level, it may be some time before a clearly discernible moderation of the rate of inflation occurs. In view of the substantial lags that supervene between changes in policy and the effects of these changes on the economy, together with the fact that the full effects of our recent restrictive policies have not yet been felt, I believe the present situation contains a distinct danger of overstaying a restrictive policy and pushing the economy over the edge into an unnecessary recession. In my view, the optimal anti-inflationary strategy is to keep the growth of demand below the growth of productive capacity for several quarters in the hope that such a period of slow growth will in due course produce the desired price deceleration without bringing on a recession and without a steep rise in unemployment.

I believe the relatively fine adjustments in policy that will be needed if this goal is to be achieved will have to be made primarily by the Federal Reserve, since monetary policy is a flexible instrument while fiscal policy is cumbersome and unsuited to closing time. The difficult task faced by the Federal Reserve in timing the shift in direction of its policy is an additional reason for prompt enactment of the administration's tax proposals. The Federal Reserve will be able to focus more effectively on the delicate problem of timing the shift in policy if it is not faced with uncertainty regarding the fiscal environment in which it will be operating.

In conclusion, I would like to look somewhat beyond the present situation and consider the problems of fiscal policy and inflation in a somewhat longer-term context. In the first place, I believe we have something to learn from our experience of the last 4 years. In my judgment, our difficulties during this period were caused primarily by poor fiscal policy. During the 3 years from the second quarter of 1965 to the second quarter of 1968, defense expenditures increased by $28.7 billion as a consequence of the Vietnam conflict, while other Federal expenditures—national income accounts basis—rose by $31.4 billion, making a total increase in Federal spending of $60.1 billion or almost exactly 50 percent. Some increase in Federal expenditures was needed during this period to maintain a healthy and needed economic expansion.

But the extent of fiscal stimulus was clearly and substantially excessive. I think nearly everyone is now agreed that there should have been a general tax increase early in 1966. In the absence of adequate fiscal restraint, the Federal Reserve stepped in with a restrictive monetary policy which slowed the excessive pace of expansion, albeit with measures which threw an excessive burden of adjustment on the housing sector and created financial strains. We had a second chance to impose fiscal restraint in the fall of 1967 when the economy again picked up excessive speed largely under the impetus of a continued expansion of Federal expenditures. But we delayed the enactment of the 10-percent tax surcharge for a year. During this period the inflationary pressures became so deep-seated that we are now finding them very difficult to bring under control.

I hope we have learned the importance of timely fiscal action from this experience. We hear much these days about the unwisdom of "fine tuning"—suggesting that our problems were caused by excessive fiddling with the dials of economic policy. As far as fiscal policy is concerned, I believe this is just the opposite of the truth. Our problems have arisen not from too frequent fiscal adjustments but from failure to take needed action—in 1966—and from excessive delay in taking action—in 1967–68. What I believe this experience suggests is the desirability of developing some kind of streamlined procedure for getting prompt tax adjustments when they are needed for purposes of economic stabilization.

It has been argued that monetary policy has exhibited both poor timing and excessive activism during this recent period. Perhaps the Federal Reserve should have switched to a policy of restraint somewhat earlier than it did in 1965, but it should be remembered that there was still excessive unemployment at that time and that the Federal Reserve did not know where the budget was headed. Once the inflationary situation became clear, I believe the Federal Reserve acted courageously and properly in applying the monetary brakes vigorously in 1966. The turnaround in policy when the economy slowed down sharply in early 1967 was also appropriate, in my judgment. In late 1967 and especially in the first half of 1968, the Federal Reserve was in an awkward position because of the uncertainties regarding passage of the tax surcharge. In retrospect, it is apparent that the monetary authorities acted prematurely in easing policy moderately following passage of the surcharge in the late summer of 1968, but I believe there is a tendency to exaggerate the extent to which that action contributed to our present inflationary problem.

The gyrations of monetary policy and the sharp variations in the rates of growth of monetary aggregates in the last 4 years or so have been primarily attributable to the need for the Federal Reserve to adjust to the instabilities and uncertainties created by bad fiscal policy. If fiscal policy is conducted in a more responsible way in the coming years, monetary policy can and surely will undergo less frequent changes. More responsible fiscal policy is, in my view, the key to a more stable monetary policy.

In addition to the problems of countercyclical economic stabilization, there are some secular issues regarding the mix of monetary and fiscal policy that disturb me. In view of the proposals for income maintenance, revenue sharing with State and local governments, and expanded manpower training that have already been advanced, together with our immense unmet needs in such areas as urban development, education, health, and control of environmental pollution, I foresee powerful forces making for increased Federal spending in the next few years. Indeed, I believe the pressures are likely to be so great as to place a severe strain on the additional budgetary resources that will become available from normal revenue growth with current tax rates together with any reductions than can be made in military spending and in lower priority civilian programs. Thus, I see the Federal budget as a probable source of inflationary strains during the next few years. To counter these strains, the Federal Reserve may be forced to maintain a continuing posture of monetary restraint with attendant high interest rates. At the same time, even with large Federal expenditures on social programs, success in dealing with urban blight and in moving toward the housing targets established in the Housing and Urban Development Act of 1968 will require the mobilization of huge amounts of funds for investment in mortgages and security issues of State and local governments.

Thus, there will be powerful forces pushing the Federal budget toward deficits at the very time when tight fiscal policy and budget surpluses will be necessary in order to permit a sufficiently easy monetary policy to keep funds flowing into housing and urban development at reasonable interest rates. This clearly suggests to me that the present is no time for tax reduction—beyond the unavoidable phasing out of the tax surcharge—even of the relatively modest magnitude provided for in the current tax reform proposals. Indeed, if we are to deal effectively with the urgent problems that confront us, we may very well have to increase taxes in the course of the next few years. I might add that the administration's concern about private capital formation as reflected in its recommendation for a cut in corporate income tax rates strikes me as being misplaced. Our emphasis during the next few years should be on the accumulation of badly needed social overhead capital rather than on private business capital. The administration is concerned about growth, but accelerated growth of measured GNP does not seem to me to be the crucial problem of the coming years. And it is quite possible that in the current context a dollar of social overhead capital will contribute more to the growth of real social output—as distinct from measured GNP—than will a dollar of private business investment.

Finally, I find it difficult to judge what kind of behavior of the price level will ultimately prove to be consistent with an unemployment rate of 4 percent or somewhat less once the present excessive inflationary pressures have been eliminated and the economy has been steered onto a steadier track than it has recently been following. But I doubt whether it will be possible to achieve through fiscal and monetary policy alone a satisfactory level of employment in combination with a pattern of behavior of the price level that our people will be willing to accept. I believe we will find it necessary to work along other lines to counter the numerous inflationary biases that now exist. Greater efforts will be needed to increase the skill and adaptability of our labor force through more extensive training and retraining programs and to increase its geographical and occupational mobility. Programs will be needed to expand supplies in such bottleneck areas as construction and medical services where price increases have been especially large and persistent. And some means will have to be found to bring the public interest in price stability to bear in cases where large business and labor organizations possess substantial market power in the determination of wages and prices.

No matter how skillfully fiscal and monetary policy are conducted, things are bound to go wrong from time to time. The underlying strength of private demand will sometimes prove to be stronger or weaker than was anticipated. If we seriously attempt to keep the economy moving along a selected high-employment growth path, resisting departures from the path in either direction, I believe we can still expect some economic fluctuations. The hope is that we can keep those fluctuations mild. But our success in that respect is critically dependent on improving the performance of fiscal policy. Improved fiscal policy would relieve the Federal Reserve of its recent impossible task of offsetting the effects of profoundly destabilizing movements of the Federal budget. Even operating within the framework established by a reasonably well designed fiscal policy, the Federal Reserve is bound to make occasional mistakes, but it should be able to make an effective contribution to economic stabilization and doing so without the sharp gyrations in monetary variables that we have witnessed recently.

Thank you.

Chairman GRIFFITHS. Thank you very much, Mr. Smith. I found all the papers very interesting. I understood Mr. Meiselman did not agree that the tax increase had done anything to slow inflation and that you, Mr. Okun, thought it did. Would you explain yourself?

Dr. OKUN. It is quite clear that we have had a change of pace in economic activity after the middle of 1968, and I don't think the evidence can really be linked in such a firm way that one can say exactly what the tax increase did here.

There has been a reduction in savings by consumers to some degree associated with the tax increase, and that does raise questions as to whether the tax bill had its full effect on spending by consumers.

We were operating in a situation where inflation had a lot of momentum, where we might well have had a decline in the saving rate from its unusually high levels of late 1967 and early 1968, the tax bill prevented this amount of income from flowing into our supermarkets and our department stores.

I think you find corroborating evidence of that in the rather marked increase in the velocity of the circulation of money in the past year. Consumers and businessmen seem to have been quite resistant to doses of monetary restraint as well as fiscal restraint. One would have expected more response to the monetary side as well as to the fiscal side.

In general, one has to conclude that it takes a fairly strong dose of restrictive medicine to curb an inflationary boom once it gets going and once it affects the psychology of businessmen and investors.

One has some evidence that the tax bill and the expenditure control measures helped to produce the degree of moderation we have seen to date.

Let me comment finally on one theoretical aspect of it. It is true that the tax bill was a temporary measure and there is some convincing evidence, that a dollar change in income that is viewed by consumers as temporary has significantly less impact on their spending than a dollar change on income which they view as permanent.

Now, we were aware of that in advance and I remember taking a 20- to 30-percent discount for the tax increase because it was temporary. The evidence of the past would suggest that is about the right discount. For one thing, the temporary character of the tax bill was very much open to question. One reason that people objected to it was their concern that it would get built into the system and it would be the same as the Korean excises, still subject to repeal 10 or 15 years later. So people couldn't be confident at all it would be temporary.

Second, in general, while we find consumers reacting to expectations as well as current income, they have great difficulty in sorting out what is temporary and permanent. In a year's time, they get overtime work, social security changes taking place, they hear about tax increases or cuts in the future, they get a big pay increase, and they are not sure whether another one is coming or not.

It is incredible that they could really sort out the tax increase and identify that as temporary and really find ways of putting their income into two categories, temporary and permanent. The data tell you that while there is evidence of a difference in the spending of consumers between permanent and temporary income, it is a very modest difference. It is as though people do look out into the future, but they don't look very far out, and hence a 20 or 30 percent difference is all that results. If anything, that is an argument for doing a little bit more on the dosage of fiscal restraint rather than doing less.

Chairman GRIFFITHS. If by the time, the tax bill was suggested and was passed, if you could at the time of passage have increased it, the amount of the tax bite, would you have done so?

Mr. MEISELMAN. Would I have increased it?

Chairman GRIFFITHS. Dr. Okun?

Mr. OKUN. Oh, no; I wouldn't have done so at that time. The outlook for private demand as I saw it, and as a great many of my colleagues in the profession saw it, was a lot less buoyant than it turned out to be. We thought housing had already begun to be hit by tight money in light of some evidence in the spring of 1968. That turned out to be misleading evidence. Housing just rebounded and surged ahead.

It looked as though plant and equipment spending wasn't going anywhere in 1968 at a time when profits were rising very sharply and sales were forging ahead. Then plant and equipment spending began to turn up very sharply at the end of the year for reasons that are still not completely clear. We thought that liquidation of steel inventories might be a significant drag on the economy.

The Government felt that it had done enough with the fiscal measures of June 1968. A great many people outside the Government warned us that we put the last nail in the coffin of the boom. The term "fiscal overkill" was widely used in the business community last year, although never in administration circles.

We don't have a good record of forecasting in the past 15 months. I would not have recommended a larger dosage as of the middle of 1968. In retrospect, I wish there had been a larger dosage of fiscal restraint at that time and an immediate pairing of that fiscal restraint with monetary restraint rather than some delay in the application of monetary restraint.

Chairman GRIFFITHS. Mr. Smith suggested that he was opposed to further tax reductions, and Mr. Meiselman seems to be for more and more tax reductions.

I would like to ask you two questions, Mr. Meiselman:

One, how are you—well, maybe it is just one question.

How are you going to get those tax reductions translated into the things that we really need, the social programs?

Mr. MEISELMAN. I really need a great many things for my family and if you don't cut my taxes I may have trouble making proper provision for them.

Chairman GRIFFITHS. I will say to you one of the first things we need in this country is pure water. How are you going to translate your tax reduction in terms of pure water?

Mr. MEISELMAN. First, I would insist that the people messing up the water pay the costs. Then, in general, I wouldn't start with a pessimistic view tht you can't do anything about the existing structure of the Federal Government and that we have to accept everything that has passed before. I think it would be much better if we started out with the general view of a zero budget, not an increment budget, so that all expenditures had to be justified, not merely adjustments to existing ones.

I don't see why we have to accept all the existing activities and expenditure programs of the Government. The point I was trying to make in the latter part of my presentation was that with a budget constraint, because you can't have more of everything, you hopefully try to find the best alternatives.

I would quite agree with you that many parts of the country would do well to have better water. But that doesn't necessarily mean that total spending has to go up. It would mean that better water initially should have to be forced to compete with some other uses for the Federal dollar and that solutions requiring expenditures compete with other ways of achieving a useful end, for example, a change in the law regarding pollution control and liability for pollution damages.

Chairman GRIFFITHS. Well, let me explain to you, last year when we passed the tax bill, and as you or one of the others suggested it was held captive to expenditure cuts, I might say I was the first member of the Ways and Means Committee who pointed out that expenditure cuts didn't make this more attractive to me. I was opposed to expenditure cuts until I found out where they were going to be, and I think the mere fact that you pass those expenditure cuts on to the President meant in reality that you gave the right to say where the expenditure cut would be to the chairmen of various powerful committees in this Congress. They were the people who determined where the expenditure cuts would be because they went down and said, "Of course you are not going to cut it out of my State. You are not going to cut the one I am interested in," and the places where they cut it were in the cities, and the very areas that needed the money most. So that you have to have a better system of making the cuts, of creating the efficiencies. This is one of the real problems, it seems to me.

All you had to do was watch the military expenditure bill on the floor of the House. The thing that was involved in the whole thing it was like a public works project bill. You saw person after person who was for a cut in everybody else's district stand up when the cut was going to cut the C–5A or something else out of his district.

Mr. MEISELMAN. It seems to me that unless you start at some point to enforce some constraint then we won't ever make significant cuts. I realize that there would be a lag between the time that the kind of budget constraint that I envisage is put into effect and the evolution of a rational and efficient allocation of available resources. But unless the sense of a budget constraint becomes widespread, I just don't see how you can make significant cuts in anything. The fact that initially some programs that you believe are worthwhile might not be funded should strengthen your resolve to vote for some cuts in order to make your preferred program possible. Competition for the available and limited funds of the Government is the only dependable way to bury dead programs and institute efficient management. Unless you take a longer-run view, and refuse to accept the status quo the Federal Government will just have to get bigger and bigger and still more cumbersome and still more wasteful.

Chairman GRIFFITHS. Well, I am quite willing to leave it to the people but I am not willing to leave it to a bunch of committee chairmen as to where the cuts should be made.

Mr. MEISELMAN. Perhaps you know your colleagues better than I. This may be one more reason to keep the lid on spending.

Chairman GRIFFITHS. I would like to ask you, you talked about tax cuts as if the Federal Government were the only government that was taxing. True we can reduce the taxes but what about the fact that in every city, in every State, and in every county, taxes are increasing. We really can't reduce them as fast as these people are increasing them, and we have no effect upon that.

Do you see any problem involved in this? I mean will the effect of our tax cuts be picked up by the private sector or are they going to be picked up by local governments?

Mr. MEISELMAN. I would expect some of each. With tax cuts there would be more resources available to individuals and, in part, they could pass some of them along to State and local governments in the form of higher taxes. But I have the same general pessimistic view of the local government and State Government as I have of the Federal Government, except less so. Because its taxing jurisdiction is much more restricted, the taxing power of a local government is less than that of a State Government, and similarly a State Government less than that of the Federal Government.

In my home State of Minnesota, State and local taxes are among the highest in the country; last year, I believe, about $165 per $1,000 of personal income. This year the State budget increased very sharply. Yet, I still hear many complaints that the State needs more revenues for many worthwhile projects. One of the things that bothers me is that a very large proportion of the State budget is devoted to the State system of higher education, where most of the benefits from the spending of public funds accrue to specific individuals, largely from middle- and upper-income families, because the tuition charges at the large number of State colleges and at the State university are minimal. How much of a squeeze can the State budget be under?

Chairman GRIFFITHS. Now that we have had some experience with attempting to change fiscal policy, of attempting to change the tax structure, and we know that it is going to take months to do it, and while I will admit that even when I first came on this committee one of the points of argument was whether or not we shouldn't give the President the right to increase or decrease taxes, but since we now know it, in place of talking about fiscal fine-tuning of the economic policy, why don't we fine-tune the indicators. Why don't we know earlier that we are going to have to do one of these things, either increase taxes or decrease taxes or increase expenditures or decrease expenditures.

Dr. Smith, what do you think the chances are of doing it?

Mr. SMITH. I am not sure I know what you mean.

Chairman GRIFFITHS. Take now, you know when you are going to have to do something, but now you know one additional thing, you are going to have to have a long leadtime because you are going to have to do it politically, so that you need to have an indicator that gives you a better lead time, what chance is there?

Mr. SMITH. To my way of thinking as long as you conduct a discretionary policy which I favor, both fiscal and monetary policy simply have to be based on forecasts of the future because of the lags. What you are suggesting is that maybe we can improve our forecasting. Many economists have been working on that. Our forecasting still leaves a lot to be desired, and I think we will continue to make mistakes from time to time. Perhaps as time goes on, we will be able to improve our forecasting sufficiently to enable us to see earlier what we need to do, thereby counteracting the delays that exist between the time we take the action and the time it affects the economy. But I don't foresee in the shortrun a real revolution in forecasting that will change things drastically. I think we can hope for gradual improvement on it, but for a long time to come we are going to continue to be faced with forecasting problems, and policies which take a very long time to change from an administrative point of view are going to be difficult to use.

Now, I don't happen to think that we ought to change fiscal policy every 2 minutes. If we could get to a situation where we formulated the best fiscal policy we could, looking at both the tax and expenditure sides at the time the budget is presented in January, and then the Congress acted on that budget as a whole within some reasonable length of time, I believe we would have achieved a lot. In addition, in unusual situations like the rapid buildup in military spending in 1965–66, we need some mechanism for making emergency changes in taxes. But I wouldn't want to take emergency action in fiscal policy every 2 or 3 months. Normally, I think if we could get effective fiscal action once a year we could rely on Federal Reserve monetary policy to give us the additional flexibility we need.

Chairman GRIFFITHS. Mr. Meiselman, in view of the fact there would be times when we are going to have a rapid increase in expenditures by the Federal Government, when it is absolutely unavoidable, how, in your opinion, should we then regulate the economy?

Mr. MEISELMAN. Following the analysis that I presented in my prepared statement, it seems to me that whether we have a rapid buildup in expenditures or a slow buildup we should accompany them with tax increases. One of the principal functions of taxes is to provide information to citizens regarding the expense of running their Government. At the very least, if there is to be either a modest, a medium-sized or a large-scale increase in Government expenditures, I would favor a correspondingly modest, medium-sized or large-scale increase in taxes at the very same time.

If the increase in expenditures is necessary and large-scale when the economy is close to full employment, it would be useful to have a larger increase in taxes than we have in expenditures to help temper inflationary pressures because of the reasons outlined in my prepared analysis.

The principal reason is that people react very sluggishly to taxes, especially income taxes. That is one of the reasons that I am not optimistic about the usefulness of short-run variations in fiscal policy for stabilization purposes. Also, shifting between fiscal policy and monetary policy is basically an illusion.

Chairman GRIFFITHS. Besides the schooling, are there other specific programs that you would like to see transferred to the private sector or are there things that you would like to see cut out altogether, I believe you mentioned the farm program.

Mr. MEISELMAN. I think that it should be cut out altogether, but not this year. We have made a large number of promises to many honorable farmers and I don't think that it is a very desirable thing to pull out immediately.

I think it would be very helpful if the Federal Government could announce that it is getting out of agricultural price fixing, controls and subsidies once and for all and to phase out the programs permanently and never get back into them again.

Chairman GRIFFITHS. Would you suggest we also get out of the oil price-fixing business?

Mr. MEISELMAN. Absolutely.

I would hope that you keep going in this direction, so that we could extend this to a wide variety of Government price-fixing schemes and schemes that prevent entry, entry both of people into jobs, of individuals into businesses, of goods into the country, of goods between States.

Chairman GRIFFITHS. Could you mention some specific ones?

Mr. MEISELMAN. Pardon?

Chairman GRIFFITHS. Could you name some specific ones?

Mr. MEISELMAN. We have a wide variety of restrictions on imports. We have a wide variety of restrictions on entry. I can't open a bank, I can't open a savings and loan association.

Chairman GRIFFITHS. These have nothing to do with expenditures.

Mr. MEISELMAN. With expenditures?

Chairman GRIFFITHS. These have nothing to do with Federal Government expenditures. Would you mention some Federal Government expenditures.

Mr. MEISELMAN. In my prepared statement I mentioned the Post Office. The Post Office is and has been an embarrassment to the country for many years, and the fact we haven't been able to deal effectively with the Post Office is an example of the reasons that I am basically pessimistic about the returns from giving the Federal Government still more revenues to spend each year.

Chairman GRIFFITHS. Would you care to say something, Mr. Okun?

Mr. OKUN. Well, the Post Office, I think, is another example of a case where one might well wish for a reform, but not for the purpose of conserving on the size of the budget or on tax revenues. The Post Office is very close to being self-financing. Yet I could certainly join Mr. Meiselman and join President Nixon and join President Johnson in suggesting that a reform of that organization would be highly desirable.

It seems to me that one should distinguish the issue of priorities from the issue of stabilization in the narrow sense, and I think you have quite a different flavor on the priorities issues from Mr. Meiselman, on the one hand, and Mr. Smith and me, on the other.

I don't believe one can say generally whether resources are more productive in private use or the contrary. I think we have a pretty good agreement in our Nation about what things are to be provided publicly and what things are to be provided privately. The debates on these issues are really quite marginal. They get down to post office and agricultural price supports and a few other things which may add up to 5 percent of the Federal budget.

Most of the big issues underline the points you made in your question about pure water. If the American public wants that, it will have to get it through Government as a public service. It can't buy a pure water supply in a supermarket. If you go down the list of pollution, social security programs, and manpower training, the Government stepped in because there aren't effective incentives in the private sector to develop these on a scale that is appropriate to the desires and wishes of the American public. There are good reasons, for example, why no single landlord in a slum neighborhood will find it desirable to rehabilitate and remodel his tenement when there is still sewage on the streets and rats in the neighborhood. It takes some Government activity to marshal the resources to do this. The same thing is true of pollution, pure water, manpower training, and health research. You can go down the list of most of the things the Federal Government is doing, including efforts to assure a minimum level of income for our less fortunate citizens, and you just can't buy them in the supermarket. They don't sell them there. If the American people want such things, they are going to have to pay for them through taxes. I don't believe the political process has been all that wrong in giving some indication of how the American people want to budget their resources between private goods and public goods.

It would be incredible if, over the long run, when our incomes grew and grew, we wanted to take all the increment in the form of private goods and none in the form of public goods. If we want more cars, we ought to want more highways along with them. That is not the top priority on my public expenditure list but it is no surprise that highway expenditures go up. It is no surprise we want better airports and better schools and better hospitals.

Representative GRIFFITHS. Do you realistically think that the Defense expenditures will decrease even if Vietnam stops?

Mr. OKUN. I don't know exactly what it means to be realistic on this. In the post-Vietnam committee report that Mr. Smith and I participated in, that was published with the economic report in January, we suggested that, on the basis of present commitments and given peace, there was room for a $7 billion cut in defense expenditures between 1969 and 1972.

Now, decisions may be made to increase the commitment or decisions can be made to cancel contracts and slow them down. But certainly it is realistic to use that as a benchmark. It suggests that without any major change in policy there is some room for a cutback in Defense spending. When one talks about large cuts, one does have to ask about our national security commitment: Should we be ready to fight two and a half wars at any point in time? What are the opportunities for negotiating disarmament with the Soviet Union? Questions of that sort may be the really key items in determining the right size of the defense budget. I think it is realistic to believe that some cut in defense spending is possible, yes.

Chairman GRIFFITHS. Thank you.

Senator Proxmire?

Senator PROXMIRE. I want to congratulate the chairman on the excellence of the witnesses we have had this morning, especially the panel. I think it is really an outstanding able panel, and a very well balanced panel, too.

I wonder if you gentlemen have had a chance to read the article in the Washington Post yesterday by Bernard Nossiter concerning Gardner Means brought up to date, so to speak. This was the argument that Mr. Means makes that we have suffered from administered price inflation as well as so-called competitive price inflation or deflation.

The policy point of the article would seem to be that an administration which ignores the fact that part of the economy is not directly and completely affected by competitive influences is an administration which is going to have to recognize that there is going to be a substantial amount of inflation if it doesn't cope with it. In other words, it is a way of saying that monetary and fiscal policy is not enough. In addition to that you have to have a certain amount of jaw-boning, you have to have a certain amount of wage-price guidelines or voluntary controls or perhaps actual controls.

What is your reaction to this, Mr. Okun?

Mr. OKUN. I have some agreement with the conclusions and some disagreement with the analysis.

I don't believe our inflation over the past 4 years should be primarily characterized as administered price inflation. If you just look at the anatomy of that inflation and look at its origins in late 1965 and early 1966, you find that the most competitive prices in our economy were the ones that jumped ahead first.

Senator PROXMIRE. Mr. Means acknowledges that and indicates, as you may recall, in the first phase of this period it was indeed, just as you say, the competitive prices that went ahead, and went ahead by a much larger margin.

Mr. OKUN. Right.

Senator PROXMIRE. However, more recently, he says there has been an increase in the more administered area.

Mr. OKUN. You can interpret this as a catching up. For example, the lags are longer in the organized areas than in unorganized areas and it wouldn't be surprising if they climbed on the band wagon later and, incidentally, if they are the last to leave the bandwagon of inflation. I would think, for example, that we might get a considerable improvement in the wage increases of unorganized sectors before the organized sectors begin to show any improvement.

But, you don't have to believe that big labor and big business are the villains of the piece in order to believe that there is an important element of discretion in their price and wage decisions, and that the decisions are responsive not merely to market forces but also to the rules of the game as they are established. A set of rules of the game, which indicate the concern and interest of the President about the way that this discretion and market power is used, will help to improve those decisions.

Senator PROXMIRE. Mr. Nossiter suggests what might be done, he suggests either the Joint Economic Committee or the Anti-Trust Committee do it, he suggests what might be done is maybe a study or have a study made because the executive branch is in the position of making it, industry by industry to either ratify or rebut the Means theses, what has been the actual experience in the last 10 years, of the extent to which administered prices and wages have been principal inflating forces so we have a clear picture.

In your view is this needed or do you think we have enough data without going into much detail here?

Mr. OKUN. I think more study is always useful. I think we have pretty compelling evidence that there is participation in any inflationary process by the areas of administered prices and wages. Particularly because of this catchup phenomenon, because they weren't the first on the band wagon, I think their behavior may be particularly critical in the year ahead. I think we know enough already to make some policy judgments on this.

There is, I think, a compelling body of evidence that in 1961–1965 period, when there weren't great strains on the economy, a program of voluntary cooperation did make a real difference. The evidence begins to fall apart when excess demand dominated our price and wage performance. Even then, I would say that the evidence of particular cases enables us to make the judgment that some assistance was provided by the efforts of the administration.

Now when excess demand is largely behind us but cost-push is strongly with us, when the administration and the Federal Reserve are pursuing a policy for achieving restraint, there are great opportunities for asking business and labor to do their share.

Senator PROXMIRE. I would like to ask Mr. Meiselman and Mr. Smith to comment on this situation. The Wall Street Journal this morning, I thought, made a very powerful case that inflation in the future is going to be a lot tougher than it has been in the last year or so.

If this is true it would seem to raise a question as to the points you make and I think almost all the witnesses we have had before this committee have made, that we ought to start to ease up on monetary restraints. The Wall Street Journal points out, number one, we can look forward to a series of government actions that are going to increase the pressure on demand and prices. Social security increases, the President has asked for 10 percent beginning next year and Congress 15 percent. I am inclined to think it would be 15 percent, which would be $4 billion of really very powerful pressure on demand inasmuch as social security recipients wouldn't save much of that, they would spend it.

Housing demands, we know we have the worst housing shortage we have had in a long time, the Government should step in, we hope it will step in, in order to assist this. We are going to meet the needs of our cities, this is one area where we certainly have to act and act promptly. The military budget, which this committee worked hard to trying to develop a background for putting it into the appropriate priority. I think it ought to be cut by $10 or $15 billion or more and other people do, too, but hoping and recognizing the realities are two different things, and I assume we might continue to have an $80 billion budget for 2 or 3 more years.

In the private sector, it is pointed out here that, in this article that, corporate expansion is likely to continue. Gainsborough's figures show unspent appropriations in manufacturing corporations $23 billion this year, and a feeling that in spite of the fact we are operating at about 84 percent of capacity that business doesn't seem to recognize that, they want to expand much more.

In addition, a negative productivity by workers in manufacturing, negative, literally negative, this year, meaning any wage settlement, increases wage costs sharply and provides an element of wage push. A reflection from the National Association of Manufacturers report that 76 percent of their respondents are reporting that they expect to increase prices, and this is the biggest response that they have had in the area of increasing prices. Demands, dammed up demand in the local area, by local governments, we know how much they need and how much they have been postponing it because of restraints that they have suffered; a substantial tax cut by the House in the bill that has passed the House and is now pending in the Senate Finance Committee, and an announcement by Chairman Long that the Senate is going to go the House one better. We are going to have a bigger tax cut than they have. So the conference is going to end up with something probably bigger than what the House has, the President may veto that, he may not because it has some good tax reform measures in it, and it is hard to predict what the President may do.

At any rate you add all these things and I am just wondering, Mr. Meiselman, if you have much of a case of beginning to ease anything including monetary policy although I would agree that ought to come first.

Mr. MEISELMAN. I have spent part of my professional career working on the inflation problems of Latin American countries, and while you were going through that rather dreary list, I could close my eyes and review a combination of some of the chaotic things one often sees in South America.

I don't say that wholly in jest, because, as I mentioned at the beginning of my formal statement, we will have a great deal of trouble for a long time as part of the unavoidable cost of adjusting to the acceleration of inflation. The increase in the payments to recipients of social security, is part of that adjustment. The increase in wages to many people will be part of that adjustment. Some of the things that are happening in the labor market that you mentioned and Warren Smith mentioned are part of that adjustment, and in attempting to slow down the inflation there will be the appearance of all kinds of apparently irrational things taking place in the economy provided you incorrectly look at this outside the context of the dynamics of inflation.

We have built inflation anticipations into the economy because, in fact, we have really had inflation. Those people who for a generation believed the announcements that we weren't going to have inflation paid a very high cost. Those people who bet on inflation reaped great benefits. The word got around, especially in the past few years. That is the principal reason that interest rates are high.

It is hard for me to see that there is anything that can be done to lower the level of interest rates until the inflation is brought under control and kept under control.

Let's say that we are successful in slowing down the inflation. Consider the typical saver who has had his funds in a bank or savings and loan and has been earning a negative real rate of return, how would you expect him to react initially? At first he might be very pleased, but he certainly woud not believe that the slowdown in inflation is permanently here. He will not change his behavior very much, nor would highly sophisticated investors either.

Because inflation anticipation appear to change slowly, if inflation moderates or stops it will mean that real rates of interest, interest rates adjusted for changes in the price level, will increase. Now, in spite of the fact that interest rates are high, real rates of interest are still quite modest for many kinds of loans.

During the transition to less inflation real interest rates will go up even though market or nominal interest rates may start coming down. It is during these times that a great many people may start to complain for the first time about the high cost of borrowing.

If we really mean to slow down the inflation this process is one of the things we have to sweat through. It is one of the lagged costs of having started this messy business in the first place.

There are many other unavoidable adjustments that are part of a very dreary process, but unless we start the process now it will be even worse later on.

Chairman GRIFFITHS. I would like to ask you, many of the people before us have referred to the unproductivity of labor as one of the real reasons for the increasing prices of the goods. What is the problem in the unproductivity of labor? Is it the picking up of new workers, the hard core unemployed or just what? Would you care to answer, Mr. Smith?

Mr. SMITH. As I said in my paper, we have had an actual decline in productivity this year because of the lag in the adjustment of employment to the slowdown in growth of output. Once the unemployment level begins to adjust to the real growth of output—and the September change in unemployment suggests that that process is now under way—I think we can anticipate that we will begin to get modest increases in productivity. But these increases in productivity will certainly not match the kind of wage increases we have been getting lately. Thus until wage increases begin to slow down I think we can anticipate continuing upward pressures on prices from the productivity-wage side. But these pressures will lessen as the increase in unemployment and the slowdown in sales begin to exert some dampening effects on wage increases.

That is the mechanism, I think, by which the inflation has to be brought under control, and that is really why there is no way to bring the rate of inflation down without suffering some costs in terms of unemployment.

Chairman GRIFFITHS. What, in your opinion, is the tolerable limit of unemployment at this period?

Mr. SMITH. I would really hate to see the unemployment rate go beyond 4½ percent, and I wouldn't want to see it stay there for very long given the social problems we have. I am afraid the unemployment rate will continue to creep up if we just go along for a few quarters with growth in output that is in the 1- to 2-percent range or less. I don't think anybody can say how long it is going to take for that process to begin to have a significant impact on prices.

We all hope that we will soon begin to get an impact on wage costs and an impact on prices from the slowdown. We don't know exactly what the timetable will be. But I think the way to play the game at this point is to try to keep the economy growing slowly for a while without going into a recession and hope that the needed adjustments will take place and that the rate of inflation will slow down.

Chairman GRIFFITHS. In this committee we are always putting out cheerful little reports that we can lower the unemployment rate and keep everybody happy and no inflation and so forth and so on. Do you think that is an idle dream?

Mr. SMITH. I don't think you can slow down the inflation we have got now without paying some costs for a while in terms of higher unemployment. What I hope is that several quarters of slow growth will take the inflationary steam out things and that from there we can move back in an orderly way to, say, 4 percent unemployment or something a little under that. If we can avoid the disorderly way in which we got there the last time, I believe we will have less inflation—but not zero inflation—at 4-percent unemployment or a little under the next time around. But there is no guarantee of that. I can't be sure what the inflation rate in a "steady state" the unemployment rate at 4 percent or less will prove to be one that we can live with. For that reason, as I said in my paper and as Arthur Okun has also said, we have to work in other ways than just through fiscal and monetary policy to try to control inflation.

Chairman GRIFFITHS. Would each of the rest of you care to comment? Mr. Meiselman?

Mr. MEISELMAN. First, I quite agree with much of what Warren Smith has just said, but again I think that in order to look at the relationship between inflation and unemployment you have to look at it in the context of a process in which a wide variety of changes take place.

For example, in the last 3 or 4 years there were large numbers of wage contracts that were signed for 2- or 3- or 4-year periods on the presumption that prices would either remain relatively stable or that there might be 1 or 2 or perhaps 2½ percent inflation. It turned out that inflation instead of being in the 1, 2, or 3 percent range was in the 4, 5, and 6 percent range. That meant that the real cost of labor to large numbers of employers was less than bargained for, and the real wages to the employees was correspondingly less than they believed they had bargained for.

When it comes time to renegotiate those contracts the employees will press even harder for wage hikes if only to get back where they were before. If you examine the statistics of the real earnings of factory workers in the United States in the past few years they haven't gone up for many. For many others they have actually gone down because prices have increased more than wages after taxes.

On the other side of the bargaining table, there is also the added incentive for employers who pay higher wages. Given the fact that the labor market has been very, very tight for some years, employers have a great incentive to offer higher wage settlements than before. That is why it seems to me that even if there should be a substantial slowdown in the near term there will be, a the same time, large wage increases resulting from the process of trying to catch up and to undo some of the things that happened in the last couple of years that had not been planned for.

If these events should take place it would not be correct to attribute price increases to a wage-push. These people haven't been pushing on wages and pushing on the price level. Previous changes in the price level caused by poor monetary and fiscal management, Government actions, have been pushing on them.

Now, the same general process is bound to happen in a wide variety of areas where there have been fixed contracts and understandings of one sort or another that are not subject to day by day or month by month revision and renegotiation.

If you look at some of the things that happened in Latin American countries when they have tried to stop inflation abruptly, you see that it often becomes difficult for people to make any contracts because they don't know what to think about the path of future prices. They don't know what they can confidently count on to build into their labor and other contracts. In countries such as Chile or Brazil or Argentina, the changes in real wage rates and real earnings that take place in a year would stagger Americans.

What we have started to do in the United States is to introduce the same kind of climate. I would think that, in a process of slowing down inflation, if the inflation slows down much more rapidly than people had anticipated, then it means that the real cost of hiring people will go up. That would be an incentive to reduce employment.

Chairman GRIFFITHS. Mr. Okun, would you care to comment?

Mr. OKUN. I would simply note that one reason that we are so uncertain about how much of a sacrifice of output, real income, and employment we need to do the job of decelerating prices is that we have never been able to keep our economy in a prosperous state without being overheated. Processes of disinflation have often turned into processes of recession. One of the important benefits that we will get if the present scenario does produce disinflation within the context of prosperity is that we will get a better reading on what the maximum safe temperature is for our economic boiler. In that process, we do have to look to measures to improve our labor markets and measures to make sure that Government policies don't add unnecessarily to costs and prices; in that way maybe over the long run, your dream of very low unemployment rates and of really good price performance can be realized. But it is going to take a long, long time.

Chairman GRIFFITHS. Thank you. I would like to thank all of you. I think from any standpoint this has been the most interesting panel that we have had. I have enjoyed it tremendously.

I have to excuse myself now and Senator Proxmire will take over the questioning.

Senator PROXMIRE (now presiding). I would like to come back again, Dr. Meiselman, I am not sure you answered my question. You say, and I quote:

> Since May there has been essentially no growth in the money supply. In my judgment if the Federal Reserve does not soon reverse itself and increase the stock of money at a rate of at least 2 to 3 percent a year we will have a serious recession in 1972.

Now, most of the witnesses agree with you, at least those who have spoken on it, say this is what we should be thinking about, they did especially the day that it was announced, that unemployment has gone to 4 percent from 3½. But my question is, in view of this overwhelming indication that the situation is going to become more inflationary, and that demand pressures are going to expand sharply, how can you justify easing up anywhere, even in the monetary area, or would you combine this with a more stringent fiscal policy than we now have?

Mr. MEISELMAN. Well, first of all, I would not necessarily accept your premise that inflation will accelerate from now on.

Regarding some of the evidence that you cited, the information regarding plant and equipment expenditures, do not represent a very good predictor of what, in fact, the price level will be in the future. Plant and equipment expenditures tend to lag business conditions, not lead them. The high and rising expenditures are a response to what has gone on before. Typically, at the peak of a business cycle, plant and equipment expenditures are high and continue to rise for some time after the economy is declining.

At least in recent business cycles it would seem that the class of expenditures that tend to lead turns in business conditions are the expenditures of consumers. My impression is that consumer expenditures have not been rising rapidly; also, that various surveys of consumer intentions and of consumer spending are not particularly buoyant.

Senator PROXMIRE. Well, let me follow up then by getting at this monetary problem: In the Banking Committee we have been very concerned about the fact that the monetary restraint just hasn't worked very well where it should work. It has been devastating for housing, it has slowed down the economy slightly but it has just about crucified housing, it did it in 1966 and it is doing it again.

So far as the economy, take the loans by big banks, 60 percent of the biggest banks of the country, industrial and commercial loans have increased 12 percent this year, at exactly the same time when the Federal Reserve Board has been putting the brakes on. What the banks did was to get Euro dollars, what they did was to sell their government obligations, some of them; what they did was to float commercial paper, their holding companies did, and so that the monetary policy didn't work where it should have. It didn't slow down the unsustainable boom in business investment in plant and equipment.

Mr. MEISELMAN. Well, first of all, I think you have to realize that there is a lag between the time that monetary policy changes and the time that its effect is felt in the economy.

Senator PROXMIRE. During that lag the poor old housing takes it on the head but good, devastating.

Mr. MEISELMAN. I quite agree with you that this may happen. In addition in the past several years there have been other things that, as you say, have been picking on housing, among them the one I mapped out in my formal presentation; namely, the sharp increase in Government expenditures.

There is a lag between the time there is a change in monetary policy and the time that it has some effect. It is usually difficult to know exactly which parts of the economy are going to feel the bite, but eventually that bite will be felt. In the aggregate it is starting to surface now.

The period of lag between a change in monetary policy and important aggregate effects themselves are variable. That is precisely the reason large numbers of people do not look with favor on substantial changes in monetary policy.

Senator PROXMIRE. I am one of them. I think we should follow a policy of expanding the money supply at a slow rate and again I just say it is very, very hard to accept any notion that this is the time for easing restraints.

Mr. MEISELMAN. If you have a monetary policy that has produced an 8-percent increase in the money supply and shortly after that go to zero, it is excessive restraint. If continued long enough it is bound to pull the whole economy down. There will be some sectors of the economy that will feel the brunt of the decline more than others.

Senator PROXMIRE. Let me ask you, Mr. Smith, we were all shocked and surprised at the suddenness of the increase in the unemployment rate from 3½ to 4 percent, very, very sharp increase, with the expectation that it is going to continue. I was surprised that the morning that after it was released we had Treasury Secretary Kennedy and Budget Director Mayo before this committee, and they told this committee that they had no plans to meet, no substantial plans, at least to meet, a continued unemployment problem. If it got worse they just said "Well, there is nothing we can do about it. There is nothing we can do about it." It seems they did say in all fairness to them, they would, of course end the President's restriction on Government construction, which isn't very much, $300 million a year annual rate at the present time, that they would step up manpower training programs, which doesn't really provide a great deal of increase in jobs under those circumstances, it does not provide a job, it does provide some training; what kind of action can we take in this very tough situation we seem to be moving into?

Supposing we have this kind of a situation: Supposing we have 5 percent, 4½ to 5, to 5½ percent unemployment, a continuous, a continual inflation, prices rising, at least consumer prices rising, what can we do under these circumstances that is likely to be most effective?

They say, you say in your papers, ease the situation for the unemployed. Well, of course, that is inflationary, too. We may have a real family assistance program, the kind that is suggested in the House with not $1,600 as a floor but $3,200, Congress might do something like that, that has its inflationary implications. So what can we do? I think it is the toughest economic problem there is. I don't expect you to give me a complete answer but what can you suggest?

Mr. SMITH. We can be generous about unemployment compensation for people thrown out of employment in order to cushion the impact of unemployment on peoples' living standards. But if it turns out that we really can't achieve an unemployment level that we are willing to accept—if the cost of controlling inflation in terms of increased unemployment turns out to be bigger than any of us think—then we may have to take another look at the situation. At some point we may have to consider accepting more inflation or look at some things like direct controls over wages and prices which are extremely unpalatable to us. That is, there comes some point at which the cost of maintaining a stable price level in terms of unemployment gets so great that you have to begin to look at some extremely unpalatable alternatives: accepting more inflation and trying to live with it, or using some methods to control it that we have hitherto essentially ruled out.

Senator PROXMIRE. How much economic sense is there in this notion: That there are certain Federal expenditures that are peculiarly inflationary. I am talking about Federal expenditures that don't meet an economic need, military expenditures, space expenditures, expenditures of this kind. Obviously if you are spending money on housing you're spending money on it has an inflationary effect but you are providing more housing, and that increases the employment. Timing isn't very good on housing, it is probably a bad example. If you are training people you have an increase in the supply of skilled labor presumably. This has a deflationary effect although the expenditures to train them have an inflationary effect. So it would seem to me that the extent to which we can shift our Federal expenditures out of this very inflationary area of military expenditures, if we can do that consistent with our national commitments, and so forth, and cut the space expenditures which it seems to me are almost completely inflationary we can improve the situation.

Mr. SMITH. The only difference I can see between different kinds of Federal expenditures in that regard is that some Federal expenditures add to the productive capacity of the economy and expand the supply.

Senator PROXMIRE. Right.

Mr. SMITH. And, therefore, may be less inflationary than other kinds. But the trouble is that the expansion in productive capacity that comes from various kinds of expenditures comes very slowly—the increase in productive capacity generated by the dollar of expenditures in the current period is like 10 cents or 5 cents, and the increase on the demand side is $1.

Senator PROXMIRE. Would this be true of manpower training?

Mr. SMITH. I think so, yes.

Senator PROXMIRE. Even though you get a 6-week, 2-month program. You take people who have no skill and you give them at least enough training so they can get a job and become productive.

Mr. SMITH. Well, it will cost you several thousand dollars to train somebody and it is going to be some time before that man's net contribution to output will be equal to the cost that you incurred in training him.

Senator PROXMIRE. Can any of you gentlemen see any path we can follow other than you have already indicated in your prepared statements to meet this kind of a situation of growing unemployment with a continuation of unacceptable inflation. Mr. Okun?

Mr. OKUN. The evidence of the past suggests that we really have no excess demand reasons for inflationary pressures in a labor market with as much as 4½ percent unemployment. If it took 5 or 5½ percent unemployment to turn things around, I would say there is something structurally wrong somewhere and that one would have to focus much more strongly on the structural areas.

Senator PROXMIRE. We, in the fifties it seemed to take something like that. It really turned it around, didn't it? We had, 1958 we went to 6.8 percent for the whole year.

Mr. OKUN. Yes, but that is not the way I read the history. It is true that we fell off the track and went up to nearly 7 percent unemployment. I think the process of deceleration of prices was already in motion, and that we could well have licked the inflation without having the recession. We got the recession, but that doesn't prove that we needed the recession in order to cure the unemployment. We got the recession because we made some very bad decisions about fiscal and monetary policy in that period. We have not done a good job of managing prosperity. That is why in so many cases in the past that the only way we got out of inflation was through a recessionary period.

Maybe we ought to look at a couple of bright spots. In 1951 and 1952 there was a very significant slowdown in prices without a recession.

Senator PROXMIRE. Korean war.

Mr. OKUN. During the Korean war.

Senator PROXMIRE. We had controls.

Mr. OKUN. The controls didn't seem to be doing a thing for us at that time. The controls may have slowed down——

Senator PROXMIRE. I would like to see controls that as you say wouldn't do a thing for us but would prevent the kind of inflation we are having as it did in the Korean war period.

Mr. OKUN. I can't imagine any set of controls that would do anything productive for us or that would help the objectives we now have.

Late in 1966 and the first half of 1967 represent a period in which we had a very marked improvement in the price and wage record with a slow down rather than a recession.

Senator PROXMIRE. Well now, right there, I think that is an important period, because there seems to be a difference between economists who testified here, and you are stating it very well right now, and the Federal Reserve Board and others who seem to be very unhappy about that period, they all feel as if they let up too soon. If they had followed through at that time and held their restraint a little longer that perhaps we could have prevented the kind of inflation we are having now. Some people feel if we passed a tax increase at that time, slowed it down to that extent, we would have been better off.

Mr. OKUN. I have no doubt there could have been a monetary policy in 1967 that would have done the job of restraint. That would have made a tax increase unnecessary and would have prevented another acceleration in prices.

My guess is that such a monetary policy would have kept homebuilding at levels of maybe half a million or at most 700,000 starts for the last 2 or 3 years. It was really a decision about social priorities on the composition of output that made it seem so important to shift off the extreme monetary brakes into the fiscal area. At that time, as you will recall with me, there wasn't compelling evidence in the spring and summer of 1967 that a new boom was emerging. There was compelling evidence that homebuilding was coming back.

If the Federal Reserve had kept the economy in check with a restrictive monetary policy, not only would this have had terribly adverse consequences on homebuilding and on real interest rates, but it also would have made it impossible ever to convince the Congress and the American public of the need to get fiscal policy back on track. We can always put down the monetary brakes hard enough to offset fiscal stimulus but we would pay a high price for it in terms of other objectives that you and I consider to be important.

Senator PROXMIRE. At any rate, I take it that you and Mr. Smith and, perhaps Mr. Meiselman, I am not sure, would feel that in the event unemployment got to a level of 5 percent that we should be prepared to act to prevent it from going higher, positive Federal action providing whatever jobs are necessary to see that it will not go higher. Is that correct?

Mr. OKUN. That would be a minimum statement of my position. I think I would be quite concerned if it continued to move up sharply from current levels.

Senator PROXMIRE. Would you say it would be sensible for an administration to be prepared in the event this happened to act?

Mr. OKUN. Yes.

And the first action that would seem to be in order would be the general reduction of monetary restraint. To put it bluntly, I don't think we should kid ourselves that any amount of manpower training would really be an effective substitute.

Senator PROXMIRE. Would you also provide for a program of jobs, if necessary, if monetary restraint didn't do it, if this notion of Keynes or Martin said you can't push a string when we had a recession.

Mr. OKUN. This would hardly be pushing a string.

Senator PROXMIRE. Not now, but the idea being if the unemployment continues to snowball and you get a psychology that is negative, conceivably you might have a situation where low interest rates which didn't do much in other periods in the last years but in this period might work, but would you say it would be sensible to have a program to have jobs for those people unemployed if it gets a level of 5 percent?

Mr. OKUN. That would be a good contingency plan. I would rather put a low probability in a 180° turn in such private psychology at this time. As you point out, all the pressures are more buoyant demands, and I would hope we would swing away from a policy of restraint before it turns——

Senator PROXMIRE. All I am talking about is you have contingency plans available as I think it is one of the elements of putting you in a stronger position of making a fiscal fight against inflation.

Mr. OKUN. I would agree.

Senator PROXMIRE. Would you agree?

Mr. MEISELMAN. I would like to comment on that, if I may. I think it would be very sad if we waited until unemployment reached 5 percent before we did anything to change monetary policy.

Senator PROXMIRE. Yes; we agree on that.

Mr. MEISELMAN. Because of the fact that what we would have done by that time to produce that effect will tend to drive unemployment even higher before a turnaround of policy takes effect. More stop-go! I think now is the time to prevent unemployment from rising so drastically. Secondly——

Senator PROXMIRE. I don't think Mr. Okun or I or Mr. Smith would disagree with you on that. All we are saying is in the event unemployment becomes catastrophic, we are prepared to do other things besides monetary policy.

Mr. MEISELMAN. Correct.

But as to what those things are, I would rather reserve judgment until I see what the prescriptions happen to be. Very often in the past, things have been done on the basis of short run problems that seem to get entrenched into law and then live on to plague us for many years and themselves become long-run problems.

Senator PROXMIRE. Well, contingency plans can be a number of things. Maybe you would favor a tax cut, is that what you had in mind?

Mr. MEISELMAN. I think that a tax cut might be called for under some circumstances.

I wouldn't depend on it to achieve a great deal in the short run, but perhaps it wouldn't do any harm to try.

I think we should try to get tax cuts every year as a systematic matter but that is largely a structural matter and not primarily a stabilization matter.

I would also like to comment on some of the discussion about the relationship between inflation and unemployment.

Different investigators have found different relationships between inflation and employment and many report no association at all. There is a wide variety of estimates available and you can take your pick among them. One of the reasons for this confusion is that measuring unemployment is very hazardous. It is the difference between two sums which themselves are very difficult to measure. The one is, of course, the labor force, and it is hard to know who is in the labor force. The second is the number of people who are concurrently employed, and that is very difficult to define, let alone measure.

Senator PROXMIRE. It is not quite that haphazard though, is it? After all more people are queried about this unemployment figure than almost anything we have going. We have what, 50,000 households polled now. Compared with any of the other polls it should be quite accurate.

Mr. MEISELMAN. But it is still a very hazardous number, not only in terms——

Senator PROXMIRE. But the unemployment index poll taker goes to the household and asks "Are you working or are you not working" directly. It is not one of those things where you just take an aggregate figure of the work force and then substract from it those who are at work.

Mr. MEISELMAN. I understand. There is a lot more that goes into making the estimate than that. But the definition of the work force and specification of the labor force and the specification of who, in fact, is employed, all depends on a wide range of economic and social factors which themselves change from time to time.

Senator PROXMIRE. The last change we made statistically——

Mr. MEISELMAN. Pardon me?

Senator PROXMIRE. The last statistical change we made would tend to tighten up. They increased the age of those they consider out of work.

Mr. MEISELMAN. Right.

This is an important statistic and there have been attempts to make great improvement in this not only in terms of the accuracy of the measurement of unemployment but also in terms of the analysis of what the figure itself means. I merely want to point out that the accuracy of the number, given its importance, leaves a great deal to be desired. Maybe that is the best we can do. I do wish to emphasize that the determinants of that number depend on a wide range of economic and social factors which themselves are subject to a great deal of change from time to time, not the least of which is the state of inflation expectations.

Again, if you look at what happens in some Latin American countries, you can find inflation of 40 percent, and unemployment of 10 to 15 percent. You can find inflation of 2 percent accompanied by essentially no unemployment. The relationship (within) individual countries and among countries varies drastically from time to time. The Phillips curve is more of a presumption of fact than a stable empirical regularity.

Senator PROXMIRE. Yes, but Mr. Meiselman, after all there is such an enormous difference between this country and Peru or this country and Colombia just as there is a grant difference in the measurement of statistics, unemployment statistics, between this country and Europe, and also in the makeup of the work force between this country and Europe.

Mr. MEISELMAN. But not necessarily in the underlying economic relationships.

Senator PROXMIRE. But wouldn't you agree over the years there has been, unfortunately, we have had a fairly stable relationship when unemployment gets below 4 percent, unfortunately the price level begins to rise rather sharply, and when it is above 4 percent we sometimes get it but much less frequently.

Mr. MEISELMAN. Again, I think you have to look at it in terms of the dynamic context of the period. If you are looking at the postwar period when we have had a secular upward drift of prices what you are doing is superimposing a business cycle on the upward drift. If you did the same thing by looking at the price and unemployment experience of the earlier U.S. history, say, from the time after the Civil War down to the turn of the century, you would not find anything like that. What you would find is that there was a downward secular drift of prices, and that you would get the outlines of different apparent relationships of employment, prices, and wages than we now seem to have over the cycle. For example, money wage rates often remained the same for long periods of time. People took productivity gain in the forms of lower prices.

Senator PROXMIRE. Well, let me just ask one other question, and incidentally, you have a great deal in your paper with which I warmly agree, but I would like to ask you if it isn't true, doesn't seem to be true, Mr. Meiselman, that the 1968 tax increase is now having a slowdown effect. You said it had little or no effect on an inflation in the period right after it was enacted, almost 12 months after it was enacted, more than 12 months, it is now 15 or 16 months, and it seems to be true, but right now it does seem the underlying forces are slowing down and unemployment is increasing to some extent. There is a slowdown in production, a slowdown in some other areas, a slowdown in the rate of increase at least. Would you deny that?

Mr. MEISELMAN. Well, I wouldn't deny the fact that there are various slowdowns going on, but the fact of the matter is that we have had two things working in the same direction at least since May, so that it may be difficult to attribute the slowdown to the change in taxes rather than to the change in monetary policy.

I can point to the fact that until there was a drastic turn in monetary policy during the spring, long after the time that the surtax was enacted, there was very little, if anything, that we could point to in terms of the effects of the surtax on either aggregate spending or in interest rates. Also, personal saving fell by virtually the same amount as income tax collections rose due to the surtax.

Since May it is rather difficult to separate the two effects. Perhaps later on we might be able to do by the use of more sophisticated statistical tools.

Senator PROXMIRE. Mr. Smith?

Mr. SMITH. I would just like to point out that the rate of growth of real GNP has slowed down noticeably in every single quarter since the second quarter of last year. I am not trying to attribute all that to the tax increase.

Mr. MEISELMAN. I would attribute most of that to the fact that we largely ran out of unemployed workers and bumped up against the constraint of the total labor force in this country. The fact we haven't grown so rapidly isn't very commendable but at the same time I believe it is largely attributable to the fact that there were just so few additional people to go to work, given the barriers in the labor market. That, itself, has nothing to do with monetary policy or fiscal policy. It happens to do with the number of hands available to work in this country.

Senator PROXMIRE. Now wait a minute, you say hands available to work. We still have, we have today, 3 million out of work. We haven't been below 3 percent during this period. In the Korean period we were down well below 3 percent at one point—not well below, but below it. So to say we are right up against the limit, our work force is at the limit. I just wonder if that is the reason why the GNP has slowed down. After all hours of work have been reduced, have slowed down some.

Mr. OKUN. If I may——

Senator PROXMIRE. Yes.

Mr. OKUN. It is remarkable that we banged into that ceiling just at the middle of 1968 when it just so happened that some fiscal policy measures were being taken. You will notice that in the first half of 1968 our real growth was advancing at a 6 percent rate, so that limit on capacity wasn't very severe at that time. In the second half of the year, as Mr. Smith pointed out, we began to get a very noticeable deceleration not only in real growth but also in the current price advances of the economy—from about a $43 billion first half to a $32 billion second half.

Senator PROXMIRE. You see I opposed the surtax, I voted against it, I spoke against it, but I do thing that the—it is hard to deny the fact that absent the surtax you wouldn't have had even higher interest rates, absent the surtax you wouldn't have had other problems that would be worse than they are at the present time economically.

Mr. MEISELMAN. Well, I don't think——

Senator PROXMIRE. I will agree we didn't have much evidence the surtax was helping until monetary policy became tight, too. But I think if we had this $10, $11 billion a year additional in the economy I doubt all of it would have been saved.

Mr. MEISELMAN. The principal effect on interest rates should have been felt within the first 6 months. There was little to see but still higher rates.

Senator PROXMIRE. The principal effect on what?

Mr. MEISELMAN. On interest rates, largely because of the reduction in the number of securities that the Treasury would have to issue, and the resulting reduction of pressure on the capital markets.

Senator PROXMIRE. I am sorry, I am afraid Mr. Smith was cut off.

Mr. SMITH. I just wanted to say the employment ceiling is a little hard to buy when you recognize the fact that total employment has increased on the order of 2.3 million from August last year to August this year. We didn't run into an employment ceiling where we didn't have any more people to employ. One of the reasons why, as I pointed out before, the slowdown in growth has not gone through into a slowdown in prices is because employment kept right on picking up while real output growth slowed down.

Senator PROXMIRE. Well, gentlemen, I want to thank all of you. This has been most spirited and interesting. As I say, Mr. Meiselman, I didn't mean to indicate I didn't have great regard for your fine paper and many of the conclusions in it. I just wanted to ask you about that particular point which does seem to be one I would like to get some answers on. Thank you, gentlemen, very, very much.

Tomorrow the subcommittee will reconvene in this room to hear three experts on medical costs. The committee will stand in recess until then.

(Whereupon, at 12:25 p.m., the hearing was recessed, to reconvene, Tuesday, October 14, 1969, at 10 a.m.)

THE FEDERAL BUDGET, INFLATION, AND FULL EMPLOYMENT

TUESDAY, OCTOBER 14, 1969

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON FISCAL POLICY,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Subcommittee on Fiscal Policy met, pursuant to recess, at 10 a.m., in room G-308, New Senate Office Building, Hon. Martha W. Griffiths (chairman of the subcommittee) presiding.

Present: Representative Griffiths.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Loughlin F. McHugh and Courtenay Slater, economists; and Douglas C. Frechtling, economist for minority.

Chairman GRIFFITHS. The Subcommittee on Fiscal Policy will come to order.

This morning the subcommittee turns its attention to medical costs, a field in which inflation has been particularly evident in recent years. Inflation in this field is of great importance not merely to individual families but also to the Congress in view of the substantial public programs such as medicare and medicaid. Hospital costs have skyrocketed under the impact of rapidly rising costs and prices.

We are very happy this morning to hear from three outstanding experts, Mr. Rashi Fein, professor of the economics of medicine at Harvard Medical School and also a member of the faculty of the John Fitzgerald Kennedy School of Government, Harvard University; Mr. Arthur E. Hess, Deputy Commissioner, Social Security Administration, Department of Health, Education, and Welfare; and Dr. John H. Knowles, general director of the Massachusetts General Hospital.

I would like to say to you gentlemen how grateful I am to you for being with us this morning. We will hear from each of you in an opening statement and then we will proceed with questions.

Professor Fein, will you please lead off?

STATEMENT OF RASHI FEIN, PROFESSOR OF THE ECONOMICS OF MEDICINE, HARVARD MEDICAL SCHOOL

Mr. FEIN. Madame Chairman and members of the subcommittee. My name is Rashi Fein. I am an economist and hold appointments as professor of the economics of medicine at the Harvard Medical School and as a member of the faculty of the John Fitzgerald Kennedy School of Government, Harvard University. I welcome this opportunity to appear before you and discuss the implications of inflation in medical care prices.

I

The issue of inflation and medical care prices is a most important one both because of the importance of medical care to all Americans, and because of the size of the price increases.

In the 3 years ending June 1969 medical care prices rose by 22.2 percent. This increase was almost twice that of the Consumer Price Index (CPI) which—excluding medical care—rose by 12.4 percent. Much of the differential was due to behavior in fiscal 1967, but even in the last year, fiscal 1969, medical care prices have risen by 7.5 percent compared to the rise in the CPI (excluding medical care) of 5.4 percent—one almost wants to say "only" 5.4 but one hesitates.

These are not insignificant increases and they cannot be ignored, particularly when we consider the nature of medical care itself. Medical care has a weight of 6 percent in the overall CPI. Most Americans include it in their "market basket" of purchases and all Americans fear that they will be called upon to spend—on an involuntary basis—a high proportion of their income for medical care. Furthermore, there is significant variation around that 6 percent weight. Some Americans spend much much more than 6 or 10 or 15 percent of their income on medical care.

All Americans fear that they may have to do so.

The fear of being sick is great. The fear of losing income when one is sick is overwhelming. To those fears are added the prospects of paying hospital daily service charges that have risen by 55 percent in the last 3 years and of paying physician fees that have risen by 22 percent.

That there is cause for alarm is evident. I shall not use the brief time available to me to document the inflationary pressures. This subcommittee is fully aware of them and these hearings are evidence of that awareness and concern.

Let me instead address myself to what I see as the reasons for the rapid inflation and the policy implications that flow from my observations.

II

The conventional wisdom offers a relatively simple explanation for the inflationary pressures in the medical arena. The explanation is simple and traditional. It assumes certain market conditions. In effect it says that the culprits are medicare and medicaid and that the process of inflation is due to excess demand. Medicare-medicaid, so the explanation runs, increased demand for medical care and demand pushing against a nonelastic supply—a supply that could not expand rapidly—resulted in price increases. I believe that I find demand and supply curves as esthetically pleasing as the next person, but the question is not one of esthetics but of analysis. I believe that the analysis is faulty.

It is true that the sharpest increases in medical care prices occurred in the first year of medicare-medicaid. It is true that one of the purposes of these programs was to expand demand. It may be true that supply did not respond as rapidly as one would like. All of this, however, does not necessarily mean that hospitals and physicians raised their prices as a direct consequence of the shift in demand and in order to fill the required rationing function. Prices did not increase in order to equilibrate supply and demand, the normal function of price increase.

This committee does not need elaboration of the concept of administered prices. For over a decade you have been concerned with the problem. I believe that that kind of an issue is involved here.

Medicare and medicaid did at least three things: (1) they expanded demand; (2) they put the Government in the business of payment—in part in the business of signing blank checks; (3) they create a climate of opinion, an even greater awareness on the part of the health professions of the medical marketplace.

Some part of the inflation in physician fees occurred, because physicians became more and more price conscious. Some occurred because physicians believe that prices would eventually be "frozen" and they wanted to raise fees before the freeze. Some occurred because physicians wanted to maintain their share of the health dollar—and with hospital prices zooming they had to increase their prices significantly to keep their "share of the pie." Some occurred because physician fees do not move in small amounts, nickels and dimes, but in dollar amounts—which on a per visit basis means large percentages. Much occurred because physicians can be—and were—fairly arbitrary in their setting of fees. The medical care market is an unusual one: It is a market with price discrimination, a market characterized by diversity in the product, by difficulties in measuring quality, by consumer ignorance and inability to judge performance, by physician ability to stimulate and expand demand, by lack of competition, and by "ethics" that restrict competitive behavior. What I am saying is that physicians can set their fees—that these fees do not arise in the inexorable way described by the law of supply and demand. Given a new climate of opinion regarding economic affairs and prices and a new financing pattern involving underwriting by the Federal Government, fees rose.

The case with hospitals is somewhat different. Here, in part, we have the catching up process for hospital employees, that underpaid group who previously were subsidizing the sick patient. The increase in their incomes, in no small measure the result of medicare and medicaid *financing*, is not to be deplored. Surely none of us would want to fight inflation by recommending that the underpaid hospital employee bear the cost of the battle. But the rise in hospital prices is not to be explained only by the increase in wages and salaries. Part of the rise is explained by the expansion of demand, an expansion that entailed higher costs. Yet, the increase was also added to by the pattern of financing, by the lack of a spur to efficiency and by the general underwriting of costs. The latter, it should be clear, is not an excess demand explanation but one which relies on the fact that producers were price conscious and that they could pass costs on to someone. The Government stood ready to pay the bill.

Could we really have expected other behavior? After a bruising political battle to enact medicare and medicaid, Government extended a hand of friendship to the medical community—and extended it in a most friendly way, by signing a blank check. And the medical community was gracious and accepted the offer. And prices—discretionary prices—rose. Did we really expect to change the whole financial structure and have prices stay the same? Pediatric care—not a service that medicare patients require and that the relatively few medicaid dollars finance—rose by 22 percent in the 3 years ending June 1969. How is this explained by excess demand? Is not the more proper explanation that the pediatrician joined his colleagues in raising fees because he, as they, could do so?

There was, after all, a whole history of behavior under Blue Cross and Blue Shield Insurance, under third party payment—a history of fee increases paid for by insurance companies—and ultimately by the consumer—because the physician and others could more readily raise their fees to that impersonal thing called an insurance company than to the individual patient. But that history was forgotten or ignored.

Let me make clear that I am not faulting the Social Security Administration or the Medical Services Administration of HEW. This is not a matter of graft, collusion, cheating. That is not the issue. HEW's hands were tied and HEW had little power and control. For the Congress, in line with our traditions, had designed a system with little control, a system which was not "run from Washington," a system with noninterference as a slogan. We wanted it both ways: little control and low prices. We batted .500 and are now all paying the price for the one we missed. But that is history. The time has come to recognize that today responsible action demands intervention. It is this matter that I now propose to turn to.

III

If the inflation is not the simple result of excess demand, if it is the result of discretionary price behavior in a very unusual market, what are the consequences?

In a letter to the Wall Street Journal published on September 2, Professor Galbraith argued for a mechanism of price-wage restraint in various sectors of the economy, but specifically *excluded* medical care. He considered this a shortage area, one in which "higher wages are necessary if resources are to be drawn into this industry—if supply is to keep pace with demand." I would disagree. While favoring higher wages for some workers, I believe that the increase in prices reflect many other factors as well. Nor do I think that the underwriting of inefficiency is desirable. This is a marketplace in which we should intervene. We simply have to say; enough! Let's negotiate prices. Let's try to stimulate efficiency. Let's provide incentives to economy. But let's not stand passively by expecting that, even in the absence of action, things will get better. There is no reason to expect that they will. Given the new patterns of financing and the market they operate in, prices will continue to climb unless we, the public, intervene. And the public does not mean the individual who is at a disadvantage vis-a-vis the physician. Nor is there evidence that Blue Cross-Blue Shield are prepared to do battle. It has to be Government. I hate to do this to Arthur Hess. I hate to hand him this headache. But I see little choice. Things have gotten out of hand.

Note here the importance of the explanation for inflationary behavior. If the traditional model of supply-demand determination were correct, the imposition of fee schedules and other controls would reduce the supply of services offered: at lower prices physicians would work less hard. This is certainly not a desired outcome. But under the model that I present it is possible for the opposite to occur. Confronted by lower prices, physicians may work harder—though, presumably enjoying it less. I would only offer this as a possibility. Yet it is important to note that this is the finding of Prof. Martin Feldstein of Harvard University. Professor Feldstein has completed an econometric analysis of physician fees. He states:

> The nation's inability to deal successfully with the problems of the health care sector, particularly rising costs and the maldistribution of health services, reflects in part an inadequate understanding of its economic behavior. The simplest models of traditional economic theory are inappropriate for this task and common sense conclusions based on that theory are likely to be misleading. He concludes that . . . physicians have discretionary power to vary both their prices and the quantity of services which they supply . . . Government policies to restrain price inflation may increase excess demand but will not decrease and may even increase the quantity of physicians' services provided.[1]

IV

But let me make clear that with all the wisdom in the world and with all the good will in the world and with all the ability that our civil servants possess, things will not improve as much as we should like. In the short run there are only limited possibilities for improvement, particularly in hospital prices. But what of the longer run?

Let me make clear that the problem of medical care prices is not only one of inflation. Medical care is expensive and it will continue to be expensive. Two consequences of that observation need to be focused on. Let me first discuss the kinds of things we must do to contain costs—things that take longer to accomplish than the sorts of controls necessary to restrain inflation. I will then conclude with some remarks concerning the financing of medical care.

The fact is that there are two aspects to the inflation in medical care costs. On the one hand there is the price of particular services: a day in the hospital, a visit to the physician, a particular procedure. These prices are rising rapidly. Even if the rate of inflation is sharply cut, prices will remain high. But the *cost* of medical care that should concern the citizens and society is only partly a function of the price of a hospital day or of a physician's visit. The cost to the citizen is the price of the service times the number of services purchased, the price of a hospital day times the quantity of hospital days required, of a physician visit times the number of physician services utilized. Ways must be found not only to reduce the price of the service but also of the quantity of the service utilized. We must simply reduce unnecessary hospital days. We must substitute less costly personnnel for physicians.

The difficulty, of course, is that there are few alternatives in today's medical care system to the hospital bed and to the physician. Confronted by an inadequate number of alternative resources, persons end up using that which is available, even if it is more than they require. If the choice is between a hospital bed and a bed at home, the former offering more than is required, the latter less than is necessary, the choice is clear: the hospital bed will be filled. If the choice is between services from a physician and no services, the choice once again is clear: the physician will be sought. And the costs of medical care will be unnecessarily high.

[1] Feldstein, Martin S., "The Rising Price of Physicians' Services," 1969, pp. 1–37.

There is a structural problem. The Nation needs more resources appropriate to the tasks to be carried out. When such resources are unavailable, waste will ensue and costs will be inflated. If hospital beds must be used because ambulatory care facilities are not sufficient, the consumer will pay the price of inefficiency. If a shortage of paramedical personnel forces the highly trained physician to deliver routine services that do not require his expert training and experience, the consumer will pay the price. Furthermore, in addition to forcing costs up by requiring payment for unnecessary services, such inefficiency contributes to direct inflationary pressures. The limited resources available, the limited number of hospital beds and physicians, must bear the full brunt of the demand pressure for medical care.

Imaginative new training programs and uses of manpower have proven themselves. Such programs need to be expanded. We need to develop comprehensive ambulatory care systems to implement group practice and primary care. We need to intervene in the system of delivery in order to rationalize the system.

Additionally, there is another structural problem. We have excess demand in some areas and underutilization in others. Voluntary hospitals are full while some Government hospitals are underutilized, some physicians in some specialties or geographic locations are overworked, while others are not fully occupied.

What I am saying is that there is a highly disorganized, inefficient, wasteful, delivery nonsystem. It is not that the hospital is inefficient. It is, but even worse is that it is not linked into other parts of the medical-care spectrum and, therefore, is misused. And so on and so forth, throughout the nonsystem. This must be changed and Government must be the force that stimulates change.

Government has the responsibility to do so. It has said that "medical care is a right." It must make that right meaningful. It must make certain the right can be exercised. And that will require intervention into the system.

V

Finally let me say that even in the best of all worlds, even in the long run, medical care will remain expensive. How will the people, and not just the poor, pay for the care. How will the people—and not just the poor—pay for the care? How will we finance medical services? For even when inefficiency and waste are eliminated, even when productivity is increased, even when the medical care delivery system is reorganized and rationalized—medical care, because of the nature of the product, will not be cheap. How will we finance the purchase of an expensive product that we have said is a right?

I submit it is time for national health insurance.

It is time for a system that pays for the medical care of *all* Americans without requiring eligibility examinations, means tests, special vouchers, cards, and certification. It is time to finance such a system of health insurance through a tax mechanism that is related to ability to pay.

I wish we had the time to discuss fully the nature of such a system and to explore in detail the economic criteria that such a financing program should meet. I do believe that because of the economic criteria (involving equity, for example) the Joint Economic Committee should hold hearings that would help develop a framework and a coherent set of conditions that other committees of the Congress might consider as they develop specific legislation.

There are a number of ways that such a program can be financed. Each of them entails certain advantages and disadvantages. One could use the progressive tax structure to finance a national health insurance program, one could proceed via tax credits—of course with payments to those whose taxes are not high enough to receive the full benefit of the credit—if you will, a kind of negative income tax for health, or one could use the social security approach. I would argue that there is no generic "best" approach, that what one favors depends upon the details of the program. One can write a bad tax credit scheme, one can write a bad social insurance approach. The criteria by which "bad" and "good" are judged are vital.

Let me be slightly more specific for only a brief moment. As some of the persons in this room are aware, I have put forwad a tax credit proposal which I feel has merit. It meets certain equity considerations because the financing mechanism takes into account family income and because persons of low income pay a smaller percentage of their income for the health insurance coverage—for example, the credit declines from 100 percent to 10 percent as income rises. Yet I would be the first to agree that the proposal has some shortcomings.

A number of these shortcomings could be taken account of by adopting a social insurance approach. Furthermore, the social insurance mechanism and the Social Security Administration (SSA) have a well-deserved acceptability on the American scene. The American public understands and trusts SSA—and they should. But were we to move toward a social security approach, we should recognize the importance of equity and of progressivity and regressivity. To simply add a few percentage points to existing social security payments would be most regrettable. Social security taxes are already far too high at low incomes and when combined with personal income tax cuts represent an undesirable shift from a progressive to a regressive tax structure. In any new program we should involve a Federal contribution, and we should gear the tax schedule to income—with a zero or low rate for the first $3,000 of income, for example, and higher rates as income rises. Of course, what I am saying is that we join the advantages of the progressive income tax structure to that of the social insurance approach. This approach I believe is required and is justified. The present social security mechanism is regressive on the payment side, but this is mitigated by the fact that it is progressive on the benefit side. Health insurance, however, should be a standard package for all. Since, therefore, there would be no progressivity in benefits, there should be no regressivity (or even proportionality) in payments.

This is not the time to develop these matters in detail. I would hope, however, that those interested in the issues would develop the criteria by which we could judge whether the particular program meets our objectives: a system that pays for the medical care of all Americans in an equitable manner.

There does remain one final point on national health insurance. It is difficult to move toward it in one great leap. The budgetary implications may be too large for the Congress to accept, given other national priorities, and the supply constraints on the delivery system may be too large. There is an acceptable alternative. Let us begin with children (say, ages 0 to 18) and let us say that in each succeeding year we will expand age coverage by 5 years so that in a period of about a decade we would cover the population up to age 65. This phasing would enable us to spread the budgetary impact and the supply impact, and would shift more dollars to children and youth, in itself desirable.

Nor is this unrelated to my discussions of the sources of inflation. For, in the inflation is not induced by excess demand, one can reject the argument that we dare not adopt any such program because of the inflationary consequences. I must confess, I would not buy that particular argument in any case for my experience gives me little confidence that as a nation we would, in fact, expand supply in anticipation of future demand legislation. This Nation does not practice preventive medicine or preventive political science. It respond to crisis situations. If we enact legislation to finance more medical care—then, and perhaps only then, will we respond with supply legislation (another reason for a phasing-in process that doesn't create a crisis under which we collapse, but does keep the pressure on). I believe this is the time to keep that pressure high.

VI

Briefly then, I have argued: (1) Yes, we have inflation—but it is not entirely due to the growth in demand; (2) it can be controlled, in part, by direct intervention; (3) even so prices will remain high and we must restructure the medical care delivery system to be more efficient and to be more of an integrated system; (4) but, even with all the "savings," we will still have a financing problem that can be met only by national health insurance. The development of specific proposals is called for and one should not at this juncture be wedded to a particular mechanism but to the objectives.

I welcome the opportunity to answer any questions you may have. I would answer them in the context of a recognition that Government having stated medical care is a right, now has the responsibility—which it cannot shirk—to do whatever is required to make that right a reality.

Chairman GRIFFITHS. Thank you very much.

Mr. Hess?

STATEMENT OF ARTHUR E. HESS, DEPUTY COMMISSIONER OF SOCIAL SECURITY

Mr. HESS. Madam Chairman, thank you for the invitation to be here today. I am speaking from the point of view of one who has an interest in public programs that finance the purchase of personal health care services.

Having checked my prepared testimony against that which Dr. Fein just gave, and which Dr. Knowles is going to give I am going to skip lightly over the data and the analysis in the interest of time because I think that we all generally agree on the phenomena that we are analyzing today.

Certainly the health care industry is one of the largest and fastest growing in the entire economy and expenditures for medical care have just, according to our very recent estimates, reached the $60 billion mark in the last fiscal year. I have attached a table which has these latest data, and I also am offering a small chart book, "The Size and Shape of the Medical Care Dollar," which is only current up to 1968 but which is being updated and will be available very shortly. If you would like, Madam Chairman, I would offer these for the record and in any event I would like to put in my entire statement.

Chairman GRIFFITHS. Thank you, your prepared statement will be placed in the record following your testimony and additional submissions will follow the proceedings as an appendix to today's session.

(See appendix, p. 250, for additional submissions by Mr. Hess.)

Mr. HESS. As we all know for almost two decades medical prices have been increasing faster than consumer prices generally, and this, as Dr. Fein has indicated, has become more pronounced in the past 3 years. The following are some of the legitimate questions that should be asked:

Are we receiving more and better services for the increasing health outlays?

Are rising prices for medical care eating up the growing expenditures?

What impact have the recent large public programs of medicare and medicaid had on medical prices, in particular, and, in general, on the organization and delivery of health care in the United States?

Are there recognized deficiencies in the health care system?

Can efficiency and effectiveness in the health industry be improved?

What is now being done to moderate rising health costs to insure that the Nation gets more for its health dollar?

What further steps are necessary in this area?

The answers are obviously not simple, and time permits only sketchy exploration of these issues.

I would cite only a word about the factors affecting increases in medical care expenditures.

In the 19-year period since fiscal 1950, personal health care expenditures—omitting research, construction, and the enviornmental activities—rose from $10 to $52 billion. Of this a $42 billion rise in personal health care expenditures, about half or $21.3 billion can be attributed to the increase in prices. I note that there are some differences in the proportions and the figures I am using and the ones that Dr. Knowles has, and we will just have to see afterward if they are entirely attributable to the fact that mine are slightly later than his. But the point is that about half of this great increase in health care expenditures—which is also reflected in an approximately commensurate increase in the proportion of GNP that health care expenditures reflect—can be attributed to increases in prices, a good part of which reflect wage costs in this labor-intensive industry.

Another 19 percent or $7.9 billion is the result of population growth.

The remaining 31 percent, or $12.9 billion, represents the increase in the average per capita utilization of health services and supplies and the rising level, quanlity, and scope of services through new techniques, new drugs, new treatment procedures, and so on.

Now, as Dr. Fein indicated, particular attention has been focused on the relationship between these recent increases and the implementation of the new program of medicare and medicaid. While I certainly agree with him that the inflation is not entirely or even largely explainable by a supply-demand analysis, I think it is correct to say that these programs have simply accelerated already existing price trends. It is nonetheless also clear that the implementation of these programs without adequate additional steps to relieve shortages and especially maldistribution of health services has aggravated inefficiencies in the delivery of health care and has probably had some effects on prices, particularly in the area of physician services.

In other words, a major effort was made through the medicare and medicaid legislation to reduce the financial barriers to the receipt of care but not enough concentrated effort was simultaneously made in both the public and private sectors to increase the capacity of the health industry to provide the care. This experience under medicaid and medicare taken together with the rising demands and expectations of the general population indicates that the time has come for us to give very special attention to systematic efforts to develop services and increase productivity simultaneously with increasing demand.

As I have said, the problem has been emerging for decades. I am not going to review the consumer price phenomena with which we are all very familiar. I would say with respect to hospital costs, which I am sure Dr. Knowles will comment on further, only that while a major force has been, as I noted before, the rising cost of wages, and while it is true that hospital administrators were probably better able to accede to wage demands because of the prospect of some financial relief resulting from the availability of operating funds under the medicare program, I wouldn't want to leave the impression that the increased costs were all due to labor costs. There have been many improvements in technology and in content of hospital care—for example, intensive care for coronary patients—that have added to the efficacy as well as the price of services. I would note also that, while many individual hospitals are hard pressed for occupancy, the medicare and medicaid programs did not create any massive new demands for services that could not have been accommodated within the Nation's existing bed capacity taken as a whole if used effectively. The problem is that people don't go to hospitals in terms of the Nation's capacity. They go to individual hospitals.

With respect to physicians' fees, I would simply concur in Dr. Fein's statement that unlike the hospital area probably important longrun influences or factors in the increases in physicians' fees are substantial increases in demand for their services without a corresponding increase either in supply or in acceptable subordinate alternatives to their services. And medicare and medicaid have probably contributed certainly to an increase in physicians' income even more than it did to an, increase in fee levels because before these programs went into effect many physicians charged less for services provided for lower income persons than to the general population. Physicians can now in good conscience charge medicare and medicaid patients the same amount they customarily charge other patients.

Now, with respect to the irrationalities of the present system, it is important to reform the present system. Medicare reimbursement was patterned after prevailing methods of hospital and physician reimbursement. The result has been to extend hospital reimbursement on a cost basis to all the hospitals caring for aged persons and to extend the degree to which physicians are paid the customary fee for their services to virtually all elderly patients.

We recognize that both these methods of reimbursement have deficiencies in that they do not contain incentives for efficiency and they tend to provide incentives for increased utilization of services. It is very, very difficult, however, to try to distinguish between unnecessary utilization attributable to a particular method of reimbursement and inappropriate utilization attributable to broader defects in the way the health care system is organized.

I might comment that while medicare did not attempt to alleviate these defects in reimbursement, it did, as you know, make a major contribution to the design of the health benefit package with coverage for extended care facility services, home health services and a combination of outpatient as well as inpatient services that can help to control overuse of inpatient care by offering alternatives.

The impact of rising medical prices on medicare and medicaid and the other public and private programs, is described briefly in my statement. In brief, I could characterize this by saying that it becomes necessary—and these will be presented to the Ways and Means Committee—to recommend increases in the contribution rate for payroll taxes for the hospital insurance trust fund; to announce, as required from time to time, increases in the hospital insurance deductible and in corresponding increases in the coinusrance that beneficiaries are required to pay. And it will be necessary, as it is from time to time, to make adjustments in the premium level of the supplementary medical insurance plan.

Similarly, with respect to medicaid the difficulties need little repetition. Even though many in need have not yet had its benefits, the Federal Government and the States are hard pressed to finance its coverage, and indeed, had in some instances had to cut back in eligibilty levels and scope of services in response to rapidly rising expenditures, in part because by increased costs of providing care.

I would like to summarize very quickly a few of the Department and administration efforts in recent months to reduce costs and, if I may offer for the record a report on "The Health of the Nation's Health Care System" by Secretary Finch and Dr. Egeberg, which was issued on July 10, this has in more detail the steps which I would like to summarize.

Chairman GRIFFITHS. Thank you, we will place it in the record at this point.

(The document referred to follows:)

JULY 10, 1969.

A REPORT ON THE HEALTH OF THE NATION'S HEALTH CARE SYSTEM—ROBERT H. FINCH, SECRETARY OF HEALTH, EDUCATION, AND WELFARE, ROGER O. EGEBERG, ASSISTANT SECRETARY-DESIGNATE OF HEALTH AND SCIENTIFIC AFFAIRS

This Nation is faced with a breakdown in the delivery of health care unless immediate concerted action is taken by government and the private sector. Expansion of private and public financing for health services has created a demand for services far in excess of the capacity of our health system to respond. The result is a crippling inflation in medical costs causing vast increases in government health expenditures for little return, raising private health insurance premiums and reducing the purchasing power of the health dollar of our citizens.

As examples of the situation inherited by this Administration: Medical costs are rising at more than double the increase in the cost of living. Physicians' fees, which were increasing at a rate of about 3 percent a year up until 1965, have since the introduction of Medicare and Medicaid been rising at 6 percent a year. The expense of one day's stay in a hospital, not including a physician's care, has gone from $44 in 1965 to $70 today, and will probably be $80 next year. Within three years at the present rate of inflation, hospital expense will hit $100 a day. The Medicaid program is costing $2½ billion a year in Federal funds alone, more than double the estimates made at the time of its passage.

Badly conceived and badly organized, the Medicaid program has attempted to provide medical services for the poor by pushing them into the Nation's already overburdened health care system without developing the capacity in the system to serve them and without building the capability in the States to manage the program. As a result, by 1975 at the present rate of increase, Federal costs for Medicaid could go as high as $12 billion per year with the States paying an additional $12 billion. And this on top of a Federal expenditure for health which today is larger than the entire budgets of each of the Departments of Agriculture, Commerce, Housing and Urban Development, Interior, Justice, Labor, Post Office, State, Transportation and Veterans Administration. The Federal health budget in fact now exceeds the total national budget of all but eight nations in the world.

Our overtaxed health resources are being wastefully utilized, and we are not adding to them fast enough to keep pace with rising demand. Our health priorities are critically out of balance. Our incentive systems all lead to overuse of high-cost acute-care facilities, while the need increasingly is for lower-cost alternatives. We emphasize spectacular achievements in the healing arts, but have given too little attention to the prevention and early care of illness, which must be the first line of attack on our health problems.

Faced with this extremely difficult situation, we nevertheless cannot abandon our National goal of effective and dignified health care for every American no matter what his station in life or where he lives. We cannot accept anything less in this the most affluent society in the world. As long as there are people in this country who are denied essential health services because of poverty, or race, or lack of access for any reason, we have fallen short of our promise as a Nation.

Our task now as a Nation is to acknowledge the extreme urgency of the situation, to take certain steps to arrest the inflation that is paralyzing us, and to put into motion initiatives that ultimately will reshape the system. This task is obviously not one for government alone, although government has a major role to play. Much of the burden must be taken up by the private sector since it has the primary responsibility for the delivery of health care. Unless government and our vast array of private institutions can learn to work together we cannot succeed. The fault in the past has been shared by both. Too often government has operated independently, and even blindly. Medicaid was launched without adequate preparation, with a staff of only 80 people to manage $2½ billion in expenditures, and with no provision for expansion in the Nation's capacity to meet the increased demand for health services thus created. And too often the private sector has been reluctant to give up outmoded practices that are unsuited to the incredibly rapid changes of our society—to new demands, and increased demands.

This Administration is committed to correcting these past failures of government, and to challenging the private sector to begin the process of revolutionary change in medical care systems. To this end we are taking the following administrative and legislative actions:

We are eliminating the allowance to hospitals and nursing homes for unidentified costs;

We are enforcing regulations limiting payment to individual practitioners under Medicaid;

We are increasing reviews of drug utilization, drug pricing, drug efficacy and safety;

We are directing the Public Health Service to promote alternative medical care facilities;

We are requiring tighter, more frequent reviews of hospital care for patients;

We are requiring that physicians be identified by social security number in all Medicare and Medicaid transactions in order to assist in the audit and review of those transactions.

To help alleviate a serious manpower shortage, we are establishing an Office of New Careers with the top priority of developing programs for returning Vietnam Medical Corpsmen;

We are proposing legislation under Medicare and Medicaid (1) to bar from participation practitioners who have consistently abused the program; (2) to gain greater flexibility to engage in incentive reimbursement and demonstration projects; (3) to withold reimbursement for facility expenses incurred contrary to regional or local plan for health care facilities; and (4) to insure that government does not pay more for services than the charges to the public at large;

We propose to shift emphasis of the Hill-Burton hospital construction programs under the leadership of Under Secretary John Veneman and Mr. Walter to the modernization of inner-city hospitals.

We will move in the direction of reducing the Medicaid burden on general revenues by shifting to various forms of prepayment.

We are establishing a Secretary's Task Force on Medicaid and Related Programs under the leadership of Under Secretary John Veneman and Mr. Walter J. McNerney, to deal immediately with the crisis in that program. This work group will

a. develop and recommend utilization review procedures, incentive reimbursement methods, and standards for medical care;

b. develop procedures for better determining eligibility for medical and public assistance, to aid the States to simplify eligibility determinations, and to develop methods for more accurately predicting costs; and

c. develop a stronger administration on the Federal level, to aid States and localities to better control their programs, and to develop technologies of medical assistance management.

These steps will insure that the Federal government gets more for its health dollar. But the major portion of the health care dollar is not spent by government. It is spent by and on behalf of private consumers through voluntary insurance and personal expenditures in the private sector. Millions and millions of health care transactions occur every day in which the determining factors are utilization and pricing decisions made by private individuals, by physicians and other professional persons, by industry and labor and by voluntary institutions. Neither government decision nor government review is a determining factor in these transactions.

We must insure that the private consumers in these actions receive adequate services at a reasonable price. This requires a major commitment by the varied segments in the private health care industry to drastic changes in the industry. To this end, we will ask National, State and local organizations to assume new responsibility for leadership in promoting such change. A good part of the job is theirs to do, and with great urgency.

In particular—

We will ask and challenge the health insurance industry, including non-profit insurers, to mobilize itself to expand coverages to additional groups, to provide broader and more effective coverage, to change their coverage to encourage preventive services, to provide incentives to keep people out of hospitals and other high cost facilities, and to play an active role in monitoring the excessive use of scarce facilities, such as hospital beds;

We will ask and challenge the physicians, dentists, and other practitioners of the Nation through the national societies, and through the county associations, to establish procedures to review the utilization by their members of various services; to review in particular the use of nursing homes which now absorb one-third of the $5 billion expended on Medicaid by Federal and State governments; to encourage utilization by their members in all instances of less expensive types of care; and to discipline those who are involved in abuses;

We will ask and challenge the hospitals of the Nation through their boards of trustees, their administrators, and their organized medical staffs, to review and revise their procedures for admissions and discharges so that no patient stays longer in an acute facility or long term facility than is absolutely necessary; and we will ask them to work with other hospitals in the community to promote management efficiency, to share equipment and services, and to reduce the unnecessary duplication of facilities;

We will ask and challenge the deans and faculties of the medical schools and all who are involved in the education and training of professinoal manpower to find new ways to expand the number of persons they are training, to shorten the time needed for training and to orient their training more towards the immediate needs of the country, such as comprehensive medical care for the poor and near-poor;

We will call upon the Governors and State Legislatures to re-examine and evaluate the role of State health departments in improving the delivery of health services and to review State requirements for licensing and certification which stand in the way of the proper use of scarce manpower;

We will demand of ourselves and the Federal government, in general, that we put our own house in order, including reviewing the role and performance of Federal hospitals, Federal health programs, and the future of the Commissioned Corps of the Public Health Service;

We will call upon citizens' groups and consumer organizations to continue their efforts to hold the medical care industry and government responsible for good management and for constructive policies in delivery and pricing of services;

We will ask and challenge American business to involve itself in the health care industry, including the creation of new and competitive forms of organization to deliver comprehensive health services on a large scale in what has been up to now largely a cottage industry.

We are creating a special industry group under the chairmanship of Hr. David J. Mahoney, President of Norton Simon, Inc., to develop and stimulate industry programs to provide health education and preventive health care for employees at every level and their families.

Over the coming months we will call together each of these groups to hear what they propose and to learn what they will expect of us in return. Many dedicated persons among them are already working towards these goals. We have much to learn from them. What we will ask of all is that their efforts be greatly broadened and intensified.

This country has made achievements in the quality of care beyond anything that could have been imagined at the turn of this century. It is that very success that has brought us to the present test of whether we have the capacity to extend that same quality of care to all in society at a price which they can afford. What is ultimately at stake is the pluralistic, independent, voluntary nature of our health care system. We will lose it to pressures for monolithic government-dominated medical care unless we can make that system work for everyone in this Nation.

Mr. HESS. We have tightened the prevailing and customary charge concepts in determining medicare payments to physicians.

The Secretary has published a new regulation to control escalating cost of payments made to physicians, dentists and other medical practitioners under medicaid.

We have eliminated the medicare and medicaid automatic allowances to hopsital and extended care facilities for unidentified costs. This terminates the flat percentages allowance which increased automatically as total volume increased without regard to the actual costs attributable to these items which the percentage allowances were intended to cover. And we believe that the more than 3 years experience now permits us to build into the reimbursement formula proper allowance for all specific and legitimate costs.

In addition, the Secretary has approved several experiments that involve methods of reimbursement.

We have been putting increased emphasis on medicare and medicaid in the review of the necessity for medical services and their proper utilization.

We have a task force on medicaid and related programs, chaired by Walter J. McNerney, which has been working diligently and which will shortly make some recommendations to strengthen the administration of medicaid, including the better utilization review procedures, standards for medical care, and better methods for determining eligibility for medical and public assistance.

We have been devoting greater departmental resources and attention toward demonstrations and research in the organization and delivery of services and in the creation of additional capacity.

I would like to finish with a word about the steps ahead.

As I previously observed, the experience under medicare and medicaid has shown that adding service-financing capability is not enough. We need also to find ways to tie increased capacity building more closely to the financing mechanisms. Availability and accessibility of an appropriate mix of services are essential.

The major portion of health care expenditures, however, is still spent by and in behalf of consumers through voluntary health insurance and direct outlays for services. Despite the recent shift to more public financing, private expenditures represent more than three-fifths of the total in fiscal year 1969. It is clear, therefore, that the private sector of the health care industry as well as the Government must work closely to achieve drastic changes in organization and delivery of health services to provide quality care at a price the Nation can afford.

Some of the urgent public and private steps are suggested below.

(1) Encouragement and promotion of alternatives to hospital care: As I mentioned, unlike many health insurance plans, medicare provides broader coverage of a spectrum of medical services, including out-of-hospital services. The availability of such a broad range of insured services enables the physician to direct the provisions of care in matters that are more responsive to the needs of the patient. Many private health insurance plans whose primary coverage is for inpatient hospital care tend to encourage overutilization of this high cost service. Private insurers must follow the lead of the Federal Government to broaden their coverage and take the lead in offering broader choices and new patterns of care. Public and private funding, to create new capacity of the right kind in the right places, must respond to the special needs of the inner city for neighborhood centers. We have got to find ways to bring primary health care to millions who now look only to the hospital emergency room for a family doctor. And this is very important—when new capacity is created, public and private service payments must support these innovative services. Patients' options should not be thwarted by unwarranted restrictions of the payment mechanism.

(2) Just a word about the support and implementation of health facility planning: It is well known that duplication of facilities, services and excessive equipment are responsible in part for the high cost of hospital care.

We must seek ways of withholding or reducing reimbursement to health care facilities that have undertaken a major capital expenditure with respect to plant and equipment which an appropriate planning agency determines does not conform to the overall plan for health care facilities.

(3) Implementation of incentive reimbursement mechanisms: As you know, Madam Chairman, the Social Security Amendments of 1967 authorized experimentation with various methods of reimbursement under the medicare, medicaid and maternal and child health programs with a view to the creation of incentives for efficiency and economy while supporting high quality service. Although several promising experiments are now going, the response in terms of suitable proposals has been disappointing. Participation in these experimental programs is entirely voluntary. From the point of view of the provider, experience to date points up the difficulties in developing on such a total voluntary basis an incentive plan where the provider's option is to

continue using a cost reimbursement formula. The administration has announced that it is seeking broader authority under medicare to implement such demonstrations and to broaden them so that new innovations may be tried.

(4) Implementation of claims review and other utilization review under public and private health payment plans: I think it is fair to say that all programs, private as well as public, that pay for health services have been inadequately equipped at the outset to deal with problems of utilization inherent in broad health care programs that cover very large general populations. Without emphasizing this any further, I simply underline, as Dr. Fein indicated, the fact that utilization, the numbers of services, the quantity and the itemization and the way in which services are delivered and charged is perhaps as large or even a larger issue today than the price of the individual service.

Public and private health insurers and the medical societies must find better ways to secure more effective peer review and more thorough involvement of medical committees in all elements of inpatient and outpatient utilization. In addition, under new reimbursement schemes we must find new ways of packaging and costing these items of services instead of paying for them on a piece-by-piece basis.

(5) Finally, stimulation of group practice, especially prepaid groups, and removal of outmoded legal impediments.

In conclusion, we must have more public awareness, public visibility and public accountability in the health care industry to assist in evaluating the effectiveness of current public and private health care programs, and to encourage the development of other methods of organizing and providing services. The interest of this subcommittee and the function that it is performing in highlighting the inflationary pressures in the medical care industry, I think, performs a great service in focusing attention to the problem of rising medical costs. We are prepared to assist in further clarifying the issues and developing with the private sector and with the Congress approaches to ameliorating this problem.

(Prepared statement of Mr. Hess follows:)

PREPARED STATEMENT OF ARTHUR E. HESS

Thank you for the invitation to participate in your hearings on the budget outlook and inflation. I will speak from the point of view of one who has an interest and concern in the planning and administration of public programs that finance the purchase of personal health care services. I appreciate the opportunity to discuss with your Subcommittee the extent and character of the inflationary pressures in the medical care industry and to suggest ways that the public and private sectors jointly can mitigate rising medical costs while still continuing to improve the health services.

The health care industry is one of the largest and fastest growing in the entire economy. Expenditures for medical care have reached $60 billion in the fiscal year ending June 30, 1969 (see table 1). In 1929—just 40 years ago—expenditures were under $4 billion. Even as recently as 1950, medical care outlays were only $12 billion.

TABLE 1.—NATIONAL HEALTH EXPENDITURES, BY SOURCE OF FUNDS, AND PERCENT OF GROSS NATIONAL PRODUCT, SELECTED FISCAL YEARS, 1929-69

[Dollar amounts in billions]

Fiscal year	GNP	Health expenditures: Total: Amount	Total: Percent of GNP[1]	Public: Amount	Public: Percent of total[1]	Private: Amount	Private: Percent of total[1]
1929	$101.0	$3.6	3.6	$0.5	13.3	$3.1	86.7
1935	68.7	3.1	4.5	.5	17.4	2.6	82.6
1940	95.1	3.8	4.0	.8	20.5	3.0	79.5
1945	211.1	7.9	3.7	2.6	32.6	5.3	67.4
1950	263.4	12.1	4.6	3.1	25.3	9.1	74.7
1955	379.7	17.9	4.7	4.4	24.7	13.5	75.3
1960	495.6	26.4	5.3	6.4	24.3	20.0	75.7
1961	506.5	28.0	5.5	7.1	25.2	21.0	74.8
1962	541.7	30.2	5.6	7.6	25.3	22.5	74.7
1963	574.5	32.6	5.7	8.3	25.5	24.3	74.5
1964	611.6	35.6	5.8	9.0	25.2	26.7	74.8
1965	655.6	38.9	5.9	9.5	24.5	29.4	75.5
1966	718.5	42.3	5.9	10.8	25.6	31.5	74.4
1967	771.1	48.2	6.2	15.9	32.9	32.3	67.1
1968	827.6	53.9	6.5	19.7	36.6	34.2	63.4
1969	900.6	60.3	6.7	22.6	37.5	37.7	62.5

[1] Based on unrounded numbers.

Medical care expenditures have obviously grown at a rapid pace and considerably faster than that of the economy in general, rising from 3.6 percent of GNP in 1929 to 4.6 percent in 1950. Today health expenditures are up to 6.7 percent. Part of this increasing share of GNP is the result of higher prices for medical care compared with prices for other items.

Since 1950, medical prices have been increasing faster than consumer prices generally and this trend has become more pronounced in the past three years. This accelerated rise in medical care prices and the growth in total medical care dollars expended has evoked considerable concern as evidenced by these hearings and those of several other committees of Congress. The following are some legitimate questions that should be asked:

Are we receiving more and better services for the increasing health outlays?

Are rising prices for medical care eating up the growing expenditures?

What impact have the recent large public medical care programs of Medicare and Medicaid had on medical care prices, in particular, and, in general, on the organization and delivery of health care in the United States?

Are there recognized deficiencies in the health care system in the United States?

Can efficiency and effectiveness in the health industry be improved?

What is now being done to moderate rising health costs to insure that the Nation gets more for its health dollar?

What further steps are necessary in this area?

The answers are obviously not simple and time today permits only sketchy exploration of such issues.

FACTORS AFFECTING INCREASE IN MEDICAL CARE EXPENDITURES

The recent focus on rising medical care prices has somewhat obscured the substantial gains in real output in this fast growing industry. Although the measurement of output, effectiveness and productivity in this industry is difficult, we do know that there have been gains in these areas as reflected by the rise in expenditures for health care when adjustments are made for increases in prices and population.

In the 19-year period since fiscal year 1950, personal health care expenditures (omitting research, construction, and community health and environmental activities such as air pollution control, etc.) rose from $10.5 billion to $52.6 billion. Of this $42.1 billion rise:

About half or $21.3 billion can be attributed to the increase in prices (a good part of which reflects wage costs in this labor intensive industry);

Another 19 percent or $7.9 billion, is the result of population growth;

The remaining 31 percent, or $12.9 billion, represents the increase in the average per capita utilization of health services and supplies, and the rising level, quality and scope of services through new techniques, new drugs and new treatment procedures.

INFLATION IN THE MEDICAL CARE INDUSTRY

With rising prices responsible for the largest portion of the increase in medical care expenditures, it is apparent that the sizable increase in medical care prices is a matter of great concern. Acceleration in the rate of increase in medical care prices in the last three years has aroused considerable discussion as to the reasons for the increase. Particular attention has been focused on the relationship between the accelerated increases and the implementation of the new public programs of Medicare and Medicaid.

In fiscal year 1966, the year before Medicare and the beginning of Medicaid, the Government's share—Federal, State and local—of total health care expenditures was 26 percent. By fiscal year 1969, the Government's portion had reached 38 percent, with much of this increasing share coming from Federal funds.

Because Medicare and Medicaid directly affect so many people and involve such a large part of the medical care industry, their impacts are widespread, affecting nearly all aspects of the health care system. True, these programs have simply accelerated already existing price trends. But it is now clear that the implementation of these programs without adequate additional steps to relieve shortages and maldistribution of health services has aggravated inefficiencies in the delivery of health care. While a major effort was made through the legislation to provide access to health care by reducing the financial barriers to the receipt of care, not enough concentrated effort was made to increase the capacity of the health industry, to provide the care. The experience under Medicaid, Medicare and the rising demands and expectations of the general population indicate that systematic efforts need to be made to develop services and increase productivity simultaneously with increasing demand.

While the accelerated increases in the prices of medical care services have made medical care prices a matter of current widespread concern, the problem has been emerging for decades reflecting the ever accelerating expectations and demands. The Consumer Price Index (CPI) indicates that since 1946, medical care prices have consistently risen more rapidly than the prices of all consumer items (see table 1 of attached Medical Care Prices Fact Sheet). During the period 1946–1960, the medical care index rose 1½ times as fast as that of all consumer items. The rate of increase as reflected in the index for all consumer items slowed perceptibly during the period 1960–1965, but the medical care with an average annual rate of increase of 2.5 percent, rose about twice as fast as the index for all consumer items during that period.

The general deceleration in price increases that took place between 1960 and 1965 came to an abrupt halt in 1966 when the rate of increase for the all items CPI was more than twice the rate for the 1960–1965 period. Medical care prices also rose in 1966 at nearly twice the annual rate for this 5-year period. The upward trend in the prices for medical care continued in 1967 and 1968 but there was some decline in the rate of increase in 1968 (6.1 percent) as compared with the rate of increase in 1967 (7.0 percent).

It is interesting to note that at the time of the 1968 slow-down in the rate of increase in medical care prices, inflationary trends became more widespread throughout the economy—the Consumer Price Index for all items and services had been increasing at a relatively faster rate. During 1968, the rate of increase for all consumer prices was 1½ times that of the previous year (4.2 percent compared with 2.8 percent).

HOSPITAL COSTS

Probably the most widely publicized increase in health care prices has been the sharp acceleration during the past three years in the BLS index of hospital daily service charges, which represents the amount charged to adult inpatients for routine nursing care, room, board and minor medical and surgical supplies. The charge for this service has been increasing faster than any other component of the medical care index. For the 3-year period ending June 1969, this component of the medical price index increased 55 percent.

Of the factors affecting the sharp acceleration in hospital charges, the major force is the pressure of rising costs. Wages of hospital employees had lagged significantly behind those in other sectors of the economy for many years. In February 1967, the Fair Labor Standards Act was amended to include hospital workers under its provisions resulting in increases for nonsupervisory hospital workers and the payment of premium wages for overtime. At the same time, there were increased demands for wage increases by professional nurse organizations and unions. To maintain equity between wages of union employees and the remainder of the staff, increases were extended to benefit all hospital workers.

True, hospital administrators were probably better able to accede to wage demands because of the prospect of some financial relief resulting from the availability of operating funds under the Medicare program. In addition, this added source of revenue provided the opportunity for many hospitals to meet demands for increased wages, to purchase additional needed equipment and supplies, and to improve and expand services to patients. I would not want to leave the impression, however, that increased costs were nearly all due to labor costs. There have been many improvements in technology and in content of care—e.g., intensive care for coronary patients—that have added to the efficacy as well as the price of services. I would note also that, while many individual hospitals are hard pressed for occupancy, the Medicare and Medicaid programs did not create any massive new demands for services that could not be accommodated within the Nation's existing bed capacity, taken as a whole.

PHYSICIANS' FEES

Like hospital daily service charges, physicians' fees have also accelerated. Unlike the hospital area, however, probably the most important long-run factor in the increases in physicians' fees is the substantial increase in demand for physicians' services without a corresponding increase in supply. Over the long-run, population increases, changes in the characteristics of the population, more widespread insurance coverage, and an increasing awareness of the benefits of medical care have contributed to the increased demand for services. Although the total number of physicians has increased during the past 20 years, the supply has not kept pace with the demand.

Medicare and Medicaid have probably contributed to an increase in physicians' income even more than to increases in fee levels. Before these programs went into effect, many physicians charged less for services provided to persons with lower incomes than to the general population. Physicians can now in good conscience charge Medicare and Medicaid patients the same amount they customarily charge other patients.

IRRATIONALITIES IN PRESENT MEDICAL CARE SYSTEM

It is important to remember that Medicare reimbursement was patterned after the prevailing methods of hospital and physician reimbursement in 1965. The result has been to extend hospital reimbursement on a cost basis to all of the hospitals caring for aged persons and to extend the degree to which physicians are paid the "customary" fee for their services. We recognize that both methods of reimbursement have deficiencies in that they do not contain incentives for efficiency and they tend to provide incentives for increased utilization of services. It is very difficult, however, to try to distinguish between unnecessary utilization attributable to a particular method of reimbursement and inappropriate utilization attributable to broader defects in the health care system.

While Medicare did not attempt to alleviate these defects in reimbursement, it did make major contributions to the design of health benefit packages with coverage for extended care facility services, home health services and a combination of in-hospital and outpatient services that can help to control overuse of inpatient care. To the extent that Medicare and Medicaid have been the focus of public concern about rising health costs, they have been the vehicle for increased public awareness of the irrational forces at work in the health care system. Thus, public concern has led to growing public awareness of many deficiencies in our present system, including the following:

prevailing reimbursement methods provide little incentive for efficiency and economy of operations and few dis-incentives for unnecessary utilization, thereby contributing to inflation of medical cares prices;

there is unnecessary duplication of high cost hospital services with consequent idle capacity;

there are shortages and maldistributions in less costly alternatives to hospital care such as outpatient care, home health services, extended care facilities, and nursing homes; and

there are inadequate incentives to use of paramedical personnel and shared services.

IMPACT OF RISING MEDICAL PRICES ON MEDICARE, MEDICAID AND OTHER PUBLIC AND PRIVATE PROGRAMS

Rapidly accelerating medical care prices do not affect any single segment of the population alone; they affect all persons who have to pay for medical services either directly or through their health insurance premiums and Federal and State programs which provide or pay for medical care. Although the effect of the unprecendented rate of increase in medical care prices is universal, the effect is best illustrated by the impact it has had on the Medicare and Medicaid programs—program costs are substantially higher than expected.

Benefit expenditures under the Medicare hospital insurance plan are estimated for a 25-year period into the future and allow for increasing hospital costs. The rate at which hospital costs have increased since the program began exceeded the allowance provided for in the cost estimates. This, together with the fact that we underestimated utilization—including originally the true rate of utilization that older people were experiencing prior to Medicare—have necessitated the recommendation for increased contribution rates from payroll taxes for the hospital insurance trust fund.

In addition, the Secretary has recently announced an increase in the Part A hospital insurance deductible from $44 to $52, effective January 1, 1970. The co-insurance payment required of a beneficiary will also increase from $11 to $13 a day for the 61st through the 90th day and payment toward extended care facility stays of more than 20 days will go up from the present $5.50 to $6.50 a day.

The supplementary medical insurance plan is affected differently by the increases in medical prices. This plan is financed on a short-term basis and benefit expenditures are estimated for a 1-year future period. Premium amounts to be paid by enrollees are set at a level that together with the matching contribution of the Federal Government is estimated to cover the cost of benefits and administrative expenses over such a period. Under the law, the Secretary of Health, Education, and Welfare is required in December of each year to determine and promulgate the standard premium rate that will apply during the 12-month period beginning July 1 of the succeeding year.

It is clear that the current premium rate of $4.00 per month—which has been held at this amount for a second year—is below the rate needed to fully meet current accruals and will have to be raised substantially for fiscal year 1971. The rate of increase in physicians' fees is the most important factor in determination of this premium rate.

The difficulties experienced in the Medicaid program need little repetition. Even though many in need do not let have its benefits, the Federal Government and the several States are hard pressed to finance its coverage and, indeed have had to cut back on eligibility levels and scope of services in response to rapidly rising expenditures, in part caused by increased costs of providing care.

DEPARTMENT EFFORTS TO REDUCE COSTS

Rising medical costs and the serious deficiencies in the organization, financing, and delivery of health care in the United States are major concerns of the Department of Health, Education, and Welfare. This concern culminated on July 10, 1969 in the "Report of the Health of the Nation's Health Care System," by Secretary Finch and Assistant Secretary Egeberg that focused on the problem of "crippling inflation in medical costs." That report, a copy of which I would like to submit for the record, outlined a series of administrative and legislative actions designed to arrest this inflation and to ultimately reshape the health care system so that the same high quality medical care is available to all at a price they can afford.

The following outlines some of the steps we have taken to moderate rising health costs to insure that the Nation will get more for its health dollar:

1. We have tightened the "prevailing" and "customary" charge concepts in determining Medicare payments to physicians by refining the standards of performance for determining the reasonable charges—and last January we instructed

carriers not to recognize individual increases in fees, except under unusual and justified circumstances, for medical services provided under the supplementary medical insurance program and to submit for prior approval any changes in general levels of prevailing allowances.

2. The Secretary has published new regulations to control escalating costs of payments made to physicians, dentists, and other medical practitioners under Medicaid. These regulations will limit payments to providers participating in State Medicaid programs to those received in January 1969 unless payments are below the 75th percentile of customary charges. The regulations further limit increases after July 1970 at the 75th percentile to no more than rises in the all services component of CPI. They also require that to effect increases the State plan must include a procedure to assure utilization review of services.

3. We have eliminated the Medicare and Medicaid automatic allowance to hospitals and extended care facilities for unidentified costs. We believe that more than 3 years' experience now permits us to build into the reimbursement formula allowance for all specific and legitimate costs. This would terminate the flat percentage allowances which increased automatically as total volume increased without regard to the actual costs attributable to those items which the percentage allowances were intended to cover.

4. The Secretary has approved several experiments that involve alternative methods of reimbursement for medical services to provide incentives for efficiency and economy.

5. In Medicare and Medicaid administration, we have been putting increased emphasis upon the review of the necessity for medical services and their proper utilization, upon measures to prevent and detect abuse under the program, and upon improvement of intermediary and carrier performances.

6. The Task Force on Medicaid and Related Programs, chaired by Walter J. McNerney, and established by Secretary Finch on July 10, 1969 has been working diligently and will shortly make concrete recommendations to strengthen the administration of Medicaid, develop utilization review procedures, standards for medical care, and better methods for determining eligibility for medical and public assistance.

7. Greater Departmental resources are being directed toward demonstrations and research in the organization and delivery of services and in the creation of additional capacity to provide health care services, particularly ambulatory care services.

THE STEPS AHEAD

The recent actions of the Department of Health, Education, and Welfare attempt to insure that the Federal Government will get more and better services for its medical care dollar. The experience under Medicare and Medicaid has shown that adding service-financing capability is not enough; we need, also, to find ways which to tie increased capacity building more closely to the financing mechanisms. Availability and accessibility of an appropriate mix of services are essential.

The major portion of health care expenditures, however, is spent by and in behalf of consumers through voluntary health insurance and direct outlays for services. Despite the recent shift to more public financing, private expenditures represented more than three-fifths (62.5 percent) of the total in fiscal year 1969 (see table 1). It is clear that the private sector of the health care industry must work closely with Government to achieve drastic changes in the organization and delivery of health services to provide quality care at a price the Nation can afford. Some of the urgent public and private steps ahead are suggested below:

1. ENCOURAGEMENT AND PROMOTION OF ALTERNATIVES TO HOSPITAL CARE

Unlike other health insurance plans, Medicare provides coverage of a broad spectrum of medical services, including inpatient and outpatient hospital care, extended care facilities, organized home health services, and physicians' services in the home, hospital or extended care facility. The availability of a broad range of insured services enables the physician to direct the provision of medical care in a manner more responsive to the actual needs of the patient. Many private health insurance plans whose primary coverage is for inpatient hospital care tend to encourage overutilization of high-cost hospital care and discourage use of alternative facilities and services. Private insurers must follow the lead of the Federal Government to broaden their coverages of the various health services and take the lead in offering broader choices and new patterns of care.

Public and private funding to create new capacity of the right kind in the right places must respond to the special needs of the inner city for neighborhood centers. We must find new ways to bring primary health care to millions who now look only to the hospital emergency room for a "family" doctor. Moreover, when new capacity is created, public and private service payments must support these innovative services; patients' options should not be thwarted by unwarranted restrictions of payment mechanisms.

2. SUPPORT AND IMPLEMENTATION OF HEALTH FACILITY PLANNING

Duplication of facilities, services, and excess equipment are responsible for part of the high cost of hospital care. In an effort to minimize duplication and excess equipment, Federal legislation (Partnership for Health Act—Public Law 89-749) was enacted by the Congress, providing additional support for planning in the States through grants to the States for comprehensive health planning and through project grants to other public and nonprofit private agencies. At the State level, New York, for example, requires hospitals, as a condition of licensure, to accept planning controls. Other States have more permissive licensure requirements encompassing planning activities and still other States are considering the enactment of legislation for health planning.

In addition, we are stressing under Part B of Medicare and under Title XIX Medicaid the need for tighter systems for claims processing and for monitoring utilization.

Public programs, private health insurers and medical societies need to find ways to secure more effective peer review and more thorough involvement of medical committees in all elements of inpatient and outpatient utilization.

3. IMPLEMENTATION OF INCENTIVE REIMBURSEMENT MECHANISMS

The Social Security Amendments of 1967 authorized experimentation with various methods of reimburesment under the Medicare, Medicaid, and Maternal and Child Health programs with a view to the creation of incentives for efficiency and economy while supporting high quality services. Although several promising experiments are now going, the response in terms of suitable proposals has been disappointing.

Participation in the experimentation program is voluntary. Experience to date points up the difficulties in developing on a totally voluntary basis an incentive plan where the provider's option is to continue using a cost reimbursement formula. The private sector has a significant role to play in this area. We are working with associations representing hospitals to see whether we can negotiate with private insurers and other interested parties on areawide demonstration projects for rates of reimbursements with the hospitals in that area. The Administration is seeking broader authority under Medicare to implement such demonstrations.

4. IMPLEMENTATION OF CLAIMS REVIEW AND OTHER UTILIZATION REVIEW UNDER PUBLIC AND PRIVATE HEALTH PAYMENT PLANS

I think it fair to say that all programs—private as well as public—that pay for health services have been inadequately equipped at the outset to deal with problems of utilization inherent in broad health care programs that cover very large, general populations.

Utilization review under Medicare is recognized as contributing to: (1) the assurance of quality of care through professional scrutiny of utilization of facilities, and (2) more economical and efficient use of facilities. Under the Medicare law, every participating hospital and extended care facility must establish a committee to review the medical necessity of care furnished to Medicare patients. Beyond its implications for cost control, an effective committee has a substantial influence on attending physicians which follows from their awareness that a committee of their peers is periodically reviewing extended institutional stays.

5. STIMULATION OF GROUP PRACTICE, ESPECIALLY PREPAID GROUPS, AND REMOVAL OUTMODED LEGAL IMPEDIMENTS

Groups of doctors practicing together can often make more efficient use of equipment, auxiliary personnel and consultation than doctors practicing alone. Where the patient has paid in advance for comprehensive medical care under a group practice plan less incentive may exist to use high-cost hospital services where lower cost alternatives would meet the patients' needs just as well.

State laws that restrict or impede the organization and expansion of group practice and the use of new health manpower personnel must be removed.

Private prepayment and insurance organizations also have an important rôle in the stimulation of the further development of prepaid group practice by facilitating dual and multiple choices among competing plans and bringing group practice options into their own arrangements.

In conclusion, I have outlined some of the factors contributing to the health care crisis and a few steps that could be taken to increase the efficiency, effectiveness and productivity of the health care industry to moderate future price increases. We must have more public awareness, public visibility, and public accountability in the health care industry to assist in evaluating the effectiveness of current public and private health care programs and to encourage the development of other methods of organizing and providing services. The interests of the Subcommittee on Fiscal Policy in the inflationary pressures in the medical care industry have focused attention on the problem of rising medical costs. The Department of Health, Education and Welfare is deeply concerned with these problems and we are prepared to assist in further clarifying the issues and developing with the private sector approaches to ameliorating this serious problem.

We must seek ways of withholding or reducing reimbursement to health care facilities that have undertaken a capital expenditure with respect to plant and equipment which an appropriate planning agency determines does not conform to the overall plan for health care facilities. The American Hospital Association has taken a significant step forward in issuing its policy statement last year that proposes to tie the financial requirements of hospitals and other health care institutions to community-wide health planning. The statement acknowledges that the capital needs of a health care institution need to be continually evaluated in the context of its place in the community's health system and that a collaborative effort within the health care institution—governing authority or owner, administration, and medical staff—and between the health care institution and the planning agency is essential.

Chairman GRIFFITHS. Thank you very much, Mr. Hess.

Dr. Knowles?

STATEMENT OF DR. JOHN H. KNOWLES, GENERAL DIRECTOR, MASSACHUSETTS GENERAL HOSPITAL

Mr. KNOWLES. Thank you, Mrs. Griffiths.

As usual, coming last, after Dr. Fein and Mr. Hess, it has probably all been said. But I think I have a certain credibility, one of those people who is responsible for some 40 percent of the medical care costs in this country, which on the average, is what hospital costs consume of the medical care dollar—total public and private expenditures—and I have assumed that you wanted me to primarily focus on that.

Before we get through I think I can show you one concrete way of reducing costs by as much as a half billion dollars in this country a year by a relatively simple mechanism, because I have assumed you wanted some specific recommendations here to consider.

Chairman GRIFFITHS. Indeed we do. Thank you.

Mr. KNOWLES. The expenditures for the national health, as you have already heard, have risen from $24.7 billion in 1961 to $46.7 billion in 1968, and the 1968 figure represents the rise of 13 percent over the previous year, as Mr. Hess has reported. The 1969 expenditure shows a similar rise and the estimated 1970 expenditure is $64 billion.

By all economic indicators, the rise in cost of medical services has outstripped all other services and the rise has been particularly rapid over the past 3 years, since the advent of medicare, which a lot of people try to relate to medicare, but which has been questioned here this morning, and I would certainly agree with that. Medicare is not the primary cause of the accelerating rise in costs.

We now spend around 6.2 percent of our gross national product on medical care (rising to 6.7% in the current year) and our per capita expenditures of $195 per year for those under 65 years of age and $590 per year for those over 65 years of age are the highest of any nation in the world. These facts are cause for great concern for three major reasons:

(1) Although we spend more money than any other country on health, the quality of care produced remains uneven, and our health statistics in certain areas are frankly embarrassing. The health of some 30 million poor people is abysmally bad and almost totally neglected. We ranked 18th of the countries of the world in 1965 in infant mortality, although I think it has been reduced to about 15th in the last 3 years. The mortality of middle-aged men is a source of concern. We rank 17th in male and 10th in female life expectancy.

In Sweden 95 of 100 males age 45 will reach age 55. In America, only 90 will, which implies the mortality rates are twice in this country what they are in Sweden.

Secondly, with rapidly rising costs—recently 12 percent annually—medical indigency increases as wages have been rising at only 3 to 4 percent annually and retirement income has withered under inflationary forces.

Medicare, for example, contrary to what the public may perceive, covers only 46 percent of the total medical costs of the aged. Other programs, such as Veterans' Assistance and medicaid cover roughly 13 percent, which means 41 percent remains the private responsibility of elderly individuals, nearly half of whom, of the 20 million over 65, live in or border on poverty.

Thirdly, with increasing tax moneys and employer-employee funds being used to pay for medical services, a collective and very powerful responsibility now exists in the hands of the third party payers and Government to serve the public interest in health more effectively. Both Dr. Fein and Mr. Hess have been saying essentially that.

What was piecework, individual and private, almost completely private, in 1930, is now organized and collective, public and private. Public scrutiny of medical care is increasing along with demands for improved quality, accessibility, comprehensiveness, and cost controls.

To simplify the subject, the three largest demands on the national health expenditures are made by hospitals, doctors, and drugs.

Hospital care, as of the 1968 figures, consumes close to $20 billion or roughly 40 percent of the total, one area: doctors' services consumed around $11 billion, which was about 20 percent of the total; and the drugs was the next largest call on the health dollar of about $5.7 billion, or about 11 percent of the $46.7 billion.

Of the total, 66.5 percent, $31 billion, are private, and 33.5 percent, $15.7 billion are public expenditures. In 1961, 78 percent were private and 22 percent were public expenditures, the large change to more public funds coming with the advent of the medicare and medicaid in 1966. In 1970, it is estimated that the percentage of public expenditures will rise to 40 percent.

I prepared a table in this presentation to show the breakdown of public and private costs, to point out that the private sector far outweighs the public in the purchase of physicians' services and drugs. At the present time 70 percent—this does not follow—but at the present time 70 percent of hospital costs, 21 percent of private practicing physicians, and 17 percent of drug costs are covered by prepayment mechanisms, public or private.

[In billions of dollars]

The year 1968	Total	Private	Public
Hospital care	19.5	10.1	9.4
Physician services	10.9	8.7	2.2
Drugs and sundries	5.7	5.4	.3

Therefore, it is quite clear where the political leverage and the public leverage will be applied by collective action and, indeed, most of the changes so far in the public and private arena have been directed to hospital costs, as well they might.

The increase in personal health expenditures since 1961 has been due to the following three factors (Secretary of HEW Wilbur Cohen before Ribicoff Subcommittee 1968):

	Percent
Population increase	15
Price increase	36
Other (quality; utilization; additional services; and increased numbers of of health workers)	49
Total	100

As can be seen from the table, only 49 percent of the increase in personal expenditures has been used to improve quality and provide new services.

Now, according to Mr. Hess' figure, 20 percent was due to population increase; 50 percent to price increase; and 31 percent to such things as improvement in quality, increased utilization, additional services, and so on.

The point of all that is that, therefore, according to Mr. Hess' most recent figures, only 30 percent of the health care dollar has been returned to the consumer in terms of better care, more care, improved quality of care, whereas the rest of it has been spent on population increase per se, plus 50 percent due solely to price increase.

In other words, 50 percent is beneficial, and the other 50 percent, I assume, can be said to be inflationary.

I am not an economist so please correct me if I am wrong, but I think that is the point of that, and that is why we were all disturbed.

The rise in the hospital costs has aroused the most interest and consternation, and justifiably so. The causes for the increase are easily identified, and are due to:

(1) Increased wages and fringe benefits which consume between 62 and 70 percent of the operating budget of the hospital. My hospital, for example, with a thousand beds, will have an operating budget for 1970 of around $47 million to support 1,066 beds, nearly $44,000 a bed or a cost of over $120 a day; and 70 percent of that cost is in the wages and fringe benefits of our employees.

(2) An absolute increase in the number of employees per bed required by the doctor and the patient to carry out their mutual work.

And (3), increased cost of construction, equipment and supplies due both to inflation and to the development of new facilities and technology required for the best medical care. (See table 1.)

TABLE I.—WAGES AND FRINGE BENEFITS [1]

Wages	1959	1969	Percent increases
Nursing graduate	$75 per week	$150 per week	100
Minimum hiring rate	$1.05 per hour	$2.10 per hour	100
Maintenance-skilled tradesman (carpenters, plumbers, electricians).	$75 to 80 per week	$150 per week	100
Interns [2]	$400 per year	$7,000 per year	1750
Residents [2]	$2,250 per year	$11,000 per year	
Fringe benefits [3]			
Blue Cross	0	$209,447	
Social Security	216,444	1,353,462	
Life insurance	0	19,153	
Pensions, formal plan in 1955 ad hoc previously	98,704	786,587	
Staff clinic, ambulatory work	[4] 46,059	[5] 394,320	
Tuitions	0	125,000	
WCA	29,828	60,395	
Total	391,035	2,948,361	

[1] Premium rate for overtime required by law in 1967 although MGH instituted the practice in 1959. The 40 hour week was instituted in October 1954. Our overtime costs in 1969 will amount to more than $1,000,000.
[2] 162 to 268 people.
[3] Paid vacations not included, current year $1,350,000 (figures for 1959 unavailable).
[4] Salaries and wages only.
[5] Plus work done on employees.

I would like to give you examples of these three areas from the Massachusetts General Hospital which, with a thousand beds, is one of roughly 50, 60, 70 hospitals in this country in urban locations of similar large size which, I think, are an adequate mirror of some of the things going on in hospitals at large.

In wages and fringe benefits, just to be specific, 10-year increase from 1959 to 1969, nursing graduates in 1959 started at $75 a week. They now start at $150 a week

The minimum wage in 1959 was $1.05. It is now $2.10 at our hospital.

Maintenance workers, skilled tradesmen, such as carpenters, plumbers, and electricians, in 1959 were $80 a week, and in 1969 are $150 a week, and we have an awfully hard time now competing with the rest of the labor market at $150 a week.

Interns and residents—when I interned in the Massachusetts General Hospital in 1951 I was paid $400 a year, and I was asked by the director whether I wanted it in cash or war bonds.

We now start our boys, and they come to my office complaining about the fact that we are not paying them a living wage which, for a family of four is now around $9,000, according to the Social Security figures. And most of the boys, 90 percent of them, are married now—we had to ask the director in 1951 whether we could get married or not, and we usually were not allowed to—and we now start them at $7,000 a year.

Collective bargaining, you will be interested to know, has now hit that group of workers, something that would never have occurred to me when I was an intern in 1951. But that is a 1,750 percent increase, and we are talking about a budget that is nearly $2 million now for the payment of interns and residents, of which we have 268.

Turning to fringe benefits, which were unheard of in hospitals until the 1950's—1955 to 1960—we did not even reach a 40-hour week or time and a half for overtime until the 1950's, we were exempted from the minimum wage, as Mr. Hess points out in his testimony, until 1967, when our exemption was removed. Fortunately, we had already moved to keep up with the minimum wage in our region, but let me tell you that many hospitals, particularly down South, have not. So, when you are told that the daily cost of many of the hospitals in the South is $40 a day, compared to a cost of $100 a day in the North, you must realize it is not necessarily due to efficiency, but rather due to the difference in wages and fringe benefits, and you will also understand why nationtal health insurance and compulsory insurance will be resisted in certain sections of the country.

Blue Cross premium payment in 1959 in our hospital was nonexistent. We spend $209,247 now for Blue Cross for our employees.

Social security payments in 1959 were $216,000; and in 1969 were $1,353,000.

As you move the base payments up, and as you increase the percentage, with the advent of medicare, we share in that with 6,000 employees, just as every other employer does.

Life insurance—we did not provide it for our employees before; we do now, and that cost $20,000 in 1969.

Pensions—we had an ad hoc arrangement whenever anybody was ready to retire. We usually did not want them to retire if possible to persuade them otherwise, because we did not have enough people. As long as we could get them to the hospital we could keep them warm and working, and in 1959 we paid out $98,000, and 1969, $786,000 in pensions.

Tuitions—you will notice we paid no tuitions for our employees in 1959. We paid out $125,000 in tuitions for our employees to go back to school nights and extended leaves from the hospital and that, by the way, has been returned to us more than fourfold by a reduction in the turnover of our employees.

We have been criticized for spending that $125,000, but we get it all back because our employees like it, and they stay with us, and you must recognize that the turnover rate is one of the things that is killing us in hospitals of this country today. I will get further into that shortly.

In this current year we will pay out $1,350,000 for vacations.

Now, it should be noted again that in many positions such as general maintenance, and dietary, janitorial, accounting, computer, clerical, and secretarial services the hospital competes with other hospitals, and with industry at large. There is a company now advertising in Boston for janitors at $2.60 an hour with a guarantee to go to $3 an hour if they will stay 1 year.

Now, our janitors can read the newspapers as well as anybody else can, and when we can only offer $2.10 an hour, and they have families to support, you can understand why they might be willing to leave us. The first thing the public complains of about the hospital is the fact that the place is dirty, with great balls of dust rolling through the place, and so on.

Thus, every new union contract, fringe benefit innovation, and improvement in minimum wage either locally or nationally must be met by us, and I will return to that in a minute, because 1 week ago they moved the minimum wage for 1971 in New York to $3.60 an hour, so no matter how we try to fight inflation over the next 3 years, I can promise you that you are going to see the continued inflation in hospital costs because if we do not rise to that to meet that, our employees, in a very short labor market, with a highly mobile population, will go to New York, and that will be the last time we will see them for another 5 or 10 years, and that is tough. (See table 2.)

(2) Increase in Number of Employees

1959	3,000
1969	[1] 4,600
Percent Increase	53

[1] Beds have increased from 927 to 1066 (15 per cent increase). Of the 4,600 employees roughly 3,300 or 3.1 per bed are related to in-patient services. Roughly 2.3 employees per bed were required in 1959.

No. 2, the increase in employees. In 1959 we had 3,000 employees. In 1969, 4,600 related to patient care activities, a 53 percent increase when our number of beds only increased from 927 to 1,066, by 15 percent. Of the 4,600 employees, roughly 3,300 or 3.1 per bed are related to in-patient services, and we had 2.3 employees per bed in 1959.

We have increasing numbers of technicians, plus new positions unheard of in 1959, such as computer programers and operators, industrial engineers, surgical technicians, cardiovascular technicians for pump teams, monitor equipment technicians and inhalation therapists, to name only a few, have been required to carry out the work of the hospital.

In 1959 we did one open heart surgical operation a week. We are now doing about 15 a week, and we have a backlog stretching from here to Washington of people waiting to get in, to get new prosthetic devices, valves, and so on, which essentially gives them a normal life expectancy.

Sometime in this country we are going to evaluate the net total benefit to the community of adding 30 more years to the productive life of the working man on the basis of spending $2,000 on him. We still do not do that in this country, however.

To mention only a few of them, and bear in mind that the licensed practical nurses in the subdivision of labor in the health field have come into their own only in the past 10 years, 1959 we essentially had no licensed practical nurses. We now have in our hospital roughly 140 such people. (See table 3.)

(3) INCREASED COST OF CONSTRUCTION, SUPPLIES AND EQUIPMENT

Construction	1959	1969	Percent increase
Plant assets and depreciation:			
Net plant assets	$13,200,000	$41,500,000	314,000
Depreciation	612,000	1,594,000	160,000

The third major area, increased cost of construction, supplies and equipment: Our net plant assets in 1959 at the Massachusetts General were $13,200,000, and that has increased over threefold to $41,500,000.

Our depreciation, which was $612,000 in 1959 is now $1,594,000 or a 160 percent increase.

The increase in plant assets is due both to increased inflationary construction and equipment costs plus additional new equipment and facilities necessitated by technological developments.

The cost of operating a hospital includes depreciation as an operating expense, chargeable to patients and/or their insurers. Therefore, depreciation reflects both inflation and new technological needs for improving patient care.

For example, that $1,594,000 is the equivalent of about $6 on our day rate. So when we are charging $100 a day, $6 goes into depreciation, so it is a not inconsiderable part of running the hospital.

Supplies and equipment	1959	1969	Percent increase
Drugs	$1,000,000	$2,500,000	150
Typewriters	150 (manual)	420 (electric)	
Hospital beds	115 (manual)	500 (electric)	
Cardiac monitors	0	52,000 (31 in use)	
Respirator	Several with 4 people.	45,000 (50 in use) with 24 people	
Raw food (per meal)	$0.269	$0.423	57
Meals (all costs) per patient per day	$3.90	$7.60	95
Utilities (gas, steam, water, and telephone)	$750,000	$1,500,000	100

Supplies and equipment, only to give you a few simple examples, drug costs were $1 million in 1959; in 1969 they were $2,500,000; a typewriter, 1959 manual, was $150; it is $420 for an electric typewriter, which we have got to use for third party payers, including the Government, in order to get through the 15 copies. We have got no choice.

Hospital beds—$115 for a crank bed, $500 now for an electric bed. Well, you may say, why don't you just let them crank it? As a matter of fact, we feel the motorized bed improves patient care because it helps reduce the amount of time nurses or other employees time spent with the patients if they are able to move their own bed themselves so the nurses can turn to more pressing personal needs of the patients.

Cardiac monitors, we had none in 1959; we now have 31 in use, with a $52,000 capital cost.

Respirators, in 1959 we had a couple with four people operating them. We now have 50 in use with a capital expenditure of $45,000, and 24 people, technicians, and so on, keeping them up.

Raw food, and in contradistinction to all our beliefs, as we go to the supermarkets, that food is the big issue, it really is not, contrasted with other technological developments and operating costs—raw food per meal in 1959 cost $.269, and in 1969 cost $.423.

For all meals cost, a roughly 100 percent increase for three meals a day, $3.90 to $7.60.

Utilities, gas, steam, water, and telephone, $750,000 in 1959; $1,500,000, 100 percent increase in 1969.

Now, this has been the national experience, generally, as relates to hospital costs, and our costs per diem have risen as follows:

	1959	1969	Percent increase
Cost per diem	$36.50	$103.00	280
Routine	24.16	62.77	254
Special Services (laboratories, X-rays, operating rooms, etc.)	12.34	40.23	325

In 1959 it cost $36.50 a day in our hospital. This year it costs you $103, a nearly threefold increase. If that is broken down, the larger part of that increase has come in so-called ancillary services, which includes all the technology, X-rays, laboratory tests, operating rooms, and so on.

37-795 O—70——15

During this time, as is true of most hospitals, the utilization of the hospital has increased from what was 87.8 percent in 1959 to what we now average 93 percent in 1969.

Now, that is essentially a 100 percent utilization of a hospital, if you take on Thanksgiving, Labor Day, Christmas, and a half day when things lie fallow on Sunday. We essentially run a six-and-a-half-day hospital, and it is awfully hard to get 93 percent utilization, but the national average, unfortunately, is closer to 80 percent, which means 20 percent of the hospital beds on an average in this country at any given time are unoccupied which, with the same number of employees, increases the cost to the public by 20 percent.

Our budget for 1969–70, like other hospitals in our region and nationally, contains another $10 increase in room rates, 10 to 12 percent, and anticipates an additional $7 million in patient income. Our costs will increase roughly 12 percent over last year, which equals the 12 to 15 percent increase in costs we have experienced this year, since 1966.

Let me give you some reasons for this year's increase in costs. When we moved our minimum hiring rate from $2 to $2.10 per hour, the rippling effect cost nearly $900,000 in additional wages. For each 5 cents that we move our minimum wage it costs us $475,000, of course, what we charge the public, an additional $475,000.

I will get back to the subject again, but when wages go to $3.60 an hour in New York, and if we were to move our $2.10 upward to try to keep people working in Boston and prevent their moving to New York by 1971, we have got to go to at least $3.10 or $3.25, and if all goes well, if that happens, our costs to the public will be $150 or more by 1971.

You can say: "Why don't you be a responsible manager, Knowles, why don't you hold the line?"

Well, frankly, my first responsibility is to take care of the sick and save them rather than save the money, and if I save the money we will be shutting beds in that hospital, without any question, and if I were a hospital employee I would move to New York, too.

Secondly, we desparately need intensive care and recovery room beds in a new 24-bed unit which will cost us $900,000 for new personnel this year, 74 nurses—bear in mind three shifts, essentially four shifts if you count holidays and weekends—and 29 technicians, secretaries, inhalation therapists, nursing assistants, and $400,000 for equipment and supplies, for a total of $1.3 million. Increasing costs of drugs adds another $343,000 to our budget this year—and so it goes.

Now, the question is how do you contain or reduce hospital costs, and I wouldn't cavil with anything that either Dr. Fein or Mr. Hess has said this morning. Quite clearly, there has got to be a control in the public interest and, hopefully, it will be done well so that unlike cuckoos, we don't all foul our nests and go down together and not achieve the desired end, and, by the way, may I add that the Nation has as yet not made it a policy that health will be a birthright, and as soon as we get over that hump it will simplify our task considerably. De facto health is not a birthright in this country today. I am not supposed to ask questions, but I do not believe anybody can argue with that fact. We say it out of one side of the mouth, but we are not doing it.

So how do we contain costs? I have divided it into internal and external factors.

Internal factors in controlling, containing or reducing costs involve the management of the hospital. A partial listing of the most important ways and means of controlling costs follows.

Full utilization is the single most important factor in containing costs. Maternity and newborn services drive hospital costs up because of wide swings in utilization. You cannot count on when people are going to come into hospitals to deliver babies, and so on. You still have to staff it for the sudden upsurge in births.

For example, after the blackout in New York, I am told that 9 months later there was a tremendous rise. Well, maybe if we could shut the lights off every 2 months we might be able to anticipate that 9 months later. But short of that there is no way that we can do it.

It costs us now roughly $40,000 a year to maintain a patient in a bed. If we budget for 92 percent occupancy or, in other words 962 patients in our 1,066 beds, and we drop to 800 patients, you can multiply that drop by the costs today because that is what you are losing when those beds are not utilized.

Hospitals should not expand any of their services until the entire region needs such expansion and all facilities are being fully utilized, and I know of no better way of making sure that a hospital is utilized satisfactorily and optimally than to maintain waiting lists in all the hospitals of this country. These conditions do not exist in many regions of the country.

Now, if anybody can tell me a better way—I do not know it—but until you have waiting lists in the regional hospitals in a given region you should not allow further expansion, and voluntary regional planning to this moment has not done the job.

I have already referred to the national underutilization of an average of 80 percent. This is a very expensive business when your high-cost facilities are only averaging 80 percent utilization.

Full utilization of the hospitals requires the full cooperation of staff doctors, and the doctor's role here is central to the issue, 6½-day work week, full operating schedules, including the afternoons, and many hospitals to this day in this country do not use their operating rooms in the afternoon.

I do not like to get everybody here into the nuts and bolts, but there comes a certain point in broad policy where I think nuts and bolts are important. We all tend to live a little bit in the fuzzy land of word facts, but when it comes down to those nuts and bolts, there are certain things to be done, and one thing Mr. Hess did not mention is the necessity to recertify medicare patients instead of on the 21st day, I think it is the 18th day, Arthur, because we did a study in our hospital showing sure enough the 21st day was a large day to discharge patients. It is possible that is not mischief——

Mr. Hess. We have just moved it because of that peaking.

Mr. Knowles. So you moved it to 18 days, hoping this would change the behavior of patients and doctors, and if it does, fine, that will save us 3 days per patient, and even to save 1 day per patient you could save millions of dollars, so these are concrete things that are worthwhile doing.

Utilization review is absolutely essential to the proper use of the hospital to prevent unnecessary admissions, unduly prolonged stays, overuse of tests, and to assure high quality of care. We have developed such a committee required under the medicare law, but which reviews all patients on a random basis. The trustees, administrators, doctors, social workers, nurses, sit on this committee, and let me asure you that the utilization and quality of care at the Massachusetts General Hospital after 160 years of existence has improved considerably, and all of us are grateful for the wisdom of the Federal Government for requiring a visible committee.

But let me also assure you that in many hospitals of this country this is only a pro forma workout by staff physicians who refuse to scrutinize each other, essentially fearful, just as all other professional groups, be they lawyers, priests, or politicians—whatever they may be.

Rapid transfer of patients to lower cost extended care facilities, we have shown the Social Security agency and the Federal Government how we have saved them hundreds of thousands of dollars, well-documented, by simply requiring our staff physicians or asking them on the first day of admissions to notify our social service department which, by the way, costs the public another $2 million a year to staff that social service department, to set up a transfer office for the speedy transfer of patients in high-cost $100-a-day facilities, to lower cost $20- and $30-a-day facilities, and if they tell us on the first day rather than the 40th day, we can get them out, we have shown how we reduced the length of stay of patients, and that saved the Government a lot of money.

But Arthur knows, and so does Rashi, and so do I, that this does not in fact exist in many hospitals.

In many hospitals in this country, in far too few of them, cost accounting is the third area, these are still internal subjects, and one cannot control costs without identifying them and quantifying them through detailed and effective cost accounting. We use the stepdown cost analysis technique as recommended by the American Hospital Association and the Social Security Administration.

Unfortunately, despite the good work of the AHA and the SSA, cost accounting in hospitals is still not what it should be. We have stepdown cost accounting on every single floor of our hospital, and if we spent 14 cents on laundry 1 month instead of 7 cents, when compared to the other floor, we send a swarm of beady-eyed accountants and systems analysis on that 14-cent floor all with gimlet eyes to try to cut out that 7-cent difference.

You cannot do a decent job of management unless you have cost accounting, and we know that it does not exist where it should, but there are tremendous stimuli through Government and AHA to do this.

Fourth, management techniques: One has got to reduce turnover rates. For example, it may cost us between $1,000 and $2,000 to bring a new nurse to a fully effective position in our hospital, and when the turnover rate reaches 70 percent annually this becomes a very costly business. Seventy percent means that if we hire 100 nurses today, 12 months from now we will have 30 of those nurses left, and we will have had to hire an additional 70. When it costs $2,000 a nurse or, let us say,

$1,000, it costs you anywhere from $70,000 to $140,000 right on that turnover rate alone.

We have been able to reduce our turnover rate by such things as subsidized housing, improved working conditions, tuition for educational programs, and so on, and these answers work.

A second issue is to reduce overtime. Unfortunately, we have to depend on our day shifts for overtime as we are unable to recruit enough people to work evenings and nights. Perhaps, as you control inflation and unemployment rises, we will be able to hire those people, it is conceivable, but with nearly full employment, the labor market is tight, and we, in contradistinction to the steel plants, cannot shut down an operation for certain periods when we do not have employees, and we have no choice but to staff that hospital at night through the small hours of the morning and to pay the overtime.

We paid over $1 million in overtime last year, and I am perfectly willing to admit it publicly because I know other hospitals are in the same bind.

The next subject, improved working conditions, by appropriate renovation of the facilities, efficiency can be increased by as much as 30 percent. The social scientists have shown this time and time again, and I think among other hospitals we have taken the lead in saying that the place does not have to look gray and dingy, with paint peeling off the walls, and with the smell of ether, because it interferes with productivity.

We lightened the whole place up, and we have reduced our turnover and increased efficiency by those methods. We use methods committees. We have regular meetings, and we have hired industrial engineers and systems analysts.

The reason I am enlarging on this subject of hospital costs again is because it is 40 percent of these billions we are spending, and it is a big area to exert leverage to contain costs.

Automation and computers can certainly enhance efficiency and reduce costs. Much of our laboratory work now is automated, particularly blood counts and blood tests, and this has markedly reduced costs.

But there is mounting evidence that computers do many things at an increased cost. Anybody who tells you that computers are going to save money in hospitals should be looked at, I believe, with a gimlet eye. I do not think it is that easy.

There are many other examples, such as employee incentive programs, the use of disposable products, and so on, which are regularly conveyed to all hospitals through many trade journals and by the American Hospital Association, and generally they have done a heroic job, a heroic effort, in improving the management of hospitals. I am not quite so dismal about the current popular wisdom which says that all hospital managers are lazy, inefficient, because they are not competing or they do not have stockholders, that they must be dolts and there must be a better way to firm up these relatively inadequate people.

I just do not believe it. I think that hospitals generally do a heroic task with the management of a system which is subject to inordinate demands, which are a 24-hour, 7-day week, including leap year operation, and it is not an easy thing for management, and every time we ask industrialists to come into our hospital to spend 36 hours with a lot of great ideas, they then go out holding their heads with a large headache.

There are an expanding number of management consultant firms which can help considerably on an ad hoc basis. We have used such help in nursing and in the radiology department recently.

Participatory management involving the greatest possible sharing of problems by as many people as possible in the hospital remains the single most important aspect of management. The old, autocratic, completely bureaucratic methods simply don't work as well as active participation and persuasion. The doctor remains a central figure in hospital management, and he should be used more effectively than he is.

It is popular to say that hospitals are mismanaged—and because most of them are nonprofit and noncompetitive in terms of their product that management lacks incentive and is lazy, disinterested, and inadequate. I do not agree, but I do feel that doctors have a far larger role of responsibility in hospital management than they have been able or willing to assume thus far.

I now have a suggestion which could save millions of dollars in hospital costs. Ordinarily, just to be specific here this morning, ordinarily every service, test or medication that a patient received during each day of his hospital stay is accounted for so that the patient and his third party payer can be charged with an itemized bill. Keeping track of what can be an incredible amount of piecework requires additional people in both the hospital and the insurance company, and the final bill of the patient with a complicated illness may be 8 feet long with hundreds of items.

I brought one of these bills today to show you what we are required to do by the Government, Blue Cross, and private insurance companies. If I may, if we can stretch this thing out in front of you, this patient came to us in the hospital in March. Let me read some of the items here. The bill is more than 16 feet long.

Medication, $1, medication, $2, day nurse, $35, clinical labs, $1. Let me get some choice ones here.

Anesthesia, $90, clinical laboratories, $1. Piecework you would not believe, every single one of these things, intravenous infusion, $1.40; medication, $2.40; everything that is done to that patient, and he is still in our hospital, and his bill at the present time is $33,304. Everything that has happened to that patient has to be put on a card, punchcard, and put into a computer, and this is what we have got on this man so far.

This is just one patient, bear in mind, and when you have 365,000 patient days, this is one patient who has been in our hospital since March.

Chairman GRIFFITHS. Is that the bill since March?

Mr. KNOWLES. This is just the bill since March, and it amounts to $33,000. A conservative estimate is, that it takes 90 of our people to do the work of keeping track of his bill.

(See p. 228 for remainder of Mr. Knowles' prepared statement.)

The point is if we could get rid of this bill and do it on the average-per-day cost to this patient, we could fill out one line on a bill, which would not take the 90 people. I know, Mr. Hess, that there are people in HEW and in your division who are looking into this, and the sooner it gets done the better.

It does not let us off the hook on good cost accounting. Not only is it politically viable—when you were paying this directly in 1930, if we were to say that, well, that cost you $15, on the one hand, if you had a serious complicated illness and you had multiple tests, and so on, you would not believe it costs $15 as compared with a relatively simple thing as here we would charge you the same price, say for having a very simple procedure.

But the third party payer is interposed between you and us, and we still have to audit our costs to keep track of all this piecework. But 90 people in our hospital means a saving of $500,000, to say nothing of supplies and computer time; and 90 people, clerks, computer technologists, and so on, who have to keep track of this piecework, which is an incredible amount of work to do.

If this were extended to other hospitals and to third party payers, the Blue Cross and insurers, they could save similar money because they won't have to hire people to check through all that. It still, as I said, does not let us off the hook, in one hospital at least. It would save $500,000, which is $2 on our day rate, which would get ours from $100 to $98 a day, but that helps at least, but it is something that bears pursuit, and I would hope, Mr. Hess, that the gears of Government and the private sector could work fast enough to maybe actually do something about this.

There are certain political problems with it but they can be, I believe, easily overcome.

Now, when all is said and done about improving management and containing costs, one picks up the *New York Times* on October 4, 1969 and reads the front page headline, page 1, "$125-a-week pact won in hospitals," and the subhead, "Nonmedical workers settled for 3-year minimum here."

The agreement was made between the Association of Private Hospitals (23 in number) and union representatives while seven of the hospitals were being struck during negotiation and State mediation, quite acceptable, may I say, in service industries in this country today whether it is people in hospitals, people on transit systems or what have you, to strike it.

It is quite viable and indeed if you are thrown in jail it makes your position all the more viable, it would appear, for violating State laws.

The new contract replaces the present weekly minimum of $83 for 37½ hours with $125 for a 35-hour work week. The new minimum wage, therefore, will be by 1971, $3.55 an hour—it is now $2.25 in New York—as contrasted with our $2.10 in Boston, and weekly wages would increase by roughly 50 percent.

If we were to move our minimum wage from $2.10 to $3.55 per hour, our per diem cost would increase from $103 to roughly $150 per day by 1971.

Now, the question really remains, who is going to stop this, because there is no increase in productivity I see there for a 50-percent increase in costs, and a reduced work week in terms of hours.

As I said several years ago—I said it several years ago in Los Angeles—hospitals will find themselves caught between the exhortation of Government to contain costs while the unions strike outside for higher wages, and the administrator sits in the middle of it, trying to make sure that the patients are served from day to day.

The only solution provided by Government thus far is to cut back on medicaid and go through the usual rigmarole of suing Blue Cross to prevent the rate increases necessitated by higher wages, fringe benefits, et cetera, which the same people suing them, the politicians, are out exhorting them to do. It is very hard for me to understand. I think at some point in this country we are going to come around the corner and meet ourselves, as Walt Kelley's famous comic strip character, Pogo, said many times, "We have met the enemy and they are us."

Now, there are external factors of cost control—Mr. Hess has mentioned it, Dr. Fein has mentioned it—all of us in the field know what they are, and I will just list them without amplifying on them.

First, regional planning. It is still ineffective in this country. The Hill-Burton Act of 1946 was supposed to provide for it through State government. It, in fact did not, and has not, to this date, other than building up rural facilities. The problem is now much more in urban facilities as it is rural.

There are other recent acts which should help, and I have listed them there.

Second, *health insurance*. To date, third party insurance companies, Blue Cross and Government, have primarily represented the hospitals' or the doctors' or the drug companies' interests and not the consumer.

Just to summarize it briefly, as Mr. Hess has said in his testimony, certain fundamental changes are needed in health insurance plans to (*a*) stimulate the use of low-cost ambulatory facilities—this is being done in some Blue Cross plans and is being attempted under the medicare law; (*b*) provide for standards and quality and utilization control—representing consumers' interest instead of the doctors' as Blue Shield does or the hospitals' as Blue Cross does; and (*c*) to build in incentives to good management, recognizing that this is very difficult to do.

The pro forma activity on behalf of consumers in terms of quality and cost containment has simply not been done by third party payers, and before we have national health insurance or any expansion of existing programs, we certainly ought to do these things, and a good step has been made in the medicare law which does stimulate outpatient low-cost extended-care facilities, does require utilization review, does not do other things which I have listed here.

Third, it has been shown unequivocally that the development of health services accessible in local communities can (*a*) decrease the expensive, fragmentary nature of the American health system, thus preventive, diagnostic, therapeutic and rehabilitative services are located together in easily accessible regions of the neighborhod; (*b*) they will reduce hospital admissions by as much as 80 percent. In our own experience in Charlestown it has reduced them by 30 or 40 percent.

So far the people who used to be admitted to our hospital can now be kept in their own community, in their own homes, and in lower-cost neighborhood facilities.

(*c*) It can establish disease prevention and detection programs which again saves money. OEO started a program which detected some 58 cases of gonorrhea in an improverished population in the Chelsea-Charlestown area, and which had gone undetected. If untreated, on an ambulatory basis, the patient can end up with heart disease, joint disease, strictures in the urinogenital tract, and so on. He has to come into the hospital, where it costs thousands of dollars, as contrasted with picking them up and shooting them with penicillin on the hoof, which costs about $10.

I could give you a hundred examples of this. When they talk about the revision of the health system in this country they are talking about those moves, relatively simple, relatively uncomplicated and, unfortunately, not enough of us doing it.

Finally, we can stimulate research into the health system and ways of enhancing the use of manpower.

For example, we are experimenting with social workers, visiting nurses, clinicians, medical ombudsmen, and so on, which would relieve the doctor of his valuable time to do what he is specifically trained to do.

Fourth, group prepaid comprehensive medical care programs such as the HIPH in New York, and the Kaiser-Permanente plan in California do result in fewer hospital admissions and lesser per capita cost without apparent sacrifice of quality. Some doctors and the AMA hierarchy have actively resisted such developments for largely, although not entirely, economic reasons.

Fifth, development of better extended care, nursing home, chronic and rehabilitation facilities, to reduce the use of high-cost, acute hospital facilities where possibly by the early transfer of the patients to lower cost facilities more appropriate to their needs.

Massachusetts, New York, Pennsylvania, and California are the four leading States in the use of extended care facilities, and even we have much increased use of all our hospitals in these States, including mine, because of a lack of inappropriate extended care low-cost facilities, so we cannot discharge our patients.

This is what we are talking about when we are talking about revising the system in this country, and the Federal role, to my mind, is to stimulate those clear signposts and not knuckle under too far to the producers interests.

There has got to be a balance of producer and consumer, I agree, but I think the balance may have shifted too far in favor of the producer in recent times, although I am sure that will raise the hackles, as usual, of some of my friends in the medical field.

Sixth, health services research. It is interesting, if dispiriting, that while we spend $1.6 billion on biological, medical research in the mad rush to acquire knowledge, some of which, I might say, acquired over 50 years ago, such as immunization, has not been used for our people yet—right in the city of Boston, looking in the shadow of the Massachusetts General Hospital, you have got pockets of impoverished children, 50 to 60 percent of whom have not been immunized for diphtheria, pertussis, polio, and measles. A ridiculous situation. We spend, despite all this, tremendous—and the latest stunt, by the way, is our medical equivalent of the moon shot, which is the heart transplant which essentially costs $40,000 a transplant and has about as much public health implication as going to the moon does in solving pollution and population problems; we spent less than $20 million to research the health system which consumes now $60 billion in this country.

More research and experimentation are needed to change and improve the present system, and there is a division now within the HEW which is designed specifically to do this, and it should be supported.

Finally, doctor and drug cost—I have said little about doctors' fees and drug costs. In the first instance, I fear governmental controls if the profession fails to restrain the price increases which are inevitable in a free, private market economy, where demand is far outstripping the short supply of doctors.

The AMA would be well advised to provide firm guidelines lest they invite Government regulation of what economists describe as a monopolistic system and not a system where both producer and consumer gain through knowledgeable action and competition. Rashi Fein has just listed the unique characteristics of the medical care field vis-a-vis traditional economic theory.

When it comes to drug costs, I can only repeat what has been repeated endlessly before one congressional committee after another in this country, and most recently a report to the President on medical care prices from the Department of Health, Education and Welfare, dated February, 1967, where it is said:

> Brand name prescribing raises the cost of drugs not only to patients but also to the taxpayers when the drug costs are covered by public programs.

Pharmaceutical companies spend 25 cents on their dollar expense to differentiate their product by their brand name from the generic name, and $3,000 per physician per year as advertising to them.

I apologize for the long-winded nature of this, but I do appreciate the opportunity to speak here.

In summary, inflationary forces apply to the medical care field as much as any other sector, and we are part of the main in that regard.

Secondly, because of an increase in services and technology, our costs have risen.

I have tried to mention ways of containing costs, both internally in the operation of a hospital as well as externally in the community, and ways in which the Federal Government may help us all in the public interest.

Thank you.

(The remainder of Mr. Knowles prepared statement, paralleling the foregoing testimony follows:)

* * * * * * *

If we could establish an all-inclusive per diem charge to the patient and his third party payer instead of the present a la carte piece-work charging system—we could, at the MGH, absorb 90 people (key punchers, clerks, accountants, etc.) into other jobs in the hospital as vacancies occur. This would save over $500,000 in one hospital (personnel as well as computer time, supplies, etc.) or as much as a half billion dollars a year if extended to all hospitals (and *more* because Blue Cross, commercial insurance companies, and government would also save on personnel costs).

In the days when patients paid their bills directly, such a system would not work for it would be impossible to charge each patient an average daily or pro rated share of the daily work of the hospital, e.g. $10 a day for sitz baths for painful hemorrhoids versus $10 a day for a multiplicity of procedures, tests, machines and people for the treatment of heart failure. With the growth of third party payers, such a system is now feasible (for in-patients, although more difficult for out-patients where third party coverage is less and direct payment more common). There are other objections to such a system, but all can be overcome. Most important, the quality of care will not be interfered with nor will the responsibilities for cost accounting and control and sound management—*and* costs can be reduced with great savings for the public.

(5) When all is said and done about improving management and containing costs, one picks up the *New York Times* of October 4, 1969 and reads the front page headlines:

"$125-a-week pact won in hospitals" and the sub-head

"Nonmedical Workers Settle for 3-Year Minimum Here".

The agreement was made between the Association of Private Hospitals (23 in number) and union representatives while 7 of the hospitals were being struck during negotiation and state mediation. The new contract replaces the present weekly minimum of $83 for 37½ hours with $125 for a 35 hour work week. The new minimum wage is therefore about $3.55 per hour, and the weekly wages will increase by roughly 50 per cent. If we were to move our minimum wage from $2.10 to $3.55 per hour, our per diem cost would increase from $103 to roughly $150 per day. As I said several years ago, hospitals will find themselves caught between the exhortation of government to contain costs while the unions strike outside for higher wages. The only *solution* provided by government thus far is to cut back on Medicaid and go through the usual rigamarole of suing Blue Cross to prevent the rate increases necessitated by higher wages, fringe benefits, etc.

External Factors in Cost Control

"Internal" methods for improving efficiency and containing costs are crucial, but far greater savings can be accomplished in the long run by certain moves external to the hospital.

(1) *Regional Planning.*—Avoids the development of unnecessary services and reduplication of costly facilities and encourages full utilization of regional facilities. Unfortunately, voluntary regional planning has been resisted, and a number of governmental health planning programs (10 to be exact) provide stimulus and money both to State government (e.g. Comprehensive State and Areawide Health Planning (P.L. 89–749); Hospital and Medical Facilities Construction (Hill-Burton Act); and to voluntary or private groups (e.g. Regional Medical Programs)). Effective regional planning will also uncover the need for additional capital expenditure to improve or add needed facilities and equipment.

(2) *Health Insurance.*—To date "third party" insurance companies, Blue Cross and government have primarily represented the hospitals or the doctors or the drug companies' interest and not the consumer. Certain fundamental changes are needed in health insurance plans to: (a) stimulate the use of low cost, ambulatory facilities (this is being done in many Blue Cross plans and is being attempted under the Medicare Law); (b) provide for standards and quality and utilization control (representing consumers' interest instead of the doctors as Blue Shield does or the hospitals as Blue Cross does); and (c) to build in incentives to good management, recognizing that this is very difficult to do.

Medicare does stimulate out-patient and low-cost extended care facilities and does require utilization review for hospital stays. It does not cover drug costs, nursing home care or a significant segment of physician fees, nor does it directly insist on quality control. Certain standards are required of hospitals and extended care facilities to accredit them for payment. This is a good law which can be improved. Medicaid is a bad law and does none of the admirable things mentioned above. Blue Cross should pay more attention to consumer demands and criticism; and Blue Shield should enlist the aid of community leaders and pay more attention to the public and a little less to the guild . . . Standards, quality control, stimulus to use low cost facilities and incentives to good management will save money while improving quality.

(3) *Neighborhood Health Centers.*—It has been shown unequivocally that the development of health services easily accessible in local communities can: (a) decrease the expensive, fragmentary nature of the American health system—thus preventive, diagnostic, therapeutic and rehabilitative services are located together in easily accessible regions of the neighborhood; (b) reduce hospital admissions by as much as 80 per cent; (c) establish disease prevention and detection programs which again saves money; (d) stimulate research into the health system and ways of enhancing the use of manpower.

(4) *Group, Pre-paid Comprehensive Medical Care Programs.*—Such as the Health Insurance Plan in New York and the Kaiser-Permanente Plan in California do result in fewer hospital admissions and lesser per capita cost without apparent sacrifice of quality. Some doctors and the A.M.A. hierarchy have actively resisted such developments for largely (but not entirely) economic reasons.

(5) *Development.*—Of better extended care, nursing home, chronic and reha-

bilitation facilities—to reduce the use of high cost, acute hospital facilities where possible by the early transfer of patients to lower-cost facilities more appropriate to their needs.

(6) *Health Services Research.*—It is interesting if dis-spiriting that while we spend 1.6 billion dollars on medical research in the mad rush to acquire knowledge (some of which, acquired over 50 years ago, hasn't been used for our people yet) we spend less than 20 million dollars to research a system which consumes nearly 50 billion dollars annually. More research and experimentation is needed to change and improve the present system.

(7) *Health Education.*—To stimulate the prevention or early detection of disease.

Doctor and Drug Cost

I have said little about doctors' fees and drug costs. In the first instance, I fear governmental controls if the profession fails to restrain the "price increases" which are inevitable in a free, private market economy where demand is far outstripping the short supply of doctors. The A.M.A. would be well advised to provide firm guidelines lest they invite government regulation of what economists describe as a monopolistic system and not a system where both producer and consumer gain through knowledgeable action and competition.

When it comes to drug costs, I can only repeat "A Report to the President on Medical Care Prices" (Department of Health, Education and Welfare, February, 1967, p. 37) where it is said "Brand name prescribing raises the cost of drugs not only to patients but also to the taxpayer when drug costs are covered by public programs." Pharmaceutical companies spend 25 cents on their dollar expense to differentiate their product by their brand name from the generic name, and $3,000 per physician per year as advertising to them.

Chairman GRIFFITHS. Thank you very much.

I have enjoyed all of your statements. You were very good.

I would like to ask, for all practical purposes, is not medical care a monopoly?

Mr. FEIN. It is closer to a monopoly than it is to anything else.

Chairman GRIFFITHS. Well, then, in place of regional planning, which is in reality among the existing hospital administrators, is it not, and Blue Cross, don't they do the regional planning?

Mr. KNOWLES. They do most of what exists.

Chairman GRIFFITHS. They do most of it, so you assume they are there to take care of themselves.

In place of that, why don't we let private enterprise have a part of this? Why don't we say anybody who is insuring—and this particularly means Blue Cross—I do not understand Blue Cross at all. Blue Cross is an insurance company. Why don't we say to them, "Look, if money is paid into this for insurance and you go to (a patient carrying that insurance goes to) a hospital that has been deemed a standard hospital, it has met tests and it is a qualified hospital, you pay"—no more of this nonsense if you are paying a nonparticipating hospital a certain amount, and other hospitals a certain amount, what is wrong with that? I really do not understand. This is the only insurance company that does any of this.

Mr. KNOWLES. What is wrong with Blue Cross not requiring evidence of regional planning, you mean, before they pay the hospital?

Chairman GRIFFITHS. Pardon?

Mr. KNOWLES. You are talking about regional planning. What would be wrong with Blue Cross finding out whether the regional hospitals in the area have complied with the standards of responsible regional planning.

Chairman GRIFFITHS. The point is that there are some hospitals that have been built with private funds that meet every standard and to which Blue Cross won't pay. Why should Blue Cross or existing hospital administrators be able to say to a private hospital, "We are not going to pay you."?

Mr. KNOWLES. It depends on what standards of planning and management they are applying, what quality controls they are applying in the public interest.

In certain instances the Blue Cross has refused to pay proprietary hospitals because of the lack of quality or standards or sufficient controls that they were simply unwilling to let their—acting in their consumers' interests, the people paying the premium, they have refused to let their patients go there. If they go there they pay their own money.

Chariman GRIFFITHS. I question that.

Mr. KNOWLES. That is all right.

Chairman GRIFFITHS. I question whether Blue Cross is really concerned with the consumers' interest. I think Blue Cross is concerned with Blue Cross.

Mr. KNOWLES. I think it is showing more interest in the consumer, but I would agree generally that Blue Cross should have, and I hope will in the future, exert more leverage on behalf of the people who are buying their insurance.

Chairman GRIFFITHS. Now, let me point out, when you have been talking about hospitals, a thousand bed hospitals, or 600 or 800, in general are not these hospitals operating within an inner city, in a big city?

Mr. KNOWLES. For the most part.

Chairman GRIFFITHS. For the most part they are. Do you then tell me that nurses, if you hire 100 nurses this year, at the end of the year you only have 30 of them?

Mr. KNOWLES. Yes.

Chairman GRIFFITHS. Is not one of the real problems that that nurse doesn't want to come into the inner city?

Mr. KNOWLES. Oh, I think quite definitely.

Chairman GRIFFITHS. Definitely—you agree?

Mr. KNOWLES. Yes. If I were a nurse and had a choice between working at the Massachusetts General Hospital or going to some nice small community hospital in an upland pasture——

Chairman GRIFFITHS. You would go to the small community hospital?

Mr. KNOWLES. For the same pay, I believe I would do it.

Chairman GRIFFITHS. I have observed that this happens.

Mr. KNOWLES. However, there are advantages to living in the inner city.

Chairman GRIFFITHS. I go to an inner city hospital but I have observed a small community hospital, the one where every patient has a registered nurse per floor. The one in the community hospital has more registered nurses per patient than I have seen in many years.

Mr. KNOWLES. With less to do. I hate to say it but there are floors of the Massachusetts General Hospital that from 11 p.m. to 7 a.m. only one nurse is available.

Chairman GRIFFITHS. The truth is that you are giving the care to those who are there more cheaply than at an inner city hospital. In the hospitals I have observed that is true.

Mr. KNOWLES. You would have to net that out because complex illnesses demand the expertise that can only be obtained in an urban general hospital.

Chairman GRIFFITHS. So I wonder if the regional planning has not tended to keep in operation high cost hospitals?

Mr. KNOWLES. I don't think so.

Chairman GRIFFITHS. Mr. Hess, what would you say?

Mr. HESS. Madam Chairman, I think you have to look at what you characterize as the inner city hospital in terms of whether it is a very large teaching institution. It frequently is a very large teaching institution which has very much heavier community obligations than perhaps the suburban or smaller hospital you are talking about. It is associated with a teaching school and it may be, because of that fact, a referral center for very much more difficult cases that are sent into it.

Mr. KNOWLES. I am glad you said that, Mr. Hess. That is what I have said.

Chairman GRIFFITHS. I didn't really mean that because many of these hospitals are not teaching hospitals, Mr. Hess. I am going to join Senator Javits on his disaster relief for the teaching hospital, I think they are in bad shape.

Mr. KNOWLES. They are.

Chairman GRIFFITHS. But there are many big city hospitals that are not teaching hospitals that are having the same trouble keeping nurses and keeping other help that any other hospitals have. If you had been building these hospitals up on the outside, and they have had to meet a certain standard of care, isn't it possible that you would have today a lower cost per hospital? What do you say, Mr. Fein?

Mr. FEIN. I would rather doubt that. It seems to me that there are a number of problems in the area which are not at the present time susceptible to solution.

First, we can't measure quality of care. We are talking about a product whose quality we cannot measure and this gets us, of course, all hung up on all our incentive reimbursements, on our comparisons between the inner city, and the other hospitals. Additionally, we are dealing with a product where one would hesitate to try to measure the quality ex post. Medical care is not a hammer that may break under pressure and you go in and you get another one. It is a major expenditure, and one where persons' well being, health and indeed even life may be involved.

Second, our inner city hospitals do have a different mix of patients and a different mix of diseases. In a sense one should consider them a national resource, to be financed by the Nation and not by the sick people who happen to be in the hospital at a particular moment in time.

I don't go to the hospital often, I am very happy it is there, and I ought to be paying for the privilege of having it there even though I don't enter it.

Beyond that, of course, we have the fact that the inner city hospital is in a place where there is a large population. That population has not been able to pay for its care in the past, and under the pressures of inflation we find many, many States and localities cutting back the reimbursements to those very institutions that serve the population and we are just kidding ourselves because somebody will have to pick up the difference between what medicaid will pay John Knowles and what it is going to cost him, and it seems to me it is highly inappropriate that that somebody should be donors of charity or should be the patients themselves in the form of expenditures which they can't finance. It just seems to me on grounds of equity that this is a problem that society should address itself to and should not then under the pressure of inflation cut back its expenditures.

I am not at all convinced that a smaller network of hospitals outside the inner city would indeed be more efficient. Most of the studies would seem to indicate that the optimal size in terms of economic efficiency for a hospital is in the order perhaps of 600 beds or larger, rather than smaller. It takes a team of physicians and of nurses to operate a small hospital, and they don't get enough of certain kinds of diseases or certain kinds of patients. The result is that (a) costs escalate and (b) probably poor quality care is given because they don't have the experience, if you will, of doing certain things often enough to become adept at them. I would rather be in the Massachusetts General today in heart surgery than 15 years ago because they are doing it more often.

Chairman GRIFFITHS. If then you continue with regional planning why should we have the Government in it or why should we have only existing hospital administrators?

Mr. KNOWLES. Well, you don't, and in fact you have State government in it under the Hill-Burton Act. You have public and private and largely a private sector in it under the regional medical programs. Under the Comprehensive Health Act you have a combination of public and private.

Chairman GRIFFITHS. Where are the consumers represented?

Mr. KNOWLES. The consumers are supposed to be represented on those councils. They can only have a certain percentage of doctors, hospital administrators, third party payers and the rest are supposed to be consumer interests. They have worked in certain areas and done a decent job but I think there have to be more teeth put into it.

Mr. HESS. Madam Chairman, I think your observation is perfectly correct that there is no traditional consumer representation in our planning generally. There is no tradition of consumer representation even in our nonprofit third party payment mechanisms, or I would say, for the most part even in our nonprofit hospitals except to the extent that board of trustees may represent the industrial side of the consumer community.

The comprehensive planning provisions under Public Law 90–174 are beginning—and I think every State now has an agency designated as its comprehensive planning agency—are beginning to provide an umbrella within which areawide planning takes place. But we are just barely getting started. And your observation is perfectly correct that up to now planning has not only had not had teeth, but it has also not been very effective. And it has not been representative.

I don't see, however, a good alternative that takes care of the public interest, the governmental interest and the consumer interest, except to try to strengthen and rationalize planning and get some hold on capital financing. Because, as has been so often said, if you build a bed it will be occupied and, as Dr. Knowles has indicated, even with the excess capacity that we still have, hospital beds are very badly distributed. Many of the inner city hospitals don't have this excess capacity, and they are badly in need of modernization. But if anybody can build a bed, either through philanthropy, or through a loan, or a grant, or whatever it may be, he goes ahead without the purview and the judgment of the community, the consumers and every payment agency are going to be committed to amortizing this bed. This chaotic situation will continue. Right now, medicare and medicaid in the hospital reimbursement formula are committed to helping to amortize anything that anybody puts up, to pay the interest on it, and to contribute to the equity interest if it is a proprietary facility.

Mr. FEIN. If I might adjust a word on that, I think that Mr. Hess is quite right. We have had planning where the planner has not had control. That is not planning. It is getting together and talking about problems and hoping that persuasion might bring some change. Medicare has, if you will, taken us a step backward on planning. I think that even with all that, however, we are infinitely better off in the hospital field than we are in the other areas of the health spectrum.

If you are living in an area where there is not a physician, and if you want to complain I would submit that you don't know where to take the complaint to, you don't know what telephone number to call. If you call the State medical society or the county medical society or the State department of health or the Harvard Medical School, or whomever you call, you will get an answer: "It is not our responsibility."

The hospital cannot be viewed as an isolated instrument in the medical care spectrum. It is tied to what goes before and what comes after the individual leaves the hospital, and as long as there is no responsibility on the rest of the system, no planning by the rest of the system, as long as everyone feels that they cannot intervene in the rest of the system not only will the system break down but the hospital will be in much worse shape than it otherwise would be.

Chairman GRIFFITHS. Now, if we are going to have planning then why shouldn't the planning be done at least on a national level?

Mr. HESS. I think at the national level—and this is a personal view now, I may be getting in deep water because I am not a professional planner—but I think, at the national level, you are in position to exercise broad priorities and to establish public polcy for public programs that will put funding in the proper direction. For example, the broad priorities would say what kind of a reimbursement formula you would have, what contribution it makes to capital, what kinds and amounts of appropriation will go into capacity building programs like Hill-Burton and the extent to which these programs will direct their attention to rural areas, to urban neighborhood centers. These are the broad priorities that you have to have at the national level.

Now the State umbrella planning council, begins to particularize the national prorities to the needs of the States and the localities and, in addition, reflects modifications or extensions of a plan insofar as the plan applies, not just to public programs, but to everything that goes on in the voluntary sector, too.

As you will recall, I indicated two-thirds of the personal health care money is still spent in the voluntary sector. There also needs to be the kind of area planning mechanism that permits consumers and those who put the money up in the voluntary sector to pass judgment on, or at least to get into the forum and mix it up with others, as to whether these are the right priorities for a particular community. It may be that what is a very good State priority for most communities might be a very poor priority in terms of the particular needs of a locality. So there is a three-level interaction.

Chairman GRIFFITHS. Well, I certainly feel that any planning suggestions, have to be better than permitting the present administrators of the present hospitals plus Blue Cross to decide on the plan.

Mr. HESS. I think you would get wide-spread agreement on that.

Chairman GRIFFITHS. These people are a monopoly. They are not going to do anything that hurts their own position and they don't care what the consumers think about it. This is only too obvious in this program.

Now, I would like to ask you, and I particularly enjoyed your mention, Dr. Knowles, of the fact that we aren't using all the research that we have. I came from a little rural town in southwestern Missouri, and 50 years after it was known that water carried typhoid every spring and every fall people died like flies in that little town from typhoid.

Mr. KNOWLES. Yes.

Chairman GRIFFITHS. So that I agree, we weren't using the research we have. I saw an article the other day that pointed out that not only do we not use research but that a very large part of the research is really worthless. It hasn't done very much for anybody. Indeed, I believe this person pointed out that some of the heart research that has been done has added literally nothing to the length of life. I assume that you have some feelings along this line, that we ought to be using research that does add, it would be better to spend the money there and to do only the research that actually adds, to life and cut out the rest of some of this research.

Mr. KNOWLES. Well, on the one hand, I don't think there is any question we are going to have to reset priorities and reallocate our national resources to the utilization of knowledge, and I think we are seeing that shift right now. I think the historians will look on the 1940's, 1950's, and 1960's as the time in point when with the moonshot and the heart transplant and all these other wonderful scientific and technological achievements, we finally decided that we had to pay some attention to the real issues of the use of knowledge on this globe if not for anything else, just mere survival. So I don't think there is any question we are going to see a resetting of priorities, reallocation of resources.

However, the second issue, the trouble with basic research, and the scientists know this and I know it, and I can't say anything else, we don't know what kind of research is ultimately going to pay off. If we try to make decisions of say we are only going to let you do that kind of work if you promise something is going to happen in 4 or 5 years in reducing heart attacks, we would be in deep trouble. We would have stopped the work that Enders did on cultivating viruses. Enders worked there as an assistant professor at Harvard just minding his own business for about 30 or 40 years, just kind of plodding away on something that nobody recognized him for at all, then he started tissue culturing viruses, and all of a sudden—and he wasn't particularly concerned with poliomyelitis—but suddenly that basic research was used to develop the vaccine which now has wiped out epidemics of poliomyelitis.

The last great one in this country was the middle 1950's. Poliomyelitis is not a major public health problem.

I say when we spend $50 million on researching the best utilization of knowledge for people as contrasted with $1.6 billion on further basic research that you should make adjustments within that mix without any question. I don't think you are ever going to be able to guide research to solve the problem. I think that would be too bad in this country if we demanded the utilitarian benefits of basic research immediately. That is not to say some people are not getting a free ride on this basis, they look at the right wing of the *drosophila* for the next 30 years and just have a wonderful life doing it, and what motivates them some of us will never fully understand.

I think the same is true of the whole study of DRA and DNA.

Certainly the study of Fleming and penicillin, a perfect example of serendipity, he just happened to see that fungus light on the plate one day and the bacteria he was cultivating all of a sudden died. His mind was prepared and he said it must be killing the bacteria, so pretty soon we had penicillin. So some of the greatest discoveries have been made by chance.

This is a long winded answer and you and I are trying to winnow out that fringe that is having a free ride by just telling me heck how can you tell and it is a pretty good ride, I might add, it is a good life and it has become quite a favored position and it is pretty good.

Chairman GRIFFITHS. I think that is what the writer was objecting to. Researchers had not added much to human life and he was tired of paying the bill. I assume that was his real problem.

Mr. KNOWLES. Yes. But you see if you put such money into such things as researching a system or putting it to work to plan regionally, develop regional centers, to research the use of prepaid practice, to research the use of other types of the medical system and to reallocate our own resources, I think you will see the private sector do this. I don't think there is any question that all of us when you can get the man on the staff of the Massachusetts General Hospital to come to Washington, the professor of medicine, pediatrics and surgery, to come down here to ask for funds to do research on the use of all the knowledge they have, something has happened. It was the first time anybody at HEW has seen anybody from the Massachusetts General coming down to Washington to use the knowledge they have as contrasted to getting more money to do research.

Rashi Fein has come down here to The Brookings Institution using resources of Harvard Medical School to initiate this kind of work, a good thing.

Chairman GRIFFITHS. Insurancewise, Mr. Fein, what are the problems of paying a per diem—have insurance pay a per diem—that actually covers in place of item by item.

Mr. FEIN. I think it all depends on how much trust one has of those who will be submitting the consolidated bill, and I trust Dr. Knowles. I don't know that I am as sanguine about the cost accounting or the behavior in smaller institutions and I think there I might be quite concerned about a consolidated bill that did not perimt me to reassess the figures. I think perhaps a solution might be to move toward a system that Dr. Knowles advocates by beginning with the larger instiutions and covering the smaller ones on a spot check basis where one is entitled to go in and on a random basis look over individual bills and try to reconstruct them. That very fear of knowing that somebody may do that will probably keep them, I was about to say, "keep them honest," but it is not a matter of graft or deceit, "keep them on their toes" might be a way of putting it.

Chairman GRIFFITHS. Suppose it was said to Dr. Knowles we will pay $100 a day and to a hundred beds we will pay $75. What would be the effect?

Mr. FEIN. I am troubled about telling anyone, of course, that we will pay *x* dollars. This is hardly a spur to efficiency. While I would agree that the real problem in the system is the relationship with the hospital, between the hospital and other parts of the medical care system, nonetheless, I think there is a little bit of fat in some hospitals that could be cut out. I would much rather see a system analogous, perhaps, to the Canadian system where there is an intensive negotiation in advance in an attempt to arrive at a figure that is based on an efficient operation, and where the hospital then, if it operates even more efficiently, gets to share in the benefits, together with the community at large. If it operates less efficiently it suffers the penalty, hopefully, not passing the suffering on to the patients. I gather, Art, that you have at least one or more reimbursements experiments, incentive reimbursements experiments along that line.

Mr. HESS. We have, Madam Chairman, a number of reimbursement experiments where we are setting targets either for internal departments of the hospitals, as in Connecticut, or where we are setting a target for the hospital as a whole, as in southern California, an arrangement which we just entered into. But I would like to pick up the idea that we do need to do something in the way of experiments with a negotiation of all inclusive rates. It is true we are working on this.

Now, when you say what would happen if you paid Dr. Knowles $100 a day, I assume we would not arrive at a figure with Dr. Knowles or anyone else simply on the basis of their saying "This is our current cost."

Any all-inclusive rate has to have in it an element of negotiation. You first have to have disclosure of costs; you have to have a theory in this negotiation of what you are willing to pay for, let's say in terms of future contribution to capital, and of certain basic questions like what you are going to contribute to the health and growth of the teaching program, and so forth. But then there would be, I assume, a negotiation which would put a little bit of a squeeze on the institution, not necessarily in terms of the rate as of today, but it ought to be a negotiation for a rate that would hold for a period of time. The institution then would be at risk in terms of meeting its emerging costs and having to scratch around real hard to reorganize its internal management and so on. There is a natural pressure of increasing costs due to technology and wages as they go along, so they would feel that the risk of bouncing up against their ceiling and knowing there wasn't going to be any retroactive adjustments. They would be stuck with this rate for awhile, and you might have to have an escape clause for some things such as a major disaster or a very unusual circumstance that came up. But the idea of putting an institution at risk and testing their mettle is something—in an all-inclusive rate or otherwise—that we ought to look into.

If I may say one more word on that long computer bill, while we can avoid having to present detailed itemized bills to individuals and third parties, there will still have to be a great deal of internal cost accounting and computerization, as Dr. Knowles indicated, because

I am sure that even if the third party who is going to pay that $30,000 bill, was it not concerned about asking questions, I think Dr. Knowles and his staff would want to know what is going on in that case—for example, how many drugs and how frequently and what other kinds of care he is getting. So an all-inclusive rate will not eliminate record keeping. It can eliminate the problem, though, of passing those records on to a lot of other places. Then audits and spot checks would be the answer to a lot of this.

Mr. KNOWLES. Yes.

Mr. FEIN. If I might just add one word on that computer printout that Dr. Knowles exhibited, the critical thing that caught my attention was that the bill was $33,000, and no matter what Dr. Knowles does and no matter how much less paper he needs, we are not going to reduce that an awful lot. Let's be heroic and assume a 20-percent reduction. That brings it down to between $26,000 and $27,000, and I think the issue before the Nation has to be how is that going to be financed? Hospital care is not going to become cheap or inexpensive. It is still going to be awfully high, and we will have to move to a system of financing that kind of a bill, not relying on hopeful efficiency to bring it down to a level that Americans can afford.

Mr. KNOWLES. I agree.

Chairman GRIFFITHS. May I ask you, Mr. Hess, what is the experience with the usual and customary fee of a surgeon or doctor?

Mr. HESS. We have had extensive experience in the last couple of years, more so than I think any Blue Shield or private insurance companies ever had before with the problem of attempting to identify and keep track of fees. This is done by our carriers, our Blue Shield and private insurance carriers, under the policies and procedures which we have laid out. We have had extensive experience of trying to keep track of usual and customary charges. As you may recall, last January we issued instructions to all carriers sharpening up on the definition of how you determine what is usual and customary; and how you determine what is prevailing; and how frequently you recognize changes in prevailing levels; and what kinds of justifications a carrier has to have in order to give recognition to a change in a doctor's customary fee. So that the tendency of our January instruction was to create in all except very unusual justifiable circumstances what I might call a "resistance factor" to the carrier simply changing the allowable charge as customary profiles and the prevailing profiles went up.

Similarly with respect to medicaid, in July or August of this year a regulation was issued establishing the medicaid ceiling on physicians prices at no more than 75 percent of the customary charges in the area on the preceding January 1, and requiring that if there are to be changes in the future, these will have to be justified not only by the existence of a good utilization review process in the State medicaid agency but also they will have to be linked to be no more than what is justified by changes in the Consumer Price Index, of all services computed without the medical services component.

Chairman GRIFFITHS. I would like to give you an example that was given to me by one of my constituents. He had had a brain operation, and he wrote that he didn't think he was doing too well. He was in with another group of people who had had the same operation, they were trying to teach them to talk, I believe. He didn't think he was doing as well as other people, and then he said at the end, "And another thing I don't understand is that everyone else in here, their operation cost $1,500 and mine cost $450."

Now, you know, it was pretty tough, I mean what can you write back, "Evidently yours was the first one your physician ever performed," or the second and maybe that was it. I would assume that this would create some problem even with the people who are involved in it.

What percentage of our practicing physicians were trained in other countries?

Mr. KNOWLES. Thirty percent of our new licentiates are from foreign medical schools.

Mr. FEIN. About 30 percent of interns and residents and almost 20 percent of newly licensed physicians are graduates of foreign medical schools.

Chairman GRIFFITHS. How many English-speaking doctors do you have on duty in Massachusetts General?

Mr. KNOWLES. Ours is unusual, all of ours are American graduates, and we have a very nice selection of the medical schools in this country. But in community hospitals 15 miles away from us none of them may be English speaking—from the Philippines, or from European countries. Thirty percent is an awful lot of people for an affluent country to be licensing particularly when these people are coming from countries whose shortage of doctors is even more acute than ours. I don't think we can count on that forever. Dr. Fein has reviewed the whole business of physician power needs and shortages and the economics of it in a book—I might as well push a few copies for you, Rashi—written under the flag of The Brookings Institution. It is a very good book. Some specialties have as many as 40 or 50 percent of their physicians as foreign graduates now. Some of them are as low as 10 percent. Internal medicine and general surgery in this country have relatively fewer numbers licensed from foreign schools, but it is an awful thing when we are short of manpower to still be depending on 30 percent of our current supply being licensed from foreign medical schools.

Chairman GRIFFITHS. What do you think would add to the cost of care if we didn't have these foreign imports?

Mr. KNOWLES. That is hard to say, because in some hospitals it would cost a lot less. In some hospitals it would cost a lot more. It all depends on who you get. Which gets us back to the old business of quality.

The quality in those hospitals that are using largely foreign graduates is not the same quality as those that are using American graduates. Therefore, does it cost less or more? Well, depending on the quality of the care that the consumer gets in that hospital it may be prohibitively costly. It is hard enough to take care of a patient when you speak the same language.

Chairman GRIFFITHS. What percentage of our practicing physicians are women?

Mr. FEIN. Probably about 5 percent?

Mr. KNOWLES. Five percent, I would say.

Chairman GRIFFITHS. Why don't we have more?

Mr. KNOWLES. We have the lowest number, I think, of any country, we are about 18th of any country in the western hemisphere. I think the eastern, too. Dr. Fein can answer that.

Mr. FEIN. I think the reason, in part, is connected with the behavior of medical schools and in part connected with the system of medical care in this country.

Note what we require of a physician when he graduates medical school is that he become a small businessman. He doesn't often seek employment because that is not in the tradition. Rather he is called upon to open an office, hang out a shingle and make it on his own. I should think that many women would be much more interested in pursuing a medical career if there were more group practices or neighborhood health centers under OEO where they could come and work, leave that occupation for a period of time, return to it, work part-time, while children are growing up and so on but we don't offer that opportunity really. Instead we say, "You ought to be in this thing full-time. You ought to be on your own. You ought to be available at night. You ought to do all those things that men complain about," and that women would find impossible given the fact that they also have family responsibilities.

Chairman GRIFFITHS. Isn't the first problem really that the medical schools do all they can to discourage them?

Mr. FEIN. I think medical schools do but note that under our system where we decide how many physicians shall be trained by admitting only a small number of individuals rather than by admitting many more and seeing who can make the grade, a medical school says to itself "Shall we use one of these very, very scarce spaces for a woman who will be in and out of the profession or shall we use it for a man who is more likely to stick with it for a full-time career?" One sympathizes with the medical school, though one shouldn't carry this sympathy to an excess, but I think that it is part of the whole system. I recall that when my wife applied for a graduate fellowship in a university, there were those who would have turned her down on the grounds that there was no point in wasting a fellowship on a woman. So I think I speak with some feeling on the matter.

Chairman GRIFFITHS. What percentage of doctors fail to practice as doctors, particularly in general practice? What percentage of trained doctors fail to practice since they object to this in women, as a matter of fact, I know quite a few doctors who are not practicing.

Mr. KNOWLES. There is a 10-percent attrition rate in medical school, which is a staggeringly high rate. Eight to 10 percent who enter never ultimately practice. We are talking, as Dr. Fein says, about a very expensive product. It costs $4,000 or $5,000 a year per student, the tuition doesn't cover more than 30, 40 percent of the costs of educating them, so it is very expensive both for women who may get married, pregnant or what have you, work part time plus this attrition rate.

Chairman GRIFFITHS. Why don't the medical schools come down here and ask increased funds for the medical schools?

Mr. KNOWLES. That is a long involved story. During the depression and after the second world war there seemed to be barriers to entry to keep the demands up. It isn't quite that simple to explain, however, but after the second world war and in the last 2 or 3 years the AMA itself, if you can believe it, has finally gone public with the Association of American Medical Colleges, 2 years ago, was the bellweather, and said yes, there was a shortage, there is a shortage of physicians, and they joined with the medical schools to petition the

Government for scholarships, and so on. Part of this was the fear of Federal stimulation and Federal subsidies and so on on the part of organized medicine. It is a long story, there have been books written on this but now all are agreed.

Chairman GRIFFITHS. How many years does it take to train a specialist today?

Mr. KNOWLES. It is 4 years of medical school and a minimum of 5 years depending on the specialty. It takes you 9 years and add another 2 or 3 to get going. It takes about 12 to 14 years, college, medical school, house staff, graduate training.

Chairman GRIFFITHS. In your judgment, are these really requirements or do you think they are artificial barriers to people entering?

Mr. KNOWLES. I think they are for most specialties, interestingly enough, I think most specialties are trying to reduce that number, trying to cut a year off college, a year off medical school and a year off graduate requirements. I do think there can be some shortening in those areas and I think you will begin to see that because I think the specialty board themselves are trying to do this now. I think it can be done but there will always be a need for more experts, more specialists in a highly technical country with an expansion generally of knowledge.

Mr. FEIN. I think the critical thing there is not so much the length of time for the super specialist, but the fact we have a system in which if you stop short of graduating from medical school, one day short, you are not 99 percent of a physician, you are not 90 or 50 or 40 or 30 percent of a physician. You are nothing. You have a very discrete kind of system where there is nothing less than this highly trained super specialists, and here is a fellow who has spent all these years, is able to do all kinds of wonderful things for very, very sick children, and he opens his office, and 80 percent of the time he is seeing well babies, and this is just silly. We obviously need the super-trained specialist, but we need individuals who have less training but are as able to carry on the tasks for which they are trained.

Chairman GRIFFITHS. Dr. Knowles, exactly how much additional personnel do we need for hospitals, how do we train them, who should be training them and how long does it take? Who should these paramedical people be?

Mr. KNOWLES. For hospitals?

Chairman GRIFFITHS. Yes, for hospitals.

Mr. KNOWLES. For general work in medicine, the latest estimate by the American Hospital Association, I think, is 200,000 of existing types, are needed but the answer can't be given until we have experimented and developed new roles. Nurse clinicans in certain sections of the country have been carrying out well-baby care and the pediatrician is only used for the complex situation. We in the Massachusetts General Hospital are using nurse clinicians to see patients without the doctors seeing them. They are trained, educated, and call the doctor when needed. So depending on how we develop new roles in medicine will affect the answer to shortages. These changes are slow. By 1970 I believe the health field will be one of the largest employers of any so-called business or industry and actually the medical field, health field is capturing an increasingly large share of the new labor market constantly, and will capture more of it as long as the folks in New York go to that $3.60 an hour minimum wage, although we will have a headache defending it.

Chairman GRIFFITHS. Do you have any idea what your national health insurance program costs?

Mr. FEIN. Yes.

I hesitate to give the figure because it depends on the particular details of the proposal. I would guess that it has got to be in the order of $15 to $20 billion. Lest that prove too shocking let me indicate that I would suggest that, given the fact that the Federal expenditures can hardly be expected to rise by that amount for this sector in any single year, that I would urge that one move into a program of this kind in a phased operation. We might first cover children aged zero to 18, but write into the law the specific requirement that every year we add 5 years of age coverage and thus over; a decade carry the population up to age 65. This would have the advantage of phasing in a Federal revenues grow.

It would also have the advantage, I think, on the supply side. I suspect that we can do better with pediatricians than we can anywhere else in the system, and it would give us a little bit of leadtime to gear this system up as we covered the total population.

Chairman GRIFFITHS. Would you submit for the record your tax credit proposal?

Mr. FEIN. I will do so. I would be glad to.

Chairman GRIFFITHS. I would be delighted to have that.

(The proposal follows:)

A PROPOSAL FOR THE FINANCING OF MEDICAL CARE VIA INCOME TAX CREDIT FOR COMPREHENSIVE HEALTH INSURANCE*

The proposed plan is described in the following memorandum. Also outlined are the assumptions that underlie it and the advantages (and shortcomings) of the approach.

(1) Medical care is, and will remain, "expensive." Since, as an organized society, we have agreed that individuals should not be denied care because of income limitations, we face the problem of developing a mechanism for financing of such care. The problem, put simply, is: how do we organize a financing system that will help in distributing an expensive product in a more equitable fashion?

(2) The various social purposes of government and the problems that the nation faces and will face are such that families and individuals who can afford to pay for all (or part) of their health care should do so (at least in part).

(3) Not withstanding point (2), means tests should be avoided since investigative procedures often involve loss of privacy and dignity and utilize scarce resources (e.g., social workers) that could be better utilized on other tasks.

(4) Because medical needs often are not predictable in advance, and because medical indigency is an important problem, determination of need (under present programs) must often be undertaken on an *ex post* basis rather than on a more desirable *ex ante* basis.

(5) In the light of the previous assumptions, comprehensive health insurance would be a desirable way for the individual's health care to be financed (thus meeting the problem of *ex post* determination of needs).

(6) It is clear that the income tax reporting mechanism is not considered a "means test." Nonetheless, it can be utilized to determine need.

It is proposed that the Department of Health, Education, and Welfare in consultation with interested parties (including the medical profession and the insurance industry) develop a suitable definition of a comprehensive health insurance policy. Such a policy should have the following two minimal characteristics: (1) It should be sufficiently comprehensive so as not to distort the patterns of medical care by providing certain types of coverages but not others; (2) It

---

*January, 1969. Rashi Fein, Harvard University.

should provide sufficient coverage so that it offers adequate protection against unanticipated large medical expenses (though it may involve financial constraints to prevent utilization abuse).

When such a definition is developed, insurance carriers would submit model plans for certification by the Department. Medical groups would also be eligible for certification of their own prepayment mechanisms if those mechanisms provide for the comprehensive coverage described in the previous paragraph.

The Department, after negotiation with carriers, would determine an appropriate price for such comprehensive insurance coverage. This price would become the relevant figure for the income tax credit to be made available. The price (and credit) would be determined on a regional or smaller geographic basis since medical care prices vary across the nation.

Families and individuals would be encouraged to purchase certified insurance protection. The family or individual would submit, along with the income tax form, a voucher indicating that application has been made for such protection. The federal government would meet all or part of the cost of the policy in the following manner: If the taxpayer's income is such that the tax due is less than or equal to the cost of the policy he will receive a full credit for the tax due and the difference between the tax due and the cost of the policy as a payment from the treasury. As income rises and the tax due increases, the amount of credit would decline (though it would always be greater than 0 percent). Thus, for example, if the comprehensive coverage policy cost $400 per family the following might be illustrative of the tax credits received.

ILLUSTRATIVE TABLE[1]

INCOME TAX CREDIT FOR FAMILY OF 4

[Policy cost $400]

Income (A)	Tax due[2 3] (B)	Tax credit[4] (percent of policy cost) (C)	Credit on tax due[5 6] (D)	Payment by Treasury (E)
$3,000 or less	0	100		$400
$4,000	$140	100	$140	260
$5,000	290	100	290	100
$6,000	450	90	360	
$7,000	620	80	320	
$8,000	810	70	280	
$9,000	1,000	60	240	
$10,000	1,190	50	200	
$11,000	1,380	40	160	
$12,000	1,600	30	120	
$13,000	1,820	20	80	
$14,000 and over		10	40	

[1] This is illustrative.
[2] Table does not include tax surcharge.
[3] Col. B is based on minimum standard deduction. IRS analysis is required to take account of itemization of deductions. Such analysis would be needed and should be utilized in setting appropriate rates for col. C.
[4] Col. C is illustrative. Credit could drop more (or less) rapidly.
[5] Policy cost assumed to be $400.
[6] If deductions are itemized, present code provides assistance on a deduction basis, for one-half of the cost of health insurance up to a maximum deduction of $150. The value of such assistance is 0 at low income levels, about $30 at incomes of $7,000 to $11,000, about $40 at incomes of $15,000 to $19,000, and about $75 at incomes of about $50,000. This is clearly inequitable. It does provide the rationale for a minimum 10 percent credit under the proposed plan for all income groups since the plan should replace the present deduction.

The following are some of the critical elements involved in this financing mechanism:

(1) The plan would involve direct payment to persons who, because of low income, would otherwise not benefit fully from the tax credit.

(2) The plan would provide some relief even for upper income groups since: (1) they receive some tax advantage today and (2) because of the advantages making coverage universal. Interest in this comes from the fact that: (a) health insurance is a desirable way to finance health care, in part because it mitigates against the possibility of the individual or family becoming medically indigent; (b) the more universal the coverage the less the possibility of adverse selection.

This plan would serve as a replacement for Medicaid and other welfare oriented financing mechanisms (all aged should be moved into Medicare coverage). Because it is national in scope it would eliminate the problem of differing state standards for eligibility or for comprehensiveness of services. It would also relieve pressures on the limited (and regressive) state and local tax base. Financed out of general revenues it avoids reliance on a regressive wage based tax as would be the case with a social security financed plan. It therefore makes possible a more equitable program.

It is recognized that such a plan would have important and considerable budgetary implications. It may therefore be desirable to phase in such a plan over a period of time even as Medicaid is phased out. This should *not* be done by making coverage less comprehensive and distorting the patterns of medical care. Nor should this be done by making the income tax credit so insignificant as to lead persons to fail to purchase such insurance. It can be done by making coverage initially available for individuals below a certain age (say, for children). Legislation could incorporate a provision that called for an expansion of age of coverage on a predetermined basis (say, adding five years of coverage every year until the person reaches an age where Medicare takes over). Such a program would make sense both because it would direct moneys initially to children and because the program would expand as the fiscal dividend (resulting from economic growth and the progressive nature of our federal tax structure) grows.

The program would require a large scale educational campaign directed at persons who have not in the past filed income tax forms. Such individuals should be able to pick up appropriate simplified reporting forms at the post office, for example. They could attach their voucher to such forms. Furthermore the program would have to take account of the fact that low income individuals can not be expected to purchase the insurance and be reimbursed at a later period. It is for this reason that we have indicated that the voucher should deal with intent to purchase insurance. These however are technical and administrative matters which do not effect the basic characteristics of the plan. One could for example make the reimbursement directly to carriers or use any one of a number of mechanisms to take care of the timing problem.

It should be recognized that this describes a *financing* mechanism. This plan does not address itself directly to problems concerning the delivery system and its efficiency, the distribution of medical-care resources or the medical price and cost problem. Nonetheless the indirect impacts of the plan are in the right directions: (1) It does make it easier for groups to begin prepayment mechanisms based on certification by the Department; (2) It does put the carriers in a bargaining position *vis a vis* providers of service and especially so since the carriers would have to bargain with the Secretary of the Department of Health, Education and Welfare on the appropriate costs for the coming year and since the Secretary would bargain carefully because the Secretary of the Treasury would be concerned about the implications of increases in cost on revenues.

Chairman GRIFFITHS. How many of the people do you anticipate, I mean that you would cover, are covered now under medicaid, Mr. Hess? Would you know?

Mr. HESS. Well, of course, it depends on the specifications of the plan. I think that under medicaid now you largely have, as you know, children and mothers on AFDC, and if you were going to move into a plan that was universal, and phasing-in as that Dr. Fein suggests, you would probably move rapidly to pick up a considerable number—providing you intended to substitute for the medicaid provision.

On the other hand, if you are aiming at coverage of all children, let's say, of the working poor, of fathers who are in the home and full-time employed, who are not now on medicaid——

Chairman GRIFFITHS. Well, they are in New York.

Mr. HESS. Well, they are in New York, but not with Federal matching.

Chairman GRIFFITHS. I see.

Mr. HESS. You have a sizable number of persons for whom there is some insurance coverage at this point under Blue Cross and Blue Shield, and again I wouldn't be able to quantify this. Perhaps Dr. Fein is the one to answer. But suffice it to say that I think there are more people off medicaid who might become eligible under his plan, coverage which they either do not now have or do not have adequately, than are on medicaid because there is this twilight zone of the low-income worker. The question is how extensive his insurance coverage is; he may have hospital insurance coverage, he may have some medical insurance coverage. But I am sure what Dr. Fein has in mind is quite comprehensive coverage when he cites an estimate of that kind.

Mr. FEIN. I would like two comments there. Though mothers and children are covered under medicaid if they are on AFDC it is to be noted that most of the medicaid dollar is going to hospitals and nursing homes and children don't usually end up in those institutions so it is very clear that very little money is really spent on physicians services for those children.

I would make a second comment that the Congress of the United States will have to address this question because under the new proposed changes in the welfare system it is not clear at all what happens to medicaid. As I understand it one of the possibilities would be an inordinate amount of computation to figure out who would have been eligible had the law not changed.

Well, if we are going to eliminate all of that paper that John Knowles brought in but substitute paper over a decade of trying to figure out whether a person would have been eligible if the law hadn't changed, I don't think we are coming out ahead.

Chairman GRIFFITHS. I would like to ask you is there anything that the Government could do now or in the new social security bill coming up, that could possibly reduce these costs of anything?

Mr. HESS. Are you addressing the experts?

Chairman GRIFFITHS. Any one of you. Is there anything we can do?

Mr. HESS. Madam Chairman, there will be in the testimony before the Ways and Means Committee a number of proposals for cost amelioration or cost effectiveness which the Department has already talked about in general terms. These have to do with encouraging planning, and broadening incentive reimbursement, and a number of other technical changes which set public policy in terms of the dollars tending to flow in the right direction. But these are not magic overnight solutions. These are the kinds of things that respond to the observation that, instead of having a program which through its cost reimbursement and fee for service payment encourages utilization and encourages itemization, we ought to experiment with methods of paying that will tend in the direction of more economical use, and such things as all inclusive rates, and other kinds of experiments.

Chairman GRIFFITHS. And you are going to request authority to carry out such experiments.

Mr. HESS. We are going to request authority, yes, Madam Chairman.

Chairman GRIFFITHS. Do I have the impression from any of you that you consider that we have sufficient hospital beds if they are efficiently used? Do you think that is true Dr. Knowles?

Mr. KNOWLES. Yes, I do think so, generally.

Chairman GRIFFITHS. We wouldn't have to build any additional hospitals?

Mr. KNOWLES. I do feel that way. I think there are certain exceptions in certain parts of the country but overall, for example, in the Greater Boston area right now there is new construction going on and

I am convinced from the utilization rates of those hospitals that this is not needed.

Now, I will bet you I can go into a lot of other areas in this country and prove to you that there isn't further need for new beds. I can show you two hospitals sitting side by side in Massachusetts and I bet he could find two in every State in this country that have under-utilized maternity divisions and their staffs and administrators and trustees will not close one down. Am I wrong in saying that?

Mr. FEIN. I would agree with Dr. Knowles. I would also offer the comment on a day in Boston when all the voluntary hospital beds are full there are probably 1,000 empty beds in the VA hospitals.

Mr. KNOWLES. Complete agreement, and furthermore I will bet you could find 10 percent of those patients in hospitals that Dr. Fein mentions if he and I went through all those voluntary hospitals in that region we could find as much as 10 percent of the patients that wouldn't have to be there on that day, if there were appropriate extended care, low cost facilities or if they just discharged the patients and hadn't used the facility in the first place. I think honestly the squeeze has to be put on better utilization and the community has got to yell when they have some waiting lists for elective procedures, and I think you have got to have waiting lists to filter out unnecessary admissions. It is the best way.

Chairman GRIFFITHS. Would you repeal the Hill-Burton Act now?

Mr. KNOWLES. I wouldn't repeal it but I would certainly focus it on urban facilities, existing facilities, and their alteration and improvement. I would doubt very much I would let it be pumped into more beds hither, thither and yon particularly building of added or small hospitals.

Mr. HESS. I wanted to point out that when you said no more general hospital beds are needed, you should not draw the conclusion that we do not need some additional capital support for the total hospital system. There is the problem of modernizing beds that are obsolete so that you keep up with changes and improvements. There also is the problem of putting capital into alternate facilities such as expanding the ambulatory services and having neighborhood health facilities that are backed up by the general hospital. And I think the important point is that the general hospital have its outreach into ambulatory care. One might say also that some hospitals are replacing their old beds with new beds and using the old beds for extended care facilities.

The point is that we have concentrated too much on the creation of acute general beds without recognizing that capital ought to be flowing into these other areas and this is where your planning can get a hold. Planning will get a hold on capital.

Chairman GRIFFITHS. I am hunting ways to tie up some of this money. If we could repeal the Hill-Burton Act we could probably. Would you open veterans' hospitals to other patients when they are not being used?

Mr. KNOWLES. I think you certainly could. It is impossible to shut a VA hospital, as I understand it, you can't even close them.

Chairman GRIFFITHS. It is impossible, and they are not very well staffed, in my opinion, at least the ones I have looked at are not.

Mr. Knowles. No, I don't think they are. They have a hard time competing in the area occasionally with the rest of us but I think again that the Federal Government ought to look into the money that has been put into the medical services, the veterans, and the Veterans' Administration to say nothing of the Department of Defense. While we are on the subject of how much the Federal Government is spending in health services there is a considerable amount of tax money going into those two areas and as far as I can tell they have been virtually completely protected from public scrutiny. I can promise you that the Government in running its hospitals does not do the job it might be doing when measured by the exhortations it gives the private sector. As I understand it, the Public Health Service at the present time is thinking of phasing out the marine hospitals——

Chairman Griffiths. It has phased out one in Detroit.

Mr. Knowles. Yes.

I think if you have a Veterans' Administration in the area that is underutilized I think that is part of the mix one way or the other for that community's needs and there must be a better way of making use. Again if you have a planning body and if you get a handle on that capital, as Mr. Hess says, all these questions should be answered in regions before you allow further capital to be used. And I am still not satisfied that we need any more new hospital beds in this country. We would all agree about alteration and upgrading.

Mr. Fein. I would rather give Boston three neighborhood health centers and it will do more for the health of the community than building an equivalent number of beds with that money.

Mr. Knowles. Absolutely.

Mr. Fein. I would not repeal or let Hill-Burton die but I would rather change it so its emphasis was a modernization and even more particularly its emphasis was on building ambulatory health facilities. The law permits it. The law says you can build an ambulatory facility but if you ask the planners "Do you mean an ambulatory facility far from the hospital" they say "no."

We don't really, have a mechanism to build an ambulatory facility 3 miles away.

Well, there is no reason that it shouldn't be done, in fact——

Chairman Griffiths. It could be 15 miles away.

Mr. Fein. Of course.

Mr. Knowles. I think all three of us are in complete agreement about the Hill-Burton on this general subject.

Mr. Fein. The pity is everybody is in complete agreement about what is wrong but nothing seems to get better.

Chairman Griffiths. Shouldn't we require that medical payment plans pay for medical services rendered outside hospitals, if they pay for these same services when rendered in hospitals? Or the same patient, would that reduce costs or wouldn't it?

Mr. Fein. I think it would. There is no question we are wasting very scarce facilities and driving costs up. I always hesitate about the word "require" that they do it but in this case I would be willing to require it.

Chairman Griffiths. How can we improve the hospital utilization base? I was told by a surgeon in Miami that he considered this the weakest part of the structure, that patients could come in with something wrong with their feet and——

Mr. KNOWLES. There is no question about that and here again we come full circle to the whole subject of regional planning and within the hospital a satisfactory utilization review that will take care of these problems. Now, it can happen, and speaking for one hospital, when I became director of that hospital in 1962 I made the point that we would not add anything to that plant until we had a waiting list and that was it, and we have had a waiting list since 1963, and our costs are the lowest costs of any hospital of its kind in the area, if not the country.

Chairman GRIFFITHS. Incidentally——

Mr. KNOWLES. We have full utilization, our surgeons operate all afternoon, they have a full operating schedule on Saturday, and there was another institution in Boston that was averaging 80 percent utilization as it nonetheless added more beds. Then if you have a utilization review committee which is public and recorded, not just doctors but administrators, social workers, trustees and other representatives of the community, you can get to maximum utilization but you have got to be careful when you are exhorting maximum utilization you don't start admitting everybody and his brother to achieve full utilization. Utilization becomes optimal where only the sick people who need it will get through that filter of a waiting list to get to that hospital.

Chairman GRIFFITHS. What do you estimate the costs per day will be in your hospital in 1975?

Mr. KNOWLES. In 1965 I said it would be $100 a day by 1970 and everybody gasped, and said "Oh, that guy must be addled." It is $100 now, even before 1970. By 1975, I would hazard a guess that it will be at least $150 a day, and that by the year 2000, if things keep going the way they are it probably will be $200 a day. But we will tell you by 1971 it is going to be $150 a day in the New York City hospitals. I know that, and it is about $125 a day right there right now when it is $100 a day here. There are many factors that the economists will give you but I am just giving you the cold cash figure.

Chairman GRIFFITHS. Yes.

Mr. HESS. Could I make one point that I think is very important for us to keep in mind? If we really succeed in pushing a lot of people who are now in hospitals, or who would go into hospitals, into alternative care which is less expensive or more appropriate, and if you keep a lid on the building of acute beds so you really have waiting lists, then Dr. Knowles' patients next year and the year after are going to be skimmed off the top. In other words, you are going to save your hospital beds with all their expensive facilities for sicker and sicker people because you are going to be keeping people who don't need to be in a hospital bed from going in and you are going to move them out sooner, so that may even further increase our per diem hospital costs. But we have to look at the costs of the whole system. It may be that in a rational system, your acute general hospital per diem will be even more costly that it is today, but it would be used by people who really need to be in there.

Chairman GRIFFITHS. Then what do you estimate that the costs per day will be for other types of care than general hospital care?

Mr. KNOWLES. Right now in our area now it is anywhere from $15 to as much as $40 a day, perhaps an average.

Mr. HESS. Extended care would be about 25 percent of the hospital's cost per day.

Mr. KNOWLES. Of the hospital. If you ask a question will the $60 billion go up too, so $60 billion by 1975, if these things happen that the three of us have been talking about, the rise in the total expenditure for health should, I believe, be reduced or at least the rate of rise will not go as rapidly if you keep these people out of hospitals. You know when that Columbia Point project at Tufts reduced the hospitalization of those people by 80 percent, and when the same people from Charlestown who use our hospital, their hospitalization has been reduced by 40 percent, you are talking about an awful lot of money in the population that has now been saved by keeping those people on the hoof and what costs $10, $20 a day to serve those people and keep them out of the $100 a day facilities.

Chairman GRIFFITHS. Then your real suggestions for reducing the prices are some kind of supplementary care, one, and some preventive medicine?

Mr. KNOWLES. Yes, very definitely.

Mr. HESS. And making sure that insurance covers the cost of these.

Mr. KNOWLES. Yes.

Mr. FEIN. I would add one thing. As one reviews the figures on inflation in the medical care sector one is impressed by the fact that the medical care sector is part of the total economy, and I would not want to leave an impression that things can be controlled or that inflation can be mitigated in this sector as long as the total economy witnesses the kind of inflation that we have witnessed in the last 2 years. I would think that the other hearings of this subcommittee are not irrelevant to the medical care sector.

Chairman GRIFFITHS I would assume that is true, too.

I must say, I am not an economist, but I worked in a university hospital at Ann Arbor, that was a long time ago and I thought, it was about the only caste system we had in America. Secondly, I thought at least the women who were working in there who were doing an awful lot of the work were grossly underpaid. As I recall I worked three summers and I think I had one coke, I was working so hard I couldn't even leave the desk.

I want to tell all of you how much I appreciate your being here and how much I think you have added to this hearing. Thank you very much. This committee will adjourn until October 22 in room S-407 of the Capitol.

(Whereupon, at 12:35, the hearing was recessed, to reconvene, at 10 a.m., on Wednesday, Oct. 22, 1969, in room S-407, the Atomic Energy Committee hearing room, in the Capitol.)

(The materials which follow were submitted by Deputy Commissioner of Social Security, Arthur E. Hess:)

APPENDIX

The Size and Shape of the Medical Care Dollar

Chart Book
1969

SS 69-41

U.S. DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE
Social Security Administration

Contents

Introduction

The past few years have witnessed sharp increases in the amounts spent for medical care and unprecedented rises in prices for such care. There also was a sizable shift in outlays for medical care from private to public sources of funds. Considerable changes, therefore, have occurred in the size and shape of the medical care dollar.

The charts in this publication present the background facts relating to the medical care dollar—who pays, what and how much is bought, for whom it is spent, how and why it has grown. The charts provide the foundation for understanding the current crisis in medical care—providing quality care at a price the Nation can afford.

The concepts, definitions and detailed figures that form the basis for the charts are available from a variety of reports prepared by the Office of Research and Statistics, Social Security Administration, U.S. Department of Health, Education, and Welfare. A current listing of these reports is presented at the end of this publication.

Chart 1

How big is the medical care dollar?

The medical care dollar today is a large one, amounting to $53.9 billion in fiscal 1968. Its growth has been at a rapid pace—faster than that of the economy in general. In fiscal 1950, medical care expenditures amounted to $12.1 billion and represented 4.6 percent of the Gross National Product (the total market value of the Nation's annual output of goods and services). By fiscal 1960, its share of GNP had reached 5.3 percent and today it is up to 6.5 percent. Part of the increasing share of GNP is the result of higher prices for medical care compared with prices for other items.

The growth in the size of the medical care dollar, especially in the last few years, has evoked much concern. Are we receiving more and better services for these large outlays? Are rising prices for medical care eating up the growing expenditures? Can efficiency in the health industry be improved?

Medical economists and health experts throughout the country are trying to better understand the underlying reasons for the growth in the medical care dollar and are seeking ways to mitigate these rising costs while still continuing to improve the health services for the people.

37-795 O - 70 - 17

Today's medical care dollar totals $53.9 billion—6.5 percent of GNP

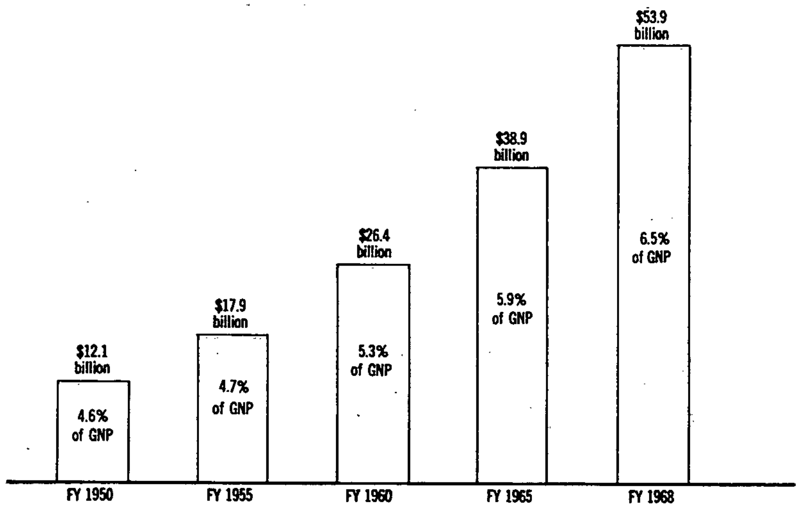


Chart 2

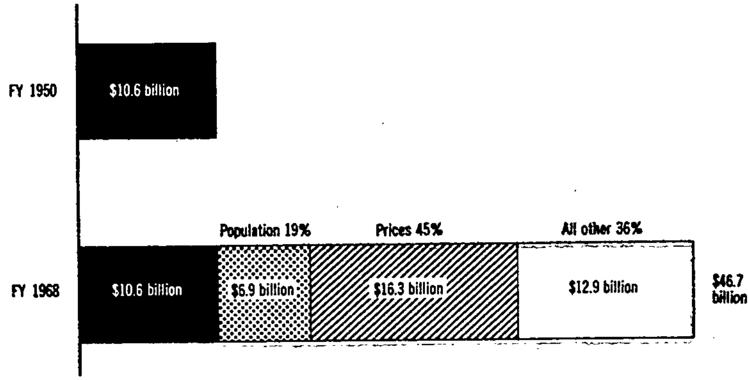
What caused the growth in the medical care dollar?

Increases in expenditures for health may result from several factors: (1) a rise in the price per unit of health service; (2) a growth in the population; and (3) an increase in the use of health services and availability of new medical supplies and techniques.

In the 18-year period since fiscal 1950, health expenditures rose $35.3 billion. Of this rise:

- About 45 percent, or $16.3 billion, can be attributed to the increase in prices;
- Another 19 percent, or $6.9 billion, is the result of population growth;
- The remaining 36 percent, or $12.9 billion, is due to increased use of services, such as seeing the doctor and dentist more often or going to the hospital more, and having access to many miracle drugs not available in 1950 and life-saving, but expensive new techniques such as open heart surgery or kidney dialysis.

Higher prices resulted in 45% of the 18-year growth



7

Chart 3

What has happened to medical care prices?

With rising prices responsible for the largest portion of the increase in medical care expenditures, it is apparent that the sizable growth in medical care prices is a matter of concern. A dollar of health care spent today does not go nearly as far in paying for a day of care or a unit of service as it would have several years ago.

Since World War II, the consumer price index (CPI) and its medical care component have been continuously rising, with the latter rapidly outpacing the former. In recent years, however, the gap between the relative increases of these two price indexes has widened considerably. From 1960 to 1965 medical care prices jumped nearly twice as fast as prices for all consumer items and the wide gap has continued. For the three-year period 1965-68, medical care prices increased at the annual rate of 5.8 percent compared with a 3.3 percent increase for all consumer items.

In the last 3 years, medical care prices have jumped almost twice as fast as prices for all consumer items

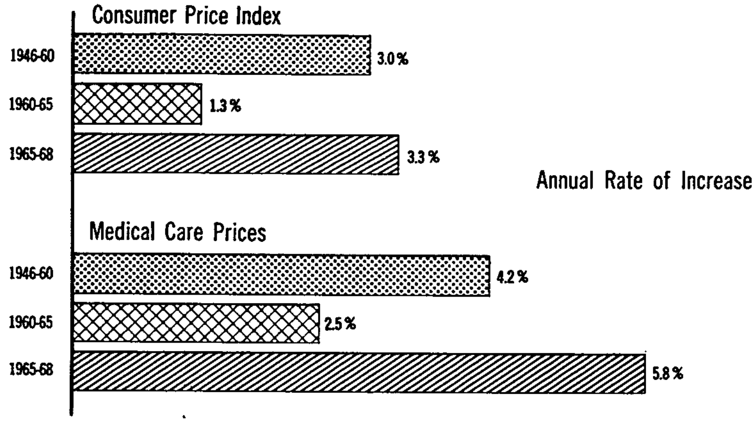


Chart 4

Which medical care prices have moved fastest?

The fastest rising medical care prices have been the hospital daily service charge. From 1965 to 1968, hospital daily service charges rose at an anual rate of 13.9 percent compared with a 5.8 percent rise for all medical care prices. A significant part of this rise in the hospital daily service charge was due to the increases in the salaries of hospital personnel as a result of the extension of the minimum wage to the hospital industry. Particularly for the nonprofessional hospital worker, wages and salaries have been notoriously low and the efforts to raise these salaries to a level comparable to those in other industries have been reflected in higher hospital daily service charges.

Physicians' fees have also increased rapidly. These fees, which had been rising at a rate of less than 3 percent annually in the 1960-65 period, averaged 6.1 percent annually in the 1965 to 1968 years.

Increases in population, especially of the aged who need more services, rising personal income, wider private and public insurance coverage, an increase in the public's faith in doctors and other factors have led people to seek doctors' services more often. The average doctor sees more patients than he did years ago. Specialization, however, has decreased the numbers of physicians available to provide care for the entire family and has resulted in a reduction in the number of persons seen per physician. As a result of this increased demand for the services of fewer doctors, their fees have gone up at an increased rate.

Beginning 1966 hospital daily service charges have moved fastest

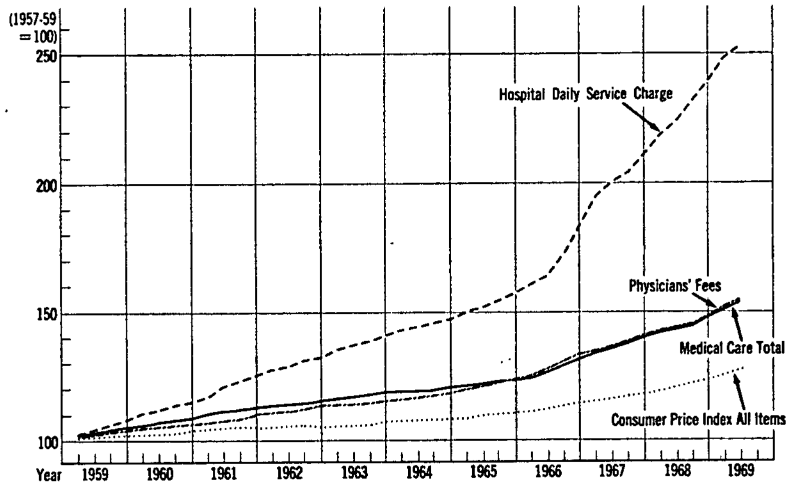


Chart 5

Who pays?

The medical care dollar is financed both publicly and privately. The private share has always been by far the largest, but in recent years, with the addition of the new public programs of Medicare and Medicaid, a shift to more public financing can be seen.

In fiscal 1950, the Government spent 25¢ of every medical care dollar. In fiscal 1966, the year before Medicare and the beginning of Medicaid, the Government's share was 26¢. By fiscal 1968, the Government's portion had reached 36¢ with much of this increasing share coming from Federal funds. Increased public spending for health has done much to alleviate the financial burden of health care for the Nation's poor and aged.

The medical care dollar is financed from private and public funds—and the public share is growing

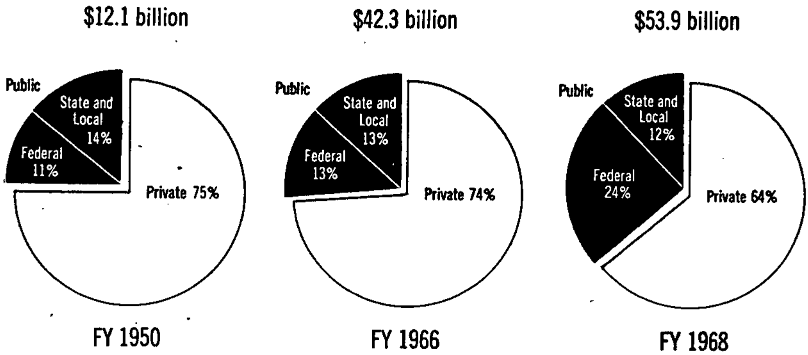


Chart 6

Where does the money come from?

The Nation's medical bill is paid by Government at all levels (Federal, State, and local), private health insurance, philanthropy and others (industry and loans), and the private individual from his own pocket. With private health insurance and the Government assuming more of the burden of financing total medical care, a smaller proportion of the medical care dollar now is paid by the individual.

In fiscal 1950, 59 cents out of every medical care dollar was an out-of-pocket expenditure. In fiscal 1966, out-of-pocket payments represented 45 cents of each dollar and by fiscal 1968, it had dropped to 38 cents. These out-of-pocket outlays are largely for items not presently covered by health insurance, such as drugs, long-term institutional care, and dental care.

Government, private health insurance, and philanthropy help reduce out-of-pocket expenses

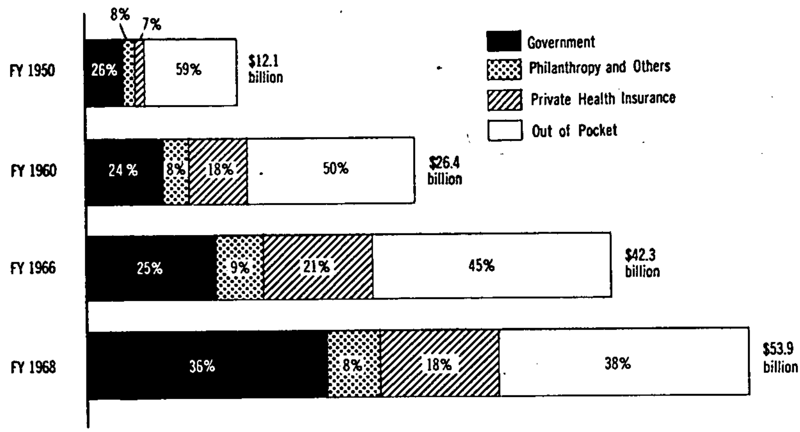


Chart 7

Which public programs spend medical care dollars?

The rise in the Government share of health expenditures can be readily understood in light of the fact that Government spending for medical care has jumped from $10.8 billion in fiscal 1966 to $19.4 billion in fiscal 1968. Much of this $8.6 billion growth was the result of the Medicare and Medicaid programs. Medicare alone was responsible for $5.3 billion or 62 percent of the increase. Medicaid, the major component under the vendor medical program of public assistance, was the second largest contributor to the 2-year increase—$1.8 billion of the growth came from this source.

Other programs contributing to the increase include the Defense Department, adding $400 million, the Veterans Administration, adding $200 million, hospital and health facility construction, medical research, and other programs such as maternal and child health, workmen's compensation health benefits, medical vocational rehabilitation, OEO health and medical care, and State and local hospital care.

Several public programs spend medical care dollars, but Medicare spends the most

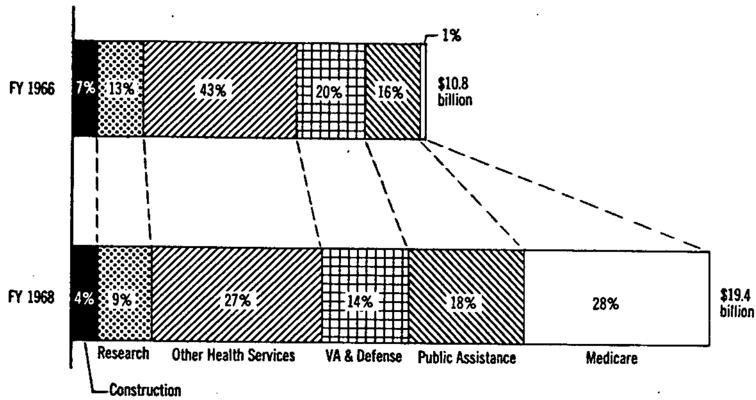


Chart 8

Do private and public medical care dollars buy the same care?

Private and public outlays for health differ considerably in the services they buy. Of the $34.5 billion spent in fiscal 1968 from private sources, $3 out of $10 was for hospital care; of the $19.4 billion from public funds, nearly $5 out of $10 was for hospital care. Similarly, nursing home care comprised 1 percent of private expenditures and 8 percent of the public. The proportions for medical research were also smaller in the private sector—1 percent compared with 9 percent.

On the other hand, one-fifth of the private medical care dollar was spent for drugs—only 2 percent of the public medical dollar went for this purpose. Likewise, 38 percent of the private compared with 13 percent of the public health dollar purchased services of health professionals.

Private and public health outlays differ

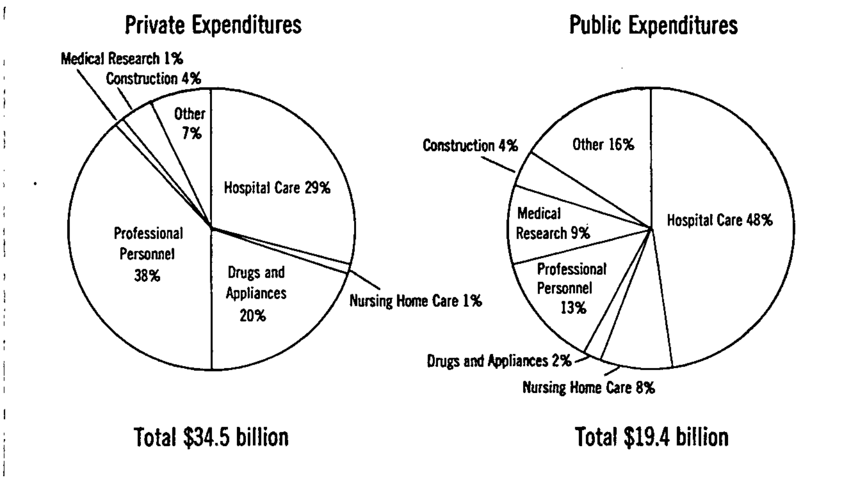


Chart 9

What care does the personal health care dollar buy?

The medical care dollar is composed of two kinds of expenditures—personal health care and nonpersonal health care. Personal health care expenditures include all outlays for health and medical care services for the direct benefit of the individual, such as for hospital care, physicians' services, etc. Nonpersonal health care expenditures are those outlays which are spent for the community, such as for medical-facilities construction, research, air pollution control, etc.

The personal health care dollar is shaped by the type of care being purchased. The largest share of this dollar is for hospital care, amounting to $19.5 billion or 42 percent of the fiscal 1968 total ($46.7 billion). Physicians' services ($10.9 billion), represent the next largest expenditure item comprising 24 percent of the total. Drugs and drug sundries purchased out of the hospital ($5.7 billion), other professional services ($4.8 billion), and nursing home care ($2.0 billion) follow.

The distribution of health expenditures by type of care was essentially the same for many years. In the last few years, however, with prices for and use of hospital care rising faster than for other medical items, this component has become a larger proportion of the total.

Hospital care and physicians' services consume most of the personal health care dollar

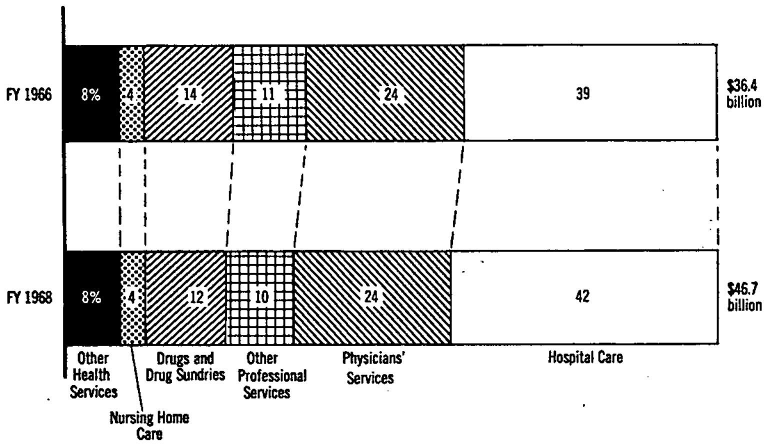


Chart 10

Who pays for hospital care?

While hospital care expenditures have been rapidly increasing, the source of financing for this care has been rapidly changing. Medicare and Medicaid have been taking over more and more of the private burden of paying for hospital care.

In fiscal 1966, the year before Medicare, the private sector contributed 64 percent of the $14.2 billion total; the Federal Government paid 13 percent, and State and local Governments spent the remaining 23 percent.

In fiscal 1967, the first year of Medicare, the private sector had declined to 52 percent and by fiscal 1968, to 51 percent. Some of the State and local share also had been shifted to the Federal Government. In that second year of Medicare, 31 percent came from Federal funds and 18 percent from State and local spending.

Private and public funds each now pay about half of the hospital care bill

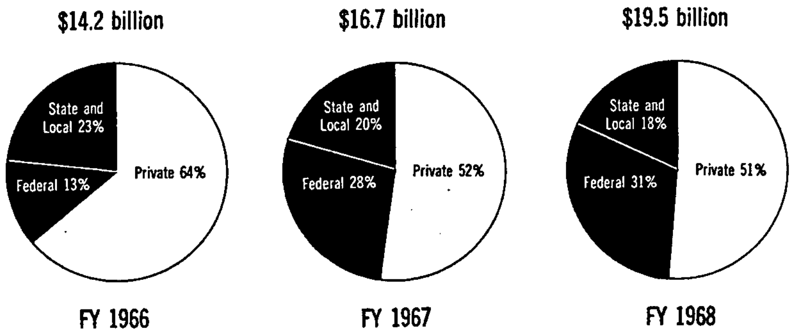


Chart 11

How much has hospital use grown?

The growth in the hospital care bill is due partly to increased prices but partly to increased per capita use of the hospital.

In 1950, there were nearly 17 million admissions to community hospitals, or 109 admissions for every 1,000 persons in the population. Today, the number of admissions is 27 million and the rate is about 136.

Because there are more hospital admissions, more days are spent in the hospital. In 1950, 136 million days were spent in a community hospital—less than one hospital day per person. Today, hospital days total 230 million and on the average there is more than one day spent in the hospital per person each year.

In the past 18 years, hospital admissions increased 63 percent and hospital days rose 69 percent

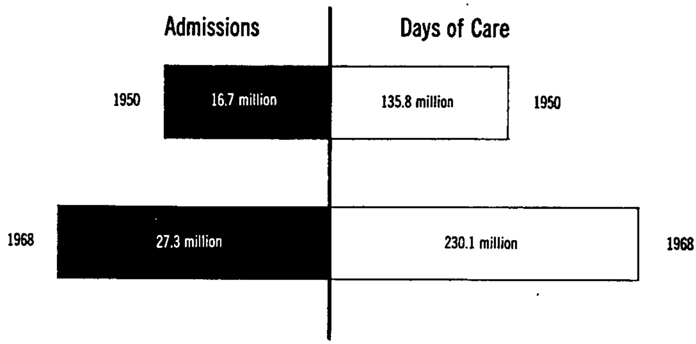


Chart 12

Who pays for physicians' services?

Private funds pay most of the bill for physician's services, but the picture has changed significantly since the advent of Medicare and Medicaid. The private share has decreased from 93 percent of the total bill in fiscal 1966 to 80 percent 2 years later.

The Federal share in paying for these services has increased from 2 percent in fiscal 1966 to 14 percent in fiscal 1968. Medicare and Medicaid payments of the physician's bill have been mainly responsible for the larger Federal share. Not all of the outlays from these two programs, however, represent a shift in financing. Many aged and medically needy persons who could not afford doctors' care now are receiving their services.

Private funds pay most of the physician's bill, but their share is decreasing

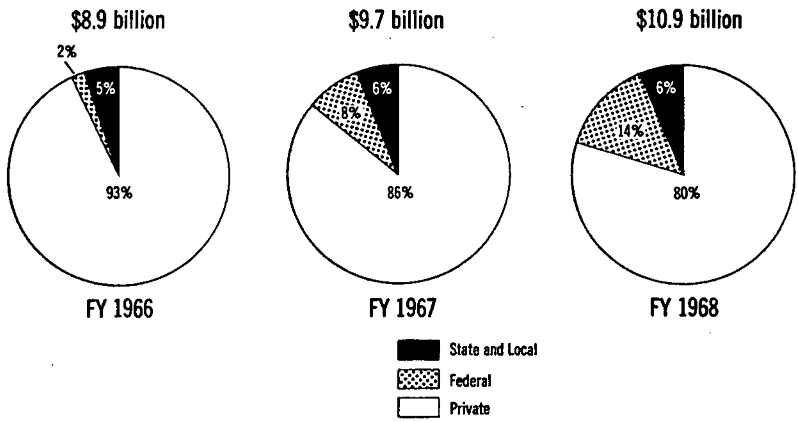


Chart 13

For whom is the medical care dollar spent?

The personal health care dollar is shaped by the age of the persons on whom it is spent.

Of the $46.7 billion personal health care expenditures in fiscal 1968, about one-fourth of this total was spent by or in behalf of the aged who make up only one-tenth of the total population. In fiscal 1966, the year before Medicare, aged expenditures represented one-fifth of the total.

This large medical bill for the aged reflects the following:

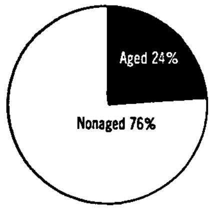
(1) the average aged person has more and costlier illnesses than the average person under age 65;

(2) the older person is twice as likely as the younger one to suffer from one or more chronic conditions and is much more likely to be limited in activity;

(3) an aged person is admitted to hospitals much more frequently and stays longer than a younger person;

(4) an older person, on the average, uses physicians to a far greater extent.

One-quarter of the personal health care dollar is spent for the aged



Who comprise one-tenth of the population

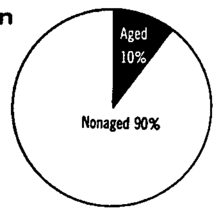


Chart 14

How much is spent for the medical care of each age group?

The medical care dollar is shaped by the people on whom it is spent. The personal health care bill for the average person in the United States was $233 in fiscal year 1968. The bill for the average aged person is about three times that of the younger person—$590, compared with $195.

The differential between the aged and nonaged varies considerably by type of expenditure. Per capita hospital care expenditures for the aged—$282 in fiscal year 1968—are more than three and a half times that of persons under age 65 ($77), but per capita expenditures for physicians' services for the aged ($97) are only about twice those for the younger age group ($50).

Health expenditures average 3 times more for the aged person than for the younger person

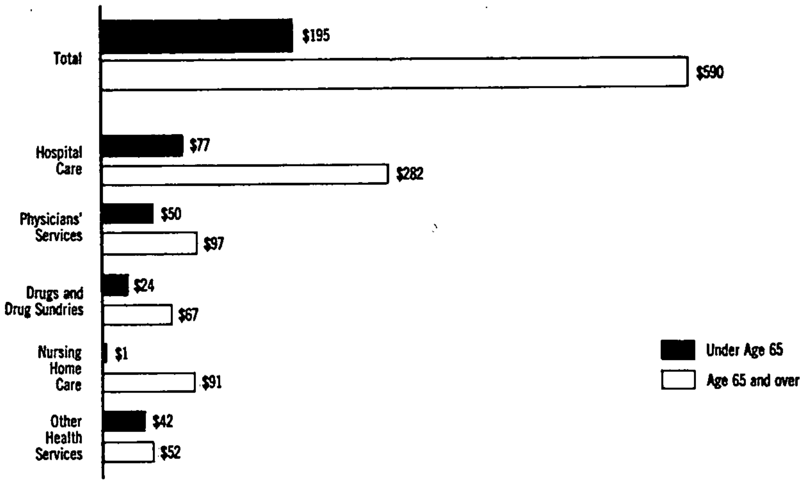


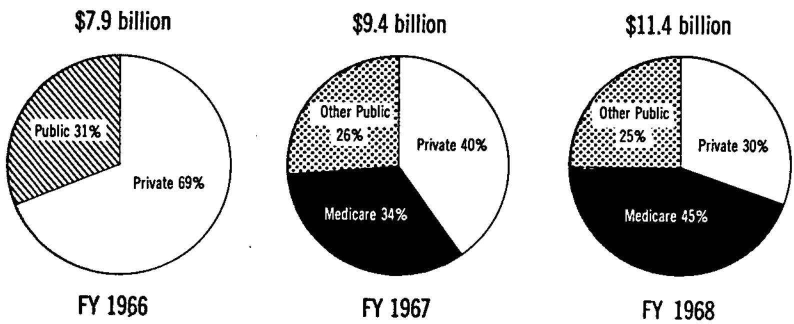
Chart 15

Who pays the bill for the aged?

The financial burden on the aged of their high costs of hospital and medical care has been substantially reduced as a direct result of the Medicare program. In the year before Medicare, $7 out of $10 of the aged person's medical bill had to be paid privately. Two years later only $3 out of every $10 came from private funds.

In Medicare's first year, benefit payments under the program represented 34 percent of the personal health care expenditures of the aged during the year. In Medicare's second year, this proportion had reached 45 percent. Much of the expenditures not covered by Medicare were for drugs, long-term institutional care, physical check-ups, eyeglasses, appliances such as hearing aids, and dental care.

Medicare pays 45% of the personal health care bill of the aged



33

What is the government doing to moderate rising health costs to insure that the nation gets more for its health dollar?

1. Elimination of the Medicare and Medicaid allowance to hospitals and nursing homes for unidentified costs.
2. Limitation of fees paid to physicians, dentists, and other individual providers of medical services under Medicaid.
3. Tightening of the "prevailing" and "customary" charge concepts used in determining Medicare payment to physicians.
4. Promotion of the use of alternatives to inpatient care.
5. Experimentation with alternative methods of reimbursement for medical services to provide incentives for efficiency and economy.
6. Encouragement of prepaid group practice and of group practice generally.
7. Stimulation of community planning to avoid duplication of services, prevent unnecessary expansion of hospital beds, and encourage expansion of less costly services and facilities.

8. Increase in supply and improvement of utilization of health manpower.
9. Establishment of the National Center for Health Services Research and Development to foster a national program of research, development, demonstration, and training projects addressed to major problems in the availability, organization, quality, delivery and financing of health services, facilities, and technical equipment.
10. Establishment of a Health, Education, and Welfare Task Force on Medicaid and Related Programs to strengthen the administration of these programs and develop and recommend utilization review procedures, incentive reimbursement methods, standards for medical care, and better methods for determining eligibility for medical and public assistance.

References

Office of Research and Statistics, Social Security Administration

"Social Welfare Expenditures, 1967-1968," *Social Security Bulletin*, December 1968.

"National Health Expenditures, 1950-67," *Social Security Bulletin*, January 1969.

"Public and Private Expenditures for Health, Fiscal Years 1965-1968 and Calendar Years 1965-1967," *Research and Statistics Note No. 22*, November 11, 1968.

"Outlays for Medical Care of Aged and Nonaged Persons, Fiscal Years 1966-68," *Research and Statistics Note No. 12*, July 16, 1969.

"Trends in Medical Care Prices," *Social Security Bulletin*, July 1967.

"Medical Care Prices in Medicare's First Year," *Social Security Bulletin*, January 1968.

"Medical Care Price Changes in Medicare's First Two Years," *Social Security Bulletin*, November 1968.

"Medical Care Prices Fact Sheet," *Research and Statistics Note No. 6*, May 9, 1969.

37-795 O - 70 - 18

RESEARCH and STATISTICS NOTE
U.S. DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE
Social Security Administration
Office of Research and Statistics

Note No. 8 ---1969 May 9, 1969

MEDICAL CARE PRICES FACT SHEET*

Longrun Trends

▶ The Consumer Price Index and its medical care component have risen continuously since World War II. The latter has considerably outpaced the former.

▶ The average annual increase in the CPI as a whole amounted to 3.0 percent for the period 1946-60. There was a perceptible slowing down in the rate of increase for all consumer items during 1960-65 when the CPI rose at an annual rate of 1.3 percent.

▶ The trend in prices of all services followed a similar pattern. But the slowdown in the rate of increase during 1960-65 for all medical care services was not as appreciable, with prices rising at about two-thirds of the annual rate of increase for the period 1946-60.

▶ Hospital daily service charges, one of the three hospital services measured in the CPI, have been increasing faster than any other component of the medical care price index.

▶ From 1946 to 1960, the annual rate of increase of daily service charges was 8.3 percent. During the 1960-65 period of general deceleration, the index for hospital daily service charges followed this trend but not to the same extent as other components, increasing at an annual rate of 6.3 percent.

▶ Over the long run, a prime force is the pressure of rising wages and other costs. Hospital wages have been notoriously low and there has been a continuing trend in recent years toward closing the gap between hospital wages and wages in other industries. Since capital has not replaced labor in hospitals to the extent that it has in many other industries, the higher hospital wages have not been matched by higher labor productivity and the result has been more rapidly rising labor costs.

*By Loucele A. Horowitz, Division of Health Insurance Studies.

▶ Physicians' fees have more than doubled in the past two decades--a faster rate of increase than that for all items in the CPI but somewhat slower than that for hospital daily service charges.

▶ From the end of World War II through 1960, physicians' fees increased at an annual rate of 3.4 percent. The period 1960-65 witnessed a reduction in the annual rate of increase to 2.8 percent.

▶ Over the long run, increases in demand without a corresponding increase in supply have led physicians to raise their prices. Population increases, changes in the characteristics of the population, more widespread insurance coverage, and an increasing awareness of the benefits of medical care have contributed to the increased demand for services. Although the total number of physicians has increased during the past 20 years, the supply has not kept pace with the demand.

Shortrun Trends

▶ The general deceleration in price increases that took place between 1960 and 1965 came to an abrupt halt in 1966 when the rate of increase for the all-items CPI was more than twice the rate for the 1960-1965 5-year period.

▶ Medical care prices also rose in 1966 at nearly twice the annual rate for the 1960-1965 period.

▶ Medical care prices continued their upward trend in 1967 and 1968, but there was some deceleration in the rate of increase in 1968 (6.1 percent) compared with the rate of increase in 1967 (7.0 percent).

▶ At the time of the deceleration of the rate of increase in medical care prices, the CPI for all items and services was increasing at a relatively faster rate. During 1968 the rate of increase for all consumer prices was 1½ times as large as that of the previous year (4.2 percent compared with 2.8 percent).

▶ During 1967 the index for hospital daily service charges increased nearly one-fifth--by 19.1 percent. In the following year, a significant deceleration occurred that resulted in a percentage increase amounting to about two-thirds that of the previous year--13.2 percent.

▶ Recent increases in the salaries of hospital personnel have played a significant part in the overall increase in hospital costs. The ready availability of operating funds under the Medicare program probably provided the opportunity for many hospitals to meet demands for increased wages, to purchase additional equipment and supplies, and to improve and expand services to patients. It is possible that Medicare also brought about a rearrangement of the pricing structure of hospitals. Before Medicare, charges for room and board and other routine services were set below their actual costs and those for ancillary services were above costs. The pricing of hospital services to relate prices to costs more closely may reflect in part the influence of Medicare, under which additional record-keeping and cost-finding is required.

▶ Like hospital daily service charges, fees for physicians' services slowed down somewhat in rate of increase during 1968 compared with that for the previous year--a 5.6 percent increase in 1968 compared with a 7.1 percent increase in 1967.

▶ Part of the increase in physicians' fees early in 1966 may have reflected an upward revision of fees in anticipation of the introduction of Medicare. Continued increases in physicians' fees since the implementation of the program are also part of a longrun trend in which increases in demand without a corresponding increase in supply have led physicians to raise their fees.

▶ Some indication of the extent of the spiralling of consumer prices in general and medical care prices in particular is clearly depicted in the movement of the CPI and its medical care components during the 36 months ended December 1968. From December 1965 to December 1968, the all-items CPI increased by 11 percent, medical care prices by nearly 21 percent, medical care services by 25 percent, physicians' fees by about 21 percent, and hospital daily service charges by 52 percent. During this 3-year period, the largest annual rate of increase for the all-items index took place in 1968. However, for the medical care items, the largest annual rate of increase occurred during 1966.

<u>Five Special Procedures of Particular Significance to the Aged</u>

▶ The Social Security Administration arranged with the Bureau of Labor Statistics in the summer of 1965 to collect prices for three surgical procedures (cholecystectomy, prostatectomy, and fractured neck of femur) and two in-hospital medical services (myocardial infarction and cerebral hemorrhage) that are important to older persons, though not necessarily limited to them. Prices are collected for these five procedures but are not incorporated in the regular sample of the CPI. It was believed that fees for such services might be sensitive to the new Medicare program and hence would provide baseline data to assess the impact of the program on physicians' fees.

▶ During 1966 the CPI for physicians' fees advanced more rapidly than any of the five special indexes of hospital procedures for the aged. By the end of 1967, however, the wide disparity between the increases in the two sets of indexes no longer existed. During the 12 months ended December 1967, three of the five special procedures moved faster than the combined CPI for physicians' fees. During 1968 the index for physicians' fees did not increase as rapidly as during the previous year. At the same time, however, four of the five special procedures moved upward faster in 1968 than in the previous year and also exceeded the rate of increase of the CPI for physicians' fees.

▶ For the 36 months ended December 1968, the index for physicians' fees increased 21 percent compared with increases ranging from 17 to 21 percent for the five procedures. Comparison of these trends suggests that physicians increased their customary fees for services to the aged in line with the general upward trend in all physicians' fees.

TABLE 1.--Consumer price index and percentage change for selected medical care components, selected years, 1946-68

[1957-59=100, unless otherwise specified]

Item	Price index 1/						Percentage change						
							Average annual					2 years, 1966-68	3 years, 1965-68
	1946	1960	1965	1966	1967	1968	1946-60	1960-65	1965-66	1966-67	1967-68		
CPI, all items..........	68.0	103.1	109.9	113.1	116.3	121.2	3.0	1.3	2.9	2.8	4.2	7.2	10.3
CPI, all services.......	63.9	105.6	117.8	122.3	127.7	134.3	3.7	2.2	3.8	4.4	5.2	9.8	14.0
Medical care, total.......	60.7	108.1	122.3	127.7	136.7	145.0	4.2	2.5	4.4	7.0	6.1	13.5	18.6
Medical care services.........	58.4	109.1	127.1	133.9	145.6	156.3	4.6	3.1	5.4	8.7	7.3	16.7	23.0
Hospital daily service charges..................	37.0	112.7	153.3	168.0	200.1	226.6	8.3	6.3	9.6	19.1	13.2	34.9	47.8
Physicians' fees...........	66.4	106.0	121.5	128.5	137.6	145.3	3.4	2.8	5.8	7.1	5.6	13.1	19.6
Drugs and prescriptions 2/....	74.6	102.3	98.1	98.4	97.9	98.1	2.3	-.8	.3	-.5	.2	-.3	0

1/ Annual average price index.
2/ Index base for prescriptions, March 1960; for over-the-counter items, December 1963.

Source: Consumer Price Index, Bureau of Labor Statistics.

TABLE 2.--CPI indexes and medical care components, selected periods, December 1965-December 1968

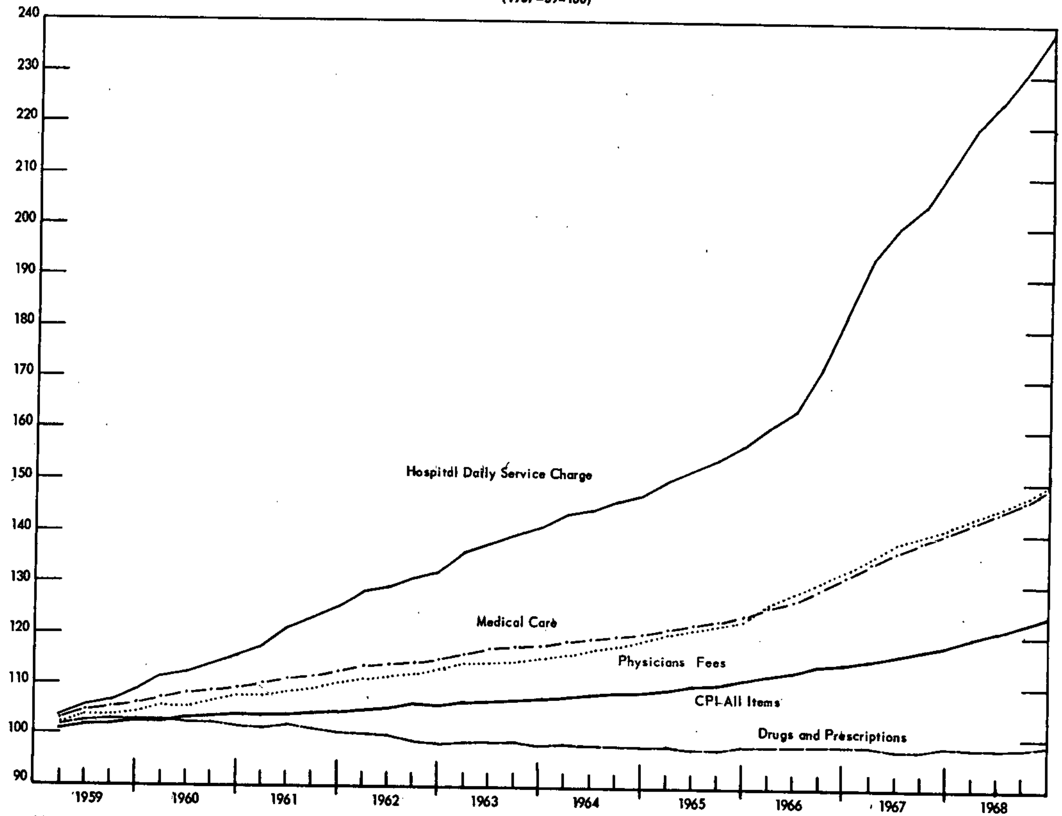
[1957-59=100, unless otherwise specified]

Item	December 1965	June 1966	December 1966	June 1967	December 1967	June 1968	December 1968
CPI, all items	111.0	112.9	114.7	116.0	118.2	120.9	123.7
CPI, all services	119.3	122.0	125.2	127.4	130.1	133.9	138.1
Medical care, total	123.7	127.0	131.9	136.3	140.4	144.4	149.1
Medical care services	128.9	133.0	139.4	145.2	150.4	155.5	161.4
Professional services:							
Physicians' fees	123.3	128.0	132.9	137.3	141.0	144.9	149.1
Family doctor, office visits	123.1	128.1	133.3	138.5	142.7	146.4	150.5
Family doctor, house visits	127.4	133.3	138.3	142.2	145.8	151.6	157.0
Herniorrhaphy (adults) 1/	105.7	107.5	110.5	114.1	116.0	119.3	121.2
Tonsillectomy and adenoidectomy	123.4	127.3	130.8	132.8	137.4	140.6	145.3
Obstetrical cases	118.6	121.9	127.5	132.5	134.6	138.4	142.9
Pediatric care, office visits 1/	107.5	115.0	119.5	123.6	126.2	129.0	133.3
Psychiatrist, office visits 1/	106.3	108.9	112.6	113.5	115.1	119.0	123.3
Dentists' fees	118.8	120.9	124.3	126.9	130.7	134.1	137.3
Other professional services:							
Examination, prescription, and dispensing of eyeglasses	114.1	115.7	118.6	121.7	121.6	125.2	127.6
Routine laboratory tests 1/	104.0	105.7	107.6	109.1	111.4	112.3	114.2
Hospital service charges:							
Daily service charges	157.1	164.2	183.0	200.1	211.4	224.6	239.3
Operating-room charges 1/	108.9	112.6	119.0	128.6	133.7	142.7	150.9
X-ray, diagnostic series, upper G.I. 1/	102.6	104.5	110.0	111.9	114.4	116.7	119.0
Drugs and prescriptions	98.1	98.6	98.3	97.7	98.1	98.0	98.5
Prescriptions 2/	90.7	90.5	90.3	88.8	88.4	87.2	87.6
Over-the-counter items 1/	101.4	102.9	102.5	103.1	104.7	106.1	106.6

1/ Index base, December 1963.
2/ Index base, March 1960.

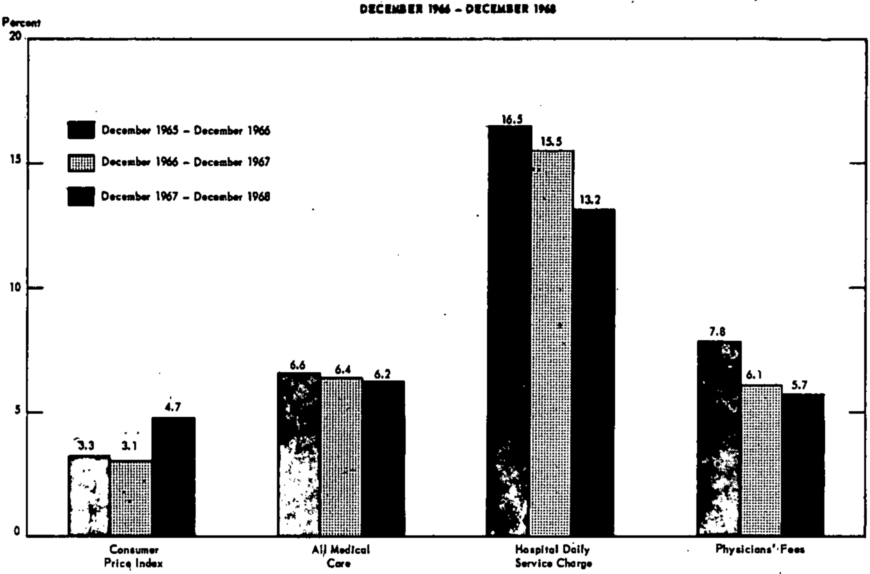
Source: Consumer Price Index, Bureau of Labor Statistics.

CHART 1.--QUARTERLY INDEX OF CONSUMER AND MEDICAL CARE PRICES, 1959–1968
(1957–59=100)



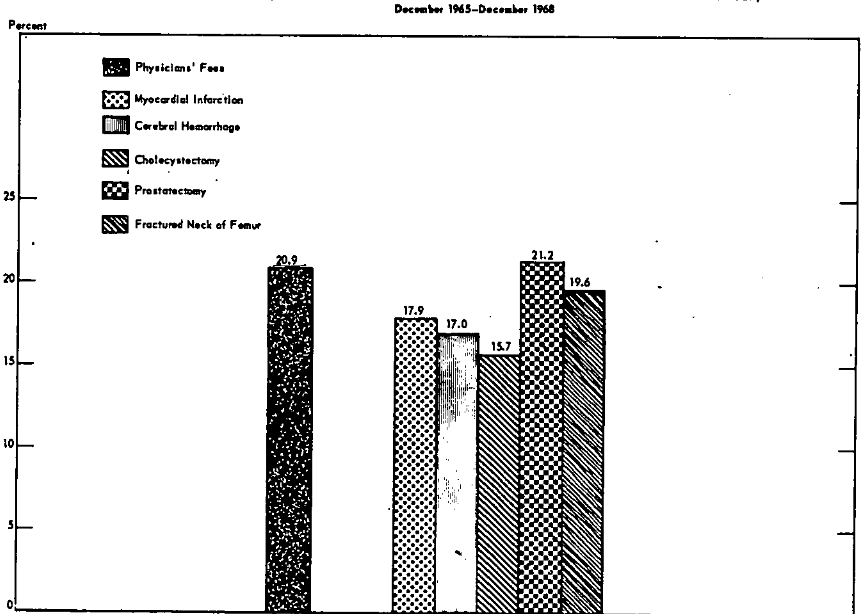
SOURCE: Consumer Price Index, Bureau of Labor Statistics.

CHART 2.—PERCENTAGE CHANGE OF CONSUMER PRICE INDEX AND SELECTED MEDICAL CARE COMPONENTS, DECEMBER 1966 – DECEMBER 1968



SOURCE: Consumer Price Index, Bureau of Labor Statistics.

CHART 3.—PERCENTAGE CHANGES FOR PHYSICIANS' FEES AND FOR IN-HOSPITAL PROCEDURES FOR THE AGED, December 1965–December 1968



SOURCE: Consumer Price Index, Bureau of Labor Statistics, and unpublished data reported to the Social Security Administration by the Bureau of Labor Statistics.

TABLE 3.--Percentage change for consumer prices and medical care components, selected periods, June 1966-December 1968

Item	6 months ending--						12 months ending--			24 months ending Dec. 1968	36 months ending Dec. 1968
	June 1966	Dec. 1966	June 1967	Dec. 1967	June 1968	Dec. 1968	Dec. 1966	Dec. 1967	Dec. 1968		
CPI, all items	1.7	1.6	1.1	1.9	2.3	2.3	3.3	3.1	4.7	7.8	11.4
CPI, all services	2.3	2.6	1.8	2.1	2.9	3.1	4.9	3.9	6.1	10.3	15.8
Medical care, total	2.7	3.9	3.3	3.0	2.8	3.3	6.6	6.4	6.2	13.0	20.5
Medical care services	3.2	4.8	4.2	3.6	3.4	3.8	8.1	7.9	7.3	15.8	25.2
Professional services:											
Physicians' fees	3.8	3.8	3.3	2.7	2.8	2.9	7.8	6.1	5.7	12.2	20.9
Family doctor, office visits	4.1	4.1	3.9	3.0	2.6	2.8	8.3	7.1	5.5	12.9	22.3
Family doctor, house visits	4.6	3.8	2.8	2.5	4.0	3.6	8.6	5.4	7.7	13.5	23.2
Herniorrhaphy (adult)	1.7	2.8	3.3	1.7	2.8	1.6	4.5	5.0	4.5	9.7	14.7
Tonsillectomy and adenoidectomy	3.2	2.7	1.5	3.5	2.3	3.3	6.0	5.0	5.7	11.1	17.7
Obstetrical cases	2.8	4.6	3.9	1.6	2.3	3.3	7.5	5.6	6.2	12.1	20.5
Pediatric care, office visits	7.0	3.9	3.4	2.1	2.2	3.3	11.2	5.6	5.6	11.5	24.0
Psychiatrist, office visits	2.4	3.4	.8	1.4	3.5	3.6	5.9	2.2	7.1	9.5	16.0
Dentists' fees	1.8	2.8	2.1	3.0	2.6	2.4	4.6	5.1	5.0	10.5	15.6
Other professional services:											
Examination, prescription, and dispensing of eyeglasses	1.4	2.5	2.6	1.6	1.3	1.9	3.9	4.2	3.2	7.6	11.8
Routine laboratory tests	1.6	1.8	1.4	2.1	.8	1.7	3.5	3.5	2.5	6.1	9.8
Hospital service charges:											
Daily service charges	4.5	11.4	9.3	5.6	6.2	6.5	16.5	15.5	13.2	30.3	52.3
Operating-room charges	3.4	5.7	3.1	4.0	6.7	5.7	9.3	12.4	12.9	26.3	38.6
X-ray, diagnostic series, upper G.I.	1.9	5.3	1.7	2.2	2.0	2.0	7.2	4.0	4.0	8.2	16.0
Drugs and prescriptions	.5	-.3	-.6	.4	-.1	.5	.2	-.2	.4	.2	.4
Prescriptions	-.2	-.2	-2.0	-.5	-1.4	.5	-.4	-2.1	-.9	-3.0	-3.4
Over-the-counter items	1.5	-.4	.6	1.6	1.3	.5	1.1	2.1	1.8	4.0	5.1

Source: Consumer Price Index, Bureau of Labor Statistics.

TABLE 4.--CPI indexes and percentage changes for physicians' fees, and for in-hospital procedures for the aged, selected periods, December 1965-December 1968

[December 1965=100, unless otherwise specified]

Item	December 1965	June 1966	December 1966	June 1967	December 1967	June 1968	December 1968
Physicians' fees:1/							
1957-59=100	123.3	128.0	132.9	137.3	141.0	144.9	149.1
December 1965=100	100.0	103.8	107.8	111.4	114.4	117.5	120.9
In-hospital care for the aged:2/							
Myocardinal infarction	100.0	101.3	104.7	107.8	110.5	113.9	117.9
Cerebral hemorrhage	100.0	101.2	104.1	107.3	109.9	112.9	117.0
Cholecystectomy	100.0	101.4	102.5	106.0	109.9	113.0	115.7
Prostatectomy	100.0	102.5	106.9	109.4	114.3	116.6	121.2
Fractured neck of femur	100.0	101.2	103.5	107.7	111.3	116.2	119.6

1/ Represents the combined index of all physicians' fees regularly reported in the CPI.
2/ Represents a special study of prices for 5 procedures, not incorporated in the regular sample of the CPI, important to, though not necessarily limited to, older people.

Source: Compiled by the Social Security Administration from unpublished data reported by the Bureau of Labor Statistics.

TABLE 5.--Percentage change for physicians' fees, and for in-hospital procedures for the aged, selected periods, June 1966-December 1968

Item	6 months ending--						12 months ending--			24 months ending Dec. 1968	36 months ending Dec. 1968
	June 1966	Dec. 1966	June 1967	Dec. 1967	June 1968	Dec. 1968	Dec. 1966	Dec. 1967	Dec. 1968		
Physicians' fees 1/....................	3.8	3.8	3.3	2.7	2.8	2.9	7.8	6.1	5.7	12.2	20.9
In-hospital physicians' care for the aged: 2/											
Myocardial infarction................	1.3	3.4	3.0	2.5	3.1	3.5	4.7	5.5	6.7	12.6	17.9
Cerebral hemorrhage..................	1.2	2.9	3.1	2.4	2.7	3.6	4.1	5.6	6.5	12.4	17.0
Cholecystectomy......................	1.4	1.1	3.4	3.7	2.8	2.4	2.5	7.2	5.3	12.9	15.7
Prostatectomy........................	2.5	4.3	2.3	4.5	2.0	3.9	6.9	6.9	6.0	13.4	21.2
Fractured neck of femur..............	1.2	2.3	4.1	3.3	4.4	2.9	3.5	7.5	7.5	15.6	19.6

1/ Represents a combined index of all physicians' fees regularly reported in the CPI.
2/ Represents a special study of prices for 5 procedures, not incorporated in the regular sample of the CIP, important to, though not necessarily limited to, older people.

Source: Compiled by the Social Security Administration from unpublished data reported by the Bureau of Labor Statistics.

RESEARCH and STATISTICS NOTE
U.S. DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE
Social Security Administration
Office of Research and Statistics

Note No. 14--1969 August 14, 1969

MEDICAL CARE PRICE CHANGES:
MEDICARE'S FIRST THREE YEARS*

Since the Medicare program began on July 1, 1966, the Office of Research and Statistics has closely followed and presented the data on medical care prices as reported by the Bureau of Labor Statistics. Medical care prices are now available for June 1969. This report presents the changes in prices for medical care during the first 3 years of the Medicare program--June 1966 to June 1969.

Two indexes are reported that have not previously been shown separately--CPI all items less medical care and CPI all services less medical services. These indexes may be useful in comparing trends in prices for medical care and for medical care services.

Table 1 presents the quarterly indexes and percentage changes for the consumer prices and the medical care components for the 3-year period June 1966-June 1969. The relative changes in these items for selected periods are shown in table 2. The remaining two tables present similar data for office and home visits regularly reported in the CPI and the indexes for five in-hospital procedures of particular importance to the aged that are not incorporated in the regular sample of the CPI. Also included are definitions and explanations of these items.

---

*By Loucele A. Horowitz, Division of Health Insurance Studies.

TABLE 1.--Quarterly indexes and quarterly percentage change for consumer prices and medical care components, by item, June 1966-June 1969

[1957-59=100, unless otherwise specified]

Item	June 1966	Sept. 1966	Dec. 1966	Mar. 1967	June 1967	Sept. 1967	Dec. 1967	Mar. 1968	June 1968	Sept. 1968	Dec. 1968	Mar. 1969	June 1969
	Price index, end of quarter												
CPI, all items	112.9	114.1	114.7	115.0	116.0	117.1	118.2	119.5	120.9	122.2	123.7	125.6	127.6
Less medical care	112.1	113.1	113.7	113.8	114.8	115.8	116.8	118.1	119.5	120.8	122.2	124.0	126.0
CPI, all services	122.0	123.5	125.2	126.3	127.4	128.7	130.1	132.1	133.9	136.0	138.1	140.9	143.3
Less medical*	120.1	121.4	122.8	123.5	124.5	125.5	126.8	128.6	130.4	132.4	134.5	137.0	139.2
Medical care, total	127.0	129.4	131.9	134.6	136.3	138.5	140.4	142.9	144.4	146.4	149.1	152.5	155.2
Medical care services	133.0	136.2	139.4	142.9	145.2	148.0	150.4	153.6	155.5	158.2	161.4	165.8	169.1
Professional services:													
Physicians' fees	128.0	130.8	132.9	135.5	137.3	139.4	141.0	143.2	144.9	146.6	149.1	152.6	155.5
Family doctor, office visits	128.1	131.1	133.3	136.4	138.5	140.7	142.7	144.9	146.4	148.1	150.5	154.1	157.6
Family doctor, house visits	133.3	135.9	138.3	140.7	142.2	144.1	145.8	148.4	151.6	154.3	157.0	161.5	163.4
Herniorrhaphy (adult) 1/	107.5	108.5	110.5	112.1	114.1	115.3	116.0	117.7	119.3	120.6	121.2	123.1	124.1
Tonsillectomy and adenoidectomy	127.3	129.8	130.8	132.2	132.8	136.9	137.4	138.8	140.6	141.5	145.3	146.4	147.8
Obstetrical cases	121.9	125.5	127.5	130.4	132.5	134.0	134.6	136.5	138.4	141.7	142.9	146.5	149.4
Pediatric care, office visits 1/	115.0	117.5	119.5	121.8	123.6	125.1	126.2	128.1	129.0	130.2	133.3	139.6	140.3
Psychiatrist, office visits 1/	108.9	110.2	112.6	113.0	113.5	114.0	115.1	118.7	119.0	120.6	123.3	125.5	129.6
Dentists' fees	120.9	122.8	124.3	125.8	126.9	128.8	130.7	132.9	134.1	135.7	137.3	140.1	144.2
Other professional services:													
Examination, prescription, and dispensing of eyeglasses	115.7	117.1	118.6	120.6	121.7	122.8	123.6	124.9	125.2	126.5	127.6	128.9	131.2
Routine laboratory tests 1/	105.7	106.9	107.6	108.6	109.1	109.0	111.4	112.1	112.3	114.3	114.2	115.4	117.9
Hospital service charges:													
Daily service charges	164.2	172.6	183.0	194.2	200.1	204.1	211.4	219.9	224.6	231.8	239.3	249.2	253.8
Operating-room charges 1/	112.6	115.4	119.0	124.3	128.6	131.8	133.7	138.6	142.7	146.4	150.9	160.4	165.6
X-ray, diagnostic series, upper G.I. 1/	104.5	107.6	110.0	111.0	111.9	113.5	114.4	115.6	116.7	118.6	119.0	121.4	122.3
Drugs and prescriptions	98.6	98.5	98.3	98.0	97.7	97.9	98.1	98.2	98.0	98.0	98.5	98.8	99.3
Prescriptions 2/	90.5	90.5	90.3	89.6	88.8	88.6	88.4	87.8	87.2	87.0	87.6	88.2	88.6
Over-the-counter items 1/	102.9	102.6	102.5	102.6	103.1	103.8	104.7	105.7	106.1	106.3	106.6	106.6	107.1
	Percentage change from preceding quarter												
CPI, all items	0.8	1.1	0.5	0.3	0.9	0.9	0.9	1.1	1.2	1.1	1.2	1.5	1.6
Less medical care	1.0	.9	.5	.1	.9	.9	.9	1.1	1.2	1.1	1.2	1.5	1.6
CPI, all services	1.6	1.2	1.4	.9	.9	1.0	1.1	1.5	1.4	1.6	1.5	2.0	1.7
Less medical*	1.5	1.1	1.2	.6	.8	.8	1.0	1.4	1.4	1.5	1.6	1.9	1.6
Medical care, total	1.4	1.9	1.9	2.0	1.3	1.6	1.4	1.8	1.0	1.4	1.8	2.3	1.8
Medical care services	1.7	2.4	2.3	2.5	1.6	1.9	1.6	2.1	1.2	1.7	2.0	2.7	2.0
Professional services:													
Physicians' fees	2.0	2.2	1.6	2.0	1.3	1.5	1.1	1.6	1.2	1.2	1.7	2.3	1.9
Family doctor, office visits	1.9	2.3	1.7	2.3	1.5	1.6	1.4	1.5	1.0	1.2	1.6	2.4	2.3
Family doctor, house visits	2.6	2.0	1.8	1.7	1.1	1.3	1.2	1.8	2.2	1.8	1.7	2.9	1.2
Herniorrhaphy (adult) 1/	.4	.9	1.8	1.4	1.8	1.1	.6	1.5	1.4	1.1	.5	1.6	.8
Tonsillectomy and adenoidectomy	2.1	2.0	.8	1.1	.5	3.1	.4	1.0	1.3	.6	2.7	.8	1.0
Obstetrical cases	1.4	3.0	1.6	2.3	1.6	1.1	.4	1.4	1.4	2.4	.8	2.5	2.0
Pediatric care, office visits 1/	5.3	2.2	1.7	1.9	1.5	1.2	.9	1.5	.7	.9	2.4	4.7	.5
Psychiatrist, office visits 1/	1.4	1.2	2.2	.4	.4	.4	1.0	3.1	.3	1.3	2.2	1.8	3.3
Dentists' fees	1.2	1.6	1.2	1.2	.9	1.5	1.5	1.7	.9	1.2	1.2	2.0	2.9
Other professional services:													
Examination, prescription, and dispensing of eyeglasses	1.0	1.2	1.3	1.7	.9	.9	.7	1.1	.2	1.0	.9	1.0	1.8
Routine laboratory tests 1/	1.8	1.1	.7	.9	.5	-.1	2.2	.6	.2	1.8	-.1	1.1	2.2
Hospital service charges:													
Daily service charges	2.1	5.1	6.0	6.1	3.0	2.0	3.6	4.0	2.1	3.2	3.2	4.1	1.8
Operating-room charges 1/	1.3	2.5	3.1	4.5	3.5	2.5	1.4	3.7	3.0	2.6	3.1	6.3	3.2
X-ray, diagnostic series, upper G.I. 1/	1.3	3.0	2.2	.9	.8	1.4	.8	1.0	1.0	1.6	.3	2.0	.7
Drugs and prescriptions	.2	-.1	-.2	-.3	-.3	.2	.2	.1	-.2	0	.5	.3	.5
Prescriptions 2/	-.4	0	-.2	-.8	-.9	-.2	-.2	-.7	-.7	-.2	.7	.7	.5
Over-the-counter items 1/	1.1	-.3	-.1	.1	.5	.7	.9	1.0	.4	.2	.3	0	.5

1/ Index base, December 1963.
2/ Index base, March 1960.
* A special index based on unpublished BLS data.
Source: Consumer Price Index, Bureau of Labor Statistics.

TABLE 2.--Percentage change for consumer prices and medical care components, by item, selected periods, June 1966-June 1969

[1957-59=100, unless otherwise specified]

Item	6 months ending--							12 months ending--			24 months ending--		36 months ending June 1969
	June 1966	Dec. 1966	June 1967	Dec. 1967	June 1968	Dec. 1968	June 1969	June 1967	June 1968	June 1969	June 1968	June 1969	
CPI, all items	1.7	1.6	1.1	1.9	2.3	2.3	3.2	2.7	4.2	5.5	7.1	10.0	13.0
Less medical care	1.7	1.4	1.0	1.7	2.3	2.3	3.1	2.4	4.1	5.4	6.6	9.8	12.4
CPI, all services	2.3	2.6	1.8	2.1	2.9	3.1	3.8	4.4	5.1	7.0	9.8	12.5	17.5
Less medical*	2.1	2.2	1.4	1.8	2.8	3.1	3.5	3.7	4.7	6.7	8.6	11.8	15.9
Medical care, total	2.7	3.9	3.3	3.0	2.8	3.3	4.1	7.3	5.9	7.5	13.7	13.9	22.2
Medical care services	3.2	4.8	4.2	3.6	3.4	3.8	4.8	9.2	7.1	8.7	16.9	16.5	27.1
Professional services:													
Physicians' fees	3.8	3.8	3.3	2.7	2.8	2.9	4.3	7.3	5.5	7.3	13.2	13.3	21.5
Family doctor, office visits	4.1	4.1	3.9	3.0	2.6	2.8	4.7	8.1	5.7	7.7	14.3	13.8	23.0
Family doctor, house visits	4.6	3.8	2.8	2.5	4.0	3.6	4.1	6.7	6.6	7.8	13.7	14.9	22.6
Herniorrhaphy (adult) 1/	1.7	2.8	3.3	1.7	2.8	1.6	2.4	6.1	4.6	4.0	11.0	8.8	15.4
Tonsillectomy and adenoidectomy	3.2	2.7	1.5	3.5	2.3	3.3	1.7	4.3	5.9	5.1	10.4	11.3	16.1
Obstetrical cases	2.8	4.6	3.9	1.6	2.8	3.3	4.5	8.7	4.5	7.9	13.5	12.8	22.6
Pediatric care, office visits 1/	7.0	3.9	3.4	2.1	2.2	3.3	5.3	7.5	4.4	8.8	12.2	13.5	22.0
Psychiatrist, office visits 1/	2.4	3.4	.8	1.4	3.4	3.6	5.1	4.2	4.8	8.9	9.3	14.2	19.0
Dentists' fees	1.8	2.8	2.1	3.0	2.6	2.4	5.0	5.0	5.7	7.5	10.9	13.6	19.3
Other professional services:													
Examination, prescription, and dispensing of eyeglasses	1.4	2.5	2.6	1.6	1.3	1.9	2.8	5.2	2.9	4.8	8.2	7.8	13.4
Routine laboratory tests 1/	1.6	1.8	1.4	2.1	.8	1.7	3.2	3.2	2.9	5.0	6.2	8.1	11.5
Hospital service charges:													
Daily service charges	4.5	11.4	9.3	5.6	6.2	6.5	6.1	21.9	12.2	13.0	36.8	26.8	54.6
Operating-room charges 1/	3.4	5.7	8.1	4.0	6.7	5.7	9.7	14.2	11.0	16.0	26.7	28.8	47.1
X-ray, diagnostic series, upper G.I. 1/	1.9	5.3	1.7	2.2	2.0	2.0	2.8	7.1	4.3	4.8	11.7	9.3	17.0
Drugs and prescriptions	.5	-.3	-.6	.4	-.1	.5	.8	-.9	.3	1.3	-.6	1.6	.7
Prescriptions 2/	-.2	-.2	-1.7	-.5	-1.4	.5	1.1	-1.9	-1.8	1.6	-3.6	-.2	-2.1
Over-the-counter items 1/	1.5	-.4	.6	1.6	1.3	.5	.5	.2	2.9	.9	3.1	3.9	4.1

1/ Index base, December 1963.
2/ Index base, March 1960.
* A special index based on unpublished BLS data.
Source: Consumer Price Index, Bureau of Labor Statistics.

TABLE 3.--Quarterly indexes and quarterly change, by type of procedure, June 1966-June 1969

[December 1965=100, unless otherwise specified]

Type of procedure	June 1966	Sept. 1966	Dec. 1966	Mar. 1967	June 1967	Sept. 1967	Dec. 1967	Mar. 1968	June 1968	Sept. 1968	Dec. 1968	Mar. 1969	June 1969
	Index, end of quarter												
Family doctor, house visit (1957-59=100).	133.3	135.9	138.3	140.7	142.2	144.1	145.8	148.4	151.6	154.3	157.0	161.5	163.4
Family doctor, office visit (1957-59=100)	128.1	131.1	133.3	136.4	138.5	140.7	142.7	144.9	146.4	148.1	150.5	154.1	157.6
Family doctor, house visit...............	104.6	106.7	108.6	110.4	111.6	113.1	114.4	116.5	119.0	121.1	123.2	126.8	128.3
Family doctor, office visit..............	104.1	106.5	108.3	110.8	112.5	114.3	115.9	117.2	118.9	120.3	122.3	125.2	128.0
In-hospital medical care: 1/													
Myocardial infarction..................	101.3	102.7	104.7	106.4	107.8	108.4	110.5	112.2	113.9	115.5	117.9	119.6	120.6
Cerebral hemorrhage....................	101.2	102.5	104.1	106.0	107.3	107.9	109.9	111.1	112.9	114.5	117.0	119.1	119.2
In-hospital surgical procedures: 1/													
Cholecystectomy........................	101.4	101.9	102.5	104.8	106.0	107.6	109.9	112.1	113.0	114.9	115.7	116.9	118.4
Prostatectomy..........................	102.5	104.8	106.9	108.3	109.4	110.4	114.3	115.1	116.6	119.4	121.2	123.2	124.8
Fractured neck of femur................	101.2	102.0	103.5	105.2	107.7	109.3	111.3	113.2	116.2	117.0	119.6	125.0	128.3
	Percentage change from preceding quarter												
Family doctor, house visit...............	2.6	2.0	1.8	1.7	1.1	1.3	1.1	1.8	2.1	1.8	1.7	2.9	1.2
Family doctor, office visit..............	2.0	2.3	1.7	2.3	1.5	1.6	1.4	1.1	1.4	1.2	1.7	2.4	2.3
In-hospital medical care: 1/													
Myocardial infarction..................	.8	1.4	2.0	1.6	1.3	.6	2.0	1.5	1.5	1.4	2.1	1.4	.8
Cerebral hemorrhage....................	.8	1.3	1.6	1.8	1.2	.6	2.0	1.1	1.6	1.4	2.2	1.8	.1
In-hospital surgical procedures: 1/													
Cholecystectomy........................	1.1	.5	.6	2.2	1.1	1.5	2.1	2.0	.8	1.7	.7	1.0	1.3
Prostatectomy..........................	1.6	2.3	2.1	1.3	1.0	.9	3.5	.7	1.3	2.4	1.5	1.7	1.3
Fractured neck of femur................	.8	.8	1.5	1.6	2.4	1.5	1.8	1.7	2.7	.7	2.2	4.5	2.6

1/ From special study of prices for 5 procedures, not incorporated in the regular sample of the CPI; important to but not necessarily limited to older people.

Source: Compiled by the Social Security Administration from unpublished data reported by the Bureau of Labor Statistics.

37-795 O - 70 - 19

TABLE 4.--Percentage change for in-hospital procedures for the aged, by item, selected periods, June 1966-June 1969

Item	6 months ending--							12 months ending--			24 months ending--		36 months ending June 1969
	June 1966	Dec. 1966	June 1967	Dec. 1967	June 1968	Dec. 1968	June 1969	June 1967	June 1968	June 1969	June 1968	June 1969	
In-hospital physicians' care for the aged:1/													
Myocardial infarction	1.3	3.4	3.0	2.5	3.1	3.5	2.3	6.4	5.7	5.9	12.4	11.9	19.1
Cerebral hemorrhage	1.2	2.9	3.1	2.4	2.7	3.6	1.9	6.0	5.2	5.6	11.6	11.1	17.8
Cholecystectomy	1.4	1.1	3.4	3.7	2.8	2.4	2.3	4.5	6.6	4.8	11.9	11.7	16.8
Prostatectomy	2.5	4.3	2.3	4.5	2.0	3.9	3.0	6.7	6.6	7.0	13.8	14.1	21.8
Fractured neck of femur	1.2	2.3	4.1	3.3	4.4	2.9	7.3	6.4	7.9	10.4	14.8	19.1	26.8

1/ Represents a special study of prices for 5 procedures, not incorporated in the regular sample of the CPI, important to, though not necessarily limited to, older people.

Source: Compiled by the Social Security Administration from unpublished data reported by the Bureau of Labor Statistics.

DEFINITIONS

Consumer Price Index--An index prepared by the Bureau of Labor Statistics that measures the changes over a period of time in average prices of the goods and services purchased by urban wage earners and clerical workers and their families. The general procedure is to measure price changes by repricing a "market basket" of goods and services at regular intervals and comparing the aggregate costs with those of an equivalent market basket purchased in a selected base period.

Medical Care Price Index--A component of the CPI that measures the changes in the prices paid for medical care goods and services used by wage earners and clerical workers. It currently consists of 19 medical services and 20 drugs and prescriptions.

Hospital Daily Service Charges--The amount charged to adult in-patients for routine nursing care, room, board, and minor medical and surgical supplies. It usually excludes additional charges incorporated in the hospital bill such as laboratory work, X-ray, operating-room, and special charges. Indexes for operating-room charges and for X-ray diagnostic services for upper gastrointestinal (G.I.) series are reported separately.

Physicians' Fees--A component of the CPI currently consisting of the fees for seven services, including family doctors' office and house visits, adult herniorrhaphy, tonsillectomy and adenoidectomy, obstetrical cases, and pediatric and psychiatrist office visits. These seven physicians' services are combined into one overall index of physicians' fees.

Fees of Family Doctors 1/

House visit--Usual fee for house visit during the day (usually 6 a.m.-6 p.m.) within corporate limits of the city to regular patients; i.e., not a first call but subsequent calls. Excludes special fees to participants in group hospitalization and surgical plans.

Office visit--Usual fee for office visit to regular patients; i.e., not first call but subsequent calls. Excludes special fees to participants in group hospitalization and surgical plans.

1/ Fees of family doctors for house and office visits are regularly reported in the CPI.

In-Hospital Care of Special Significance to the Aged 2/

Myocardial infarction (heart attack)--Usual hospital visit fee for first day, second day, etc., and/or the constant charge per day to regular patient suffering from myocardial infarction. Includes cost of admitting, hospital write-up, examination, and other services. Excludes cost of cardiograms, other laboratory fees, and medications. Assumes a 21-day stay in the hospital.

Cerebral hemorrhage (stroke)--Usual hospital visit fee for first day, second day, etc., and/or constant charge per day to regular patient suffering from a cerebral hemorrhage. Includes cost of admitting, hospital write-up, examination, and other physicians' services. Excludes cost of laboratory fees and medications. Assumes a 14-day stay in the hospital.

Cholecystectomy (gall bladder)--Usual fee for cholecystectomy with exploration of common duct. Includes usual single preoperative visit and postoperative care. Excludes fee for diagnosis and tests, fee for appendectomy, and anesthetist's fee.

Prostatectomy--Usual fee for prostatectomy by one of the following procedures: (a) transurethral electroresection of prostate; (b) perineal, subtotal; (c) suprapubic, one or two stages; or (d) retropubic. Includes usual single preoperative visit and postoperative care. Excludes fee for cystoscopy, diagnosis and tests, and anesthetist's fee.

Fractured neck of femur--Usual fee to repair fractured neck of femur by open reduction with pinning. Includes usual single preoperative visit and postoperative care. Excludes fee for diagnosis and tests and anesthetist's fee.

2/ Fees of internists and surgeons for these 5 procedures are not incorporated in the CPI but reported separately to the Social Security Administration by the Bureau of Labor Statistics.

THE FEDERAL BUDGET, INFLATION, AND FULL EMPLOYMENT

WEDNESDAY, OCTOBER 22, 1969

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON FISCAL POLICY,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Subcommittee on Fiscal Policy met, pursuant to call, at 10:05 a.m., in room S-407, the Capitol Building, Hon. Martha W. Griffiths (chairman of the subcommittee) presiding.

Present: Representative Griffiths.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Loughlin F. McHugh and Courtenay Slater, economists; and Douglas C. Frechtling, economist for minority.

Chairman GRIFFITHS. This morning the Subcommittee on Fiscal Policy continues its review of the relation of Government policy to inflation and full employment, by considering price and cost trends in food. This is the last of the three specific fields we have been concerned with in our current investigation.

Hearings on the two other specific fields, construction and medical costs, were held last week.

Tomorow we will conclude our hearings with testimony from the Council of Economic Advisers who will discuss the budget and inflation.

Today the subcommittee is particularly concerned with the rapid increases in food prices in the past year. Also in the longer range, with the more basic question of how the gains of agricultural productivity are distributed in our society.

We want to be sure that the consumer as well as the producer benefits from the gains of our amazingly productive agricultural sector. What has happened to costs in this sector compared to those in the rest of the economy? Why have these costs behaved the way they have? What can be done to reduce the degree of inflation in this particular field?

This morning we have scheduled three witnesses. We are honored to have as our first witness the Honorable Clifford M. Hardin, Secretary of Agriculture. He will be followed by Dr. Ben B. Seligman who is with the Labor Relations and Research Center at the University of Massachusetts. Mr. Joseph Danzansky, president of Giant Food, was also scheduled to be with us this morning, but has been attending a meeting of his company in Boston this past week and was unable to get a flight out of Boston that would get him here in time. His statement will appear at the end of today's hearing.

We are indeed grateful to you for being with us this morning Mr. Secretary. We will hear from you first. Please proceed in your own way.

STATEMENT OF HON. CLIFFORD M. HARDIN, SECRETARY OF AGRICULTURE; ACCOMPANIED BY DON PAARLBERG, DIRECTOR OF AGRICULTURAL ECONOMICS

Mr. HARDIN. Madam Chairman, I have prepared a statement here. Would you like me to read it?

Chairman GRIFFITHS. Yes, if you will, please.

Mr. HARDIN. Which I will for the record. There has been considerable attention in recent months to the rise in food prices, especially meats and particularly beef. Reasons given for the price rise are quite varied. I appreciate the opportunity to appear before the Subcommittee on Fiscal Policy today.

Food prices have risen substantially in the past year with much of the rise in recent months. However, they have not risen as fast over the year as nonfood items in the cost of living index. Despite higher food prices, food costs for the average family have not gone up as much as disposable income.

This year consumers have spent only about 16½ per cent of their income after taxes on food—the lowest in the world. This will be down from 16.8 percent last year and from 20.0 percent in 1960. One hour of wages in August this year would buy: 2.4 pounds of round steak, or 11.5 pounds of margarine, or 5 dozen eggs. In 1960, 1 hour of wages bought only 2.1 pounds of round steak, or 8.4 pounds of margarine, or 3.9 dozen eggs.

The increases in food prices in recent months have been a result of strong consumer demand, fractionally lower per capita supplies of livestock products, and the general inflation which has affected prices of all items. As in the past, food prices and food output will continue to be largely a function of supply and demand conditions in the market.

Since the interest of this committee in the increases in food prices is concerned primarily with meat prices and mainly beef prices, I will focus my remarks in that area.

Consumers have a strong preference for meat, and especially for beef. A recent national poll asked respondents how they wanted to spend their additional income. The idea of having "steaks and roasts whenever we want" ranked right behind color TV sets and air conditioning the house.

Total per capita red meat consumption last year was a record 138 pounds, 22 pounds more than in 1960. In addition, per capita use of poultry during this period increased by 11 pounds to 45 pounds per person in 1968. Beef consumption per person increased from 85 pounds in 1960 to a record of over 109 pounds in 1968. Pork consumption per person has changed little for many years, fluctuating in a range from 58 pounds to 68 pounds a year. It was 66 pounds per person in 1968. Consumption of veal and lamb, however, has been trending downward.

Accompanying the increase of nearly a fourth in per capita consumption of beef, retail prices rose 13 percent from 1960 to 1968. Retail prices for pork averaged nearly 23 percent higher than in 1960, but per capita use was only fractionally higher.

Retail prices for poultry fluctuated below the 1960 level and in 1968 averaged 3 percent lower. But per capita use of poultry increased nearly a third over the period. These price changes compare with an increase of 15 percent in retail prices for all food used at home.

I make a distinction there in the home as contrasted to buying in restaurants.

After-tax consumer income per person rose each year and in 1968 was 51 percent above 1960. The advance in consumer demand for beef as incomes rose was strong enough to absorb a fourth more beef per person and still increase prices for beef only a little less than the rise in retail prices for all food. Trends in recent years attest to the very strong consumer perference for beef.

Producers of beef responded to the expansion in demand and rising prices with an increase in beef production of 41 percent between 1960 and 1968. In addition, imports of beef in 1968 were nearly double those in 1960 and the ratio of imports to production rose from 5 percent to 7 percent. This increase in beef supplies accommodated the rise in per capita use plus an increase of 11 percent in the population.

Prices received by farmers for beef cattle during 1968–69 fluctuated between $18 and $23.40 per hundred pounds. The high for the period in 1968 was 15 percent above 1960 but 18 percent below 1951. During the same period, the index of prices paid by farmers rose each year and in 1968 was 19 percent above 1960.

With rising costs and fluctuating prices for beef, the earnings of cattle producers and feeders have varied widely during one of the most prosperous periods ever for the economy as a whole.

This description of supply, demand, and price trends for beef provides a setting by which we can examine the changes in market forces contributing to the sharp rise in beef prices last spring.

Beef production through August 1969 averaged at the year-earlier rate. Veal and lamb production continued to decline, but pork output was up 2 percent and total red meat production held at the record 1968 level. At the same time, consumer incomes continued to rise rapidly, though somewhat less than in 1968. Moreover, general inflationary pressures permeate the entire economy. The consumer price index in August was up more than 5½ percent from a year earlier.

Retail prices of beef and veal peaked in July of this year at a level 16 percent above a year earlier and almost half this increase came in May, June, and July. In May and June, the number of cattle going to slaughter temporarily dipped below year-earlier numbers. Even though the reduction in supplies was small, the strongly advancing demand for beef resulted in an immediate surge in cattle prices in May and June. Hog prices also shot upward for the same reasons plus seasonally smaller supplies.

As marketings picked up in the summer, fed cattle prices declined and in early October they averaged about $6 below the high in June and only $1 above a year earlier, and I might insert parenthetically here that as of yesterday morning beef prices for live cattle were below a year ago, and also carcass prices were below a year ago as of yesterday.

Chairman GRIFFITHS. Do you consider this is because there is less demand or more beef?

Mr. HARDIN. There is slightly more beef. That is a fact. The demand side of the equation is a little harder to determine. If it is true that there is some bit more unemployment, this could be a factor on the demand side, but it is really too early I think to be certain of this. But it is a fact that the prices as of yesterday were lower than a year ago. And we are concerned, I might add, Madam Chairman, at this point that it may sag a bit more in the next few weeks. We have a feeling that we may be tending in that direction.

Retail beef prices continued to rise into July. However, with declining cattle prices, retail prices for beef eased off slightly in August, and that is the latest month for which we have the official index.

As a result, the farm-to-retail price spread widened. In September, the difference between the farm value of a beef carcass and the retail price of beef was up to almost 41 cents per pound compared with 35 cents a year earlier. Average farm value per pound dropped 9 cents from 67.7 cents in June to 58.5 cents in September. And I might add as a result of these figures I just gave you obviously that will be still lower in October.

There has been some concern, by both beef producers and consumers on the action the Department has taken under the 1964 meat import quota law during the past year. At this point I would like to establish what has transpired.

The Meat Import Law requires the Secretary of Agriculture to estimate and publish prior to the start of each calendar year, the quantity of certain meats—primarily chilled and frozen beef and mutton—that are expected to be imported into the United States during the calendar year. This estimate is revised and published quarterly during the year. It is prepared in the Foreign Agricultural Service.

The Foreign Agricultural Service started preparation of its estimate of 1969 imports of meat subject to the Meat Import Law early in November 1968. The estimate was based upon several kinds of information. These include information relating to anticipated supplies and disposition of these meats in the countries eligible to ship chilled or frozen meats to the United States.

This estimate incorporates a projection of market conditions in the United Kingdom and in the European Community, which are the major meat importing markets besides the United States in the world. It is also based upon an estimate of market conditions expected to prevail in the U.S. market which is provided by the economic research service in the Department. Based upon our analysis of these kinds of data the Department's estimate of the quantity of these meats that will be imported into the United States during the calendar year is prepared.

In addition the economic research service prepares, each December, a determination regarding the quota quantity and the quantity at which quotas would be triggered for the ensuing calendar year.

By way of introduction, a voluntary restraint program was started during the last quarter of 1968. Unexpected increases in shipments from Australia and New Zealand during the third quarter led to this program—under which both Australia and New Zealand reduced sharply their exports to the United States during October–December 1968.

By mid-November 1968 it became apparent that the estimate of imports during calendar 1969 would be in excess of the trigger quantity for 1969. Not only did our estimates of availabilities of supplies in exporting countries suggest that they would be larger than in 1968, but it also appeared likely that the U.S. market would continue in 1969 to be relatively more attractive for foreign suppliers, especially for those in Oceania than for those in either the United Kingdom or European Community markets.

In addition, there were animals in Australia and New Zealand that would have been slaughtered for export in late 1968 but for the restraint program, then in existence, which added to the available supplies in 1969 for export from those countries.

The information that the estimate of imports in 1969 would probably exceed the trigger quantity was communicated to the respective agencies in the administration that were interested in this matter.

Meetings were held by these agencies and the various options regarding courses of action were discussed. In the course of the interagency deliberations, serious consideration was given to the alternative options of triggering quotas or avoiding quotas through the use of voluntary restraints. A study of the relative advantages and disadvantages weighed in favor of voluntary restraints.

In the first instance, it was clear that quotas would violate our obligations under the General Agreement on Tariffs and Trade (GATT). For many years the United States has been in the forefront of the international efforts to obtain a reduction in quota restrictions. In pressing other countries to reduce their barriers to American exports we have laid great stress on their obligations under the GATT. U.S. quotas on meat would not only seriously weaken our position internationally, but might also subject exports of U.S. industry and agriculture to retaliatory measures abroad.

Moreover, the imposition of quotas and the problem of allocation of these quotas would have presented serious foreign relation problems. Since the Meat Import Act requires that quotas be allocated on the basis of a representative historical period, the Latin American countries would have suffered sharp reductions in their exports to the United States under mandatory quotas.

It is only in recent years that the Latin American countries, which are seeking to diversify their economies and lessen their reliance on traditional single crops such as coffee and bananas, have succeeded in developing a cattle industry. To have forced these countries to curtail sharply their exports to the United States would have been a blow to their diversification efforts and would have resulted in severe criticism of our foreign policy toward Latin America.

On the other hand, the traditional suppliers to our market, such as Australia, New Zealand, Mexico and Ireland, would have raised strong objections to a distribution of quotas which did not recognize their historic share of our market.

A further consideration which weighed in favor of voluntary restraints was the rigidity of quotas, which once imposed are difficult as a practical matter to remove. The voluntary restraint program, on the other hand, could be modified or discontinued more easily should circumstances warrant.

Late in November, the State Department initiated a series of meetings with representatives of the governments of the principal countries supplying these meats to the United States. USDA representatives participated, and the program of voluntary restraints for 1969 was outlined and discussed.

Negotiations for the voluntary restraint program were completed in December, after each of the participating countries had made commitments. The estimate by the Secretary of Agriculture of imports during calendar 1969 was then revised to take into account the voluntary restraint program.

The Foreign Agricultural Service has maintained surveillance of performances of the countries participating in this program based on current reports of shipments from the supplying countries and also on inspections of arrivals by the consumer and marketing service of the Department. Quarterly estimates have been prepared as of the end of March, June, and September 1969. In each case, the estimate reflected the continued voluntary restraints on shipments of these meats by the principal supplying countries.

Sharp price changes for cattle and beef during the past several months have been of concern to beef producing and consuming groups alike. Most of this change has occurred over a relatively short period of time. However, serious consideration should also be given to the matter of how much producers may increase output in the years ahead.

Many forces affect the supply, demand, and price of beef. Most foods compete to some extent. Certainly all meats and poultry compete for the main course in most meals. Prices of beef are affected by supplies of beef, pork, lamb, and poultry as well as by the level of consumer income.

Beef production has increased substantially over the past 15 years through increases in the size of the beef herd and increases in the number of cattle moving through feedlots. With prices favorable to cattle production, beef output will continue to increase.

However, unlike in past years, beef producers are now finishing around three-fourths of all beef animals going to slaughter. Consequently, most of the cattle suitable for feedlot finishing now are fed out. As a result, beef production cannot be increased greatly in a short time simply by finishing a larger proportion of cattle. In other words, it has been done.

For the most part, growth in beef supplies in the future will depend on expansion of the beef herd. For this to occur, cattle prices must be high enough to encourage producers to continue to expand production.

If prices are low for an extended period and producers view the future unfavorably, they may become discouraged and liquidate some of their present breeding herd. While this would increase the supply of beef in the short run by increasing slaughter, it would at the same time reduce the future potential for producing beef.

We believe that producers will be able to expand the breeding herd in coming years at a rate that will allow continued steady growth in beef supplies. If demand expansion continues rapid, cattle prices will be well maintained in coming years.

We must recognize that inflation affects the welfare of all Americans, producers as well as consumers of beef. Rising costs of production also tend to limit output and push up prices. If the general price level continues to rise, prices of farm products must also rise. I am sure none of us would want farm prices to go down if other prices are going up.

Chairman GRIFFITHS. Thank you very much.

Mr. HARDIN. There are attached tables that supply perspective, Madam Chairman.

Chairman GRIFFITHS. We will include them in the record at this point.

(The tables accompany Secretary Hardin's prepared statement for inclusion in the record follow:)

PRODUCTION AND CONSUMPTION PER PERSON OF RED MEAT, UNITED STATES, 1955–69 [1]

PRODUCTION [2]

[In millions of pounds]

Year	Beef	Veal	Lamb and mutton	Pork	Total
1955	13,569	1,578	758	10,990	26,895
1956	14,462	1,632	741	11,200	28,035
1957	14,202	1,526	707	10,424	26,859
1958	13,330	1,186	688	10,454	25,658
1959	13,580	1,008	738	11,993	27,319
1960	14,753	1,109	768	11,607	28,237
1961	15,327	1,044	832	11,408	28,611
1962	15,324	1,015	808	11,827	28,974
1963	16,456	929	770	12,427	30,582
1964	18,456	1,013	715	12,513	32,697
1965	18,727	1,020	651	11,141	31,539
1966	19,726	910	650	11,339	32,625
1967	20,219	792	646	12,581	34,238
1968	20,875	735	602	13,063	35,275
1969 [3]	21,030	660	550	12,970	35,210

CONSUMPTION PER PERSON

[In pounds]

Year	Beef	Veal	Lamb and mutton	Pork	Total
1955	82.0	9.4	4.6	66.8	162.8
1956	85.4	9.5	4.5	67.3	166.7
1957	84.6	8.8	4.2	61.1	158.7
1958	80.5	6.7	4.2	60.2	151.6
1959	81.4	5.7	4.8	67.6	159.5
1960	85.0	6.1	4.8	64.9	160.8
1961	87.7	5.6	5.1	62.0	160.4
1962	88.8	5.5	5.2	63.5	163.0
1963	94.3	4.9	4.8	65.3	169.3
1964	99.8	5.2	4.2	65.3	174.5
1965	99.3	5.2	3.7	58.5	166.7
1966	104.0	4.5	4.0	58.0	170.5
1967	105.9	3.8	3.9	63.9	177.5
1968	109.4	3.6	3.7	66.0	182.7
1969 [3]	109.6	3.2	3.5	64.6	180.9

[1] 50 States, beginning in 1960.
[2] Production of red meats is total dressed weight from total United States slaughter.
[3] Preliminary.

QUARTERLY MEAT CONSUMPTION FROM 1967-69

[Pounds per person]

Item	Commercial production I	II	III	IV	Total	Total production including farm
Beef:						
1967	26.2	26.6	26.8	25.7	105.3	105.9
1968	26.7	26.8	28.2	27.3	109.0	109.4
1969	26.9	26.5				[1] 109.6
Veal:						
1967	.9	.9	.9	.9	3.6	3.8
1968	.9	.8	.9	.8	3.4	3.6
1969	.8	.7				[1] 3.2
Pork:						
1967	16.1	14.9	15.3	16.9	63.2	63.9
1968	16.2	15.7	15.8	17.6	65.3	66.0
1969	16.7	15.8				[1] 64.6
Lamb and mutton:						
1967	1.0	.9	1.0	.9	3.8	3.9
1968	1.0	.9	.9	.9	3.7	3.7
1969	.9	.9				[1] 3.5
Total, meat:						
1967	44.2	43.3	44.0	44.4	175.9	177.5
1968	44.8	44.2	45.8	46.6	181.4	182.7
1969	45.3	43.9				[1] 180.9

[1] Preliminary.

BEEF CHOICE GRADE—RETAIL PRICE, WHOLESALE VALUE, FARM VALUE, FARM-RETAIL SPREAD, AND FARMER'S SHARE OF RETAIL PRICE, ANNUAL 1955-67, MONTHLY 1968-69

Date	Cents: Retail price per pound [1]	Wholesale value [2]	Gross farm value [3]	By-product allowance [4]	Net farm value [5]	Farm-retail spread (cents): Total	Wholesale-retail	Farm wholesale	Farmer's share (percent)
1955	67.5	50.8	44.9	3.8	41.1	26.4	16.7	9.7	61
1956	66.0	49.0	42.9	3.8	39.1	26.9	17.0	9.9	59
1957	70.6	52.2	46.5	4.0	42.5	28.1	18.4	9.7	60
1958	81.0	60.3	55.7	4.8	50.9	30.1	20.7	9.4	63
1959	82.8	61.5	56.9	5.4	51.5	31.3	21.3	10.0	62
1960	81.0	58.7	52.7	4.5	48.2	32.8	22.3	10.5	60
1961	79.2	55.8	51.2	4.9	46.3	32.9	23.4	9.5	58
1962	82.4	60.8	55.6	4.9	50.7	31.7	21.6	10.1	62
1963	81.0	56.1	51.1	4.5	46.6	34.4	24.9	9.5	58
1964	77.8	53.8	46.6	4.2	42.4	35.4	24.0	11.4	54
1965	81.4	57.6	51.6	4.8	46.8	34.6	23.8	10.8	57
1966	84.3	58.9	55.5	5.9	49.6	34.7	25.4	9.3	59
1967	84.1	59.7	54.3	5.0	49.3	34.8	24.4	10.4	59
1968	87.3	63.0	57.5	5.0	52.5	34.8	24.3	10.5	60
January	86.3	61.7	55.3	4.8	50.5	35.8	24.6	11.2	59
February	86.5	61.8	56.2	4.7	51.5	35.0	24.7	10.3	60
March	86.4	62.5	57.4	4.9	52.5	33.9	23.9	10.0	61
April	86.2	62.6	57.7	5.3	52.4	33.8	23.6	10.2	61
May	86.8	62.9	57.8	5.3	52.5	34.3	23.9	10.4	60
June	86.8	63.1	57.8	5.3	52.5	34.3	23.7	10.6	60
July	87.2	64.4	58.2	4.9	53.3	33.9	22.8	11.1	61
August	88.1	63.8	58.6	5.1	53.5	34.6	24.3	10.3	61
September	88.3	64.2	58.9	5.1	53.8	34.5	24.1	10.4	61
October	88.3	62.6	56.8	5.2	51.6	36.7	25.7	11.0	58
November	88.5	62.4	56.8	5.1	51.7	36.8	26.1	10.7	58
December	88.1	64.0	58.7	5.0	53.7	34.4	24.1	10.3	61
1969:									
January	90.1	64.9	59.7	5.1	54.6	35.5	25.2	10.3	61
February	90.0	64.6	60.3	5.1	55.2	34.8	25.4	9.4	61
March	89.9	65.5	61.3	5.2	56.1	33.8	24.4	9.4	62
April	92.7	68.2	63.3	5.6	57.7	35.0	24.5	10.5	62
May	94.8	72.5	67.6	5.9	61.7	33.1	22.3	10.8	65
June	100.0	77.7	73.8	6.1	67.7	32.3	22.3	10.0	68
July	101.7	77.1	72.4	6.0	66.4	35.3	24.6	10.7	65
August	100.1	72.7	67.5	5.9	61.6	38.5	27.4	11.1	62
September [6]	99.4	68.3	65.1	6.6	58.5	40.9	31.1	9.8	59

[1] Estimated weighted average price of retail cuts.
[2] Wholesale value of quantity of carcass equivalent to 1 lb. of retail cuts: Beef, 1.35 lb.
[3] Payment to farmer for quantity of live animal equivalent to 1 lb. of retail cuts: Beef, 2.25 lb.
[4] Portion of gross farm value attributed to edible and inedible by-product.
[5] Gross farm value minus by-product allowance.
[6] Preliminary.

SELECTED FARM AND RETAIL PRICE INDEXES, 1955-69—1957-59=100

Year and Month	Food: Meats: Beef and veal	Food: Meats: All	Food: Cereal products and bakery products	Food: Fruits and vegetables	All food	Public trans-portation	Health and recreation	Home ownership	Apparel and upkeep	Consumer price index, less food	Consumer price index, all items	Price received by farmers for beef cattle	Prices paid by farmers [1]
1955	84.4	87.7	93.4	91.8	94.0	89.0	91.4	92.6	95.9	93.1	93.3	75.8	94
1956	83.1	84.8	94.7	96.3	94.7	92.5	93.6	94.1	97.8	94.7	94.7	72.4	95
1957	89.2	94.2	98.4	96.0	97.8	96.0	97.0	98.2	99.5	97.9	98.0	83.6	97
1958	103.8	104.9	100.4	102.8	101.9	100.5	100.3	100.4	99.8	100.1	100.7	106.4	101
1959	106.9	101.0	101.2	101.2	100.3	103.5	102.8	101.4	100.6	102.0	101.5	109.9	102
1960	104.2	99.2	103.2	103.8	101.4	107.0	105.4	103.7	102.2	103.7	103.1	99.2	103
1961	102.5	100.5	105.4	104.2	102.6	111.7	107.3	104.4	103.0	104.8	104.2	98.2	104
1962	106.2	102.5	107.6	105.0	103.6	115.4	109.4	015.6	103.6	106.1	105.4	103.5	106
1963	105.0	100.9	109.1	111.0	105.1	116.9	111.4	107.0	104.8	107.4	106.7	96.7	108
1964	101.9	99.4	109.6	115.3	106.4	119.0	113.6	109.1	105.7	108.9	108.1	87.5	108
1965	106.8	106.9	111.2	115.2	108.8	121.4	115.6	111.4	106.8	110.4	109.9	96.7	111
1966	112.4	116.8	115.8	117.6	114.2	125.8	119.0	115.7	109.6	113.0	113.1	107.9	116
1967	113.1	113.8	118.5	117.5	115.2	132.1	123.8	120.2	114.0	116.8	116.3	108.4	119
1968	117.7	116.4	119.0	126.8	119.3	138.2	130.0	127.0	120.1	121.9	121.2	113.8	123
1969													
January	121.1	118.6	120.5	27.0	122.0	144.8	133.3	132.7	123.4	124.9	124.1	114.7	127
February	121.3	119.0	120.8	124.7	121.9	145.5	133.7	133.6	123.9	125.6	124.6	117.6	128
March	121.4	119.1	121.2	127.6	122.4	147.5	134.3	135.7	124.9	126.8	125.6	122.5	129
April	125.1	121.2	121.3	127.9	123.2	148.0	135.1	137.1	125.6	127.5	126.4	128.3	130
May	127.9	123.4	121.6	130.0	123.7	148.0	135.7	138.0	126.6	127.9	126.8	139.0	131
June	134.6	129.5	122.0	130.8	125.5	149.1	136.3	138.7	127.0	128.4	127.6	143.9	132
July	136.8	131.7	122.6	132.3	126.7	149.5	137.0	140.0	126.8	128.8	128.2	136.1	131
August	135.4	131.9	122.6	130.2	127.4	149.7	137.7	141.3	126.6	129.3	128.7	131.3	130
September												126.0	130

[1] Prices paid by farmers for production items, interest, taxes, and wages.

Chairman GRIFFITHS. I would like to ask you, supposing there were no import quotas that could be triggered, what do you think the effect upon imports would be? How much meat do you think would be imported in this country?

Mr. HARDIN. I am not sure that I could give you a figure, Mrs. Griffiths. We import about 6 percent of our total now.

Chairman GRIFFITHS. Do you suppose it would double or triple in a year or two?

Mr. HARDIN. Conceivably there might be enough beef production in the world at attractive prices. I think doubling would be an upper limit, but this would require more than a year or two.

Chairman GRIFFITHS. What about lamb?

Mr. HARDIN. In the short run?

Chairman GRIFFITHS. What about lamb?

Mr. HARDIN. Lamb is a peculiar situation. Our own production of lamb is declining, has been for several years. Our per capita consumption of lamb is declining, contrary to all of these other figures that we have been studying. Our imports of lamb from New Zealand and Australia are up a bit, but not as much as the difference in our loss in production.

There are those who say, and I cannot, I am not an authority in this, that the supplies available are so low that some of the stores simply do not feature it any more, and this has contributed to the decline in demand. I have heard this said. I cannot verify it.

Chairman GRIFFITHS. Why don't we encourage the production of lamb? Why do farmers not want to raise lambs?

Mr. HARDIN. That is an interesting question. The economic forces are fairly favorable for the production of lamb, and it is encouraged, but for some reason farmers have continued to go into other livestock commodities, mostly into beef, in contrast to lamb, preferring if I guess. It may have something to do—I have talked with some of the sheep ranchers—with the availability of men who are willing to herd sheep, and it does require a special talent and a special kind of person, and if I just had to make a guess, I would guess that that is the single most important factor.

Chairman GRIFFITHS. Really? Lamb as far as I can remember never was anything but high-priced. It seems to me that the price of lamb has remained more consistent through the years than the price of any other meat.

Mr. HARDIN. Yes, I think that is right.

Chairman GRIFFITHS. Why don't we permit more lamb to come in from Australia? Would we be triggering quotas if we permitted too much?

Mr. HARDIN. No. Lamb imports are not covered by the meat import law. The amount that enters is determined by supply and demand.

We have encouraged, however, the lamb producers in New Zealand and Australia to meet with our own lamb producers, and they are getting together this fall to discuss this whole situation among themselves as lamb producers all interested in this market, to see whether or not they can make some joint recommendation that might improve the situation.

Chairman GRIFFITHS. I was in Australia last year, and I by pure accident happened to meet with some of these people, and since I like lamb I urged them to ship more lamb, but it seems to me they need to develop a market too.

As you point out, one of the reasons perhaps the market has declined is that no real special effort has ever been made to build up a market for lamb.

Mr. HARDIN. The New Zealand people have been very excellent marketers. They market a high quality lamb in this country, and they are spending money in market development.

Chairman GRIFFITHS. Good.

Mr. HARDIN. At the present time, the Australians have not. Actually most of their imports to this country are mutton instead of lamb, and they have not followed the same orderly marketing arrangements that the New Zealanders have.

Chairman GRIFFITHS. Since we are inquiring as to what Government does that has tended to help create inflation, wouldn't you say really that these quotas have helped to create inflation, the possibility of triggering quotas, and as a matter of fact I think the Congress and perhaps the Ways and Means Committee on which I sit should take full responsibility. I do not believe that our President ever asked for the quotas, did he?

Mr. HARDIN. Not to my knowledge.

Chairman GRIFFITHS. I think Congress ought to. It was a terrible mistake in my opinion.

Mr. HARDIN. Well, it is a matter of judgment. I think had we had more foreign competition on our beef, that our own supplies would have not expanded as rapidly.

Chairman GRIFFITHS. I see.

Mr. HARDIN. And we could have also still had high prices.

Chairman GRIFFITHS. May I ask you, in case you looked at the House-passed tax bill, and while I do not think there is too much danger of its passing, what would happen to beef? Do you think that the production of beef would be affected by the loss of tax advantages?

Mr. HARDIN. Yes, it would some. Again I cannot give you the exact detail of the language. You perhaps have it. But it did have to do with the use of the capital gains——

Chairman GRIFFITHS. I particularly was attempting, you know, to stop Wall Street from being involved in the production of beef.

Mr. HARDIN. And with this we are in sympathy completely, and we just hope that the language can be repaired in such a way that it will not take away the tax advantages that the legitimate beef producers have. They need it.

Chairman GRIFFITHS. But every lawyer and every doctor, I heard this at least 20 times in the committee, is now competing with my farmers, so that I am sure it would have some effect upon the production of beef, because you would redirect capital out of the market.

Could you explain briefly how your proposed program that you gave before the House Agricultural Committee differs in philosophy from the present program, and would you tell us how much money it would cost?

Mr. HARDIN. Yes, I will be very happy to. The principal changes that we are recommending in general, and we are not down to specific programs as yet, would give the individual farmer a bit more freedom as to decisions on what he can plant on his own farm. This is No. 1.

No. 2, it would make the market prices domestically freer. They would be tied to the international markets more closely than some of them are at present. This varies from month to month because of the price supports.

Our price supports, our loan programs would be used primarily as sources of credit rather than price supports as they have been in some instances in the past and still are, and the payments to farmers would be on the basis of their domestic allotments of the crops involved, and it is our guess that the dollar amounts would be approximately the same as they would be under existing programs.

Chairman GRIFFITHS. What is the cost of storing crops today that the Government pays, or does the Government pay for this storage?

Mr. HARDIN. The Government pays for the storage of only those stocks that are taken over by Commodity Credit Corporation through the loan program, about $90 million per year.

Under the program that we are recommending, if it works as we would like for it to work, the stocks under Commodity Credit ownership would be greatly reduced.

Chairman GRIFFITHS. Has the growth of large corporate farms at the expense of traditional small farms promoted price increases or not?

Mr. HARDIN. I do not believe so.

Chairman GRIFFITHS. Why not?

Mr. HARDIN. Well, first of all there are not enough of them to have made this much difference yet. I think—is it less than 2 percent or less than 1 percent—less than 1 percent of farms are corporate farms, and they supply between 6 and 7 percent of the total farm output, and this is concentrated mostly in specialty crops, broilers, eggs, a little bit in the ranching areas, and in fruits and vegetables.

The corporate type of structure has had practically no impact in the general livestock and grain areas across the great Midwest of the country, and I think there is a reason for this.

Our studies show that the large, well-maanged family farm is just about as efficient as you can get in terms of costs per unit. Yes, the farmer can make more money if he would double his acreage, but his cost per unit would not be reduced thereby.

Chairman GRIFFITHS. That is a large farm in various areas of the country, I presume?

Mr. HARDIN. Well, let us say in Indiana, Illinois, or Iowa we would be thinking in terms of 600 acres.

Chairman GRIFFITHS. What is the capital investment in such a farm?

Mr. HARDIN. In the range of a quarter to a half million dollars.

Chairman GRIFFITHS. This includes the land, the animals if any and the equipment?

Mr. HARDIN. Yes.

Chairman GRIFFITHS. Is that not true?

Mr. HARDIN. That is correct.

Chairman GRIFFITHS. What is the margin of profit for invested capital annually?

Mr. HARDIN. Dr. Paarlberg, you may have to help me. Returns to capital has been running about three-fourths of that for the country as a whole.

Mr. PAARLBERG. That would be right.

Mr. HARDIN. I do not know what the exact interest rate on that is.

Mr. PAARLBERG. It depends on what you charge for labor. If you charge an average wage for the farm operator, then his return to capital has been running around 5 to 4 percent.

Mr. HARDIN. But if we add labor and capital we can say that both of them together are running about three-fourths of the return in the rest of the economy.

Mr. PAARLBERG. Yes.

Chairman GRIFFITHS. What does the average farm owner on a 600-acre well-managed farm realize per year?

Mr. HARDIN. Can you give us the figure?

Mr. PAARLBERG. His net income——

Chairman GRIFFITHS. Cash income.

Mr. PAARLBERG. The return to his labor and management might be $10,000 or $12,000.

Chairman GRIFFITHS. What I want to know is why, with a quarter of a million dollars invested, and working about 360 days a year, about 12 or 13 hours a day, why that man gets less money than the man that delivers the milk in Detroit?

Mr. HARDIN. Well, you have put your finger on the No. 1 problem we have in American agriculture, and it has to do with the nature of the enterprise, the fact that we have several million farm producers who make independent entreprenurial decisions which are right for them in terms of their own anticipated prices, but which do not add up necessarily to what is best for the industry.

You have a situation in which the ability to produce far exceeds what we need particularly or so far have been able to sell abroad and so there is this built-in tendency which we have had for 40 years to overproduce.

This is a part of the problem, in spite of very strong efforts to regulate production. I think we must recognize another very important factor; more and more of the expenses of the farmer are determined by other people, the things that he buys, tractors, machinery, chemicals, all sorts of things. He buys more than he used to. The prices of these are controlled by labor contracts and other built-in fixed costs, and so that his costs become fixed to him.

But on the other side of the equation he is operating almost in a free market for the things that he sells. This results in what we call the cost-price squeeze. It is very very real for the farm producer.

Chairman GRIFFITHS. Then let me ask you, farm equipment has no restrictions on its import, does it? There is no tariff on farm equipment coming into this country?

Mr. HARDIN. I do not know of any.

Chairman GRIFFITHS. I do not believe there is. I understand that an American producer, I just heard this yesterday, building tractors in England, while he himself is not bringing them here and selling them cheaper, enterprising other people are doing so. They are bringing them in in large quantities and undercutting the price of the American producer by $1,200 to $1,500. As a matter of fact, in this case the Government has not had any effect, because the Government does not have a tariff against those tractors. Why can't those tractors be brought in and sold cheaper?

Mr. HARDIN. There is no tariff, I know of no reason they cannot be.

Chairman GRIFFITHS. Why don't we publish it? I mean why don't we publicize the fact that this is possible?

Mr. HARDIN. I presume it would be handled in the same way that foreign cars are handled, and they are certainly coming in in competition. The economics of producing tractors and automobiles are about the same.

Chairman GRIFFITHS. But it would help the farmer?

Mr. HARDIN. If the machinery was good.

Chairman GRIFFITHS. If the machinery came in?

Mr. HARDIN. And was good.

Chairman GRIFFITHS. Out of Europe, that is made much cheaper. What has happened here is that we have a Government support program which keeps farm prices unduly high, and this is accomplished in large part by keeping farm resources out of production.

Now if we have then this program you are suggesting, we will have a program that lets farm prices find their true long-term levels, is that right?

Mr. HARDIN. Which will be tied, most of them, to world prices, because all of the major commodities that we are discussing here that have been involved in the farm program are export commodities, the feed grains, cotton and wheat.

Chairman GRIFFITHS. Do you assume that such a program would actually put all of the commodities into the hands of people who would use them? There is a limit I would assume to what you could eat, but there are a lot of people that are not eating all they can I also assume?

Mr. HARDIN. Yes, I think we have a problem here. We will have hungry people in America, because of the breakdown in our system of distribution and income, particularly income distribution, and this is what we are attempting of course to cure through the commodity distribution program and the revised food stamp program—to at long last get this comprehensive enough that we can distribute food to the people who need it.

Now, we have several problems abroad which are more complicated because when we give food to other countries that may need it, we also run the risk of slowing down their own agricultural development by competing, having our food competing with their own producers, and this has been a particularly nasty problem, but one I think that we have over the years made good progress on in handling properly.

The situation with respect to wheat right now is an interesting one. We have a free world price on wheat or substantially so in spite of the international grains arrangement. It perhaps influences the price a little bit, but there is more wheat than we seem to be able to sell at any price, and I am speaking here of the exporting nations totally.

Formally we would say that if you drop the price enough you could move any quantity, but there does seem to be a limit beyond which at least in the short run you cannot go with wheat.

Chairman GRIFFITHS. I happen to agree with that economist who says that what these developing nations need is not steel plants but steel-tipped plows. They need better farming equipment and they need to recognize their economy around the production of food for a long time to come. But supposing they do this. What then happens to all of the markets? Will there be great enough demand?

Mr. HARDIN. And if it is good.

Chairman GRIFFITHS. Of course. It is American manufacturers.

Mr. HARDIN. Oh, and if parts are available.

Chairman GRIFFITHS. Parts are available. They could get the parts right here in this country. It might be of some real help. Now, in this case the Government is not interfering, but the Government is in most farm cases really interfering.

You have said elsewhere that we must continue the $4 billion subsidy to farmers not to produce. You make the point these things are built into the farm structure, land values, mortgages, expectations, et cetera.

Mr. HARDIN. Yes.

Chairman GRIFFITHS. Isn't this always the case where you have long-standing subsidy program?

Mr. HARDIN. Yes.

Chairman GRIFFITHS. And the expectations that they will be continued?

Mr. HARDIN. I think it is always the case, and it is one of the problems on getting rid of it. If you make a substantial reduction in payments you would disrupt every rural community in this country and not only the income of the people as this infers, but the price of land and many of these have mortgages clear up to the limit of their market value of their farms, so you interfere with the mortgages, and also the tax structure.

Chairman GRIFFITHS. If you could start it over, if when you came in as Secretary of Agriculture you could have begun completely afresh without the past to bother you, would you have added subsidies?

Mr. HARDIN. Certainly not in the same way. I am sure that if we could start over, which you cannot do, it would not be the same program. I do not know how you can divorce yourself from history in our country.

Chairman GRIFFITHS. One of the programs that always made some sense to me was that program which said let the price of the item find its own market value. Let the farmer sell it for whatever it will bring, and then we will reimburse him the difference.

Why don't we do that?

Mr. HARDIN. That is precisely what we are recommending.

Chairman GRIFFITHS. Well, great. You can count on my support, because I never have understood why we did not do it that way. It seems to me to make much more sense than anything else ever has.

Mr. HARDIN. Yes, I think eventually there will. Of course, you look at the world food situation and this is one area that I have been concerned with personally for many years, with our big population explosion and the probability of at least 6 billion people in the year 2000. Can they be fed? As Dr. Paarlberg has pointed out, if they are alive in 2000 they will have been fed something, but can they be fed adequately?

We feel that with the technology now in existence or predictable, and by predictable I mean adapting some hybrid varieties or new crop varieties to a particular locale which we know can be done, this type of thing, we have the technology and the resources do exist in the world to feed adequately 6 billion people.

But if this is to be done, it would be our judgement, and particularly as this applies to the developing countries, in excess of 90 percent of the food that they consume in these countries in the year 2000 would have to come from their own soil, and for a very important reason, and that is the availability of foreign exchange in their hands to pay for any more than that.

This has been the pattern. I think it will continue to be the pattern, and only the advanced countries like Britain historically, like Japan, have been able to import a substantial portion of their food supply, which they then pay for with industrial products, but this is an option that usually is not open to the developing countries.

One exception might be one rich in minerals, like perhaps Venezuela where foreign exchange would come more easily, but this is not the typical developing country situation.

As these countries develop, their first and most ready source of foreign exchange is in the agricultural area, and small exports of whatever crops they are particularly good at and have advantages in, and then industrialization seems to come later. Some of these, however, in due course become very good markets for our farm commodities, and two good examples of this are Taiwan and Korea, which were developing countries a few years ago that we were helping, are now on their own feet, and are now buying large quantities of farm commodities from the United States and paying for them in hard cash.

Chairman GRIFFITHS. One of the things that bothers me is the removal of farmland from surplus and putting it into housing. What are you going to do about oranges and grapefruit? They are building houses on the orchards.

Mr. HARDIN. And I presume this is going to continue. We have urged people from time to time when they plan their cities, expansion of their cities, to look at the alternative use of the land that they have, and other things being equal to the poorer land rather than the best, looking with an eye to the future, but when you compare agricultural values with urban values, it is usually a losing battle.

Chairman GRIFFITHS. Why don't you come out with a program to set aside some of the best land throughout all the Nation for farming? We own a farm in four square miles of the best soil ever tested by Michigan State in Michigan. It is going to be a matter of practically months until that farm is gone. We will not be able to pay taxes on it.

Mr. HARDIN. Is that in Lenawee County?

Chairman GRIFFITHS. No, it is in Montcalm. So that it is just hopeless.

Mr. HARDIN. A few cities have made a special provision for agricultural land that falls within their total environment, and have continued to tax farmland as farmland, and not as a potential real estate development.

This is being done increasingly and is helpful, and I presume in your situation that is not being done.

Chairman GRIFFITHS. The reverse was done with the new constitution.

Mr. HARDIN. But I think that is the only way that you can really solve this, because the lever that the city has, or the people in the city, is the taxing system, and this is local, under local control. I do not think the Federal Government has any means to do this.

Chairman GRIFFITHS. The next time you see Secretary Romney I hope you take this up with him.

Mr. HARDIN. All right.

Chairman GRIFFITHS. It is generally assumed that there has been great productive gains in agriculture, that U.S. agriculture is marvelously efficient.

Mr. HARDIN. This is true.

Chairman GRIFFITHS. I heard Secretary Freeman say one time that if our technology were as good as our agricultural production, we would already be making commuter trips to the Moon, and I think that is probably right.

Has this productivity advance continued during the 1960's?

Mr. HARDIN. Yes, it has. I can quote the exact figures for 15 years. The production per person in agriculture has increased, compounded at 5.3 percent per year for this 15-year period just past, which compares with 2.7 percent for the rest of the economy.

Chairman GRIFFITHS. Retail prices for food have risen slightly less than the total consumer price index over the past 10 years, so presumably the consumer has gotten some of the benefit from productivity gains.

Mr. HARDIN. They definitely have.

Chairman GRIFFITHS. But have consumers shared in the gains as fully as they might have? Would you recommend any fundamental changes in our agricultural marketing system which would result in lower consumer prices?

Mr. HARDIN. Well, when we look at this we are looking at the most efficient processing and distribution system that the world has ever known. The American system is marvelously efficient.

I would not know how to make any major recommendations, that would result in lower food prices—with this qualification—if we are to assume that American consumers still want the built-in services that the food people have provided for them in recent years, the precooking, the special packaging, the year-round supply of commodities that we used to get on a seasonal basis, the standardization of the commodity so that what you buy today is exactly like you bought 3 months ago.

This sort of thing does cost additional money. But so long as American consumers want these services built in, and are willing to pay for them, I don't see how there can be a major reduction in the price spread between the farm and the consumers.

I am very much concerned that, while this has been going on, farmers have not shared equitably in our advanced technology and the fruits of it. As we talked a while ago, their rates of return have continued to be low. I would like it better if more of these gains in efficiency could go to the farm community.

Chairman GRIFFITHS. What kind of administrative procedures do you have within the Department to insure that the consumer interest is represented when your policy recommendations are formulated?

Mr. HARDIN. Consumer interests are represented? I am not sure that I can be as specific right off the top of my head on that, Mrs. Griffiths. I am sorry. Most of the policies that we are operating are determined by the Congress, and the administrative leeway on these is rather narrow, and I would presume then that when farm legislation is passed, that this has been the responsibility of the Congress through the hearing system to permit all groups to be represented in establishing these policies.

We do hold hearings on several areas in which there is a public interest. For example, fat in the hot dogs and other items, at which all groups are invited to present information. We have the administration of marketing orders for dairy products, for certain fruits and vegetables that usually are locally produced within a small geographic area.

The actions here are taken after full dress public hearings, at which all groups in society, including consumer groups are invited, permitted, and do present information. Dr. Paarlberg, do you think of others?

I think in almost all instances where there is administrative flexibility, we do use the hearing process. There may be a few exceptions to this.

Mr. PAARLBERG. I think the Secretary has outlined it very well, Mrs. Griffiths.

Chairman GRIFFITHS. Could you give us an idea of how much money is being spent on traditional vocational educational programs?

Mr. HARDIN. Traditional vocational agriculture?

Chairman GRIFFITHS. Educational programs.

Mr. PAARLBERG. We do not have that number with us, Madam Chairman. We can supply it.

Chairman GRIFFITHS. You can supply it?

Mr. HARDIN. We can supply it. It is administered, Mrs. Griffiths, in HEW, not in Agriculture, and is not a part of our budget, so I do not know the figures.

Chairman GRIFFITHS. We shall be glad to have that from you for inclusion in the record.

Mr. HARDIN. We will furnish that to the subcommittee.

(The information to be inserted in the record at this point follows:)

The Office of Education, Department of Health. Education, and Welfare, indicated to the Department of Agriculture staff that the States reported spending $26 million of Federal funds for vocational training in agricultural subjects in the 1967–68 school year. This sum does not include State or local funds spent for such subjects.

Chairman GRIFFITHS. Some time ago there was a figure which showed that many farm States were spending a fantastic proportion of their funds for agricultural training at the very time the Government was admitting there were too many people on the farms, so there is some real possibility that we are training too many. Is that true or isn't it?

Mr. HARDIN. I would say on this, however, that not all of these people are being trained to be farmers. There is this great group of people who are employed in agriculturally related industries—in the distribution of food, the processing of food, in the preparation of farm supplies—and a great many of these people have received basic agricultural training, and go into these pursuits, and I suspect that this altogether would be the largest single group of people in our total agriculture-related labor force.

So you would want to include this in your consideration.

Chairman GRIFFITHS. I see. You have suggested that your proposed program would cost about the same as at present. Is there any proposal that will phase the cost down?

Mr. HARDIN. There are plenty of proposals that would phase the cost down, but I know of none that have been proposed, none whatever, that would not affect farm income adversely, and almost dollar for dollar in terms of the reduction in the cost of the program, at least in the short run, and that would be 2 or 3 years.

I may say that the program that we hope the Congress will adopt by putting more flexibility in the market and in the individual producers may result in due course in a larger return at the marketplace, and this is a hope and you cannot prove it. We hope it will do this, and would provide a basis at some later time for reducing the cost of the programs. But I do not want to hold this out as a promise.

I would rather have it looked upon as a possibility that everyone hopes might materialize.

Chairman GRIFFITHS. One of the problems for any person going into farming now or in the future is going to be the increasing land costs, the increasing equipment costs, the increasing of other costs. If we can go back for a minute to that meat price and meat quota, do you think that if we had no quotas at all that our farmers could not compete with production in other parts of the world, and if not why not?

Mr. HARDIN. In other words, can we compete costwise?

Chairman GRIFFITHS. Yes.

Mr. HARDIN. With Australia and New Zealand and the South American countries?

Chairman GRIFFITHS. You certainly could with South America, couldn't you? I went down there and I was astounded. Armour had a plant in Uruguay, and the fringe benefits to the people in that plant were so great that Armour finally gave them the plant, and they were operating it themselves. And among the fringe benefits, every person had steak for lunch.

Mr. HARDIN. I don't know quite how to answer this question. I think we can compete on like quality, but we are competing with some countries that are almost desperate for foreign exchange, who are taking advantage of the new technology with lower wages rates in the processing area, which makes a difference.

I rather think that at the farm level we can compete successfully with any country in the world.

Dr. Paarlberg, you have studied figures like this more than I have.

Mr. PAARLBERG. I would only add that for grain-fed animals, for finished beef, and for pork which is grain-fed, I think we can clearly compete with any other country. There is some question as to whether on grass-fed beef we would be able to be fully competitive say with the Australians.

Chairman GRIFFITHS. There used to be a saying I believe in Kansas City that the longer you chew the bigger it grows, if it is grass-fed. Why have the prices of pork been going up? Consumption has not.

Mr. HARDIN. It is a matter of supply. The farmers simply have not responded with larger supplies of pork with these prices, and we have consumed all we produce.

Chairman GRIFFITHS. Are they not making a return that is equal to that which they could make on any other item?

Mr. HARDIN. Yes. The returns to the swine producer today certainly have been better in recent years than they were historically.

That is in 1969 they are. The numbers, however, have not responded as you would have expected on the basis of history, and I am not sure that I can give you the reason. I guess it is simply the cost side of the equation has discouraged them.

Chairman GRIFFITHS. Did the tax break work for them? It did not, did it?

Mr. HARDIN. No.

Chairman GRIFFITHS. The tax break really called capital into the production of beef without any question, but not into the production of lamb or of pork.

Mr. HARDIN. Not to the same extent.

Chairman GRIFFITHS. So that in reality the tax break was probably more effective than any other one thing in producing beef?

Mr. HARDIN. Meat prices tend to follow each other. There is a relationship between beef and pork prices. As beef prices rise it will pull pork up with it, because of substitutability; so the demand has remained strong, and it may be that in another year the supplies will respond, but they have not. The indications at this point are that it is going to be a modest increase.

Chairman GRIFFITHS. I would like to ask you, what effect do you think that the control by large slaughtering companies of the supply of beef, chicken, turkeys, or whatever, what effect does that have upon the price?

Mr. HARDIN. Well, if you take broilers and poultry, which is where the corporate structure has had its greatest impact, and you look at the prices, they are no higher than they were almost any period in the past.

Chairman GRIFFITHS. But, Mr. Secretary, they should be much much lower. There really is not any reason for it. I can remember that when I was a child you had an incubator and you had 150 eggs. My brother was in the turkey business and I think he raised 100,000 turkeys in 1 year, and he didn't even have to have very much labor connected with it.

Mr. HARDIN. Right.

Chairman GRIFFITHS. The thing that put him out of it really was Armour, because they began controlling their own, and they put them on the market on any particular day that they wanted to. They slaughtered them when they wanted to, breaking the market, so that in reality now you have put out all of the small producers.

Another one of the nice little bills that government put through here, and I am ashamed to say that I voted for it, was this inspection of chicken. There was not that kind of need at all. That was nonsense. That was a scare program. The real truth was that you gave production of chickens to the large producers.

Mr. HARDIN. Well, many of the broilers are still produced by the small producers on contract with the large companies.

Chairman GRIFFITHS. I even see farmers out in Michigan that are on contract with the large companies.

Mr. HARDIN. Yes.

Chairman GRIFFITHS. I have seen fields of cauliflower, perfect cauliflower that had been taken by a frost, because there was no requirement for it. If that cauliflower had been put on the market the price of cauliflower would have gone down, so that in reality it was the big producers that controlled it. In this case I think it was one of the big supermarkets. How effective is that on the price?

Mr. HARDIN. The only way I know to answer that is look at prices. This is an area in which prices at retail have steadily declined, but you may say, and you might be able to prove that they should have been still lower. But the efficiencies have at least in part been passed on to the consumer. That is as far as I can go on the basis of my present knowledge.

Chairman GRIFFITHS. But it really is a controlled market. There isn't too much competition in this market?

Mr. HARDIN. I am not prepared to speak to that issue, the extent of competition. It is true that in these areas the major portion of the business is being done by the large companies. How competitive these companies are with each other would also have to be determined.

Chairman GRIFFITHS. Well, I have a feeling they compete in advertising.

Mr. HARDIN. Certainly they do.

Chairman GRIFFITHS. And I am not sure they are competing in prices.

Mr. HARDIN. But the story of the conversion of feed to poultry meat is one of the fantastic stories of applying the results of research.

Chairman GRIFFITHS. And of course the fowl is so much better than the fowl that we eat. It is just so good.

Mr. HARDIN. The turkey that you buy now is a splendid animal.

Chairman GRIFFITHS. Yes.

Mr. HARDIN. As compared with any time in the past.

Chairman GRIFFITHS. Of course. I am sure that it really is selling at too high a price. No matter how low the price it could be lower because the production methods are so fantastic. The productivity in this must be greater than it is in any other thing in the whole country, and the return on the investment must be greater.

Mr. HARDIN. I am not familiar——

Chairman GRIFFITHS. On broilers you are turning them over every 6 weeks.

Mr. HARDIN. I am simply not familiar with the returns to the processors in the broiler-turkey business. I do not know them.

Chairman GRIFFITHS. I think that would be really a very interesting field to investigate, to determine what the return is and if they are not really making far more money than they are entitled to make, if it would not be better if we repealed some of these laws we have.

Mr. HARDIN. That is another matter.

Chairman GRIFFITHS. And let the private individuals get into the market.

Mr. HARDIN. About the only indication I have had that some of these companies who have these operations wish they could get rid of them, which may be an indication that profits are not high.

Chairman GRIFFITHS. I do not believe it. They may tell you that, but I do not believe that they want to get rid of them, because they are controlling both the supply and the final market.

Mr. PAARLBERG. The Congress authorized a study of food marketing some years ago, Mrs. Griffiths, and a very comprehensive report was published——

Chairman GRIFFITHS. Yes.

Mr. HARDIN (continuing). That you might wish to examine.

Chairman GRIFFITHS. Yes.

Mr. HARDIN. It goes into the profits of the poultry business and the beef business.

Chairman GRIFFITHS. Yes.

Mr. HARDIN. And other aspects of the marketing picture.

Chairman GRIFFITHS. Yes. Well, I want to tell you how much I enjoyed having you here.

Mr. HARDIN. I appreciate the opportunity.

Chairman GRIFFITHS. Mr. Secretary, I must say that I think from many standpoints you preside over by far the most interesting department of government; you reach really American life and life all around the world, and I certainly wish you the very best.

Mr. HARDIN. Thank you, Mrs. Griffiths, and thank you for the privilege of being here.

Chairman GRIFFITHS. Thank you very much.

Mr. Seligman, you are recognized, sir, and you may proceed.

I am delighted to have you here.

STATEMENT OF BEN B. SELIGMAN, PROFESSOR OF ECONOMICS, DIRECTOR OF LABOR RELATIONS AND RESEARCH CENTER, UNIVERSITY OF MASSACHUSETTS, AMHERST, MASS.

Mr. SELIGMAN. Thank you, Madam Chairman.

I am pleased to have the opportunity to take part in these deliberations. The problem of inflation in the United States today is a most difficult one and, as we are all aware, failure to control the explosive upward movement of prices is bound to have serious consequences for all.

In this statement I should like to address myself to several aspects of the retail business. Prior to coming to the University of Massachusetts, I was the director of research for the Retail Clerks International Association here in Washington.

As you know this organization, with a membership of more than 500,000 in the retailing industry, is very much concerned with the relationship of wage and price movements. This is particularly so at this time when wage adjustments achieved through collective bargaining are eroded by rapid price rises.

The fact is that prices have risen faster than wages in retailing. Data from the Department of Labor show that average earnings of nonsupervisory employees in retailing have risen approximately one third between 1960 and 1968. However, since prices during this period, as measured by the Department of Labor Consumers Price Index, went up 15 percent, the consequent increase in real wages was quite modest, rising from $57.76 per week to $65.16 in terms of real dollars.

I might add parenthetically that this is an increase in real wages of about 1⅓ percent per annum, which is considerably less than the approximate 2 percent rise in real wages generally throughout the economy. In essence, more than half the wage increase during this period was eroded by prices.

The immediate impact of price increases is felt at the point at which the consumer attempts to meet his needs, namely the retail store. Not too long ago housewives sought to picket supermarkets in protest against rising prices. It is obvious that this was not very successful.

The largest sector is retailing in the food industry. Around $90 billion worth is consumed at the retail level. The most important part of the retail food business is, of course, the supermarket, which increasingly has come to dominate the industry.

As supermarkets have grown in size supplying a greater and greater variety of articles for sale, their investments have had to increase. Yet data show that retail sales have increased even faster than capital outlays.

Some of the factors accounting for the phenomenal growth in supermarkets include the growth of suburbia, automobile transportation, and home refrigeration making it possible for the housewife to store food without any difficulty. The growth of supermarkets has also been accompanied by increasing concentration typified by the expansion of both national and regional chains. Frequently wholesalers have created so-called cooperatives, which in effect have represented chain operations.

The product market, or the area reached by supermarkets, has widened. At one time it was the neighborhood or the town; now it is an entire metropolitan area. The strength of the chains is such that in 1963 one-half the sales in some 200 metropolitan areas were made by the top four food store corporations. This ratio was an increase of about 5 percent over the previous decade. The trend has continued.

Since many of the chains are active in buying as well as selling it becomes difficult to blame high prices on vendors.

At this point may I interject, Madam Chairman, that your comments toward the end of the previous discussion were I think most appropriate, since they related to the fact that competition in food retailing is really not in terms of price but rather in terms of advertising, specials, gimmicks, and the like.

The fact is that many of the chains are deeply involved in integrated operations and they have sought to unify production with advertising, with wholesaling, and with retailing.

Some question has been often raised concerning the impact of such merchandising devices as trading stamps. It has been argued that such marketing inducements simply add to prices. Since the issues on this matter are subject to debate, it would seem to be desirable to conduct further study even though the Department of Agriculture and the National Commission on Food Marketing have looked into the matter on several occasions. I would suggest that the problem of trading stamp impact on prices is still a moot one. My own view on the matter is that they do conduce to higher prices. That view is disputed, and I would suggest that on this issue further examination would be desirable, Madam Chairman.

Retailers often argue that wage increases contribute to price increases. The fact is that unit cost, however defined, is affected in a retail store, by many factors other than wages—managerial skill, equipment, size of store, layout, the area of checkout counters, and the like.

Moreover, the retail worker surprisingly enough has been quite productive in the postwar period. A few years ago I made a study of retail productivity in the retail industry and was surprised to learn that the increase in productivity in this industry was on the order of

3 percent per annum, a performance that matched that of other industries.

Chairman GRIFFITHS. How do you measure the productivity of a retail——

Mr. SELIGMAN. The procedure I used was to calculate value added, which would be the more appropriate basis for determining productivity in retailing rather than gross sales. Some investigators have used gross sales, but I had to reject that, because it does involve double counting, since it would include the cost of the merchandise sold.

The definition of value added as determined by the Department of Commerce is coterminous with that of gross margins, and so it became a simple matter to establish gross margins in the retail industry from IRS data, both for corporations, partnerships, and single entrepreneurs.

After establishing that, I determined the average number of man-hours input in retailing on the basis of data supplied by the Department of Labor. Unfortunately, since I did want to go back to 1950, I had to use total retail employment since the distinction between supervisory and nonsupervisory employees in retailing was not made by the Department of Labor until about 1956.

Nevertheless, using total manpower input, and after constructing appropriate index series, I did find that the average increase in productivity was on the order of 3 percent per annum and I though that that was indeed a very good performance.

Further, when I was asked by the National Commission on Food Marketing to supply a statement with particular reference to productivity in supermarkets, I employed the same technique and found that in supermarkets the average increase in productivity approximated 5 percent per annum. That statement is in the record of the National Commission on Food Marketing.

Now, I had to do these computations myself simply because we—when I say "we" I mean the Retail Clerks Union—could not convince the Department of Labor, particularly the Bureau of Labor Statistics, to undertake studies in this area.

As a member of the Labor Advisory Committee to the Bureau of Labor Statistics, I badgered the Bureau for a period of about 8 years to undertake studies of this kind. To my knowledge they have not done so as yet, and I would think that the procedure that I have just sketched would be the most appropriate one.

It is essentially a determination of productivity in value terms rather than in physical terms. I should think that in attempts to measure physical productivity would be virtually impossible considering the nature of the services in the retail industry. A value measure is in essence a second-best choice. In checking the procedure with a number of statisticians and economists, it was thought that the procedure I had used was satisfactory.

Chairman GRIFFITHS. You divided the total number of clerks into the total increase in——

Mr. SELIGMAN. No.

Chairman GRIFFITHS (continuing). For total number of employees?

Mr. SELIGMAN. It was not done on the basis of the total number of people employed. What was done was to take the average employment for each year in the retail industry, multiply that by the average number of weekly hours, in order to determine the average man-hours input——

Chairman GRIFFITHS. I see.

Mr. SELIGMAN (continuing). In the industry, and then on the basis of that, to construct an index number series. Similarly an index number series was constructed for value added or for gross margins in retail industry, and then simply dividing one index series by the next to establish an index series for movements in productivity.

Chairman GRIFFITHS. Does the 3-percent increase in productivity include any effect of price increases?

Mr. SELIGMAN. Oh, yes.

Chairman GRIFFITHS. Yes?

Mr. SELIGMAN. Oh, yes, insofar as there was any change in the product mix. However, the value added series was deflated by the Consumer Price Index for commodities in order to provide as closely as possible a productivity measure in constant dollars.

Chairman GRIFFITHS. Thank you.

Mr. SELIGMAN. Indeed, the increase for supermarkets alone was close to 5 percent per annum.

Retail firms often argue that it is a low wage industry because its productivity is low. The foregoing facts suggest otherwise.

Indeed, I should think that productivity will continue to increase in the retail industry if one is to draw the appropriate inferences from the statement of Mr. Danzansky, particulary in the paragraph in which he alludes to the fact that the industry will continue to mechanize and to rationalize. Certainly that is understandable, if the industry is to continue to make progress, but nevertheless this will result in a further upward movement of productivity.

Moreover, it is contended that the profits on sales in the retail industry are generally not more than 1 or 2 percent, thereby suggesting that retailers may be in a difficult economic situation.

But this ratio is hardly the significant one, as profits ought to be computed as a percent of investment. When this is done for retailing the ratio is usually substantially more than 10 percent, a figure that compares quite favorably with that of other industries.

I might note again that Mr. Danzansky in his statement has conceded this point.

If I may add a bit of personal history: a few years ago when I was still with the Retail Clerks Union, a dispute broke out between supermarkets in Baltimore and the Retail Clerks Union, a dispute that became rather protracted. During the course of the dispute, the retail chains announced to the public that they could not meet the demands of the union because their margin of profit was 1 percent or less.

The union's response was to analyze the figures and to demonstrate to the public that the rate of return on investment was on the order of 14 percent.

It was conceded that the latter figure reflected a rather favorable economic situation for these firms.

I should agree with the National Commission on Food Marketing when it assigned responsibility for increasing retail food prices to upward drifting gross margins. Since these margins represent payments to other factors, including net profit, it would seem clear that the pressures are so generalized throughout the economy as to suggest the difficulty of maintaining a lid on price increases.

Nevertheless, insofar as increases in gross margins reflect increases in net profit responsibility would have to be placed directly on the retail industry. Again this requires further detailed study in order to determine the extent to which the conventional principle of profit maximization underpins increasing margins.

In any case, a sober analysis of the available factual data would suggest need for a careful examination of any single factor theory of inflation. For example, it would be a most dubious proposition to lay the blame for higher prices in retailing at the door of the unions functioning in that industry, for the fact is that this industry is one of the most poorly organized in the country.

Despite the significant progress of such organizations as the Retail Clerks Union in recent years, its 500,000 membership must be contrasted with a total of more than 9 million nonsupervisory employees. Even if we eliminate half of the latter figure as representing employees outside the jurisdiction of R.C.I.A., the ratio of organization would be somewhere around 11 percent.

Add to that figure organization by other unions such as the Teamsters, the Amalgamated Butchers, the Retail Wholesale and Department Store Employees Unions, and we would still not exceed 15 percent. The vast majority of employees in retailing are still unorganized.

Further, it would be necessary to examine the ratio of direct labor cost to total cost. In retailing, as in other industries, this ratio has been declining over the years, as retailers introduce and will continue to introduce rationalization and mechanization.

For these reasons, consequently, I suggest that it is unwise to search for devils in this situation. Inflation is a complicated phenomenon stemming from a multiplicity of factors and requiring a full arsenal of tools.

I should agree with Prof. John Kenneth Galbraith who has wondered whether now would not be the proper time for selective price controls, particularly for certain key commodities. I should also think that the well-known instruments of monetary and fiscal policy ought to be used with more rigor and determination than seems to be the fashion now. I would urge the Congress to adopt the device of flexible tax rates in order to allow the Government to respond quickly to changing economic circumstance.

I would urge that measures be adopted to slow down the pace of capital investment, for this more than anything contributes to an overheated economy.

In sum, I should urge that the very complexity of our current economic situation calls for flexibility of response and above all for a multiplicity of measures.

Chairman GRIFFITHS. Thank you very much, Mr. Seligman.

Are you and Mr. Galbraith recommending, for instance, that we have a price control on steel? Would you assume that would be one of them?

Mr. SELIGMAN. I should think that might very well be one of the selected commodities.

Chairman GRIFFITHS. Then are you suggesting to Mr. Abel that we have a price control on the wages for steelworkers?

Mr. SELIGMAN. That would be required as well.

Chairman GRIFFITHS. And if they have a control on the wages for steelworkers, are you going to suggest that the things that steelworkers buy in stores be particularly priced for steelworkers?

Mr. SELIGMAN. I am not suggesting they be particularly priced for steelworkers, but what I believe Professor Galbraith has in mind is the sort of situation that was adopted back in 1940 and 1941, when price movements began to trend upward rather sharply.

At that time Leon Henderson had suggested selective price controls. Unfortunately we moved into a war situation when such controls had to be extended to a broader range of commodities and then throughout the entire economy. But as I recollect controls applied to selected commodities worked fairly effectively in the early stages.

During the war a wage control formula was also imposed. In particular industries, such as the steel industry, it would seem to be that controls of this sort might very well be needed, if inflation continues to move. I think the cost of such controls would be much less to our society and to our economy than the present inflation.

Hopefully they would be maintained for not too long a period of time, only until such time as our superheated economy might cool down.

The fact is, Madam Chairman, that in the steel industry, since you select that as the basis for your question, price movements have been much more frequent than wage movements. In the 1950's the steel industry secured two price adjustments for every wage adjustment that the steel union under Mr. Macdonald was able to obtain. I think that is significant.

This relates to your remark at the end of Mr. Hardin's testimony indicating that prices are established in industries such as steel not by market forces but by the firms themselves.

These are characteristically industries in which prices are administered. And in the 1950's they were administered twice for every wage increase that was secured by the union.

Chairman GRIFFITHS. But I would assume no matter what you might have done in the early 1940's you did not have a real test case if it did not work very long. You had an immediate total price control, total price and wage control. It would be exceedingly difficult to apply any selective price and wage control in as highly inflationary an economy as this one. Why should steelworkers be told that they cannot have an increase no matter how much the prices of things they buy go up?

I meant to ask Mr. Danzansky, but unfortunately he is not going to be able to be here, but I would like to ask you, if you know, what is the total cost of stealing out of food stores? How much a factor?

Mr. SELIGMAN. The pilferage?

Chairman GRIFFITHS. Yes, how much a factor is this in determining the cost?

Mr. SELIGMAN. I did know the figure when I was with the union. In terms of sales, as I recollect, and this would be I suppose for the early 1960's, it was under 1 percent of sales.

Chairman GRIFFITHS. How long ago was that?

Mr. SELIGMAN. As I say, that would be for the early 1960's, around 1961–1962.

Chairman GRIFFITHS. What is the cost of advertising? Do you know that?

Mr. SELIGMAN. No, I do not recollect that figure.

Chairman GRIFFITHS. As a matter of fact, hasn't advertising really taken over in many ways the job of the clerk?

Mr. SELIGMAN. Without question. A few years ago I wrote an article on the retail industry, basing myself largely on the findings of the National Commission on Food and Marketing, and I pointed out that one of the characteristics of supermarketing is that services are actually performed by the housewife. She selects the articles herself, putting them in the basket; she will go to the coffee grinder, if they still have those things in supermarkets, and grind the coffee herself; she will move the commodities in the basket down to the checkout counter; and likely—especially if she happens to be doing her purchasing on a Monday or Tuesday—she will carry the packages out to her car herself.

I suggested that the housewife ought to be compensated for these services in the form of lower prices. Unfortunately she is not.

In effect that is the purpose of supermarketing, to develop a kind of business in which the selling carries itself. Advertising is a significant factor.

The whole object of supermarketing is to reduce the inside selling function and to make commodities sell themselves. Indeed, ideas have been suggested for fully automating the supermarket. A housewife would simply enter with a key, insert the key into a slot and the commodities would be delivered automatically to the checkout counter and be tallied automatically and all that would have to be done is for the bundle to be delivered to the car.

No, there is no competition in pricing. Some people may speak of the specials that take place in supermarkets, but these usually are concerned with just a few items. These are mere devices to attract the housewife.

By and large, of the several thousand items for sale in a supermarket, specials relate to but a handful, and advertising is simply geared to drawing the housewife into the store and to perform services for herself.

Chairman GRIFFITHS. I will be happy to bundle up all my own things if I will be paid for that 30-minute wait to get to the checkout counter.

Mr. SELIGMAN. You ought to be paid.

Chairman GRIFFITHS. That is the place I really resent it.

Mr. SELIGMAN. Indeed.

Chairman GRIFFITHS. Why the American public puts up with that, why a group of housewives put up with that is beyond my comprehension. Personally I attempt to purchase in small stores, personally owned. It may be a little higher, but it saves a lot of time.

I would like to ask you, you say that workers in food retailing are relatively low-paid, that it is not due to low productivity. You also imply return on investment is not high, at least relatively. Could you expand then on why wages are low?

Mr. SELIGMAN. There are several reasons. At one time before World War II, the average hourly wage for a retail employee was higher than that for a worker in an auto plant, was higher than that for a worker in a steel plant.

Chairman GRIFFITHS. Really?

Mr. SELIGMAN. Indeed. The figures will attest to that. The average hourly wage for a worker in a retail plant ran about 30 cents an hour higher than that for a worker on the assembly line in an automobile plant. That situation has been reversed. The employees in the auto industry and the steel industry have moved up steadily through the years. To be sure the unions in these respective industries have had much to do with that.

But there also has been a change in the composition, in the character of the employee in retailing, which I think accounts for the failure of average hourly wage rates to move consistently with other industries in the American economy.

At one time the retail employee was really a white collar worker, a service worker, a man who genuinely had to be skilled in the operations of the business. He had to know the commodities, he had to know the customers, he had to sell, literally to sell. This was a skill of a high order.

As supermarkets developed, particularly after World War II on the west coast, and on the east coast, and then throughout the country, a different type of person came into the supermarket to work. These people were not as highly skilled. They did not have to know the nature of the commodities that they were selling.

They worked in the back of the store. They were much more of the character of materials handlers than they were clerks.

I have characterized this shift as from white collar to gray collar. Supplementing such a change has been the fact that women and young people have come in to work in the retail industry for short hours.

People have wondered why this development occurred, I would say that it was the result of the attempt of retail store operators to convert what to all intents and purposes was a fixed cost, a commitment of wages-to-be-paid for the week, into a variable cost.

Now, let me explain. When a retail merchant employed a retail clerk in the old days, he hired him for the week, and whether sunshine or snow, he had to pay him. He reported for duty and there might be traffic, there might be no traffic. Yet he was paid. In that sense the wage cost was fixed for the week. Today the technique of part-time employment is used to tie wage cost to traffic movement.

The greatest wage cost for a supermarket occurs on Thursday, Friday, and Saturday. Consequently, by adjusting employment to traffic flow, retail store employers are able to handle their wage cost in a manner that requires them merely to employ a small steady crew for the full week, and then to hire women who are willing to work 10, 15, or 20 hours, and young men in high school, young women in high school or in college, to work for 10 hours a week or so on Thursday, Friday, and Saturday.

Chairman GRIFFITHS. Do they give bonuses in retail stores for sales?

Mr. SELIGMAN. In supermarkets?

Chairman GRIFFITHS. Not in supermarkets but in department stores.

Mr. SELIGMAN. Oh, in department stores there will be a bonus system, usually tied to the particular commodity that is being sold. It might be an item that has a very low turnover, and the sales person may be encouraged to sell that particular item, and will receive a bonus of 50 cents or $1 on the item.

37-795—70——21

Chairman GRIFFITHS. I go to stores selling clothing and other such things. It seems to me I see the same clerks all the time. They have one day off a week. Why aren't those clerks drawing this pay? They have been there for years. Let us refer to department stores.

Mr. SELIGMAN. In department stores we find the same tendency. It is not as highly developed as in supermarkets. My description referred exclusively to supermarkets. But even in department stores one finds the same general trend.

There will be a regular force, which will be geared to the minimal requirements for a full week's work, but on peak days additional help will be hired. That is traditional.

That process has expanded considerably. This is true also in variety stores. It is not true in specialty stores. In a specialty store one may find the same clerks that were there 10 and 20 years ago. That is a traditional shop. Of course it is a shop that carries higher priced merchandise. The tendency I have described has developed in supermarketing, and is developing in department stores and in variety stores.

Chairman GRIFFITHS. Is that why they are low paid?

Mr. SELIGMAN. Yes. Many women are willing to go to work in a supermarket for 10 or 15 hours a week to earn extra money.

Chairman GRIFFITHS. What is the union doing about it?

Mr. SELIGMAN. The union is making an effort to rectify the situation, but as I say, the union reaches only about 15 percent of the work force. The situation I referred to in Baltimore revolved about this condition.

This was not a dispute over wages or hours. This was a dispute over available hours, and providing such available hours to the regular journeymen clerks rather than to the part-time employees for Thursday, Friday, and Saturday. It was a very severe dispute, and the companies finally conceded that they would provide as much steady work as they could.

This would attract a somewhat higher level of clerk than had been the case up to now.

A youngster that goes to work in a supermarket really is not going to make a career of it. He wants a few dollars to carry him through school.

The housewife wants to earn a few dollars to help pay for the new television set or for the family automobile.

Chairman GRIFFITHS. What price, how much of a woman's employee's wages, if you know, go back to the department store that employs her?

Mr. SELIGMAN. I am not sure I understand the question.

Chairman GRIFFITHS. Where she buys things. And do you consider this in what you consider the woman is being paid?

Mr. SELIGMAN. I don't know if anyone has made a study of how much of an employee's wage would be spent in the same enterprise, but there are a number of department stores that will offer a discount on their own merchandise to their employees, and very many women who work in department stores, say they find this an attractive inducement.

Chairman GRIFFITHS. I understand that a study was made in a store in Detroit, and that more than 80 percent of women's wages went back to the store.

Mr. SELIGMAN. That may very well be.

Chairman GRIFFITHS. They were working split shifts. They got, I think, a 20-percent discount, and since the store probably had a 50-percent markup, the real truth was that the store was paying them practically nothing for their services. They were getting customers out of it.

Mr. SELIGMAN. That is right.

Chairman GRIFFITHS. You refer to growing concentration in the food retailing industry. Do you have any reason to suppose that this is a factor in rising food prices?

Mr. SELIGMAN. The National Commission on Food Marketing Report on Supermarketing suggested that this might be a contributory factor. Personally I think it is.

Chairman GRIFFITHS. What about the meat processing?

Mr. SELIGMAN. Insofar as meat processing is controlled by the distributor, that is by the retail firm which seeks to establish an integrated operation, this may very well be a contributing factor. I am not convinced that this has no relevance to the situation.

When on examines prices paid to farmers, and I base myself on my recollection of the national commission's data, I do not think we can hold farmers responsible for increasing food prices. These data suggested that farmers were not benefiting from the upward trend in prices.

To the contrary, the process of distribution, the process of conversion, was absorbing a good deal of the price.

Now, it may very well be argued that these are necessary functions. That is a matter of study, for the question may be raised whether it is not merely a marketing device. I am not sure that one would go along with such additional sources.

Chairman GRIFFITHS. But the housewife is going along with it?

Mr. SELIGMAN. Very often the housewife is cajoled into going along. I am reminded of the famous incident concerning prepackaged meats in the Grand Union Stores. The late Lansing Shields invented the idea of prepackaged meats. He placed these items on the counter in his supermarkets, and housewives rejected them. They would not purchase prepackaged meats. They insisted on talking to a live, human butcher.

Mr. Shields was puzzled by this. He solved the problem quite simply by placing a glass partition behind the counter, bringing the butcher out from back of the store and putting him behind the glass partition where the housewife could watch him at work. Shields put a button on the counter so that the butcher might be called out from behind the partition if the housewife wanted to talk to him.

When the housewife saw the butcher working, she accepted the prepackaged meat. Today on walking into a supermarket, one no longer sees the butcher working.

I am convinced that with appropriate measures housewives can be convinced of all sorts of services offered to them.

Chairman GRIFFITHS. You suggest that monetary and fiscal policies should be used with more rigor and determination. Do you think interest rates ought to be higher?

Mr. SELIGMAN. I would be reluctant to discuss this issue in any detail since I am not an expert in fiscal and monetary matters. I approach this area as a general economist.

As I read, some of the indicators are now beginning to reverse themselves. Whether this is to be attributed to the recent increase in interest rates I am not prepared to say. I think I would have to defer to my colleagues who are more expert in this area than I am, Madam Chairman.

One problem is that decisions on fiscal matters have a built-in lag. Such a lag, I think, does have some unfortunate consequences.

For example, the 1964 tax cut took upwards of a year to secure. By that time circumstances had been altered and I have the feeling that by the time the tax cut was instituted the economy was already begining to get out of the doldrums it had been in.

Chairman GRIFFITHS. Do you think taxes should be higher now?

Mr. SELIGMAN. I would think that the tax structure ought to be somewhat higher than it is now for purposes of controlling the inflationary spiral that we are being subjected to, but let me add this proviso. I did once urge the Congress to consider the prospect of flexible tax rates, of allowing the executive to move tax rates, within limits, upward or downward in quick response to changing economic circumstance.

Unfortunately the changes that we have to make are very often made too late. I would not be prepared to comment on what the Federal Reserve System has done with regard to interest rates. There has been some dispute on that. I know that some of my colleagues in the profession are rather critical of what the Federal Reserve has done. But as I say, I think I should prefer to leave that question to those who are more expert.

Chairman GRIFFITHS. I want to thank you very much, Mr. Seligman.

Mr. SELIGMAN. Thank you.

Chairman GRIFFITHS. We are indeed sorry that Mr. Danzansky was not able to be with us this morning. We will, however, include his submitted statement at this point in the record as though read. Also, Representative Seymour Halpern (R., N.Y.) submitted a statement on "Controlling Food Prices" for consideration by the subcommittee in connection with today's hearing. If there are no objections I should like to have it also included in the printed record of the hearing as though read, following Mr. Danzansky's statement.

(The statements referred to above follow:)

STATEMENT OF JOSEPH B. DANZANSKY, PRESIDENT, GIANT FOOD, INC.

Mr. DANZANSKY. Madam Chairman, and members of the Joint Economic Committee. I am Joseph B. Danzansky, president of Giant Food Inc. Our company is headquartered in Landover, Md., and our 88 supermarkets serve the Maryland-Washington, D.C.-Virginia region. I have been president and chief executive officer of Giant Food for 5 years, and have been a member of the Board of Directors of the National Association of Food Chains, the past 4 years.

I welcome these hearings as evidence of a Congressional determination to come to grips with inflation. Inflation is a fearsome problem partially because most Americans do not recognize the insidiousness of its impact. Most of us have never lived through a real and prolonged inflation. Small doses of inflation have thus far given many of us a false sense of well being. Businessmen can point to increased sales; workers to higher wages and salaries. But these advancements, until corrected for inflation, are poor indicators of relative economic progress. Furthermore, inflation compounds our pressing social problems, especially the problems of the poor. Therefore, control of inflation must be among the first steps in waging a war on poverty, although the need for other steps cannot be deferred. Indeed, they must be intensified as inflation continues. More important still, control of inflation is necessary to maintain the continued growth and prosperity of the economy—the economy that must produce the resources which make social reform possible. Reform cannot be purchased with a valueless currency.

One further comment before getting into my specific testimony on inflation in the food industry. In discussing inflation, a basic truth is often overlooked. Wage and price increases are not the basic causes of inflation. They are only symptoms. Inflation is caused by an increase in the supply of money relative to the goods available for which money can be spent. For if the growth in the production of goods matches the growth in the money supply, and indeed generates it, the inflationary factor is minimal.

Another basic inflationary force is the production of war materials which generate income but which produce no goods that consumers can buy. Again money increases faster than goods.

Food retailers have a special reason to be concerned about inflation. In our intensely competitive industry, we must be greatly sensitive to our customers' reactions to changing prices. Americans have many alternative places to purchase food. There is a variety of food products to meet both the tastes and nutritional requirements of every shopper. Furthermore food is purchased often and in relatively small amounts. Therefore, there is no segment of the economy where the customer can punish a firm more rapidly than in the food business.

Because food is purchased so often and because it is one of the remaining items bought for cash, consumers are more aware of and hostile to food price changes. While consumers frequently accept or quietly resist the purchase of many items as prices advance, there is often a public outcry and perhaps organized boycotts when the public is displeased with food prices, services or practices.

Food retailers consequently raise their prices with caution, and their costs therefore rise faster than their prices. During periods of rising prices, whether caused by inflation or by supply shortages, food industry profits invariably suffer. For these reasons and other historic reasons, food retailers operate on much smaller profit margins than most other industries.

The smaller margins, the unusually competitive nature of the industry, and the consumer awareness result in the food retailing industry being very adversely affected by inflationary trends which, in the short run, appear to benefit some others.

Despite food price increases, disposable income (or income after taxes) has increased even faster. Thus relative to income, food prices actually are down. USDA recently reported that in 1968 the percent of disposable income spent for food dropped to 16.8% and was expected to go down to 16.5% in 1969—the lowest point in history.

This figure is down from 26 percent in the immediate postwar period. The reduction this year is not unusual. The percentage of disposable income spent for food has been going down gradually but consistently for the past 20 years. To put this another way, the American consumer devotes a smaller portion of his labor and income to food than anywhere else in the world. One reason for this is the relatively great technological advance in agriculture, and in the retail food industry. Also, the farmer and the food retailer have not been able to claim their share of increased incomes as fully as some others.

Further, such trends to lower food cost in relation to incomes can be expected as incomes go up, as patterns of consumption continue and the food industry adopts technological innovations which will help keep our distribution costs from rising faster than our wage increases.

The reduction in percent of after-tax income spent for food has occurred despite a strong upgrading in the quality and variety of food consumed, much more eating away from home, and a great increase in convenience foods, which require more processing and must sell at higher prices. If the same foods were being consumed today in the same way as they were in the late 1930's, food would represent less than 11 percent of disposable income—a 50 percent reduction in about 20 years.

The 16.8 percent of disposable income spent for food in the United States compares to around 30 percent in the northern European countries, about 40 percent in the Mediterranean countries and Japan, about 50 percent in Russia, and much more in many of the developing countries.

The adverse effect of inflation upon food chain profits is clearly evident in table 1 and figure 1. These show profits after taxes over a periodof 22 years correlated against the combined effect of two major components of retail costs, wholesale prices, which account for about 78 percent of the Supermarket sales dollar, including some non-food items, and wages which account for about 10 percent of the sales dollar and about 50 percent of the food retailers' operating cost. It will be noted that whenever the retailers' major costs increased, his profits went in the opposite direction. During the period 1964 to date, retail food industry profits have declined continuously from an already low level of 1.41 cents per dollar of sales in 1964–65 to .99 cents in 1967–68. Profits are expected to average about 1 cent per dollar of sales in 1968–69. So rather than being inflationary, changes in food chain profits actually contribute a small degree of stability to the food economy.

FIGURE 1

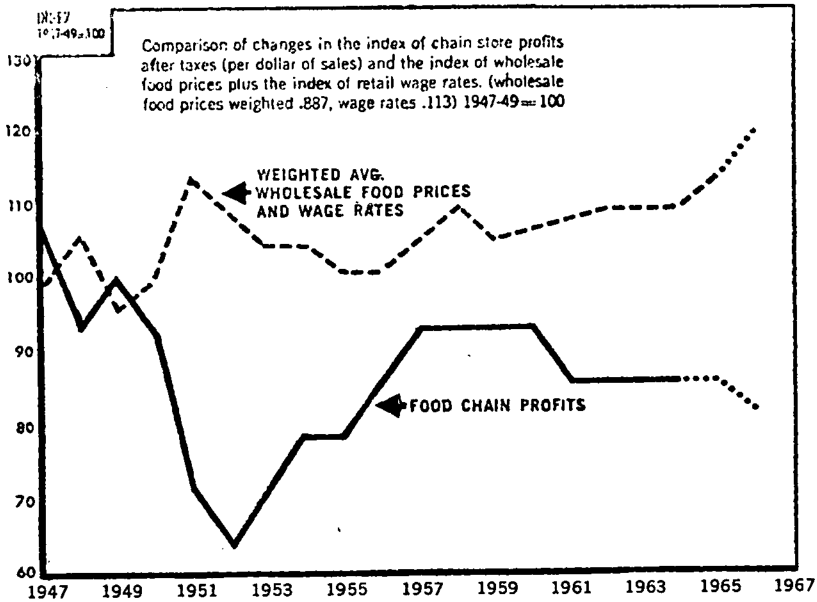


TABLE 1.—NET PROFITS AFTER TAXES, LEADING RETAIL FOOD CHAINS, 1947–64 [1]

Year	Profits after taxes			
			Index of profit (1947–49=100)	
	Percent on sales	Percent on net worth	Percent on sales	Percent on net worth
1947	[2] 1.5	[2] 16.0	107.1	102.7
1948	1.3	15.5	92.8	103.3
1949	1.4	15.3	100.0	102.0
1950	1.3	13.8	92.8	92.0
1951	1.0	10.4	71.4	69.3
1952	.9	10.1	64.3	67.3
1953	1.0	11.3	71.4	75.3
1954	1.1	11.8	78.6	78.7
1955	1.1	12.1	78.6	80.7
1956	1.2	13.2	85.7	88.7
1957	1.3	14.1	92.8	94.0
1958	1.3	13.5	92.8	90.0
1959	1.3	12.6	92.8	84.0
1960	1.3	12.2	92.8	81.3
1961	1.2	11.2	85.7	74.7
1962	1.2	10.8	85.7	72.0
1963	1.2	10.8	85.7	72.0
1964	1.2	11.0	85.7	73.3
1965	[2] 1.2		85.7	
1966	[2] 1.15		82.1	

[1] Organization and Competition in Food Retailing, Technical Study 7, NCFM, Chapter 15.
[2] Estimates based on similar series compiled by NCFM; same source as footnote number 1.

The one-cent after-tax profit per dollar of sales translates to approximately 10 percent return on net worth. Relative to most other industries, this is a low return. In a tight money economy, it presents a real problem in attracting or accumulating needed capital for expansion and modernization, and for the research and development necessary for continued increases in efficiency, and in providing improved quality in both goods and services.

Competition in food retailing has encouraged the rapid adoption of technologies and practices which have helped to keep food-at-home prices down. Food prices have not risen as fast as the other components of the Bureau of Labor Statistics official price reports.

From 1957–59 (the official BLS base period) through 1968, food-at-home prices increased only about three-quarters as much as all items on the Consumer Price Index.

Food-at-home prices, of course, as included in the index, lower the all items index. Looking independently at the major components of the index, it is even more evident food-at-home went up much less than any other component in the last 10 years through 1968. Here I would refer you to table No. 2.

TABLE 2

[Index 1968 (1957–59=100)]

Food-at-home	115.9
Food away from home	136.3
Housing	119.1
Apparel and Upkeep	120.1
Transportation	119.6
Health and recreation	130.0
All services	134.3

During the first 8 months of 1969, food-at-home prices increased more than any other major components, at about 5 percent as compared to 4 percent for all items. Here I refer you to table 3. This change in the relative rate of increase came about mostly in June, July, and August.

TABLE 3.—RELATIVE PRICE CHANGES, SELECTED ITEMS BLS CONSUMER PRICE INDEX DECEMBER 1968 TO AUGUST 1969

Item	Index		Percent change in prices
	December 1968	August 1969	
All items	123.7	128.7	4.0
All food	121.2	127.4	5.1
Food away from home	139.4	145.8	4.6
Food at home	117.4	123.6	5.3
Cereal and bakery	120.1	122.6	2.1
Meat, poultry, and fish	114.4	127.9	11.2
Dairy products	122.6	125.0	2.0
Fruits and vegetables	126.4	130.2	3.0
Other foods at home	108.4	110.5	1.2
Housing	122.3	127.8	4.5
Apparel	124.3	126.6	1.8
Transportation	120.2	124.2	3.3
Health and recreation	132.8	137.9	3.7

The sharp increase in June and July food prices was mainly accounted for by abrupt increases in beef and pork prices. The index of beef prices increased from 118.7 in December to 136.8 in July.

The index of pork prices was up from 114.9 in December to 129, in July. Relative to July a year ago, retail beef prices as reported by BLS were up 16 percent and pork prices about 11 percent in July 1969.

Part of the overall rise in food prices in the midsummer period is due to the seasonal pattern of food price changes. Due to climatic conditions in the United States, the "harvesting" of the major volumes of both plants and animals is low in midsummer and peaks out in the fall with accompanying lower prices.

The sharp rise in beef and to some extent pork prices was originally attributed to exceptionally strong demand, as official statistics actually showed increase in production. Revised figures, however, indicate beef production was down some in these months which, when accompanied by strong demand, sent prices to beef producers at near record levels. The producer price increase was reflected at wholesale, but was never fully reflected at retail. Thus, retailer's margins on beef were substantially reduced—despite the retail price increases indicated above.

The sharp fluctuation in beef prices emphasizes one important fact about food prices: they reflect (1) supply-demand and (2) costs of distribution. Costs of food distribution are influenced by the same inflationary forces that affect the general economy. Since processing and distribution costs account for 60 percent of the retail price of domestically produced food, retail prices tend to move with the general price level. But more than other consumer items, food price trends are modified by fluctuations in supply. These fluctuations can be abrupt because of weather conditions. They can be rather pronounced due to decisions at the farm to increase or decrease production in both the shortrun and the longrun.

Although consumer demand, is an important element in price changes, demand for food fluctuates no more—and probably not as much as—the short-term demand for most consumption items. In the longrun, the demand for some foods change dramatically. Beef is the most striking example. Per capita consumption increased from around 60 pounds in the late 1940's to over 110 pounds in 1968, and is projected at 112 pounds in 1969. These increases in consumption have taken place despite increasing prices.

So, in summary, the main reason for the more rapid rise in food-at-home than in overall prices in mid-1969 was the relative supply of beef and to some extent pork.

Meanwhile, it should be noted that in August, the latest month for which CPI figures are available, the index of food-at-home prices, measured against the 1957–59 base, was still below any major component of the consumer price index. Here I refer you to table 4.

TABLE 4

[Index 1968 (1957–59=100)]

All Items	128.7
Food-at-home	123.6
Housing	127.8
Apparel	126.6
Transportation	124.2
Health and Recreation	137.7

What about food price prospects immediately ahead?

As I indicated earlier, retail food prices are a function of two somewhat unrelated sets of conditions—relative supply of farm products and costs of distribution.

Fortunately for the consumer, farm supplies overall appear to be relatively abundant for this fall and winter. Farm prices will probably be lower than in the peak summer months, and will thus exert little upward pressure on retail food prices.

On the other hand, marketing costs are expected to continue upward, exerting continuing upward pressure on retail food prices.

Rising consumer resistance will probably make it more difficult to pass along rising costs. Consequently for the 4–6 months ahead, I would estimate that retail food prices will probably increase only moderately. This also is the official view of the economists at the United States Department of Agriculture.

Eventually, retail food prices must certainly advance along with the overall price changes, as the industry competes in the same labor, land, and money market as other industries. There are, however, promising innovations which will aid in keeping food-at-home prices from going up quite as fast as all items in the CPI Index. I will mention some of these innovations later.

According to the Bureau of Labor Statistics, wage rates in the overall economy were increasing at a 6 percent annual rate in the second quarter of 1968. Similarly the USDA marketing and transportation situation for August shows wages for food marketing employees to have jumped 5.6 percent from April–June 1968 to the same period in 1969.

In the post World War II era, hourly wages for food marketing employees have increased 140 percent from $1.11 per hour in 1947–49 to $2.67 per hour in the second quarter of 1969. (In our stores in the Washington, D.C. area, wages were up about 210 percent for the same period.) By comparison, all manufacturing production wages rose only 130.5 percent in the same period. Food-at-home prices increased only 34.6 percent during this period compared with 46 percent for all other items, a result of substantial increases in output and efficiency in food processing and distribution. This is remarkable in light of the greater variety and improved quality, packaging and convenience which are now characteristic of the food supply.

From 1957–59 to April–June 1968, average hourly earnings of food distribution employees increased nearly 47 percent, compared to 42.5 percent in manufacturing wages. During this period food-at-home prices rose by 23.6 percent compared to 28.7 percent increase in overall prices.

These figures emphasize that the poor, the retired and the unemployed are most seriously hurt by inflation. Those who are able to maintain employment generally have stayed well ahead of price advancements.

I assume you have asked me to appear before your committee in part to get my views, as a retail food executive, on what might be done to combat inflation. There are, of course, several alternatives.

Since there is some evidence that the economy is beginning to cool, some would say our most cautious alternative would be to do nothing. With this I cannot agree. In light of the wage increases we face, the shortage of employable labor, tight money and continuing near record level Governmental expenditures, continued inflation appears too threatening and too serious. There are too many adverse ramifications to justify a hands-off position.

Obviously there are no simple or easy answers. As with other complex problems, there can only be complex solutions. But one thing is certain—any effective long-run solution must be designed to relieve the pressures that cause inflation—that is, the shortage of goods and services relative to the amount of money available to purchase them. Even if some price controls were imposed, I hope may be avoided, they would be much more tolerable if the pressures which precipitated them were minimized.

Briefly, I would now like to sketch out in broad terms my view of the alternatives open to us as a Nation.

First, we should consider balancing the Federal budget, or even creating a surplus budget, by further reducing expenditures in selected expenditure areas.

A reduction in defense spending would be the most effective in controlling inflation. Defense spending injects billions of dollars into the economy without at the same time producing goods which can be purchased with the wages and salaries earned in producing them.

I would emphasize that in reducing Federal expenditures, programs designed to help the rural and urban poor, and to improve our decaying cities must not be sacrificed. The poor are the ones hurt most by inflation. We must design anti-inflation programs that will not force them to bear more of the price for greater national economic stability.

Second, something must be done about rising interest costs. Rising interest rates like other rising costs, are inflationary. Most practical businessmen share this view, although rising interest rates have a restraining effect in some cases. The upward spiral of interest rates must be halted and if possible, reversed.

Third, tax policy can be a useful tool in combating inflation. The retail food chain industry actively suported the extension of the surtax. We felt it was essential to drain off some of the excess consumer money, and if inflation does not slow down, we should extend the surtax further.

In my opinion, considerable tax reform is needed. However, tax reform should not be confused with taxation as a fiscal tool to control inflation. In fact, many of the proposed tax reforms would be inflationary rather than deflationary, by curtailing essential additions to plant investments and modernization.

Fourth, I am concerned about the long-range production outlook for selected food items. Many farmers are unhappy with the return on their investment. Various programs to curtail production are being discussed. A better system is needed to insure a balancing of farm supplies with demand at acceptable prices. Somehow, the fear of a return to overabundance and depressed farm prices must be dealt with. Farm costs are increasing along with those for all other segments of the economy. Farmers cannot be expected to bear the brunt of a war on inflation by producing themselves into a depressed price situation. Some of our most serious current supply problems are the result of prolonged periods of production at levels which brought prices below costs of production. The consequence has been a liquidation of many farm enterprises. Lower farm prices are counterproductive, even from the viewpoint of retail food prices, if they depress production below optimum.

Fifth, increased efficiency is a short-run as well as a long-run goal which obviously must always be considered in any economic climate. Greater efforts must be made to achieve a breakthrough with labor so that institutional barriers to efficiency or innovation may be eliminated. The food industry is willing to pay higher wages if productivity can be increased proportionately.

Despite high relative efficiency of the food industry, there are developments underway aimed at holding down operating costs and lessening the pressures for price increases.

For example the processing, cutting and packaging of meat which is now done in the some 38,000 individual supermarkets and in hundreds of thousands of small stores across the land, can be done more efficiently in a few central locations. Improved sanitation and temperature control now makes this feasible and it should be encouraged.

Semiautomated front-end checkouts now being introduced in supermarkets will permit information and inventory controls, automatic price marking and automatic reordering, all of which will greatly reduce costs.

On the wholesale or warehouse level, the first semiautomated warehouse systems are now being installed. This will help to move goods more efficiently and less expensively from producer to warehouse to retail store. In addition, efforts are underway to standardize the more than 12,000 different sized shipping containers now in use. This will permit further automation and should cut costs substantially.

Finally, and with considerable hesitancy, here are some thoughts about the controversial subject of price and wage controls. According to the National Association of Food Chains on whose board I serve, a majority of its members are opposed to wage and price controls. Their thinking is that since wage and price increases are but a symptom of inflation, the adoption of controls cannot solve the basic problem; and fiddling with the thermometer won't reduce the temperature. The Association takes the position that controls are expensive for Government to administer and also expensive and burdensome for industry to comply with. Also, except in the very short-run, controls are ineffective. They conclude from the experiences of World War II and the Korean War that despite controls, costs continue to creep upward and to squeeze profits since prices cannot legitimately be raised. Scarce items, priced below their true supply and demand price level, disappear from normal channels into the black markets. Numerous other unethical and inequitable practices come into being.

In principle, the Association has taken the position of the "Cabinet Committee on Price Stability for Economic Growth" of some years back, and I quote:

"While reasonable stability of the average level of prices is desirable, variability of individual prices is essential, because that controls the efficiency and the progress of our dynamic economy. Differences in prices show the scarcities of different raw materials, machines, and personal skills, and thereby induce managers, who seek to produce at least cost, to use methods and materials which are most abundant and to conserve those which are most scarce.

If prices are regulated they cannot reflect accurately the relative priorities of various goods and services, or the relative scarcities of various means for producing goods and services. The result will always be—as history shows clearly that it always has been—waste, inefficiency, and slowing down of progress.

Furthermore, price control inevitably leads to wage control. The two together inevitably lead to rationing goods and regulating jobs and working conditions. The resulting loss of freedom would ultimately prove even more disastrous than the loss in living standards."

There is, of course, much to be said for this argument. I favor it until we have exhausted every other constructive approach to combating inflation, although I do not believe that purely ideological objections to controls should stand in the way.

As a last resort, however, and then only after serious efforts to control inflation in other ways had been exhausted, I think price and wage controls might be considered as a very temporary measure to break the cycle of the wage-price upward spiral.

Meanwhile, Congressman Reuss has proposed that the President appoint a price stabilization board to study and review prices, wages, and productivity with the aid of the Council of Economic Advisers. The board would hold up to public scrutiny proposed wage increases that exceed productivity as well as price increases that cannot be justified by increased costs. This procedure has its limitations but despite its limitations should be considered along with other analogous proposals, again as a last resort and again only in concert with programs to reduce the basic causes of inflation—excess money relative to goods available for purchase by consumer. As I see it, the defects in previous guidelines were: (1) Specific standards for wages, but not for prices or profits, (2) application of inflexible wage increase formula to all industries, (3) lack of sufficient uniformity in efforts to achieve compliance. In other words, I feel that the guidelines idea has merit, and that it did not work previously for reasons which can be corrected.

Thanks very much.

STATEMENT OF HON. SEYMOUR HALPERN, U.S. REPRESENTATIVE FROM THE STATE OF NEW YORK

Representative HALPERN. Madam Chairman, I am happy to submit a statement to this committee on the very important—and very touchy—subject about which there is almost as much division between the Government and the people as the Vietnam war issue. Talk to almost any housewife about the cost of living, particularly retail food prices, and I can almost guarantee she will have a sharp—even stinging—comment. At that point, it is never wise policy to quote the Secretary of Agriculture on food prices; indeed, it is probably safer to change to a relatively safer subject—Vietnam, the draft, the "new" motion pictures, sex education—anything except food prices.

The other day, October 30, the Christian Science Monitor commented on Secretary Hardin's testimony on food prices before this committee. He said that although consumers are paying more for food this year, they still will lay out only 16.5 percent of their take-home pay for groceries, the lowest on record. Then the Monitor article went on to say, "The Agriculture Department chorus about food costing less as a percentage of family take-home pay looked a little threadbare when the Bureau of Labor Statistics reported that living costs in September rose five-tenths of 1 percent, continuing the sharpest inflationary spiral in 20 years."

The point I want to stress in the Monitor's report is their description of the Agriculture Department's "chorus" being a "little threadbare." I would say that the Monitor was, in its usual conservative and balanced fashion, understanding what is, in effect, the credibility gap that exists between the Government's very logical, very statistical, explanation of the cost of food to American consumers, and the American housewife.

As you know, the Department of Agriculture, with its very sophisticated statistical analyses, regularly informs the American housewife that a smaller and smaller percentage of her husband's take-home pay each year is needed to purchase the family's food needs. This year, the percentage is down to 16.5 percent; last year it was 16.8 percent; 5 years ago, it was 18.4 percent; and in 1960, it was 20 percent. The Department informs us that these percentages are perhaps the lowest in the world. They tell us that, as compared with a half century ago, today's average worker can buy, with one hour's pay, 3 times as much bread, more than 3 times as much milk, and more than 3 times as much round steak. Finally, to cap off their "chorus" the Department tells us— again with impressive and unassailable statistics—that the farmer's share of the consumer's food dollar is only a little more than it was in 1958, and 8 percent less than it was in the 1947–49 period.

If this evidence is not enough to convince the American housewife that she's better off than ever before with respect to food prices, then we have the equally authoritative reports of the Bureau of Labor Statistics which show that, although the price of almost everything (including food) is higher, increases in wages continue to outpace living costs.

Will all this evidence, then, why is it that housewives and wage-earners continue to be dubious—even suspicious—of the Government's assessment of food costs? Why is it that food buyers' strikes are being organized throughout the country by housewives?

The reason, I suspect, is that in spite of all the Government's evidence, round steak in a New York supermarket on November 12, 1969, was $1.63 a pound. That is 23.7 percent more than the New York average retail price for 1968.

The New York housewife who went to do the family shopping on November 12, 1969, had she carried with her the Department of Labor's "Estimated Retail Food Prices by Cities—1968 Annual Averages," and had she compared the prices she had to pay on November 12 for various food prices with the 1968 average prices, would have discovered that 23.7 percent increase in the price of round steak. She would have found, also, that a head of lettuce, the average cost of which in 1968 was 26.5 cents per head, on November 12, 1969 was priced at 49 cents—an increase of 84.9 percent.

A member of my staff took the estimated retail food prices by cities, 1968, and carefully compared prices at a New York supermarket on November 12. We made comparisons between the two sets of prices and I have a table here of some of those comparisons:

Product	1968 annual average price, New York (cents)	Nov. 12, 1969, New York area supermarket price (cents)	Percentage change
Flour, white (5 lb.)	58.2	65.0	+11.7
Corn flakes (12 oz.)	28.5	31.0	+8.8
Rice, short grain (1 lb.)	20.5	17.0	−17.1
Bread, white (1 lb. loaf)	21.2	22.0	+3.8
Steak, round (1 lb.)	131.8	163.0	+23.7
Chuck roast (1 lb.)	62.8	79.0	+25.8
Hamburger (1 lb.)	61.9	69.0	+11.5
Pork chops (1 lb.)	123.5	149.0	+20.6
Frying chickens (1 lb.) [1]	38.1	30.0	−21.3
Milk, fresh, grocery (½ gal.)	59.9	55.0	−8.2
Butter (1 lb.)	81.7	81.0	−.8
Apples (1 lb.)	23.5	19.5	−17.0
Oranges, size 200 (1 doz.)	81.5	118.0	+44.8
Grapefruit, size 80 (each)	14.1	14.7	+4.3
Potatoes (10 lb.)	71.6	79.0	+10.3
Lettuce, size 24 (head)	26.5	49.0	+84.9
Tomatoes (1 lb.)	45.0	49.0	+8.9
Fruit cocktail (No. 202 can)	28.6	39.0	+36.4
Orange juice concentrate (6 oz. can)	19.6	23.6	+20.0
Eggs, grade A, large (dozen)	54.6	73.0	+33.7
Salad-cooking oil (24 oz.)	54.5	53.0	−2.8
Sugar (5 lb.)	62.0	57.0	−8.1
Grape jelly (10 oz.)	25.6	31.0	+21.1
Coffee (1 lb. can)	83.2	77.0	−7.5

[1] This was an advertised "special"; the usual price is more nearly 47 cent per pound, or 23,3 percent above 1968.

Madame Chairman, I realize the criticism that can be brought against such a computation. We may have overlooked some food bargains—we may not have selected exactly the same quality foods used by the Bureau of Labor Statistics. But we did approach the supermarket in much the same manner as the housewife does; we selected a number of items that are bought (we think) fairly regularly by most housewives, and, to the best of our ability, we picked out items that compared in size, weight and quality, with the BLS list.

In our particular computation, we did average the cost of a few items, where we could find more than one that compared with the BLS list. For instance, the butter we found was priced at 79 cents a pound for one brand, and 83 cents for another; accordingly, we arrived at an average of 81 cents. We did the same thing with the price of fruit cocktail and orange juice concentrate. One more footnote: We were not able to discover whether the oranges we compared were size 200's, or the grapefruit size 80's, or the lettuce size 24's—nor could the two clerks we approached enlighten us. We were faced—as any housewife is faced—with an orange, a grapefruit, a head of lettuce—take it or leave it.

As I say, I realize the shortcomings of such a comparison as we made. But I submit that the situation we found is what really faces the New York housewife. In spite of all she may have learned from the Department of Agriculture and the Bureau of Labor Statistics, meat prices to her on November 12 were up as much as 25.8 percent above a year ago, lettuce was almost 45 percent higher than a year ago. And, Madame Chairman, housewives remember! I submit that the situation we found is the reason why the old chorus of the Department of Agriculture is a little threadbare, as the Christian Science Monitor noted.

It occurs to me that, in spite of the reports regularly issued by the Department of Agriculture, they contain precious little comfort to the housewife who is facing such escalating prices as I have just described.

I know the theory behind the idea that housewives need to be careful and critical shoppers—to be able to switch from higher-priced cuts of red meats to, say, chicken. But among the various products I mentioned, one can do only a limited amount of substituting, if one is to provide the balanced diets that growing families require. And I daresay, that, whatever we may think of the average grocery shopper, she is not an expert nutritionist. She is, as most of us are, inclined to buy foods that are familiar—foods that she knows will be acceptable to her family. Moreover, again, like most of us, she is susceptible to the advertisers, whose siren songs of convenience, palatibility and wholesomeness have not been lost.

I confess I have not been able to find alternatives to this dilemma. One can take up the suggestion that most housewives will take to very readily. They are already tired of substitutes—and even more, of trying to convince their families that the casserole she puts before them is as nutritious and tasty as the streak or roast they'd expected.

Housewives can strike, too. But most, I suspect, would rather not. Housewives have limits to the amount of time they can devote to that sort of thing, and I suspect they feel a helplessness when a few of them tackle some of the giants who are selling a majority of the food in America today.

If I understand anything about the food price situation today, I have to believe that farmers are not getting rich. I think the percentage of the consumer food dollar that ends up in their hands proves this.

Not long ago, I read in the Washington Star a report by Gaylord Shaw and Don Kendall which reported that the cost of getting food from the farmer to the housewife rose 160 percent in the past decades. Now I know that these "middlemen" have been producing a wide variety of convenience foods for the American housewife, and that the "built-in maid service" in these products has to be paid for. But that doesn't explain why middlemen can be or ought to be exacting a marketing charge of 34.3 percent of every dollar the consumer spends for milk, as was the case in April–June of this year.

Madam Chairman, as I said a few moments ago, I have no firm knowledge of what can be done to ease the burden of rising food prices. But I think that questions which have been raised about the USDA's reports on food prices—the "credibility gap" which I mentioned—warrants a hard look to see whether the sampling measures used by the Department really reflect the buying habits of American consumers.

In addition, I think that some thought ought to be given to a more effective system of consumer information, with particular reference to food, than is presently available to the American consumer. With needed information, consumers themselves may do things to help to correct the situation when certain foods get out of line with others as to prices. For reasons we need not discuss today. consumers have recently concentrated demand on beef. Substantially larger amounts of good beef have been provided by producers; prices have risen nevertheless.

With all this conflicting evidence, it seems to me Mr. Chairman that Congress should authorize the administration to do a thorough-going, independent analysis of food prices. Perhaps a bipartisan group of experts, representing consumer, commerce, agricultural and labor department approaches, is needed to come up with fresh ideas on what is causing—and what's to be done about—rising food prices.

Chairman GRIFFITHS. This committee will adjourn until tomorrow morning at 10 o'clock in this room at which time we will hear from the Council of Economic Advisers.

Thank you.

(Whereupon, at 11:55 a.m., the subcommittee was recessed to reconvene at 10 a.m., Thursday, October 23, 1969.)

37-795—70——22

THE FEDERAL BUDGET, INFLATION, AND FULL EMPLOYMENT

THURSDAY, OCTOBER 23, 1969

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON FISCAL POLICY,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Subcommittee on Fiscal Policy met, pursuant to recess, at 10 a.m., in room S-407, the Capitol Building, Hon. Martha W. Griffiths (chairman of the subcommittee) presiding.

Present: Representative Griffiths, Senators Proxmire and Javits, Representative Conable.

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

Chairman GRIFFITHS. With this morning's hearing the Subcommittee on Fiscal Policy will conclude its current review of the relation of Government policy to inflation and full employment. Our earlier hearings have been concerned both with overall economic conditions and with some particular problem areas of the economy. We have examined the construction industry and the health care industry, the two areas in which inflation has been particularly persistent, and we have examined rising food prices, an aspect of inflation which is a source of particularly widespread public concern and indignation.

Our previous witnesses have made very clear the dilemma faced by economic policy. Inflation must be brought under control, but there is no simple or cost-free way of doing so. Can inflation be controlled only by slowing down our rate of economic growth? If so, what does this mean in terms of rising unemployment? For how long must our rate of economic growth be held below its potential? How long must our housing industry bear the brunt of high interest rates? Can we afford the costs of a slowdown policy and can we achieve a slowdown without plunging ourselves into a recession or has the time come to supplement fiscal and monetary policy with more direct anti-inflationary measures, credit controls and/or wage-price guide-posts?

This morning we have as our witnesses the Honorable Paul McCracken, chairman of the Council of Economic Advisers; Dr. Hendrik Houthakker and Dr. Herbert Stein, members of the Council of Economic Advisers.

Our previous witnesses have raised many difficult questions. Today, gentlemen, we are looking for the answers. We are indeed grateful to all three of you gentlemen for being with us this morning, and you may proceed in your own fashion.

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

Mr. McCRACKEN. Thank you very much.

I have a relatively short statement here. If I may I shall proceed with that.

Chairman GRIFFITHS. Please proceed.

Mr. McCRACKEN. We welcome this opportunity to discuss with you the economic situation and its relationship to the budget and fiscal policy.

We shall first summarize briefly the current state of the economy, the outlook as we see it, and the administration's strategy for economic policy in these circumstances. Then we shall consider at a little greater length some of the main issues of appraisal and policy that deserve continuing attention.

At the beginning of this year, when this administration came into office, the need to cool off the inflation had become critical, more critical than at any time since the end of World War II. This was not a partisan issue. The American people were becoming more and more impatient as they saw the widening scope of the damage that inflation was doing across the economy generally. Moreover, there was a real danger that unless effective measures were taken promptly rapid inflation would become so geared into economic processes that it could not be stopped without very great trouble.

The essential course of policy was to achieve and to retain fiscal and monetary restraint. This has been done. The turn of fiscal policy was made last year with the Revenue and Expenditure Control Act of 1968, which imposed the 10-percent tax surcharge and placed a ceiling on Federal expenditures. The problem since then has been to retain the budgetary position thus achieved. This has required stringent limitation on the growth of Federal spending. To achieve this in the face of the rising costs of existing and newly legislated programs, the administration has already had to cut about $7.5 billion out of fiscal 1970 expenditures. The administration has also recommended keeping the surcharge at 10 percent until the end of 1969, and at 5 percent until the end of June 1970, together with repeal of the investment tax credit. The turn of monetary policy in an anti-inflationary direction came near the end of 1968 and policy has become even more restrictive since about midyear. Several measures of the change in fiscal and monetary policy are shown in the accompanying table (table 1).

TABLE 1.—MEASURES OF FISCAL AND MONETARY POLICY

[In billions of dollars]

	Fiscal years 1965	1966	1967	1968	1969	1970
Unified budget:						
Outlays	118.4	134.7	158.4	178.8	184.8	192.9
Receipts	116.8	130.9	149.6	153.7	187.8	198.8
Surplus or deficit	−1.6	−3.8	−8.8	−25.2	3.1	5.9
Change from prior year:						
Outlays		16.3	23.7	20.4	6.0	8.1
Receipts		14.1	18.7	4.1	34.1	11.0
Surplus or deficit		−2.2	−5.0	−16.4	28.3	2.8

CALENDAR QUARTERS

	1968				1969		
	I	II	III	IV	I	II	III
	Billions of dollars, seasonally adjusted annual rates						
Federal sector NIA:							
Expenditures	174.1	180.3	184.2	187.4	188.5	189.3	193.7
Receipts	165.7	170.8	181.4	187.3	198.1	202.3	
Surplus or deficit (−)	−8.4	−9.5	−2.8	−.1	9.6	13.0	
Change from prior quarters:							
Expenditures	5.3	6.2	3.9	3.2	1.1	.8	4.4
Receipts	9.3	5.1	10.6	5.9	10.8	4.2	
Surplus or deficit (−)	3.9	−1.1	6.7	2.7	9.7	3.4	
	Percentage change, seasonally adjusted annual rates						
Money stock [1]	5.6	9.0	7.0	7.3	4.2	4.5	0.4
Bank credit [1]	7.1	6.2	20.1	11.1	2.3	3.8	−.5

[1] Last month of quarter compared with last month of preceding quarter.

Sources: Treasury Department, Bureau of the Budget, and Board of Governors of the Federal Reserve System.

The change of policy was expected to act upon the rate of inflation in two stages, each of which would take time. First, fiscal and monetary restraint would reduce the rate of growth of total spending. This reduction would not come fully and immediately when policy changed. For example, consumers would at first respond to an increase in their taxes by reducing their saving rates, and most of the effect on consumption spending would come later. Also, businesses and households would at first respond to monetary tightness by reducing liquidity and finding substitutes for money—adjusting their spending more slowly to these changes.

In the second stage of this adjustment process the decline in the rate of growth of spending would begin to reduce the rate of price increases. This also would take time, especially after a long period of inflation. Cost increases built in by previous wage contracts and other commitments would continue for a time. Price and wage decisions would for a time reflect the presumption that the long inflation would continue. During this period, when prices continued to rise strongly even though the rate of growth of demand had diminished, the rate or growth of real output would decline. However, in time the slower growth of demand and of production would result in a slower rate of inflation.

Neither wage-price controls nor "guidepost" policy were necessary or useful, starting from the circumstances of early 1969, to achieve the objective of the transition to a more stable price level.

THE DISINFLATIONARY PROCESS

This was the basic strategy of economic policy. And the evidence is now accumulating that the process which will lead to a reduction of the rate of inflation is underway. Earlier in this year, even though policy had turned, such evidence was not clearly visible. People who did not take account of the inevitable lags between a change in policy and its visible effects on the economy had the feeling that the policy was not working. There is much less of this feeling around today.

Much of the relevant evidence is summarized in the accompanying table (table 2) and we shall not go over it in detail here. However, a few observations are in order.

TABLE 2.—CHANGES IN SELECTED ECONOMIC INDICATORS (SEASONALLY ADJUSTED EXCEPT AS NOTED)

Indicators	Percentage change, annual rate						
	1968				1969		
	I	II	III	IV	I	II	III
GNP, current prices	9.7	11.7	8.5	7.6	7.5	7.3	7.8
Final sales, current prices	14.1	7.5	10.0	6.0	9.4	7.2	6.7
Federal purchases, current prices	12.5	11.7	7.9	4.0	−1.2	−3.9	11.2
Non-Federal final sales, current prices	14.3	7.0	10.2	6.3	10.9	8.7	6.2
Real GNP	5.9	7.4	4.0	3.2	2.6	2.0	2.1
GNP deflator	3.7	4.0	4.0	4.3	4.9	5.2	5.4
Deflator, total private purchases	3.1	4.2	3.4	4.1	4.7	5.4	4.3
Industrial production	6.1	5.3	2.5	5.4	6.9	5.8	3.8
Nonfarm payroll employment	3.6	3.3	2.8	3.4	4.8	3.3	1.8
Total employment	2.2	2.0	.7	2.1	6.4	−.3	2.9
Consumer price index [1]	4.1	4.8	5.1	4.7	5.0	6.9	5.8
Wholesale prices all commodities [1]	5.4	2.6	1.9	1.8	6.4	5.1	2.9
Wholesale industrial prices [1]	3.8	1.9	1.1	3.3	5.6	2.9	2.2
Absolute numbers:							
Unemployment rate (percent)	3.7	3.6	3.6	3.4	3.3	3.5	3.7
Housing starts (thousands, annual rate)	1,469	1,418	1,524	1,579	1,692	1,496	1,405

[1] Not adjusted for seasonal variation.

Sources: Various Government agencies.

The picture shown by the statistics is not of a strong economic decline in process. The objective was never to lock the brakes so severely that the economy would be thrown into the ditch. What we see is the early stage of a slowing down of rates of increase, which is what was expected and desired. There are few absolute declines, but declines in rates of increase are pervasive. Even in this there are some exceptions, as might be expected, given the undramatic character of the overall movement.

The prime mover in the disinflationary process was the reduction in the rate of growth of total spending, as measured by GNP, and final sales in current prices. The leading ingredients of this were the declines in the rates of increase of Federal Government purchases and of residential construction. Despite the reduction in the rate of increase of spending the rate of increase of prices continued to rise through the second quarter of 1969. As a consequence, the whole effect of the slowdown in spending—and more—was seen in the decline in the rate of growth of real output, as measured by the real gross national product. In the first three quarters of this year the rate of increase of real output was about 2.2 percent, roughly half of the rate of the preceding three quarters. For a time this slowdown of production was not confirmed by the index of industrial production, which continued to rise rapidly. However, the rate of increase of that index also slowed in the third quarter, and the index actually declined slightly in August and September.

Earlier this year, despite the slowdown in the rate of growth of real output, employment continued to rise fairly rapidly as output per man-hour declined. However, we have now had a reduction in the rate of increase of employment and some rise in unemployment.

Of course, the result that is desired is the slowdown in the rate of inflation. It is also the last result to expect. During the first half of this year the rate of inflation actually accelerated and was higher than at any earlier period of the current inflation. However, in the third quarter the increase in the consumer price index, in the index of wholesale prices and in the GNP deflator for private purchases were all lower than in the second quarter.

A special word should be said about the preliminary estimates of the gross national product for the third quarter. These estimates show the GNP at current prices to have risen at the annual rate of 7.8 percent, a little more than in any of the three previous quarters. But the rate of inventory accumulation was larger in the third quarter than earlier. We regard the increase in inventory accumulation as a portent of future deceleration, rather than of increases. If we take the inventory accumulation out and look at final sales, we see a slower growth than in the earlier quarters of this year. Also, the third quarter increase of GNP was distorted by the big Federal pay increase in July, which presumably will not be repeated for another year. Final sales other than to the Federal Government increased at a much lower rate than in the preceding quarters. The Federal pay increase also affected the behavior of the GNP deflator, raising its rate of increase to the highest of this inflationary period. However, the deflator for private purchases, which is more relevant for most people, rose less than in the previous two quarters.

With the moderate path of disinflation we foresee it is quite likely that there will be months in which many indicators will rise. We should not leap to the conclusion that the direction of the economy has changed. All experience and logic tell us that the policies now pursued, if continued, will cool off the inflation. The evidence of this year shows that this process is unfolding according to the pattern that economic research would lead us to expect.

HOW TO INFLUENCE PRIVATE BEHAVIOR

It was clear from the outset that the speed and smoothness of the disinflationary process would depend on how the private sector, mainly business and labor, responded to it. If business and labor recognized quickly that there had been a basic change in the economic prospect, that they could no longer count on indefinite continuation of rapid inflation, and quickly adjusted their price and wage decisions to that change, the transition would take place more promptly. But if business and labor continued to raise wages and prices at rates that had been possible and appropriate in the earlier more inflationary environment, the process would be slower and more painful, not only to those who made these decisions but also to others.

Basically, we have confidence in the ability of the private parties in the American economy to recognize the facts and to act upon them in their own interest, which in most cases is also in the national interest. This is, after all, the fundamental basis on which the American economic system rests. Its unequaled performance is testimony to the validity of the thesis. At the same time, we had little confidence in our ability to persuade them that the facts are something different than they are. Neither did we believe that we had any right to do so.

On this reasoning we concluded that the most useful thing we could do to influence private behavior was to change the facts. We had to establish the fact that Government policy was firmly directed to slowing down the rate of inflation and that the result would actually follow. We had to establish this by visible action.

We believe that we have now established this fact and can usefully and legitimately call attention to it. The President has now done this in a letter to business and labor leaders and in a number of public statements. He is saying that circumstances have changed, and that private decisions which fail to take account of that change will be harmful to those who make them. People can no longer count on being floated off the consequences of excessive wage and price increases by a rising tide of inflation.

There have been many suggestions that the administration should go beyond this. It is suggested that instead of pointing out the facts so that people may respond to them in their own interest we should set standards of good price and wage behavior and appeal to the moral responsibility of business and labor for adherence to those standards. This latter is what is commonly called "guidepost policy."

We decided not to go down that path, basically because we believed that it was the path to futility. After all, we have had some experience with that policy, under a variety of circumstances, since 1962. The question whether it made any difference at all to the rate of wage increase during its best days before 1966 is the subject of much dispute among economists. Some studies have found evidence of a displacement in the price level for a few years in the early 1960's, which would be consistent with the hypothesis that something was moderating the price level in those years. Those studies have been subjected to the usual scholarly criticism, as I indicated in my own testimony before the House Committee on Government Operations on September 23, 1969. We have tried ourselves to estimate the weight of the various objective factors that have influenced the behavior of prices in the past. We have then calculated whether the rate of price increase during the guidepost period was less than would have been expected from the objective factors, aside from the existence of guideposts. These calculations do not reveal any systematic displacement effective for that period. (See the appendix, p. 340, at the end of this statement.)

THE FUTURE OF FISCAL POLICY

Restrictive fiscal policy is a key element in the Government's anti-inflation program. We can call this the Government's program rather than the administration's alone because the Congress set the Government on this path when it enacted the Revenue and Expenditure Control Act of 1968. The administration is determined to hold fiscal 1970 outlays to the ceiling of $192.9 billion that it set for itself. We accept the proposition reflected in the 1968 act that at this juncture, with the inflation danger still great and the pressure for additional Federal expenditures enormous, there is no effective substitute for drawing the line somewhere and holding it. This line is the symbol of the priority which the Government gives to controlling inflation at this time over the claim for expansion of any particular program. It is in defense of this line that the administration has cut over $7.5 billion out of fiscal 1970 expenditures. The President has indicated his intention to veto a pay increase bill that would upset this fiscal plan. But a responsible fiscal policy also requires the cooperation of the Congress. If it is forthcoming, the line can be held.

The administration has proposed that the tax surcharge be phased out by extending it at a 5 percent rate until June 30, 1970. The administration has also proposed repeal of the investment tax credit, effective

April 18, 1969, just before the proposal was announced. It is the fiscal and economic effect of the investment credit repeal that permits the reduction of the surcharge rate. On both of these matters the assent of Congress is, of course, needed. The President cannot veto failure to pass a bill.

If the expenditure line is held at $192.9 billion and the tax requests are granted by Congress, there will be a unified budget surplus of about $6 billion. Failure to enact the requested taxes would reduce the surplus to about $2 billion.

The fiscal effects may be seen better by looking at the estimates on the basis of the national income and product accounts, because we have them on a quarterly basis, seasonally adjusted. With the Administration's proposals the annual rate of surplus in the NIA accounts would be about $7 billion in the second half of calendar 1969 and about $3 billion in the first half of calendar 1970. (The difference from the estimated $6 billion surplus in the unified budget is due to differences of definition and timing.) If the tax requests are not granted, we will slip into a deficit at the rate of at least $5 billion in the first half of 1970. The budget for fiscal 1971 is in process of development, and we can give only the most tentative indications of it. However, our present view is that even with maximum restraint on expenditures, and if the Administration's tax proposals are adopted, the rate of surplus in the second half of calendar 1970 will fall somewhat below the $3 billion rate. But without those tax recommendations, even with tight expenditure control, the surplus would be eliminated and there might be a deficit.

Unemployment and Disinflation

We are often asked for our "target" unemployment rate. So long as there are people looking for work and unable to find employment, we have unfinished business. Yet we cannot approach this problem of cooling off the long-sustained inflation and give assurance that it will have no adverse effect on unemployment. Is it responsible to embark on a course of policy that courts this risk? We must weigh the social consequences of alternative courses of action. If we had embarked on a course of keeping the economy under enough pressure to avoid any risk that unemployment might rise it would probably have involved a rate of increase in the price level that was not only high but also accelerating. In fact, the rate of inflation was rising during 1968 and the early part of 1969.

This accelerating inflation was itself doing widespread social damage, and inflicting burdens on people generally. As the President said in his message last week:

> The Nation must dedicate itself to the ideal of helping every man who is looking for a job to find a job. Today, about 96 percent of the work force is employed; we want it to be more, but we cannot effectively and fairly make it more by ignoring the widespread hardship that a runaway cost of living imposes on so many Americans.

It remains true, however, that cooling off the inflation exposes us to the risk of some rises in unemployment. Any balanced strategy for cooling off the inflation must, therefore, also have regard for measures to minimize the adjustments of those who may be adversely affected and to overcome labor shortages that contribute to inflation. The administration has put forward several programs that are directly relevant here. In this fiscal year, over one million man years of training will be provided under Federal manpower and rehabilitation programs. This represents an increase of 23 percent since fiscal year 1969.

One of the most successful innovations in job placement is the computerized job bank which currently is operating in seven United States cities and, by next June, our target is to have such facilities operating in a total of 55 cities. The job bank plan produces a daily, up-to-date computerized list of available jobs to help place the unemployed.

The administration has proposed many other improvements in our manpower training efforts in the Manpower Training Act of 1969 which coordinates separate manpower programs and creates a comprehensive manpower services system. The bill would decentralize the administration of manpower programs to States and local areas and authorize a 10-percent increase in manpower programs when the national unemployment rate reaches 4.5 percent for 3 consecutive months.

The administration has also proposed legislation to strengthen our unemployment insurance system. The legislation would require States to permit workers to continue to receive unemployment insurance benefits while enrolled in job training programs. It would also extend unemployment insurance to 5,100,000 workers not now covered and automatically extend the duration of benefits in periods of high unemployment. Eligible workers would receive additional benefits for up to 13 weeks if insured unemployment were to go as high as 4.5 percent for 3 consecutive months.

The subject for these hearings suggests that the budget and fiscal policy will play an important role in how well we manage the transition to a more stable price level. The emphasis is not misplaced. The basic disequilibrium in the budget, which produced a $25 billion deficit in fiscal year 1968, was a major factor in driving the economy along a more inflationary path. And these deficits also make it more difficult to pursue a rational monetary policy. Once again the Joint Economic Committee has a particularly vital role to play here. You, with the advice of many economists in and out of Government, did much to help convince the Congress and the public that a budget deficit is not a sin. Now you have a great opportunity to teach that a surplus is not wasted resources, nor is it just a traditional but useless ornament on a budget. A surplus in appropriate times, and this is certainly such a time if ever, is an essential instrument for the stability and growth of the economy and for achieving its urgent needs. We cannot give it away with impunity to suit our short-run convenience.

Thank you very much.

(The appendix material submitted by Dr. McCracken and referred to on p. 338 of his testimony, follows:)

APPENDIX

Measuring the Effects of a Guidepost Policy on Prices and Wages

The impact of the guideposts has been the subject of a number of articles and books in the past several years. Almost all of the empirical studies have concentrated on the impact of guidepost policy on wages. The outstanding example is an article by G. L. Perry, "Wages and the Guideposts," which appeared in the

American Economic Review of September 1967. Although some of these studies tend to suggest that guideposts may have been a moderating force on wages, their principal shortcoming is that they cannot separate the effects of guideposts from a number of other plausible causes of the low wage increases from the third quarter of 1962 through the first quarter of 1966. The methodology adopted in these studies is best exemplified by Perry's work.

THE PERRY MODEL

Perry hypothesized, estimated and tested a quarterly wage model which combines unemployment rates and corporate profits as the crucial variables in determining average hourly earnings in manufacturing. The final form of this model is:

$$\Delta W_t = -4.313 + \underset{(6.96)}{0.37\Delta C_{t-1}} + \underset{(6.72)}{14.71 U_t^{-1}} + \underset{(6.24)}{0.424 R_{t-1}} + \underset{(4.53)}{0.792\Delta R_t}$$

$R^2 = .88$

—method of estimation is ordinary least squares

—t-statistics are in parentheses under each coefficient

where ΔW is the percentage change in straight-time hourly earnings over the past year.

ΔC is the percentage change in the Consumer Price Index over the year.

U^{-1} is the reciprocal of the percentage unemployment rate over the year.

R is the average profit rate in manufacturing over the year (after tax profits as a percentage of equity).

ΔR is the quarterly first difference in R.

This particular theory of how wages are determined does not explicitly account for special forces such as wage guideposts. If the model is a correct specification of how wages are determined, it is possible to compute what the rate of increase of wages would have been if a guidepost policy had not been pursued. When Perry made these computations he found that the actual rate of increase of wages was considerably slower from 1962 to 1966 than the equation predicted. He suggested that the policy of wage guidepost may account for this discrepancy. He then went on to analyze the wage behavior of individual industries in an attempt to determine the industry effect of guideposts. Again he found tentative evidence that guideposts had moderated the rate of increase of wages.

This analysis of the impact of the guideposts has been subject to considerable criticism both in casual discussions and in the academic literature. For example, a series of such critical papers by Paul S. Anderson, Adrian W. Throop, and Michael T. Wachter appeared in the *American Economic Review* of June 1969. The criticism is not with the methodology or general approach but with the statistical procedures and the wage model which Perry adopts. The statistical criticism revolves around the sensitivity of the tests to minor changes. For example, closer examination of the data indicates that Perry's results are highly sensitive to the period of estimation and to the period of forecast. The criticism of Perry's model is generally aimed at its simplicity or its misspecification. There are a number of special factors which influenced wages but are not included in the equation. The most prominent are:

(1) Labor productivity; (2) the shift in compensation from wage rate to fringe benefits; (3) the growing importance of import competition; (4) the development of special government programs to promote labor mobility; and (5) changes in the union-nonunion structure of wages.

On balance the evidence which Perry presents is highly suggestive but not conclusive. The purpose of this appendix is not to pass judgment on his work but to apply his methodology to price determination. We can also ask the question whether a positive impact for guidepost policy appears in price determination as well as wage determination.

AN ALTERNATIVE PRICE MODEL

There is probably no reported empirical work on the effects of the guideposts on prices because the evidence is largely negative. Instead, the empirical studies isolate wages and an inference is made that prices will be affected in the same way as wages if profit margins are constant. This proposition has not been tested directly because price equations—with or without guidepost variables—have not been very effective in predicting price behavior.

Several members of the Staff of the Council of Economic Advisers have developed a price model which performs reasonably well because it appears to be statistically significant, stable, and capable of a plausible interpretation. The current form of the price equation is:

$$\Delta P_t = -.00613 + .618\Delta P_{t-1} + .0321 U_t^{-1} + .019 U_{t-2}^{-1}$$
$$\quad\quad (3.4) \quad (6.8) \quad\quad (2.6) \quad\quad (1.2)$$

$R^2 = .87$
Durbin-Watson Statistic = 1.51
Standard Error of Estimate = .0022
Method of Estimation = Ordinary least squares
t-statistics are in parentheses under each coefficient.

The price change variable is the GNP deflator and it is measured as a six month proportional change, or

$$\frac{\Delta P_t = P_t - P_{t-2}}{P_{t-2}}.$$

The equation was estimated using quarterly data from the third quarter of 1954 through the second quarter of 1969. The unemployment rate is the global rate.

This model has been very stable over the past twenty years since the coefficients are similar when the model is estimated across different subperiods. This stability test is one which the Perry equation cited earlier did not pass. The reason for the inclusion of the variable $U_{t-2}{-}^1$ is that it seems to add stability to the equation when it is estimated across different time periods, even though this variable is not highly significant.

This price model has been subjected to considerable testing. The statistical fit in the period of estimation is good. The equation has been simulated throughout the postwar period and there is no substantial accumulation of errors. The model has good empirical characteristics and a distinct plausibility. The unemployment variables are regarded as measuring demand pressures on the price level while the lagged price changes approximate "cost-push" forces. For example, a high price change in the past may influence wage decisions with a lag and finally this additional cost component will affect prices. In any case, it is important that all three variables in the price equation lend significance *and stability* to the equation. Alternatives have not performed as well on both grounds.

If we accept the price equation as a reasonable estimate of price determination, then we can test the hypothesis that the guideposts affected price determination. This methodology is the same that Perry used in testing the effects of guideposts on wage determination. The procedure is to estimate the model for the period 1954III to 1962I and then "forecast" price changes with the actual values of the independent variables. If the model tends to overpredict price changes, then this prediction error may be attributed to the guideposts. If not, then either the guideposts were ineffective or other factors excluded from the model canceled their effects.

When the model is estimated for the period 1954III to 1962I the results are:

$$\Delta P_t = -.0066 + .613\Delta P_{t-1} + .040 U_t^{-1} + .0162 U_{t-2}^{-1}$$
$$\quad\quad (2.7) \quad (5.1) \quad\quad (2.8) \quad\quad (.8)$$

$R^2 = .85$
Durbin-Watson Statistic = 1.58
Standard Error of Estimate = .0021
Method of Estimation = Ordinary least squares
t-statistics are in parentheses under each coefficient.

This model can then be used to forecast price changes across the guidepost period. Table 1 presents the actual and predicted values and the errors of prediction for this forecast. For the period 1962III to 1966 there is no marked tendency to overpredict price changes because of the exclusion of a guidepost variable in the equation. Furthermore, there is no tendency to underpredict for the period 1966–1969. This result is not the same as Perry's in his application of this methodology to wage determination.

TABLE 1.—FORECAST OF PRICE CHANGE, 1962-II TO 1969-II

	ΔP	Predicted ΔP	Error of prediction
1962:			
II	0.00476	0.00911	−0.00436
III	.00284	.00631	−.00347
IV	.00663	.00532	.00131
1963:			
I	.00851	.00722	.00129
II	.00659	.00854	−.00196
III	.00469	.00746	−.00278
IV	.00748	.00622	.00126
1964:			
I	.00933	.00816	.00116
II	.00649	.00966	−.00317
III	.00832	.00829	.00003
IV	.01014	.00957	.00056
1965:			
I	.01008	.01098	−.00090
II	.01004	.01129	−.00125
III	.00726	.01191	−.00465
IV	.00723	.01101	−.00378
1966:			
I	.01261	.01199	.00062
II	.01794	.01556	.00237
III	.01868	.01914	−.00046
IV	.01674	.01988	−.00314
1967:			
I	.01485	.01869	−.00384
II	.01300	.01709	−.00409
III	.01635	.01596	.00039
IV	.02139	.01779	.00360
1968:			
I	.02032	.02143	−.00111
II	.01926	.02107	−.00181
III	.01992	.02065	−.00073
IV	.02054	.02182	−.00128
1969:			
I	.02278	.02256	.00022
II	.02496	.02351	.00145

There are nine observations that were underpredicted and seven that were overpredicted in the period 1962II to 1966I. This does not present any strong evidence that there was a substantial effect for the guidepost policy. It is true that on average the underpredictions are larger than the overpredictions, but this evidence is not sufficiently strong to counter some of the weakness of this analysis.

Many of the criticisms that were leveled against the Perry model apply to this model. For example, it excludes the direct effects of the large productivity gains of the early 1960's. This would have a moderating effect on the price increases in the guidepost years and its effects are intermingled with the guidepost effects. On balance the weakness of the guidepost effects and the possible influence of other excluded variables argue that the case for guideposts is still not proved.

Although this analysis should be viewed with the same skepticism as other econometric models and tests, nevertheless it does follow an established methodology. The price equation is one we have gained experience with and one we have confidence in. The foundation for the technique is probably stronger than Perry's and it does not indicate any substantial effects on prices for the guidepost policy.

Chairman GRIFFITHS. Thank you very much for a very interesting statement.

I would like to congratulate the President on the statement that he has made, the letter he has sent out to business and labor leaders and the public statements he has made on the fact that we really are in a changed situation now and that we are going to try to deflate the economy, that they can count on it.

But it seems to me that the President has used up a lot of political credibility. It is a brave and courageous statement.

Supposing the Senate does what it is obviously doing to the tax bill, it is cutting it, how are you going to make the President's words come true?

Mr. McCracken. Well, if the kind of tax action which would be most appropriate in this situation is not forthcoming, then it does throw additional burdens on other instruments of policy. It would certainly require a further, admittedly very painful, review of the expenditure side of the budget. It would also throw additional burdens on monetary policy, and it would tend to mean greater pressures in the money and capital markets. This would be a distinctly second best way of trying to handle the problem. I hope it will not come to pass.

Chairman Griffiths. The Johnson administration asked for a 10-percent surcharge through June of next year. In your judgment now, with the inflationary pressures, do you think that that request should have been continued?

Mr. McCracken. That the full 10 percent should have been——

Chairman Griffiths. Full 10 percent.

Mr. McCracken. No, I think the recommendation which the administration made was adequate in the light of the circumstances. The fiscal plan that was put forward did project a substantial surplus for this year which was very much in order. It seemed to me this kind of orderly phasing out of the surcharge of 10 percent for half the year and 5 percent for the second half was consistent with what seemed to be the requirements of the situation.

Chairman Griffiths. Does the paper you have just read take into account the suggestion of a $17 billion cutback in the armed services budget by next year?

Mr. McCracken. A $17 billion cutback in their expenditures you mean?

Chairman Griffiths. I note in this morning's paper the Defense Department is reported to be depending on a cutback to $17 billion next year down from $25 billion and $30 billion a year ago.

Mr. McCracken. These estimates were based on an assumption of some decline in defense spending but not an overall decline of anything like $17 billion.

(Supplementary comment by Mr. Paul W. McCracken follows:)

The colloquy here about the trend in Vietnam spending became blurred because of a confusion between two things. At the outset the question was in terms of a reduction of $17 billion in the Armed Services Budget next year. Subsequently it became clear that the question was in terms of a reduction to an annual rate of $17 billion by the end of the fiscal year for Vietnam. The estimates on which my testimony was based did take this trend into account, and were fully consistent with figures announced by the Secretary of Defense on October 22.

Chairman Griffiths. Well, why didn't you take it into account?

Mr. Stein. I think the question really relates to fiscal 1971, and what has been said in the paper relates to fiscal 1970. The fiscal 1971 budget is in process of development and the size of the defense budget in the fiscal 1971 budget is still under consideration.

Chairman Griffiths. The paper says, unless they are wrong and sometimes they are, at the annual rate of $17 billion by June 30, 1970.

Mr. STEIN. Well, our estimates do call for a substantial reduction in the rate of defense expenditures between now and the second quarter of the next calendar year.

Chairman GRIFFITHS. If you really cut it back that much then do you need the 5 percent surcharge after January 1st?

Mr. McCRACKEN. Well, if total defense spending were by June 30, were to be at an annual rate of $17 billion below the current level then that certainly would make the surcharge, the 5 percent surcharge less necessary.

Chairman GRIFFITHS. Was this announcement made then without your knowledge?

Mr. McCRACKEN. I was not aware of this. I have not seen the morning paper.

Chairman GRIFFITHS. Are you aware that over the radio this morning, at least, I heard that the President is sending next week to Congress a message asking us to make our Merchant Marine, I believe, the first Merchant Marine in the world, which will require an enormous expenditure of funds. Is this considered in your message?

Mr. McCRACKEN. These assumptions are factored into the figures that we have but, of course, our figures don't really go beyond about the middle of next year.

Chairman GRIFFITHS. I see.

But you do show in 1971 a decreasing surplus, do you not?

Mr. McCRACKEN. Our figures are not firm for 1971, but as best one can infer from the tentative evidence that is available, the surplus would probably decline, yes.

Chairman GRIFFITHS. I must warn you that the staff of this committee feels that under your own best figures you are going to have a surplus in 1970 and you are going to have a declining surplus from then on, which, in their judgment, means you are going to slow up in 1970 and then reaccelerate the rate. Would you assume this is true or not?

Mr. McCRACKEN. Reaccelerate, that the economy itself——

Chairman GRIFFITHS. That the economy, the inflation will reaccellerate, too? Would you assume this is true or not?

Mr. McCRACKEN. I would think that the slowing up of business activity, which seems to be in process now, would not continue through calendar 1970, which would, I assume, be consistent with the broad picture that the staff has indicated.

Chairman GRIFFITHS. Does the cut in the surtax in the first half of 1970 explain the sharp drop in the National Income accounts surplus from $7 billion per year now to $3 billion per year next spring?

Mr. McCRACKEN. The sharp drop in surcharge?

Chairman GRIFFITHS. Yes, the drop in the surcharge accounts for the drop in surplus. Does it or does it not?

Mr. McCRACKEN. Yes, that would be the primary factor.

Chairman GRIFFITHS. Well, isn't this really moving toward an inflationary fiscal policy?

Mr. McCRACKEN. I think if we can keep the budget in a surplus position even if the surplus were not to be quite as large as the level that we are projecting for fiscal 1970, that we can still manage to move along a less inflationary path.

If we were to move on into a strong deficit position then this would be very much more difficult.

Chairman GRIFFITHS. Have you looked at the welfare bill that the Ways and Means Committee is now considering, the plan under which they are operating?

Mr. McCRACKEN. Yes.

Chairman GRIFFITHS. Are you aware there are members of that committee and part of the staff that believe that this would result in a matter of a very brief time in place of a $4 billion additional annual expenditure some thing like $25 billion?

Mr. McCRACKEN. No, I was not.

Chairman GRIFFITHS. So that all of these—are you assuming in 1971 that if this bill passed that it would continue to be at $4 billion annually?

Mr. McCRACKEN. We don't really have anything more than tentative and very fragmentary estimates for fiscal 1971. Our own quantitative projections here are not firm beyond the middle of 1970 and, of course, they are still projections at best. But we would assume something like the $4 billion figure, moving on into 1971.

Chairman GRIFFITHS. Well, in general, is the Federal budget going to be more restrictive or somewhat less restrictive over the coming year?

Mr. McCRACKEN. Over the next 12 months I think it will become somewhat less restrictive.

Chairman GRIFFITHS. Thank you.

Mr. Conable?

Representative CONABLE. Thank you, Madam Chairman.

I want to compliment you on your statement, I think it is a fine exposition of our policy, and I personally support that policy very strongly.

As I understand it there are three factors involved in the very high rate of inflation we have had. One is faulty fiscal policy; one is faulty monetary policy; a third is a kind of a credibility gap which led private industry not to believe the Government was going to do what was necessary to get inflation back under control. This gap created a phychology which fed private spending to a large degree.

Now, lately we have been hearing an awful lot about monetary policy. We obviously got our fiscal policy back under control by moving from a deficit of $25.2 billion to an actual surplus—under the unified budget concept anyway, it was a surplus—and now all of a sudden everybody is talking about monetary policy as being the villian with the black moustache. We are aware of this in Congress a good deal, too. All of a sudden people think that fiscal policy isn't terribly important here, at least they are voting as though that were so, and we find, in the House anyway, we have had three votes recently that have gone very substantially over the President's budget figures.

A lot of the rationalization now runs, "It is the money managers who are feeding the inflation and, therefore, we don't need worry about fiscal policy any longer." Of course, these are popular programs and popular provisions which have led the House to go beyond the figures which in their wisdom the managers of our priorities in the executive branch thought they should implement. Congress wouldn't be tempted if they weren't popular programs.

I am wondering, is the President going to continue to put the needed emphasis on fiscal policy by taking tough steps with respect to these occasional congressional aberrations in the fiscal field? Is he going to veto some bills, when necessary?

Mr. McCracken. Yes, sir.

I think the President is going to take a very firm position in regard to the importance of maintaining a strong budget policy. He has made that very clear in the last week or so. I might add that while even at the technical level there is the inevitable difference of opinion about the relative importance of monetary policy and fiscal policy in influencing the course of the economy, I think the evidence is pretty clear that a strong and orderly management of fiscal policy is absolutely indispensable here. It is important in its own right and moreover a fiscal policy which gets drawn substantially off course, as was true in 1968, for example, makes it extremely difficult then to pursue the kind of monetary policy which we ought to have.

Representative Conable. Fiscal policy does affect monetary policy, doesn't it, to a very substantial degree?

Mr. McCracken. They are very intimately related, yes.

Representative Conable. I realize the stock market in economic terms is not worth a great deal except as a possible harbinger of the attitude of the business community. It is interesting to me that if there is any real move or rumor that there is some move toward peace in Vietnam, the stock market immediately goes up. Now certainly the Vietnam war has been an inflationary fact of life as far as our fiscal condition is concerned. War creates inflationary pressures, and yet the minute there is an indication the war might end, we have this sudden surging of the stock market as though the business community would think this were an inflationary sign. Would you give me some interpretation of this? Does it mean then that perhaps the money managers and the fiscal policymakers would be expected by business to relax considerably if the war were to end?

Mr. McCracken. Movements in the stock market often puzzle me. I certainly pose as no expert.

My impression is that anything which is interpreted to suggest a resolution of the conflict in Vietnam is sort of generally interpreted to be an optimistic harbinger, a good thing, for the U.S. economy. Certainly it would make it possible to pursue a more rational, orderly, management of fiscal policy, and in that sense perhaps this is being reflected there. But I really don't know.

Representative Conable. Isn't psychology a large factor in the continuing inflation?

Mr. McCracken. Very often so.

Representative Conable. I find myself speculating about the stock market—not on the stock market, about it.

Mr. McCracken. About it?

Representative Conable. Let's talk about jawboning a little. Has the opposition of the administration to guidelines and to jawboning the private sector been based on the feeling that it was ineffective or the feeling that it would be unfair. I have noticed generally that where you have voluntary programs and you urge businessmen to comply with the voluntary programs those that do usually wind up with a disadvantage in the competitive sense over those that haven't. Is fairness a substantial factor involved in the tendency of the administration not to go to the kind of voluntary restraint that is involved in lecturing people about restraints?

Mr. McCRACKEN. Fairness is certainly an important dimension of this. As you have indicated the guys in white hats, as it were, ultimately have been disadvantaged by voluntary compliance with programs such as this. There are all kinds of equity problems that are involved. A price which increases always tends to get more visibility than a price which ought to go down but merely stays put. The problem of translating the very general arithmetic of the relationships between wage increases, productivity, and movements in the general price level into specific situations becomes extremely difficult. But I think that perhaps in the immediate sense our skepticism about having this as an element of the anti-inflationary program is based on the inconclusive nature of the evidence as to whether it had any real displacement effect in the movements of the general price level.

Now, this is a matter about which there are differences of opinion, and there were hearings, I think, before the Joint Committee within the last year in which some evidence was presented which would indicate there was some systematic displacement effect during the period from about 1962 to 1966.

We have done some research, using somewhat comparable methodology, and we find less evidence of any systematic displacement effect.

There is certainly general agreement that once the generalized inflation emerged at the end of 1965 and the end of 1966, then the guideposts were swamped by this inflation, and the guideposts de facto had really been dead for 2 or 3 years before we arrived. So it has both dimensions to it.

Representative CONABLE. Thank you, Madam Chairman.

Chairman GRIFFITHS. Senator Proxmire.

Senator PROXMIRE. Dr. McCracken, and gentlemen, I am delighted to see you. As I understand it, Dr. McCracken, the process by which you gentlemen and the administration expect to slow down inflation is something like the following: You are slowing the economy deliberately and you have evidence that this is being accomplished. Gross national product, the real gross national product, is growing more slowly.

No. 2, unemployment is increasing. This is an unfortunate fallout effect of slowing down the economy, but it is one of the fallout effects that you expected.

At the same time there is no convincing evidence that I have seen that prices are really moderating. We are all familiar with the fact that the most recent statistics we have, only 48 hours old, are that the consumer price index went up last month at an annual rate of 6 percent.

You point to wholesale prices, but I quickly point out that the only really encouraging aspect of that is the seasonal or erratic drop in food prices, farm prices. If you eliminate that we still have rising wholesale prices, maybe not quite at the same rate but certainly there hasn't been a sufficiently long period to give us much confidence that wholesale prices are easing.

And then when we go into the most disturbing fundamental economic factor of all, it seems to me that we have to be really concerned about, and that is that wage settlements continue to be very high, and wages even outside the organized labor area are continuing to go up sharply, and productivity is actually negative, productivity not only is not increasing at some rate that would ease it, but it is going down.

Now, it takes a relatively modest increased wage settlement to be inflationary when you have stable productivity and falling productivity but when you have the kind of wage settlements we have now and the kind of negative productivity it seems to me the only conclusion we can come to is there is going to be continuing and powerful pressure on industry to increase their prices or have a serious profits squeeze. How about that?

Mr. McCracken. The empirical evidence we have about the sequence of events that normally tend to happen as an economy slows down or as the rates of increase at least slow down would suggest something like the pattern that you have indicated here As the increase in the money demand for output slows down, for a period the rates of increase in the price level continue to roll along. Naturally, this has an adverse effect on real gains in the economy. It has an adverse effect, therefore, on productivity, and on costs per unit of output, and incidentally, of course, this all tends to have an adverse effect on profits, too, and we have seen this to some extent.

Now, all of these things in and of themselves are not the kinds of things we want. But we have to go through an interlude here where we build stronger back pressures in the economy.

Senator Proxmire. What I am concerned about, you see, is the combination of these things means that 1970 could be a year of very, very serious economic trouble.

Number one, you have the pressure on prices so that we are likely to have, it seems to me, continued inflation at an unacceptable rate.

Number two, at the same time you are likely to have pressure on profits so that business will not be as profitable as it was.

Number three, the wage settlements will be hotly contested under these circumstances, with growing unemployment and with profit margins shaved, so we are likely to have strikes.

So it seems to me we might very well be confronted with a situation where we have continued inflation, continued rising unemployment, and strikes, serious strikes, at the same time.

Now, you say that some of this, of course, is the kind of price we have to pay. But the name of the game in this business, it seems to me, is to moderate this kind of very unfortunate impact on the economy in any way we can consistent with, of course, achieving our ultimate objective. What can we do and what program does the administration have to try to meet these serious problems?

You see without jawboning of some kind, without the President exerting specific pressure on particular industries that are out of line, particular unions that are out of line, it would seem to me we are going to have to go through a much more painful process than if we did use the great power and prestige of his office.

Mr. McCracken. I would have two or three comments to make about this.

In the first place, I think we do face a difficult year in the period ahead. I don't think there is any question about this. I would like to write a different scenario, as it were. We would certainly like to have the economy moving ahead more vigorously in real terms but making rapid progress in the direction of stabilization of our wage and price levels.

On the other hand, we have got a legacy of history to contend with.

I know of no experience which would lead us to the conclusion that there is any way to get directly at the cost-price aspect of this without going through a period that will have its painful aspects where we build up these back pressures in the economy against inflationary price and wage adjustments.

I wish that I could be more optimistic that direct requests or action directed to unions and businesses would ameliorate this. I don't find myself encouraged about the effectiveness of this on the basis of our own history with it or on the basis of international experience either. At the same time I would want to say that we certainly have approached this disinflation carefully. As I indicated in my statement it was not our intention to lock the brakes and throw the economy in the ditch, but it was our objective to try to step up the restraints of fiscal and monetary policy.

Senator PROXMIRE. You see, what I am asking for is something pretty moderate, it seems to me. I am not asking for restoration of the wage-price guidelines, I know they are impractical now. I know you can't tell unions and expect to have them pay any attention to it that they can only increase wages at 3.2 percent or some other modest figure, and we have negative productivity anyway so they would have to take a wage cut if they are going to reduce wage costs or if they are going to keep wage costs stable. I can't expect that.

However, without asking for that, it seems to me there is a moderate position the President can take, to as least give us information when you have these sharp increases in administered price industries like the automobile industry. General Motors recently had a substantial price increase, the biggest they had had in many years. The steel industry had a big price increase recently, the oil industry had a big price increase a few months ago after the most profitable year they ever had. I write you and asked you for information, not expecting the President to necessarily crack down but at least let the public know the basis, the cost basis, for these price increases. Were they justified? And the President apparently wasn't willing to give us that basic kind of information so we could make a judgment, and exert whatever public pressure, congressional pressure, Presidential pressure could be exerted on the industry to hold down their price increases.

Now why isn't that a fair kind of request, at least a factfinding effort by the administration?

Mr. McCRACKEN. Senator, I did, of course, submit a substantial amount of factual information in response to your letter. We did not ignore your request.

Senator PROXMIRE. You responded but I didn't get any assurance that there would be any analysis of whether General Motors, for example, was justified in making the kind of very sharp price increase which they proposed for the automobile industry and which was followed by the other companies.

Mr. McCRACKEN. If one is going to go down that road, then one has to have a very carefully developed set of criteria as to what constitutes justified and what constitutes unjustified price performance.

Senator PROXMIRE. I am not asking for a judgment. I am asking for the facts and information and let us come to some conclusion if we can. I think it would be very helpful if you, with your expert knowledge and the kind of economic competence you have at your disposal, would give us a judgment, but absent that, I think it would be at least helpful to have the facts on it.

Mr. McCRACKEN. We shall always stand ready to provide whatever factual information——

Senator PROXMIRE. You didn't though, you didn't.

Mr. McCRACKEN. If there was information absent, we shall certainly be glad to supply it.

Senator PROXMIRE. Now, it seems to me there is a ray of light in this, I hope, in this inflationary situation, provided that two stories out of the Defense Department can be substantiated. One was that Secretary Laird indicated that there would be a cutback of 500,000 of employment in defense altogether, counting the cutback in military personnel, counting the cutback in civilian personnel in the Pentagon and those who were employed by Defense contractors. This, it seems to me, disregarding the complicated dollar figures, appears most helpful. And then we have this morning the dollar figures to which Mrs. Griffiths referred which would indicate by June of this year Vietnam costs would be down to $17 billion, a little more than half, but very sharply below what it was a year ago of over $30 billion and $8 billion below what it is right now.

Now, doesn't this help us to move into a position where we can use this Vietnam dividend in a constructive way to combat inflation and to perhaps move ahead with some of these programs we have been starting?

Mr. McCRACKEN. Yes.

Senator PROXMIRE. And how can we do that?

Mr. McCRACKEN. Anything which is going to enable us to have a stronger budget position makes a fundamental contribution to the program of restraint here. Just how these figures are going to unfold perhaps remains to be seen, but in any case this is absolutely essential, and this whole matter of trying to achieve a strong budget position has been a very important part of our strategy all along.

Senator PROXMIRE. My time is up.

Chairman GRIFFITHS. What we really have been trying to find out is what does the budget, what does the Government do to help create or stop inflation?

Now, one of the things we have certainly found out is that the Government is the big spender, the Government is responsible for constantly increasing rates, and one of the things I learned in the 15 years I have spent here, because I once sat on Banking and Currency, is that every time we have inflationary pressures, the people who must walk the plank are those involved in housing. Every time we have a recession, we try to do something to increase housing.

Isn't it really time that we looked at the needs of this country, and housing is one of the first needs. If we are going to look at what is going to happen to the country, what is going to create real problems in the country, one of the real things that is going to cause it is the lack of housing. We need housing.

Now, the President has the authority to cut back on any of these programs he wants to. What is the rate of spending now on roads?

Mr. McCracken. I am not sure we have it.
Mr. Stein. Around $4 billion.
Chairman Griffiths. Around $4 billion?
Mr. McCracken. Somewhere around there.
Chairman Griffiths. Why don't you cut it out completely. I come from a State, as you know, that we use them. But cut it out, forget about roads, and build homes.
Mr. McCracken. I share fully your concern here about the fact that whenever policies of restraint are pursued, to use your metaphor, the industry which seems to walk the plank is always housing. This was true, of course, in 1966, but going on back——
Chairman Griffiths. Going back all through the 50's.
Mr. McCracken. That is right.
Whenever we touch the brake pedal the pressure seems to be very severe in the case of housing.
This, I think, does highlight the importance of doing something quite fundamental here to see that housing is less marginally positioned as a claimant for the savings flows in our economy. I don't at the moment have the answer but I am quite sure that we have got to go very deeply into this to see what it is that puts housing so far out at the end of the economic whipcracker.
Chairman Griffiths. Let me ask you, why do we have to have the supersonic jet? Why do we have to have it right now? Why don't we wait?
Mr. McCracken. This program in the next year or so is not going to be a major claimant on the budget. Its differential impact on housing would not be great. It is, of course, one of the many claims on resources which ultimately has to compete with housing and other programs.
Chairman Griffiths. All right.
Why don't we give direct loans for housing? There was an amendment offered on the floor yesterday, in my opinion it was an excellent amendment. If you were making $12,000 a year or less, and you were building a house of $24,000 or less, and you couldn't get a loan at a reasonable interest rate, you were going to be permitted to go to the Government and they were going to make a loan. Why don't we do that, and cut out roadbuilding right now. Wouldn't this really help?
Mr. McCracken. Well, the loan program would certainly make an incremental contribution to housing. Of course, I think myself that the fundamental solution to this is going to have to be to examine our financial structure to see whether we can have the flows of savings into housing being a little less marginal in the picture than they are at the present time.
Chairman Griffiths. All right.
Why don't we have 15 percent if you want to put up a business building, 6-percent interest if you want to put up a house, residential house. Why couldn't we do that?
Mr. McCracken. Some kind of direct selective controls, you mean?
Chairman Griffiths. Right.
Mr. McCracken. Selective credit controls.
Chairman Griffiths. Couldn't we do that?
Mr. McCracken. This would be a possibility. Of course, what we fundamentally need here, I think, is a substantial expansion in the capacity of the construction industry generally, and in our capacity to finance housing. There are two dimensions.

Chairman GRIFFITHS. But these are things that the Government could do and we could do them right now. We don't have to wait until tomorrow, next week. We can do it. And the President could do some of these. He doesn't have to ask Congress. He can start.

Mr. MCCRACKEN. I wouldn't want to give the impression that we are simply neglecting this area. We have, of course, given a substantial amount of attention to it. My colleague, Herb Stein here, has been particularly working in this area and I would like to have him comment on it in more detail.

Chairman GRIFFITHS. I would be glad to hear him.

Mr. STEIN. Well, I think it should be recognized first that the Government-sponsored agencies are currently putting more than $10 billion a year into housing finance through Fanny May and the Federal Home Loan Bank Board and also that a new program was just announced the other day, the so-called Tandem plan which would add $650 million a year to that.

I think it should also be pointed out that one of the important motivations for asking for repeal of the investment credit was to reduce the preference given to the flow of funds into business investment partly in order to make more funds available for housing.

Furthermore, of course, the Federal Government is cutting back its own construction contract awards by 75 percent as the President has announced, and the President has urged the States, which are the agencies that carry on the highway and other construction programs, to cut back their contract awards, and has said that if there was not adequate voluntary compliance from the State with this, that the Federal Government would consider other measures.

Now, with respect to highways, of course, you know there is a great difference of opinion in the country about the relative priority to be given to them, and this is a program which has strong advocates and claimants also. However, the administration has indicated its desire to see total State and local construction cut and we have some evidences of willingness of States to cooperate.

Chairman GRIFFITHS. Now, the evidence before this committee is that there is absolutely plenty of hospital space in America. We don't need any more hospitals. Why don't we repeal the Hill-Burton Act? Why don't you ask for it? At least if you are not going to repeal it why don't you say we are not going to spend a dime on this for the next 5 years, not a penny?

Mr. STEIN. Well, I am not a student of that program. I wouldn't say whether they need more hospitals or not. The program for expenditure for hospitals has always found very strong support in Congress. I don't know whether your view would be generally shared.

Chairman GRIFFITHS. Forget about Congress, just say "This is it, we are not going to spend any more money period. This is the end. You are wasting too much money. I have the authority to cut it and this is the place I am going to make the cut right here and right now."

Now, let me ask you, we had Mr. Hardin in here, the Secretary of Agriculture, a very delightful gentleman, and we talked about the price of food. One of the prices dealt with was the price of lamb. What I don't understand is why don't we urge New Zealand and Australia to send in more lamb in place of the voluntary restrictions that we now have, why don't we push it right up to where we would trigger the quota? Of course, the quota bill should never have been passed and I don't suggest you send down a bill on that, you may get more quotas, but I do think that we ought to urge these other nations to send in food. This would result in lowering the food price, at least I think it will, would it?

Mr. McCRACKEN. May I ask my other colleague, who happens to follow these matters more closely, to comment on that?

Chairman GRIFFITHS. All right.

Mr. HOUTHAKKER. Madam Chairman, in the first place there are at the moment no quotas on lamb.

Chairman GRIFFITHS. But there is a voluntary restriction, is there not?

Mr. HOUTHAKKER. Not on lamb.

Chairman GRIFFITHS. Not on lamb? It is just on beef? Why don't we get lamb in here, I like lamb.

Mr. HOUTHAKKER. Well, the New Zealand and other producers of lamb are certainly able to send here as much as they like but there is competition from other countries, too.

Chairman GRIFFITHS. Let's urge all of them, ship in more.

Mr. HOUTHAKKER. I think that we would certainly not want to go into jawboning in New Zealand any more than we want to do it in this country. [Laughter.] This is a decision made in the marketplace, and if our lamb prices are sufficiently attractive then undoubtedly more lamb comes in.

There has been an effort on the part of New Zealand to make lamb more popular. As you know, the demand for lamb has been declining in this country because of different habits in meat consumption. There has been a subsititution of beef for lamb. This is one of the reasons——

Chairman GRIFFITHS. Secretary Hardin explained all this and he thinks it is because we can't hire sheepherders, that is the real answer to it.

But what we are asking is does the Government have any effect on inflation, and what are the things that the Government could do to slow down inflation. And these are all quite simple things to do and easy. Just the President could do this; you don't have to have us at all.

Mr. HOUTHAKKER. Madam Chairman, I would like to point out that the Beef Import Act of 1964, which was accompanied by a conference report, does put rather severe restrictions on the authority of the President to suspend or increase the quotas.

Chairman GRIFFITHS. In beef you mean?

Mr. HOUTHAKKER. In beef, yes.

Chairman GRIFFITHS. We are just talking about lamb now.

Mr. HOUTHAKKER. Well, as I said, in the case of lamb it is a free market, and we have no authority over New Zealand to send more lamb here. Maybe they don't have any more at the moment. Lamb is a relatively minor product, as I say. I am sure that bringing more lamb into the country might be helpful to inflation, but the fact is that it is such a minor component of total meat consumpion that the effect would be small.

Chairman GRIFFITHS. I have a lot more questions.

Senator Javits?

Senator JAVITS. Thank you, thank you, Madam Chairman.

First, I would like to endorse all your questions. [Laughter.] And those that Senator Proxmire asked which covered a good deal of ground. I shall do my utmost to confine myself to other things.

I do not think, I might say, Madam Chairman, that the health situation of the country is in any way a situation where we could suspend the material expenditures. It may be that we could do something about bricks and mortar for hospitals, but we are in terrible trouble over maintenance, and over education of doctors and other health personnel

Chairman GRIFFITHS. Right. They told us that, but they said we don't need the bricks and mortar.

Senator JAVITS. I would like to ask you gentlemen more about the approach of the administration and especially in terms of its monetary policy. You have emphasized fiscal policy but the impression that I have, and I will just say I, although I think the impression is general here, is that the administration is trying a very orthodox approach to the control of inflation. It is orthodox by modern standards, perhaps even a little old fashioned. It is playing everything right through the middle of the line. You are reducing the supply of money, you are reducing the supply of credit, you are raising interest rates. You are giving us no target of acceptable unemployment, except to say that you don't like any unemployment, and that is quite natural—Secretary Kennedy did the same.

Now, in your judgment, is there danger in this policy of a recession induced by unemployment, and what measures are you taking to guard your flank so that we do not have, as we continue to apply these brakes very sharply, a recession which is induced by unemployment?

Mr. McCRACKEN. Senator Javits, I think the answer to that question really begins with our attempt, from the outset, to devise a strategy to deal with this problem, and we indicated that we were going to approach this need for disinflation very carefully. Rates of expansion of monetary aggregates, particularly the money supply, became lower during the first part of the year than had prevailed in 1968. Since the middle of the year monetary policy has been quite severe.

So far as fiscal policy is concerned, I would say there we have been struggling to achieve a strong budget position but not a massive kind of deflationary budget picture such as we had in the late 1950's and 1960's, before the tax reduction of 1964.

So I think the first answer is that we have tried to approach this decisively but, on the other hand, carefully.

Now, this combination of monetary and fiscal policies and specifically the current course of monetary policy is one which would not on an on-going basis be consistent with the growth requirements of the economy. At some point, in other words, it will have to be changed.

We are watching this very carefully. We are trying to be cognizant of the fact that there is a long lead time between an easing of policy and visible effects of those changes on the economy, just as there was a substantial lead when we started to tighten policy. We are watching it very carefully.

I should add, of course, that monetary policy is the prerogative of the Federal Reserve System and not the administration in the narrow sense of the term.

Senator JAVITS. But the administration must be very well aware of what monetary policy is being pursued in order to shape its own policy, is that correct?

Mr. McCracken. Yes.

Senator Javits. Right.

Now, isn't it a fact that as far as you know we have no danger signal of unemployment percentage? In all frankness, Dr. McCracken, I think the country is entitled to know that of you. I don't agree with Secretary Kennedy much as I have the deepest affection for him, that we should avoid setting a danger signal of unemployment percentage. I don't think it is revealing anything to get such a signal. I don't think it would be anything but giving the country a sense of confidence if the administration said to us "We would consider such and such a percentage as alarming, and we would do something about it."

Otherwise, I cannot frankly see the legitimacy of your orthodox policy without protecting ourselves, in some way, against the danger of a recession induced by unemployment. Mrs. Griffiths suggests controls, others may have other suggestions. I think frankly, too, that as we are dealing as Dr. Stein has said with the people, I think the people are very alarmed. I believe this in all candor, and I say this as a member of the administration's party. The people are more afraid of a recession right now than of inflation because you don't seem to have abated the inflation. You give a lot of good reasons for it, you know, to economists, but the fact is that the figure for September is as bad as any, almost, and so the people are continuing to have to take you on faith.

Well, if they are continuing to take you on faith, don't you think the least that we can do is to give them a stop loss, to use a stock exchange term, on employment, whatever it may be, 5 percent? We heretofore heard that 4 percent was the acceptable unemployment figure. If we got that we wouldn't be in too bad shape.

But the administration gives us nothing, and I respectfully submit to you—and would greatly appreciate your comment—that if we were given a percentage figure, which when you would figure the red ball was going up, you would do something about it, whatever it may be, this would be very reassuring to the American people.

Mr. McCracken. Senator Javits, we watch the unemployment situation very carefully. We, of course, watch a great many measures of the course of the economy beyond that, and I would hope we can accomplish this needed program of disinflation with minimal effect on employment or unemployment.

I think it would be extremely difficult at this stage to try to set quantitative targets for either unemployment or rates of growth in real output or other measures of the progress of the economy that would constitute in themselves a signal to change policy. We watch all of these.

I am very sensitive to the point that you make there. We have not felt that, given the problems of calibrating the course of the economy, and the problems of forecasting what our policies would do to a specific figure like unemployment, that it would be wise to to try to have a target figure.

I might add that the figure last month illustrates the problem here. In 1 month's time we had a jump from 3½ to 4 percent, and this is just an indication of the difficulty of trying to set a target for a figure like this.

Senator Javits. I might tell you that in the eyes of the people, as I see it, they are rather dismayed by the fact that the administration considers that a success. In other words, the fact that the unemployment figure has gone up somewhat seems to vindicate in the eyes of the administration the success of its anti-inflation policy. Well, in the eyes of the people that is a pretty unsatisfactory measure to use for that purpose.

Mr. McCRACKEN. I couldn't agree more. And our objective is not directed toward increasing unemployment. If that occurs, that is an unfortunate fallout effect, to use a phrase that was used earlier this morning.

Our objective here is to try to achieve the basis for a more stable price level, and we want to do this with as little adverse effect on employment as we can. On the other hand, we do have to recognize that embarking on this course of policy courts this risk, and it is for this reason that measures to try to soften the effect of this, if it occurs, become important, and I indicated in my statement some of these programs which have been recommended.

Senator JAVITS. Now, the main programs you have indicated are manpower training, which take a considerable time to get underway, and where we are far from action. However, as Mrs. Griffiths has said, and this is true, there is much that can be done by the administration to jazz up manpower training, et cetera.

Would you agree with me or would you say for the administration that the manpower training program plus the improvement in unemployment compensation, which the administration has also proposed, are entitled under these circumstances to equal priority with the whole anti-inflationary effort, including the extension of the income tax surcharge for the first 6 months of 1970?

Mr. McCRACKEN. Yes, I think this is all part of a unified program.

Senator JAVITS. Would you agree with me too, that this point has not been emphasized in either the country or the Congress and we need to do that. I know that the President put it in his message, but wouldn't you agree it is necessary for the Congress to go in team harness, as it were, to have both horses to pull us out of this slough of inflation together. We must not just emphasize the extension of the surcharge, but we had also better watch our flank because the tendency of humankind is to fall prey to outside forces which, in this case, would be unemployment?

Mr. McCRACKEN. Yes, I think it would be important to emphasize a balanced approach here.

Senator JAVITS. My time is up. May I just ask one more question? I was wondering about the technique. I was very much intrigued with Mrs. Griffiths' questions about priorities as she looks at it in a very feelingful way. Don't you think that in lieu of controls, which I know the administration rejects under these circumstances, some selective financing of the shortfall, the interest rate shortfall, would be desirable as an easing in this situation through the mechanisms of the Fanny May, and Ginny May——

Mr. McCRACKEN. Ginny May?

Senator JAVITS (continuing). And actually subsidizing for this high interest rate exactly as we have just done in the insured student loan program?

Mr. McCRACKEN. This is certainly one way to try to ameliorate the effect of these high interest rates on these programs.

Senator JAVITS. But the administration has no recommendation on that score?

Mr. McCracken. I would have none now.

Senator Javits. Thank you very much.

Chairman Griffiths. Thank you, Senator Javits.

Senator Proxmire?

Senator Proxmire. Congressman Conable is ahead of me.

Chairman Griffiths. We go from Democrat to Republican.

Senator Proxmire. Fine. I am appalled, frankly, Chairman McCracken, that you didn't really know, didn't have knowledge, of these cuts that Secretary Laird has announced. It was in the paper this morning, and it seems to me that in a well coordinated administration the Council of Economic Advisers should be among the first to know it and know it in advance and be in position to comment on it before the Congress. After all this has the most profound kind of effect if we reduce the Vietnam expenditures by June of 1970, as Secretary Laird has said, to $17 billion a year annual rate from a $25 billion a year and a year ago $30 billion a year. This is the most significant economic fact we have and we ought to be informed about its significance.

Why weren't you informed about that?

Mr. McCracken. Well, we do have estimates of the projected course of defense expenditures and we have worked on the basis of these expenditures on through the current fiscal year. This does carry with it a projection of some decline in total defense spending.

I think we are working with the latest overall defense expenditure projections that are available.

Senator Proxmire. That brings me to the point I earlier wanted to make. It looks as if we are seeing right now before our eyes the Vietnam dividends eaten up. We had hoped that as our expenditures in Vietnam were cut back that this would mean less overall military expenditures. It appears now that much of this is going to go into expensive weapons systems. We, of course, had a long experience in the Senate during this year's debate from July 3 until the middle of September over weapons systems. We are going to have continued debates in the coming years. But my conclusion from your remark now is you have the overall figure and the overall figure might indicate some moderation in defense spending but not as spectacular certainly as the Vietnam reduction, meaning that much of this, perhaps most of it, maybe all of it, will go into expensive weapons systems. So here is the kind of priority system we are confronted with, and I would like your comment on it.

On the starved side, on the basis of administration recommendation, is housing where you have $500 million available but won't expend it and it takes no action by Congress in the 221(d)(3) and other specialized housing programs; poverty where you have made recommendations far below what Congress feels we should go ahead with; education, we have a bill now coming up this morning on the floor for a very sharp increase in GI education benefits, President Nixon has indicated he will veto it if we pass it with that kind of an increase; health, where there have been some sharp recommended cutbacks; mass transportation, where the administration is recommending a program that every mayor says simply isn't going to provide any effective funds because they have to have it guaranteed with a trust fund concept or something of the kind and the administration refuses to give us that; pollution control, where the administration indicates that Congress is going too far.

On the other side, on the stuffed side, if you want to look at it that way instead of starved, you have roads, highways, public works going ahead apace, the biggest public works program we have ever had, we never have had one this high, it seems to me, in dollars, as we have had this year. The President has suggested a cutback but it is apparently only going to have an effect of $300 million a year in expenditures. Weapons systems going ahead apace, sugar subsidies, SST, space, and a weak tax enforcement program and, of course, Congress may be weaker but I do think that the President has to take the leadership in this kind of thing because of the unusual pressures that are much more effective on the basis of our history on Members of Congress than they are on the President of the United States.

So when you add all this up it seems to me a very clear emphasis on the side of the, on the part of the, administration on the side of priorities that don't really meet our fundamental social human needs.

Mr. McCRACKEN. The shift in priorities that is now going on, of course, is in the direction that you were talking about, that is defense expenditures are declining, and their relative claim on resources is declining. In fact in absolute terms, this is true also.

Senator PROXMIRE. What I am concerned about is the fact with the Vietnam war declining, and I am delighted, that the administration is cutting back but some of us feel it ought to be cut more quickly and deescalate more quickly, but we agree with you it is what you should do, but it seems we are expecting on the basis of your testimony this morning we are going to put much of that into more expensive weapons systems.

(Supplementary comment by the Council of Economic Advisers follows:)

The question has been raised whether the combination of the estimates for Vietnam spending and for total defense spending indicates that the resources released from Vietnam are being absorbed by the non-Vietnam defense program. The facts about this are presented here.

Secretary Laird has estimated that Vietnam spending will have fallen by mid-1970 to an annual rate of about $17 billion. Our current estimate for total defense spending (national income account) in the second quarter of 1970 is $75 billion, seasonally adjusted annual rate. This leaves $58 billion for non-Vietnam defense.

The report of the Johnson Administration's Cabinet Committee on Economic Planning for the End of Vietnam Hostilities estimated that following a truce in Vietnam, 10 quarters after the end of hostilities, the rate of defense spending would have declined by $19 billion (in 1968 prices). Total defense spending in 1968 was $78 billion. Reducing that by $19 billion would have left $58 billion of defense 10 quarters after the end of hostilities. However, that would have been at 1968 prices. The average price of Federal purchases rose 8.5% between the average of 1968 and the third quarter of 1969 (largely as a result of the pay increase). It is reasonable to expect that the average price of Federal purchases will be about 12% above the 1968 average by the second quarter of 1970. This would raise the cost of the post-Vietnam defense program as implied in the Johnson committee report to $65 billion, compared with the estimated $58 billion of non-Vietnam defense spending in the second quarter of 1970.

The Johnson committee estimated that at the end of 1968 expenditures for the Vietnam War were running at the annual rate of $29 billion in 1968 prices. However, the committee said that "Of resources currently used for Vietnam, $10 billion would be required in other military uses in peacetime." This $10 billion was an allowance for the fact that a large part of the expenditures charged against Vietnam was actually the cost of maintenance, operations, replacements, etc., that would have been going on even if there had been no Vietnam War. If we disregard this fact, and consider that the whole $29 billion was an additional cost of the Vietnam War, we get the following results:

[Billions of dollars]

	1968		
	In 1968 prices	In II–1970 prices	II–1970, in II–1970 prices
Total defense	78	87	75
Vietnam	29	32	17
Other	49	55	58

Even on this extreme and unrealistic assumption we find that of $15 billion released from the Vietnam war only $3 billion has been absorbed in non-Vietnam defense spending.

Another way to look at the question is to compare the projected non-Vietnam defense spending with total defense spending before the Vietnam buildup. In 1964 and 1965 total defense spending was almost exactly $50 billion a year. By the second quarter of 1970 the average price of Federal purchases will probably be about 22% above the 1965 level. Thus the cost of the pre-Vietnam defense program would be about $61 billion in II–1970, compared with the estimated $58 billion of non-Vietnam defense spending in the second quarter of 1970.

Mr. McCRACKEN. I can't, of course, speak here to the allocation of the defense dollar among the various claims within those programs. But the other claims are growing in importance in the budget relative to defense.

The highway program is one which, of course, has strong support from many sources. The question could be raised as to whether a reallocation of resources away from highway construction, as Mrs. Griffiths has indicated here, might be a better total allocation of resources in the public sector than we now have.

Senator PROXMIRE. Let me just raise this other point too, and I would like your comment on it because I think you as an economic expert can help us. It seems to me that the expenditures for space and military are expenditures which are peculiarly inflationary. They don't meet an economic need. They don't increase the supply of economic goods. Whereas expenditures in the housing area, in the manpower training area do increase the productivity and productiveness of our society. Therefore, from an inflationary standpoint, as you starve these areas or fail to provide adequate funding for these areas of counteracting povetry and lack of skills or manpower and adequate housing and so forth and put it instead in the military, you have an inflationary impact, isn't that correct, more inflationary impact?

Mr. McCRACKEN. Any kind of public expenditure which does not itself give rise to a subsequent service that is put on the market, as it were, is in that sense more inflationary than if there is a service which then begins to emanate from that original investment.

But it is once again a question of the totality of the decisionmaking process in arriving at the kind of allocations that we have. I would only say that, in the relative sense, it seems to me we are moving in the direction that you were talking about. It may be that the movement ought to be faster. There are all kinds of cross currents in the pressures that finally determine what these are going to be but I think we are moving in the right direction.

I think Dr. Stein wants to make a comment.

Senator PROXMIRE. Yes.

Mr. STEIN. I would like to say something about the priorities questions as it affects the military. I am not sure about the relation of the announcement that Mr. Laird made this morning to the overall budget figures. We always did know that when direct spending for Vietnam declined there would be a necessary period of restocking in the Defense Department to make up for some deficiencies which had been allowed to accumulate during the period of heavy Vietnam spending. It seems to me the critical issue is how things look out beyond this transitional period. The administration is in the process of developing a new 5-year-defense program about which nothing can be said at this moment except that the process through which we have been going, I believe gives more attention to the problem of balancing the relative claims of the defense program against the claims of nondefense programs and as against the claims of the private sector than has ever been done before; that this balancing of claims has been integrated into the decisionmaking process of the National Security Council, and is exerting a great influence on the decisions being made; and that the civilian side, particularly the Budget Bureau, is exercising a greater degree of control over the decisions made about the size of the defense——

Senator PROXMIRE. I would feel much better if you gentlemen were brought into this much more than you are. The National Security Council is essential for our defense and I am all for their having enormous influence and they, of course, do but for them to make any overall priority decision it seems to me is like having the catcher call the balls and strikes.

Mr. STEIN. They don't make the decision, the President makes the decision, and I am pleased by your confidence in us and we have had a considerable——

Chairman PROXMIRE. I feel that very strongly.

Mr. STEIN. We have had a great deal to do with that in connection with the Security Council decision considerations.

There was a very thorough study of the economic and fiscal implications of alternative defense decisions including the implications for other nondefense programs with some attempt to rank those by priorities, and this was done cooperatively by the Council and the Budget Bureau.

Also this whole program has been looked at in another context, aside from the National Security Council context, in the context of a long look at the post-Vietnam problem, where in connection with the Cabinet Committee on Economic Policy, and the Urban Affairs Council, the nondefense claims were laid out in considerable detail, and in juxtaposition with the defense claims. So that without wanting at this moment to project what the outcome of this process will be, I feel quite confident that the process is one which does give more weight to these competing claims than has ever been done before.

Senator PROXMIRE. My time is up.

Chairman GRIFFITHS. Mr. Conable?

Representative CONABLE. Thank you, Madam Chairman.

I would like to ask Dr. Houthakker a question. We are aware that in a time of serious domestic inflation every time the cost of living goes up 1 percent it has a demonstrable effect not only on exports but imports. And we are aware that last year the balance of trade went down very substantially until it was almost in absolute balance, and that a balance of payments was possible only because of short-term considerations which resulted in very substantial equity investment in this country of Eurodollars and European investment generally which was in part stimulated by the short-term consequences of Czechoslovakia.

We haven't heard much about balance of payments lately and I can only assume that the balance-of-payments situation in view of the continuing inflation is not good. Yet we haven't had any lack of confidence apparently in dollars held abroad. We haven't had any serious runs on the dollar. We have had apparently greater currency stability relative to our condition last year, at least in the eyes of the world market.

Now, is this an increase in confidence as a result of the steps the administration has been taking? As a second part of the question, are there any special steps we must take in our economy to protect against the impact of possible further erosion of our balance of payments? How does this fit into the overall picture we have been discussing?

Mr. Houthakker. Congressman, the question you have been discussing goes right to the heart of our problem. We did have an apparent surplus in 1968, although I think it is important to remember this was due to a very large amount of so-called special transactions which are really a form of window dressing. These special transactions are now being unwound and to some extent contribute to the deficits which we have been incurring on the liquidity basis this year.

Now, the balance of payments situation, as you say, is one that is not easy to understand at first sight. Our deficits on a liquidity basis have been quite large this year, and they contrast quite sharply with what we had in 1968. At the same time, as you say, the dollar has been quite strong, and we have not had any of the worries we have had in previous years even though in those years our liquidity deficits were much smaller.

This is due in part to the fact that we have had an official settlements surplus through the second quarter of this year, which means that the dollar holdings of foreign central banks have been going down, and as a result, therefore, these foreign central banks were less inclined to present their dollars for gold.

Also it is correct to say that the foreign central banks have expressed confidence in our anti-inflationary policy which, of course, they have urged upon us for a long time, and they see now that the policies which they have been advocating have been adopted—not because they said so but because we ourselves felt that these policies were necessary for domestic reasons.

Now, there has been another factor in all this which is worth pointing out. The fact that the dollar has been strong is due in large part to the fact that the private demand for dollars has been strong. Private foreigners have been demanding dollars in the marketplace primarily because of the high interest rates in the Euro-dollar market. The Euro-dollar market, with interest rates that until recently were 11 percent, has attracted money from abroad. To invest in the Euro-dollar market, foreigners had to buy dollars, and this buying of dollars has kept the dollar strong in the face of a very large liquidity deficit. This is a somewhat paradoxical situation which undoubtedly cannot persist forever.

When our interest rates come down, and I think they will come down, the attraction of the Euro-dollar market will become somewhat less. So that we cannot necessarily be confident that the stability of the dollar, which you mentioned and which has prevailed until now, will continue.

However, there are some favorable factors, too. In particular the movement of the German mark during the last few weeks does promise to improve our competitive position so that there is some progress in that area. But I would say that the balance of payments continues to give us concern, and that we cannot assume that the large liquidity deficits we have had during the year 1969 can be continued with impunity.

Representative CONABLE. The administration does not expect to make any recommendations with respect to additional actions that may be necessary with respect to the balance of payments?

Mr. HOUTHAKKER. Well, the administration has done certain things in this area. In the first place, our principal balance of payments program is the anti-inflationary program itself——

Representative CONABLE. Yes.

Mr. HOUTHAKKER. (Continuing). Which is very necessary to maintain confidence in the dollar, and to restore our competitive position. So this is the most important thing we are doing.

Apart from this, the administration has also been supporting various proposals for improvement in the international monetary system. We believe that the international monetary system in the last several years has worked in a way that has weakened the competitive position of the dollar, and one of several reasons why we are interested in improvement of the international monetary system is to make it easier to restore our competitive position in international trade.

Representative CONABLE. Mr. McCracken, in your statement you said that the first three quarters of the year the rate of increase of real output dropped substantially, while the index of industrial production continued to rise rapidly, and I just don't understand that. How do you explain this apparent contradiction?

Mr. MCCRACKEN. There is some question about the extent to which these two measures of real output can be reconciled. It is, of course, perfectly true that the real output in terms of real GNP covers a good deal more than just industrial output.

Representative CONABLE. Well, the implication is the rest of it must be going down.

Mr. MCCRACKEN. But, if one tries to infer a measure of real industrial output by looking at the GNP data then one gets a different rate of growth than would be obtained from the industrial production index.

I think we have here a little hiatus in our information system. (See correspondence between Mr. Stark and Mr. McCracken at end of today's hearing, p. 377.)

Representative CONABLE. Do you expect the inventories to start falling this next quarter or do you expect them to continue to build up? Apparently there was not a dramatic but nevertheless some change in the inventory situation in the last quarter?

Mr. MCCRACKEN. Do you mean by the fourth quarter?

Representative CONABLE. The fourth quarter, yes.

Mr. MCCRACKEN. This is very difficult to predict. It is not uncommon, of course, at this state in the economic situation to have fairly high rates of inventory accumulation. This is not intended, but it will occur if sales don't quite live up to expectations and, of course, the new goods keep coming in.

37-795—70——24

One source of information that one has in addition to the statistics is conversations with people where sometimes you can get a little feel of what is shaping up. You can't always generalize from this, but I have had the impression that several businesses are a little concerned about this now, that their sales are not quite up to what they had expected and, therefore, their inventories are moving up a little more rapidly than they would like to have them do. Now this could continue into the fourth quarter.

Representative CONABLE. You know, as a layman, it is very difficult to judge whether economic policies just aren't working or whether they are working but there is a large time lag involved. Would you care to summarize again just briefly why you think there are sufficient harbingers of success here, success in turning down at least the superheat in the economy, so that we can have some confidence this tough line we have been following and which I have fully supported is, in effect, going eventually to bring us into a period of relative stability?

Mr. MCCRACKEN. Yes, I would be very glad to summarize.

Representative CONABLE. The harbingers?

Mr. MCCRACKEN. Yes.

Representative CONABLE. That is all they are at this point.

Mr. MCCRACKEN. My response to that would be along these lines. At the time we started to try to shift our policies, suppose we had sat down and said: "Now, what does economic research suggest about the sequence of events that we can reasonably expect in the period ahead?"

We would have said first of all that we are going to have to run for quite a period before we seem to see much visible effect of any kind. It takes time for policies to start to show their effects on the economy.

Secondly, we ought to start to see a deceleration in the money demand for output, which we have seen, and we would have to assume on the basis of experience that for a time the price level would continue to roll along and, therefore, gains in real output, productivity, and so forth, would be disappointing.

Now, the important thing is to be very clear as to what to expect in this interlude. I wish the sequence were different. I wish the price level was the first thing that would behave and we could skip the rest of it.

Representative CONABLE. I assume you also wish you could take steps that wouldn't have any consequences other than to reduce prices.

Mr. MCCRACKEN. That would make my job a lot easier.

Representative CONABLE. Thank you.

Chairman GRIFFITHS. If the President has asked me as one layman to another I would have advised him not to lay his political prestige on the line for a group of economists' prognostications.

What is the amount of American investment abroad in businesses?

Mr. HOUTHAKKER. I haven't seen any recent figures on this. You mean total investments of American business abroad?

Chairman GRIFFITHS. Yes.

Mr. HOUTHAKKER. Direct investment abroad was around $65 billion at the end of 1968.

Chairman GRIFFITHS. In your judgment has the American consumer ever realized any real advantage from this?

Mr. HOUTHAKKER. I would say that there has been some advantage, yes.

Chairman GRIFFITHS. In lower prices?

Mr. HOUTHAKKER. To some extent the international position of this country has been improved, I wouldn't say in all respects, but in some respects it has been, to the extent that products can be manufactured more cheaply abroad than they can be here and have come back to this country. Although this may have been undesirable for the balance of payments it has contributed to lower prices here, yes.

Chairman GRIFFITHS. Let me give you an example. One of the Congressmen from a Southern State told me the day before yesterday that he was having great trouble in his district because an item made by an American company abroad was being bought by, he said, fly-by-night operators, and being brought back into his district and sold at $1,300 less than the same item being sold by the American company here.

Now, I got to thinking about that. We just came from a country abroad, and there was an American manufacturer doing business in my own State, and I found that the wages that he was paying the employees of that plant were 33⅓ percent the wages that were being paid in the American plants, that the top tax rate was 25 percent. I have never heard of their selling the item in this country at those savings.

Why doesn't the Government, why doesn't the President, hunt up some of these fly-by-night operators, I will help you, and give them an award of merit for bringing the item in cheaper.

We don't have any import duties on it. I think it is a great idea. If they are selling these things cheaper in England and Europe than they are selling them here, and we have no duty on the item, why don't we bring them in here and sell them cheaper?

Mr. HOUTHAKKER. Well, I certainly agree with the implication of your question that imports can help reduce inflation. I am not familiar with the example you mention, and I think we would want to know a little more about the circumstances to see to what extent there has been a restriction of competition but I would say that there are certainly examples of commodities produced by American companies abroad which come back into this country. In fact I may mention an example which perhaps is not very popular in your home State but which nevertheless is in this category. General Motors and Ford produce cars abroad which are sold in this country, and presumably the sales price in this country is lower than it would have been if the same cars had to be produced here. There are, I am sure, other examples, too.

Chairman GRIFFITHS. Are they selling them cheaper here?

Mr. HOHTHAKKER. They are selling them cheaper than what these same cars would cost if they had to be produced here. I am not saying they are selling them cheaper here than they are selling them in England or Germany.

Chairman GRIFFITHS. Why are we letting these companies sell them cheaper in a foreign country than they are selling them here? What good does it do us to have all these nonrestrictive tariffs? This is our fault. We can do something about it.

Mr. HOUTHAKKER. Well, we have done quite a lot already in the course of the last few decades. We have reduced tariffs, which goes in the direction you advocate here.

Chairman GRIFFITHS. Isn't one of the real reasons for reducing tariffs that you are going to help consumers, isn't that it?

Mr. HOUTHAKKER. It certainly is, yes.

Chairman GRIFFITHS. Well, are we really helping them or aren't we?

Mr. HOUTHAKKER. I think we have helped consumers, yes. I may perhaps point there is an interesting comparison one can make between the import and export figures in the National Accounts in current and in constant dollars. We see there that we have indeed gained by the fact that import prices generally speaking——

Chairman GRIFFITHS. Are we only helping them if it is a foreign producer?

Mr. HOUTHAKKER. I am afraid I don't understand your question.

Chairman GRIFFITHS. If it is an American producer, is he bringing it in at the same price as American-made goods, are we only helping America's consumer if the seller of the goods in this country is a foreign producer?

Mr. HOUTHAKKER. I don't think there is any great difference there. However, it is true that if an American producer has plants both here and abroad, then he may be tempted to set up his price structure in such a way as to protect some of his domestic production. He would have a lot of support among labor if he did.

But I would say basically the benefits of the consumer will be as great if it is American production aboad, or if it is done by foreign producers. I don't see any reason——

Chairman GRIFFITHS. If it is an American production abroad and the consumer gets nothing out of it, absolutely nothing, then the only person really hurt is American labor, isn't it?

Mr. HOUTHAKKER. I would agree with this particular line of reasoning. I would add though that the earnings on production abroad do increase our national income. They have to be taken into account, too.

Chairman GRIFFITHS. If they bring it home?

Mr. HOUTHAKKER. Yes, that is right, yes.

Chairman GRIFFITHS. And don't just build another plant.

Mr. HOUTHAKKER. Well, as you know, there are programs both tax programs and control programs, which force corporations in general to repatriate at least a large part of their earnings.

Chairman GRIFFITHS. What would be necessary in action to permit the oil imports to go to private sellers in place of to the oil companies? Do you have to have a change in the law or can the President do it himself?

Mr. HOUTHAKKER. The oil import program does tie certain kinds of imports to historical quotas, and it so happened that in the base periods most of the imports were in the hands of oil companies, as is quite natural because they had the marketing apparatus as well as the refineries.

Chairman GRIFFITHS. Well, if we changed that, wouldn't it have a good effect upon the American price structure?

Mr. HOUTHAKKER. By itself the effect of this would be relatively minor, but let me also say that the whole oil import program, as you are aware, I am sure, is being studied right now by a task force of which Secretary Schultz is chairman, and this is one of the questions which the task force is addressing itself to.

Chairman GRIFFITHS. But if we get all of these minor things together, lamb and oil and tractors, we would begin to make a major attack upon the price structure. Prices would begin to go down.

Mr. HOUTHAKKER. I am sure there would be some impact. We have to remember, though, that imports are still a rather small part of our total supply, of the order of 3 percent or somewhere thereabouts, so that even if imports were doubled, which I think would be way beyond the realm of the possible, there would still be a relatively minor impact. The main thrust of our anti-inflationary program has to be on the domestic economy. Imports can at best be a small supplement to it.

Chairman GRIFFITHS. Then let's go back to the housing. Supposing that you said that hereafter in periods of inflation or right now, if you want to build or renew your business plant you are going to pay interest at the rate of 25 percent, and housing will be at 6. The effect of it would be, that heretofore the Government has made the decision, all interest rates are up and it forces upon the private builder new decisions. Business can look at it and say "Well, prices are going to go up, therefore I will build a new plant and I can pass it back to the customers." But in fact the builder of homes can't do it quite that way because the customer can't afford to pay it.

The testimony before this committee is that at the present time in a new home the owner is going to be paying 55 percent of his wage for housing, 55 percent, and he said, now this is when a wife goes to work, right then, she has to. Why don't we let the decision with the Government be on who is going to pay these interest rates or for what purpose, and then let the private decision be "Shall I now build it or shall I wait." We are forcing that private decision upon the builders of homes. Is that right?

Mr. MCCRACKEN. The question that is posed is the broad question of the extent to which we want to have an array of selective credit controls or selective instruments. As I indicated in my comments earlier this morning, I do think in this whole area of housing and the institutional arrangements for getting savings into the hands of potential home buyers that we have got a lot of unfinished business here. I think it is quite clear from history that housing is entirely too marginal a claimant in this market.

Now, of course, what the effects would be of this specific kind of differential, that is a 25-percent rate on plants and equipment spending and a 6-percent rate or something like that on mortgages, I really don't know. I would have to work this out. A very substantial part of plant and equipment expenditures are financed without recourse to borrowing at all, financed through internally generated funds by corporations, but there is a marginal element which varies from industry to industry that does require borrowing.

This would raise a great many questions about how far we would want to go down the road of these selective controls.

Chairman GRIFFITHS. Thank you very much.

Senator Proxmire?

Senator JAVITS. Excuse me. Dr. McCracken, I asked you before something that interested me deeply about the relationship between unemployment and the anti-inflationary efforts of the administration and I would like now to ask if, with your permission we might not get the views of your colleagues upon the same question that I asked you as they might or might not have some added light to put on them.

To rephrase the question for both your colleagues, what I am very interested in is what action is the administration taking to prevent itself from falling into the abyss of a recession induced by unemployment, or what action should it take at the same time that it is keeping the anti-inflationary brakes on so very hard, especially in terms of the money supply?

Mr. STEIN. Well, I think our policy from the beginning was directed towards moderating the rate of inflation with as little setback in real output, employment and unemployment as could be managed. That was the basis for deciding on a policy which would not crack down on the economy immediately, which would spread the restraints over a considerable period and would imply that we were prepared to see the rate of inflation decline rather slowly and prepare to stick with that policy over a considerable period. And while you have described our policy as old fashioned, a term which I don't particularly object to, nevertheless it has also been described as something which has not been tried before, that is to cool off and reduce a boom without squeezing the economy into a recession. I think the basic instrument by which we are trying to avoid a recession is a course of moderation in these restraints.

We have to look ahead as well as we can, because the question, of course, is not what we should do now about the 4-percent-unemployment rate of last September but what we should be doing now with respect to the possibilities of next year. We look at these as carefully as we can.

While you have described the policy as one of extreme restriction, on the fiscal side the policy has been essentially to maintain the position that was established by the Revenue and Expenditure Control Act of last year. That is, we have tried to maintain approximately that degree of surplus and, as we have indiacted, this policy, if pursued, will involve even some reduction in that rate of surplus as we go into 1970.

Now, we are constantly concerned with the degree of monetary restraint that is being exercised and are in consultation with the Federal Reserve about this, and I think we have very similar views about how essential it is not to prolong a monetary squeeze which will cause a recession. I don't think there is any disagreement that the question is one of timing. As Dr. McCracken has said, nobody thinks we are going to go on forever with a zero rate of monetary growth. The question of the point in time in which to relax that is a critical one but I am sure that decision will be made in full consideration of the outlook for the economy as a whole.

And I think these are the critical things upon which we must rely. We have indicated our great interest in the unemployment insurance program, and the training programs under present law and under proposed legislation, but fundamentally we must be concerned with the general state of the economy. We should make clear that our expectation, on the basis of such projections as we can make, is that we are going to come through this process with a gradually and visibly diminishing rate of inflation and without a recession.

Senator JAVITS. What do you think will be the maximum rate of unemployment that we will reach?

Mr. STEIN. Well, I wouldn't like to set a number for that. I think that the exact point will depend somewhat on the time pattern of a number of events we cannot foresee including such things as inventory developments. But what I don't foresee is what would be classically called, in old fashioned terms, a recession.

Senator JAVITS. Serious unemployment?

Mr. STEIN. No.

Senator JAVITS. So you think you can go this course and you are confident of enough Federal Reserve cooperation so that what it does on monetary policy will not run at cross purposes with what the administration does on fiscal policy?

Mr. STEIN. Yes, I am confident of that.

Senator JAVITS. Do you, Dr. McCracken, support the present monetary policy of the Federal Reserve Board?

Mr. MCCRACKEN. Yes, sir, I do.

Senator JAVITS. So you think that there is really no problem of lack of coordination in terms of ultimate action taken?

Mr. MCCRACKEN. No.

I think you are touching on a very important point. I think the coordination, the consultation on this is very close and on an on-going basis.

Senator JAVITS. Well, it is fair to say then that if anything goes wrong the administration is going to have to bear the total responsibility, because there is no out in blaming the Federal Reserve.

Mr. MCCRACKEN. We embarked on this game plan conscious of the fact that that probably would be the case.

Senator JAVITS. Okay.

Now, could we hear from your other colleague on these same points?

Mr. HOUTHAKKER. Senator, I agree with what my colleagues have said so far. I would perhaps add one thing and that is that the unemployment rate is a somewhat erratic statistic. In the past its movements have not been highly predictable, especially the kind of relatively minor movements which we are looking at now. A move from 3.5 to 4 percent is certainly an unusual one. At the same time though there is some question whether either the 3.5 or the 4 represents the true state of the labor market. We have seen in the past that the development of unemployment has been hard to explain. I remember in 1967 there was a slowdown in the economy in the first part of the year, which did not have any effect on unemployment. After the economy picked up again during the summer of 1967 unemployment suddenly rose to a level which would have been alarming if at the same time it had not been clear the economy was rising. So we can't go by just this one figure.

There is another important aspect of this. I think one of the reasons obviously why unemployment stayed low during the first 8 months of this year, even though our policies had been fairly restrictive, is that productivity was falling, which, by itself, is a very unusual thing, and productivity like unemployment is a figure that is hard to explain in the short run. The short run movements of productivity and unemployment are both hard to predict and, therefore, I think the unemployment rate should not be the only thing we should look at. If we found that the unemployment rate was high and various other things also looked disquieting, then—I am sure I speak for my colleagues— we would definitely consider what needs to be done in those circumstances. But it is not enough to look at the unemployment rate alone.

Senator JAVITS. Now, Mr. McCracken, the only reason I come back to you is because, after all, you are the Chairman and you are all in such close touch that I assume you express the point of view of the Council. What are then the key things we must watch? We must watch the increase in prices which is, I assume, both wholesale and cost of living prices. We must watch the unemployment index. Now, what else is the fever chart for our economy that we must watch in order to be sensitive to the need for a change in policy or direction?

Mr. McCRACKEN. We have now quite an elaborate economic information system with a great many components. I have a thick black book which is kept up to date daily, and I use this rather closely. But broadly speaking, I would want to watch the evidence of what is happening to the course of production, of employment, and of those indices which are sometimes broadly called leading indicators of business activity, such as new orders for durable goods, the length of the workweek and so on. This is merely indicative of a wide array of things.

I would also want to watch what is happening in the bond market because I think this is one indication of the extent to which there may be an emerging confidence that possibly the disinflationary policy was going to start to be effective. In that sense I look at developments in the bond market in recent days as interesting and encouraging. They perhaps have not gone far enough to be conclusive but at least it is worthy of note.

Senator JAVITS. That means that if interest rates continue down, is that one of the indicia?

Mr. McCRACKEN. This is what I mean, that renewed confidence in the price level is itself going to be worth a good many basis points in the bond market.

Senator JAVITS. Mr. McCracken, the worker has a tremendous stake in this. Is it not true that notwithstanding his wage increases he is practically not ahead at all from what he was 2 years ago, and that, therefore, his whole expectation in the economy now depends upon a reduction in the price level and a reduction in the interest level.

Mr. McCRACKEN. Yes.

You mean in terms of real weekly earnings.

Senator JAVITS. Right.

Mr. McCRACKEN. Or something like that.

Senator JAVITS. Right.

Mr. McCRACKEN. Yes, the real weekly earnings in manufacturing, as I recall it, have increased in the last 3 years, 1 to 2 percent. In fact, one can take other periods where there has even been a decline. This is one of the less happy aspects of the experience we have been in in recent years.

Senator JAVITS. Does the administration have a goal for the worker? What ought to be his annual increase in actual well being in terms of the real increase in his enjoyment of life through what he earns?

Mr. McCRACKEN. On an on-going basis the average annual gain in productivity that it seems reasonable to expect ought to be reflected in real earnings. Now this will not be true from year to year, of course. But on an on-going basis this ought not to be reflected.

Senator JAVITS. But have you no figure in mind? Would you say, for example, 1½ percent in a couple of years is pretty poor performance.

Mr. McCRACKEN. That is subnormal performance.

Senator JAVITS. What would you say is an optimal figure?

Mr. McCRACKEN. I would think in terms of a figure of, say, 3 percent a year.

Senator JAVITS. Can you pledge to us that the administration will be really so sensitive and so flexible with respect to its policy that if it does see any really serious recession danger, it will be flexible enough and willing, and you people will be ready, to recommend change, even if it is radical change?

Mr. McCRACKEN. Senator Javits, I am perfectly willing to pledge right here that I watch this kind of thing practically by the hour, and as soon as I think there is evidence to warrant a change in the basic direction of policy my efforts will be in that direction.

Senator JAVITS. I thank you very much. Thank you, Madam Chairman.

Chairman GRIFFITHS. Thank you, Senator for being here.

Senator Proxmire?

Senator PROXMIRE. I would just like to call attention, Dr. Houthakker, to the data I have on what would happen if you repeal the oil import program. You indicated that the effect would not be very significant. The data I have come from the Office of Energy Planning and from the hearings and the conclusion of the staff of the Senate Anti-Trust Subcommittee which has been having very detailed hearings on this matter. They conclude if we repeal the oil import program it would save 5 cents a gallon on gasoline, 3.9 cents a gallon on home heating oil. They conclude further that there would be a $7 billion a year saving. This latter conclusion, I should say, comes from the Bureau of Mines, and they argue that this could be done without a catastrophic effect at all on domestic oil companies.

Now, I know that the Schultz committee is investigating this but I think that Chairman Griffiths point that we can ameliorate inflation by easing up on the restrictions on imports is a very important observation and it can affect the cost of living directly and seriously.

Mr. HOUTHAKKER. Senator, I would like to correct an apparent misunderstanding. I thought that Chairman Griffiths was referring to imports as a whole. She mentioned a number of products, and I quite agree that in some of those relaxation of restrictions would make a substantial difference. I was addressing myself, perhaps mistakenly, to the question of what an overall increase in imports on all commodities would do and there I pointed out that this, although it may be very useful, cannot have a major impact because——

Senator PROXMIRE. You see there are many, many things that enter into this and the point we are trying to make up here is that monetary and fiscal tools are vital but there are others antitrust policy is one, import policy is another, and when you put these things together they can have a significant effect on the cost of living.

Mr. HOUTHAKKER. I entirely agree with you that they can have an effect. How large it would be we can calculate. I think the figures which you have mentioned in connection with oil are estimates that seem to fit in with most of the other estimates of this effect and to that extent a complete relaxation of the oil import program would certainly have a marked effect on gasoline and products like that. But there again we do have to remember that, after all, the expenditure on gasoline is only a small part of the consumer budget. This is why I may have seemed to throw some cold water on the idea that a complete relaxation of oil import controls would have a major effect. It would have some effect.

Senator PROXMIRE. It would seem to me a $7 billion saving is one worth thinking about.

Mr. HOUTHAKKER. It certainly is and I can assure you that the task force on which I am an observer is looking into this very carefully. (See correspondence between Mr. Stark and Mr. McCracken at end of today's hearing, p. 377.)

Senator PROXMIRE. I would like to ask you, Dr. McCracken, something that concerns me very much as I think about your statement. It seems to me that you are indicating there is going to be an easing of fiscal restraints beginning in January, beginning only a few weeks from now. I can't reach any other conclusion, but that from the fact that you say that the National income accounts budget which shows a surplus of $7 billion at the present time, will move down to a surplus of $3 billion beginning in the third quarter of fiscal 1970. That is the 1st of January, and then shortly after that, as I understand it, we expect to have a substantial increase in social security benefits payments to the tune, if it is 10 percent would be around $3 billion, if it is 15 percent would be over $4 billion. If you put these together, it seems to me we are moving into an area where the direction certainly is to ease fiscal restraint and put much more presure on monetary policy which means higher interest rates again.

Mr. MCCRACKEN. I think as best one can evaluate the evidence at the present time, it would look as if there would be some easing of fiscal policy in the first half of the calendar year. Probably most of the easing that would come in 1970 would come with the beginning of fiscal year 1971. But nonetheless there would be some in the first half of 1970.

Senator PROXMIRE. Doesn't this contradict the advice of many, many economists, almost everybody who has appeared before us including Secretary Kennedy, and Director Mayo, have told us that they felt that the first easing should be in monetary policy, that here is where the let up ought to be. Fiscal policy ought to hold the line.

Mr. MCCRACKEN. I am not myself persuaded that changes in fiscal policy can be timed well enough for relatively short-run stabilization purposes anyway, so it almost inevitably means that the major burden here has to be carried by monetary policy. I would myself be just as happy to have a somewhat stronger fiscal policy carried into next year. But at least I hope we can retain essentially the kind of picture that seems reasonable now.

Senator PROXMIRE. Now, absent that stronger fiscal policy, with which I would agree with you, although I arrived at it in a somewhat different way perhaps, absent that why wouldn't it be wise to give some serious consideration to either selective credit controls or voluntary credit controls of the kind we had during the Korean war period so that there can be a moderation in demand that can be under control, and so we wouldn't have to move to a situation where perhaps a year from now we might be forced into having overall price and wage and rent controls.

If one of our purposes is to avoid restraining the economy and immobilizing resources, wouldn't it be sensible to consider this kind of halfway house which does allow a great deal of freedom, has worked to a considerable extent in the past, and would seem to be in order in view of the fact that inflation is continuing.

Mr. McCRACKEN. My guess is if we were to start down that route of selective controls we would decide that in any case they would come along a little late in the game. I don't see the changes in fiscal policy being of quite the magnitude which would make it necessary to do this.

Moreover, if we were to go down the route of selective credit controls, this has more significance for allocative purposes than in terms of its overall effect on the economy unless this is backstopped by an appropriately more restrictive overall monetary policy. In other words, if we pursued the same overall monetary policy, but imposed selective credit controls, it would be more apt to divert credit into other purposes than to change the total.

Senator PROXMIRE. Well, that is exactly what I want to get to. We just passed a bill out of the Senate Banking Committee which would affect mortgage credit, and one of the provisions in that bill would be to provide for voluntary credit controls of the kind we had in the Korean war period trying to put pressure on the banks not to continue to loan at this unsustainable pace to business for investment in plant and equipment and try to channel more money, as you indicated, into the housing sector. The administration opposed that and I expect will oppose it on the floor, and the committee was divided along partisan lines unfortunately.

Now, it seems to me if you are going to oppose this kind of action and oppose so much of the action that we have tried to get to help housing, that the administration is not going to enable us to come anywhere near meeting this goal that the Congress set last year and the President signed into law of 26 million housing starts a year. This year we will fall far below it. We are moving, we had an increase last month which may be temporary, but it looks as if we are going to end up the year with housing starts at an annual rate of one million or maybe only a little more than a million a year.

Do you really feel, maybe both you and Mr. Stein, or maybe Mr. Stein would like to answer this, do you feel we can meet our housing goals without some kind of a clear emphatic administration program that will make resources available to housing that are not available now?

Mr. McCRACKEN. Well, of course, the 26 million pertains to the decade ahead obviously.

Senator PROXMIRE. Correct.

Mr. McCRACKEN. Obviously we can't continue at current or recent rates of housing starts and meet that goal, but this is a very short-run swing, as a matter of fact, and I think here we do have to take a longer run look.

To repeat what I said earlier, I do think myself that we do have to take a look at the institutional arrangements by which savings move into mortgages so that mortgages are a little less marginally positioned in the capital markets than they have been.

But I would think that this kind of voluntary program, which would not be apt to last very long anyway, would not make a major contribution. I think there would be more fundamental matters that we would have to look at there.

Senator PROXMIRE. Well, more fundamental matters, I have talked with other people in the administration who say that something must be done about housing. We just have to do it if we are going to achieve anything like our goal, if we are going to meet the greatest housing shortage we have had in more than 20 years. If we are going to provide the kind of potential we should have and keep people at work and keep the economy going after Vietnam eases off, this certainly ought to be one of our high priorities. What major kind of a program would you suggest or what method can we have to meet this goal?

Mr. McCRACKEN. The answers to that question are to a large extent yet to be found, but I think we can identify some of the problems at least that we are going to have to wrestle with. We have, of course, the problem of interest rate ceilings which, when market levels breach these ceilings, tend to produce disintermediation and divert funds away from housing. This is a very complex problem. It is not easy to specify what the resolution of this might be but this is a problem area.

It may be that whole new instruments for acquiring funds that then move on into housing will then be needed.

I agree that this is an area we have got to look at but I would want to take this in the context of the longer run, 10 year objective, and not try to solve the long run problem by relatively shorter run movements. We want to do what we can, of course, even in the short run.

Chairman GRIFFITHS. Would you like to ask something else?

Senator PROXMIRE. Yes.

Mr. STEIN. I have one thing to add. If you look at this thing as a 10-year housing goal, you have to recognize there are a number of other goals which have to be served simultaneously. We do have a goal, as Senator Javits indicated, about the growth of real per capita income in this country, which will require a very high rate of growth of business investment in plant and equipment. We have a great many goals about the activities of State and local governments which are going to require probably a large volume of State and local borrowing. All of this means, if taken together with the housing goal, that our basic requirement is for a higher rate of total saving in the country than we have previously had, and if we confine our efforts only to diverting a larger share of the total saving into housing we are going to be impairing the achievement of other goals. So it seems to me that the basic consideration without which nothing else will work is to increase total savings, and I would suggest that a large Federal surplus is the main thing we can do about that.

Having done that, we can then consider the methods by which we divert an adequate portion of this total supply of savings into housing.

Senator PROXMIRE. I am not talking about operating on a deficit now. In fact the thrust of my questioning this morning has been that we have to maintain a strong fiscal policy.

Mr. STEIN. Yes.

Senator PROXMIRE. I would like to see us get much more of our resources out of military not because I think we should have a weak military force, I think we ought to have a strong one, but I think we can on the basis of efficiency available with military recommendations cut $10 to $15 billion, push more of it into housing and we ought to have a program to do this and I don't see or hear of any program.

Chairman McCracken tells us this should be long term and not short term and maybe short term expediency is good but I don't see any long term effort to meet this.

This fits in with what Senator Javits was very properly stressing earlier and that is if the administration had some kind of a clear-cut series of standby programs with which they can meet growing unemployment, you would be in a much stronger position, it seems to me, to combat inflation. You would have much better support in the Congress and in the public, but I don't hear that kind of specific delineation of what you will do in the event unemployment increases.

One of the big things you can do is to have a really clearcut housing program which, of course, would absorb an enormous amount of manpower if we did this properly. The same thing is true in the area of State and local government operations where Mr. Stein properly points out that there are enormous needs that are unmet. But there ought to be a Federal program that is ready and available and that Congress knows about and the public knows about to meet this otherwise we would be very hesitant to take some of these restrictive fiscal policy measures when we think that, well, maybe we might be pushing ourselves into a recession, maybe a depression that we are not going to be able to get out of for several years.

Mr. MCCRACKEN. May I comment on that? I think we do have a program here which has very important longer run implications for housing. I would say the single most important thing to achieve here so far as housing goes is the kind of confidence in the longer run outlook for the price level that will give us lower interest rates. What we have seen in the last couple of years is chiefly just the classic response of interest rates to a growing lack of confidence in the price level. What people more and more insist upon is a rate of interest which even after allowing for the expected inflation will give them a decent rate of return on their money. This has had a very adverse effect on housing. This is why I indicated to Senator Javits that I think more confidence in the future of the price level would itself be worth a good many basis points in the bond market, and this would be favorable to mortgages.

So far as contingency planning in terms of unemployment, I did indicate in my testimony this morning that this aspect of the problem must be a part of any program for trying to counter the problems that we have. The strengthening and the expansion of the unemployment compensation program would be exactly along the lines that you have indicated. The manpower training programs are pentinent here also. In other words, I did go beyond just fiscal and monetary policies, and indicate the kind of broad spectrum approach that is necessary.

Senator PROXMIRE. I hesitate to impose on the Chairman further but I would like to ask about this manpower training program. I was very concerned about the way that was presented here. I am all for it. I think the best time for it however, of course, is the time when you have 3½ percent unemployment. As you get 4 percent, 4½, 5 percent it doesn't do much good if you train people and you have no job for them or you train them for the job and somebody else loses his job. The best time to meet your program in a manpower training program, would seem to be when you have a great pressure on prices and a labor force which is inadequate and then you take the three million people out of work and you give more of them skill and more of them an ability to work.

When you get up to 3⅓ million, 4 million out of work you train them and the manpower training program won't get you another job. It is not the fundamental kind of an answer to it.

It seems to me the Federal Government ought to be ready to provide leadership for the economy so the economy can provide these jobs and so that we won't go down to this level of unemployment.

Mr. McCRACKEN. The best solution for the problem of a man who is unemployed is a job. However, I think a strengthened manpower program here does have relevance even in the context of what we are talking about. Those who are unemployed, or the pool of unemployed, consist of a group with a changing population. Alternatively we might think in terms not of the percentage of the labor force unemployed but of the average length of time that a person is out of work. If there is going to be an interlude of unemployment, at least manpower programs then hopefully would provide an opportunity for that time to be used to beef up skills and earning power.

I quite agree that this is not intended as an ultimate substitute for employment. It is part of this kind of contingency planning.

Senator PROXMIRE. Thank you, Madam Chairman.

Chairman GRIFFITHS. I would like to thank all of you for coming here as I would like to thank the staff too for its help in these hearings.

If there is anything of which I have been convinced it is the fact that the Government is really one of the largest villains in inflation.

I think that it is necessary that steps other than high interest rates and recession be taken to avoid inflation, and I think the Government has it within its power to do those things.

Maybe it won't be popular originally to do some of the things that I have suggested. But I think all of these things could be done, and I think inflation could be stopped without people going through the problems of recession.

For instance, I think that you are not even counting in the unemployment work force more than a million people who really are unemployed, and who are large consumers. That is women who are the mothers of children that they are maintaining in their homes and that the rest of us are supporting. Personally I am for putting those women to work. Now, the welfare bill doesn't suggest this really. We are still going to say that if you have a child under six that you can stay at home. Nobody, in my mind, has that right. All you have to do is to substitute the word "parent" for mother, and you can put those women to work and I am for doing it. That would be one other thing that would help you reduce the expenditure of government. Welfare is the third largest expenditure, I believe, right behind defense, and interest.

I think that we should look over the whole budget with the idea of what can the government do to cut these expenditures, and I think we should look over the whole realm of international trade and see what we are doing that keeps us from buying cheaper imports, if you really want to stop inflation. Thank you very much for being here.

Mr. McCracken. Thank you.

(The following correspondence between Mr. Stark and Mr. McCracken was subsequently supplied for the record:)

October 23, 1969.

Hon. Paul W. McCracken,
Chairman, Council of Economic Advisers, Executive Office of the President, Washington, D.C.

Dear Paul: Because of the pressure of time, Senator Proxmire was not able to ask you to comment on the following two questions he had intended to ask:

(1) Is not the total price effect of imports proportionately much larger than their share of GNP, because imports are a crucial share of certain key items? For example, steel imports had a *big* impact on steel prices in 1968. Domestic prices have to respond to import prices.

(2) I had the impression from some of Chairman McCracken's remarks that there are available two different measures of industrial production: one by the Federal Reserve and the other derived by the Department of Commerce in its computation of GNP, and that these measures showed somewhat different results over the course of 1969. Am I correct in these impressions?

Would you please supply your comments on these points for the printed record of the hearings?

Cordially,

John R. Stark,
Executive Director.

The Chairman of the Council of Economic Advisers,
Washington, October 27, 1969.

John R. Stark,
Executive Director, Joint Economic Committee,
Congress of the United States

Dear Mr. Stark: This is in response to the two questions in your letter of October 23. Let me answer the second one first.

There are indeed two measures of industrial production that are commonly used—the Federal Reserve Index of Industrial production (FRB) and the OBE's gross product originating in manufacturing industries (GPO). The former is available on a monthly basis and the latter on a quarterly basis. Unfortunately, the two published series are not strictly comparable on a cenceptual level, but they are very similar and are used to represent industrial production in manufacturing.

In the period from the third quarter of 1968 to the first quarter of 1969 the FRB index was not only rising but at an increasing rate. In contrast, the rate of increase of gross production was falling in this period. However, since April the FRB index has leveled off and even fallen in August and September. The two measures therefore are both reflecting the slowdown in the economy.

The disagreement in the behavior of the two series has led to several detailed studies which isolated several of the differences. It appears that the two series differ principally in the behavior of the price deflators which are used to convert the money output to real output. It is possible to trace this back to the product coverage for the deflators. The FRB index used a deflator which covers all products but has a serious problem with changes in the product mix influencing the deflator. In contrast, the GPO deflator is constructed from the wholesale price indices of the Bureau of Labor Statistics; these price indices have a narrower coverage but changes in the product mix do not affect the deflator. Finally, the quarterly changes in the two series cannot be compared because the different benchmarks in the two series have a significant influence. The final result of these analyses is that the GPO series is probably better than the FRB index but in either case the quarterly movements are subject to considerable erratic behavior, which makes inferences from the data somewhat risky.

With regard to your first question it is clear to me that the total price effect of imports is proportionally much larger than their share of GNP. For one thing, empirical studies have shown the price elasticity of imports to be greater than one. This is partially a result of the fact that decisions are made at the margin, and a small decrease in the price of an import has a large number of new buyers in the United States. I might add that the force of *potential* imports is one that may be very powerful in moderating domestic price increases. The capacity of foreign countries to produce for the U.S. market has been increasing and this constitutes a significant change in the effect of potential imports on the U.S. economy.

Sincerely yours,

PAUL W. MCCRACKEN.

(Whereupon, at 12:35 p.m., the hearing was adjourned.)