508

THE 1971 ECONOMIC REPORT OF THE PRESIDENT

HEARINGS

BEFORE THE

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CONTENTS

WITNESSES AND STATEMENTS

FRIDAY, FEBRUARY 5, 1971

TUESDAY, FEBRUARY 9, 1971

WEDNESDAY, FEBRUARY 17, 1971

THURSDAY, FEBRUARY 18, 1971

FRIDAY, FEBRUARY 19, 1971

SUBMISSIONS FOR THE RECORD

Friday, February 5, 1971

Tuesday, February 9, 1971

SUBMISSIONS FOR THE RECORD—Continued

Wednesday, February 17, 1971

Thursday, February 18, 1971

SUBMISSIONS FOR THE RECORD—Continued

FRIDAY, FEBRUARY 19, 1971

THE 1971 ECONOMIC REPORT OF THE PRESIDENT

FRIDAY, FEBRUARY 5, 1971

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

The committee met, pursuant to notice, at 10 a.m., in room 1202, New Senate Office Building, Hon. William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Sparkman, Humphrey, Javits, and Miller; and Representatives Reuss, Widnall, Conable, and Brown.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Loughlin F. McHugh, senior economist; John R. Karlik, Richard F. Kaufman, and Courtenay M. Slater, economists; Lucy A. Falcone and Jerry J. Jasinowski, research economists; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig and Leslie J. Barr, economists for the minority.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The committee will come to order.

Today we start our regular hearings on the state of the economy. This committee and the witnesses appearing here today do not need any reminder that we are living through one of the most trying times since the end of World War II. Not only are we engaged in a war in Indochina which is causing the destruction of the lives of many of our finest citizens, but our domestic problems loom so large as to threaten the very fabric of American society.

Because of the urgency of these problems, we have already had extensive hearings on the state of the economy in advance of our regular hearings which begin today. We heard from Governors of four of the largest States, from mayors of some of our most distressed cities, and from expert students of such major issues as the impact of inflation and high unemployment on the consumer, housing, the poverty-stricken, and minority groups.

Among the domestic economic problems which are highest on the agenda are:

(1) A present unemployment rate of 6 percent—far higher than any modern advanced society can tolerate. A special factor will be a rapid winding down of the war in Southeast Asia—which if it eventuates will mean a more than normal growth in the civilian labor force and places a heavy duty on all of us to insure our returning veterans worthwhile, responsible, and remunerative peacetime opportunities to which they will apply their talents.

(2) Two years of inflation which shows little, if any, signs of abatement. The consumer price index at yearend was once again rising at

an annual rate of 6 percent, and wholesale prices at an even greater rate.

(3) State and local governments in a state of near bankruptcy—in good part, at least, due to a stagnating economy and inflation over which they have no control.

(4) An acute housing shortage, particularly for the poor and middle income citizens. Although there are signs of recovery showing in housing markets, even the recovery now seemingly apparent will fall far short of meeting the housing goal of 26 million at 2.6 million per year, set for the 10-year period ahead in 1968.

(5) A welfare program—if it can be called that—which is in a shambles with difficulties accumulating by the hour.

These are some of the economic problems facing us today. Obviously if not solved soon, they will have a more pervasive and deeper impact on our society as a whole. For this reason we have planned to hold more extensive hearings with the Executive Branch on the President's Economic Report than has been typical in the past. In addition to the Council of Economic Advisers, we have called on the heads of the Office of Management and Budget and the Departments of Treasury, Agriculture, Defense, Housing and Urban Development, and Labor, as well as the Chairman of the Federal Reserve Board.

We shall cover in these hearings not only the traditional aggravative economic policies—fiscal and monetary—but such major issues as a rational program for a general reordering of our national priorities, how best to readjust from a wartime to a peacetime economy, how to aid the States and localities to meet their heavy financial burdens, how to make adequate housing available to all who need it at reasonable costs, what must be done to make our welfare system more equitable and adequate.

I realize, Mr. McCracken, this is a tall order, and cannot be adequately covered in the brief period covered by these hearings. But at least, I know we shall all be trying to make a good start toward better understanding of the nature of the problems and the solutions that must be found.

We all have great respect, Mr. McCracken, for your outstanding ability, your fine reputation both before you assumed your present office and since you have assumed it, and, of course, the fine reputation and record of your distinguished colleagues.

We might not be able to get to all the questions we would like to ask you, and so I hope you will be willing to reply to those we may submit to you in writing.

We do expect however to have these lengthy sessions because there are so many questions which I am sure you anticipate we will ask.

Senator MILLER. Mr. Chairman, would it be permissible for me to read a statement of the minority?

Chairman PROXMIRE. By all means, Senator Miller, go right ahead.

OPENING STATEMENT OF THE MINORITY MEMBERS

Senator MILLER. In the absence of Congressman Widnall I would like to read this opening statement we have from the minority.

As this committee opens its annual hearings following receipt of the President's 1971 Economic Report, we find the economy in a difficult state of transition with regard to both unemployment and inflation. This situation is a direct consequence of the irresponsible fiscal and monetary policies of the previous administration from 1966 through 1968. Large deficit spending at a time of full employment created excessive demand and high inflationary pressures which have been exceptionally difficult to overcome. However, as a result of the present administration's economic policies during the last 2 years, which have by no means been adequately carried out by those in control of the Congress, recent encouraging signs have appeared in the economy. The rates of increase in wholesale prices declined significantly in the last half of 1970. There are indications that consumer prices are beginning to follow suit. Increased industrial productivity will tend to keep unit labor costs from rising as fast as in the recent past. Credit availability has expanded and interest rates have dropped sharply in the last few months. One result of this has been that housing starts increased rapidly as 1970 ended.

During 1970 the dollar remained strong in the international economy and our trade surplus more than doubled over the 1969 level, even though a persistent balance-of-payments deficit remains a matter for concern.

Now that increases in unemployment and inflation seem to be coming under control, the administration's goal is to continue to stimulate the economy toward full employment without aggravating inflation. The presentation to the Congress by the President of a "full employment budget" is a logical approach in moving toward this objective. Such a budget supports the economy by means of an operating deficit at a time when overall demand is weak, as at present, without sacrificing fiscal discipline. Additionally, a balanced full employment budget has the desirable feature of avoiding excessive levels of spending, since expenditures do not exceed the revenues that the tax system would generate when the economy is operating at full employment. As projected, the President's "full employment budget" will aid the economy in attaining full employment without aggravating inflation and in achieving the growth in gross national product outlined in the President's report.

An additional difficult problem facing our economy is that of prices and wages which continue to rise during periods of both moderate and slack demand. It has been suggested that the causes of this problem are a desire on the part of managment and labor to "catch up" because of prior inflationary rises and to protect against possible future rises, and the market power of concentrated economic units, be they large corporations or labor unions. Whatever the causes we must be concerned with solutions. The President has wisely rejected mandatory price/wage controls, which are incompatible with a free enterprise system, have historically resulted in numerous inequities, and involve great difficulties in their imposition, enforcement, and ultimate removal. The Economic Report also quite properly points out the general futility of completely voluntary programs. We support the administration's attempt to find ways which avoid the weaknesses of mandatory and voluntary controls, at the same time reserving the right to propose measures in our minority views to the annual report. The President's policy of regular "inflation alerts"—which was proposed by the Joint Economic Committee minority last year— is a useful one; governmental action in certain concentrated industries such as lumber, steel, copper, et cetera, regarding inflationary price increases can also be productive.

During these annual hearings we are traditionally concerned with current economic difficulties such as inflation and unemployment. However, we must also be concerned with other ongoing national problems, such as the financial plight of State and local governments, the welfare system, housing, national health, regional government, the environment, et cetera. Every decision which the Congress makes regarding any one of these problems includes an implicit decision about the others.

Even with our great national wealth, our resources are limited. In this regard, the discussion in the President's 1971 Economic Report of our national priorities, as related to our national output, is timely and useful. The projections through 1975–76 of national "unallocated resources" indicates that both our old ongoing programs and our projected new programs must undergo hard examination concerning the resources to be devoted to each. The Congress cannot enact a whole series of new spending programs, whether they be revenue sharing, tax credits, or national welfare payments, without specifically deciding from where the funds for such programs will come and which other programs will be foregone or postponed. Without this approach to our national priorities, accompanied by sound monetary and fiscal policies, our economy will be unable to meet the challenges of the decade ahead.

It would be well to bear in mind that our goals can only be reached if everyone pulls together—the Congress in keeping spending within the President's full employment budget spending ceiling, labor in exercising restraint in wage demands, and management in exercising restraint in price increases.

Thank you, Mr. Chairman.

Chairman PROXMIRE. Mr. McCracken, you go right ahead. Incidentally, if you skip over any part of your statement, the entire statement will be printed in full in the record and you proceed in your own way.

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

Mr. McCRACKEN. Thank you very much, Mr. Chairman and members of the committee. My two colleagues, Mr. Stein and Mr. Houthakker, and I very deeply appreciate this opportunity once again to appear before the Joint Economic Committee. I do have a statement here which is rather short. I may paraphrase a little of it but I would like to run through it.

We have just published our views on the recent past and the near future of the U.S. economy at some length in the annual Economic Report of the President. Since this has been available to the committee, we shall not try to summarize its contents of that report here. Instead, we shall concentrate on a few points which seem to be of substantial interest.

The President's message and the Economic Report have emphasized the need for orderly expansion of the economy in 1971. We have suggested that orderly expansion would yield a gross national product in the neighborhood of $1,065 billion, and that this figure is both an appropriate target and reasonable expectation. Many of the questions which have been provoked by our report hinge in one way or another on this figure. Several aspects of this figure need to be discussed:

1. Is this a realistic, or credible, or probable estimate for 1971?
2. What policies would be needed to achieve it?
3. Would this achievement be consistent with reduction of the inflation rate?
4. Is the rate of expansion implicit in this figure consistent with our international economic goals?

We should make clear at the outset that while for convenience we shall talk about a figure of $1,065 billion, the issue is not about that specific figure. We use that figure to represent a path of the economy which would significantly reduce the unemployment rate during 1971 but would not create a new burst of inflation.

It is perfectly understandable that $1,065 billion should seem to many people an improbably high figure for GNP to reach for 1971. The implied increase from 1970, 9 percent, is larger than our normal experience. Moreover, the figure is above the forecasts that economists outside the Government have commonly made for 1971, which have tended to be in the range from $1,045 to $1,055 billion.

We were, of course, well aware of these facts when we made our estimate. However, we do not find these facts a compelling argument against our belief that $1,065 billion GNP in 1971 is feasible and the probable outcome for the year.

To start with some elementary facts, a year-to-year GNP increase of 9 percent or more has occurred five times since 1947 and there were three additional increases in excess of 8 percent. So while the 9-percent increase we project for 1971 is unusual, it is not so rare as to justify calling it extremely improbable. Moreover, there is general agreement that even with reasonable success in restraining it, the rate of inflation between 1970 and 1971 will be higher than average and higher, of course, than we can be content with looking down the road.

Our own estimate is that an increase of about 9 percent in money GNP between 1970 and 1971 would imply an increase of about 4.5 percent in real GNP or perhaps slightly more. Increases that large, or larger, have occurred in 9 of the last 23 years, and increases in excess of 4 percent have occurred in 12 of those years. The projected rise of 4.5 percent in real GNP from 1970 to 1971 is not at all extraordinary.

The implied increases between the fourth quarter of 1970 and the fourth quarter of 1971 are, of course, larger. The fourth quarter 1970 figures were depressed by the auto strike and do not reflect the underlying supply or demand conditions. After adjustment for the effect of the strike on the fourth quarter of 1970, the estimate for 1971 implies an increase of money GNP to the fourth quarter of 1971 of 10 percent. The increase of real GNP would be about 6 percent, this is fourth quarter to fourth quarter. Again, these are higher than average figures. But they are not extraordinary in view of the condition from which the economy starts. These are the figures of a strong business revival within the pattern of postwar experience, and nothing more.

It is true that most economists outside the Government forecast that the GNP in 1971 will be less than $1,065 billion. An average of such forecasts would be about $1,050 billion. What light does this cast on the feasibility or probability of $1,065 billion? One should recognize first that while economists' forecasts tend to cluster together within a narrow range, the range of probable outcomes is actually much larger. In the period 1962 to 1969, inclusive, the average departure of the actual change in GNP from the change forecast by the Council of Economic Advisers was equal to 1.15 percent of the actual GNP. This may be taken as an approximate measure of the average deviation of the "consensus" forecast from the actual outcome. Indeed, the consensus errors were probably larger than the Council errors during that period. Moreover, there is a persistent tendency for forecasts to underestimate when the economy is rising most strongly. In our opinion, a consensus forecast of $1,050 billion by no means rules out the possibility of an outcome of $1,065 billion.

But we are saying something more than that a GNP of $1,065 billion is possible in 1971. We are saying that it is the probable outcome. In this we surely differ with the consensus. There is one basic reason for this difference. We incorporate in our view of 1971, as earlier private forecasters have not always done, the facts that $1,065 billion GNP is the target of Government policy for 1971, that the Government has the means to achieve the target and that the Government will use them. It is the target of Government policy because it describes the path that would reduce unemployment as rapidly as is consistent with reduction of the inflation rate. In this sense the target is required by the Employment Act of 1946. We should not aim for less. When we say that the Government has the means to achieve the target we are not suggesting that the target can be hit right on the button. However, we believe that the most probable outcome is the one the Government is aiming at.

The probability of the GNP forecast for 1971 thus comes down to the question of the existence of policy instruments for achieving it and determination to use these instruments of policy. As indicated above, the expansion we forecast is not more than has occurred in other business revivals. However, we do not count on a spontaneous revival to produce the desired expansion. We count on appropriate policy to achieve it.

One ingredient in that policy is the Federal budget. The administration has proposed a budget which will make a strong and proper contribution to the projected 9-percent increase of GNP between calendar 1970 and 1971. This may be seen in various ways. Between 1970 and 1971 expenditures in the national income accounts will increase by 8.2 percent. At the same time there will be a net tax reduction, from various rate and base changes, including the depreciation reform, equal to about 1 percent. Thus there is an independent budget stimulus of something over 9 percent. The deficit on the national income account will be almost exactly the same in calendar 1971 as in calendar 1970 if the $1,065 billion GNP in calendar 1971 is achieved. This means that if gross national product tends to lag behind the target figure the deficit will rise, which will limit the lag, and if the GNP tends to exceed the target figure the deficit will decline, thus limiting the excess.

Similar results are obtained by looking at the excess of the receipts that would be generated at full employment over the expenditures or, in other words, the so called full employment surplus. This surplus, in the national income accounts, is almost exactly the same in calendar 1971 as in 1970. This means that the Budget is tending to support the expansion of the economy between the 2 years at about the rate at which the potential output rises. This is approximately the rate of expansion implied in the $1,065 billion forecast.

The proposed Budget will support the desired orderly expansion of the economy. It is not a Budget which takes upon itself the entire burden of pumping the economy up to its desired rate. Neither is it by any standard a big-spending budget. The increase of expenditures is less than the projected increase of GNP and much less than the increases of earlier years, whether measured in dollars or in real terms.

The increase of the Budget has been restrained by the principle that expenditures should not exceed the receipts that would be obtained at full employment. This principle serves the useful purpose of drawing a fairly objective line which expenditures must not exceed without a decision also to raise tax rates. It also, if observed, prevents the generation of deficits when they would be inflationary. On the other hand it provides enough flexibility to permit the Budget to support the economy by running actual deficits when we are below full employment.

This Budget with a complementary monetary policy will yield the desired $1,065 billion GNP in 1971. What we mean by a complementary monetary policy policy is this: It should induce a rate of private expenditure for the purchase of goods and services that, when added to public purchases, will equal $1,065 billion. We do not propose to discuss just what monetary policy is adequate for that purpose. The determination of monetary policy is the function of the Federal Reserve, operating under the guidance of the Congress. Although the administration has continuous consultations with the Federal Reserve, we think it best that the communication between us be in private. However, we do think it useful here to indicate that there is a feasible monetary policy which would yield the target $1,065 billion GNP in 1971.

Over the postwar period the amount of money people have wanted to hold relative to their incomes has declined, with the result that that GNP has in fact risen faster than the stock of money. From 1952 through 1970 the annual rate of increase of GNP was about three percentage points higher on the average than the annual increase of the money stock. If this relationship continued, a 6-percent increase of the money stock between 1970 and 1971 would produce the desired 9 percent increase of GNP. In recent years GNP has risen less rapidly relative to the money stock than that 3-percentage-point figure. From 1967 to 1969 the annual rate of increase in GNP was 1.8 percentage points a year more than the money stock. On this basis an increase of 7.2 percent in money would, of course, be needed to provide an increase of 9 percent in GNP between 1970 and 1971.

More sophisticated approaches to the problem do not yield very different results. A statistical relationship between percentage changes in money and in Government expenditures and percentage changes in GNP over the past 18 years indicate that the 9 percent increase in GNP in 1971 could be achieved with a 6-percent increase in money. Other econometric studies suggest the need for a larger increase in the money stock. These figures may be compared with the 6.1 percent rate of increase of money in the first 9 months of 1970; that is, before the auto strike.

Clearly we do not know precisely what monetary policy in 1971 would yield a GNP of $1,065 billion. The answer to that will depend not only on which turns out to be the best expression of the average past relationship but also on the particular circumstances of 1971. There will have to be a process of trial and error; no one can expect to stay precisely on the desired path and policy will have to be adjusted from time to time. But the errors can be in either direction and need not cumulate, and achievement of the target would be the most probable outcome.

We believe that the rate of expansion at which we are aiming and which we expect to achieve is consistent with reduction of the rate of inflation during 1971 and 1972. The slowdown of the economy has already stopped the speedup of the inflation that was going on through 1969 and begun to reduce its rate. The antiinflationary effect of the 1970 slowdown will continue to be felt in 1971. It is worth remembering that the decline of the inflation rate that followed the 1957 recession did not come when the economy was falling but came later after the strong revival began. We are obviously dealing with a process in which the passage of time is critical.

The expansion we foresee for 1971 would still leave the unemployment rate at the end of the year around 5 percent, so that throughout the year there would be restraining pressure of excess supply on the price and wage level. At the same time, output would be rising strongly, business managers would be continuing efforts already begun to tighten up their operations, and the conditions would exist for an exceptionally high rate of productivity growth in 1971. This should make for a low rate of increase of labor costs per unit of output, and contribute to a lower rate or price increase.

Forces that are already present in the economy and that will be here during 1971 will work to reduce the rate of inflation as the economy revives. The administration will attempt to supplement these forces in every practical and effective way in order to make the desired result more certain. Particular emphasis will be placed on measures to correct market conditions that insulate prices or wage rates from the competitive forces that are at work in the economy.

The administration's new more active program for restraining price and wage increases will largely center in the Cabinet Committee on Economic Policy. On January 18 the Cabinet Committee directed the Council of Economic Advisers to report to it promptly on important cases of wage or price increases so that remedial Federal action might be considered. The Council has made three reports to the Cabinet Committee since that date.

The study of the steel industry ordered by the President at the time of the first proposed increase in the price of certain steel products last month is being conducted under the aegis of the Cabinet Committee. One element in the study is a consideration of ways in which the existing restraints on steel imports might be adapted to protect better the interests of U.S. users of steel, many of whom also face foreign competition. More generally, the study is concerned with the development of a healthy U.S. steel industry that will meet U.S. needs most efficiently.

Earlier the President directed two steps intended to restrain the price of crude oil, by relaxing restrictions on imports and by increasing production on Federal offshore leases. Further measures to expand domestic supplies are under consideration by the Oil Policy Committee.

Soaring wage rates, costs and prices in the construction industry have been a serious concern of the administration for almost 2 years, and numerous actions have been taken to deal with the problem. In the most comprehensive attack on the question so far, the President last month asked the unions and contractors in the industry to cooperate in developing a program for reducing excessive increases in wages and prices in construction.

The Regulations and Purchasing Review Board has under examination a number of Government policies that may be contributing to excessive wage or price increases. Two weeks ago for the first time it intervened in a case before a regulatory agency involving an application for a rate increase, opposing the increase on the ground that it was inflationary.

The Council of Economic Advisers will continue the publication of the periodic inflation alert to call public attention to wage and price increases of outstanding inflationary significance and to general practices of similar effect. The next alert will appear in March.

In a longer-run context, the National Commission on Productivity, composed of representatives of business, labor, the general public and the Federal Government is studying means to step up the rate of increase of productivity. One object of this is to slow down the rise of costs and consequently of prices.

It is clear that we now have in effect many elements of what has come rather loosely to be called an incomes policy. We are now considering ways to make these elements more systematic and comprehensive, and to provide more adequately for their management, which already strains the quite limited resources of the Council of Economic Advisers. The basic principle by which we are guided is the one stated in the Economic Report, where we say: "What is called for is a policy of doing what can effectively be done, whenever it can be done, and not pretending to do more."

Such efforts can be expected to make only a marginal contribution to the problem of reconciling reasonably full employment with reasonable price stability. We believe that the steps we have taken and others we may take in the future to operate upon particular product and labor markets will be helpful. But the critical thing will be to achieve the orderly expansion which is the heart of our program.

The policy of orderly expansion on which we are now embarked also has implications for our international economic relations. Perhaps the most important implication is that our price level has to benefit from the invigorating forces of competition, both domestic and foreign. While there are cases where rapidly growing imports may need to be temporarily restrained in order to ease the burden of adjustment, we have to make sure that these restraints do not serve as a cover for excessive price increases. The methods we choose for restraining imports have to be designed in such a way that vigorous competition is preserved.

Our balance of payments will also reflect domestic policy, though the repercussions are many and varied. Both our exports and our imports are sensitive to our price performance. The improvement in our trade performance in 1970 over 1968 and 1969 can be attributed in part to the deceleration in our wholesale prices and also to the slowdown in the economy. In fact it is not always realized that the United States has made greater sacrifices to keep domestic price increases in check than any other major country with the exception of Canada—where unemployment rose to a higher level than it did here. For the first time in several years we thus succeeded in slightly improving our competitive position, which depends primarily on relative price performance here and abroad. One estimate suggests that a 1 percent reduction in our wholesale prices compared to those in other countries would increase our merchandise trade surplus by more than $1 billion. Some further improvement in our competitive position may be expected in 1971, since several other countries have not yet come to grips with their inflationary pressures. This improvement will help offset the adverse effect on our trade surplus of an increase in our real GNP.

Other effects of domestic policy will come through capital movements, some of which are highly sensitive to interest-rate differentials. The fall in U.S. interest rates has been matched by some countries but not by all, and as a result some capital has left the United States. It is too early to say what the net effect of an orderly domestic expansion on the various measures of our international economic position will be. As we indicated in the Economic Report, some of the traditional measures—especially the liquidity balance—have lost much of their usefulness as guides for policy. Our primary responsibility to the rest of the world cannot be expressed in terms of any particular balance-of-payments concept; it is, rather, to attain high employment of our resources with reasonable price stability. We are adopting an expansionary policy because it is needed at home, but we also believe that it is in the interest of other countries. Few things, in fact, would be more harmful to the development of the world economy than continued economic sluggishness in the United States.

The course we have laid out for the economy is ambitious and it is not free of risks. We believe that the times require an ambitious policy, and that to settle for less would involve more risks and costs, not fewer. It would accept continuation of a high unemployment rate, probably with little advantage on the side of inflation.

When we first appeared before this committee 2 years ago we said that all the easy ways of doing things had been used up, all had been tried and all had failed. Then, with the frustrations of these past years still in sight, this seemed clear to everyone. But the lesson faded. The experience of 1965–68 became more remote, and present unemployment and continued inflation became more painful. The temptation then to talk as if there were an easy way out of our dilemmas became very great. The administration, however, could not call upon others to perform miracles. It had to do the hard things—holding down the budget, supporting a policy of monetary restraint, and then turning policy toward moderate expansion while inflation was still high, but not reinflating the economy despite the agonizing rise of unemployment, and all the time resisting the siren song of the controlled economy.

We have done what had to be done—not perfectly but effectively. Now, if we look at our prospects realistically and objectively we can see the way to better times. It will require from the Congress, from the administration, and from the monetary authorities a combination of courage and discipline to get there. But surely this is not more than the country can reasonably expect.

Thank you very much, Mr. Chairman.

Chairman Proxmire. Thank you, Mr. McCracken.

Mr. McCracken, you are predicting and expecting that the economy will grow at a highly optimistic rate this year. In fact you predict the economy will grow to a size of $1,065 billion. Now, the economy has grown, as you point out, more in the past but I doubt there ever has been a time in the American history when the economy has grown at anything like this rate when we have been winding down a war. Your estimate, as you point out, greatly exceeds that of the independent, competent economists. I have a list here of 31 economists listed in Business Week practically all of them disagree with you. Their estimate, their modal, and median average estimate is the economy will grow to $1,045 billion.

It strikes me that your estimate is a highly political one. When I say it is highly political, I say this with all respect, and I say it because it serves the political interests of the President.

If the generality of economists are right and we have a $1,045 billion economy then we won't have $11.3 billion deficit you estimate but an $18 billion deficit. If the economists are right we won't have the 5.25 average percentage unemployment you estimate during the year but a 6-percent average.

Now it is obviously in the interests of the President, in the interests of his reelection, to have this kind of an estimate. How do you respond to that?

Mr. McCracken. I am very glad to respond to that, Mr. Chairman. I do not have any judgment on the political aspects of this. Others will have to respond to that aspect, but I would like to comment on two things which bear on the question as to whether the $1,065 billion is a reasonable and attainable figure.

So far as the estimates of the private forecasters, I touched on that a bit in my testimony. If one looks back over the period of the decade one will find that there has been a rather systematic tendency to underestimate, and this is quite clearly evident also in the forecasts that have been put forward by the Council of Economic Advisers.

But if one examines that record, the juxtaposition of the forecasts of private forecasters together with this $1,065 billion does not in any sense demonstrate that the $1,065 billion is unattainable. The record would rather suggest the opposite.

But now let me comment on what I think is a more fundamental aspect of this question. The economic basis for that $1,065 billion figure really has to be evaluated in terms of the policies which influence the course of the economy.

Chairman Proxmire. That is exactly right, and with all respect, again, Mr. McCracken, I don't see any new policies here. All I see is that you are relying on the full employment budget, which will stimulate to some extent, and you are relying on a monetary policy which you suggest, I think rather conservatively, should be around a 6- or 7-percent increase in the money supply. Of course, we don't have, you don't have, control over that, the executive branch does not, but I see no other stimulative policies. You have just two, fiscal policy, budget stimulation, pump priming, on the one hand and then the monetary policy, or more credit available. Nothing else that I can see here, nothing in a big way. Can you see anything else?

Mr. McCracken. These are the two major instruments which can tend to influence the course of the economy.

Chairman Proxmire. We have had those in the course of the last year and they have given no growth at all. You predicted we would have a $1.3 billion surplus, we have an $18 billion deficit. You pre-

predicted 4.3 percent unemployment. For 10 of the 12 months last year we were over 4.3 percent. We are now at 6 percent.

You estimated a growth of about 5 percent, we had no growth at all, a decline of about one-half of 1 percent, and I think in view of this record I just wonder if we have a basis for relying on the superior judgment of the Council.

Mr. McCRACKEN. First of all, Mr. Chairman, I think you will find that the projection of gross national product in the Economic Report last year has a smaller average deviation than you will find in any other period since 1962.

Chairman PROXMIRE. Exactly, but the trouble is that the increase was made up of inflation and not of growth and we have that same thing this year. You could have a $1,065 billion GNP average this year but if it is made up of inflation I think you would agree with me it would be a terrible disappointment and a significant economic failure. It would mean, as we all know, high unemployment as well as the terrible problem of inflation, would it not?

Mr. McCRACKEN. May I finish my comment on the $1,065 billion?

Chairman PROXMIRE. Yes.

Mr. McCRACKEN. After all the two basic instruments that determine the economy are fiscal and monetary policy.

The fiscal stimulus can be estimated at approximately 9 percent or perhaps slightly more. Consequently, one can at least say that the budget which has been put forward means that fiscal policy will be carrying its load to try to achieve a 9 percent growth in the economy.

The other major instrument for determining the overall course of the economy is monetary policy. Monetary policy, of course, and fiscal policy influence the economy with some lags, though estimates vary about that. We have not tried to pinpoint the specific rate of monetary growth required for the economy. We said that one cannot rule out the possibility that the 6-percent rate of growth which we have had much of last year might be consistent with a 9-percent growth in the economy.

Chairman PROXMIRE. Last year we had no growth at all, and we had a stimulating fiscal policy. We have a deficit of $18 billion. We had a full employment budget, in effect. We have some growth in the money supply, what, around 4 or 5 percent, not far from what you say this year. I just can't see any change, any dramatic change, that is going to give us the stimulation. We have the President squarely opposing the kind of job program the Congress passed last year. What new is there in here that is going to give us the jobs and give us the economic expansion?

Mr. McCRACKEN. I think we have to see last year in the context of the policies which determined the course of the economy. Monetary policy during much of 1969 and into 1970 was really quite restrictive. It was not until about March that we started to get a significant easing of policy.

With normal lags that seem to prevail in monetary policy one would not have expected the change in monetary policy at that time to have had much opportunity to influence the economy last year. So the fact that policy, monetary policy, last year was what it was does not rule out the fact that this more expansionist monetary policy will carry through into the economy and give us a more rapid rate of growth.

Chairman PROXMIRE. Let me get at what really bothers me about the economic report and your statement this morning. On pages 82 and 83 the economic report reads as if you rewrote those details we have been talking about. You rewrote this, I should say, without putting the numbers in that you should to substantiate your estimate. There is nothing here on what will happen to personal consumption, what will happen to housing, what will happen to State and local purchases, what will happen to, in other words, what is really behind gross national product, how these are going to increase. In the past you always have given us those numbers. This year you have left them out. It is as if you made the estimate based on those numbers and got a decision from a higher authority, the President, and knocked out those numbers and gave us generalities. Just as in your statement this morning instead of stating where the increases are going to be, you just give us a vague notion that somehow the economy is going to come along.

You don't say how personal consumption is going to increase, how housing is going to increase, what are we going to do about stagnant investments in business plants and equipment and so forth. All of the tough figures that I have here, that the staff has given me on the basis of the best estimates they have, have to go way, way out in these areas to find any substantiation for a $1,065 billion economy. Our staff has a devil of a time trying to justify the specific figures on which a $1,065 billion GNP would be based.

They estimate, for example, that you would have to have a 50-percent increase in housing starts this year. They estimate that you are going to have to have a 38-percent increase in inventories. They estimate that you are going to have a very large increase in personal consumption in spite of the fact the Michigan survey, one of the most objective and competent surveys we have in this area, is pessimistic about what consumers will do during this coming year. Can you give us, fill us in with, these facts and statistics so that we have some background for your estimate which is, as you say, not in tune with what other economists have estimated. Where is your proof?

Mr. MCCRACKEN. Chapter 2 and the section outlining the path of the economy in 1971 does, in my judgment, indicate the most important things to say about the factors which will be determining the course of the economy.

Chairman PROXMIRE. Why don't you give us the figures?

Mr. MCCRACKEN. This section lays out the basic fiscal policy, which is one of the major instruments of policy to achieve the overall target for the economy. We have some discussion there of monetary policy. We do indicate some of the evidence that we now have in the picture about investments outlays and the saving rate. For example, the consumer saving rate is now relatively high. I don't think there is any question but what in terms of the basic forces of policy which determine the path of the economy we have laid those out both in terms of fiscal and monetary policy.

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

Congressman Conable.

Representative CONABLE. Thank you, Mr. Chairman.

Mr. McCracken, unlike the chairman, I see in your report here increasing activism on the part of the Council of Economic Advisers. It seems to me you have been willing to get out on a limb here to press for a more vigorous economic policy, including the adoption of a full employment budget, which is a departure from the past practice. You have done this in face of what many of us have detected as an increasing modesty among economists and increasing caution about predicting what is going to happen and about what Government policy is accurate and most effective. We can understand why there is some increasing modesty among economists when we look at the fact that Government policy in 1969 was a very restraining policy and in the free market many economic decisions were being made which were expansionary and, therefore, the Government restraint was frustrated.

In 1970, the Government moved toward a more expansionary policy and, at the same time, the business community was losing confidence, and so the result of Government policies again was dampened and these policies were somewhat frustrated by countervailing decisions made on the side of the economy that represented actually four-fifths of our GNP, the Government controlling roughly one-fifth through its $200 billion budget.

Now, my concern is a different concern. Do you see any problem of the credibility of our Government policies if, because of factors beyond our control in our free market economy, once again we are frustrated? You are taking an increasing activism in connection with the economy, and yet we have already had it demonstrated that the Government does not control the economy and cannot guarantee all the results. It can only influence them. Can we, therefore, wind up with a serious issue of creditibility as you move toward a more vigorous position?

Mr. McCracken. Mr. Conable, these are considerations, of course, that have to be kept in mind and will have to be kept in mind as we move through the year. As we indicated in our statement, it is not possible in any mechanistic way to set one's sights on some bull's-eye and just mechanistically move toward it. As we indicate it will be necessary to some extent for the management policy to feel its way along, there will be a certain amount of trial and error.

On the other hand, the total process of economic policymaking does require both setting out some targets which we want to attain and then trying to shape the decisions about the fiscal, monetary, and other policies to achieve it, and that is what we have tried to do at this stage, recognizing that while the Economic Report is put out once a year, the management of economic policy is a continuing thing. But we certainly will have to watch these considerations as we go along.

Representative Conable. Am I correct in saying that you consider the state of the economy sufficiently delicate so the Government must take the risk of taking a more active role in trying to influence it; is that correct?

Mr. McCracken. In our judgment it was important at this stage to set a fairly ambitious target. There are risks in any course of action that one sets out.

Representative Conable. I am interested in the mechanism of the full employment budget, sir. Doesn't this involve many assumptions? For instance, the assumption that our tax system is entirely appropriate to the state of the economy, that the figure that would be generated at full employment by our revenue collecting system, therefore, is an appropriate figure as the measure of the actual deficit that you are going to accept under a full employment economy. Is this assumption one that safely can be made?

How many variables are involved in the formula of the full employment economy, and is it sufficiently accurate so that we can call it a formula or is it only an indicator that the stimulus, some stimulus, of some sort of actual deficit, is necessary?

Mr. McCracken. The basic contribution which the concept of a full employment budget makes to policymaking, it seems to me, is that it provides logically both for the use of fiscal policy as an instrument of stabilization and, at the same time, keeps explicitly in the picture the concept of fiscal discipline, and thus provides a more balanced framework within which the specific decisions that must be made about the budget can be made.

One can go back a step further, as it were, and raise the question about whether the tax system that we have is making the proper allocation of our national income as between the public and private sector or even within that decision whether the tax structure needs to be modified in any way better to accomplish other goals that society may have. So this is not a mechanical thing which will answer all the problems, but it is a useful framework within which fiscal policy and budget policy decisionmaking can better be made.

Representative Conable. I understand the need for a discipline. We are substituting a new discipline for the old discipline of the balanced budget here. Is this discipline more accurate in an economic sense that the discipline of the balanced budget?

Mr. McCracken. I think it more accurate in the economic sense, and also perhaps, therefore, more effective. The basic problem of the always-balanced-budget rule was that in a period where, for whatever reason the economy was below par, the budget would then show a deficit, and this rule logically required either cutting expenditures or increasing tax rates which would tend to make the economic situation even worse. The same thing would be true if the economy were in an overly inflationary period.

For this reason, in looking back over a long period of years, the attempts to try to balance the budget in a recession, or the counterpart of that on the topside, were not usually made and thus, in fact, the disciplinary aspect of budget policy has tended to be weakened.

In the full employment budget principle we do have a measure or a means of giving us some guides to fiscal discipline, and at the same time it encourages us to use fiscal policy to handle the state of the economy.

Representative Conable. Is it possible to accommodate efficiently a full employment budget in a moving economy, in an economy that is in transition? You are setting your goals at the beginning of the year, and there is change, and are we pretty well locked into a posture that then cannot be changed until the following year. Do you see any problems in this respect?

Mr. McCracken. We have the usual problems. We have problems with our economic information system, and economic policy management is, of course, not a once-a-year proposition. We will have to watch; we will have to keep constantly close to this as we go along.

If I may, I would like to refer this question to one of my colleagues who has probably done more than any other economist in the Nation in developing this concept of the full employment budget.

Mr. Stein. I might comment on some aspects of the Congressman's question. First, with respect to the implied assumption that the existing tax system is appropriate, this is not a requirement of the full employment budget idea. The full employment budget idea only requires that the level of expenditures should be guided by the revenues that the tax system we have would yield. If someone should decide, if the President and the Congress should decide, that we ought to have either a higher level of tax rates or a lower level of tax rates this would, of course, change the level of expenditures as appropriate under the full employment budget idea. So that the idea itself says nothing about what level of tax rates is appropriate. It only prescribes an appropriate relationship between the expenditures and the taxes.

With respect to the question of the accuracy of the estimates, I think it should be noted that any budgetary process which has some notion of balancing in it requires an estimate of the revenues for the future, so the question really is whether we can estimate more reliably the full employment revenues or the actual revenues. I think it is fair to say we estimate the full employment revenues more reliably than we estimate the actual revenues, because to estimate the full revenues you not only have to estimate everything that is required for estimating the full employment revenues but you also have to estimate what the condition of the economy will be relative to full employment. There have been some hints around here this morning that we didn't estimate that very well. [Laughter.] I think that is all I would add at this point.

Representative CONABLE. My time is up.

Chairman PROXMIRE. Congressman Reuss.

Representative REUSS. Thank you very much, Mr. Chairman.

Mr. McCracken, and gentlemen, I intend later to get into some of this fascinating budgetary arithmetic but first I think we ought to address ourselves to what seems to me the real policy bombshell of this report; namely, your section on the environment and particularly your policy recommendations on page 122 of the report. I will just read them with you, starting near the top of the page, and I am quoting:

> New rules for use of the environment are bound to affect competitive relationships within and among industries, localities, and nations. As industries are forced to bear the costs of using the environment, those who have high costs will lose part of their market to those with lower costs of using the environment. Inevitably, there will be pressures for Government action to prevent this reallocation of production. It should be realized, however, that such reallocation is necessary if environmental resources are to be used efficiently. Government interference with this process should therefore be limited to mitigating the transitional effects.
>
> The same considerations apply internationally as well as domestically. Our high level of material wealth has caused us to place a high value on clean air and water than they are assigned in countries which have lower incomes—

And here I interpolate that is all countries since they all have lower incomes—

> or where clean air and water may still be abundant. As this value becomes reflected in the costs imposed on our producers, those for whom the costs of pollution control are high will find it harder to compete with producers in countries where clean air and water are less valuable or where pollution is lower. The resulting reallocation of production among nations should benefit all nations. * * *

I find that appalling and astounding. What you are doing is erecting a Magna Carta for every laggard State in the Nation and every industrial laggard country in the world to pollute.

You are saying, for example, to the Wisconsin paper industry that if it imposes decent conditions of eliminating water pollution on its Wisconsin interstate waters that the Federal Government should stay out if States X, Y, and Z decide that they don't care much about their rivers and streams and that they want to give their industry a competitive advantage, and so the Wisconsin paper industry, the model, is supposed to die, while the streams of States X, Y, and Z become progressively more degraded.

Not content with that you then apply it internationally and say if Germany, Finland, and Italy want to play the ideological dog in the manger they can make it impossible for this country to compete with them. I find this right-to-pollute philosophy appalling and I ask did you clear this with the Council on Environmental Quality? [Laughter.]

If you didn't you are in violation of the law which requires an environmental impact statement from every agency making a policy position like this.

Mr. McCracken. This chapter, this section, Mr. Reuss, certainly is not a license to pollute nor does it take a casual view of this. It is merely laying out the fact that as societies come to place a higher value on environment and clean air and clean water that this becomes a factor in the industry location, and this may be the kind of readjustment which takes account of that just as other location factors are also pertinent.

If I may, Mr. Reuss, I would like to have Mr. Houthakker comment on this also since he has been particularly close to this issue.

Representative Reuss. Yes.

Mr. Houthakker. Mr. Congressman, in the first place, I want to reassure you that we have taken account of the law requiring us to clear our statements with interested agencies including the Council on Environmental Quality.

I feel that you read into the statement much more than it actually says. I may perhaps refer you to page 121 where we point out the Federal Government does have a role under present legislation in setting national standards.

Representative Reuss. Oh, yes, but you restrict that role, and I quote, "When poisons enter the food chain in a river and eventually damage fish caught in a distant waterway, the Federal Government must insure minimum standards are set" but when you are through with direct interstate murder you withdraw and say two sentences later: "It is not clear, however, that the Federal role should extend beyond the setting of minimum standards where most benefits and costs of pollution are borne locally," and you go on to repeat that which, if the English language means anything, says that the Federal Government should not attempt to impose national standards to prevent unfair interstate competition.

It is like the early English industrialists in the Industrial Revolution advertising "labor docile and water plentiful, come put your plant in our town."

Mr. Houthakker. Perhaps I may point out the circumstances are different everywhere. Corn is grown in Iowa and various other States because Iowa happens to have a climate and a soil perticularly suitable for the growing of corn. Bananas are grown in the West Indies and Central America for the same reason. Similarly, different parts of the country are better equipped to deal with consequences of pollution. We find for instance if a plant which emits pollutants is located in the center of a large city there will be far more people adversely affected than if this plant is located in a rural area where the population is small and where the wind may be strong, but the situation is such that the pollutants don't particularly bother anybody.

I would emphasize the Council of Economic Advisers is very much concerned about pollution and make these suggestions here in order to help the antipollution effort not to hinder it so that, therefore, if there are differences among different parts of the country and of the world in their bid to cope with pollution then it is elementary with economic efficiency that certain things are carried out in certain places that cause the least concern. That is the only reason we point to the fact that overall pollution control may be improved if the regional location of the industries is adapted to the different circumstances.

Representative REUSS. I have heard you and I continue to be as appalled as ever. You apparently don't distinguish, the Council does not distinguish, in its mind between factors of production, whether the climate is hot or cold, the existence of transportation, skilled labor, natural resources, which are legitimate factors of industrial location, and whether a given government can be sufficiently conned and corrupted into not doing anything about its pollution, and apparently you are all set to give that do-nothing government a competitive advantage over its neighbors.

Don't you think that the citizens of all the States have an interest in the condition of a river in State X?

Mr. HOUTHAKKER. Mr. Congressman, we live in a country where power is decentralized and where citizens have the means of influencing their local environment as well as the actions of the National Government.

We have to allow some leeway for the concerns of citizens in every part of the country about the extents to which they want to be either exposed to pollution or to be able to earn a profitable living, to have profitable employment. There is a balance and by making this balance explicit we hope that the overall pollution control effort will be more effective. If we impose the same standards everywhere irrespective of location, it is clear that some activities will have to be dropped. Now these activities may have a secondary or the primary benefits that may outweigh, in some cases, the direct pollution they cause and therefore, we feel that an effective pollution effort should recognize differences in the different environments which exist in different parts of the country and different parts of the world.

Representative REUSS. Then what you are saying is that I as a citizen of the United States have no right to be interested in a river in a given State if the people of that State, through their legislature, decide that that river should be degraded because they want to get business from other States?

Mr. HOUTHAKKER. I am sure you would not deny that the citizens of every particular area should have some say over their own destiny. That, I think, is essentially what is involved here.

Representative REUSS. I don't deny that but I don't see how that is relevant to the question I asked.

Let me inquire with great specificity: Did the Council of Economic Advisers secure the written approval of the Council of Environmental Quality to the policy position which I just read which is contained on page 122 of your report?

Mr. MCCRACKEN. Let me comment on that. Mr. Reuss, the succeeding drafts of the Economic Report are circulated to all agencies who might have any interest in this, and obviously this included the

Council on Environmental Quality. Certainly it was circulated to them.

Representative REUSS. Well, they received a copy of this in their incoming mail. Do you know whether they read it or reacted to it or said OK?

Mr. McCRACKEN. Of course. And we received their copies back. I do not, of course, remember the details of comments from various agencies, but this was certainly circulated to all of them.

Representative REUSS. Well, would you resubmit, Mr. McCracken, this section and particularly page 122 to the Council on Environmental Quality and include at this point in the record their comment on what is set forth in the report, they either agree with it or share my feeling that this is an outrageous step backward in environmental control.

(The following information was subsequently supplied for the record:)

The National Environmental Policy Act of 1969 (Public Law 91–190) requires that recommendations or reports affecting the environment should not be issued until careful consultations with appropriate environmental agencies are completed to obtain their comments. The Council of Economic Advisers, following long historical practice, circulates drafts of chapters of the Economic Report of the President to all appropriate agencies. Successive versions of chapter 4 of the 1971 Economio Report of the President were submitted to the Council on Environmental Quality and the Environmental Protection Agency, and their comments and suggestions were carefully considered in preparing the final draft of the section on "Safeguarding the Environment" in chapter 4.

Mr. McCRACKEN. It is really because we share the growing concern about environmental pollution, and we have no reason to think that it is going to be reversed, that we have to take into account the kind of procedures that can carry out what we want to achieve in an optimum way economically. There is an interface between this problem and economic considerations. It was this aspect of it that we discussed here.

Representative REUSS. Well, if your page 122 remains the administration's position I predict every polluter in the land will use it as a Magna Carta to justify his local pollution, all on grounds of allocation of production. I guess my time is up.

Chairman PROXMIRE. Congressman Widnall.

Representative Widnall. Thank you, Mr. Chairman.

Mr. McCracken and the other two members, I have read with interest your testimony. Do you have projections of what would happen to the rate of inflation and unemployment if the GNP does not attain the 9 percent growth rate which you predict?

Mr. McCRACKEN. If gross national product does not attain the growth rate which we have projected here, one would have to assume that the major effect is going to be a higher level of unemployment than would otherwise have occurred.

So far as the difference in terms of the price level is concerned, I think that would be of a lesser magnitude. Price-making forces move slowly through the economy, and the difference between the projected rate of growth and a rate of growth a point or two lower than this would be less significant for the price level. It would have its major impact on real output and on employment and to a lesser extent on the rate of inflation.

Representative WIDNALL. Many of us are concerned about the ability to estimate $1 trillion figures so exactly that we can predict up to the accuracy of one-tenth of $1 trillion, to wit, predicted $11.3

billion deficit for fiscal 1972 and a slim $1.3 billion that it represents under the full employment surplus.

Suppose you are wrong this year, as you were last year, in estimating total revenues, is it not possible we could, in fact, have a full employment deficit if this projection were off even slightly?

Mr. McCracken. As Mr. Stein indicated earlier concerning our ability to forecast the full employment revenues, we probably can do that somewhat better than we can project actual revenues, at least there are pretty persuasive reasons for expecting that.

On the general point of not imputing excessive accuracy to figures that are projections for the period ahead, we strongly agree. Because these are estimates, we must be very cautious about attaching pinpoint accuracy to figures. As a matter of fact, even our estimates of business activity for the period that was just concluded have to be considered within a certain range or zone of accuracy.

Representative Widnall. Of course, we are counting on the projections that you present to us and to the country and, of course, at the critical position we are in right now with respect to the economy, where we are hoping for it to continue to change and go up, it is highly important that we try to pin it down as closely as possible, and not go all out in an optimistic way if the facts and figures are not there.

I just hope that we don't become too optimistic on some of these things when the full justification still isn't there.

I would like to turn to something else. At the IMF conference at Copenhagen last autumn the managing director of the IMF, Mr. Schweitzer, said and I quote:

> Until the payments position of the United States is brought into balance it is important that the U.S. balance of payments deficit should be financed by the use of U.S. reserve assets to the extent necessary to avoid excessive expansion of official holdings of dollars by other countries.

In other words, Mr. Schweitzer invited surplus countries to cash in their excess dollars in return for gold or other U.S. reserve assets. What has been the effect of this statement?

Mr. McCracken. I would like to make a general comment on this, Mr. Widnall, and then Mr. Houthakker may also have more specific technical comments to make. Certainly the basic point which Mr. Schweitzer here makes about the importance of the United States taking into account its external economic activity and its external responsibilities in the international financial and trade community is a very important one, and has been very much in our minds all along. And, as indicated in the Economic Report, we were very conscious of this.

On the question of what the impact of the speech may have been on our reserve asset holdings, do you have information on that, Mr. Houthakker?

Mr. Houthakker. We have been somewhat mystified by the reasons why Mr. Schweitzer made this particular statement. Whether countries want to hold their reserves in the form of dollars or in the form of gold or SDR's is essentially up to them. It is a preference which they can exercise.

It has been the experience during the last year that countries prefer to hold dollars, among other things, because dollars give a good rate of interest whereas gold earns nothing at all and SDR's earn a very small amount.

Therefore, we are ready to pay out gold or SDR's to those countries which feel they need them. So far our outflow of gold has been very small, at least the outflow to other countries. We have paid out some gold during this year to the International Monetary Fund.

Representative WIDNALL. What was the outflow last month?

Mr. HOUTHAKKER. During the month of January?

Representative WIDNALL. Yes.

Mr. HOUTHAKKER. I am afraid those figures are not yet available. I cannot tell you, but I believe the amount is very small.

Representative WIDNALL. Is it not unusual that our total reserve assets should have dropped more than $1 billion from September to December 1970?

Mr. HOUTHAKKER. I do not think that is an unusual change by any historical standard. Our reserves do fluctuate considerably, and we still have very large reserves in various forms.

Representative WIDNALL. Part of that could be attributable to the statement made by Mr. Schweitzer.

Mr. HOUTHAKKER. It is conceivable but, as I said before, our reserves, particularly of gold, have dropped in large part because we returned to the International Monetary Fund an amount of gold which we borrowed a long time ago, because we did not feel that this was a necessary investment, given the high interest costs attached there to it. We also paid out some gold because the quota in the IMF was increased, and under the existing rules one-fourth of the quota increase has to be paid in gold, which we did.

Apart from that, we have not had any major outflow of gold. So I do not have impression that until now Mr. Schweitzer's statement has had a major impact on the behavior of other countries.

Representative WIDNALL. What was our final balance-of-payments deficit for 1970?

Mr. HOUTHAKKER. We do not have final figures, but the best estimate we have now is that our official settlements deficit was somewhere between $9.5 and $10 billion.

Chairman PROXMIRE. Between $9.5 and $10 billion?

Mr. HOUTHAKKER. I beg your pardon.

Chairman PROXMIRE. You said $9.5 and $10 billion?

Mr. HOUTHAKKER. That is right, Senator.

Chairman PROXMIRE. Thank you.

Mr. HOUTHAKKER. And our liquidity deficit is somewhere in the neighborhood of $4 billion, but new figures are still coming in, and we will not have a more or less final figure until the middle of March

Representative WIDNALL. Wasn't that balance-of-payments deficit the largest we have had in years?

Mr. HOUTHAKKER. The official settlements deficit this year is the the largest we have had. The liquidity deficit, however, is smaller, considerably smaller, than it was last year, 1969.

Representative WIDNALL. What do you believe would be the future of SDR's if the United States continued its rather large balance-of-payments deficits? Would other, especially surplus, countries put pressure on the IMF membership to slow down drastically the rate of SDR creation? Would such a move seem logical,would it not?

Mr. HOUTHAKKER. We believe SDR's are necessary because there is a demand for unconditional reserves, owned reserves, as distinct from reserves which are owned, which are the liability of another country, particularly the United States. So we do not believe that the desirability of SDR's should be judged primarily by this criterion, although we recognize that the accumulation of dollar holdings by other countries is an alternative form of liquidity.

Since this particular form of international liquidity is one which we and other countries do not think should be expanded too much, we feel that there is a role for SDR's now and in the future.

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

Chairman PROXMIRE. Senator Sparkman.

Senator SPARKMAN. Thank you, Mr. Chairman.

Mr. McCracken, I have followed the statements that have been made now for some time with reference to the plans for 1971, and I want to say that my best wishes are for their accomplishment. But I do have a hard time feeling hopeful, and you have explained a good many things to us here.

First, let me ask you this: this is referred to as a full employment budget. The first thing that puzzled me when I heard that statement was the fact that you were seeking deficit spending in order to stimulate the economy, step up production, increase employment, and to achieve, I thought, full employment.

I just could not see how you could do all three of those and hold down inflation. Maybe I have the answer this morning because, I believe you say, that you do not expect to have full employment unless you count 5 percent unemployment full employment, and that is not a good definition of full employment, is it?

Mr. MCCRACKEN. No, Senator Sparkman.

May I comment on your statement?

Senator SPARKMAN. Oh, yes, I would like you to.

Mr. MCCRACKEN. Certainly 5 percent is not full employment, and the $1,065 billion for this year is not a full employment level of activity.

You have raised a question which, I am sure, is a question in the minds of many people. Is it possible to have a rate of expansion for the economy of about 9 percent, year to year, and continue to make progress on the rate of inflation.

One can never be sure about these things, and a certain modesty in the estimates of economic activity is in order.

But, let us look at the evidence here. If you go back in the 1950's, the stability of the price level, which began to fade toward the end of 1965 or early 1966, was really established going back to about the latter part of 1958.

The interesting thing is that the price level was continuing to rise all through the decline in business activity in 1957 until the early or middle part of 1958. The stabilization of the price level really came along as the economy was rising very rapidly and, indeed, rising at a rate something like this year's projection, perhaps a little more.

Moreover, as one looks at the analytical evidence of what seems to be associated with pricemaking forces in the economy, one of the factors is what is happening to the unit costs.

There is a time, of course, for restraint, fiscal and monetary restraint, even though one has to recognize that it will have adverse short-run effects on output and, therefore, on output per man-hour and, therefore, on unit costs. But there does come a time also when the more rapid expansion of the economy, and the more rapid gains in output per man-hour which that makes possible, will start to relieve the pressures on costs per unit of output. It is for that reason that it is reasonable to expect that in 1971 the rise in costs per unit of output should be less than in 1970.

So that whether one looks at history or at the analytical evidence we think that it is reasonable to expect further progress against inflation even with this rate of expansion. All of us, of course, would like to have an even more rapid expansion. Five percent, for unemployment, as you point out, is too high.

On the other hand, if one puts very heavy pressure on the economy, one is courting a greater risk of reactivating inflationary pressures, and certainly we do not want that.

Senator SPARKMAN. Then, if I understand correctly, the hope lies in the possibility of reducing the unit price of the products that will be made in a stepped up production.

Mr. McCRACKEN. Unit costs?

Senator SPARKMAN. Unit costs.

Will that be translated to unit price to the buyer?

Mr. McCRACKEN. The evidence, once again, the analytical evidence, would suggest that it will be.

Senator SPARKMAN. Well, I can see that that would have an impact on inflation.

By the way, you mentioned the monetary policy, and you referred to the fact that this is a matter more or less under the control of the Federal Reserve System, and I agree with you fully that transactions between you and the Federal Reserve System should be kept private. But let me ask this question: Has there been collaberation between your Council and the Federal Reserve Board with reference to this budget, this program, that is being submitted?

Mr. McCRACKEN. We are in continuing consultation with the Federal Reserve on a wide array of subjects, including fiscal and monetary policy, and international monetary policy.

The consultation has been on a continuing basis. I think it has been very helpful.

Senator SPARKMAN. And that will continue?

Mr. McCRACKEN. I am sure it will.

Senator SPARKMAN. Mr. McCracken, something was said about the number of housing starts that we plan to step up. I think we are going to have a greatly improved situation in the housing field. How many starts did we have in 1970; is that figure available yet?

Mr. McCRACKEN. Yes, it is.

I think the figure was 1,450,000.

Senator SPARKMAN. Yes. What do you anticipate for 1971?

Mr. McCRACKEN. It is 1,429,000, apparently. Total private housing starts were 1,429,000.

Senator SPARKMAN. That is 1970?

Mr. McCRACKEN. That was 1970.

Senator SPARKMAN. What is your prediction for 1971?

Mr. McCRACKEN. I think Secretary Romney indicated last month he thought we could look toward, say, 1,800,000; he thought 2 million was a possibility. I think 2 million housing starts is a reasonable prospect if we need the housing.

It does underline the urgency, of course, of our starting to have a somewhat more favorable price-cost performance in the industry.

Mortgage funds are becoming more readily available, and that has been an encouraging development.

Senator SPARKMAN. Well, with reference to cost-price, the cost-price situation, one of the members earlier asked you a question, if it was not true that the administration was adopting a more activist policy in that field. That is true, and I notice in your statement you say that whatever needs to be done, the administration is going to do it.

I remember 2 years ago just about this time when you first appeared before us, as I recall, you announced it, and I am sure the Secretary of the Treasury announced it, and others who met with the committee, that we were not going to have guidelines and yet you were not going to engage in jawboning.

I remember fussing with you a good bit about that, and with all of the others, saying that you needed guidelines, and that you needed to do some of this thing that you called jawboning. I prefer to call it moral suasion, and I am thinking, for instance, right now of the General Motors settlement. As I recall, the President criticized that settlement, said it was inflationary, and yet what was done before the negotiations got underway? No guidelines have been suggested, they are not sponsored or suggested for their guidance, and I assume no interest—I won't say no interest, but no active participation taken in the course of the negotiations to try to keep them in line.

I am pleased to say that of late apparently there has been a good bid of jawboning, and I still think that it would be a good policy for the Government to have guidelines suggesting levels within which price-wage contracts would be made, and to use its great, its enormous, power of moral suasion during the negotiation and in connection with the final settlement.

Would you comment on that?

Mr. MCCRACKEN. Yes; I would be glad to, Senator Sparkman.

The absence of formal guidelines really goes back to about 1966, when airline mechanics strike was finally settled for substantially beyond the guidelines which had been promulgated to that point and, I believe I am correct, in the next Economic Report no numerical guidelines were suggested.

The most recent experience with guidelines, with an explicit guideline, has been that of our friends to the north in Canada. A guideline of 6 percent was laid down by the Income and Prices Commission there. The actual wage settlements in Canada have been roughly in line with those in the United States; in fact, they may have been slightly higher.

I have given a great deal of thought to this. As I look at the experience I find it difficult to see either the role that a numerical guideline can play in this kind of a situation or the effectiveness of it in cases where, including recent cases, it has been tried.

At the same time, I think it is also fair to say that the tempo of our activity, of our concern, about hastening adjustments in the economy that will enable us to move forward in a more expansionist way, without reactivating a rising rate of inflation, is something that all of us would support.

As we said in our statement and in the Economic Report, we want to do all that we can in an effective way.

Senator SPARKMAN. My time is up. Thank you very much.

Chairman PROXMIRE. Senator Miller.

Senator MILLER. Thank you, Mr. Chairman.

First, I would like to make this observation. The suggestion has been made that possibly some of the estimates of the Council of Economic Advisers were motivated by political considerations.

I note in some of the estimates of the economists from the private sector, an estimate by Robert Turner of Indiana University of $1,070 billion, which is in excess of what the Council estimated. Mr. Turner is a former member of the Council of Economic Advisers under former President Truman.

I suppose that Gardner Ackley's estimate of only $1,042 billion might be politically motivated simply because he was a member of the Council under a Democratic administration.

But I would say, my reaction would be, that the Council has probably bent over backwards to avoid being political on this. I would suggest that since we are professionals, and you have a great amount of professional pride, particularly in the Council of Economic Advisers, that to preserve the credibility and enhance the credibility of the Council you probably have been sorely tempted to have underestimated, to be on the safe side; is that so?

Mr. McCracken. If the projection to be put forward were merely another one of the many guesses about something, in this case a level of GNP, then there might have been a temptation to have a figure that is well within the range that everyone else is talking about.

We see these projections in a quite different light. We see them as a part of a package of economic policies. You cannot manage economic policies until you know what you are trying to achieve.

Capsulating these objectives in quantitative terms has certain hazards because, in all probability, as we see over the last 10 years, what finally happens will be a little different from the projections. Nonetheless, it does add a specificity to our objectives which is worthwhile. We thought in this economy, having already last year incubated a good deal of disinflation which has not yet hatched out, it was important for us to set as a guide for policy a fairly ambitious target which could be obtained without seriously reactivating inflation.

Senator Miller. Would it be correct to say in making these estimates that the Council made certain assumptions such as that the international picture would remain relatively the same as it is, that the domestic scene would remain relatively stable and tranquil?

Mr. McCracken. Yes.

Senator Miller. All right.

Now, if that is so, and then there is an international development of major consequences, for example, suppose the Common Market should decide to violate the GATT rules as a result of which there would be a serious impact on our exports or on the domestic scene, that there would be a rather long and costly strike in the steel industry or in some other area of major consequence, I would gain from what you said then that all bets are off and that the estimates are going to naturally be less in their results than you had expected.

Mr. McCracken. Yes. Those contingencies, of course, are not embedded in these figures.

Senator Miller. And then if the Congress does not stay within the President's spending budget and decides to exceed it substantially, all bets are off, too; is that not so?

Mr. McCracken. Yes, that would alter the figures, too.

Senator Miller. Now, Mr. McCracken, there was quite a stir raised in some quarters by the President's statement on television recently that he was a Keynesian, and there has been the suggestion made that if that is so then, perhaps, he was influenced in this respect by you or the Council as a whole.

I would like to read from the hearings of this committee on the 1967 Economic Report of the President:

Senator SYMINGTON. One final question: everybody today is a Keynesian. Some stress structural employment, some public works expenditures, some lowering taxes, but the basic theory of Keynes, was it not, was in times of prosperity to increase taxes and reduce Government expenditures, and in times of nonprosperity, vice versa. We are not pursuing that policy, are we?

Mr. MARTIN. We have failed to compensate. We have been relying too much, in my judgment, on deficit financing without ever having a surplus. I think that you have got to have a balance. We should use deficit financing under certain circumstances, but if deficit financing becomes permanent then I think it is just a matter of time before you do undermine your currency.

Senator SYMINGTON. These disciples of Keynes perhaps haven't read everything he wrote on the subject of the importance of the integrity of the dollar. Many years ago he said, "Lenin was certainly right. There is no subtler nor surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction and does it in a manner which not one man in a million is able to diagnose."

Would you agree?

Mr. MARTIN. I would indeed, and I would like to inject here, in a recent talk I made in London I had the privilege of knowing Lord Keynes and I had several long discussions with him. Before the end of the war he was convinced that the main problem of the post-war world was going to be unemployment. Later when I sat at the Bretton Woods meeting at Savannah with him I had a 2-hour conversation with him in which he explained to me that his views had completely changed and he was convinced that the problem of the post-war world was going to be dealing with inflation. He recognized that inflationary surges would bring inevitable adjustment from time to time, putting two and three people out of work when otherwise only one person would have been unemployed.

Now, insofar as the Keynesian theory is concerned with respect to debauchery of the currency and inflation, would you say that the Council subscribes to that?

Mr. MCCRACKEN. We certainly have been deeply committed to the importance of maintaining the value of the currency, and we continue to be.

Senator MILLER. Well, do you subscribe to what has been set forth in that interchange between former Federal Reserve Board Chairman Martin and Senator Symington as to Keynes views on this subject, on these points.

Mr. MCCRACKEN. Keynes' position on these policy issues was apparently flexible, as was indicated by the shift in his position here.

Senator MILLER. I am talking about his final position.

Mr. MCCRACKEN. Final position, yes. The basic thing we are trying to get at in this concept of the full employment balance in the budget is precisely to try to reconcile two things in fiscal policy.

When Keynes first came along back in the 1930's—his major book was published in 1936—the problem with compensatory fiscal policy was that it addressed itself to the problem of economic instability. But we found we then had lost something which was very important, the always balanced budget; namely, the concept of fiscal discipline.

On the other hand, if we had tried always to balance the budget it could have produced short-run perverse changes. No one knows what Keynes would say if he were here, but I would hazard a guess that he would be able to look fairly realistically at the world we have now.

Senator MILLER. Well, we know that his last position was fear of inflation.

Mr. McCRACKEN. Right.

Senator MILLER. And when we realize that compared to a 1939 dollar worth 100 cents, our dollar is worth about 35 cents today, I presume that he would be concerned about it, and I suggest the Council must be very concerned about it, too.

Mr. McCRACKEN. Very much so.

Senator MILLER. I would just like to ask one further question, and that is, in your projections and in this full employment budget theory, I recognize the logic of the theory, the logic is powerful, and I also recognize that there is quite a difference in inflationary impact between deficit spending under a full employment, in a full employment, economy and deficit spending in an underemployment economy. But I am concerned about two things:

No. 1, what it would look like if we took 1971, as it is going now, and said this is a full employment budget picture, and yet we do not have results or probably won't have results for fiscal 1971 that would have been forecast; and No. 2, the softness in these statistics and figures on the basis of which you make your estimates. You will recall, Mr. McCracken, last December I asked you about this article in the local press indicating that because of inadequate reporting requirements from corporations we might be $10 billion low in our estimate of GNP on that one area alone.

Now, you cannot make sound estimates without sound figures and sound statistics. I think you have come pretty close to this. A $1.5 billion difference in GNP estimate sounds pretty good, but that could be off because of your statistics. Would you care to comment?

Mr. McCRACKEN. Yes.

Senator MILLER. Pardon me, I am referring to the Washington Post article which was carried in the December 15th issue, "GNP Estimate Possibly Distorted by Data Lack."

I am sure you saw that.

Mr. McCRACKEN. Yes, I do remember that story.

Certainly the problems of information are one of the major vexations for all of us in forming economic policy. It is no criticism of the people, of course, but it is true that we have had several instances of this during the 2 years I have been here.

We have had two major revisions in the money supply which gave a somewhat different picture from the track that we thought we were on, and there have been other revisions of the figures which have altered the appearance of the economy. For this reason the Council has supported efforts to try to tighten up our estimating procedures so that we are not subjected to this uncertainty as to where we have been, let alone where we are going.

Certainly these are going to continue to be problems. The one thing we are going to have to emphasize as we move ahead is, in view of the uncertainty of these figures, to try to give ourselves the benefit of the doubt in the management of the budget and fiscal policy.

I think you have touched on something that is very important.

Chairman PROXMIRE. Senator Humphrey.

Senator HUMPHREY. Mr. Chairman, it is generally agreed that Democrats are the most optimistic of humans, particularly in the political arena. I have been accused of congenital optimism myself.

But I want to say I take second best to your statement this morning. Of course, that is not unusual for me, I have been second best in a number of things. [Laughter.]

I am, like Senator Sparkman, hopeful that everything you say here will turn out to be just like you say, only a little better.

I was not here a year ago, through the will of the electorate, and the facts in the Constitution, but I recall reading the projection that for the fiscal 1971 budget there would be a surplus of a little over $1 billion. Then in May a revision converted that to a deficit of over $3 billion. Now, I believe, the deficit has climbed to around $17 or $18 billion.

I merely point out that as we now judge the prescription of the doctors, I think we must also know a bit about the record of cure and rehabilitation.

I had read this statement with considerable interest. We clearly do not have time to review it in detail. But one part is very intriguing. It says here, "This budget, with a complementary monetary policy, will yield the desired $1,065 billion GNP in 1971."

And then you define what we mean by a complementary monetary policy, and then you say, "We do not propose to discuss just what monetary policy is adequate for that purpose."

But then you proceed to discuss exactly what you believe to be adequate for that purpose. You say that "determination of monetary policy is the function of the Federal Reserve, operating under the guidance of Congress." May I say, that is a new revelation to me. The Federal Reserve has not been doing much consulting with Congress over the past 50 or 60 years, though the administration has continuous consultations.

Then you say, "Over the postwar period the amount of money people have wanted to hold relative to their incomes has declined, and from 1952 to 1970 the annual rate of increase of GNP has been about three percentage points higher on the average than the annual increase in the money stock."

Discussing monetary policy now, "If this relationship continued," and I remind you, you said you did not propose to discuss just what monetary policy would be adequate for that purpose, you say, "If this relationship continued, a 6-percent increase of the money stock between 1970 and 1971 would produce the desired 9-percent increase of GNP," the 9 percent you say is essential to achieve a GNP of $1,065 billion.

You discuss what has happened in recent years relative to the money supply. I call your attention now to this, "From 1967 to 1969 the annual rate of increase in GNP was 1.8 percentage points a year more than the money stock. On this basis an increase of 7.2 percent of the money, of course, would be needed to provide an increase of 9 percent in the GNP between 1970 and 1971."

Well now, you just said that 6 percent would be adequate, viewing the history of the 1952–70 period. Then you point out that it will take 7.2 percent. Then you say, before the committee, and here is the kicker, "Clearly, we do not know precisely what monetary policy in 1971 would yield a GNP of $1,065 billion."

Mr. McCracken, am I correct in stating that until about the last 6 months the Federal Reserve was increasing the money supply at about a 6-percent annual rate?

Mr. McCRACKEN. Yes, that is correct.

Senator HUMPHREY. What actually was the rate of increase in the last 6 months? What is the money supply rate of increase?

Mr. McCRACKEN. It was a little less toward the end of the year.

Senator HUMPHREY. About 3.8 percent?

Mr. McCRACKEN. That sounds reasonable.

Senator HUMPHREY. Well you say, according to your figures, it took 7.2 percent from 1967 to 1969 to achieve an increase of 9 percent in GNP. But your projections for the coming year plus a present rate increase of 3.8 percent, plus your outline here of the complementary relationship between an expansionist budget and monetary policy seem inherently contradictory. And then to compound the confusion you say you really do not know what the monetery policy is or what it is going to be. Mr. McCracken, what kind of medicine is this?

I mean, what are we to presume?

Mr. McCRACKEN. Senator Humphrey, let me comment on this.

First of all, what is the point of any allusion to monetary policy here beyond simply a general statement that monetary policy will undoubtedly have something to do with the way the economy works out? The basic point is this: The budget that was put forward is not a budget which attempts to do everything through fiscal policy, but that this budget, together with a complementary monetary policy can reasonably be expected to lead to our objectives.

Having said that, we did have some obligation to raise the question at least as to whether we were just using a phrase, complementary monetary policy, which really would have implied something that was substantially outside the boundaries of experience. It is for that reason that we went through this arithmetic.

The fact of the matter is that different analytical models with essentially comparable technical validity will give somewhat different answers. It is just a fact of life. There is no absolutely precise and mechanically fixed relationship between monetary policy or an increase in the money supply and the subsequent course of the economy.

What we did want to do, however, was to indicate that the phrase "complementary monetary policy" on the basis of this kind of evidence was well within the boundaries of experience.

We do not manage monetary policy. We recognize that monetary policy is a very complex thing, as is true of other instruments of policy, but that at least as we are talking about it here, it is something reasonably within experience.

Senator HUMPHREY. Mr. McCracken, if I may just conclude on this point. It is a fact, is it not, that your expansionary budget, your full employment budget, as we call it now, requires a monetary policy fostering a percentage increase in the money supply.

Mr. McCRACKEN. Yes.

Senator HUMPHREY. You said here that it was, and I quote, "We do think it useful here to indicate that there is a feasible monetary policy which would yield a target for your GNP in 1971." Then you describe it, and how do you describe it? You say "a 6-percent increase of the money stock between 1970 and 1971 would produce the desired 9-percent increase in GNP." You proceed through a few more sentences and then say, "On the basis of an increase of 7.2 percent of money it would be needed to provide an increase of 9 percent in the GNP." Then we find we have had a 6-percent increase plus a very heavy deficit. We also note that the increase rate of the money supply is less than 4 percent at the present time. It seems to me that there is a conglomeration of figures here which is not only confusing to the layman, but not very reassuring to the expert.

If you say that it takes 6 percent for a feasible money supply to bring you up to your projected 9 percent growth of GNP in one page and then you point out from the experience of 1967 to 1969 it would take 7.2 percent and then you frankly say, "Clearly we don't even know what precisely the monetary policy is of 1971 would yield the desired GNP." And you end up finding out right now you have less than a 4 percent money supply increase. I ask you, what kind of reassuring evidence is this that you over here? The fiscal-monetary mix that will produce the results you project—which are not too bright anyway, including a 5 percent rate of unemployment. I really believe this is the Achilles' heel of your whole argument.

The rest of it is based upon very neatly constructed assumptions. The fact is that your evidence reveals that with less than a 6 percent money supply you are not going to get anyplace, and the fact of the matter is you say so. But then you say you need a 7.2 percent money supply increase on the basis of the evidence from 1967 to 1969, and now we look at the solid facts and find out Mr. Federal Reserve actually is giving us less than 4 percent.

What assurance do you have, Mr. McCracken, that the Federal Reserve is going to come up with a 7-percent increase? What assurance do you have even that they would maintain it at 6 percent? Very frankly, may I ask what is the money supply—what is the policy that you need? Would you resolve your dilemmas here more precisely? "We do not know precisely what monetary policy in 1971 would yield this GNP."

I say we are presently at four and you say, "Well, frankly, gentlemen, we don't know." Well, now, if you don't know how in the world can we have a budget or an Economic Report here that makes any sense?

Mr. McCracken. There is a key word in that, Senator: We do not know precisely. What we tried to do in this statement was in effect to raise this question: What does the evidence suggest about the rate of monetary expansion that would be consistent with a $1,065 billion track.

We looked at this in different ways. We looked at some monetary mathematical models and we looked at the experience of the relationship between the money supply and the level of business activity allowing, by the way, for a rather significant lag between changes in the money supply and the visible effect of those changes in the economy.

The point of this arithmetic was this: That there are credible analytical models that would suggest you can get the $1,065 billion—a 9 percent GNP growth—with a rate of increase in the money supply as low as 6 percent. There are others that would suggest a somewhat higher rate. I am not acquainted with any analytical model which would suggest that on a going basis you can have a 9 percent growth of GNP with a 4 percent growth in the money supply.

Senator Humphrey. What is the rate you think you need, Mr. McCracken, in light of your budget? If not precise, what is an educated, carefully thought out percentage figure in money supply?

Mr. McCracken. I would want to respond to that in terms of a range because the fact of the matter is we cannot pinpoint it that precisely, but I would say that any sustained shortfall from the 6 percent would strike me as courting a risk of not making our economic objectives because I don't know of any analytical evidence which would support anything less that that.

Senator HUMPHREY. Thank you.

Chairman PROXMIRE. Before I yield to Senator Javits, let me say to Senator Humphrey that his interrogation I think has been tremendously important and especially to the functioning of this committee.

Mr. McCracken is absolutely right, of course, in his statement that the Federal Reserve Board is independent of the Executive but it is under the Congress, it is under our supervision. We are having Arthur Burns, the Chairman of the Federal Reserve Board, before us on February 19, Friday, and I hope very much you can be here at that time, and this is an indication of how useful this committee can be in trying to get some kind of coordination and coherence in our economic policies, because the administrative branch and the Congress have control, of course, over fiscal policy. It is up to us to exert some real influence on monetary policy, something we haven't done adequately in the past.

Representative REUSS. Mr. Chairman, may I make a unanimous consent request that I and other members be permitted at the end of their colloquies with the witnesses to propound additional written questions so that the Council may answer them, when they correct their transcript for the record.

Chairman PROXMIRE. Yes. Without objection, and I ask Mr. McCracken to respond to those questions when he corrects his transcript for the record.

Mr. MCCRACKEN. We will be glad to do that.

Chairman PROXMIRE. Senator Javits.

Senator JAVITS. Mr. Chairman, I thank you very much.

Mr. McCracken, don't you think that we ought to have the opportunity from you to do something which the administration may not be willing to recommend but which we may think is absolutely essential? If we don't agree with your optimistic forecasts, shouldn't we be equipped with your best expertise as to how we ought to proceed if we believe that the forecasts prospectively which you make of unemployment and inflation are too optimistic?

Mr. MCCRACKEN. We, of course, feel that these estimates are the best estimates that we can make now of what the policy ought to be and what will be attained, but, of course, we always stand ready to consult on any aspect of this problem.

Senator JAVITS. Now, this whole thing, all your forecasts, can go overboard can't they, if you have inflationary settlements in respect of steel and other industries which must be reflected in price?

Mr. MCCRACKEN. The wage-cost aspect of the problem has been one of the very difficult areas to try to make progress. Certainly if we could start to see some evidence that our rates of increase in compensation are beginning to come into line better this would be enormously reassuring in looking at our inflationary problem in the period ahead. I do regard this as the most difficult aspect of the problem.

Senator JAVITS. Do you consider, do you wish us to accept, the way in which you now practice inflation alerts as they relate to wages and prices to be adequate in order to keep the situation on the basis upon which you base your suppositions? Let me see if I can phrase the question better: If we just go along with what you have got in the way of inflation alerts, do you represent to us that that is enough to keep wages and prices in line to the extent that you expect them to be kept in line these forecasts?

Mr. McCRACKEN. The door must always be kept open for new and different ways to deal with economic problems. Over the last year, several steps have been taken which were new. For example, the President last month called in representatives of the construction industry to discuss the very difficult problem that we face in that industry and asked them to come back within a month to make suggestions as to how to get hold of this. Here is an action in a very difficult area of the economy which we have taken very recently.

We have taken certain other actions. The inflation alerts are one of several ways to try to get at this problem.

Senator JAVITS. Do you feel that the 6-percent increase in steel and/or, pick either one, the increase in wage rates from the automobile industry, are consistent with a policy which will sustain your estimates?

Mr. McCRACKEN. I would certainly hope for something better. I would not want to venture an opinion on a specific price or wage situation here as to what would be appropriate or adequate; but I would hope for something better, and we are going to have to be making progress in this area if we finally break out in the open with a more stable cost-price level.

Senator JAVITS. Do you know of any other single item that is more likely to spoil your estimates than wage and price increases?

Mr. McCRACKEN. I think that is very high on the list.

Senator JAVITS. Very high on the agenda.

Under those circumstances, and with the experience it has had, why doesn't the administration recommeend a wage-price board or some other more effective machinery to hold the lid on wages and prices?

Mr. McCRACKEN. There are several ways of trying to get at this problem. The action that was taken in construction was reasonably well tailored to the nature of the problem here.

So far as a general outside wage-price board is concerned, this has been suggested. It has certain advantages. One does have to say that the evidence of experience in other countries is not reassuring, particularly when it comes to the wage side as indicated by what happened, of course, in Canada last year.

But I would want to say that we remain open-minded. I can see no reason to think that the rising tempo of activity in this area by the administration will necessarily stop.

Senator JAVITS. So, Mr. McCracken, you would not necessarily exclude the need for some form of stricter regulation, perhaps a wage-price board even in this very year, in dealing with wages and prices?

Mr. McCRACKEN. I would certainly not exclude other possible ways of trying to get at this problem than the ones that are being used at the present time, and that would include this one.

Senator JAVITS. Well, there is a widespread feeling that the administration, because of the views of the President, will simply not ask for a wage-price board or other tighter controls because the administration just doesn't believe in it. Now, is there anything in the administration's doctrine or philosophic beliefs that you know of that would prevent it from seeking that or a more stringent remedy directly to wages and prices than it has yet sought?

Mr. McCracken. I suppose the administration's basic orientation has been one of a concern about maintaining the vitality and viability of our free economy, and that is a concern which must always be thought through very carefully in a specific action. Of course, ultimately what decisions are made here would be the decision of the President himself.

Senator Javits. I have just time for one other question, Mr. McCracken. Would you tell us what legislation you think we need to pass, as, for example, a manpower training public service employment bill which is on my mind very strongly because of the veto, or some other measure or measures, which would be of the greatest assistance in carrying out these policies and making good these forecasts on unemployment and inflation.

Mr. McCracken. I would not have any comments in terms of specific legislation at this time. But certainly action which can improve the operation of the labor market so that jobs and people can get together more easily would have to be on this list, and other types of actions which might have some effect on market forces that are determining costs and prices would also be on that list.

Senator Javits. Would that include the antitrust laws either in their enforcement or their revision?

Mr. McCracken. Certainly the antitrust laws and any legislation concerned with that sort of agglomeration of power would be on that list.

Senator Javits. I thank the chairman very much.

Chairman Proxmire. Congressman Brown.

Representative Brown. Mr. McCracken, in this business of predicting the economy and reacting to it and trying to take action to stimulate it or restrict it, it seems to me that there is always a timelag from policy to result. I notice for instance with reference to jawboning or moral suasion, as it has been called this morning, we had Mr. Califano of the Johnson administration before us the other day, and he said there was a certain point before that administration where they just simply abandoned jawboning based on the 3.2-percent-increase guidelines because those guidelines had been exceeded by what was happening within the economy, inflation, and it was pointless after that to undertake jawboning on a basis certainly of 3.2 because time had passed that moment by.

President Nixon has been reluctant to take up jawboning and I assume or do I assume properly that the reason for that was that the situation when he came into office was pretty much out of control. Nobody knew quite where he was going to be headed.

Now, that we seem to be having some yielding of the price structure or the inflationary pressures, do I sense properly that he is going to undertake this jawboning with some more vigor? Is that the thrust of your remark?

Mr. McCracken. Certainly, the activity of the administration concerned with developments in specific market problems has accelerated in the last year. The climate and the conditions have changed. When the economy is splitting at the seams, as it was with long inflation, it was unrealistic to expect that much could be done.

Representative Brown. In other words, the psychological factors, plus all the economic factors, were working in the other direction, weren't they?

Mr. McCRACKEN. Both were working in the other direction.

Representative BROWN. Well now, if we follow this assumption that in economics just as in humor or politics timing is everything, let me go back to the question raised by Senator Humphrey with reference to the monetary policy, is there a time when that policy should begin to turn? In other words, how long do you continue expansionary monetary policy in the interests of trying to balance out this very difficult position of stimulating the economy so that we can cut down on the unemployment, and not stimulate it so much that we start setting prices soaring again?

Mr. McCRACKEN. You are touching there, Mr. Brown, on something that is extremely important; namely, the timelag between the change in policy and the effect that we see in the economy from those changes.

I think failure to recognize this has probably been, over the history of fiscal and monetary policy, one of our major problems. Changes in policy can come too late. There is a tendency to want to see in the economy what we are after before policies change; but, of course, that leaves you with the effect of the old policies for quite awhile. The return to the zone of reasonable full employment is ahead of us, so we don't want to slow the growth rate prematurely or to overshoot.

Similarly, in the period of restraint, the question had inevitably to be raised about how long one could pursue policies of restraint before it was appropriate to relax. The one certain thing was that the time to relax would probably be before it looked as if the time had come.

Representative BROWN. Now, with reference to the monetary policy and your ambition to achieve a 9 percent growth in gross national product, a 4.5 percent increase in prices or 4.5 percent inflationary increase, would that indicate that sometime during that growth period, as I gathered, the monetary policy should be, monetary expansion policy should be, slowed?

Mr. McCRACKEN. Sometime down the way the rate of monetary expansion would have to be slowed because we must try to effect this reentry into the zone of full employment rather carefully or we will do what we did last time. We will collide with the economy's productive potential and jar loose our price-cost situtation.

Representative BROWN. To go off to another generalized area, let me just ask you what are the major steps that would be expansionist, that the Government could take and that you could recommend at this time? Are there any expansionist steps which have not been taken which would serve to stimulate our economy? I have in mind, for instance, the fiscal deficit. You have indicated there is a fairly close formula, the full employment budget that you are following in that regard. In monetary expansion you pursue the idea that that is somewhere between 6 percent and 7.2 percent monetary expansion on an annual basis, and in your comments you indicated that what is a historical factor was a current fact that we are also having now a tax reduction which puts more money into the hands of consumers. One of the things that Congress unfortunately didn't get around to last year was the social security increase which would have been expansionist. Are there any other steps which you would recommend in the expansionary area which either the administration ought to take or the Congress ought to take which we are not taking?

Mr. McCRACKEN. I think the basic program which has been put forward, which is given expression in the $229-billion budget, together with a complementary monetary policy, as discussed here, does give promise of realizing this target.

Representative BROWN. Those are the major steps, the tax reductions and the social security, I assume, and the other two would be minor steps. Are there any others that you can suggest that would be major or minor?

Mr. McCRACKEN. The one beyond that I suppose would be housing. But I want to say the program as it is laid out now is all that I would be prepared to support now. We will naturally have to watch this as we go along and we will have to adjust our policies as new evidence comes in.

Representative BROWN. Now, restrictive steps are being taken with reference to inflation, and apparently an increase in jawboning on price and wages increases, and the expansion of imports, the lifting of some quotas is under consideration, is that right?

Mr. McCRACKEN. The question of voluntary restraint program in steel is one that has been in the news recently. These are some of the specific steps and, as we indicate here, where effective action can be taken we will certainly want to take them.

I think very few things would contribute more to realizing these targets than growing confidence in the price level.

Representative BROWN. All right. Now that is the other thing I want to go to. It seems to me we spent very little time this morning just discussing what may be a very important factor in this whole picture, both ways, both with reference to inflation and with reference to the stimulation of business. And that is the matter of confidence, the psychology of inflation, the psychology of not investing in capital goods, or not developing business expansion plans. Quickly, if you can respond to this, how important is consumer confidence, how do we establish it both for the benefit of the economy in these areas of inflation and business expansion, jobs, and what is your future assessment of it?

Mr. McCRACKEN. First, I consider that changes in consumer sentiment or confidence are important in determining consumer demand. For some years I had a slight association with the survey research center at the University of Michigan, and there is a good deal of empirical evidence that consumer spending is responsive to these changes.

When we come to the question of what are the influences which bear on consumer sentiment we are a little more in the area of conjecture. We can measure changes in sentiment, but it is not quite so easy to try to identify the forces which determine these changes. But one of the factors, at least historically, that has had debilitating effect on consumer confidence has been uneasiness about the price level. In other words, growing concern about inflation does not lead people to spend more. This conclusion may seem strange, but it tends to reduce their inclination to buy. This is not so irrational as it sounds because the explanation seems to be that the most important items, the big items require borrowing, and people don't want to commit themselves for future payment.

The most important thing is, through basic policies, to start getting the economy moving up and as people start to have a little more confidence in the basic job situation, the unemployment rate starts to edge downward instead of edging upward, these things can make their contribution.

Representative BROWN. Perhaps optimism by the Council of Economic Advisers might be beneficial. Thank you, Mr. Chairman.

Chairman PROXMIRE. Mr. McCracken, it is past 11 o'clock now so I think we can discuss the fact that we are told that the unemployment rate last month in January was 6 percent. We are now told at the same time that the unemployment rate has been revised to a 6.2 percent level in December.

Now, it is my understanding that the 6.2 percent should be further corrected to allow for the impact of the GM strike. One newspaper reported that the estimate of the administration on the effect of the GM strike on unemployment was about four-tenths of a percent. If this is correct, I mean if you correct that 6.2, that absent the GM strike you would have had about a 5.8 percent unemployment in December, and a 6-percent unemployment in January, unemployment is high still at 6 percent, perhaps it is rising if we have a full analysis of what has happened. What would your view be of this?

Mr. MCCRACKEN. The trends in the unemployment picture are very complex at the present time. The unemployment rate, as you have indicated, declined from a revised figure of 6.2 percent in December to 6.0 percent in January. On the other hand, if you look at the unemployment rate based on unemployment compensation data you will find that figure dropped in December and it dropped again in January. This is not a drop which seems to be explained by such things as you are talking about.

We do have to bear in mind that it is not unusual for the unemployment rate to reach its apex somewhat after business activity itself starts to rise because in the early stages you get very heavy gains in productivity and, consequently, you get gains in the economy which are not paralleled by a corresponding rise in employment.

Chairman PROXMIRE. Let me——

Mr. MCCRACKEN. May I make one further comment.

Chairman PROXMIRE. Yes, please.

Mr. MCCRACKEN. We estimated, I think this was for November, that as much as a half percentage point of the unemployment rate at that time might be the GM strike.

Chairman PROXMIRE. How much in December?

Mr. MCCRACKEN. I simply don't have that figure. It would be less.

Chairman PROXMIRE. Would it be fair overall to assume then that unemployment is about the same, absent the GM strike in January as it was in December seasonally corrected? Of course it's gone up by 780,000 people more out of work, as you know.

Mr. MCCRACKEN. It would look as if that figure was essentially unchanged now. The decline in unemployment compensation rate would be lower.

Chairman PROXMIRE. There has been some reference again, I don't want to labor this point because we have discussed it, but I want to go back to the point that you seem to be all alone and all out of step with the other economists who have been estimating what is going to be happening to the economy. I have 31, Senator Miller picked up Robert Turner of Indiana who estimated $1,070 billion, but he estimated a lower real growth and a higher inflation. Nobody comes to the growth that you estimated. He estimated a growth of only 4.3 percent, so once again you seem to be really out by yourself, everybody is out of step except the Council, it would seem, and I just feel that you are taking the attitude that was taken by Mr. Pangloss as you will recall in Voltaire's Candide when no matter what happened, you might say, no matter how bad unemployment is or inflation is but you say it is all for the best in the best of all possible worlds. It is hard for me to accept this notion that you can come up with an estimate which does serve the political interests of the administration and, at the same time, does seem to be so far out of keeping with what other economists have estimated.

Mr. McCRACKEN. In the first place, the $1,065 billion constitutes what, in our judgment, ought to be the target toward which fiscal and monetary policies ought to be managed.

Chairman PROXMIRE. As a target it is one thing but I understand you think this is an expectation.

Mr. McCRACKEN. If we manage our fiscal and monetary policies well we have a reasonable expectation of getting it.

Chairman PROXMIRE. In your response to Mr. Brown, you indicated that you thought that there were elements in this budget which were particularly expansionary. What concerns me is that it represents an increase of about $17 billion in expenditures. Of those $17 billion, which is about an 8-percent increase, 5 percent is accounted for by inflation, only about 3 percent by growth in real terms, and yet you expect this to have the kind of stimulating effect you have described. How do you justify it?

Mr. McCRACKEN. I would justify that on the grounds that when you take an account of the 8-percent thrust on the expenditure side and about another percentage point on the revenue side that fiscal policy is moving in step with the 9-percent growth in the total economy that we want, and that we have laid out as the objective for policy.

Chairman PROXMIRE. But the actual stimulation in real terms, really corrected for inflation, is only about a 3-percent stimulation.

Mr. McCRACKEN. The $1,065 billion is in terms of current prices.

Chairman PROXMIRE. Well, I realize that, I am afraid so much of it is going to be inflationary.

I just don't feel, as chairman of this committee, that I should let you get away with not giving us the figures you have always given us in the past, the breakdown of what the gross national product is composed. You didn't tell us in answer to my questions, didn't tell us in the report, you didn't tell us in the statement what this increase is going to mean in terms of personal consumption, in terms of fixed purchases, the principal ingredient of the gross national product. If you cannot tell me that now, and perhaps it is unfair to ask you just off the cuff to give the precise estimates which would be very important to the country, will you do that when you correct your remarks so that we can have it in the next few days because without this kind of breakdown it is very hard for this committee to make a responsible analysis of its own.

I hope you will give us those specific figures.

Mr. McCRACKEN. We shall see what we can do.

(The following information was subsequently supplied for the record:)

FEBRUARY 5, 1971.

Hon. PAUL W. McCRACKEN,
Chairman, Council of Economic Advisers,
Executive Office of the President, Washington, D.C.

DEAR MR. McCRACKEN: As I indicated at the hearing this morning, the Committee attaches considerable importance to obtaining the Council of Economic Advisers' 1971 forecast in greater detail. In view of the divergency between your forecast and the predominant private forecast, it is difficult to evaluate the outlook objectively in the absence of more information. In particular, we would like to have you supply your best estimates of the 1971 average for the major components of Gross National Product, including personal consumption expenditure, fixed nonresidential investment, residential investment, inventories, Federal purchases, State and local purchases, and net exports.

We would be grateful if this information could be supplied promptly so that the Committee and the Committee staff can have it available as we proceed with our evaluation of the outlook.

Other questions which the Committee members may wish to submit for the record will be forwarded to you within a few days. Let me add my thanks for your fine testimony this morning, and for the cooperation we can always count on from the Council.

Sincerely,

WILLIAM PROXMIRE,
Chairman.

CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS,
Washington, February 12, 1971.

Hon. WILLIAM PROXMIRE,
Chairman, Joint Economic Committee, Congress of the United States, Washington, D.C.

DEAR SENATOR PROXMIRE: You have asked that we supply estimates of the major components of the $1,065 billion gross national product that we have projected for 1971, and I am glad to respond. First, however, I would like to make some general observations that may be helpful in interpreting them.

Some of the questions raised have seemed to imply that the GNP can be reliably forecast only by separately forecasting and adding up a number of components, or at least that the validity of a forecast for total GNP can be tested only by the plausibility of the estimates for the components. These are very doubtful propositions.

Many forces operate upon the economy and determine its total level and composition. For some of these forces we are better able to predict the effect on the total than the distribution of these effects among the components of GNP. This does not mean that the total effects are unreal or mysterious or that they will not in the event be distributed among the components. It only means that to know the distribution we would need additional information that we may not have. The relation between changes in the money stock and changes in GNP is of that character. We are more confident of the effect of changes in money on the total GNP than of the distribution of those effects among components, while recognizing of course that the effects on the total will be seen in the components.

On the other hand there are forces whose effect on some component of GNP may be fairly clear but whose effect on the total is obscure. For example, one might be confident that an increase in the rate of family formation would increase residential construction. However, the effect on total GNP, if any, would depend on a chain of developments including effects on interest rates, savings, business investment and the demand for money. The use of more savings to finance mortgages, for example, might mean reduced financing for State and local construction or business investments.

In these circumstances it is easily possible that an estimate of GNP made by adding up independent estimates of components would be less reliable than an estimate of the total made without regard to components. This does not mean that one approach should be used to the exclusion of the other. It does mean that such information as we have about particular sectors must be interpreted in the light of information about influences operating upon the level of total economic activity. We try to do this in our continuing work at the Council. In the Economic Report we briefly reviewed the conditions in the main sectors of the economy and concluded that while they supported the expectation of an advance in the economy they did not suggest the probability of a sufficiently strong spontaneous advance to achieve the goals of economic policy without strong support from fiscal and monetary policy.

We did not present a breakdown of the $1,065 billion GNP projection, although we could easily have done so, because our position with respect to the total is different from our position with respect to the components. The $1,065 billion GNP for 1971 is, in our view, the target for the economy which is consistent with national requirements and the equipments of the Employment Act. It is the probable outcome because the Government will follow policies aimed at achieving it. The Government does not have targets of the same importance and specificity with respect to the composition of the GNP and will not be following policies aimed at achieving some precise composition of the GNP. Therefore, there is no particular composition of the GNP which has the same probability as the total. How the GNP will be distributed among its components will depend upon the propensities of the private sector as well as upon details of Government policy.

In the table below we present an estimate of a composition of the GNP in 1971 that would be consistent with a total of $1,065 billion achieved by the combination of spontaneous forces, the President's budget and a complementary monetary policy. We emphasize that this is not the only possible composition that would yield $1,065 billion.

GNP, BILLIONS OF DOLLARS

	1970	1971 estimate
Total	$976.5	$1,065
Business fixed investment	102.6	106
Residential construction	29.7	41
Inventory change	3.5	8
Net exports	3.6	4
Federal purchases	99.7	98
State and local purchases	120.9	135
Personal consumption expenditures	616.7	675

The 1971 estimates may be briefly explained:

The estimate for business fixed investment is about $2 billion higher than would result from literal application of the 1-½% increase from 1970 to 1971 reported in the most recent Commerce-SEC survey of business intentions. This $2 billion is intended to allow for the catch-up of business purchases of automobiles and trucks, the effects of the depreciation reform, and the adjustment of plans to a faster rate of economic expansion than was commonly forecast when the survey was made.

The estimate for residential construction implies starts of 2 million houses in 1971, continuing the strong upward trend begun in 1970 and reflecting the large increase in funds available to finance housing.

The increased rate of inventory accumulation for the year as a whole incorporates some make-up after the auto strike and an adjustment to the projected rate of economic expansion.

The net export figure is held unchanged.

Federal purchases are based on the President's budget.

State and local purchases rise more rapidly than in 1970 because of an extraordinary increase in Federal grants, the improvement of the economy which raises the State and local revenues and the easing of credit conditions.

Personal consumption expenditures are derived from an estimated personal savings rate of 6.9% in 1971, which is reduced from the 7.3% rate of 1970 because of improving economic conditions and consumer confidence, rising consumer assets and liquidity, the effect of high residential construction on purchases of furniture and household equipment, some catch-up of automobile purchases deferred because of the 1970 strike and other factors. However the estimated 6.9% saving rate is still higher than in any year of the 1960's except 1967.

All of these estimates require judgments about matters that are inevitably uncertain. I would only emphasize, repeating what was said earlier, that disagreement about one or another component does not necessarily imply disagreement about the total GNP, since there are many possible sets of components that would yield the same total.

Sincerely yours,

PAUL W. MCCRACKEN.

Chairman PROXMIRE. Now, you have given us some analysis of the effect of defense spending on the economy, the first time in a long time. You confined it, however, to six pages in the report and in those six pages to the effect of the slowdown of the war on employment. You attribute 1.1 million unemployment increase in 1971 to the war slowdown. Now, it seems to me that this administration should have been able to do more than just give us a historical record in view of the fact the President told the country again and again and kept to his promises how much we were going to wind down the war, withdraw our troops, discharge people from the milltary, cut down on defense contracts. We ought to have had some, we should have had some, plan for putting these people to work. As you recall after World War II, 13 million men were discharged, defense spending dropped over $70 billion, and we had very little unemployment. Now, it is true at that time we had pent-up demand but we have pent-up demand now, if we can find a way through Government leadership of providing jobs in those areas of pent-up demand. We certainly have it in housing, in health services, in pollution control, in rebuilding central cities, in cities' services, and so forth, but where is the administration program to provide the people who have been laid off and are going to be laid off in defense to find these kind of constructive jobs other than a vague notion that monetary and fiscal policy will take care of them, which it certainly didn't last year.

Mr. McCRACKEN. The figures that we give on the employment impact of the cutback on defense spending pertain, of course, to the total change during the 3-year period, fiscal years 1968 through 1971.

Chairman PROXMIRE. No. I was referring to 1970, I have gone over those figures four or five times because I had an argument with my staff on it and I am referring to the 1.1 millon figure, is that correct?

Mr. McCRACKEN. During 1970; that is correct, I was looking at another figure.

Chairman PROXMIRE. All right.

Mr. McCRACKEN. The total unemployment problem is, of course, a combination of both trying to come to grips with the general problem of inflation and at the same time the specific problem of unemployment in defense. This was more than an ordinarily difficult problem because it occurred at the same time we were trying to relieve the pressure on the economy. If the unemployment had been spread a great deal more evenly over the economy, it would have been easier.

On the other hand, a great deal was done. The Department of Defense had a substantial amount of manpower training programs to returning veterans.

Chairman PROXMIRE. Can you give us specifics for the record of how many they have trained, how many have found jobs after the training, and so forth?

Mr. McCRACKEN. I will be glad to see what can be done on that, Mr. Chairman.

Chairman PROXMIRE. That is the kind of information we would like to have because it is my impression that there was very little of that when you consider the fact that we knew this was going to happen. It was predicted well by you last year and by the President.

Mr. McCRACKEN. Well, I will be glad to see what can be done about that.

Chairman PROXMIRE. Will you do that right along the line in all of these other areas, Department of Defense or any other agencies of the Government?

Mr. McCRACKEN. Yes.

(The following information was subsequently supplied for the record:)

Department of Defense related manpower retraining programs are as follows:

A. Project Transition:

This includes over 200 programs on different military bases, each of which has three functions:

1. To counsel returning veterans (job market information)—800,000 have been counseled since the Project's inception in January 1968.
2. To provide skilled training for these veterans—approximately 150,000 have received training thus far.
3. To provide job placement for these veterans—data are not available here as the response to post-training questionnaires has been small.

B. Jobs for Veterans Program:

This program is designed to promote better use of existing avenues of job placement. It includes no training, but does solicit by mail the pledges of employers to hire returning veterans.

C. Referral Program:

This is a computer job-matching project for service retirees. People who plan to retire from the service can submit their résumés which are sent to industry on the basis of job vacancy information submitted by industry. Since it began in June 1970, this project has sent 22,000 résumés to various industries.

Chairman PROXMIRE. Now, if I have time, I would like to get into another area.

Representative BROWN. Mr. Chairman, would you yield on that point you just made for an observation?

Chairman PROXMIRE. I ask unanimous consent not to take it out of my time.

Representative BROWN. One of the things which has occurred to the veterans returning from the Vietnam war is very low-rate utilization of GI opportunities in the educational field which this Congress and this administration and previous administrations and Congresses have provided for them; and it seems to me we would serve the current situation well if we could figure out some method to encourage more utilization of the GI bill of rights education benefits for those men, both for them now and, the situation now and, in the long run for this country.

Chairman PROXMIRE. My time is about up. I would like to ask one other question. The heart of an effective anti-inflationary program consistent with expansion of the economy, it seems to me, is improvement in productivity. This it seems to me is exactly what we have not gotten. It's been very disappointing. These have been predictions in early 1970 that productivity was improving and increasing. The facts seem to point in the opposite direction. The average increase in 1970 over 1969 was only six-tenths of a percent and in the fourth quarter of 1970 it was a minus nine-tenths of a percent in productivity. In other words, we are not getting the kind of productivity increase even allowing for the General Motors strike.

It seems to me we are far below what we need. The traditional increase, historical increase, in productivity has been about 3 percent. Now, if we do not get this, then it seems to me we are in very difficult circumstances because the only way we get expansion of GNP is through very serious inflation. What is your response there? What encouragement can we find that we are moving in the direction of improved and increased productivity in view of the disappointing record of 1970?

Mr. MCCRACKEN. If one looks at the 1970 picture in terms of productivity, the quarterly pattern is as follows: We had a decline in productivity at the rate of 2.9 percent per year in the first quarter, a rise at the rate of 3.9 percent in the second, 4.5 percent in the third, and then a decline, a modest decline, 0.9 percent, in the fourth. This, by the way, is in the nonfarm private sector figure. It will vary a little bit depending upon what sector we are using.

Both logic and juxtaposition of the figures here would suggest that the automobile strike played a major role in that reversal of productivity in the fourth quarter.

Chairman PROXMIRE. After all, this is a nine-tenths drop. It could have played a big part and you would still have a very disappointing record for the whole year and a very disappointing trend in the last quarter.

Mr. MCCRACKEN. But we did have a very good gain here in the second quarter and again in the third quarter, and so it is the 0.9 percent drop which was out of step with the data, and it is, I think, quite reasonable to expect that this is going to look better after the strike.

My guess is that we are going to see some fairly sharp gains in productivity if we get the kind of economic expansion we are talking about because output per man-hour is output oriented and the most important thing we can get here is a strong gain in productivity—a strong gain in output in order to get a strong gain in output per man-hour.

Chairman PROXMIRE. We should get it but we are not getting it. My time is up. Thank you.

Congressman Conable.

Representative CONABLE. Thank you.

Mr. McCracken, the chairman has alluded several times to the unduly optimistic projections of the gross national product serving the political aims of the administration. I don't want to appear argumentative but I wonder if it would be your idea of a good political strategy to make a big mistake now 2 years in advance of a general election. It seems to me that would be a particularly poor strategy that if that is your motivation in an optimistic report.

Isn't it true that one of your serious problems is the credibility of the Government, certainly when you are dealing with a distant election?

Mr. MCCRACKEN. Well, I can certainly say that my recommending $1,065 billion as the objective was not political. Our interest in this as an objective of policy was just that. Taking into account the state of the economy, it represents what needs to be done by way of gains in output and employment. This represented the kind of optimum figure that was as high as it was realistic to go without courting excessive risks on the inflationary front.

My political colleagues must evaluate its political implications. This is a bona fide target or objective for economic policy.

Representative CONABLE. I think this whole area is one of concern to Members of Congress. We are aware that psychology does play a large part in the economics of a free market economy, and looking at the whole issue of jawboning about which Mr. Brown cross examined you, we recall in John Gardner's "No Easy Victories" his reference to the fact that an anthropologist friend of his studied the Zuni Indians and came up with the conclusion that the rain dance didn't bring the rain but made the tribe feel better. Now we are aware making the tribe feel better is one of the functions of leadership, but that if you have the rain dance eight times and don't get any rain after awhile there is a reduction in the marginal pleasure for the tribe in repetition of the formula. While I am sure the administration wants to encourage confidence of the economy it is aware of the fact that there has to be somewhere some good performance. Is that an accurate analysis of the role of psychology here in the process?

Mr. McCRACKEN. I certainly agree.

Representative CONABLE. Well, now, what about the business of consumer saving at this point, is the rate of saving continuing to rise or has it leveled off? How much relationship does this bear to an expansionary monetary policy? As a layman, I don't quite understand whether there is a complete tradeoff between the rate of saving and the need for an expansive monetary policy.

Mr. McCRACKEN. The saving rate averaged 7.3 percent last year, which was high, of course, by historical standards although not a peak. It was 7.4 percent in 1967. Through the year it was as low as 6.7 in the first quarter and as high as 7.6 in the third quarter. It dropped a little in the fourth.

I would expect a fairly high savings rate during a period when measures of consumer sentiment and—consumer confidence—were fairly cautious. I think it is reasonable to expect some tendency for the savings rate to assume a more normal or average level as the economy starts to stabilize and move upward, and this will then, in turn, help to carry along the expansion.

Representative CONABLE. How direct a relationship is there between the need for monetary expansion and the rate of saving? There is some tradeoff obviously. If there is a high rate of saving, conventional sources are available for the financing of mortgages, for instance. If there is a high rate of saving it obviously has something to do with the available capital resources in the country.

Is there any rule of thumb that we can apply here? If the rate of savings stays very high, is it likely to require a less expansionary monetary policy or more expansionary monetary policy on account of the Fed?

Mr. McCRACKEN. The evidence here would be rather inconclusive as to what efforts to make. One can argue that with savings providing more of the flow of funds to potential borrowers, the rate of monetary expansion might need to be less.

One could also say that this higher saving rate is an indication that people want to hold more money, more of their resources in liquid assets, and it ought to be the objective of public policy to provide those liquid assets, provide these funds for money that people want to hold.

The evidence is a little unclear, but I would not in this context want to rely on an unusually high assumption about the velocity of money in order to assure the expansion we want.

Representative CONABLE. May I ask Mr. Houthakker if he expects continuing improvement in the balance of trade or if in their respect other factors than relative rates of inflation are likely to become dominant?

Mr. HOUTHAKKER. As we said in our statement today, we do not expect much improvement in the balance of trade. There are two offsetting factors. One is that our price performance appears to be somewhat better than that of the rest of the world. With all the differences it is not very significant. On the other hand, we are projecting a considerable expansion of the economy which by itself would tend to reduce the trade balance so right now the best we can foresee is a fairly small reduction in our trade surplus, 1971 compared to 1970.

Representative CONABLE. You are recommending extension of the interest equalization tax, are you not?

Mr. HOUTHAKKER. I am afraid I have to defer that question until the Secretary of Treasury comes here.

Representative CONABLE. I see, all right. Thank you.

Chairman PROXMIRE. Congressman Brown.

Representative BROWN. Mr. McCracken, you made a reference or, as a matter of fact, several references, this morning to the circumstance of 1957–58 when we experienced a somewhat briefer but sharper decline in the economy, and you indicated that the reduction in the increase in the rate of inflation didn't really begin to occur until the economy was on the way up. During that time when the economy was on the way up, the rate of increase in the gross national product, how did that compare to the projected growth in the GNP which you included in your figures for this year?

Mr. MCCRACKEN. In money terms, the rate of increase in the gross national product might have been slightly less, but it was, I think, fairly comparable with what we are talking about here. I would be glad to supply the precise figures for the record if that would be helpful.

(The following information was subsequently supplied for the record:)

From the first quarter of 1958 to the first quarter of 1959, GNP rose 9.0 percent.

Compare rate of increase in GNP starting with expansionary phase in 1958 with projected expansion for 1971 (fourth quarter to fourth quarter without adjustment for the strike).

[In percent]

	58 II–59 II	70 IV–71 IV
Real, GNP	9.2	7.5
Money, GNP	11.1	11.7

Representative BROWN. And relative price stability was accomplished then in what period of time during that experience?

Mr. MCCRACKEN. By the latter part of 1958, as I recall it, the price level had pretty well established its stability. I think by the latter part of 1958.

Representative BROWN. In the colloquy you had earlier on the matter of pollution, I have read over that section and tried to find you writing the Magna Carta in favor of pollution and with all your other sins I didn't want to let you off the hook on that one, or all the other implied sins, but I just don't find the concern in there.

It seems to me what you are saying in effect is that the cleanup of pollution is going to cost industrial nations money, isn't that about it; and that there are some nonindustrial nations which may opt in order to industrialize for the option that apparently this and other nations took in recent history of going ahead and polluting as a means of diffusing the costs of the developments of their industrial economics but that we are living in a more critical time now when, to permit other nations to pollute, has a more direct adverse effect on us both economically and in the ecological areas. As I read your final statement, you are calling, in effect, for some kind of international understanding to defer this adverse ecological and economic effect by trying to control the degree of pollution in the world. Is that unfair, am I giving you virtue that you don't have in that?

Mr. McCRACKEN. No, I think that is stated very well. Our basic concern was just that, that having regard for our environment, the cleanup of pollution in the rivers and air, is going to involve a substantial commitment in the way of economic resources. We need to be aware of these things and to use our resources so that we commit in this direction as effectively as we can.

Representative BROWN. Now the cleanup of pollution, where it may be an additional economic cost to a product, in other words, to keep a steel mill from polluting may actually add to the cost of a ton of steel. From that point I would like to switch to what I consider the economic benefit area and that almost surely is the area of transportation. It seems to me that investment made in transportation or anything that reduces the cost of transportation and increases its efficiency has a distributable economic benefit over the whole economy. Would you concur?

Mr. McCRACKEN. Yes, I would.

Representative BROWN. Would you comment in some—well, let me phrase the question this way: You suggested in your section on transportation that we may get economic benefit from the deregulation of transportation or relative deregulation of transportation so that the forces of competition lower the rates, lower the costs of transportation nationally; but you mention, I think, natural gas where these costs have been held down by tighter regulation.

Are you really saying that we should deregulate or are you saying we should regulate better? That is my question.

Mr. McCRACKEN. The language that we used in the case of natural gas was that it was important that the price be closer to a market clearing level because if the price is held substantially below that we naturally both encourage the use of this resource and tend to discourage exploration to increase supply.

In the case of deregulation—or, to put it differently, in the case of the problems we had in surface transportation—certainly, we would all agree that we have substantial problems. There are significant areas where the price has been different from the social costs and this has produced certain distortions in the pattern. The problem of trying to rationalize this is not a new one. The solution might be found in the direction of better regulation, it might be found in the direction of deregulation, or it may be found in some combination.

Representative BROWN. Let me suggest just one other thing in this connection, and that is that, in view of the delicacy and the depth of those problems which you outline in the transportation area, that before we deregulate perhaps we should achieve some better balance among the modes in the regulation because, it seems to me, if we deregulate roughly it is sort of like throwing the farmer into a free market economy—you have an ultimate benefit for society in a generalized sense but you may in the process have abruptly terminated the successful operation of some people who have learned to lean on the process which Government has imposed on them—in this case regulation; and it seems to me we have such a series of delicate problems in the transportation area we ought to be careful.

I want to get back into one other area in the hopes we might establish some confidence in our economy that can be developed from it and that is this increase in savings on the part of the individual.

The consumer who perhaps from the standpoint of the economy and employment is saving more now than we would like to have him save because right now we would like to have him out there spending it to put some of that 6 percent back to work; but even like the 6 percent unemployment the Chairman mentioned where the rate has, the rate of increase in unemployment has now leveled off, which seems to me to be a very good sign, we can gain some comfort from the fact that this increase in savings makes the average citizen much less—puts him in much less position of hazard for the current economic circumstance if his job becomes jeopardized or his hours decrease. The average citizen is in a better position to sustain himself and activity of the economy in the face of such occurrence, isn't that correct?

Mr. McCRACKEN. Yes, I agree, it is an important aspect of economic security.

Representative BROWN. So, really, we are in a better position in this regard than we were some months ago when that savings rate was quite low. You indicate that we have developed over this recent inflationary psychology period a tendency for the average person to be on a pretty slender thread economically. Is there some index of the improvement of that situation that you can give?

Mr. McCRACKEN. One could assemble the statistics on liquid savings held by individuals. That would be one possiblity. The reduction or any change one way or the other in their debt position would be another. Yes, I shall supply some information on that.

(The following information was subsequently supplied for the record:)

SELECTED LIQUID ASSETS HELD BY THE PUBLIC, 1946–70 [1]

[Billions of dollars, seasonally adjusted]

End of year or month	Total	Demand deposits and currency [2]	Time deposits: Commercial banks [3]	Time deposits: Mutual savings banks	Postal savings system	Savings and loan shares	U.S. Government savings bonds [4]	U.S. Government securities maturing within 1 year [4]
1946	239.1	108.5	33.9	16.9	3.3	8.5	48.6	19.4
1947	246.2	112.4	35.3	17.8	3.4	9.7	50.9	16.6
1948	254.1	110.5	35.9	18.4	3.3	11.0	53.4	21.6
1949	262.1	110.4	36.3	19.3	3.2	12.5	55.0	25.5
1950	271.4	115.5	36.6	20.1	2.9	14.0	55.8	26.4
1951	281.0	120.9	38.2	20.9	2.7	16.1	55.4	26.8
1952	296.0	125.5	41.2	22.6	2.5	19.2	55.7	29.3
1953	311.5	127.3	44.6	24.4	2.4	22.8	55.6	34.4
1954	320.3	130.2	48.2	26.3	2.1	27.2	55.6	30.6
1955	332.5	133.3	49.7	28.1	1.9	32.0	55.9	31.6
1956	343.2	134.6	52.0	30.0	1.6	37.0	54.8	33.2
1957	356.0	133.5	57.5	31.6	1.3	41.7	51.6	38.8
1958	373.1	138.8	65.4	33.9	1.1	47.7	50.5	35.6
1959	393.9	139.7	67.4	34.9	.9	54.3	47.9	48.8
1960	399.2	138.4	73.1	36.2	.8	61.8	47.0	41.9
1961	424.6	142.6	82.5	38.3	.6	70.5	47.4	42.6
1962	459.0	144.8	98.1	41.4	.5	79.8	47.6	46.8
1963	495.4	149.6	112.9	44.5	.5	90.9	49.0	48.1
1964	530.5	156.7	127.1	49.0	.4	101.4	49.9	46.1
1965	573.1	164.1	147.1	52.6	.3	109.8	50.5	48.6
1966 [5]	601.5	168.6	159.3	55.2	.1	113.4	50.9	53.9
1967	650.4	180.7	183.1	60.3		123.9	51.9	50.5
1968	709.6	[6] 199.2	203.8	64.7		131.0	52.5	58.5
1969	731.8	206.8	197.1	67.3		135.0	52.4	[7] 73.2
1970 [8]	785.0	207.6	233.7	71.2		146.0	52.7	73.8

See footnotes at end of table, p. 47.

SELECTED LIQUID ASSETS HELD BY THE PUBLIC, 1946-70 [1]—Continued

[Billions of dollars, seasonally adjusted]

End of year or month	Total	Demand deposits and currency [2]	Time deposits: Commercial banks [3]	Time deposits: Mutual savings banks	Postal savings system	Savings and loan shares	U.S. Government savings bonds [4]	U.S. Government securities maturing within 1 year [4]
1969: January	703.7	188.8	203.4	64.8		131.0	52.5	63.4
February	705.7	189.9	202.9	65.2		132.0	52.3	63.4
March	713.2	192.4	201.9	65.5		133.4	52.2	67.7
April	711.3	190.8	201.8	65.7		133.3	52.2	67.5
May	714.4	191.6	202.7	66.1		133.6	52.2	68.3
June	713.9	194.2	200.4	66.3		133.7	52.2	67.3
July	709.6	[2] 191.9	197.5	66.3		133.7	52.2	68.1
August	713.3	193.3	195.6	66.4		134.2	52.1	71.6
September	718.2	194.1	195.5	66.6		135.4	52.0	74.6
October	715.1	193.9	195.7	66.7		135.0	52.0	71.7
November	722.2	195.8	197.9	67.0		135.4	52.0	74.2
December	731.8	206.8	197.1	67.3		135.0	52.4	73.2
1970: January	720.6	195.4	196.0	67.0		133.7	52.2	76.3
February	722.0	194.8	196.7	67.4		134.3	52.1	76.6
March	733.7	199.3	198.8	67.5		135.9	52.0	80.1
April	731.4	196.7	201.5	68.0		136.5	52.0	76.8
May	734.1	197.9	201.7	68.4		137.0	52.0	77.2
June	738.7	199.8	202.9	68.7		137.6	52.0	77.7
July	749.9	198.7	211.8	69.2		139.2	52.4	78.5
August	751.1	199.3	215.4	69.4		140.3	52.0	74.6
September	765.6	203.6	221.5	69.9		142.4	52.1	76.0
October [8]	764.7	199.6	224.5	70.4		143.5	52.1	74.5
November [8]	773.7	201.2	230.3	70.9		144.8	52.2	74.3
December [8]	785.0	207.6	233.7	71.2		146.0	52.7	73.8
1971: January [8]	785.8	201.7	239.6	71.2		148.6	52.8	71.9

[1] Excludes holdings of the U.S. Government, Government agencies and trust funds, domestic commercial banks, and Federal Reserve Banks. Adjusted wherever possible to avoid double counting.
[2] Agrees in concept with the money stock, table C-52, except for deduction of demand deposits held by mutual savings banks and savings and loan association. Data are for last Wednesday of month. Data prior to July 1969 have not been revised to conform to the money stock revision.
[3] Time deposits at all commercial banks other than those due to domestic commercial banks and the U.S. Government (same concept as in table C-52). Data are for last Wednesday of month, except that June 30 and Dec. 31 call data are used where available.
[4] Excludes holdings at Government agencies and trust funds, domestic commercial and mutual savings banks, Federal Reserve Banks, and beginning February 1960, savings and loan associations.
[5] Effective June 1966, balances accumulated for the payment of personal loans (about $1,100,000,000) are excluded from time deposits at all commercial banks and from total liquid assets.
[6] Estimates for Tuesday, Dec. 31, rather than last Wednesday of December.
[7] Beginning 1969, data have been adjusted to conform to the new budget concept.
[8] Preliminary.

Source: Board of Governors of the Federal Reserve System.

Representative BROWN. There has been a substantial decrease in the amount of accumulated consumer debt, hasn't there?

Mr. MCCRACKEN. That is right.

Representative BROWN. My time is up.

CHAIRMAN PROXMIRE. Well, I would just like to say, Mr. McCracken, before we are through, and I want to thank you so much for your patience and your efforts to respond to us this morning, I would like to once again emphasize as strongly as I can that unless you are able to give us a breakdown in this increase in gross national product which is out of step with what every other economist predicts, the skepticism in the Congress and the country is going to grow that the administration is making too optimistic an estimate, and I think there would be far less faith in our policies because you failed to give us the analysis that has always been given to this committee in the economic report before us.

So I hope you will give us the consumption figures, the investment figures, the governmental purchases, all broken down by the categories we have had before.

One other concluding point, I think I must say that this six percent unemployment figure is not only disappointing both in human terms and under the terms of the employment act that gives this committee its charter, but is just plain unacceptable if not intolerable.

Mr. McCracken. I agree with you.

Chairman Proxmire. I want to thank you once again very much. The committee will stand in recess until Tuesday morning at 10. Unfortunately, on Monday, Governor Connally will not appear because he will not have been confirmed at that point by the Senate. We will have no session on Monday. On Tuesday, we will have hearings with Mr. Shultz, director of the Office of Budget and Management.

Mr. McCracken. Thank you.

(Whereupon, at 1:05 p.m., the committee recessed until 10 a.m., Tuesday, February 9, 1971.)

(The following information was subsequently supplied for the record:)

Response of the Council of Economic Advisers to Additional Written Questions Posed by Representative Reuss

Question 1. On page 6, an 8.2 percent rise in Federal spending is added to tax changes equal to 1 percent of GNP to obtain a 9.2 percent stimulus. This seems inconsistent. Wouldn't the proper procedure be to take ⅕th of the 8.2 percent and add it to the 1 percent to yield a stimulus of 2.6 percent? After all, Federal spending is only about ⅕th of GNP and this must be considered in calculating fiscal stimulus *or* have you assumed a multiplier of 5 to 1?

Answer. The statement on page 6 regarding the Federal Budget was not meant to imply that proposed expenditure increases and tax cuts between calendar 1970 and 1971 would cause a 9.2 percent rise in GNP over the same period. Both the rise in expenditures and scheduled net reductions in taxes will provide a stimulus to the economy insofar as economic activity in 1971 would be lower in the absence of such stimulus. These were described as "an independent budget stimulus of about 9.2 percent."

As indicated on page 7 in connection with the full employment surplus the proposed budget will permit the economy to expand at about the same rate at which the potential of the economy is rising. Monetary policy is expected to provide the additional thrust needed to reduce the gap between actual and potential output.

Question 2. On page 72 of the Economic Report emphasis is placed on *changes* in the full employment surplus as an indicator of fiscal stimulus. On page 7 of your statement you say that the full employment surplus in calendar 1971 will be the same as in calendar 1970. Thus you seem to be saying there is no fiscal stimulus or very little. But on page 6 you suggest a large fiscal stimulus. Which is right? Why?

Answer. As noted in the Appendix to Chapter 1 of the *Economic Report,* changes in fiscal policy can be measured in a number of ways, and it cannot be said that any one method is "more right" than any of the others. The suggestion of a large fiscal stimulus on page 6 of the *Report* refers to the result of discretionary fiscal actions by the Government, that is to say, changes in expenditures and changes in tax legislation. In 1971 such policy actions will have an expansionary impact on balance.

The full employment surplus concept not only considers the effect of discretionary policy actions, but it also includes the automatic growth in tax revenues which would occur as full employment GNP grows. If no discretionary policy actions were taken the budget would automatically become more contractionary along a full employment growth path. The expansionary policy actions projected for calendar 1971 almost exactly offset this automatic tendency towards contraction. Consequently, along a full employment path the combination of discretionary policy changes and automatic effects is virtually neutral between calendar 1970 and calendar 1971, but it can be said that the budget will be much more expansionary than it would be if no discretionary actions were projected or if there was an attempt to balance the actual budget.

Question 3. On page 7 of your statement you state that the so-called full employment surplus will be almost exactly the same in calendar 1971 as in calendar

1970. In the Economic Report (page 24) this is indicated to be $6.7 billion for calendar 1970, but in the Budget (page 9) the full employment surplus for fiscal year 1971 is $1.4 billion and for fiscal year 1972 it is $0.1 billion. Granted there are some differences in the concept involved—perhaps as much as $1 billion to $2 billion. That still doesn't explain the discrepancy between a little over $1 billion in the Budget and something in the order of magnitude of $6.7 billion in your Report. What is the explanation? Can you provide a detailed reconciliation between the two sets of full employment budget data?

Answer. On page 24 of the *Economic Report* the surplus of $6.7 billion is calculated according to national income accounting (NIA) concepts and refers to calendar 1970 whereas the $1.4 billion in the Budget is calculated according to unified budget concepts and refers to fiscal 1971. The first step in the reconciliation process is to compare the two full employment surplus concepts for the same time period. For fiscal 1971 we estimate that the NIA full employment surplus will be $5.7 billion compared to the unified full employment surplus of $1.4 billion.

On the revenue side, full employment NIA budget receipts are estimated at $218.5 billion whereas in the unified budget, full employment receipts are $214.2 billion. National income receipts are "grossed up" for Government contributions to employee pension funds and there are also important differences in timing between the two budgets. In the unified budget corporate tax payments are recorded when payment is received whereas the NIA budget records receipts when the tax liability is accrued. There are also differences in the timing of personal income tax receipts. These and other conceptual differences are described in detail in *Special Analysis A* of the Budget, pp. 17–19.

On the expenditure side, it so happens that unified and NIA full employment outlays are equal at $212.8 billion. However, this is pure accident and there are important conceptual differences in the estimation of the two budgets. Lending does not appear in the NIA budget and there are important differences in timing between the two budgets. Again, the details can be found in *Special Analysis A*. Aside from the conceptual differences between NIA and unified budget expenditures, there was a slight difference in the method of estimating full employment expenditures in the two cases. In the former a downward adjustment to actual expenditures was made in order to reflect lower outlays on unemployment compensation at full employment. In calculating the unified full employment expenditures, it was believed that there would be offsetting factors at full employment and this adjustment was not made.

In summary, the difference between the $6.7 billion 1970 NIA full employment surplus which you quote and the $1.4 billion unified budget surplus for fiscal 1971 is comprised of $1.0 billion due to the difference in the time period considered and $4.3 billion which is due to conceptual differences on the revenue side. The conceptual differences on the expenditure side cancel out.

Comparing fiscal 1971 and fiscal 1972 the NIA full employment surplus goes from $5.7 billion to $7.9 billion while the unified full employment budget goes from $1.4 billion to $0.1 billion. In other words conceptual differences between the two budgets are expected to grow in importance over the period. Comparing calendar 1970 and 1971 the NIA budget goes from $6.7 to $7.1 billion. None of these changes are very large relative to the size of the total budget.

In conclusion, it must be emphasized that no one budget concept provides a perfect indicator of the Government's impact on the economy. All must be watched constantly along with various Government credit programs which are not reflected in either budget.

Response of the Council of Economic Advisers to Additional Written Questions Posed by Senator Miller

Question 1. What is the real dollar increase in the "full employment" budget spending for fiscal 1972 compared to the estimated spending for fiscal 1971?

Answer. While Government purchases of goods and services can be deflated by the Government portion of the GNP deflator, it is not clear how transfers, grants-in-aid, interest and subsidies less the current surplus of Government enterprises should be deflated in order to get the real value of all Government spending. Therefore, any calculation of the real dollar increase in full employment expenditures will be extremely crude.

One approach is to deflate goods and services expenditures by the Government deflator while using the overall GNP deflator to calculate the real value of all other Government spending. Using this approach and national income accounting concepts, full employment spending of $228.1 billion in current dollars for fiscal 1972 is reduced to $214.1 billion measured in fiscal 1971 dollars. This represents an increase of 0.6 percent in "real" full employment spending over the $212.8 billion projected for fiscal 1971.

Question 2. What is the real dollar increase in defense spending in the fiscal 1972 budget compared to the estimated defense spending for fiscal 1971?

Answer. On a national income accounting basis the real value of defense spending, measured in 1970 dollars, will decline to roughly $65.0 billion in fiscal 1972 from $71.6 billion in fiscal 1971. The relevant price deflator is expected to rise about 10 percent in fiscal 1972 partly because of the pay increases resulting from the move toward a volunteer army.

Question 3. What is the estimated loss of jobs over the past twelve months resulting from reductions in defense and space contracts?

Answer. During 1970 there was an estimated decline of 1.1 million jobs attributable to the fall in Department of Defense expenditures. The employment situation in space industries has not been studied as carefully, but employment losses will have been small relative to those in defense-related industries. While the real value of defense purchases fell by roughly 10 billion 1970 dollars between 1969 and 1970, the fall in the real value of space spending was less than $1 billion in 1970. Therefore, as a rough approximation, job losses were less than one-tenth as important as those in defense-related industries or probably less than 100,000.

Question 4. Is it not true that the makeup of the GNP can have a substantial effect on both revenue and employment? For example, one mix in GNP might produce a certain amount of revenue. Another mix might produce less. If this is so, it would seem that the Council's estimated GNP would have made some basic assumptions about the mix of that GNP. What were they?

Answer. The composition of the income side of the GNP accounts is an extremely important determinant of Government revenues. The two most important components are personal income and corporate profits before tax. Our estimate of this breakdown is provided on page 73 of the Budget. For a 1971 GNP of $1065 billion, the breakdown is: personal income, $868 billion; and corporate profits before tax, $98 billion. The latter figure is a projection of corporate profits under the old depreciation rules. This concept is used so that 1971 corporate profits can be more readily compared with those of earlier years.

Theoretically, the composition of the expenditure side of the GNP accounts should have some relevance to the level of empolyment. However, we do not yet possess detailed knowledge of the characteristics of this relationship. Therefore, we find it more satisfactory to base our forecast of the unemployment rate on aggregate relationships which have been studied in detail by many economists.

Of course, if significant changes are expected in the composition of expenditures and these have known effects on employment, our aggregate forecasts are adjusted accordingly. Our breakdown for 1971 GNP is:

Personal consumption expenditures	$674. 6
Business fixed investment	106. 0
Residential construction	40. 6
Change in inventories	7. 9
Net exports	3. 5
Federal spending on goods and services	97. 8
State and local government spending	135. 0
Total GNP [1]	1, 065. 2

[1] Details do not add to total because of rounding.

Question 5. Reference Chairman McCracken's statement, page 11, second paragraph. What "remedial Federal action" might be considered? Please specify.

Answer. As a general rule "remedial Federal action" would involve the modification of Government policies which make it easier for firms and labor unions to raise prices and wages. The recent suspension of the Davis-Bacon Act is a good example of the sort of action implied by this philosophy. Other examples would include the relaxation of import quotas, and sales of commodities from Government stockpiles.

Question 6. Same statement, page 12, second paragraph. Please list several of the "numerous actions".

Answer. Some of the actions taken to limit rising prices, wages, and other costs in construction are as follows:

(i) In March 1969, the Administration increased the supply of timber from national forests and took steps to reduce Government demand for softwood lumber and plywood.

(ii) In the fall of 1969 Operation Breakthrough was established by HUD to investigate the technological and market feasibility of innovation in the housing industry.

(iii) On March 17, 1970, the President issued a statement covering a large number of programs to lower the costs in construction, including programs to encourage and increase skill training in the construction industry.

(iv) Most recently the President suspended the Davis-Bacon Act.

Question 7. Same statement, page 14, second line from bottom. How much was the improvement in competitive position? It would be helpful, for example, to have specified several major products on a country-by-country basis (e.g., major competitor countries).

Answer. The statement concerning the slight improvement in the U.S. competitive position during 1970 referred to relative price movements here and abroad. We do not have the information which would be required to determine by how much our price-competitiveness improved, but the general picture is a composite of the following pieces of information: as compiled by the International Monetary Fund, the U.S. index of unit labor costs in manufacturing and our index of export unit values in manufacturing each increase at a lower rate than the comparable composite index for competitor countries during each of the first three quarters of 1970, while the U.S. wholesale price index for manufacturing increased at a less rapid rate than the competitors' index during two of the three quarters. Supporting data are given in Table 1, attached.

The Department of Commerce unit value index for all U.S. exports increased by 5.7 percent from 1969 to 1970, while the comparable index for all U.S. imports increased by 7.8 percent. As indicated in Table 2, more rapid increases were registered in the unit value index for imports than in the comparable index for exports in three of the five major commodity groups. These unit value indexes are extremely rough measures of price change, since they are not adjusted for quality changes, but they are all that are available.

The U.S. share of total world exports increased marginally in 1970, after dropping in 1969, but this aggregate masks widely divergent experiences in different commodity groups. The long-run trend in the U.S. share of world exports has tended to be downward, reflecting the effects of the rapid recovery and expansion of other industrial economies since World War II. In any case, we would expect that much of the impact of the relative improvement in U.S. price trends during 1970 would affect trade flows in subsequent periods, rather than during the same year.

TABLE 1.—CHANGES IN PRICE INDEXES—UNITED STATES AND COMPETITOR COUNTRIES (PERCENTAGE INCREASE OVER PREVIOUS QUARTER AT ANNUAL RATES)

	1970–I	1970–II	1970–III
Unit labor costs, manufacturing (national currency basis):			
U.S. index	3.6	−0.4	1.1
Competitors' index	4.0	9.2	10.9
Wholesale price index, manufacturing (national currency basis):			
U.S. index	5.3	−0.3	2.4
Competitors' index	7.8	4.1	0.7
Export unit values ($U.S. basis):			
U.S. index	3.3	3.3	0
Competitors' index	8.5	3.9	5.0

Indexes for the following countries, weighted by trade: Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, United Kingdom.

Source: International Monetary Fund.

TABLE 2.—UNIT VALUE INDEXES OF U.S. IMPORTS AND EXPORTS (1967=100)

	Imports			Exports		
	1969	1970	Percent change	1969	1970	Percent change
Total	104.2	112.3	7.8	104.7	110.7	5.7
Crude foods	104.9	122.9	17.2	96.6	99.0	2.5
Manufactured foods	106.6	112.1	5.2	101.6	105.7	4.0
Crude materials	104.9	105.7	0.8	99.6	107.1	7.5
Semimanufacturers	104.1	109.5	5.2	96.2	101.7	5.7
Finished manufactures	103.7	112.5	8.5	109.2	115.6	5.9

Source: Department of Commerce.

Question 8. Granted the logic of the "full employment" budget approach, will not the Government borrowing needed to cover the deficit have an adverse impact on the interest rates in the money market and impose, at least, a "drag" on expansion in certain areas of the economy?

Answer. It is quite accurate to say that Government spending financed by issuing bonds is less expansionary than spending financed by money creation. On the other hand, it is more expansionary than spending financed taxation. Our forecast includes this "partial offset" to our expansionary fiscal policy. Let me also note, however, that the sector which is likely to be most sensitive to such interest rate pressures is housing. The housing sector, however, will be subject to numerous expansionary forces (e.g., the current large deposit-inflows to savings institutions) that will more than compensate for the upward pressure on rates due to Government debt sales. Furthermore, while interest rates would be "higher than otherwise" due to debt financing, the overall level of rates will be lower in 1971 compared with 1970.

RESPONSE OF THE COUNCIL OF ECONOMIC ADVISERS TO ADDITIONAL WRITTEN QUESTIONS POSED BY ONE OF THE COMMITTEE MEMBERS

Question 1. This year's economic report does not contain the chart showing actual and potential GNP which has been a standard feature of past reports. The Committee has available, however, the Council's estimates of potential GNP through 1975, which were supplied last year and printed in our hearing record. Do you have new estimates of potential GNP; or do the numbers you supplied last year still represent your best judgment as to our economic potential? If there are new estimates, please supply them for the record.

Answer. There have been no revisions in the calculation of potential real GNP since the 1970 *Economic Report.* This is evident in the long-term analysis of Chapter 3 in the *Ec. Report 1971* where Table 26 specifies levels of potential GNP (in constant 1969 dollars) that are consistent with the levels in the 1970 *Economic Report.*

Question 2. The Administration has indicated that $1065 billion gross national product in 1971 will represent an economy that provides significant reductions in unemployment. Even if the 9 percent gain in GNP over 1970 that the $1065 billion represents is comprised of 4 percent inflation and 5 percent real output, it seems unlikely that the economy will grow fast enough to both absorb the increase in the labor force and reduce the number of unemployed.

During the last five years the labor force (including the armed forces) grew an average of over 1,700,000 a year. Demographic and other pertinent data indicate that there should be at least 1,700,000 persons joining the labor force in 1971. The civilian labor force should grow faster than the total labor force. The armed services declined 0.5 million in the last year and are expected to decline about 0.3 million in 1971 (Special Analyses, Budget of the United States Government for Fiscal Year 1972, Table H–2). From the pool of 0.8 million men that represents reduction in the armed forces, there will be an additional increment to the civilian labor force. The number may easily be 0.3 million, which would result in a 2.0 million increase in the civilian labor force in 1971.

A 1.7 million increase in employment would be more than 2 percent. Since productivity is expected to increase at least 3 percent in 1971 in order to meet the Administration's expectations for inflation, a 5 percent gain in real GNP would hardly be enough to achieve a reduction in unemployment. How, then do you explain the Administration's expectations that unemployment will begin to decline this year?

Answer. All of the statistics in this question specify labor market conditions in calendar year 1971 relative to calendar year 1970. The inference is then made that it may be difficult to reduce the unemployment rate in 1971 relative to the unemployment rate in 1970.

The target GNP path of $1065 B in 1971 was never presented as a path that would definitely reduce the 1971 average unemployment rate relative to the 1970 average. Rather it was claimed that the unemployment rate in December 1971 would be lower than the unemployment rate in January 1971. On the $1065 B GNP path the real growth rate (fourth quarter 1971 over the fourth quarter 1970) is close to 8 percent. This rate should be more than sufficient to absorb the normal increases and even the extra increases in the civilian labor force that may occur this year, thus resulting in a declining unemployment rate throughout 1971.

THE 1971 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, FEBRUARY 9, 1971

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

The committee met, pursuant to recess, at 10:05 a.m., in room 1202, New Senate Office Building, Hon. William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Miller, and Percy; and Representatives Boggs, Reuss, and Brown.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Loughlin F. McHugh, senior economist; John R. Karlik, Richard F. Kaufman, and Courtenay M. Slater, economists; Lucy A. Falcone and Jerry J. Jasinowsky, research economists; and George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig and Leslie J. Barr, economists for the minority.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The committee will come to order.

Today, we continue our regular hearings on the state of the economy, using as our takeoff point the President's Economic Report and budget message. Last Friday we heard from the Council of Economic Advisers. While the Chairman, Mr. McCracken, was testifying as to how the administration's economic policies were turning out, the Labor Department was issuing its report on the unemployment situation in January, etching the sad fact that for the last 3 months—November, December, and January—unemployment averaged more than 6 percent. And just a week or two ago, we had the equally sad report of consumer prices rising at a rate of 6 percent.

I must confess that the Council's testimony last Friday has in no way narrowed the credibility chasm which has been widening over the past year, as the President and his economic advisers tried to talk us out of a recession while failing to recognize that the economy was indeed in a stagnant quagmire, caught up in inflation and rising unemployment.

Today we have with us Mr. Shultz, Director of the Office of Management and Budget and one of the foremost and broadgaged economists in the country, a man with an outstanding and well-earned reputation both before he came to office in this administration and since. While we shall tend to concentrate our discussion with him on budgetary and fiscal policy matters, I am certain he is fully capable of covering the broad range of economic policies.

We shall, I am sure, derive some wisdom from his comments on the relation of fiscal and monetary measures. Just how expansive is the

President's 1972 budget? Mr. Shultz is well aware that just putting two words—full employment—before the word "budget" does not make it expansive. I intend to direct some of the dialog for example to a point raised by Mr. McCracken's testimony in which he notes that the full employment budget—on a NIA basis—is approximately in balance in both fiscal 1971 and fiscal 1972. Where then is the expansionary impact which is going to thrust the economy upward to a GNP of $1,065 billion this current year a rise of 9 percent?

What sort of monetary policy would be "complimentary" to the fiscal policy enacted by the President? This is another question the answer to which is still quite hazy.

There are many of us here in Congress who are uneasy that this administration is still wedded to the outmoded notion that only fiscal-monetary policy counts. We are convinced that this administration must do far more in the wage-price area if inflation is to be brought under control while we move forward to a healthy full employment economy and beyond to an economy with steady growth without inflation.

We shall also discuss the adequacy of whatever steps are being taken to assure returning servicemen displaced defense workers and of course, the existing unemployed that adequate, economically productive employment is available.

Finally, needless to say, we shall, I hope, have a meaningful dialog on the extent to which the present and 1972 budgets provide for meeting our most urgent needs while dispensing with programs of lower priority.

Mr. Shultz, you may proceed in your own fashion. I note that you have no prepared statement. You have as you indicated to me informally prepared a number of quite detailed statements, on the budget, so there is no question of where you stand on the budget. But I think it would be helpful if you could summarize your views before the questioning begins.

STATEMENT OF HON. GEORGE P. SHULTZ, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET, ACCOMPANIED BY CASPAR F. WEINBERGER, DEPUTY DIRECTOR; SAMUEL M. COHN, ASSISTANT DIRECTOR FOR BUDGET REVIEW; JAMES SCHLESINGER, ASSISTANT DIRECTOR; DONALD RICE, ASSISTANT DIRECTOR; RICHARD NATHAN, ASSISTANT DIRECTOR; AND ARTHUR LAFFER, ECONOMIST

Mr. Shultz. Thank you, Mr. Chairman. I appreciate the opportunity to appear here. As you suggested, we have written a great deal of testimony. You have the President's budget, the Budget in Brief, the Special Analysis volume, and the large appendix before you. It was our view in getting ready for this session that the time would be better used if we didn't have me reading a long rehash of the budget, but rather making a very brief oral statement and then proceeding directly to the questions that you might want to raise about it.

In order that we might be as fully responsive as possible to your questions, we have brought along the people in the Office of Management and Budget who have been most directly concerned with the working out of the budget detail.

The Deputy Director, Mr. Weinberger, is detained at the White House momentarily but he will be here very soon, and his Assistant Directors, Schlesinger, Rice, and Nathan are here, as well as his Assistant Director Cohn, whom you have known for many years, and who can find any number in the budget faster than any other human being. He is the quickest gun in the Office. We are glad he is here.

In addition, Arthur Laffer, who is in charge of the economic work in the Office of Management and Budget. So we look forward to responding to your questions.

I might say a word about the budget and our current outlook on it.

The budget is a massive document involving a tremendous amount of money. As we go through the process of budget review, we question everything and review all the agency requests, not being so impressed with this or more impressed with that. To an extent, that puts us into a negative frame of mind. That is, a frame of mind that questions what is put forward.

Nonetheless, we want to look upon this document as a positive document. The large sum of money that is expected to be spent, $229 billion, is a sum of money with which we hope to accomplish things for the American people, and we want to look at it in that regard.

The budget contains a large number of important initiatives that the President has spelled out in his state of the Union message and, of course, detailed here to a greater extent in the budget document itself. The revenue-sharing proposal and the reorganization proposal come to mind first. The President will be sending up a health message very soon. The environmental message came up yesterday. Incidentally, there is is a great deal of material in the budget on that subject.

You made reference to the full employment budget concept. The President has very explicitly had this in mind; it provided the basic guide for the 1972 budget.

The full employment concept is a helpful one from the standpoint of looking at the impact of the budget on the economy. In a deeper sense, however, it should be regarded not so much as a short-term fiscal policy guideline but a long-term guideline. The basic idea of the concept is to relate budget outlays to the revenues that the tax system can generate when the economy is at full employment and to guide decisions about outlays by that market.

The full employment budget concept does not mean that we would spend all of that all the time, but experience indicates when outlays exceed full employment revenues—and the excess tends to cascade over a period of years—we get into very serious economic trouble. Then we have to wrench the economy back to get it on to a different path. We had to do that between fiscal 1968 and fiscal 1969; as a result, there was a very large fiscal swing in the budget of almost $30 million from one year to the next.

It is important to avoid that kind of a wrench to the economy.

I might note that there was a bipartisan effort involving the passage of the surtax by the Congress.

So using as a guide the full employment revenue, it is possible to make a plan for Government expenditures that is more orderly and that is sustainable over a period of years. At the same time, when the economy is operating at less than full employment actual outlays tend to exceed receipts. Under those circumstances, the Government budget is helping to stimulate the economy and, the actual deficit that arises is not something to be deplored but to be accepted as a means of helping the economy move forward.

The use of the full employment budget concept—a new idea but an important idea—has been helpful to us in the budget process.

Mr. Chairman, as I said, we are here to respond to your questions and we look forward to exploring the budget, the budget in relationship to the economy, and other questions that you may raise. We will do the best job we can in answering your questions.

Thank you.

Chairman PROXMIRE. Thank you very much, Mr. Shultz.

One measure of the straits of our economy at the present time is that you predict or expect, have as your goal, unemployment which will be approaching 5 percent as the year goes on. Five percent and inflation which will be four and a half percent during the year.

Now, both of these are shockingly high on the basis of recent history, over the past 20 years, and yet at the same time, the irony is that everybody says these are very optimistic, and it is unlikely you can do even that well.

In view of the fact that the administration has been in office, this is its third year, what is your explanation of the grim state of the economy and what many people seem to feel is the grim outlook for the economy?

Mr. SHULTZ. I think that the outlook for the economy is not grim but rather it is quite good. If we hold to a reasonable and steady course, we will be able to get the economy into the zone of full employment, and where we will have the rate of inflation will be declining and moving toward a more acceptable rate.

The basic explanation for the difficulties that we are having with inflation lies in the extraordinary excesses that were built into the 1966, 1967, and 1968 fiscal year budgets, accompanied as they were by a very rapid increase in the money supply. The increase in money supply continued even after President Johnson tried to bring some sense to the situation in the latter half of 1968, and it left us with a residue of inflation that is very hard to whip. The current indicators say that the back of the inflation problem has been broken, even though there is no doubt that the inflation problem is still very much with us.

I share your sense of puzzlement at the criticisms of the administration's outlook. It is important to achieve a gross national product of at least $1,065 billion—and I would hope that we can do better—if we are to have success in bringing unemployment down. The prospects are that the rate of inflation will continue to decline while we have that kind of expansion. Obviously you can't have an expansion that blows the lid off and expect to continue to make progress against inflation.

Chairman PROXMIRE. I want to get into both of these in turn, both the employment outlook and effects in unemployment, and also on inflation. I just wonder in view of your response how long the administration is going to justify and how long the Republicans are going to campaign against Lyndon Johnson's inflationary actions of 1966 and 1967. It reminds me of the fact we Democrats have been campaigning with some success for 40 years against Herbert Hoover. I wonder if you expect to campaign 40 years against Lyndon Johnson.

Senator PERCY. No. Thirty, 35 years. [Laughter.]

We have got quite a few years to go.

Chairman PROXMIRE. That is on Senator Percy's time. [Laughter.]

Mr. SHULTZ. I take your comment to suggest that the very inflationary budget and situation that we inherited is somewhat comparable.

Chairman PROXMIRE. Well, perhaps, but I think that most people, fair-minded people, certain economic historians like yourself, realize that whatever advantage the Democrats got out of campaigning against Herbert Hoover was pretty badly misplaced. By 1935 or 1936 the Democrats after all were on their own. Herbert Hoover couldn't be blamed for continuing the depression. The Democrats didn't do enough to get us out of this depression. They did something, a lot more than Hoover did, but not enough, but I don't see that you have done a great deal.

Let me point to the details of that budget of yours. It seems to me that unless you have some kind of magic up your sleeve it is very hard to see how you are going to get to this 4½ percent zone of unemployment. Although it is extraordinarily high on the basis of recent standards. Let's examine the budget piece by piece.

In the first place, defense spending is going back up but that is in dollar terms only. In real terms it is certainly not going to stimulate the economy. Quite the reverse. Commerce and transportation is declining, no stimulation there. Income security, largest civilian item in the budget by far, the programs that really get money into the hands of consumers. Social security and veterans' pensions, et cetera, that is increasing less than half as much in fiscal 1972 as in fiscal 1971. Education and manpower up just half as much in 1972 as in 1971. Less than half in percentage terms. Health up just a little more than half as much in 1972 as in 1971. Again less than half in percentage terms. Veteran's benefits, up just a little more than half as much in 1972 as 1971, again less than half in percentage terms. Community development and housing, a smaller increase in 1972 than in 1971. As badly as we need housing, up only 17 percent in 1972.

In short, the whole civilian budget is increasing by $5 billion less in 1972 than it did in 1971. That is including revenue sharing and everything else except defense.

Now, I don't say that you are not right in holding down some of this spending. I would agree especially in the defense area, but unless we are going to reduce taxes or take some other kind of action, I can't see that there is a fiscal stimulus of the kind you described that would move us in the direction of substantial lowering of unemployment. Where is it?

Mr. SHULTZ. Well, when we are talking about the economy as a whole, we want to look to the budget as a whole. The fallacy of trying to pick apart particular things as suggested by your comments about housing is that in doing so we tend to lose sight of the major forces that drive the economy. Housing starts have gone up very sharply during the past year, and, for the most part, people didn't quite anticipate the strength of that rise. It has been a reflection of many things, including household formations. It is partially a reaction to the quite sharp decline in interest rates. To some extent, the strong recovery of housing is a budget matter; to some extent it isn't. In any event, the strong recovery is something that is going on.

We have to look much more broadly than we have in the recent past. The overall rate of expenditures is up by about the same between fiscal 1971 and fiscal 1972 as between fiscal 1970 and 1971, about $16 billion.

The rate of taxation is down a little, partly as a result of scheduled declines contained in the Tax Reform Act, and partly through the change in depreciation rates.

Chairman PROXMIRE. Are you saying there is more stimulus from reducing taxes or revenues in fiscal 1972 than there was in 1971, because there was some reduction as you know in 1971.

Mr. SHULTZ. I think a little.

Chairman PROXMIRE. I would like to see an analysis of that. The only direct explicit action taken by the administration recently that I know of is the increase in depreciation which I approve. Many people disapprove. I think it is good, but that is a long term influence. Wouldn't you agree that is not going to do much for us in fiscal 1972?

Mr. SHULTZ. It will do something for us immediately but I think its basic impact is a longer term one. Fundamentally, it will help improve the rate of increase in productivity. It will help us deal with the inflation problem. It will help us to increase our real standard of living.

Chairman PROXMIRE. My question, Mr. Shultz, was what stimulus we are going to get out of this budget? You immediately referred to housing, pointed out housing has been rising more rapidly than many people expected. It is a sort of thing most people didn't anticipate. Senator Percy and I are on the Housing Subcommittee. We are unhappy about the relatively low levels against our goals which are 2.6 million housing starts per year.

I can see some stimulus here. I don't think it flows from the budget and I doubt very much if it is enough to provide the kind of employment increase that is needed.

Mr. SHULTZ. Well, I would say that concentrating exclusvely on the budget as the sole and only tool of economic policy is not correct and that we should also look at monetary policy. That is an extremely important ingredient. Beyond that, when we are thinking of these broad aggregates that we are talking about, it is much better to consider the economy as a whole. The process, whether in the form of very fancy econometric models or less elaborate techniques, of looking at the economy piece by piece and trying to add it up has consistently over the years led people to underestimate the strengths of the economy.

I think that is a pretty well demonstrated proposition.

Chairman PROXMIRE. Let's get it piece by piece. We can't really understand what is meant unless as we compare the stimulus in this 1972 budget to the budget stimulus of the economy in 1971 fiscal year, I can't see that the 1972 budget represents any greater degree of stimulus.

You might say there is some lag involved. But it certainly isn't the kind of dynamic, forceful effect which would give confidence to those of us in Congress and the public generally.

Senator PERCY. Mr. Chairman, would you yield at that point because you have mentioned that I was unhappy about the housing situation.

Chairman PROXMIRE. Yes, indeed.

Senator PERCY. I certainly have been in the past. But I think of all the areas of the economy which have shown the effects of a wise and prudent administration policy coupled with wise policies of the Congress, the housing industry is one of the brightest spots we have today. And it will account in large part for a renewed stimulative growth because of its rippling effects.

The administration took necessary action to bring down prices. It freed up lumber supplies. It made available routes to get at that lumber. It brought about a reduction in interest costs which is the biggest single factor in the housing market. Now people can afford to finance 25- and 30-year mortgages where before they would be stuck for 30 years with an 8.5-to 9-percent mortgage.

So housing starts this year look as though they are going to be a very stimulating sustaining basic factor in the economy. That will have a favorable fallout in household goods and in many, many other areas of the economy.

So I would like to commend the administration. Though I have been very unhappy in past years, I think this has been one of the dramatic illustrations of what a wise policy can do to stimulate the private sector.

Chairman PROXMIRE. I think that is right but you see this is exactly the problem.

I agree with much of what Senator Percy said, in fact virtually all of this. This administration did a fine job in the area of low-income housing, better than it has been done before. This administration has done well perhaps in housing generally. But when we ask where the stimulus is coming from we say, well, housing and that is part of the answer, but housing is not going to do the entire job. Is it going to do half the job?

The Council of Economic Advisers wouldn't tell us how much they expect to increase. I don't see any specific estimate from you. There is nothing in any documents of this administration as to how much it is going to increase. We can't really analyze this to determine where the stimulus is coming from. Sure, there is going to be a stimulus in housing. Everybody agrees with that. It may be 1.8 or 1.9 million starts this year. It may be more than that. We all hope and pray it will be but we would like to know, we would like to have a breakdown so we can determine the extent to which additional policies are needed.

Mr. SHULTZ. Let me respond to that, if I may, by again saying that I think this method of trying to add up the economy from the inside out consistently misleads you. As some side evidence of that, let me go over the record of the so-called consensus. It is this forecast that the administration's forecast is being compared with, and it is the basis for everybody's statement or lots of people's statements that our forecast is not correct.

We went back through the National Industrial Conference Board publication "Business Outlook." As you know, each year they assemble a group of private economists who know a lot about various sectors of the economy. These economists talk about how much to expect from construction and how much to expect from new plant and equipment, and how much to expect from this, that, and the other thing. They discuss the various expert opinions and come out with a so-called consensus forecast.

There are some differences but this is a process of forecasting that is very, very widespread.

I might say that this is not a process that produces a set of independent forecasts by economists or businessmen who individually think it over for themselves, by themselves, and come out with a view that is then compared with independent views. They are formed by a kind of interactive process in which there must be a lot of social pressure on the person whose initial thoughts are somewhat different. At any rate, this is the process which results in the consensus forecast that ours has been compared with.

We compared this over the period of the 1960's, during which the gross national product was rising; it is a very instructive comparison. I don't want to make too much out of it, but I think it is still instructive.

In 1961, which was not an expanding year, the error was a negilgible shortfall of $2 billion. In 1962 as the economy started to move forward, the shortfall in the consensus forecast was $12 billion. In 1963 it was $23 billion. In 1964 the shortfall was $17 billion. In 1965 it was $29 billion. In 1966 the shortfall in the consensus forecast compared to the actual was $40 billion. In 1967 it was $7 billion. In 1968 it was $23 billion. In 1969 it was $16 billion.

And so typically they were on the wrong end of it. They overestimated by $9 billion.

Now, I don't say this as a matter of derogation of the people involved, but I think the record shows that when the economy was expanding, these forecasts consistently underestimated by a substantial amount the capacity for expansion in the economy. Interestingly enough if you take these errors and express them in percentage terms to the GNP. and average them—I am not suggesting this as a technique of forecasting but it is kind of interesting when you do that—and then take the consensus forecast for this year and add that amount on, you come to a number higher than the one the administration has put forward.

Chairman PROXMIRE. Well, my time is up but let me just say that both you and Mr. McCracken primarily defended the administration's forecast by pointing historically how poor the forecasts of other people have been in the past. There hasn't been the kind of detailed specific justification, affirmative justification of why the administration's analysis is right. I don't see how you can provide an analysis unless you break it down by ingredients and say what is going to happen to personal investments, what is going to happen to personal income, what is going to happen to Government purchases, et cetera. You can vaguely generalize, I suppose, but I just don't see how this is going to be convincing.

Mr. SHULTZ. No; there is another method and that has a more empirical basis. It goes at the problem in a different way. We have used this different method and in some respects have elaborated it to quite an extensive degree. We will be glad to discuss that with you and show you some of the bases for our own estimates.

Chairman PROXMIRE. As I say, my time is up.

Mr. Brown, you are next. Senator Percy came in first. I want to yield to him because he did come in first.

Mr. SHULTZ. As a former Secretary of Labor I am glad to see you are still honoring seniority.

Senator PERCY. We are doing the best we can to break it down.

Chairman PROXMIRE. I might say every year that seniority looks better to me. [Laughter.]

Representative BROWN. Even comity between the two bodies, I might say.

Senator PERCY. The senior Republican member told me the other day when we changed our rules in the Republican caucus that your are going to regret this in 10 years, but right now we are not.

Mr. Shultz, I had a group of prominent Illinois Labor Leaders in my office this morning. We got so deep into the economy and what was happening that I finally invited them to come in and join me here to listen to you.

They told about the problems in the electronic industry, small companies that were down in volume and therefore being forced out of business, imports coming in, and the general softness in employment in Chicago, particularly in the electronics area.

I wonder if you could comment on some of the things the administration is doing to stimulate employment? I told them about the subsidized interest program for small business which is an administration program. They asked particularly about the program for public service positions to provide employment until the economy comes back. I think you could answer their questions better than I could and these general questions on the economy that all of us in the Congress are getting from our constituencies.

Mr. SHULTZ. Well, let me address the public service employment question, since it is one that people have been interested in, and it has been receiving continued attention.

First, I would state that the Nixon administration pioneered a public service employment program which got started a little more than a year ago. It has been working quite well. It is an effort to put into place a public service counterpart of the private job opportunities in the business sector program. That is, you would contract with units of Federal, State, and local governments to employ a disadvantaged worker, particularly on a public service job, train that person and get that person into the regular employment.

The program has been going along well; it is a constructive and helpful program. Beyond that, as the manpower bill was being worked on last year by the Congress, the idea of federally subsidized temporary public service jobs that would be viewed essentially as a training device was welcomed by the administration. We worked with the Members of the House of Representatives who are trying hard to make that a reality.

The bill that finally came to the President proposed essentially a return to personal public works and subsidization of personal government jobs, not necessarily jobs that needed to be done but jobs that were created in order to employ somebody.

Our feeling has been that the kind of jobs that we want in a healthy economy are jobs that are there because somebody wants that service, whether it is a public service or a private service. We think that the public service area is an area in which job development can take place and where support of the kind I have mentioned is appropriate. More than that, we think the way to have healthy employment opportunities is to have a healthy economy, and a healthy economy will absorb people and give jobs that have permanence to them and that have the attribute that they are there because the community wants to have the job done. I think that this is the kind of job that people want.

You mentioned the subject of import competition. The whole subject of international trade and monetary affairs is one that we have given a great deal of thought to within the administration. Very recently, in order to bring a greater sense of strategy and coherence to the area, the President has put into play a Council on International Economic Policy that will stand with the Domestic Council and the National Security Council as a policy-making body. He appointed an outstanding businessman to be the executive director of that council, Peter Peterson, who is a young fellow from an otherwise unheard of company named Bell and Howell.

Senator PERCY. I understand they are looking for a Democratic replacement so that we won't have such a high rate of attrition out there. [Laughter.]

Mr. SHULTZ. That sounds like a good long term move, all right. [Laughter.]

Senator PERCY. I wonder if you could comment, Mr. Shultz, on what will happen to inflation and unemployment levels if we do not achieve the 9 percent projected growth rate in fiscal 1972? If we see that we are not achieving that level as we go into that year, what steps might the Federal Government take to stimulate the economy more than would otherwise be the case?

Mr. SHULTZ. We estimate that if the economy moves at the prospected 9 percent rate in calendar year 1971, the rate of inflation will continue to fall and unemployment will fall. Those are counterparts, so to speak, of the $1,065 billion estimate.

Now, if the economy operates at a lesser pace, then we would expect to see the rate of inflation decline even more and, obviously, the rate of unemployment would be higher. So that as you think about economic policy, trying to see what the Government can do that will help the economy be a healthy economy, you always have to think about the problems of both inflation and employment or plant utilization, to see how much thrust there is together. You never can lose sight of either one. The objectives that we have set, and the expectations that we have, are compatible with the balance moving on both of these fronts.

Our view is that with the budget that has been put into place—one that doesn't have a full employment deficit—and with strong support from monetary policy, we will be able to achieve a lessening of the rate of inflation and a fall in unemployment.

I know that a great deal has been said about policies toward wages and prices and I welcomed your comment on it. The administration's position has been from the outset that it is extremely important to examine the way in which individual wage and price markets are working, and try to make them operate as competively as possible so that all the discipline of the marketplace can be exercised.

There have been quite a number of examples of action of that kind and we will continue to take actions of that kind.

Senator PERCY. The change by the administration in amortization and depreciation schedules, which has been called a two and a quarter billion dollar windfall for business by the administration, I happen to think will create jobs, will lower costs, will make us more competitive and will broaden our worldwide competitive position. In your judgement will this change have an effect that is measurable in the fiscal 1972 and fiscal 1973 years? In calendar year terms the President has said those years will be a better year and a good year in that sequence. Will that have an effect on those years?

Mr. SHULTZ. I think it will help. It is always difficult to disentangle one event from all other events and spotlight exactly what its impact is, but I think it will have an impact immediately, and as we were discussing a little bit earlier, it will have an impact over a period of time, particularly along the lines that you suggest.

It is the sort of thing that helps make our industry competitive and leads to investment and improved technology.

Senator PERCY. I support the full employment budget concept. I think it is a brilliant concept. It is hard for some Republicans to swallow, I suppose, but I think it does give us a guide by which we should project our budget surplus or deficit.

Could you comment, however, on the Committee on Economic Development's call for a $6 to $9 billion full employment surplus as against the $0.1 billion surplus in the actual budget? How do you reconcile these differences in viewpoint?

Mr. SHULTZ. Well, the idea of operating with a large full employment surplus in a year when we would like to see the economy expand did not strike the President as very sensible economic policy. There may be times when you would want to have a substantial full employment surplus, in effect, the government doing the saving on behalf of the community. But in this day, with very high personal savings and with the economy operating at a rate less than we would like, the President's view was we should bring the budget at full employment about into balance.

His decisions, which were not simply spending decisions—the tax impact decision that you mentioned was part of it—were designed to do just that. In this sense, the budget goes right up to the limit of what the President feels it can do to sustain a strong expansion in the economy.

Senator PERCY. Thank you very much, Mr. Shultz.

Chairman PROXMIRE. Congressman Reuss.

Representative REUSS. Mr. Shultz, suppose that Congress behaves angelically with regard to the President's economic program, does everything that is asked of it, and suppose all the other blocks fall into place except that as you go ahead with this program in the months to come, it develops that actually you are not progressing at the 9 percent rate and aren't on your way to the $1,065 billion GNP which you confidently predict.

If that should happen, what would be your recommendation at that time as to monetary policy? Or to put it another way, this would indicate, would it not, that the Fed has not been creating enough new money to validate the projections.

Mr. SHULTZ. Well, our analysis of the situation, and our way of looking at the economy, shows that monetary policy is a very important active ingredient in determining the direction of the economy. And we would look to monetary policy to be expansive and to be a strong support of attaining the kind of objective that we have set forth, which——

Representative REUSS. But suppose, though, that at this projected time, say 4 months from now, 6 months from now, the Fed has been creating new money narrowly defined as the 7 percent a year which is ordinarily considered to be expansive but still even though everybody else has been cooperating the thing isn't working and you aren't on your way toward the $1,065 billion GNP upon which hang all the hopes as to reducing unemployment, inflation, and so on.

Would that situation indicate to you that 7 percent new money has not been enough and that the Fed should be more expansive?

Mr. SHULTZ. Well, I would certainly be surprised if that rate of monetary growth were sustained——

Representative REUSS. We would both be surprised.

Mr. SHULTZ (continuing). Up and down——

Representative REUSS. But suppose that is what happened?

Mr. SHULTZ. We would have to go back and look at the textbooks again because I think the evidence is very clear in economic history that when you combine the kind of big budget swing that occurred between fiscal 1968 and fiscal 1969 with the extremely tight money policy that followed in the latter half of 1969 and 1970, that the input gets an output. I think that we have been feeling the effects of those policy devices, particularly the very, very tight money policy in 1969 and early 1970.

Now, I think by the same token you can turn that around. Budget policy has been more expansive beginning in the wintertime of last year, and monetary policy has also shifted. All our economic history teaches us that when you get this kind of a switch, particularly if one were to have a certain monetary policy that you suggest, that we would have a strongly expanding economy.

Representative REUSS. But if we should turn out to be wrong, if we do everything in the budget that you and the President have recommended, but we aren't growing sufficiently to meet our target in this case, monetary policy would have to be the culprit, would it not, and whatever rate of monetary increment had been the order of the day for the Fed would in the event it should turn out to be wrong and should be increased.

I suppose I am trying to put words in your mouth but not maliciously because this seems to me——

Representative BROWN. Or successfully.

Representative REUSS (continuing). That is what you have been saying.

Mr. SHULTZ. I suppose that people all have their own ideas about who is the culprit for what, and we have our analysis of the economy operating. We do put a lot of weight on monetary policy. At least, it looks to us from our analysis that monetary policy is exceedingly important, and all of our experience suggest that what you are suggesting as a monetary policy will bring a very strong expansion. I would like the record to show that the 7-percent figure was your suggestion, not my suggestion.

Representative REUSS. Yes.

Mr. SHULTZ. I don't want to have that word in my mouth.

Representative REUSS. It so shows.

Turning to another field, it is still your view, is it not, that it would be a mistake for the administration to impose a temporary price-wage freeze in order to get a handle on inflation?

Mr. SHULTZ. My analysis of the wage and price situation is that the problem, to the extent that there is a problem, is widely dispersed. Particularly if we look at the wages, the picture varies a great deal across the economy. There are many sectors of the economy where it looks to me as though the wage changes that are being put into place are quite moderate and, given the rate of inflation that accompanies them, are barely keeping workers even in terms of their real income.

It never has appeared to me that you can solve the inflation problem by forcing workers to take reductions in real income. I just don't think the situation works that way or that this is tolerable.

Now, by the same token, I think there are areas where the wage bargaining picture seems to have gotten out of control and badly so. Perhaps the most important and obvious one is the construction industry, where rates of increase have soared way beyond what is happening in most other industries.

We are working on that problem. We have had a commission on collective bargaining in the construction industry for about a year and a half. Their attitudes are constructive and concerned. They met with the President 2 or 3 weeks ago, and his challenge to them was to come up with a program of some sort. We are in the midst of doing that, and we will have to see whether or not it is possible. But I think that when it comes to the wage picture, you need to figure out where your problems are. They aren't everywhere, just in certain places.

Representative REUSS. In addition to opposing price-wage compulsory controls, do you still continue to oppose the evolution of wage-price guideposts?

Mr. SHULTZ. My analysis of that approach, whether it is an enunciated guidepost that is enforced to some extent by the Council of Economic Advisers and the strong right arm of the President or by the Justice Department or by somebody that has some clout over individual companies, is that it really hasn't been very successful in dealing with the problem of inflation broadly speaking. To the extent that it has been successful, it has been exclusively concentrated on large visible firms. I don't know of instances where that approach has really had much impact on the wage picture. As I have heard the people who talk the most about this kind of thing, they complain the most about construction wage settlements. I agree with the analysis that those are real problems, and I think that whatever is proposed has to meet the test of whether or not it is going to do anything about those wage settlements. That is what we are concentrating on.

Representative REUSS. Finally, everybody has been making his own estimates of what the GNP in 1971 will be, and I suppose it is a game that any number can play. My own projection is, and I would ask your comment on it, particularly in light of what you have just said on inflation, that if this country does attain a $1,065 billion GNP in 1971, most of that 9 percent growth rate will be in inflation rather than real growth. That is the Reuss projection. I take it you don't agree to that.

Mr. SHULTZ. No, sir; I don't.

Representative REUSS. How far wrong do you think that is, and I hope it is wrong.

Mr. SHULTZ. Well, I do not want to put numbers in your mouth.

Representative REUSS. I ask you to.

Mr. SHULTZ. But, if what you are projecting is a rate of growth of real gross national product on the order of, say, 1 percent and money gross national product on the order of 9 percent in a rapidly accelerating rate of inflation, I just do not think that makes sense.

Representative REUSS. All I said is that of the 9 percent growth, something more than 4½ percent would be in price increases and something less than 4½ percent in real honest-to-goodness growth?

Mr. SHULTZ. Yes. Well, the lower the real growth, the lower the price inflation will be. So, those who are pessimistic about real growth are projecting a picture in which prices tend to be held down more than in the kind of growth picture that we are projecting—at least given a common understanding of the way prices behave.

Representative REUSS. But it is clear to your view, and here is where we differ, that if your goal of $1,065 billion GNP is realized, and you are confident it will be, that the majority of that 9 percent growth will have been real growth rather than inflation?

Mr. SHULTZ. Yes. I think that word majority is well chosen. On the point of confidence, I do think that we will have strong real growth. It may turn out that $1,065 billion is a conservative number rather than an optimistic number. At the same time, as I observed earlier, I think we economists have a lot to be modest about when it comes to predicting the economy, so that the notion of watching as you go along, and changing as conditions warrant is an important concept here.

Representative REUSS. Yes. The requirement of modesty is why I stay away from predicting a figure myself. I simply say that if that figure is realized you are going to find yourself doing it more by inflation than by real growth, but we will see and we both hope I am wrong.

Mr. SHULTZ. I think that the point that you are making, which I fully agree with, is that the $1,065 billion as such is not a particularly meaningful figure. The important thing really is: what is going on with real growth? That is the most important thing. Are we moving ahead in terms of real growth, and, at the same time, are we managing to get a little better control of the inflation problem as we go along? Whatever the exact number comes out to be, I agree with you, if we got $1,065 billion and it was practically all inflation, that would be a very sour victory for those who have been arguing for $1,065 billion.

Chairman PROXMIRE. Congressman Brown.

Representative BROWN. Some of those inverse things fascinate me and one of them that you mentioned now appeals to me to find out just what the facts are.

You said that the experts tend to be wrong by a considerable amount. What is the percentage on average that the experts fall short in their predictions over a period of expansionary time?

Mr. SHULTZ. It has been about 2.3 percent.

Representative BROWN. Well, if I read the figures that are before us correctly, the experts have sort of averaged out or found a consensus around $1,045 billion as the budget—gross national product for next year. So 2 percent error would make it $1,065 billion. Two and a half percent raises that to about $1,070 billion; is that right?

Mr. SHULTZ. In the general vicinity, yes. I do not want to leave the implication that there is some one number that everybody else has settled on and then there is this other number that the administration has proposed. There is a lot of dispersion. But $1,045 billion is the approximate central tendency.

Representative BROWN. Well, suffice to say if the experts are correct with their usual degree of correctness, the budget will—the GNP will run about $1,070 billion and you will be wrong too.

Mr. SHULTZ. We would be delighted to be wrong in that regard.

Representative BROWN. Let me ask you directly, the expansionary steps taken by this administration, the full employment budget concept, the fiscal approach, I think has been fairly well laid out in the budget booklets that you put out. An $18 billion deficit is inclined to be rather specifically expansionary. What rate of expansion in the monetary efforts, in the money supply, are you recommending or have you urged in the councils—at the administration level?

Mr. SHULTZ. I would prefer to get at that question in a roundabout way, without trying to settle on any particular number, and just say that it seems to us that the rate of expansion suggested by the administration's forecast and plan is a reasonable, doable, and desirable situation. And if we can do a little better that would be even more desirable.

I think it is a starting point. We should ask ourselves: would it be desirable if the economy were to expand on the average by about 9 percent with a majority, to use Congressman Reuss word, in real growth, meaning that the rate of inflation will be declining? The answer to that question is "yes."

Now, as far as monetary policy is concerned, beyond saying that it is obviously of great importance, I would settle for general agreement that this goal is desirable and achievable but I would try to tell the Federal Reserve how to do its job in detail.

Arthur Burns and his colleagues are in charge of that.

Representative BROWN. The figures that we heard from Mr. McCracken and members of the Council of Economic Advisers range between 6 and 7.2 percent, at least in general terms. They assumed that somewhere in there would take care of the expansion. Would you think that those were realistic figures to accomplish the expansion in the growth—the expansion of GNP that you have in mind in terms of monetary expansion?

Mr. SHULTZ. Well, as I say, I would prefer not to get into a discussion of specific numbers but rather to focus attention on the objective and the do-ableness and desirability of the objective, and to look to the Federal Reserve to take the policy actions that are needed to get us there or to improve on the situation. But certainly we need a strong level of monetary growth.

Representative BROWN. Let me move into another area, then, failing specific response on that question, and that is the psychological area. How do we get the psychological response that would free up the consumer spending in the economy which would help make this kind of expansion possible? It occurs to me that perhaps the pessimistic statement does not serve an expanding economy very well and that a continual attitude of pessimism may be harmful. It also occurs to me that perhaps the very area of jawboning may in effect be a dampending effect on the expansion of the economy. Would you care to comment on those two comments?

Mr. SHULTZ. Well, this question of people having confidence is an important one. It is an elusive sort of an idea, but I think that, fundamentally, people take confidence from what they see around them. That is, they're perceptive of what the facts are.

It is fruitless to try to talk people into thinking something that is not confirmed by the policies that they see and by the results of those policies.

At the same time, I think there is a lot more to this than just the economics of it.

I was interested to read in the paper this morning, for example, that apparently there has been an increase in retail sales in the city of

Washington, D.C. That must have a lot to do with the fact that the crime rate has declined somewhat. So I think that if we work more successfully on some of these problems, on some of these nightmares, as the President has called them, and get those nightmares behind us, we will give people confidence that the society is working well, and that things are getting more under control. This would tend to buoy the kind of confidence that will also spread over into the economic field.

I believe that the touchstone of the revenue-sharing proposals, both the general revenue sharing and special revenue sharing—with all that can be said for them in terms of relative merits, tax systems, and the fiscal crises of the States and cities—is the desire to put a greater element of decisionmaking authority and power and control into the hands of people all over the country on matters that are closest to them. When people have that control, and they are making headway because of what they do in solving their problems as they see them, then we tend to tone up the whole society. That in turn, tends to spread across and help the economic area, just as when the economy improves, it tends to help other areas as well.

Representative BROWN. Now, are you suggesting that revenue sharing is a significant sign, psychological impact on people who spend because they think their taxes might not be going up? Is that what you are saying? I am a little bit lost of how this revenue sharing fits the——

Mr. SHULTZ. My point is that the outlook that people have is related to lots of things, some of which fall in the economic sphere strictly speaking, but some of which are totally outside of it. And when people feel, for example, that crime is rampant and uncontrolled, that does not do very much for their sense of confidence in the society or in the economy. On the other hand, if they feel that crime is being brought under control, that helps and overlaps.

I am really just trying to get at your point about confidence and what builds it and to suggest that there are things outside the strictly economic sphere that contribute.

Representative BROWN. Let me ask you specifically about price and wage controls as opposed to jawboning or what we have like you been through, a period of let-alone in reference to price and wage renegotiations. Would price and wage contrcls serve to stimulate this psychological feeling of encouragement about the economy or would they in fact tend to depress the economy, do you think?

Mr. SHULTZ. Well, I think that if we were to have a full-scale wage and price control program, with all of the accompanying rules and regulations and the bureaucracy that would be required to enforce them, people would rapidly get fed up with it. Beyond that, controls would rapidly strangle the economy.

Representative BROWN. In order words, the tight price and wage control may have, in effect, a depressing effect on the expansion of the economy, is that what you are saying?

Mr. SHULTZ. Could very well be.

Representative BROWN. What about trade policies, Mr. Shultz, in terms of stimulating the economy toward a $1,065 billion GNP? Restrictions on imports to gain a short-range stimulation of domestic business or freeing up of imports?

Mr. SHULTZ. I think, in general, we gain very strongly from trade, in this country and in other countries. We gain by importing things that can be produced more economically abroad and exporting things that we can produce more economically. It is noteworthy that we are and have been, over a long period of years, net exporters. If you were just looking at it from the standpoint of jobs alone, there are more people who have jobs in exporting businesses than in importing businesses. So the idea of just cutting off all imports, which would have quite an impact on our export markets, does not seem to me like the road to improving employment. It certainly is not the road toward improving our standard of living.

Representative BROWN. Are there any expansionary steps that this administration might take in terms of stimulating economy that they are not taking?

Mr. SHULTZ. Well, the principal expansionary elements are the President's decision to budget outlays right up to the full employment revenue, and a strong expansive monetary policy. Those are the two principal elements.

Representative BROWN. Are there others?

Mr. SHULTZ. Those are the ones that will affect the overall requirements of the economy and, at the same time—going back to a comment that I made earlier—the administration has, from the beginning, been working on the question of trying to get individual wage and price markets to work well. This is also an important element in the picture.

Representative BROWN. Thank you.

Chairman PROXMIRE. The Chair takes great pride in recognizing a veteran member of this committee, served on the committee for 15 years and this year, of course, he has become the majority leader of the House of Representatives. So it is with great pride as I say I recognize Congressman Boggs.

Representative BOGGS. Mr. Chairman, I am very pleased to be a member of this committee.

Mr. Shultz, it is good to see you.

I read a piece in the Post this morning, a column by Mr. Rowen who has always struck me as being a very wise man, and I quote in part from that column:

> After two years of searching, the Nation and Administration has located its jawbone, and is beginning to exericse it.

Then Mr. Rowen goes on to say that:

> "Incomes policy" is a loosely defined phrase generally taken to mean some measures of direst government intervention—short of price and wage controls—to limit the upward spiral of wages and the cost of goods and services. Presidential Advisor Paul W. McCracken went so far as to say that a wage and price board to bring pressure against bit wage and price increases before they go into effect, was among the possibilities.

Writes Mr. Rowen:

> That represents a long distance for the Nixon Administration to have traveled. At the beginning the President volunteered an unrestrained commitment to "the free market." He said in last year's Economic Report that he would not interfere with private wages and prices, but now the President has switched signals, belated as it is, it is welcome.

What accounts for this shift in signals?

Mr. SHULTZ. Well, first of all, this is not particularly a shift in signals. One of the first efforts in the administration, as Senator Percy noted, was the effort to do something about lumber prices.

Representative BOGGS. Well now, hold on just a minute. When did you jawbone? When did you start jawboning?

Mr. SHULTZ. "Jawboning" is a term of art. Would you consider the actions the administration took in trying to improve the supply and curtail the demand for lumber in the light of rapidly rising lumber prices to be jawboning? If so, that has been with us a long time.

The big point is that the Government in a number of ways——

Representative BOGGS. It seems to me that the market really took care of the lumber prices. In the beginning of 1969, prices were astronomical but because of the recession in building, brought on by the administration policies, prices went into decline precipitously in a matter of a few months.

Mr. SHULTZ. Well, there were many things that contributed to the change in lumber prices but I think that the effort the administration made contributed to lower prices and——

Representative BOGGS. Of course. It almost became disastrous.

Mr. SHULTZ. You asked in your question for a historical illustration of when the administration tried to posture the Government so as to encourage the operation of wage and product markets, and the lumber case was an early example of that.

Representative BOGGS. I do not really understand you on the lumber case. You had a depression in the lumber market. It is only now beginning to recover. Unemployment on the west coast ran something like 14 percent in the lumber-producing area.

Mr. SHULTZ. The lumber market was very tight and a number of steps were taken.

Representative BOGGS. When your administration came in it was tight.

Mr. SHULTZ. And I think these efforts contributed to lower prices. Obviously, the falloff in housing starts also was a powerful contributor to that change, but there were many others.

Representative BOGGS. What was the difference in housing starts in 1968 and 1970?

Mr. SHULTZ. I do not have that.

Representative BOGGS. Would somebody supply that for the record.

Mr. SHULTZ. We will supply that for the record.

(The following information was subsequently supplied for the record:)

Year	Housing starts (in thousands)	
	Private	Private and public
1968	1,508	1,546
1969	1,467	1,500
1970	1,429	1,463

Representative BOGGS. Now, what about the steel case. When did you decide to jawbone on steel?

Mr. SHULTZ. Well, there was no jawboning on steel in the sense of——

Representative BOGGS. What happened? Somebody talked to somebody in the steel business, didn't they?

Mr. SHULTZ (continuing). Getting up and denouncing people, which is what seems to be meant by that term.

The effort was to examine the Government's own activities in relationship to the problems of the steel industry and the behavior of prices in the steel industry, and to see whether or not the things that Government is doing there were properly conceived and executed.

Representative BOGGS. Well, Mr. Shultz, if somebody connected with the President——

Mr. SHULTZ. If you want to call that jawboning, it is all right with me.

Representative BOGGS. Did somebody connected with the President talk to someone connected with the steel industry, and of so, whom?

Mr. SHULTZ. I do not know that I can detail from my own knowledge what all the various conversations were, but the——

Representative BOGGS. Who participated in the conversations?

Mr. SHULTZ. I know that there were people in the steel industry who were interested in what the President and his press secretary had to say.

Representative BOGGS. You did not answer my question; who talked to whom?

Mr. SHULTZ. I do not know the answer to all of that. I did not personally talk to anybody.

Representative BOGGS. It is a fact that somebody talked to somebody?

Mr. SHULTZ. I think that is correct. [Laughter.]

Representative BOGGS. What was the result of this conversation that you were not aware of?

Mr. SHULTZ. You would have to find the people who had the conversations and have them testify.

Representative BOGGS. Your job is Director of the Office of Budget and Management.

Mr. SHULTZ. But, in general, I think there was a sharing of information. That is about the size of it.

Representative BOGGS. Did you get any of this information?

Mr. SHULTZ. Well, only in a general way.

Representative BOGGS. How can you manage a budget if you do not get this information?

Mr. SHULTZ. Well, I sometimes have my difficulties. [Laughter.]

Representative BOGGS. Do you mean by that you do not have access to information in the executive branch of the Government?

Mr. SHULTZ. Oh, yes, I have pretty good access.

Representative BOGGS. Well, are you just trying to avoid my question or what?

Mr. SHULTZ. No, sir. I know that there were some steel people who——

Representative BOGGS. What steel people? I remember back in President Kennedy's administration they sent the FBI out to see some of them.

Mr. SHULTZ. Well, I am glad you mentioned that because it is a point of great contrast. [Laughter.]

Representative BOGGS. Well, this time it is ethereal. I mean nobody knows who did what.

Mr. SHULTZ. I can assure you there was none of the business of using the FBI or threatening people or any of that kind of thing.

Representative BOGGS. Who was it? After all the FBI is part of the executive branch of the Government. Did the President talk to the president of the United States Steel Corp.?

Mr. SHULTZ. Not that I know of.

Representative BOGGS. Well, did one of his administrative assistants talk to the president of the United States Steel Corp.?

Mr. SHULTZ. I believe that Paul McCracken talked to some of the steel leaders, but I am not certain exactly who, when, where, or what was said. I did not participate, so I really am not a very good witness.

Representative BOGGS. Does the cost of steel which is basic to the economy make any difference in the budget of the United States of America?

Mr. SHULTZ. Not very much.

Representative BOGGS. Not very much?

Mr. SHULTZ. No, sir.

Representative BOGGS. You mean in the building of armaments and the whole process of containing inflation, it does not mean anything?

Mr. SHULTZ. The price of steel is a small part of the total price structure of the country, and in terms of gross quantitative effect on the budget of the United States, it is not a big item.

Representative BOGGS. What impact does it have on the automobile industry, for instance?

Mr. SHULTZ. The rises in the price of steel relative to other possible substitute products have, together with improvements in the qualities of substitute products, such as plastics, over the years led to a lesser and lesser importance of steel to the automobile industry, although it is still a very important element.

Representative BOGGS. If it had no impact, why the jawboning? This was just a vain and useless thing?

Mr. SHULTZ. Don't try to maneuver me into the position of saying that the steel industry is not a significant and important industry.

Representative BOGGS. I thought you just said that. I am not trying to maneuver you into anything.

Mr. SHULTZ. No; the point is that steel is one among a great many industries for which, as a matter of general policy, as well as in specific instances, there is a desire to examine the impact of the Government's regulation and purchasing on the way markets are working.

Representative BOGGS. Well, let me put my question in a different way. Was it significant or was it not significant for the White House to jawbone on steel prices?

Mr. SHULTZ. Would you like to define jawboning for me?

Representative BOGGS. Any way you like; it means that the Government intervenes in some fashion or another and says, look, that price rise just cannot go into effect. That is what it means. That is what happens.

Mr. SHULTZ. The parallel—I do not know whether you are reaching for it but you mentioned it—was the situation in which President Kennedy denounced the steel industry.

Representative BOGGS. This is a fictitious distinction.

Mr. SHULTZ. And you mentioned the FBI. I am just using your analogy——

Representative BOGGS. If you are going to jawbone you might as well jawbone the whole way.

Mr. SHULTZ (continuing). To that kind of thing.

Representative BOGGS. What you are saying—you are nice about it. You have just spoken in a calm tone of voice. I understand.

Now, let me go ahead with one or two other things here. Last year the President vetoed an increase in education, medical care and housing, and he vetoed a bill for training programs, public service employment. We have introduced new bills now on the latter subject. If passed by Congress, would you recommend a veto of that bill?

Mr. SHULTZ. First, let me say that the President proposed in his budget last year and this year important positive thrusts in the areas that you mentioned. It is not a question of whether or not more should be done in those areas but a question of what amount in the light of all the other things in the budget. It is a question of looking at the overall picture and related parts of the budget and, also, some of the details of the bills that you mentioned that led the President to his veto decision.

I really do not want to speculate on what I would recommend to the President on some, as yet, undefined bill which may or may not get to him.

Representative BOGGS. How much was in the bill last year, Mr. Shultz?

Mr. SHULTZ. Which bill?

Representative BOGGS. The one that he vetoed for public service training.

Mr. SHULTZ. I am not sure. I do not recall all the details on it.

Representative BOGGS. Someone on your staff must know.

Mr. SHULTZ. Well, we can certainly make an analysis of that bill and we can certainly supply the details of that bill for the record if you like.

Representative BOGGS. No. I would like to have an answer right now.

Mr. Cohn, don't you know the answer?

Mr. COHN. On the public service bill; no, sir.

Representative BOGGS. The bill that Nixon vetoed late last year and the veto was sustained by the Senate.

Mr. COHN. I do not think the basis for that veto, Mr. Boggs, was the cost of the bill or a——

Chairman PROXMIRE. Speak a little louder.

Mr. COHN. I do not believe the basis for the veto of that bill was the cost of the bill. It was more the character of the employment opportunities being provided.

Representative BOGGS. You mean jobs like policemen, parkworkers, firemen, crime prevention, et cetera?

Mr. SHULTZ. I think the point is a little different. The problems with that bill were, first, that it perpetuated the narrow categorical approach to manpower training which the administration's bill had sought to get away from and which the special revenue sharing proposals to the President are seeking to get away from.

Second, it put into place a very large new category that envisaged permanent subsidized jobs of a public service nature so that we would try to solve our employmnt problem by large budget outflows that committed us over a long period of time to subsidizing jobs put there not because somebody wanted them done either by public or private means but just in order to put people on payrolls.

Representative BOGGS. I would call your attention to the testimony by the mayors yesterday which is entirely in direct contradiction to what you have just said. In a——

Mr. SHULTZ. I talked to——

Representative BOGGS. Let me go ahead on revenue sharing, but do you mean on revenue sharing that New York City could not use the money it received to pay policemen?

Mr. SHULTZ. The point is—and I talked to the mayors yesterday too, and we went into this in some detail—that the needs of different cities vary. Some would like more money to support their payrolls, while others do not need that at all. In fact, a number said that they did not need more money for payrolls. They felt they had more people on their payroll than was desirable, and that they needed the money for other things. This illustrates the fallacy of the highly categorical approach. It fits some places, it does not fit others.

Representative BOGGS. Surely. Let's see, with revenue sharing, if New York City gets a billion dollars revenue sharing, Mayor Lindsay could not use that to pay policemen and firemen?

Mr. SHULTZ. Certainly he could.

Representative BOGGS. Could he use it to employ park superintendents, and so on?

Mr. SHULTZ. Yes.

Representative BOGGS. In other words, he could use it any way he wanted to?

Mr. SHULTZ. That is correct.

Representative BOGGS. But now if we pass a bill that says that Mayor Lindsay can supplement his police force which he says was about 2,000 under what was required, or can keep six men on the fire engine rather than three, and the six is apparently what he says is required, then you are against that?

Mr. SHULTZ. What I am against is the exertion of authority by the Federal Government over all the details of how every State and city and town should be managed. There is no reason to think that what fits Mayor Lindsay's situation in New York will fit the situation of some other mayor out in Peoria or somewhere else.

Representative BOGGS. Right. I understand.

Mr. SHULTZ. So let us have a system that puts the responsible elected official of government in a position to use the money in ways that will meet the needs of his particular area.

Representative BOGGS. Let me go ahead with that, a thought to which you seem to be wedded. Why is it, then, that you only recommended $5 billion revenue sharing and you have $11.1 billion in new category—why didn't you recommend just $16 billion in revenue sharing?

Mr. SHULTZ. The President feels that some functional areas should be designated as national priority areas, which we have called special revenue-sharing groupings. These groupings——

Representative BOGGS. That does not include education and hospitals?

Mr. SHULTZ (continuing). Are developed by folding in narrow categorical grants and in the process, giving much more discretion to State and local governments about just exactly how in the field of transportation or law enforcement or whatever they are going to spend that money and——

Representative BOGGS. You have not answered my question. Why do you recommend just $5 billion in revenue sharing when you say that there went to the States and the cities a total of $16 billion. What is wrong with the other $11 billion?

Mr. SHULTZ. I think the situation we are in is that the Federal Government has put forward very large sums of money in the form of relatively narrow categorical grant programs.

Representative BOGGS. I know what you mean. Let us be specific about categorical programs, education, poverty, manpower training, health, and housing. These are all category problems.

Mr. SHULTZ. Those are words, Congressman Boggs, not programs, and you mentioned the word manpower. Now, in the present manpower setup there are lots and lots of programs, individual categorical programs, that flow to particular places. This is just the sort of thing that led the administration last year to propose a changed manpower bill. There are lots and lots of cases where a city or a State will be in the position of saying we have more money than we need for this program over here, but not enough for that one over there. And the design or the weighting of the categories done by Washington may fit some places, but it does not fit all of them. So the whole idea is, within an area like manpower training, to allow the people in a local area and give them some sense of confidence to fit the structure of that money to their needs as they see them. That is the whole point of it.

Representative BOGGS. Mr. Chairman, I have consumed too much time. This is really rhetoric. I noticed in the Wall Street Journal this morning where a massive public relations campaign was underway at the White House to sell this stuff. I think it is going to have to be very massive.

Chairman PROXMIRE. Thank you very much, Mr. Boggs.

Mr. Shultz, I would like to get at your inflation estimates and I do not mean to be at all personal in this because I do not think we have to be. We just have to take a look at the record of what has happened over the last 8 years.

Since 1962, for the first time since records have been kept in 1930, since 1962, for 8 successive years, every single year inflation has been greater than the year before. The rise in the cost of living has been greater than the year before. Without exception. It has risen from 1.1 percent in 1962 to 5.5 percent this year.

Now, each one of these 8 years the Budget Director has come in—that is why I do not mean to be personal, because all Budget Directors have done this—and estimated inflation would be less than the year before. Every year they have been wrong. You are keeping the same litany. You are coming in and telling us inflation is going to be less than the year before and in fact the year before that.

I am just wondering what there is to give us any confidence in this kind of an estimate when we recognize that the latest figure we have is that the cost of living is going up at a 6-percent annual rate, the latest month on the Consumers Price Index, and the wholesale price index goes up even more rapidly than that. Analysis of the productivity and rises in prices, fourth quarter, which came out last week, productivity is off, which is crucial if we are going to get inflation under control. I am just wondering what you are going to do about inflation.

You answered Congressman Boggs this morning by indicating some reluctance to engage in as vigorous a wage-price policy as the previous administration did. What are you going to do?

Mr. SHULTZ. Well, let me say first that I think it is not a good idea to take a particular figure for a particular month and try to make too much out of it.

Now, let me just take the wholesale price index figure that you alluded to as an example.

As you know, there are broadly speaking two components to that index. One has to do with industrials and the other has to do with farm products and processed foods and feed. The latter is very volatile. Over the years, those prices go up and down very rapidly, and jump considerably from one month to the next.

In the month before last, there was very large decline in that element of the index, and in the most recently recorded month there was a bounce-back of about half.

Now that bounce-back is what led to the increase in the index, just as the bounce-down led to a decline the next month.

There are two things to take a look at. One is what happened on the industrial side and the seasonally adjusted picture. That went up by a tenth, which is very small. Again I do not want to make too much out of that. It is one month but there it is.

Now, beyond that what we want to do in looking at the wholesale price index is to look over a longer period. And there what you see this year is a considerable amount of progress on the wholesale price index. I believe myself that the structure of the wholesale price index is such that it overestimates the way prices are behaving in the industrial sector because it directs itself toward list prices rather than transaction prices, and typically when markets are soft, the transaction prices are under the list prices. There has been a very fine piece of research explicitly on this point, published about a year ago, that I think is worth looking at.

Chairman PROXMIRE. Let us just take a look at what the faces really show. On page 56 of the Economic Report, consumer finished goods went down 2.8 percent in the first of 1997, down 2 percent in the second half. Other consumer nondurable goods up 2.6 percent in the first half, up 4.8 percent in the second half, twice as fast. Consumer durable goods, 2.7 percent in the first half, 5.9 percent for the second half. Producer finished goods 3.7 percent in the first half, 6.2 percent in the second half.

Now, this is just a record of wholesale prices in the area that can be affected by fiscal and monetary policy and I would agree with you that food is much less subject to that kind of influence. Where they can be affected they are going up more rapidly before. The trend is up, not down.

My question to you is what are you going to do about it? What are you doing to it?

Mr. SHULTZ. The things to do about that are, first of all, to have the economy grow, and grow at a rate that does not take all of the discipline out of these markets. I do not really think there is much question but that discipline is getting to those markets now. We also must do the sorts of things that will enable output per man-hour to grow at a rate equal to the rate of increase in wages. Once we get that situation in place, unit costs will cease to rise, and there will be a tendency for prices to stop rising. Then we will have really done something constructive about inflation. Overall this has been the tendency recently.

Chairman PROXMIRE. The fact is the economy has not grown. The economy has declined in the last year. It has gone down as I think you know.

Mr. SHULTZ. That, I think, Mr. Chairman, is an artifact of the automobile strike, let alone many other strikes.

Chairman PROXMIRE. Forget the automobile strike. It certainly has not grown in anything like the long-term trend. It has not grown, leaving out the automobile strike, has not grown at 1 percent, let alone 2 or 3 percent, 3 percent being the long-term average, or 3½. Far below.

Mr. SHULTZ. If we had not had the automobile strike, then I think it is pretty easy to show that the rate of growth in the third quarter would have been up about 2 percent in real terms and in the fourth quarter would probably have been a little bit better than that. We would have had growth in those two quarters, following a decline in the first quarter and the increase in the second quarter was so slight that I would call it no change. So we have a pattern of the economy starting to expand and the auto strike coming in and hitting us as a gigantic air pocket hits an airplane. The strike is a very major factor.

I think it is an interesting thing the economy has withstood that and is now moving forward again.

Chairman PROXMIRE. That is certainly the greatest emphasis I have heard by any economist on the effect of that strike. The steel strike which we may have, most people seem to think we are likely to have this, could be even more pronounced.

Let me ask you what you have done in specific terms. How would you think about taking the following kind of action which is available to the President to hold down prices:

1. Removal of the oil import quotas.
2. Removal of voluntary quotas on steel imports.
3. Reduction of the preference given domestic over foreign suppliers of defense equipment.
4. Sales of materials out of the Government stockpiles.
5. Immediate introduction of the final reductions of tariffs under the Kennedy round.
6. Abandonment of the efforts to obtain import limitations on textile imports.

Any prospect that any of these actions that would have a specific direct effect in holding down prices, that the President is considering them or might take them?

Mr. SHULTZ. Most of those relate to the import question and I made clear, I think, that the discipline of international markets is very good for our economy. It is not by chance, I think, that what is perhaps our most undisciplined market is construction, which is insulated from international markets.

Chairman PROXMIRE. That is a nice general statement, Mr. Shultz, but the administration has not been following that. They recommended textile quotas. They have been the ones who have not put into effect a reduction in oil import quotas. Canadian oil especially, there has not been any case made that that has any relationship to national defense. All along the line we hear the administration may favor free trade, but where is the evidence?

Mr. SHULTZ. The broad evidence is that the President's trade bill in the last session of the Congress was a proposal for continuing the effort toward free trade. With the exception of the textile case his statements consistently opposed the imposition of quotas, either directly in the form of the so-called basket clause that was put forward in the Congress. I think there is an important point there.

This administration did conduct a very thoroughgoing study of the oil import question and all of that material is on the record and has been published.

Chairman PROXMIRE. Well, studies have been made, Mr. Shultz——

Mr. SHULTZ. And then beyond that, in recent months, several steps have been taken to free a larger flow of oil into this country.

Chairman PROXMIRE (continuing). But where is the action? The fact is the spokesmen in the area—the Secretary of Commerce favors this kind of restriction. I say the Secretary of Commerce has been fighting hard for these restrictions and you may have made a study of the oil import situation but you certainly have not taken any action.

Mr. SHULTZ. No. There have been definite actions as Mr. Boggs probably can tell you. [Laughter.]

Chairman PROXMIRE. Is the administration satisfied with the 6.8-percent increase in steel that Bethlehem and United States Steel finally stayed at? Is it satisfactory?

Mr. SHULTZ. I think it is a mistake to get into the position of passing judgment on the precise details of a given price increase anywhere in the economy.

Chairman PROXMIRE. Let me move very quickly to something else.

The Economic Report contains an analysis at long last of the effects of defense spending in the economy. We welcome that. It is not enough but what this analysis shows is that 1.1 million jobs were lost or were eliminated because of the various actions in the defense sector and I think that was good. I would like to have seen a swifter cutback but the point is the President programed this, we knew it was coming. What action has been taken to provide jobs? You as the former Secretary of Labor, you are probably the most able man in the administration in the area of manpower training and providing jobs.

What action in view of the President's veto of the Manpower Training Act, what action has been taken to see that the planned scheduled demobilization of people in the military, that jobs have been provided for them?

Mr. SHULTZ. The most important action, of course, are those that the administration is doing that will lead us to a healthy economy. The economy we inherited was a very unhealthy economy. I hope and think that we are getting back to the point where our economy, in general, is healthy. That is the most important thing we can do by way of getting jobs for people. Beyond that, the administration proposed an important revision of the whole manpower training system, involving provisions for much better management of that program and, beyond that, putting forth the idea of a trigger mechanism that would bring in more funds to manpower training if we had a rise in unemployment.

We put that forward a year and a half ago and very little was done about it. We also proposed a strengthening in the system of unemployment insurance which I am glad to say was acted upon by the

Congress. I remember working with Mr. Boggs on this in the Ways and Means Committee and I think the committee and the administration worked together very constructively.

Representative BOGGS. You did a fine job, Mr. Shultz. I commend you.

Mr. SHULTZ. We did not get all of the things we wanted. We wanted to get some coverage of farmworkers, but we did not get it. We had a few other complaints, but, on the whole, this was a good bill and the most sweeping, far-reaching revision of the unemployment compensation system since its original passage.

I think that the bill was a constructive step. Now, there are also lots of administrative actions that this administration has taken. The process of finding jobs for people who have transition problems—people who were laid off or quit a job and want another—this whole process of movement from one job to another needed a considerable amount of work. This was recognized, and from a standing start, this administration has put into place well over 50—and we can get the exact number for the record—job banks, which have had a major impact in facilitating the process of helping people find work.

(The following information was subsequently supplied for the record:)

There were 59 job banks in operation on January 1, 1970. Four more were added during that month, for a total of 63 as of February 1.

Mr. SHULTZ. There has been a great variety of other things that we have sponsored to make the labor market work better. Not the least of these is in the civil rights area.

Chairman PROXMIRE. Well, my time is up. I just say in conclusion, Mr. Shultz, that while you undoubtedly have done something, and I think you have done perhaps more than anybody in the administration in this area, you obviously have not done nearly enough because unemployment is 5,400,000 people as you know. It has been increasing rapidly. There is every indication, you project, it will be around 5 percent at the end of the year. We just have to do a great deal more than we have done but I would say you have done as much as you can as an individual but the administration it seems to me is far short of what they can do and should do.

Senator Miller.

Senator MILLER. Thank you, Mr. Chairman.

Gentlemen, a year ago we were presented with a proposed balanced budget for fiscal year 1971 and now in the estimates in the Budget in Brief, we find an estimated deficit of $18½ billion for this fiscal year.

Could you tell us the components of that $18½ billion deficit? What went wrong? What is the makeup of that in shortfall in revenue which I know is one component. Can you give us a breakout on that?

Mr. SHULTZ. Yes. I have some tabular material here. There is a short form and a long form, so to speak. I will summarize it if you would like, or I will be glad to put the tabular material in the record.

Chairman PROXMIRE. Without objection, the entire form will be put in the record.

(The information referred to follows:)

TABLE 1.—*Effect of changes in 1971 estimates on surplus and deficit*

[In billions of dollars]

February 1970 estimate of 1971 surplus	1. 3
Changes to May 19, 1970:	
Mandatory changes:	
Outlays (including pay raises)	−3. 8
Receipts	−1. 1
Total, uncontrollable changes	−4. 9
Congressional changes:	
Outlays	−. 2
Receipts	+. 2
Total, congressional changes	-----
Other changes:	
Outlays	−. 8
Receipts (proposed legislation)	+3. 1
Total, other changes	+2. 3
May 19 estimate of deficit	−1. 3
Changes to January 1971 estimate:	
Mandatory changes:	
Outlays	−6. 1
Receipts	−6. 6
Total, uncontrollable changes	−12.7
Congressional changes:	
Outlays	−2. 6
Receipts	−3. 5
Total, congressional changes	−6. 1
Other changes: Outlays	+1. 5
January 1971 estimate of deficit	−18.6

TABLE 2.—*Change in 1971 outlays from February 1970 budget*

[In billions of dollars]

February 1970 estimate of 1971 outlays	200.8
Mandatory changes:	
Pay raises—civilian and military raises effective January 1970 and January 1971 and wage board increases	3.2
Unemployment benefits (including benefits for veterans and former Federal employees)	2.3
Interest on the debt	1.8
Retirement payments—civil service, Foreign Service, military, and railroad retirees	.4
Offsetting interest and retirement payments within the Government	-.6
Veterans benefits (excluding effect of new laws)	.4
Social security benefits:	
Under existing legislation	.2
Under proposed legislation	1.1
Public assistance grants including medicaid	.9
Sales of financial assets	1.0
Farm price supports	-.5
Medicare	-.5
Food stamp program (excluding effect of congressional action)	.1
Subtotal	9.9
Effect of congressional action (including inaction):	
Appropriations:	
Defense and military construction	-.8
Other	1.1
Postal rate increase (effect of inaction)	1.2
Veterans bills	.5
Inaction on laws to permit sale of stockpile commodities, Alaska railroad, and veterans housing loans	.4
Inaction on veterans, medicaid, and other reforms	.4
Revenue sharing and family assistance programs	-.8
All other action, net	.1
Subtotal	2.1
All other changes, net [1]	(2)
January 1971 estimate	212.8

[1] This total is the net result of many increases and decreases in estimates.
[2] Less than $100,000,000.

Senator MILLER. Just a few of the highlights there.

Mr. SHULTZ. All right.

Senator MILLER. The big items.

Mr. SHULTZ. You have to take this in two pieces, rather than in terms of deficit or surplus. First look at outlays and then look at receipts. Then you put the two together and that is what gets you the difference.

We started out with estimated outlays of $200.8 billion.

Senator MILLER. How much?

Mr. SHULTZ. $200.8 billion as a starting point. Now, there were about $9.9 billion, of changes that were mandated in one manner or another.

Senator MILLER. Mandated by whom?

Mr. SHULTZ. Well, in all cases by law. In some cases the result of an existing law, the automatic operation of which resulted in a change. The most important example is the unemployment insurance law, where outlays came to about $2.3 billion more than were originally estimated. That is, of course, a measure of the shortfall in the economy.

The largest single number here is for the pay raises, civilian and military pay raises, some effective January 1970, and some effective January 1971. For fiscal 1971, the outlay impact of pay raises was $3.2 billion.

The estimate for interest on the debt, as interest rates rose, had to be raised by a total of $1.8 billion. I am not reading everything on the list, only the major items.

Social security benefits. Of course, we do not know the extent to which the social security benefits will be increased. The amount of the outlay increase depends upon the benefit increase that is adopted. Assuming that the President's proposed 6-percent increase, the outlay estimate would be $1.1 billion above that originally estimated.

There are also some negatives in the mandatory changes; that is, where our present estimate is a little lower than the original estimate. But the net effect of all mandatory changes comes to a total of $9.9 billion more than was originally estimated.

Now, there were, of course, a large number of cases in which Congress acted for spending or failed to act on something that the administration had proposed. These also made a difference on the outlay side. In some cases the Congress' action reduced our estimates, and in other cases not.

For example, the administration proposed revenue sharing last year. The administration also proposed the family assistance plan, a welfare reform, last year. Congress did not act on either of those. We had an estimate in the budget, and the failure of the Congress to approve the welfare system reduced budget outlays slightly. I think it cost the country quite a lot in terms of the welfare system; but, nevertheless, just in terms of this kind of tabulation, those two things together reduced outlays by $0.8 billion.

On the other hand——

Senator MILLER. Pardon me. On that point, there was an estimate of over $4 billion increase in the budget for that welfare program, was there not?

Mr. SHULTZ. That was for the first full year.

Senator MILLER. Yes.

Mr. SHULTZ. Now, as you get started, you start and there is a lesser amount.

Senator MILLER. How much was there for fiscal 1971 in that?

Mr. SHULTZ. I think about half a billion dollars for fiscal 1971 was in the budget which will not be expended. Of course, revenue sharing was also proposed. Last year's proposal would have started very small and then built up. This year the President has proposed a much more ambitious startup.

The failure to take action on a postal rate increase by Congress costs us revenue. Postal rates are proposed to rise now and should, we think, but last year's cost was about $1.2 billion. Various appropriations actions by the Congress raised 1971 outlays by about $1.1 billion. And there are various other items in the list that I have submitted in the tabular material for the record.

At any rate, all of this together, the pluses and the minuses, moved the outlay estimate from $200.8 billion up to what we are currently estimating as $212.8 billion. This is a large increase in outlays.

Senator MILLER. I appreciate the fact that there are some of these items in here that are quite different when it comes to estimating from trying to estimate gross national product, but as you well know, the administration's estimate of $1.065 billion GNP is considerably higher than a consensus figure of many economists, upwards of $20 billion.

Mr. SHULTZ. I discussed that consensus figure just before you came in Senator.

Senator MILLER. Well, the point is that if they are right, if the consensus is right and you are wrong, what revenue impact would that mean which would be reflected in an increased budget deficit? Do you have some rule of thumb?

Mr. SHULTZ. I have a table here that estimates the difference in revenues that would result from varying levels of GNP. Our budget revenue estimates are based on a $1.065 billion GNP.

Senator MILLER. Now, I just want the difference between the consensus. Let us have the $1,065 billion revenue estimate or budget deficit. I think that would be easier. The budget deficit with $1,065 billion is $11½ billion.

Now, what is the budget deficit with a $1,045 billion GNP?

Mr. SHULTZ. Well, our tentative estimate, we figure that if the gross national product were $1,045 billion, it would cost in terms of revenues about $7.1 billion, so you can add that on. That would be $18.7 billion.

Senator MILLER. In other words, your mathematics indicates roughly a $7 billion figure of revenue for $20 billion of GNP?

Mr. SHULTZ. Roughly, yes; that is right.

This is our arithmetic based on one set of assumptions. Of course, as you change your GNP assumption you change your revenue assumption.

Senator MILLER. Right. But would not that revenue assumption vary according to the makeup or content or qualitative content of the GNP?

Mr. SHULTZ. Yes; it would vary some depending upon the distribution of corporate profits and personal income in your tax base. Our estimates are based on our assumptions as to what would happen to corporate profits and personal income at various GNP levels. That is the way we made them up.

Of course, if we are at this lower level our corporate profit picture would be much worse. That is the most volatile element in these ups and downs of revenues.

Senator MILLER. I am sure that you have a highly sophisticated method of making your estimates but that highly sophisticated method existed a year ago and we were told we would have a balanced budget and I must say that while I am hopeful and certainly pray that you are right, that many people are concerned over the accuracy of the estimates that you have projected. If we are going to be off as much as we were a year ago in the budget deficit I query if we may not be off just as much again on our estimate of only an $11 billion budget deficit premised on a $1,065 billion GNP.

I understand Mr. McCracken said the other day that unforeseen developments which are not included in the assumptions, grave international incidents which could affect our exports, serious strikes on the homefront, if these occur all bets are off. I can appreciate that. But—and you have already indicated that the General Motors strike interfered seriously with your assumptions—absent those changes I am wondering how accurate our estimates really are?

Mr. SHULTZ. Well, let me distinguish the point, if I may. I think that the Treasury can do a fairly good job of translating a given level of gross national product into estimated receipts. They can be off a little bit this way or that way but that is something that is calculable, and they can hit fairly well.

The problems that people have had, not only government economists but private economists, in estimating what the gross national product will be a year ahead or so are more difficult. We have confidence in the method that we are using, and we think that if the policies that we hope for, particularly from the monetary side, are put into place, those estimates will turn out to be all right. And maybe they are even a little conservative. Estimates are subject to error. I noted earlier that the private forecasts to which you referred as being lower than ours this year, have, through the expanding GNP years of the 1960's, been off consistently. They have systematically underestimated the expansion such that if you added their average error to the present estimate, it would bring the number to above $1,065 billion.

Senator MILLER. My time is up. Thank you very much.

Chairman PROXMIRE. Senator Percy.

Senator PERCY. Mr. Shultz, you have been answering questions for about 2 hours now. If you would care to have Mr. Weinberger, Mr. Nathan, Mr. Cohn, or any of your other colleagues, respond to my questions, it would be a very satisfactory substitute.

I would like to say also that, along with Internal Revenue Service, I look on the Office of Management and Budget as the most efficient, effective agency in Government. In my own experience here in 4 years, including this past 2 years, I have had excellent cooperation when I have gone for assistance to the Office of Management and Budget and asked what can we do in the Congress to save the taxpayer money? My own personal experience is that billions and billions of dollars are saved by this particular office in a highly efficient, effective manner. The staff is small but is a dedicated group of men and women. I think that should be made a matter of public record.

I would like to ask you a question on priorities. We have been paying farm income stabilization payments for many years. In the 1972 fiscal year it will be $4,227 million, which is an increase of 3.6 percent over the preceding year.

Is there any program that the administration has to wean ourselves away from these surplus payments which concentrate themselves in just a relative handful of crops—peanuts, cotton, tobacco, corn, wheat and so forth? Can we get ourselves away from these surplus payments and the controlled market that costs us so much?

Mr. SHULTZ. Well, some efforts were made in connection with the farm bill last year and perhaps since you suggested different people might do a little of the commenting, I could call on the Assistant Director who worked on this area, Mr. Rice, to respond to that question.

Mr. RICE. Thank you. Senator Percy, as you know, this Administration has tried——

Chairman PROXMIRE. Mr. Rice, will you pull the mike a little closer to you.

Senator PERCY. I think you have to speak up a little bit.

Mr. RICE. This administration has tried to emphasize that——

Mr. SHULTZ. As a matter of habit, I know he speaks very softly, and I think the technique is to make you listen carefully. [Laughter.]

Mr. RICE. We have tried to find ways to emphasize the free market approach more in agriculture and a lot of possibilities are moving in that direction. Some of them were discussed and some incorporated in the farm bill last year. Nonetheless, I think it is important to note that such movements cannot in any sense be precipitous, they have to be a gradual kind of transition. They have to be made with a very clear eye on the protection of farm income.

At the same time, efforts were made to move to a more market-based-farm program.

One of the principal changes that was built into the recent farm bill is to give the farmer a great deal more flexibility to mix up his crops on the acreage that is available for planting. This allows him to make his choices in a way that he thinks will maximize his farm income. This is an area that the administration is most concerned about and one in which we are trying to make movements in the direction you suggest. But I think it is important to understand that they should not be precipitous moves.

Senator PERCY. As a result of the Republican change in the seniority system, we have a new ranking Member now, Senator Miller of the Agricultural Committee, so he may want to pursue that a little further.

I would like to take the other side of the question, how much we are able to spend on the hunger program. We are pending $4,200 million on farm subsidies. We are spending about $2 billion on feeding the hungry and it is estimated by the Office of Management and Budget that the minimum amount required to do this is about $2,900 million. So we are deficient.

I saw a headline in the New York Times the other day: "Delegates to the Second White House Hunger Parley Attack President's Program."

I would like to take a minute, Mr. Chairman, and ask permission that an article be inserted in the record from the Evening Star of February 5, "Survey on Hunger Program Reveals Significant Gains." I think we should point out that we are making progress. The article says:

> The Nixon Administration's antihunger program has produced significant, often dramatic gains, a New York Times survey of recipients and experts across the country has disclosed. * * *
>
> In New York City, for example, the number of people who have benefited from Government programs has quadrupled since the Nixon Administration took office. The number has doubled since last September.
>
> In every area surveyed, there has been substantial improvement in Federal assistance. In Pennsylvania, for example, the number of children receiving lunches has jumped from 25,000 a month in January 1969 to almost 2.8 million a month.

An incredible figure, if correct.

> In South Carolina, the number of those receiving food stamps has gone from 118,000 to almost 270,000 * * *.
>
> Nationally, administration statistics show that the food stamp program has grown from 3.6 million recipients to 9.3 million in they ear. Spending has increased in 3 years from $248 million in 1969 to a projected $2 billion starting next July.

(The article referred to above for the record follows:)

[From the Washington Evening Star, Feb. 5, 1971]

SURVEY ON HUNGER PROGRAM REVEALS SIGNIFICANT GAINS

New York Times News Service

The Nixon administration's anti-hunger program has produced significant, often dramatic gains, a New York Times survey of recipients and experts around the country has disclosed. But the job in only half done, they say, and they now fear a leveling off of federal efforts.

"Half a loaf is better than none," said one expert. "But it's still half a loaf."

Yesterday, on the eve of the second White House Conference on Nutrition, both critics and beneficiaries cited gains in the number of needy people now receiving food stamps, subsidized school lunches, and other federal food assistance.

In New York City, for example, the number of people who have benefited from government programs has quadrupled since the Nixon administration took office. The number has doubled since last September.

MANY NOT REACHED

But at the same time, the survey disclosed, large numbers of needy people still are not being reached.

The 750,000 people now receiving food stamps in New York City are estimated to be only 38 percent of those eligible.

In such places as Seattle and Detroit, depressed economic conditions appear—even in the face of sharply increased federal food assistance—to have swollen the number of the needy. And, despite presidential assertions of "an impressive record indeed," a coalition of anti-hunger groups insists that only half the needy children are receiving food assistance.

The administration's new budget for anti-hunger programs, meanwhile, is leveling off, says Robert B. Choate, a leading Washington authority on hunger groups insists that only serves recognition for what it has done, he said yesterday. "But the new budget figures seem to be more of an epitaph than a progress report."

The new White House conference is a one-day follow-up to the conference of 3,000 consumers, industry representatives, and poor people held in Washington in December 1969.

By contrast, the meeting that begins today in Williamsburg, Va., will be limited to about 200 participants, few if any of them poor.

The participants, in their evaluation of progress made since the 1969 conference, will hear reports of significant gains from administration spokesmen.

Many of these gains are confirmed by the Times survey, covering 10 select and disparate areas ranging from Maine to Arizona.

ASSISTANCE IMPROVES

In every area surveyed, there has been substantial improvement in federal assistance. In Pennsylvania, for example, the number of children receiving lunches has jumpted from 25,000 a month in January 1969 to almost 2.8 million a month.

In South Carolina, the number of those receiving food stamps has gone from 118,000 to almost 270,000 in the same period. In Maine, the number receiving either stamps or surplus food has increased from 68,000 to 91,000.

Nationally, administration statistics show that the food stamp program has grown from 3.6 million recipients to 9.3 million in the last year. Spending has increased in three years from $248 million in 1969 to a projected $2 billion starting next July.

But despite the increases, hunger and malnutrition remain severe problems, in in several of the areas surveyed.

The number of food stamp recipients in West Virginia has increased almost 50 percent in two years. Yet authorities believe that more than a fifth of the state's families still exist on inadequate diets.

The obstacles to broader participation are by no means limited to federal spending levels. In many areas, particularly where surplus food continues to be used rather than stamps, some people are too proud to participate. Others do not know how to enroll. Still others are deterred by complex regulations.

"There are times when they just don't have the $41 needed to purchase the stamps—and two weeks later they will have to come up with another $41," says

Arthur Schiff, director of the food stamp program in New York City. "Six consecutive (misses) and they are dropped from the program. It takes a long time to reapply."

But in several other areas, the administration is credit with triumphs over red tape.

A Detroit official says the subsidized lunch program "is the least cumbersome federal application I've ever worked with."

Senator PERCY. Senator McGovern, though he has been critical, has said this administration has done more to feed hungry malnourished people than any administration in history. I say this before asking this next question, because I feel we have made great progress but still have a way to go.

The President did pledge to have a feeding program for feeding six and a half million schoolchildren by last Thanksgiving. Regretfully that deadline was not met, though we did substantially increase the number. We may never have achieved it if he had not set a goal.

Is there in this budget adequate provision made to now reach six and a half million school children in the school lunch program?

Mr. SHULTZ. I would like to ask the assistant director who works on this area, Richard Nathan, to respond to that.

Senator PERCY. Mr. Nathan.

Mr. NATHAN. Senator, the figures that you cite, the administration's record in the hunger area, are indeed impressive, but just to make some additional points that I think are useful to bear in mind, there has been a sevenfold increase in the expenditures under the food stamp program. Under new legislation that this administration recommended, it would now be possible to provide free food stamps to families without any income at all. This is the first year in which participation in the food stamp program—this will happen shortly—will exceed 10 million people.

Senator PERCY. Mr. Nathan, my specific question was on school lunches.

Mr. NATHAN. I am not sure whether we are going to exceed the target of having six and a half million children participate in the school lunch program. But on the point that you made in reference to not having achieved this goal by Thanksgiving of last year, we did face a situation last year where the legislative authority that we needed in order to expand the program was not available to us. It is my recollection that we now have that authority and that we are now able to move on that program in a way that will permit us to achieve the target previously announced.

Senator PERCY. Could you also provide for us the figure as to how much is being spent in this budget as against what the Office of Management and Budget would project as the required amount to close the gap in this country to feed the hungry?

(The following information was subsequently supplied for the record:)

The 1972 budget provides $2 billion for food stamps, $583 million for child nutrition programs, $513 million for commodity distribution programs. Further increases in social security and welfare reform will provide substantial improvements in the cash position of millions of poor families—enabling them to purchase more food and other living necessities.

We do not have reliable figures on the extent of hunger and malnutrition in the United States—and the cost of their elimination. The Department of Health, Education, and Welfare is presently conducting a National Nutrition Survey that will determine not only the extent of hunger and malnutrition, but also the causes. The National Nutrition Survey should determine the extent of malnutrition and answer such questions as: How much hunger and malnutrition is a result of low—or no—income? Of poor allocation of resources? Of lack of education?

The Administration has emphasized the goal of eradicating hunger and poverty's other characteristics by an income strategy designed to provide long-term income security for American families. A vital first step in this direction is welfare reform, which the Senate will consider this year.

Senator PERCY. My last question is a short one. It just has to do with consumer sentiment.

In the Economic Report it is indicated that consumer buying sentiment was not very good in the third quarter of 1970. Is there a more current estimate we have of consumer sentiment which has so much to do with the strength of our economy.

Mr. SHULTZ. I believe you are referring to the surveys such as the University of Michigan Survey Research Center.

Senator PERCY. Right.

Mr. SHULTZ. I hesitate to say offhand because I do not have the numbers in mind. My impression is that their index of sentiment has been moving upward with a greater increase but I am not positive and I do not have the numbers here. Perhaps somebody else has got those.

Mr. LAFFER. I do.

Mr. SHULTZ. I hope I am not wrong on that. If I am wrong, you had better say——

Senator PERCY. I do not want to take the time of my colleagues. If you would just like to furnish that for the record when you find it I would appreciate it.

(The following information was subsequently supplied for the record:)

The index of consumer sentiment registered a 72.4 in the fourth quarter of 1970 on a scale where the first quarter of 1966 equalled 100. Throughout the year 1970, the consumer sentiment index has been 78.1, 75.4, 77.1, and 72.4 from the first through the fourth quarters, respectively.

Mr. COHN. Let me provide the answer to your prior question, Senator Percy. I have had a chance to look in the telephone-book-size appendix for free and reduced price school lunches.

The budget plan Mr. Nathan referred to is that in fiscal year 1971 we will serve 6.6 million children with free and reduced price school lunches. So I gather the target is being reached.

Senator PERCY. Right. I very much appreciate that.

Chairman PROXMIRE. Mr. Brown.

Representative BROWN. Mr. Shultz, I want to turn to a specialized portion of the Economic Report and that is the part dealing with trasportation beginning on page 122 and the subsequent pages.

In this the report calls for the deregulation of transportation insofar as possible, particularly surface transportation, to allow the onset of competitive rates in those areas, rates that according to the arguments presented by the report will bring the actual costs closer to the true social costs of transportation.

It seems to me that transportation is one of those areas which, if allowed to operate as firm as it can, or if it can be improved, would stimulate the growth of the economy. The thrust of the report deals with the unevenness of Federal regulation but it makes a couple of other passes at some additional problems which I should like to pursue just for a moment.

The report says:

While the focus here will be on regulations, this is not the only Government policy that creates a divergence between private and social costs. Inland waterways, for example, are developed and maintained out of general tax funds. There is no direct charge levied on the barge operators who use them. Many barge rates consequently fall short of the social cost of such traffic and lead to uneconomic diversion of traffic to barges.

In addition some States have laws that inhibit the efficient utilization of labor on railroads.

That portion of the paragraph deals with several other aspects which I think along with uneven regulation need attention from the Federal Government. One is uneven subsidization. It occurs to me that highways and waterways are both maintained by the Federal Government and that in the railroad industry the rights-of-way are maintained by the carrier and passed on directly to the users of that carrier in terms of costs in that they maintain the rights-of-way at all.

There is also an unevenness in taxation between States and between modes of transportation. And an unevenness in the application of labor laws. The Teamsters, for instance, fall under the Taft-Hartley law, the railroad workers and airline employees fall under the Railway Labor Act.

Since your responsibility as Director of the Office of Management and Budget also deals with the reorganization of the executive branch of government, are we going to have a concerted effort to even up this question of uneven regulation and uneven subsidization of the various modes of transportation?

Mr. SHULTZ. That is certainly the direction in which we would like to work with the Congress.

If you look at the situation in much of the transportation industry, and the problems that we see there in the managerial area, collective bargaining area, and elsewhere, there is very little reassurance that high degrees of regulation produce good results.

Representative BROWN. Well, I think it is more than just regulation but it occurs to me because of the delicate health of certain aspects of the transportation industry in our society that before we move to a sharp deregulation, that perhaps we should move to a more equitable regulation under return circumstances which might call for the combination into a single regulatory agency of the modes of transportation.

Does the administration intend to push aggressively for this policy or this program of equalization of regulation?

Mr. SHULTZ. The problem of regulatory agencies and their operation was one that the President put to the Ash Council. They did make recommendations to the President about rearrangements of the organizational structure of regulatory agencies, and their report is about to be released.

Representative BROWN. It has already been in the papers but I guess it has not been officially released.

Mr. SHULTZ. All of it leaked long ago.

Representative BROWN. I assume the answer to the question whether the administration is going to push for it is yes; is that correct?

Mr. SHULTZ. Yes. I think it is a fair statement. The regulatory agencies are creatures of the Congress. So, it was appropriate that, having made a study and having put some ideas forward, the report should be put into your hands. Together, we can see what ideas can be developed. But this is, I think, something particularly appropriate for Congress to dig into.

Representative BROWN. Has any thought been given to the economic impact of the unevenness of the subsidization of the maintenance of right-of-way of various modes of transportation?

Mr. SHULTZ. Yes; but I do not know how to respond to your followup question of just what and where and in what respect. Mr. Rice, can you?

Mr. RICE. I can offer an example which relates to one of the points that you brought up, Congressman. As you may have noticed, we do not have in the revenue projections for this budget a specific provision for a specific amount based on a proposal about a waterways user charge. There have been such proposals in previous budgets, but we do not have one included here at this time because we have had the Department of Transportation studying that matter in a great deal of detail.

Previous proposals, based largely on taxing the fuel for barge operations, have not been passed by the Congress. So the Department has been looking at a wide range of alternative types of user charges that might be appropriate.

We expect to have a proposal in that area in the next few months.

Representative BROWN. I am very encouraged by the attention given to this rather basic problem in the transportation industry, by the report. I must say, however, that I just do not think the report goes far enough and that there is a great deal of additional detail that must be brought into balance here in order to have efficient utilization of the modes of transportation in our society and economic development of them, balancing of them, so that they can be most effectively utilized for the social benefit that they are in our economy.

I would like to ask another question in a different area but in the same vein. And that is the question of costs of education.

It occurs to me that one of the vehicles which has not been adequately explored by the administration and Congress for reducing the costs of education are the possibilities implicit or inherent in effective utilization of what started out to be educational broadcasting and has now suddenly become public broadcasting with a deemphasis on the instructional and educational use of that medium and increasing emphasis on the cultural use of that medium, whatever that is. It seems to me there are great opportunities in this area to reduce the costs of both public and private education and those have not been adequately followed up on by either the Congress or the administration and I would like to see, personally, some attention given to that area of reducing the economic costs and increasing the social benefits to be derived from this public source.

I wonder if anyone has any comment on whether that is likely to be explored or has been explored in the past?

Mr. SHULTZ. I do not have any immediate comment on that. I think that the whole area of new technology and its use in education is a very important matter. Sometimes the developments turn out to have more promise than they actually produce; in other cases we see quite startling and productive uses of new technology. I think Mr. Weinberger has a comment on that.

Mr. WEINBERGER. Congressman, what is done in this area should in the administration's view, be done locally to the largest extent possible. There is, however, a substantial amount that the Federal administration can do to point out possible savings. The Corporation for Public Broadcasting, which is funded to a very considerable extent by the Federal Government, has some work underway in allocating both construction and program grants to local areas and to private groups that can encourage a greater use of educational television, both as an adjunct to the classroom and in the classroom itself.

Some of the States are working through educational television stations, supported partially by Federal grants, to substitute a substantial amount of classroom teaching by the use of educational television tapes, some produced nationally some produced locally.

HEW also has some construction grants to encourage the increased use of facilities and construction of facilities for this purpose.

There is no doubt that there can be substantial savings made in the actual condition of classroom instruction and, in some areas, some reason to hope that we can get a more competent form of classroom instruction through the use of well-prepared television programs both with respect to basic subjects and others. Of course the success of Sesame Street and other such programs is very well known and these at the moment are being used as supplements.

I can see a time when they may very well be used as substitutes for a more expensive form, and in many cases a more ineffective one.

Representative BROWN. It seems to me they offer a better promise than has been acted upon by either the Federal Government or the directors of Public Broadcasting.

Mr. SHULTZ. Mr. Nathan has some additional comments.

Mr. NATHAN. One other comment pertinent here is that the President proposed in his education message last year that there be established a National Institute of Education in HEW. Legislation is pending and has received quite serious consideration on the Hill. When the President proposed that legislation, he stated that it would permit us to make a major effort to study new ways to provide educational services and to improve the technology and productivity of education programs along just the lines, Congressman, that your question suggested we need to go. So this is something that is very much of interest to us in terms of the role that the Federal Government can play in the development and dissemination of new techniques in this field.

Representative BROWN. Mr. Chairman, if I may ask just one more question and terminate my question period.

In the budget, Mr. Shultz, you have related the total Federal debt as a percentage of the gross national product, and I note that just for the last 2 years that percentage has leveled off at 30 percent.

Now, granted that the direction over the past several years in that percentage has been happily downward, I would like to ask you as an economist what is that percentage that is desirable or where should it level off? Does this infer that you level off at 30 percent of our gross national product, or do you have some other ultimate figure in mind?

Mr. SHULTZ. I don't have any ultimate figure in mind, and I don't think there is anything especially magic about the present proportion. Our expectations would be that, with the economy moving upward, which would result in a smaller deficit in fiscal 1972 than fiscal 1971 and be smaller in fiscal 1973 than in 1972, and with the GNP growing, the proportion would tend to fall, as it has been doing for quite a long period of time.

Chairman PROXMIRE. Mr. Shultz, you base your confidence in your $1,065 billion forecast on which a great deal depends on the argument that in the past the consensus has been wrong, has been underestimated, but it has been called to my attention by the staff the very interesting fact is that the consensus by and large has been wrong, because they have underestimated inflation, not growth.

For example, in 1969, they overestimated growth. Their growth track record has been far better than their record overall. The principal error has been in the inflationary area, so that I think if we recognize that, and recognize the fact that your real growth estimates are higher than any other economist that we could get, 31 of them, it seems to me your estimate is particularly optimistic and you responded to other members of the committee by saying that what you are talking about, what you are aiming at primarily is not $1,065 billion GNP made up primarily of an increase in inflation, but an increase in real growth.

Mr. SHULTZ. Yes. Well, I don't want to leave the impression that we arrived at this estimate by taking the private estimates and then adding their typical error and coming out that way.

Chairman PROXMIRE. I understand, but I must say that is the general impression we get up here, because you won't give us a breakdown. You won't tell us and neither will Mr. McCracken, what your estimate is of the components of the GNP. You will not tell us what the increase is going to be in percentage consumption, what it is going to be in percentage investment, what it is going to be in State and local outlays.

[illegible] at, we just have to assume that you have got some kin[illegible] which is not a very clear one as far as we are concerned.

Mr. SHULTZ. Well, I would say, and I think I have said it before, that we have tried to go about this in a different way. We have looked at all sorts of statistics about the economy and the leading indicators, and all that type of material, but beyond that I have tried to work out a characterization or model of the economy.

Chairman PROXMIRE. But you have not let us in on that. I can understand you can go about it in several different ways.

I would prefer you to build it on a sector-by-sector analysis which has been the procedure usually used in the past. I can understand how you reject that, but having arrived at a figure of $1,065 billion, you ought to break it down and say what the components are. I cannot understand why there is this curtain between the administration and the Congress.

Mr. SHULTZ. Not necessarily, because if you try to make an estimate on the basis of gross movements of the economy and on the basis of the kinds of model that we have constructed, it doesn't necessarily lend itself to a detailed breakdown of all the inputs and outputs and their relationships. One of the problems is that when you try to go about it from the inside out, so to speak, you constrain your model by——

Chairman PROXMIRE. Again, go about it any way you want to. All I ask is having done that, then give us what the components are. It seems to me we are not really being let in on what the GNP really means.

Let me ask you this: The new budget contains funds for highly complex and sophisticated expensive weapons systems, and it has been a great matter of puzzlement to many of us whether the defense budget is going up, military going down, military personnel being cut, in spite of all the pay increases and inflation, the only answer seems one that Aviation Week came up with. I would like to quote:

> In almost every key new weapons program, a green light has been flashed, and the necessary funding increases to implement the signals have been added to the budget.

It seems to me that is why the budget really is going up.

Look at the systems. The billion-dollar systems include ABM, MIRV, B–1 bomber, F–14, F–15, USMS, AWACS, SRAM, Maverick, S–3A, P–3C, and F–5.

Does your agency examine these requests in detail and do you require that the military justify them? Do you run analyses on them to determine their strategic worth, their technological levels, and that kind of thing?

In view of the great waste that has been disclosed by this committee and others in recent years, we are deeply concerned about this.

Mr. SHULTZ. Of course, we do make an extensive review of the defense budget, but let me say that the increase in the defense budget is more than accounted for, so to speak, by changes in rates of pay.

Just the regular increases in pay account for $1.5 billion between the 2 years here. Beyond that, there is the proposal to move toward a greater acceptance of volunteerism, a volunteer armed force, and the Secretary of Defense proposed, by way of example, increases in pay of those with under 2 years in service by 50 percent.

Chairman PROXMIRE. Yes. That is a $1½ billion increase in pay, but the cutback in Vietnam has been in the order of $13 billion in the last 2 years. There should be a great deal of saving involved here. The President also indicated the Nixon doctrine means withdrawal from some other forward points, that we are going to give up some other bases elsewhere in the world.

Mr. SHULTZ. There are two points that I would make on this. First, in real terms, so to speak, adjusting for particular price escalations as they affect defense, including the wage changes, I believe that we are somewhere in the neighborhood of the 1964 level. In other words, it has gone back to approximately a pre-Vietnam level.

Second, the developments around the world within the last year, and I think particularly the very aggressive movements of the Russians in the Middle East, have certainly led the President to feel that this is no time to let down our defense guard, and I think that this is an important factor to be kept in mind. I don't want to get into the position of seeming to explain why the defense budget rose and to compare it too much with the 1964 level, because I think the spirit of it is that we want a strong national defense and the President is doing everything he can to put it there.

Chairman PROXMIRE. I want to question on this.

Senator Miller wanted me to yield. I yield.

Senator MILLER. Thank you, Mr. Chairman.

It seems to me another very important factor that must be taken into account is the inflation factor. I served on the Armed Services Committee for 4 years, and I know that each year the price of various types of hardware, especially weapons systems, was increasing even at a faster rate than the normal inflation rate in the country.

Do you have any figures there to show how much of this new budget for national defense reflects inflation over the last year or two?

Mr. SHULTZ. Yes. I think the best person to respond to that is the assistant director who works in the defense and international area, James Schlesinger. Let him comment on the general impact of inflation on defense cost.

Mr. SCHLESINGER. Senator, the increase in price, 1972 over 1971, is $1.2 billion.

Senator MILLER. How much?

Mr. SCHLESINGER. $1.2 billion.

Chairman PROXMIRE. I might say, of course, we have been fighting against that kind of inflation. We have got worse inflation in defense than in any other area of our economy. GAO estimated that 38 major systems were more than $23 billion or 50 percent above the contract agreements, so the problem is that inefficiency in procurements which is resulting in spending these sums far beyond their contractual agreements and then they turn around and blame this on inflation which is caused in fact by their own inefficiency.

Let me ask you this. It is hard for us to break all of this out, Mr. Shultz, unless you give us what the previous administration gave us, and that is what is the incremental cost of the Vietnam war. Previous budgets have given us that, at least President Johnson's budget did. You don't give us that. We are groping in the dark here. You won't let us in on what the factors are that are responsible for this increase in defense costs. You say inflation, pay increases, and then you don't give us the facts so that we can evaluate them.

Mr. SHULTZ. First, let me comment on the cost overrun points that you were making and say that, in response to that problem which was here when we arrived, very substantial changes have been made in procurement policies and procedures. Defense officials, of course, can speak about this much better than I, but we feel——

Chairman PROXMIRE. I might say the only Cabinet officer who refuses to come before this committee is Secretary Laird. Everyone agreed to come and is coming when asked. We asked most of them. But he won't come. So it is hard for us to get at the answers when the top man won't come before us.

Mr. SHULTZ. I have the impression Secretary Laird spends most of his time testifying before one committee.

Chairman PROXMIRE. But not before this committee. That committee is pretty friendly to him and doesn't like to ask the questions we do.

Let me ask you this. What I would like to get at because your function is so important in holding down excessive military spending, or can be. For 2 years, administration spokesmen including former budget Director Mayo has been assuring this committee that preferential treatment of the Defense Department would be ended. The information that I have received indicates just the opposite is taking place. The Pentagon has more privileges, more independence from the annual review process by which all the budget requests of civilian agencies are scrutinized.

For example, this year I am told you proposed a much lower defense budget, and that during the review process defense spending was pared down from $72 billion and then to $66 billion, but Secretary Laird supported an increase and Laird's views prevailed.

I am also informed that the defense hike was accepted because of the economic reasons, that is, to support an expansionary fiscal policy rather than military reasons.

Do you deny this and deny OMB still submits to a joint review of the defense budget and does not conduct an independent review as it does with the civilian agencies?

Mr. SHULTZ. First of all, Mr. Chairman, I think it pertinent to point out that the budget is the President's budget, not the Secretary of Defense's budget, not my budget. It is the President's budget, and the decisions about defense matters, as well as other matters in the budget, are the President's decisions. Our effort, along with the other Cabinet officers' efforts, is to see to it that the President has before him a well prepared set of analyses, as good as he can get, so that he can make his choices with full information.

So, it is the President's budget, and I can tell you that he has paid a great deal of attention to the defense budget problems.

Second, insofar as the point of desiring greater defense expenditures for the purpose of stimulating the economy is concerned, there is no foundation to that whatever. If one wants to use the budget to stimulate the economy, there are lots of ways in which revenues could be reduced or expenditures increased. There is no need to spend a single dollar of defense money purely and simply and only for that purpose.

The defense money is spent for the purpose of defense, and the economic aspects are different. So far as the joint review is concerned, this is a process that was going on when I assumed my present job, and it, I think, has a great deal of merit.

Chairman PROXMIRE. Why shouldn't it be applied to civilian agencies, too?

Mr. SHULTZ. I think it is a fair point. I have thought about whether or not we would be better off, acquire more information—big points of information—if we spent more of our budget review time out of the Executive Office Building and in other buildings.

You do get some feel for how the people are looking at the world and what their insights into their problems are. I don't say that is necessarily desirable, but I think it is a point worth considering.

Chairman PROXMIRE. The review, as I understand it, gives the Secretary of Defense an especially privileged position vis-a-vis your Office.

Mr. SHULTZ. No, I don't think so.

Chairman PROXMIRE. Unlike the others.

Mr. SHULTZ. I don't think that is the case at all. I don't think the joint review gives them any especially privileged position. It is a somewhat different process through which the early stages of review go, but the Director's review of the defense budget is undertaken by the OMB in the same way as other agencies are reviewed.

Of course, actually the kind of effort, appropriate type of effort applied, varies from one agency to the next.

Representative BROWN. Mr. Chairman, would you yield?

Chairman PROXMIRE. My time is up.

Representative BROWN. I would like to ask, Mr. Shultz, if it would be possible to take, or if you can do this right now, the amount of money being spent on the defense budget, say in 1962 or so, pre-Vietnam year, and relate that in dollars of those years to see what has happened in effect to defense spending. Has it increased, decreased; where are we? The inflationary factor has been mentioned.

Another way to look at this might be to take the third year of new administrations, for instance. That is what we are talking about.

There seems to be very heavy emphasis on whether this is being done right or wrong. The third year of previous administrations as they have come into office to see how that relates. Can you give me any figures on that?

Mr. SHULTZ. Yes, I can. I mentioned the fact that the defense budget in real terms was approximately in the vicinity of 1964, which was a prebuildup year. In terms of materiel purchases, the relative comparison is $31 billion versus $32 billion. So approximately the same on that scale.

Comparing defense outlays with the gross national product in 1962, just reading off this chart and interpolating, it was approximately 9 percent, declined to what looks like about 6¾ or 7 percent by 1964 or 1965, and it rose back up to over 9 percent in 1968. Then, since this administration has been in office, it has declined steadily and now, as a proportion of GNP, is below any time in the last 10 years.

In other words, it is below that low point of the 1964–65 period.

Representative BROWN. So in the——

Mr. SHULTZ. In excess of 6 percent.

Representative BROWN (continuing). Kennedy-Johnson years prior to the war in Vietnam, in other words—I don't want to misread this—we were spending about 9 percent, is that what you are telling me, of our GNP defense?

Mr. SHULTZ. It was declining. I will read you the exact numbers, if you would like. I will start with 1962. Defense outlays as a percent of GNP.

Representative BROWN. All right.

Mr. SHULTZ. 8.9 percent in 1962; 8.6, 8.3, and 7.2 in 1965; 7.7 in 1966. Then it turned around, 8.9 in 1967 and 9.4 in 1968. That is the high proportion. Then, beginning in 1969, 8.8, with a decline to 8.1 in 1970. We estimate 7.4 in 1971, and 6.8 in 1972.

Representative BROWN. So we are talking about actually back to a lower level than we have had experienced in defense spending as a percentage of our GNP in any year since when? This goes back to 1962, and I gather 6.8 is lower than anything since?

Mr. SHULTZ. I don't have the numbers on that.

Representative BROWN. You don't have it beyond 1962?

Mr. SHULTZ. I wouldn't want to make a statement without looking and seeing and—do we have the figures somewhere?

Mr. SCHLESINGER. I think that you have to go back to pre-Korean years to find a lower percentage of GNP going into defense.

Representative BROWN. In other words, the years in which Louis Johnson was dismantling the Defense Department before the Korean war?

Mr. SCHLESINGER. 1950 and 1951.

Representative BROWN. A very interesting figure and I think fairly significant in terms of what we are doing. It seems to me to be a relationship that makes sense and seems to be a relationship with reference to the inflationary factor that is of some significance.

In other words, we are buying a whale of a lot less bank for the buck. That was the term used back during the McNamara era, and we are not only putting less of our national resources into defense, but we are buying a good deal less because of the inflationary factor.

Can you relate that in some way to any other expenditures, some of the other fields, education, pollution, something that has motherhood and the flag tied into it today politically?

Mr. SHULTZ. Let me say that I think that national security has a lot of motherhood and the flag in it.

Representative BROWN. Not as much influence as before. Apparently the Secretary today is not as popular a figure as Mr. McNamara was in his day.

Mr. SHULTZ. The comparison of defense and the classification called human resources as proportions of the budget is: for 1968, which was the high year that we recognized, defense outlays were 45 percent of the budget, and human resources outlays were 32 percent.

That has shifted. As projected in 1972, there is almost a complete reversal, with defense outlays expected to be 34 percent of the budget and human resources outlays 42 percent.

So in terms of the budget outlay impact, there is that reversal.

Representative BROWN. Can you give me those figures for 1962, the first year you had available here when we were spending 8.9 percent of the GNP?

Mr. SHULTZ. For defense 48 percent and 29 percent for human resources.

Representative BROWN. Thank you.

Mr. SHULTZ. Let me just say again that I think that it is good to see that defense is not dominating the situation.

On the other hand, it is also important to everybody, I am sure, to examine this spending, to try to make it all count for as much as possible, but at the same time not to be taking a lot of chances with our national defense.

Representative BROWN. Well, I would suggest, Mr. Shultz, that if it shows anything, if you are being dominated by the Secretary of Defense, you are not being dominated much.

Chairman PROXMIRE. Well, would you answer my question, Mr. Shultz? Did you recommend a $72 billion budget and then a $66 billion defense budget for 1972?

Mr. SHULTZ. No. This is a process that we work through and it culminates in a decision by the President and as far as I am concerned, that is the President's decision.

Chairman PROXMIRE. Well, I understand that.

Mr. SHULTZ. And I support it.

Chairman PROXMIRE. My question is, Did you recommend it? I know it is a process the President must determine. My question is, Did you recommend a $72 billion budget for defense, and then a $66 billion defense budget?

Mr. SHULTZ. The whole internal mechanism of who recommended what and whatnot is something that I cannot talk about. Whatever I recommend to the President is something that I think I keep to myself.

Chairman PROXMIRE. I was afraid that you would give me that answer, but I appreciate it and understand and I respect you for it.

Mr. SHULTZ. One other point——

Chairman PROXMIRE. What is that, sir?

Mr. SHULTZ. One other point on defense spending. We have a chart that was made up following a projection made at the end of the Johnson administration. The projection contrasts what would have happened to defense spending if hostilities in Vietnam continued. The chart gives the Johnson administration estimate of defense spending under the assumption of continued hostilities. And then it contrasts this estimate with what would happen to defense spending if there had been a truce back in 1968–69. We can compare current spending with both these estimates, although it is difficult to know just how to adjust the Johnson administration figures for price inflation. Of course, we are disappointed that we don't have a truce, although the President has succeeded in winding down that war to a very, very considerable extent.

The chart presents quite a contrast. Starting out with $80 billion in 1969, defense spending was projected by 1972 to be in the neighborhood of $90 billion if there were no truce, and if a truce occurred, in 1972 to be in the range of about $72 billion.

So you can see that without a truce, the administration has achieved almost the path projected on the basis of the truce.

Chairman PROXMIRE. The administration is asking for obligational authority of what, over $80 billion for defense next year; isn't that correct?

Mr. SHULTZ. I think it is slightly under $79 billion.

Chairman PROXMIRE. About eighty. Then, of course, what concerns me very much, Mr. Shultz, is the constant referral to the comparison of the defense budget and so-called human programs. The reason you get that comparison is that with human programs you are lumping in all of social security which the administration has been fighting hard to dissuade Congress from increasing, at least increasing by as much as we did.

Mr. SHULTZ. I beg your pardon, Mr. Chairman.

Chairman PROXMIRE. You are including veterans' pensions, you are including a number of other fixed cost programs that—essentially those two, but fixed cost programs that are self-financing, and if you simply compare them with education, with housing, with health, and then defense on the other side and take the controllable programs, you still find that defense alone dwarfs the so-called human programs; isn't that correct?

Mr. SHULTZ. Well, first, let me say that the administration has supported an increase in social security benefits, and beyond that, has supported a change in the way in which cost of living problems are reflected in those benefits so that the elderly can be assured that their income will not be eroded by inflation. This was advocated by the President before he took office and since. The administration is very firmly behind the idea that social security benefits should be adjusted so that the elderly do not lose by this process of inflation—and making the adjustment automatic. That is the first point.

Chairman PROXMIRE. I understand that.

Mr. SHULTZ. The second point is that I don't see how you can classify programs designed to help the elderly as anything other than a human resource program. That is money going to a lot of people at an age when they are not able to earn. From my standpoint, one of the great things that we have done in this country is to put into place a good, strong social insurance, social security system.

Chairman PROXMIRE. All of us support that and have had it in effect for 30 years.

Mr. SHULTZ. And there it is.

Chairman PROXMIRE. And it is self-financing.

Mr. SHULTZ. Fine.

Chairman PROXMIRE. It is in effect not in the same degree of control as the defense budget, education, health, housing, and these other areas with which we can vary. If you take the part of the budget that is subject to control, year-to-year control by the Congress and the administration, in the sense that we can cut them or increase them, and then in the sense that they are not self-financed, certainly defense dwarfs the rest of the human programs.

Then, of course, your definition of defense is something else that concerns me very much. For example, most of the national debt was incurred during wars and because of wars, but that is not included as part of the defense cost. Veterans' payments are obviously defense related. That is not included, but excluded. The Coast Guard is largely a defense operation, but that is included as a part of Commerce and Transportation. The persistent exclusion from the breakdown of national defense, it seems to me, is a public deception.

Mr. SHULTZ. Well, I wouldn't accept that, Mr. Chairman, because all of the numbers are there. Anybody can combine them in any way they want. If you don't like our combination, you can make another one.

I would point out, in addition, that it may be artificial, in the sense that you put it forward, not to classify a fair amount of defense spending as human resources. Defense puts a great deal of effort into training people.

Chairman PROXMIRE. I understand these classifications are not easy.

Mr. SHULTZ. Schooling in the Defense Department.

Chairman PROXMIRE. If you are talking about defense——

Mr. SHULTZ. The Department of Defense did quite an outstanding job in bringing in so-called disadvantaged, getting them into the military, and training them. So there is quite a little human resource spending in the Defense Department.

Chairman PROXMIRE. There is and one of the problems we have in Congress, in the Senate, at least, is that we have a lot of trouble holding down some programs which have put them into the defense category even though they have very little relationship to defense, research programs of various kinds, educational programs of various kinds. There is very little time for analysis by Members of Congress as compared to the civilian program.

Let me ask you, while David Packard has been working with Mr. Haughton, of Lockheed, on the C–5A dispute, there has been no indication of how much the settlement will cost the taxpayers. Can you give us some idea of the budgetary impact that can be expected from the Pentagon-Lockheed settlement? Can you give us your opinion as to what the economic repercussions would be if Lockheed Corp. does go out of business?

Mr. SHULTZ. As I understand it, Secretary Packard is in the midst of a very careful study of that whole problem, which undoubtedly has been complicated somewhat by the Rolls-Royce bankruptcy, and he is due to make a report to the Congress very soon. I think the best thing is to wait for that report and refrain from comments at this point.

Chairman PROXMIRE. Do you have anything in the budget at all for that now?

Mr. SCHLESINGER. As you know, Mr. Chairman, there was an item of $200 million included in the 1971 budget.

Chairman PROXMIRE. Yes, we voted on that. We had an amendment on the floor. I introduced an amendment to beat that, and my amendment lost.

Mr. SCHLESINGER. At that time, it was requested that Secretary Packard, for the Defense Department, report back to the Armed Services Committee. That report by Secretary Packard is due shortly.

Chairman PROXMIRE. How can you have a complete budget without—what do you estimate? Don't you have to have some kind of a rough estimate of what that is going to cost the defense budget or is the defense budget so lacking in budget discipline you don't feel that will be a factor, that it will only be a few hundred million dollars?

Mr. SCHLESINGER. The possible loss at the present time that you are referring to is limited to the $200 million in the 1971 budget.

Chairman PROXMIRE. 1971, yes, but 1972; you must make some allowances for how much we are going to have to spend again to bail out the C–5A. I presume the administration wants us to go ahead with the C–5A, another $1 billion or $800 million.

Mr. SCHLESINGER. We wouldn't want to forecast at this time the results of Secretary Packard's study.

Chairman PROXMIRE. How can you have a budget without forecasting? I don't see how you can have a firm figure for defense unless you know how much this very large sum is likely to be.

What have you done with it? Just left it out completely? Assumed there would be no cost, or have you put in some figure?

Mr. SCHLESINGER. The firm figure for defense will result from the Congress acting on the President's recommendation.

Chairman PROXMIRE. What is the President recommending? That is my question.

Mr. SCHLESINGER. The President is recommending for the defense budget authority on the order of $79 billion.

Chairman PROXMIRE. What is he recommending for Lockheed?

Mr. SCHLESINGER. There is no Lockheed.

Chairman PROXMIRE. What is he recommending for C–5A?

Mr. SCHLESINGER. There is no recommendation for the C–5A in the 1972 budget.

Chairman PROXMIRE. So it will be more. It will be more by whatever the cost of the C–5A is for fiscal 1972.

Mr. SHULTZ. I think the point is that the recommendation will be forthcoming in connection with Secretary Packard's study, that Secretary Packard will be reporting on that, as directed by the Congress.

Chairman PROXMIRE. That will be some kind of a supplemental request for additional funds, unless they decide not to go ahead with the C–5A, that is correct?

Mr. SHULTZ. I think that we should wait and see what he reports.

Chairman PROXMIRE. Well, at any rate, in great likelihood it would seem to me, if we don't stop funding the C–5A, there will be additional supplemental requests for defense at least to provide more funds for the C–5A, is that right?

Mr. SHULTZ. I would say that we should wait and see what the report has to say, and then proceed on that basis.

Chairman PROXMIRE. They announced a settlement. They announced that, and Lockheed accepted it. Lockheed accepted the agreement that the loss would be be limited to $200 million. The estimate last year was the total loss was going to be $800 million in this contract. This means $600 million more of Federal spending. If so, how much of that is in the 1972 budget?

Mr. SCHLESINGER. Mr. Chairman, I think the acceptance by Lockheed of a provisional offer by the Department of Defense has been unsettled by the Rolls-Royce situation——

Chairman PROXMIRE. You can say that again.

Mr. SCHLESINGER (continuing). And the salvation of Lockheed becomes a question that has to be reviewed once again. Secretary Packard will be presenting his recommendations to the Armed Services Committee shortly.

Chairman PROXMIRE. Well, I have finished. Do any of you gentlemen have questions?

Senator Miller.

Senator MILLER. Mr. Rice, on page 36 of this "Budget in Brief," do you have it there?

On page 36, at the bottom of the page, the last paragraph, the second column, "In 1972, outlays for farm income stabilization programs will be $4.2 billion. The major portions of these outlays are for farm commodity price support and supply adjustment programs."

Now, this is what I want to ask about.

"Due to the corn blight and increased demands for wheat and soybeans, 1971 outlays are below initial estimates."

Why is that? I know about the corn blight and I know about the increased demands for wheat and soybeans and corn, too, I suppose. I don't get the relationship between that increased demand and the outlays being below initial estimates.

Mr. RICE. Senator, I don't have the detail here with me today as to just why those outlays changed, but we can lay that out and supply it for the record.[1]

Senator MILLER. Will you do that, and additionally——

Mr. COHN. The effect of the corn blight is a very substantial factor in reducing the supply of farm commodities that were produced for market. Some of those commodities were taken by increased demands, and since there were fewer total commodities, the Commodity Credit Corporation had to buy less than we originally estimated.

The corn blight reduced the total supply of corn that was available for private and Commodity Credit Corporation purchases. That was the reason.

Senator MILLER. I thought that might be it, but I wanted to find out.

Now, also, it says in the next sentence, "lower receipts resulting from more normal marketing conditions account for most of the increase in net outlays in 1972." Are you saying this in reverse because of the production, getting back to more of a normal state that the CCC will therefore be getting into the purchasing of these commodities more in this next year than they did last year?

[1] See response for the record on p. 102.

Mr. COHN. Well, it behooved us, Senator, having been very optimistic about demand for many years in these estimates and having underestimated on them for many years prior to 1971, to be conservative in our estimate of demand for commodities. We didn't want to assume that the very exceptional buoyant market conditions that existed this year would exist again next year.

We hope they will, but the estimates did not assume that large a demand.

Senator MILLER. Well, your estimate does not assume—well, there is another way of looking at it. You may have the same amount of demand, but you have got four crops.

Mr. COHN. That could be.

Senator MILLER. And, therefore, the market prices are lower and therefore it gets down into the CCC loan support area, CCC is going to have to buy more.

Mr. COHN. That is right.

Mr. RICE. Excuse me, Senator. Can I add a thought there? I think you are on the right track. The lower receipts estimate does imply the hope that it will be necessary for the CCC to sell lower amounts of stocks in 1972 than was necessary in 1971. The corn blight made corn short in supply and led to larger than expected sales by CCC. Receipts from these sales operate as an offset against outlays and tend to reduce outlays.

Senator MILLER. Would you be good enough to supply for the record a breakdown of the material that backs up those two statements?

Mr. RICE. Yes, we can provide that.

Senator MILLER. Thank you very much.

(The following information was subsequently supplied for the record:)

COMMODITY CREDIT CORPORATION OUTLAYS

Senator Miller asked for a brief explanation of the last paragraph on page 36 of The U.S. Budget in Brief, Fiscal Year 1972.

Fiscal year 1971 outlays are currently projected $392 million lower than the earlier projection primarily for the following reasons:

Corn blight substantially reduced the size of the 1970 corn crop. As a result of the short crop, outlays for commodity loan advances to farmers are down $109 million and proceeds from feed grain sales from CCC stocks are up $323 million from the earlier estimate.

Wheat export estimates have been increased from 600 to 735 million bushels. This has contributed to higher CCC receipts of $135 million from additional commodity loan repayments by farmers and $96 million from added wheat sales from CCC stocks.

Soybean use (domestic and exports) is up sharply from the projection of a year ago. The strong demand-price situation is now projected to increase CCC receipts by $74 million from additional commodity loan repayments by farmers and $305 million from added soybean sales from CCC stocks.

With an assumed return to more normal marketing conditions in the 1971 crop year (fiscal year 1972), together with CCC holdings of corn and soybeans at sharply reduced levels, both CCC sales proceeds from inventory dispositions and receipts from commodity loan repayments by farmers are expected to be substantially lower than in fiscal year 1971 for feed grains, wheat, and soybeans.

Senator MILLER. Now, I have two more questions, Mr. Chairman. We read many reports recently about the economic crisis facing the Nation's nonpublic schools, especially nonpublic colleges and universities, but there are problems in all areas. However, the new budget puts more emphasis on pupil assistance where the ultimate beneficiaries are more likely to be schools in low-income areas and which does not attack directly the accelerating costs of nonpublic education.

What does the administration plan in the way of increased aid to deal with this problem of accelerating costs to our nonpublic schools?

Mr. SHULTZ. I will ask Assistant Director Nathan to respond to that.

Mr. NATHAN. Senator, I take it you are talking about elementary and secondary education.

Senator MILLER. And higher education, too.

Mr. NATHAN. You have to distinguish between the two. In the case of elementary and secondary education, the programs that are most relevant to nonpublic schools are programs that are affected by the President's proposal for a special revenue-sharing program in the field of elementary and secondary education. These programs, as I am sure you know, are the library programs and title I program. We are in the process of developing the criteria and the components of this new legislative proposal which will be before the Congress shortly, and one of the questions that is being addressed is that question which you raised. The books program and the libraries program, and the title I program, to an extent, are the programs that today permit State governments, where they have constitutional provisions that allow them to do so in the case of title I, and even where they don't in the case of the books and libraries program, to use Federal aid for nonpublic schools.

Now, in the case of higher education, the administration's program places stress on direct aid to students through a combination of grants and loans, and the President has proposed to the Congress legislation for a national student loan bank, I think it is fair to call it, plus a major overhaul of existing programs to put emphasis on direct assistance to students.

This approach gives the student the opportunity to make his own choice. Of course, the student who chooses to go to private schools, be they parochial or nonparochial, will be treated on roughly the same basis as far as the Federal student aid approach is concerned, as students going to State supported and locally supported institutions.

Senator MILLER. Thank you, The last question: In the 1972 budget, no increases have been requested for the programs that represent public service employment type of efforts under current manpower law, such as the Neighborhood Youth Corps, Mainstream, the summer job program, and WIN. Nevertheless, we have testimony before this committee about the dire needs of States and local governments for manpower services which a public sector jobs program could provide. How does the budget propose to fill these needs for manpower, on the one hand, and employment on the other?

Mr. SHULTZ. If you look into the part of the budget that discusses special revenue sharing, there is a section on manpower. The amount has been increased in that grouping by about $400 million above the amount carried in the various categorical classifications that would be folded into the special revenue sharing for manpower programs.

Now, it is our belief that if the manpower money flows to the States and units of general government in a more flexible manner, getting away from the narrow categories, the mayors and the Governors will be able to use those funds more nearly to suit the needs that they actually have.

The answer to your question is that the amount of money budgeted has been increased sharply and the flexibility with which it could be used is proposed to increase greatly, and, therefore, the money should be much more effective.

Senator MILLER. Well, as you know, there have been some people that expressed concern at what they visualize is a slashing back of these programs in the budget, and the answer we can give to them is that while those programs may be cut back, there is not only going to be the same amount of money that has been going for those programs, but $400 million more that is going to go into the overall manpower program to replace that.

Mr. SHULTZ. Under special revenue sharing, it is important to say—and this is not only true in manpower programs but in the other programs as well—none of them are eliminated. What is done is that the money is made more flexible so that if you are, say, a mayor in Sioux City and this money comes to you, you can use it in exactly the way that the Federal Government used to tell you you should use it in, but you don't have to. You can use it in a different way if that seems to suit the problems of your city better than the earlier specified way.

Senator MILLER. Now, additionally, isn't there anything in here under the welfare reform program to cover the use of or to make use of public sector employment? We had something written in in the Finance Committee last year which was in the final product before the Senate, and it was my recollection that the President himself felt rather favorably inclined towards a limited approach in this area, and I believe that the Department of Health, Education, and Welfare was in support of that, too.

Mr. SHULTZ. As you know, the so-called WIN program is a program for training recipients of welfare and getting them into jobs.

Senator MILLER. I am not referring to the WIN program, Mr. Shultz; I am referring to—I think Senator Ribicoff is the one who brought up the proposal originally, and that was to have public service or quasi-public service activities or opportunities, I should say, for welfare recipients in the municipalities, in the hospital area, and the like.

Mr. SHULTZ. Yes. Well, I think, as you suggest, we did work out a solution to that problem in our discussions with the Senate Finance Committee. I did want to say that the outlay estimates under the WIN program, which is working in that general direction, go up fairly sharply from $146 million in 1971 to $231 million in 1972.

Senator MILLER. Thank you very much.

Thank you, Mr. Chairman.

Chairman PROXMIRE. I will be very brief. It will only take a minute or two to point out, No. 1, that I have got the appendix of the budget here, and on page 306 it says, under airlift aircraft:

> In this activity, funds estimated to cover the prior year unfunded moneys for the C–5A aircraft are included as our funds to procure C–130 aircraft and maintain the existing air fleet.

This is $400 million of budget plan or, I take it, outlay, and $622 million of obligational authority. Apparently, this does not include the settlement which Mr. Packard, you say, is working on now with Lockheed and that will have to be added to it.

Mr. SCHLESINGER. That is right.

Mr. SHULTZ. I will just say again that I think we must not prejudge what Secretary Packard's study will show.

Chairman PROXMIRE. I am not asking you to prejudge it. I am just saying it is likely. I think everybody expects there is going to be a several hundred million dollar agreement of some kind, and this will have to be additional defense expenditures for that one weapons system.

How many people do you have altogether now in the Office of Management and Budget?

Just give me a rough estimate, a thousand, 800, whatever it is.

Mr. SHULTZ. If Mr. Sam Cohn cannot find it, nobody can.

Mr. COHN. Senator, I have the figures for the professional staff. This excludes the clerical, and this year we have an estimate of 430 for the total professional staff in the OMB.

Chairman PROXMIRE. 430; does that represent an increase or decrease or is it about the same?

Mr. COHN. That compares with 357 in 1970, last year.

Chairman PROXMIRE. How many of that professional staff are assigned to the Defense Department or assigned to monitoring expenses of the Department of Defense?

Mr. COHN. Of that total professional staff of 430, 192 are assigned to examining departmental budgets. Of that 192, 59 are engaged in examining national security programs; that is a little over 30 percent.

Chairman PROXMIRE. What do the rest of the professional staff do, if they don't examine budgets?

Mr. COHN. We have a staff that is involved in legislation. We have a staff that is involved in coordinating statistical programs in the Government. And then we have the "M" in OMB, which is a staff assigned with public management and the organization of the executive branch.

Chairman PROXMIRE. Mr. Shultz and Mr. Weinberger, do you feel that is adequate, 59 people to consider and analyze and evaluate, recommend, these enormous expenditures of the Defense Department?

Mr. SHULTZ. Well, I think the point you have to recognize is that they are very good people.

Chairman PROXMIRE. Well, I recognize that, that that is undoubtedly the case. My question is, is that enough?

Mr. WEINBERGER. I think it is, yes, Senator.

Chairman PROXMIRE. How does it compare with what we had in the past?

Mr. WEINBERGER. We had 52 in 1970, and we have 59 for the current year, and we estimate 59 during the budget year. Given the structure of the Department, our relationship with it and our ability to get information, that this is adequate. They are trained, experienced people. That is an important aspect to it.

Chairman PROXMIRE. In view of the criticism from the GAO, just last night in the evening papers, there was a report that GAO is reporting once again billions of dollars of waste by the Defense Department. They have come out with that report. They will in a few weeks. This committee has exposed what we consider to be wasteful practices. Many other reports by the GAO have indicated this again and again and again. What is wrong? Don't you have enough people to do this?

Mr. WEINBERGER. Typically, the GAO reports are of episodes that occurred several years ago. We are very hopeful that with the procedures we have now and with the procedures internally in the Department of Defense, a great many of the criticisms will be eliminated. I don't suppose it is possible in any organization that spends $70 billion to eliminate all waste, but we certainly can hope to eliminate the examples of the kinds you cite, most of which originated in practices that began several years ago.

Chairman PROXMIRE. I think that is the case, but, frankly I don't see a great deal of this kind of improvement. I hope we can get it.

Well, at any rate, I feel many of these answers could best be given by the one man who will not appear before us, the Secretary of Defense.

I want to thank you very, very much, Mr. Shultz, and I mean it. You are a highly competent man, as we all know. You have a fine staff. You have been most responsive. My questions, while critical, certainly were not personal in any way at all, and I thank you very much.

The committee will stand in recess until a week from tomorrow, Wednesday, February 17.

Unfortunately, the Secretary of the Treasury will not be sworn in until tomorrow, and, therefore, it was felt that he shouldn't appear until he is sworn in and he will appear on Friday, February 26, before this committee.

(Whereupon, at 1:20 p.m., the committee recessed until 10 a.m., Wednesday, February 17, 1971.)

(The following information was subsequently supplied for the record:)

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, February 11, 1971.

Hon. GEORGE P. SHULTZ,
Director, Office of Management and Budget, Washington, D.C.

DEAR MR. SHULTZ: I gathered from our hearings last Tuesday, February 9, that you would send us shortly for inclusion in the record your model for output growth and inflation for 1971. I should appreciate your sending this material to us as soon as possible since we would like to have our remaining witnesses comment on its utility.

I would also like to have you present for the record the following estimates or projections based on a $1,065 billion GNP for 1971:

1. The full employment surplus on a NIA basis for calendar years 1970 and 1971;
2. The full employment surplus on a NIA basis for fiscal 1971 and fiscal 1972;
3. The full employment surplus on a unified budget basis for—
   (*a*) Calendar years 1970 and 1971; and
   (*b*) Fiscal years 1971 and 1972.

Once again, I would like to express my appreciation and that of the Joint Economic Committee for your appearance and extended discussion before us.

Sincerely,

WILLIAM PROXMIRE,
Chairman.

MARCH 2, 1971.

Hon. GEORGE P. SHULTZ,
Director, Office of Management and Budget,
Executive Offices of the President, Washington, D.C.

DEAR MR. SHULTZ: The Joint Economic Committee is now involved in preparing its report to the Congress on the state of the economy. In performing this work, it is most important for members and staff to have both the amended transcripts of administration witnesses and their responses to questions submitted for the record.

In your case, we need very much your analysis of the reconciliation of full employment GNP as between the unified budget and the national income accounts.

Likewise, we need the information requested of you on the subject of the relationship between fiscal and calendar year estimates of full employment GNP.

Your cooperation in supplying your responses forthwith will be appreciated.

Sincerely,

WILLIAM PROXMIRE,
Chairman.

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
Washington, March 19, 1971.

Hon. WILLIAM PROXMIRE,
Chairman, Joint Economic Committee,
New Senate Office Building, Washington, D.C.

DEAR SENATOR PROXMIRE: This responds to your letters of February 11 and March 2. Your letter of February 11 requested a copy of the paper describing our model of the economy and estimates of the full-employment surplus for both the national income accounts and the unified budget bases for calendar years 1970 and 1971 and fiscal years 1971 and 1972. Your letter of March 2 asked for a reconciliation of GNP as between the unified budget and the national income accounts.

In accordance with your request, the description of our model [1] was sent to your staff shortly after the February 11 letter was received.

The estimates of full-employment surplus are:

[In billions of dollars]

	National income accounts basis	Unified budget basis
Calendar year 1970	5.1	2.0
Calendar year 1971	3.1	.7
Fiscal year 1971	2.2	1.4
Fiscal year 1972	3.6	.1

We interpret your request for a reconciliation of full-employment GNP as between the unified budget and the national income accounts to have meant a reconciliation of full-employment receipts. These figures are enclosed.

Sincerely,

GEORGE P. SHULTZ,
Director.

FULL EMPLOYMENT RECEIPTS

	Fiscal year 1971	Fiscal year 1972
Unified budget basis	214.2	229.3
Government contribution for employee retirement	2.7	2.8
Other netting and grossing and adjustment to accruals	.3	1.6
National income accounts basis	217.2	233.7

RESPONSE OF THE OFFICE OF MANAGEMENT AND BUDGET TO AN ADDITIONAL WRITTEN QUESTION POSED BY SENATOR JAVITS

Question. The new budget raises the local share for summer job funding for fiscal year 1971 from 10 to 20 percent. And it increases the local funding share for community action programs by 5 percent. Why is this being done, in view of the fiscal plight of States and local governments, which the administration recognizes in its revenue sharing program?

[1] See model on p. 279.

Answer. To counter the current period of high unemployment, manpower resources have been shifted to adult programs, which will contribute most directly to attaining full employment. Evaluations of the Neighborhood Youth Corps Summer Program have found that it generally fails to provide enrollees with lasting economic, educational or employment benefits. Thus, the President's budget maintains the Summer Program at 1970 enrollment levels for both 1971 and 1972 rather than expanding it.

In order to maintain the program at the 1970 level while providing wage increases from $1.45 to $1.60, program sponsors will be offered the option of increasing their contribution to 20 percent of program costs or reducing the period of enrollment from 10 to 8 weeks. This design has several advantages:

1. The President recognizes the need to provide summer jobs to disadvantaged youth. The new matching rate/enrollment period option will permit continuance of the 414,000 jobs funded in 1970, while shifting funds to higher priority adult programs.
2. An endemic problem in the Summer Program is the low-quality of work experience provided by sponsors. The higher matching rate option will increase the sponsor's stake in the enrollee's work output, resulting in more careful supervision and better work assignments
3. In many projects, enrollees tend to quit their jobs in the final weeks of the summer The shorter enrollment period option recognizes this tendency.
4. The proposed 1971 and 1972 program levels afford ample resources for experimenting with new supportive services which are needed to make the Summer Program effective in countering the school drop-out rate and unemployment after leaving school.

THE 1971 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 17, 1971

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

The committee met, pursuant to recess, at 10:05 a.m., in room G-308, New Senate Office Building, Hon. William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Sparkman, Bentsen, Javits, and Pearson; and Representatives Reuss, Moorhead, and Brown.

Also present: James W. Knowles, director of research; Loughlin F. McHugh, senior economist; John R. Karlik, Richard F. Kaufman, and Courtenay M. Slater, economists; Lucy A. Falcone and Jerry J. Jasinowsky, research economists; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig and Leslie J. Barr, economists for the minority.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The committee will come to order.

We resume our hearings on the President's Economic Report and the state of the economy as we hear this morning from two distinguished witnesses for the administration. The Honorable George Romney, Secretary of Housing and Urban Development, is here with us now. The Honorable Maurice H. Stans, Secretary of Commerce, will appear a little later this morning.

Secretary Romney, you are in charge of some of the most important domestic programs dealing with our highest priorities: Provision of adequate housing for our middle- and lower-income families and the revitalization of our urban communities.

As you know, Congress has attached such importance to the housing situation that it established a housing goal of 26 million new units for the decade ending later in the 1970's.

It was my amendment that was adopted by the committee and by the Congress, and we had in mind that we would move as rapidly as possible to 2.6 million housing starts a year.

We have so far fallen woefully short of that goal, and I notice in the letter from the Chairman of the Council of Economic Advisers which I received just last last Friday, that the administration is predicting just 2 million new starts in 1971, once more far short of the target set by Congress.

I consider this prospect rather dismal, particularly when the industry was already operating at almost that rate at year's end.

I had hoped that in your testimony today you could assure us that we would do better in 1971, but your prepared testimony suggests that we may not even make the 2 million forecast.

We have had extensive testimony earlier from Governors and mayors as to the terrible financial plight of many, if not most, of our States and urban communities. Many indeed are on the verge of bankruptcy, and many more have had to reduce vital services in order to meet their payrolls. Once more I say we look forward to your testimony on this matter.

We welcome you to our committee this morning. Since we have had to schedule two witnesses this morning, I hope you will try to make your opening remarks as brief as possible, knowing that your full text will be included in the record as if read.

STATEMENT OF HON. GEORGE ROMNEY, SECRETARY, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, ACCOMPANIED BY FREDERICK W. DEMING, SPECIAL ASSISTANT; AND NATHANIEL J. EISEMAN, DIRECTOR, OFFICE OF BUDGET

Secretary ROMNEY. Thank you, Mr. Chairman.

Let me say this with respect to the housing goals: As you know, the housing goals broke down into two parts. One part was to be achieved by stimulating private effort in housing construction and the other part was to be achieved by subsidized housing production.

The only part that the Department has complete responsibility for is the subsidized housing production. In that area the Department has done what the Government has not been able to do for over 35 years—that is, to achieve real volume housing production. As a result of the appropriations by Congress and the much greater sums that have been made available for subsidization in the past 2 years, we more than doubled the housing starts in the subsidized areas. As a matter of fact, we have almost tripled in the last 2 years.

In the last calendar year we had subsidized housing of 470,000 units, and in the current calendar year we expect to be well above 500,000 units, and in the fiscal year, next fiscal year, we expect to be hitting the 10-year average called for by the national housing goal as far as the subsidized housing is concerned.

Now, I give this by way of background. I think my testimony will begin to focus attention on some of the factors involved in the lag in the conventional or private housing production which is where we need a great deal more stimulation.

There is one other comment I might make by way of background. While Congress did not indicate one way or another how the mobile home units should be treated in terms of housing production, I think it is clear that the mobile home units now being produced are no longer—in the main—the type trailers or type units that were produced in earlier years. They are housing units that low-income families particularly are turning to—and many other families, elderly families and young married couples—as a very satisfactory means of meeting their housing needs.

I think that any complete consideration of the housing picture should take into account the mobile housing units even though they represent kind of the model A of the industrialized housing field.

Well, now, if I may, let me quickly go through my statement and then I will be happy to answer questions.

Senator SPARKMAN. Mr. Chairman, may I break in right there?

Chairman PROXMIRE. Yes, sir.

Senator SPARKMAN. I am going to have to leave in about 20 minutes to present the money resolution before the Rules Committee.

I was going to ask the Secretary that very question. I am always puzzled in discussing the number of units that we have built or the number of units we expect to build as to what to do with the mobile homes. I am not sure I have the complete answer, but it seems to me that a mobile home even though it may not be the highest type of housing that everyone would prefer, nevertheless, as you have pointed out, it is the type, the only type, that many can afford.

Secretary ROMNEY. That is right.

Senator SPARKMAN. And if it provides a safe, a sanitary and decent place for a family to live; it seems to me it ought to be used.

I may be off in that but I hope some thought will be given to it and that something will be worked out so we will know whether to count them in or else say we had x number of starts, which does not include the y number of mobile homes built.

Chairman PROXMIRE. Before I call on Secretary Romney, let me say that when I put that amendment in I did not think of mobile homes. It is my understanding mobile homes are included in the housing starts in this estimate of 1.7 million.

Secretary ROMNEY. Oh, no.

Chairman PROXMIRE. It does not?

Secretary ROMNEY. It does not include mobile homes.

Chairman PROXMIRE. What is your estimate of mobile homes?

Secretary ROMNEY. Neither does the subsidized figure. The subsidized figure, 470,000 figure, last year does not include mobile homes.

Chairman PROXMIRE. It was my intention to exclude mobile homes.

Secretary ROMNEY. And the 1,750,000 which we project unless we do some things besides those in the pipeline does not include mobile homes.

Last year the mobile home output was 400,000 units. There is no reason to believe it will be less this year. If you add the 400,000 to 1,750,000, why obviously you get 2,150,000 units. There isn't much question but that the mobile home as it is being produced today in the main is really a forerunner of the industrialized housing unit. As a matter of fact, the Congress has seen fit to encourage mobile home production by authorizing the Department to give assistance to those who develop mobile home courts so that the sites that they can use for the mobile home unit are more attractive and better from an environmental standpoint, and the Congress has also seen fit to authorize us to give some assistance in the insurance of mobile homes.

Chairman PROXMIRE. I would agree wholeheartedly with Senator Sparkman, in many cases mobile homes are perfectly adequate, they are safe, sanitary, modern, up to date, they are clean, and they are warm, but the difficulty is we do not have qualitative statistics on it.

You say 400,000, we do not know how many fit into this category and how many are pretty ramshackle. As you know, and as I know, I visited many mobile home areas where I found that the homes are very inadequate and most unsatisfactory, and in many cities they are regarded as an area that is most undesirable, so I think we should have and try to get some notion of how many of these housing starts really provide mobile homes that would meet some fair standard.

Secretary ROMNEY. I think it is proper to keep them separated from the figures we use——

Chairman PROXMIRE. Yes.

Secretary ROMNEY (continuing). On subsidized production or conventional production so we do not mix the two.

Senator SPARKMAN. May I put it this way: We authorized you to insure mobile homes and, as I recall, we provided that you should set standards and issue regulations. Are you insuring them now?

Secretary ROMNEY. I think you authorized us to set the standards for the trailer court, Senator, but not necessarily for the units that go into those trailer courts.

Senator SPARKMAN. Not for the homes?

Secretary ROMNEY. That is my recollection, that is, my understanding.

We have been undertaking to upgrade the trailer court.

Now the mobile home people themselves have been establishing standards to step up the quality because it is perfectly apparent that it is in their interest to convince people that is a good way to live.

Senator SPARKMAN. Maybe I used the wrong term in saying set standards, but I do think we certainly intended that in connection with insuring you would satisfy yourself.

Secretary ROMNEY. That is right. The units we insure under title I do have to meet our loan requirements and they have to be units that will——

Senator SPARKMAN. Yes.

Secretary ROMNEY (continuing). As far as we are concerned warrant the type of insurance given.

Senator SPARKMAN. Yes, my question implied that you had to set the standards.

Now, Mr. Chairman, if I may just ask one more thing and I will go.

Mr. Secretary, there was quite an article in yesterday's Washington Post, "HUD's Biggest Housing Effort Runs Into Trouble in Michigan"—that is your State, isn't it? [Laughter.]

Secretary ROMNEY. I like to claim it.

Senator SPARKMAN. Did you read that article?

Secretary ROMNEY. Yes, I read the article.

Senator SPARKMAN. I have difficulty in getting just what the picture is. I wonder if, I won't ask you to comment on it now, but I would be glad if some staff member of yours would prepare a statement regarding the article and the difficulties.[1]

One other thing: Here is a picture of 235 houses in this area. Every one of them is exactly alike.

Secretary ROMNEY. Which is absolutely——

Senator SPARKMAN. And furthermore they seem to me to be rather—well, they just do not strike me as being houses of any value.

Secretary ROMNEY. They look like crackerboxes.

Senator SPARKMAN. That is right. And I do not believe that was intended by Congress—most of the 235 programs I have seen have been very nice.

Secretary ROMNEY. That is right.

Senator SPARKMAN. With different types of architecture and so on and so forth.

[1] See response on p. 114.

That looks like an oldtime mill village. I hope that in approving 235 projects a better job will be done than this appears to be. I am not condemning it because I realize——

Secretary ROMNEY. I agree with you, Senator. As a matter of fact, building units in that manner is completely contrary to the rules and regulations of the Department, and that is one reason why we, our area director, when this matter was brought to his attention immediately froze the building of any more 235 units in that township, in Beecher Township. He did it because on the basis of information brought to his attention it seemed to him there was clear violation of the rules by the builders involved and, consequently, he directed the branch office of FHA up in Flint to stop any further 235 commitments until he could thoroughly investigate the situation.

Now, not only has he frozen the situation but he is in the process of making a very careful study of the situation because apparently it was not only some violation there, how extensive it was is not yet known, but also we did have some homeowner complaints from people in that area, and he has been in the process of getting builders to go back in and take care of those complaints.

Now clearly units of that type are not desirable in terms of what the program is designed to do. The regulations call for difference in appearance and elevations and so on in units so that you do not get that deadly monotony that is indicated in the photograph.

To what extent units of that type are in that area is something we are checking into. I do not happen to know offhand. Hopefully, there are not too many of that character because they are not typical of the new 235 units.

Now, I think also that it is realistic to recognize that as you move from the low volumes of housing production, subsidized housing production, that we have had to the present volumes of housing production, that you do encounter problems and difficulties that you weren't experiencing previously. Unquestionably, in stepping up this volume of subsidized housing there have been instances like this. As I understand it, the reason that a very high proportion of the 235 units in the Flint area went into Beecher Township was because the Beecher Township had the water and the sewer facilities and land was not as costly as it was elsewhere. In providing new housing for low- and moderate-income families, the cost of land is not an unimportant consideration. So that the fact that there was zoning that permitted the units to go in there, the fact that the land had been developed, the public facilities were available so far as water and sewer was concerned, I think, resulted in a very large percentage of the 235 units going into Flint Township.

Again that raises another question and one that I think the Congress and the Department should address themselves to, and that is the question of whether we are ever going to get an adequate meeting of land needs and housing needs in terms of location unless we insist that in metropolitan areas like Flint or any other metropolitan area where you have a central core city and then many surrounding separate suburbs, that the planning for housing needs be undertaken on an area basis rather than just on an individual governmental unit basis.

Now where you undertake it on an individual governmental unit basis, then you encounter situations like in Flint where one governmental unit, in this case Beecher Township, was zoned and had the facilities for housing and low-cost land, but other communities around Flint were not so zoned and made no comparable provisions. So you get an overconcentration in the one particular area, and this is as a result of not insisting that the communities in a metropolitan area give some joint consideration to how the housing needs of people of various economic levels can be met on a reasonable basis.

So I think the problem there in Beecher Township raises some very fundamental policy questions for us to give very careful consideration to jointly that we have not yet dealt with.

Senator SPARKMAN. Thank you very much. I apologize for throwing you off the track but I did want to find out something about this.

(The following information was subsequently supplied for the record:)

REPORT TO JOINT ECONOMIC COMMITTEE ON BEECHER SCHOOL DISTRICT

This Report reviews the status of and criticisms leveled against activities under the Section 235/236 housing subsidy programs in Beecher School District, Genesee County (Flint), Michigan. In general the criticisms are that these programs have brought a severe impaction on the Beecher school system and community at large, and that the local FHA Field Office has been negligent in not recognizing these problems and uncooperative in developing meaningful solutions. The Report first describes the general background of the situation and then evaluates both the general and a number of specific criticisms.

The Report makes clear that the Section 235/236 programs and other independent factors emerge as causes contributing to the problem of impaction that presently confronts the Beecher School District. However, leaders of the School District and the community at large, with cooperation from Federal officials, can take steps which to some extent will relieve the burdens of impaction and will prevent the situation from getting any worse.

BACKGROUND

The Beecher School District borders the City of Flint on the north about 65 miles northwest of Detroit, and includes parts of Mt. Morris and Genesee Townships. Next to Detroit, Flint is the largest Standard Metropolitan Statistical Area (SMSA) in Michigan in both total and minority populations. The population living within the Beecher School District is said to be about 25,000 split approximately 70% white and 30% black.

The local economy is dominated by the manufacture of automobiles and auto parts. Employment opportunities had been expanding at a healthy pace until about a year ago. Then, tightness in the mortgage market, the slump in the overall economy, and the 1970 auto strikes created severe hardships both for the local economy and the residential housing market.

Beecher School District is primarily a residential community, containing single-family homes of modest value. Prior to 1960, most if not all of the population in the Beecher area was white, and many were of a southern and rural background. Except for a few isolated pockets, blacks lived in the City of Flint, to the south.

From 1962 onward, black families began moving into the Beecher area. The availability of modestly priced homes in an area near to their former residence and to their auto industry jobs was probably the principal reason. According to some local sources, there may also have been some determination by real estate organizations that this was an area opportune for integration and lower-income occupancy. Residential building activity picked up slightly for a time (1965–66) but then slackened again as development patterns shifted outward toward more affluent areas.

The shift of development away from the Beecher area in the late 1960's caught some builder-developers with land holdings for which they no longer had a market. While many of these lots were unimproved areas of the township, and were without paved streets or sidewalks, they were easily accessible to existing water and sewer facilities and could be quickly developed if the builders could find some way of attracting buyers.

It is at this point that funds became available for the Section 235/236 programs and increased emphasis began to be placed on stimulating housing production to meet the overall housing shortage and the particular needs of low and moderate income families. To date, there have been reservations and commitments under these programs for a total of 2,562 new housing units in the overall Flint SMSA, 619 of which are located in the Beecher School District.

Developers' applications for these program commitments have been processed through the Flint/FHA Service Office, which until September 30, 1970, reported to the Detroit FHA Insuring Office and now reports to HUD's Detroit Area Office. The Flint Service Office has 30 employees. Much of their prior experience was with the straight-forward FHA mortgage insurance program under Section 203, in which FHA's principal role is simply to process applications according to relatively routine standards.

FINDINGS

Excessive concentration

The principle criticism is a charge of excessive concentration of Section 235/236—Assisted Housing in the Beecher School District, both in particular neighborhoods and in this District compared with other towns around Flint.

(1) A review of the Flint Service Office records indicate Section 235 fund reservations have been issued for 1,958 units and Section 236 reservation for 604 units for Genesee County. The geographic distribution is as follows:

	Sec. 235	Sec. 236	Both programs
City of Flint	1,315	343	1,658
(Model Cities area)	(493)		
Beecher area	358	261	619
Rest of county	[1] 285		[1] 285
Total	1,958	604	2,562

[1] Includes 60 units without specified location.

As is apparent, 24% of all the Section 235/236 units funded to date in Genesee County are or will be located in the Beecher School District. By way of comparison, the District has about 5½% of the county's total population, and perhaps 10% of the nonwhite population of the county. Excluding the City of Flint, Beecher has about 10% of the remaining total population in the county and almost all of the remaining nonwhite population.

Within Beecher, 55 of the Section 235 units are located on scattered sites in the eastern half of the District. The other 564 Section 235/236 units are in a few small areas in the western half of the District.

There are three Section 236 projects in this western half of Beecher: 48 units (cooperative) in partial occupancy; 53 units (cooperative) in construction; and 160 units (rental with rent supplement planned) in construction. These units are within three blocks of one another.

Near this same area, there are several instances in which entire blocks have been developed with Section 235 assisted housing whose monotonous design and homogeneous occupany create a pattern of development equivalent to traditional public housing projects. This pattern of development will increase the risk of establishing "block" ghettos. Upon completion of the Section 236 projects mentioned above, there will be 320 to 400 units of Section 235/236—Assisted Housing within a four block area.

Plans for some of the units developed in this concentrated area had Model Cities endorsement. Of more relevance, however, this is the area where zoned lots were available at reasonable cost and with public water and sewer facilities available. Projects apparently could have been located in other areas of the county, but HUD did not attempt to direct locations of building activity.

(2) Total school enrollment in the Beecher District was essentially stable between 1966–1969. Then in 1970, enrollment jumped from 6,470 to 6,879 and further increases are expected. This has clearly created overcrowding in some of the District schools.

Some of this increased enrollment presumably reflects a general influx of population into the county rather than the building activity under the particular HUD programs in question. Seven other school districts in Genesee County experienced greater enrollment gains during the 1966–1970 period than was the case in Beecher and three districts showed gains similar to those in Beecher.

Within Beecher, there is some correlation between enrollment increases in individual schools and Section 235/236 activity in the immediate neighborhood. But this correlation is by no means perfect. On a net basis, the most serious problems appear to be in the secondary schools, in which enrollment has been rising steadily since 1966. Between 1966 and 1970 secondary school enrollment increased by 620, much of which is clearly not associated with Section 235/236 activity.

In the primary schools, aggregate enrollment in 1970 was 4,044, down from 4,198 in 1966. This reflects a net loss of about 350 pupils in the four elementary schools in the eastern half of the District where Section 235 activity has been scattered, offset by a net increase of about 200 pupils in three of the schools in the western half near the concentrations of Section 235/236 activity. HUD has not attempted to explore whether the overcrowding in these western schools could be relieved by shifting some pupils into the less crowded eastern schools.

It should be noted that the total impact of the building activity under the Section 235/236 programs has not yet shown up in school enrollment statistics. Some of the units are not yet completed, and not all of the children in those units that are occupied are yet of school age. It is estimated that total school enrollment in the District may increase by more than 500 next fall and by another 450 in 1972. These annual increases are larger than in any previous year back at least to 1961–62. The District clearly must take some action to accommodate such an increase in enrollment.

(3) The difficulties being encountered by the Beecher School System are not just the result of more families living in the District but also reflect the fact that many of the new resident families have more than an average number of children while at the same time have lower than average incomes from which to pay taxes in support of the schools.

Thus, the 358 families purchasing the Section 235 homes include a total of 1,296 children, or an average of 3.6 children per family. It is claimed that unsubsidized families in Beecher average about 2 children per family. Nationally, new occupants of all new Section 235 homes insured in the third quarter of last year averaged about 2.5 children per family.

Nearly 48% or 170 of the 358 purchasers of the Section 235 homes in Beecher receive public assistance, mainly ADC payments. On a nationwide basis, the comparable figure is about 12%. The Beecher program also includes 144 families with annual incomes less than $5000, 94% of whom receive ADC and 98% of whom are one-parent households. The median annual income of the Section 235 buyers in Beecher at time of purchase was $5,769 compared with $6,135 nationally in the third quarter of last year.

Most builders of Section 235 homes in Genesee County communities other than Beecher had a relatively low concentration of ADC families among their sales. Reasons for the concentration of such families in Beecher have not been determined.

With respect to race, about 40% of the Section 235 buyers in Beecher are black and 60% are white. This is close to the racial balance already prevailing in the community.

(4) Interviews with various officials and leading citizens found little or no surprise at the relatively large volume of Section 235-assisted homes that were developed in the Beecher District. It was stressed that the area was already racially integrated, a water and sewer system existed, and vacant lots were relatively inexpensive. Some builders already owned lots for which there was no market until the advent of Section 235 and 236. It was also noted that the Western half of Beecher, where most of the Section 235/236 units are located, is in Mt.Morris Township, which has minimal building restrictions and inspection requirements and is thus conducive to large scale development.

The investigation also indicated serious communication problems between the local FHA Service Office and the community. There was apparently very little, if any, discussion between the Flint Service Office supervisory staff and builders and community interests regarding fund allocations, site locations, and community problems. There was *no* contact with the County Planning Commission regarding the best possible locations in view of land-use changes occurring within the City of Flint and the County. Despite the historical problems of the Beecher area, the lack of local government resources, and the early warning signs of more difficulties, effective communication among the various community interests did not take place.

New construction vs. existing housing

A second criticism is that too much of the subsidy allocations was used to stimulate new construction in the Flint area relative to analysis of market need and the prevailing vacancy situation in existing units.

A 1969–70 FHA market analysis estimated the total need for subsidized housing in the Flint area during the following two years at 2,430 units. As noted earlier, reservations for Section 235/236 units in Genesee County total 2,562 units. Completions of these units are phased over a two-year period. No inference should be drawn, however, that there was a basis in the market analysis for permitting a concentration of 25% of these units in the small area of Beecher.

Beecher is said to have vacancies in 190–200 homes. On a county-wide basis, the vacancy rate in April 1970 was down to 1.1%, which is definitely below average for the area.

It is clear that the economic downturn, auto strike, and tight money situation have had a depressing effect on the housing market during the past year, though efforts to establish just how soft the market was or is have not revealed a clear picture. Against this background, claims that new construction under the Section 235/236 programs has aggravated the total housing market are difficult to prove or disprove. On the other hand, within certain neighborhoods, there does appear to have been some distress selling, and it is probably not unreasonable to attribute this to a reaction to the types of units and families moving in under Section 235 assistance.

Poor quality construction

Criticism of the poor quality of design and construction of many of the Section 235 units in Beecher appear to be amply justified. Investigations and conversations with buyers showed a hatred or dislike for one builder in particular because of an alleged consistent failure by that firm to make repairs or live up to what the buyers' felt the builder has promised. Many of the complaints apparently involved the lack of storm doors, screens, lawns, and in some instances, paved streets and roads.

The FHA Service Office in Flint did make inspections of these properties during the construction process. Despite the warnings implicit in the increasing volume of complaints, however, such inspections continued to be only routine, and thus were not detailed or exacting enough to prevent the problems that manifestly exist. In several areas, moreover, the Field Office completely failed to address itself to clear violation of regulations against monotony through repetition of design more often than every fifth house. What is most disturbing of all, these deficiencies occurred in homes that were consistently approved for the maximum mortgage limits permissible under the Section 235 program.

It should be emphasized that not all of the Section 235 units in Beecher and Genesee County are of poor quality. Some of the builders were quite conscientious in producing sound and appealing units whose value could easily stand market test. Unfortunately, there was no insistence on similar high standards on the part of all the builders.

Delinquencies and foreclosures

One other major criticism of the Section 235 program in Beecher is that it is experiencing excessive delinquencies and foreclosures. What evidence there is supports this charge.

Two financial institutions with mortgages on 656 Section 235 homes in the county report 188 delinquencies and 19 foreclosures. A third institution stated that its delinquencies and foreclosures on 235 homes were running three to four times the average for its overall business.

One developer-sponsor in the area did develop a homeownership training and credit counselling program in connection with its sales program. Welfare families in the lowest income categories were not selected for homeownership under this program, and the training given to the buyers who were selected apparently minimized financial and maintenance difficulties. Other builder-developers, however, made little or no effort to provide their buyers with training or counselling, even in the case of ADC families.

Many of the ADC families buying Section 235 homes came from Flint's public housing projects. Some of these families even owed the housing authority as much as six month's back rent. The monthly shelter allowances for these families are sufficient to enable them to cover their required share of the mortgage payments and initial taxes on their new homes. But high utility costs, as can occur during winter months, or an increase in tax rates have sometimes made for more demands on their budgets than they can afford and led to early delinquency. The FHA Field Office has made no effort to resolve these kinds of problems.

CONCLUSIONS

Three broad conclusions emerge from this review.

(1) Serious problems have arisen in the Beecher School District and community which if not met effectively do threaten the quality of the educational system and the racial and socio-economic balance that developed in the community during the 1960's. Absorption of almost any volume of new housing is likely to create at least some problems for a community. The key is to plan ahead so that such problems are minimized. This was not done in Beecher.

(2) The Section 235/236 programs undoubtedly contribute to these problems, though they are not the only factors at work. Some of the problems reflect laxness in following program regulations and procedures. The most serious problems, however, are the result of independent private decision-makers working within the permissible framework of the programs. While these kinds of problems should and probably could have been prevented, to have done so would have required relating the Department's housing programs to community planning in order to deal with social problems—a capacity absent until recently in many local Field Offices.

(3) Major efforts will have to be taken to prevent recurrences of the Beecher situation in other localities across the country, re-orienting HUD personnel and regulations as necessary to accomplish this. In addition, strong leadership on the part of officials in Beecher and cooperation of the community at large is needed to maintain the viability of the community and its school system. Federal officials will work with the community in developing a meaningful program. No specific Federal program aid has been promised, but it is expected that applications for such aid will be filed and considered promptly.

Chairman PROXMIRE. Thank you very much, Senator Sparkman. It is good to have the chairman of the Banking and Urban Affairs Committee here this morning and we appreciate your coming in view of your other appointments, and we are delighted you proceeded a little out of turn.

Senator SPARKMAN. If I get through in time, I will be back.

Chairman PROXMIRE. Very fine.

Secretary Romney, go right ahead.

Secretary ROMNEY. Thank you.

I am going to go through it hurriedly. Presumably you have copies of my statement and I am not going to take more time than I have to to go through the text.

As you know, our Department is responsible for housing and community development.

1970 HOUSING RECORD

Housing had what I would call a mixed year in 1970. It was a year of significant achievements as well as unsolved problems.

The most significant achievement was making good on the promise to end the slump in housing production.

Recall that just a year ago, housing starts had dropped 25 percent from their 1969 peak and there were widespread expectations of a further drop to an annual rate of less than 1 million units. That unacceptable outlook had to be changed and the President fully committed the administration to take the steps required to produce the change. Thus, I was able to testify before the Banking and Currency Committees in February and early March that a housing recovery "* * * can and should be underway by summer. For the full calendar year 1970, we are striving to achieve approximately 1.4 million starts, with the rate in the final months well above that level."

The President's goal was, of course, not only met but exceeded, with total housing starts actually reaching 1,463,000 units in 1970. And the annual rate in the final quarter of the year was indeed well above even that figure—at more than 1,750,000 units.

I cite this record not to claim exclusive credit for the administration. Clearly, the Congress played an important role by voting requested appropriations and enacting the Emergency Home Finance Act. The independently determined policies of the Federal Reserve, the Federal National Mortgage Association, and the Federal home loan banks were also crucial.

The point is, however, that the only way all these diverse steps could be set in motion in a coordinated way was through the personal involvement of the President. And with his commitment, achievement matched promise.

A second major achievement last year was the production of 470,000 subsidized housing units for low- and moderate-income families. This was double the alltime record set the previous year, and it accounted for almost a quarter of the volume of all housing units—including mobile homes—produced during the year.

In the 2 years of the Nixon administration, production of subsidized housing has totaled 700,000 units, which is more than was produced during the entire preceding decade.

A third achievement is the significant change that has taken place in the mortgage and related financial markets. A year ago, mortgage lenders were closing their doors, and those still open rationed their limited supply of loans by charging ever-rising interest rates and restricting other loan terms. Today, there is almost a flood of loanable funds flowing into mortgage lenders, and they are steadily reducing their interest rates and liberalizing other terms to put this money to work.

In some places, mortgages are being originated today at interest rates as low as 7 percent, compared with rates of 8½ percent a few short months ago. And, Mr. Chairman, this morning I reduced the FHA ceiling on interest rates from 7½ to 7 percent, so the FHA ceiling rate as of today is 7 percent.

The key housing problem that still confronts us in 1971, however, is the problem of housing cost. I will return to this in a moment.

HOUSING OUTLOOK

The conditions that sparked the housing recovery during the past half year have by now gained such momentum that the housing outlook is perhaps the brightest spot on the overall economic horizon.

For the past 5 years, a continuing shortage of mortgage money has curtailed housing production below the volume needed to keep pace with household formation and loss of dwellings by fire, demolition, and other causes.

In 1971, I see no reason to expect any constraint on housing production from the availability of mortgage money. Lenders may not remain quite so flush with surplus funds as they appear to be at the present time. But they should be able to meet the demands of all prospective homebuyers who actually do seek a mortgage.

A second significant factor in the housing outlook is the further expansion contemplated in production of subsidized housing. HUD's fiscal 1972 budget includes a request for $560 million of new contract authority for production under various subsidized housing programs. This is an increase over the $530 million made available for fiscal 1971, and it will stretch much further to support production because of the lower interest rates now prevailing.

These funds, along with the operations of the Farmers Home Administration should be sufficient to push total subsidized housing production above 500,000 units, actually it should be around 550,000 units with this reduction in the interest rate in this calendar year and could be well above 600,000 units for the fiscal year 1972.

That clearly is a tremendous prop under the overall housing market.

Against this background, I believe that just a continuation of developments now in the pipeline should bring housing starts to a total of 1,750,000 units this calendar year, up nearly 20 percent from the 1970 total. I also believe, however that if we succeed in effectively curbing the continuing inflation of housing costs, housing starts could reach as high as 2 million units this year.

I recognize that these predictions are somewhat above the forecasts of housing starts generally developed by private economists. But as was the case last year, I am really talking about a housing target not a forecast. And with the President's personal leadership, steps are again being set in motion to achieve the kind of housing volume that is desirable.

We are not satisfied with just accepting the 1.75 million starts that now seems to be in the cards, even though such a production total would be above the volume called for this year to meet the 10-year housing goal.

Mr. Chairman, in any production situation you do not suddenly move from where you are to an average for a 10-year period.

Chairman PROXMIRE. I understand. I have some questions on this specific item, on the basis of goals you set forth.

Secretary ROMNEY. Production toward the upper end of my range—that is, somewhere near 2 million housing starts this year—will be necessary if the overall economy is to meet the GNP target of $1,065 billion called for in the annual report of the Council of Economic Advisers.

HOUSING COSTS

The key to achieving the high level of housing production that we believe is desirable is to gain effective control over construction costs. As I noted earlier, this continues to be the major housing problem.

The average new home built in 1965 with FHA financing carrier payments for the mortgage, insurance, real estate taxes, utilities, and maintenance of about $148 per month. A house of that same size on the same size of lot built and financed in 1970 would have carried payments of more than $270 per month.

This is an 84-percent increase in the effective cost of housing in 5 years, over a period when median family income was rising by only 46 percent.

This sharp divergence between costs and incomes clearly has priced more and more families out of the housing market. Its continuation assures either a failure in our efforts to meet the Nation's housing goal or an increasing federalization of housing in order to keep production as high as will be needed.

I believe both those alternatives are unacceptable. We must meet the housing goal without increased federalization of housing production, and to do so we must break down the many barriers that now severely restrict competition in the housing sector and thereby drive the cost beyond many consumers' reach.

MONEY

The recent reductions in the FHA–VA interest rate ceilings have already brought some relief on the cost side. In the example I used a minute ago, financing the house at today's 7 percent interest rate instead of those prevailing during most of last year would save a family $24 a month. The cost of money is clearly the largest single factor affecting the cost of housing, and the recent reductions in interest rates certainly will benefit homebuyers and housing production.

LAND

Money, however, is not the only cost affecting housing. In 1965, the average FHA-insured new home was built on a site of about 10,700 square feet valued at a little more than $3,400.

Last year, the average FHA-insured home site cost nearly $5,000, up 44 percent from 5 years earlier. But more significantly, in order to hold land costs down, the size of the average site was cut by nearly 20 percent to only 8,850 square feet. The cost per square foot of land was up nearly 80 percent, again over a period when median family incomes were rising by only 46 percent.

I must admit that I do not yet have a fully worked out proposal to gain control over skyrocketing land costs. The orderly community development envisioned in our new communities program, in the Urban Growth and New Community Development legislation enacted last year, and in the President's environmental message submitted this year should all be of some help. But we need to go much farther into revisions of the basic structure of the local property tax system and probably into revisions of the treatment of capital gains resulting from land speculation.

MATERIALS

Costs of construction materials, on balance, have not been so much of a problem. The index of overall construction materials cost is up only bout 18 percent in the past 5 years. Selected problems in such materials as lumber and asphalt are beginning to appear, however, and the administration is examining them to see what can and should be done.

LABOR COSTS

Finally, let me turn for a moment to the extremely serious problem of constructed labor costs.

As this committee well knows, average hourly earnings of construction workers have increased by 41 percent during the past 5 years, compared with only 29 percent for manufacturing workers and 31 percent on the average for all workers in the private nonfarm sectors of the economy. Last year, new wage contracts negotiated by the construction trade unions provided an average first-year increase in wages and fringe benefits of 19½ percent and an average increase over the life of the contract of 15.3 percent. These are more than twice as large as the increases negotiated by union workers in manufacturing.

Mr. Chairman, 1971 already has in store deferred wage increases from existing contracts averaging 13.3 percent for nearly 1.1 million construction workers. That is nearly a third of the construction workforce.

In addition, there is every indication that unless strong action is taken, many new contracts will try to beat the gains won last year. If that happens, the cost of a typical new home will have to go up by more than $2,500 over the next 3 years just to cover the added labor costs.

That alone would wipe out the effects on monthly payments resulting from the reduction in the FHA interest ceiling from 8½ to 7½ percent, and most of it down to 7 percent.

It was against this background that the President called the Construction Industry Collective Bargaining Commission into a session with him last January 18 and asked for recommendations within 30 days to deal with the construction cost situation. Just how effective those recommendations will be remains to be seen.

Well, this is the 30th day and we don't have any recommendations, so to this point it is not very effective. I think it is no secret that trade unions believe they have enough support in Congress to get by without seriously altering their current dominating position at the collective bargaining table.

I also believe, however, that the American people are fed up with paying the ever-rising costs of housing resulting from exorbitant construction wage settlements, and that it is time that these objections are reflected in effective actions to bring construction wages under control.

There is, of course, both a short-run and a long-run aspect to the construction wage problem. The short-run problem is to reach some kind of agreement that will affect the settlements coming up for negotiation in the next several months. That is what the Collective Bargaining Commission is focusing on presently.

The long-run, and in many ways more difficult, problem is to restore a better balance between labor and management at the construction industry bargaining table. I say it is more difficult because it probably requires legislation. A number of suggestions have been made in this area and I would like to lay a few of them on the table for this committee's specific consideration.

Many people agree that we need some basis to overcome the trade unions' present exclusive control over the hiring halls. That really is control over entry and placement of workers. To be sure, contractors can pick up workers away from the hiring hall. But they do so in full awareness that if such workers are not acceptable to the union, trouble may well develop on the project, with resultant delays, increased costs, and squeezed profits. This is one of the ways that unions have limited entry of minority workers in the construction trades. I think that is an abuse of union power.

Second, the President has already requested study of steps, including legislation to provide for consolidated bargaining on an area or regional basis in the construction industry. This will help overcome the fragmentation that exists in the industry, a fragmentation in which the local unions have far more strength at the bargaining table than the many independent contractors.

Third, much emphasis has been placed on the need for a thorough reexamination of the Davis-Bacon concept of requiring that "prevailing wages" be paid on Federal and federally assisted construction. Paying what is truly the prevailing wage in the local area for the type of work being done is clearly appropriate. That is what generally happens in a competitive market, and one wonders why in today's world such a practice needs to be ratified by bureaucrats in Washington. In fact, of course, the wage rates said to be "prevailing" have in practice, generally, been union scale, thereby forcing even nonunion contractors to pay those rates if they wish to bid on Federal projects.

The result is that the Government pays higher costs than necessary for housing. A survey by the Comptroller General found that Davis-Bacon determinations of prevailing wages on seven public housing projects inflated costs by an average of 18 percent.

In my opinion, restrictions on competition such as the Davis-Bacon procedures are the surest way to price housing construction right of the market.

Finally, a strong case has also been made for legislation to overturn the so-called *Philadelphia Door* decision by the Supreme Court. Under this decision, trade unions have been able to prevent introduction of new products or techniques by arguing that such projects would threaten jobs provided in their labor agreement with the contractor. The effect is to keep housing costs high and not allow consumers to enjoy the benefits of new technology.

HUD's statutes for our research and technology programs contain language that has helped prevent this kind of restrictive union philosophy in our Operation Breakthrough efforts. I think this is vital to the success of any effort to promote full development of industrialized housing.

OPERATION BREAKTHROUGH

As you know, it was to promote the industrialization of housing that we launched our Operation Breakthrough program a little more than a year and a half ago. That program has already accomplished much. Site grading and site development work are now underway on eight sites across the country, and we are negotiating with 22 housing system producers to define the specific costs for the 3,000 units that are to be built. Tests are already being conducted on designs for these systems, and those tests are being conducted the purpose of establishing performance standards by the National Bureau of Standards and the Academy of Sciences, to get rid of the building code restraints that are preventing modern technology and volume production of housing..

More importantly, the program has served as the catalyst for bringing homebuilding into the 20th century. Some people criticize the program for not having spawned a completely new technology. It is too early to know how much will ultimately emerge in this area. But it is absolutely clear that well-known technology that previously was being repressed by building codes, labor practices, and other restrictions is now finally breaking through the barriers into effective use. This is because Breakthrough has sought changes far beyond the narrow field of technology.

It particularly seeks change in labor requirements for homebuilding. It is totally impractical, inefficient, and unworkable to operate a factory under industrialized conditions with 17 or more separate crafts as are presently involved in on-site construction work. The industry has recognized this, and so have the unions—at least at the national level. Thus, recent agreements between Stirling Homes and the carpenters, between module communities and the laborers and between American Standard and the plumbers have permitted industrialized housing factories to be organized in practical and realistic operating ways. My authority under HUD's research statutes to assure that there is no restraint to development of new techniques on research projects, although so far not used explicitly, has clearly been a significant factor in achieving these agreements and may well provide a model for broader coverage if that proves necessary.

There are only two ways I know to effectively stimulate and discipline an economy. One is through some form of absolute authority. The other is through free and open competition, with the Government undertaking vigorous competitive enterprise policies to assure that market power is evenly balanced and that restrictive practices are eliminated wherever found. Operation Breakthrough is one significant effort in this area. I urge this committee to begin meaningful examination of additional steps to restore the kind of market competition that made this country great economically.

COMMUNITY DEVELOPMENT

Let me turn now briefly to the other principal area of my concerns: The problems of community development.

This committee has already heard ample and eloquent testimony from mayors and Governors about the crises being faced by State and local governments.

The community development this Nation has experienced to date has fragmented and balkanized our metropolitan areas into so many political jurisdictions that it is difficult if not impossible to mount an effective attack on current problems. And meanwhile, the cost of such an attack has soared way beyond the means of State and local government budgets.

In the 1960's the conventional response to these problems was to set up some new categorical aid program in Washington to funnel funds back to the local areas. In practice, the areas that got the money were not necessarily those with the most pressing problems, but those with the greatest understanding of how to pull the Federal levers.

Moreover, in each community there was a natural tendency to apply for funds not for the most needed projects but for those most likely to be accepted by the Washington administrators. I find it remarkable that this kind of system has not broken down before now.

Fortunately, I think we are ready to replace it with a new system that can work.

As you know, we recently announced the second phase of a functional organization of our Department. In the first phase carried out last year, we consolidated all subsidized housing production programs under one Assistant Secretary. This establishment of a clear line of authority was a major factor in our success in doubling subsidized housing production last year.

In the second phase, we will among other things consolidate all our housing management under one Assistant Secretary, all community planning and management programs under another Assistant Secretary and all our community development programs under a third Assistant Secretary. The latter will have full responsibility for such current programs as urban renewal, model cities, water and sewer grants, rehabilitation loans, neighborhood facilities, open space, and public facilities loans.

This kind of consolidation and functional responsibility makes sense even as a move by itself for it enables us to better serve the overall needs of our applicant communities. But it is even more significant as a precursor of the major reorganization that the President has proposed for our Department and others.

In that reorganization many of our present separate categorical aid programs to assist in community development will be folded into one broad special revenue sharing program.

Details of this program are not yet announced. But let me just point out what is involved.

Under the new approach we will place far greater reliance on mayors and other local officials to determine what their community's needs are and to spend their resources as they see fit to meet those needs.

The Federal participation will be focused more appropriately on helping provide the resources rather than on second-guessing the projects undertaken.

Citizens will then truly be able to hold their local officials to account for actions instead of having the buck passed back and forth among city hall, the State house, and Washington. And with responsibility clearly delineated, more efficient and economical action will generally follow.

Under the new approach, we will also place much greater emphasis than in the past on developing adequate areawide planning to anticipate and allow for community growth, so that actual development can take place in a much more orderly way than in the past.

Finally, I see the new approach as much fairer to all communities and hence to the American people than our present system.

Funds will go where needed and used as local people say they should be used, rather than as they are now to projects with the best grantsmanship capability.

We have a little concrete experience to show what this consolidation of programs can mean to a city.

Between July and December of last year our Chicago regional office carried out extensive negotiations with Mayor Richard Hatcher and his associates from the city of Gary, Ind., culminating in an agreement for funding a broad package of programs to assist Gary in the coming year. The package—the first of its kind—included funding for several urban renewal projects, a water and sewer project, for code enforcement, for a citywide demolition project, for a neighborhood facility, for urban beautification, for the second year of the model cities program, and for several housing projects, all chosen by Gary as meeting its priority concerns. In announcing the agreement, Mayor Hatcher stated: "If this is how President Nixon and Secretary Romney intend to shape their Republican federalism, then as a Democratic mayor I support it fully."

A second example is in the Federal planning grants recently awarded to the consolidated city of Indianapolis. In this agreement, a total of $660,000 under several independent Federal programs go to assist consolidated planning in the whole Indianapolis metropolitan area. Indianapolis estimates that the consolidation will save half a million dollars compared with the cost of the program if funded separately in the traditional way.

I believe these two examples provide a significant clue as to how Federal assistance programs can be improved through special revenue sharing.

Now, Mr. Chairman, if we can get costs under control in housing and move to a truly consolidated community development program along lines that the President will be proposing, I am confident we can make greater progress in meeting this Nation's housing and community needs.

Chairman PROXMIRE. In that last phrase, Secretary Romney, you have put your finger on what is crucial, and very crucial, not only for housing but for the economy. A great deal of the performance of this economy in the next year depends on what happens, as you so well know, in housing. Everybody is counting on it. The assumptions are it is going to increase very substantially and that depends on, as you point out, getting costs down, not only labor costs but financing costs, and so forth.

Now, the papers in the last couple of days have been filled with stories about the efforts on the part of the administration to try to persuade the construction trades and the building industry to get together to hold down wage demands and wage settlements so they can hold costs down and so they can, we can, get inflation under control.

It appears that that hasn't been making much progress. The administration indicates they may put into effect some kind of a wage-price freeze or wage-price control, a mandatory control, in the construction industry.

How could this apply effectively if it is confined strictly to one industry?

Secretary ROMNEY. Well, it could apply effectively if that course is decided upon because, after all, the collective bargaining and the economics within that industry are completely out of line with the rest of industry in the United States, and just as they are completely out of line so action with respect to that industry could be useful in bringing them back into line.

I do not want to indicate by that that taking action just with respect to the most flagrant instance of excessive costs would necessarily deal with the whole national problem. But at least I think it would improve the situation as it relates to that industry and indirectly have some influence on the rest of the economy.

Chairman PROXMIRE. On the basis of your experience which is, I suppose, about as extensive as anybody's in the administration, with the housing industry itself a very diffuse industry, it is an industry characterized by small units, can this be effectively enforced, in your view and, if so, how large an enforcement agency would be required?

Secretary ROMNEY. Well, let me quickly point out that I am not one who believes that this is the fundamental way to deal with the problem. As I have indicated in my testimony I do not think it is the fundamental way to deal with the problem. At best it is an expedient if it has to be resorted to. At best it can only be used effectively for a certain period of time and it won't cure the problem. It just simply permits an opportunity to take more meaningful action.

But I think what we are confronted with is the fact that the contract settlements in the construction industry over the past 3 years have been increasing every year.

Chairman PROXMIRE. I think, as you say, there is enormous sentiment in favor of this. But what I am asking is whether or not this can be enforced and how large a group it would take to enforce it, and would you have in mind the notion that it would be a freeze or would it be a limit on the size of the settlements?

Secretary ROMNEY. Well, Mr. Chairman, as I think you know from the papers, there has been no decision with respect to such action and, as I understand it, the Secretary of Labor is going back down to Miami tomorrow and will make an effort to persuade the building trades unions to participate in a meaningful voluntary wage stabilization agreement.

Now, thus far that has not occurred. But before taking action of this very drastic character there will be an additional effort to bring about a voluntary agreement.

Now, furthermore, I do not think that there has been any change in the basic viewpoint, that an action of that character, if it has to be resorted to, represents any permanent solution to the problem.

Chairman PROXMIRE. I understand that. I am wondering about the practicality of putting it into effect and, as I understand it, we have provided the authorization for the President to put into effect a price and wage freeze, but I presume it would take some further action to provide the machinery to enforce it if it is going to be enforced for any length of time.

Secretary ROMNEY. Obviously that would be the case.

Chairman PROXMIRE. Now, I would like to ask you about your statement when you talked about the goals, and you indicated that you thought you were ahead of the schedule.

I have in front of me—it seems to me this must be the Romney report, it is the Second Annual Report on Housing Goals dated April 2, 1970. It sets goals for the fiscal year instead of goals for the calendar year but by averaging the goals for the calendar year we come out with what the fiscal year would be, and it seems to me the deficit for fiscal 1971, the deficit of houses, is 482,000, the deficit for fiscal 1972——

Secretary ROMNEY. I did not hear that, Senator.

Where are you reading from?

Chairman PROXMIRE. Page 23 of the Second Annual Report on Housing Goals.

Secretary ROMNEY. I do not happen to have the goals before me but I have figures here on the national goals. Now my figure for 1971 fiscal year——

Chairman PROXMIRE. You have the fiscal year, that is right.

Secretary ROMNEY. 2,040,000 in fiscal 1971.

Chairman PROXMIRE. For fiscal 1971, 2,040,000, that is correct.

Secretary ROMNEY. That includes mobile homes.

Chairman PROXMIRE. No, mobile homes are separate, it is listed in a separate column, shipments of mobile homes are in the fourth column of that page.

Secretary ROMNEY. The 2,040,000 includes mobiles homes.

Chairman PROXMIRE. Well, mobile homes here are stipulated as separate.

Mr. DEMING. Mobile homes were a component of the total.

Chairman PROXMIRE. I see.

Then I stand corrected on that. But once again, we are back to the whole controversy. You are going to get to the housing goals if you get mobile homes, and that was the question Senator Sparkman was asking earlier.

It appears you are including mobile homes in your overall goal when you are talking about being on target, a little bit ahead of target you are including mobile homes as part of that, and I understood you earlier to say mobile homes were not part of it.

Secretary ROMNEY. Well, I did indicate that they should be a part of the meeting of overall housing goals as far as I was concerned. There might be some question as to whether you include the absolute total. But mobile home units have reached the point where they certainly constitute housing that is considered very satisfactory by a large number of families.

Chairman PROXMIRE. Well, some of the mobile homes are, as you pointed out in your response, you do not have standards now in mobile homes. We all know there are some mobile homes that are pitifully inadequate, there are some, of course, that are showplaces.

But whether or not you have a sufficient number that are adequate, of course, is a serious question.

At any rate, if you leave out mobile homes you are far short of your goals, if you put them in you are pretty close to on target, so this seems to be the critical point, and we do not have the assurance that mobile homes do meet the standards although you have standards for the trailer parks you do not have standards for the homes themselves.

Secretary ROMNEY. There are standards in our loan requirements. We are not going to insure loans except in those instances where the mobile homes justify such insurance.

Chairman PROXMIRE. Congressman Brown.

Representative BROWN. Mr. Secretary, I am impressed with your testimony. I am impressed with the results that have been achieved by your Department under your stewardship.

I would like to ask two or three questions, however, with reference to some things that were not mentioned in your testimony.

First, what about rehabilitation of existing housing, how much is there, the sort of thing where the individual homeowners adds a room, puts on a garage, adds a back porch or some other kind of facility to his property, and is this reflected anyplace in the figures that you have given us? I do not see it or at least I haven't figured out where it is reflected, and are there, what are the successes or failures of Federal programs in this area?

Secretary ROMNEY. Well, No. 1, the number of rehabs, where you have a real rehabilitation of a housing unit, are not nearly as great as they ought to be. This is one of the most difficult aspects of the whole housing situation.

Representative BROWN. Can we separate the two things here in our discussion: One rehabilitation method, of course, or expansion of housing is what the individual homeowner does to his property in the way of increasing the size of it and its serviceability for housing.

The other one is where we have had housing projects that have been abandoned but then are being rehabilitated. There are examples of that here in Washington.

Would you separate that in your comment?

Secretary ROMNEY. Well, of course, rehabilitation can occur with respect to a unit that has not been abandoned.

Representative BROWN. Indeed.

Secretary ROMNEY. As a matter of fact, many of the units that ought to be rehabilitated are currently being used but should be improved to lengthen their life and to keep them from being abandoned.

Once the unit is abandoned, the risk is that you are going to lose the unit, so it is much better to catch the unit before abandonment.

But the amount of rehabilitation is not very great despite the fact that we have been putting a great deal of effort and energy into that area.

As a matter of fact, I organized within the Department Project Rehab to see if we couldn't get a certain number of cities to make rehabilitation a special project and a special effort. Now we have been able to get a certain number of cities to do that. But the number of units that are being rehabilitated in cities like Buffalo or in Washington or some of the others that have become a part of this Project Rehab is very limited—from 2,000 to 3,000 units at most.

Well, that is a very small number of units in relationship to the deterioration taking place in the large number of units in those cities. From an overall standpoint in 1970 the Department was able to bring about 25,175 rehabilitated units under our subsidized programs.

The Department of Agriculture, through the Farmers Home Administration, assisted in 11,644. So you had a total of about 37,000 units rehabilitated on a national basis as a result of efforts of the subsidized programs of the two departments in 1970.

Now, for 1971, we estimate about 56,000 units. Well, that is not very many in relationship to the problem.

Representative BROWN. How does it compare with the number of units going out on an annual basis?

Secretary ROMNEY. Well, the number of units going out of use on an annual basis is very difficult to ascertain with certainty.

The 1970 census will give us a good indication of how many have gone out of use over the decade. But I haven't seen any really reliable annual figures.

We know it runs into several hundred thousand a year as a result of fire, demolition and so on. So this rehabilitation is just a fraction of those being abandoned and going out of use.

But, the rehabilitation problem is complicated by many things. One is the high cost of rehabilitation, because the high cost element applies to rehabilitation as well as to new starts. A second complication is local tax structures. Actually, local tax structures are generally of a character that results in higher assessments of property than land and this higher assessment of property is a very discouraging thing as far as the homeowner is concerned and as far as rehabilitation is concerned. It is a common experience for a family to rehabilitate a home only to have the assessment increased well beyond the amount put into the rehabilitation of the home.

So all of these things, this tax situation is an element in this whole rehabilitation picture.

Representative BROWN. That is one of the questions I wanted to ask about property taxes, and I hope to get to that, but let me press on the other side of the tax question with reference to rehabilitation.

The President has proposed in the maintenance of historic sites and buildings in his message on the environment that a Federal tax credit be given in order to maintain these sites, as I understand that proposal. Now, would it be possible through some kind of a tax break for those involved in rehabilitation of their homes or of property which they maintain for rent to offset this present problem of the proper tax increase in some way?

It seems to me it would be a worthy investment for the Federal Government to encourage the rehabilitation, maintenance and improvement of existing units.

Secretary ROMNEY. Well, in the Tax Reform Act passed the year before last depreciation of the rehabilitation costs over a 5-year period was permitted as an incentive to increase rehabilitation. Consequently, there has been an effort to provide incentives for rehabilitation. But this still has not encouraged the amount of rehabilitation that we really need.

Representative BROWN. Well, I would just like to suggest a promotional effort or some further attention to that problem because I think there is a possibility here.

I would like to suggest one other thing, if I might, Mr. Secretary. I would appreciate comments from you, because my time is about up, but in reference to rural areas in reference to the cost problem you have outlined that rural areas provide some answers to this question and, of course, the Interstate Highway problem and the interurban kind of public transportation systems would be of some help, but in the rural area I would think you have the lowest land costs to work on.

From my experience the low interest rates, at least from my experience the lower interest rates, in rural and local banks, at least in this recent crunch were relatively lower than they were in metropolitan centers in the same general area.

There is less union control of the building effort and there is more building labor available, people who have some carpentry talents and building talents that might be utilized.

There are fewer zoning and code restrictions. There are generally lower taxes, and there may be just as high or perhaps in some cases higher economic need for employment and the utilization of housing.

I would like to suggest to your Department that increased attention be given to the encouragement of housing in the rural areas.

Now, in my own district, which is mixed from city limits to metropolitan limits to relatively small communities, the mobile home market has moved more rapidly and has been developed with better benefit in the more rural areas, largely, I think, because of zoning and code restrictions in the metropolitan type centers. In this whole area it seems to me that the encouragement of industrial relocation so that we could obviate the need for transportation, that is another public cost that would be helpful, but is there an answer in this area that has not been fully explored?

Secretary ROMNEY. Well, there just isn't any question but that we should encourage the development of housing and other facilities in the less settled areas of the country and in the growth areas that are outside the metropolitan areas and this we are doing.

Now we have been working closely with the Department of Agriculture so that in our joint efforts we could encourage this to the maximum. And actually in terms of the grants we have made with respect to water and sewer and other programs that we have as they relate to housing and housing developments, a much greater percentage of those grants has gone into smaller communities than into the larger communities. This is for the purpose of encouraging the very sort of thing you are talking about.

So I do not disagree with what you have outlined at all, and we have a joint effort going on as between our two departments to encourage that very thing.

Representative BROWN. Perhaps we can pursue it further.

Chairman PROXMIRE. Congressman Reuss.

Representative REUSS. Thank you, Mr. Chairman.

Mr. Secretary, in response to a question by Chairman Proxmire you testified that the administration, as far as you knew, in the event that a voluntary wage-price agreement could not be worked out with construction labor and industry, was contemplating mandatory wage-price controls. In your judgment, would it be fair to impose wage controls on construction workers, without doing anything to stabilize prices generally of the commodities that hard hats, like anybody else, have to buy—food, clothing and all the rest?

Secretary ROMNEY. Well, number 1, I think I made it clear that no decision had been made.

Representative REUSS. Right.

Secretary ROMNEY. And No. 2 I think it has been very unfortunate that the economy has suffered from excessive settlements, much more excessive settlements, in the construction industry than we have had in other areas of the economy. Because these settlements have had such a harmful influence on the rest of the economy, it seems to me quite clear that the part of the economy that has been so abnormal ought to, could very properly, receive action—that action could be taken to undertake to reduce the degree of abnormality that seems to be accelerating in that particular part of the economy. I think it will have a beneficial influence on the economy as a whole if there can be some sound way ultimately worked out to bring costs in that part of the economy under control because there isn't any question but when you get settlements of the magnitude we have gotten in the construction industry that they act like a magnet on wages in other parts of the economy.

Representative REUSS. In expressing the view that you do Mr. Secretary, namely, that it would be fair to apply wage controls just to construction workers because, as you say, their hourly wages have gone up proportionately more than any other segment of labor, in reaching that view have you taken into account the fact that construction workers work a much shorter year due to climatic and other conditions than do workers in manufacturing generally?

For example, I just called the Department of Labor and am told by them that the average number of hours that construction employees work annually is 1,400 hours, versus 1,900 hours for the entire economy. That indicates the construction workers work only around 70 percent of the number of hours a year that others do and, therefore, high though their hourly pay is, don't you have to leaven that lump a bit by looking into the fact that their children eat by the year and want to be clothed by the year?

Secretary ROMNEY. Mr. Congressman, the seasonal effect on the construction work has been going down. Now this reflection of the seasonal factor in the wage differential between construction workers and other workers has been built in going back through the decades.

It is not some new element and, consequently, the spread that used to exist reflected that.

Now what has been happening is the spread between construction workers and other workers has been increasing very rapidly—particularly in the last 3 years. Three years ago the wage spread between construction workers and manufacturing workers reflected the seasonality picture, and the seasonality situation is not as bad now because methods are being taken to enable construction workers to work more steadily.

As a matter of fact, having been a construction worker myself in the Rocky Mountain area and having gone into open buildings to nail lath and put shingles on the roof and do outdoor and indoor work in the most inclement weather, I know something of the effect of weather on construction work, and it has been greatly reduced in recent years. And, furthermore, one of the very alarming things that think we have to look at is this: With this tremendous need for housing, with this tremendous need for other things involving construction workers, we have very high unemployment among construction workers. This to me indicates that the cost level has reached the point where they are pricing themselves out of the market. It is a financial catastrophe today for the average family to have to call a plumber into the home or an electrician into the home, let's face it. And it is a common experience to have people who are in the construction industry employing union workers who are called by friends to get a little work done to say, "Don't use my workers, they are unionized. Get Joe over here. I use him to do my work. He will charge you one-fourth or one-third of what you will have to pay."

It is that sort of thing that is affecting the situation here. And when you couple that with the Davis-Bacon Act and its application to Federal construction and subsidized housing construction, it is easy to see why we have high unemployment when there is a great need for such workers, an actual shortage in terms of need.

Representative REUSS. My time is up, Mr. Chairman. I yield it, however, with the observation that as the author of the law now on the books which authorizes the President to impose mandatory wage-price controls, I was told when it was being fought by the administration last summer that it would never be used. It is interesting to see that its use is now at least conceived of by the administration.

Thank you, Mr. Chairman.

Chairman PROXMIRE. I take great pleasure in calling on our newest member of the committee, a man who has won the friendship of just about everybody in the Senate. He is a remarkable fellow, very intelligent, diligent, and one of the things all of us like most about Jim Pearson, he is a vigorous nonpartisan in his attitude. He works with both Democrats and Republicans. We are very happy to have a man of his caliber on the committee.

Senator Pearson.

Senator PEARSON. Mr. Chairman, I was so impressed with your remarks I have forgotten my questions. [Laughter.]

Mr. Secretary, first, I want to associate myself with the concept developed by Representative Brown in regard to the great opportunities in rural revitalization. I think it was ironic, perhaps the scholars understood it but it was ironic, there were the great riots and burnings in the cities that first dramatized the relationship between the hard core of the metropolitan areas and the dying rural communities, the interrelationship caused by the great migration in, first, the unskilled who thought they were taking the first step up the ladder of economic achievement only to find that by lack of those skills they slipped back into the ghettos and on to the welfare rolls, and the second part of that great migration were the bright, young, educated young people who took away the leadership capabilities in the rural areas.

Now, I applaud your efforts and, of course, understand your association with the Department of Agriculture. I just want to make the observation that the Department of Agriculture's Rural Revitalization Department or agency over there has been very weak. I don't know of any imaginative proposals that have come forth from it.

The first proposition are some jobs and, the second, I think, is some housing, and whatever you can do in that regard will, I think, be an enormous effort to do something in the field of population balance.

Let me ask you this: You make four recommendations regarding labor costs in construction today, exclusive control of hiring, hiring halls, collective bargaining on an area or regional basis, reexamination of Davis-Bacon, and reversal of the so-called Philadelphia Door decision. Is the Commission that the President appointed and now working with the parties-in-interest, are they addressing themselves to these four areas of labor costs or do you know?

Secretary ROMNEY. Well, I am a member of the Commission so I have knowledge of what the Commission has been giving consideration to. There has been a good deal of consideration of the question of regional bargaining and improving the bargaining structure.

As far as the other subjects are concerned, I would have to say that obviously they have been discussed but there is a very strong difference of viewpoint as between employer and union members of the Commission.

Senator PEARSON. Have these proposals been reduced to any sort of a legislative draft or proposals that we might have——

Secretary ROMNEY. Yes.

Senator PEARSON (continuing). With reference to Davis-Bacon and the exclusive control over hiring halls?

Secretary ROMNEY. In the case of the Davis-Bacon Act and the Philadelphia Door case there is legislation that has been introduced in Congress that is pertinent and will be pretty effective.

As far as the hiring hall part, I don't know if fully perfected legislation has been developed in that area.

Senator PEARSON. I thank the chairman.

Chairman PROXMIRE. Congress Moorhead.

Representative MOORHEAD. Thank you, Mr. Chairman.

Mr. Secretary, in your testimony you ask about the production of 470,000 subsidized housing units, and then later you predict for the future a rate up to 500,000 and 600,000. Are those figures, limited to new production or does it include rehabilitation, does it include existing housing under section 205?

Secretary ROMNEY. It includes subsidized rehabilitation of the magnitude that I indicated—last year, 25,000 units from our Department, and about 11,000 from the Department of Agriculture.

Representative MOORHEAD. Does it include existing housing that is subsidized but not rehabilitated?

Secretary ROMNEY. No, it does not.

It includes new starts and subsidized rehabilitated units.

Representative MOORHEAD. I wonder, Mr. Secretary, if you could provide for the record a breakdown by program, not only for the present 470,000, but also in your projections—which programs are going to increase more than others?

Secretary ROMNEY. I will be very happy to. We have it here basically through 1971. I don't have the projection here but we can give you that projection for 1972.

Representative MOORHEAD. I think it would be helpful for the record.

Secretary ROMNEY. Yes, Mr. Congressman. It will be in the goals report which the President will be submitting shortly. He has to submit a new goals report every year. But we will be glad to submit it for the record.

(The following information was subsequently supplied for the record:)

TABLE I.—HOUSING GOALS AND PRODUCTION

[In thousands of units]

	Total production	Subsidized units: Total	Subsidized units: Starts	Subsidized units: Rehabs.	Unsubsidized units: Total	Unsubsidized units: Starts	Unsubsidized units: Mobile homes	Total starts
Fiscal years:								
1969:								
Goal	2,001.0	198.0	155.0	43.0	1,803.0	1,440.0	363.0	1,595.0
Actual	1,997.2	191.6	163.6	28.0	1,805.6	1,436.9	368.7	1,600.5
1970:								
Goal	1,850.0	310.0	260.0	50.0	1,540.0	1,090.0	450.0	1,350.0
Actual	1,791.9	334.8	302.6	32.2	1,457.1	1,056.0	401.1	1,358.6
1971:								
Goal	2,040.0	505.0	445.0	60.0	1,535.0	1,060.0	475.0	1,505.0
Low estimate	2,070.0	530.0	480.0	50.0	1,540.0	1,120.0	420.0	1,600.0
High estimate	2,120.0				1,590.0	1,170.0		1,650.0
1972:								
Goal	2,330.0	650.0	575.0	75.0	1,680.0	1,230.0	450.0	1,805.0
Low estimate	2,295.0	695.0	620.0	75.0	1,600.0	1,180.0	420.0	1,800.0
High estimate	2,765.0				2,070.0	1,650.0		2,270.0
4-year total:								
Goal	8,221.0	1,663.0	1,435.0	228.0	6,558.0	4,820.0	1,738.0	6,255.0
Low estimate	8,154.1	1,751.4	1,566.2	185.2	6,402.7	4,792.9	1,609.8	6,359.1
High estimate	8,674.1				6,922.7	5,312.9		6,879.1
Calendar years:								
1970:								
Implied goal [1]	1,945.0	407.5	352.5	55.0	1,537.5	1,075.0	462.5	1,427.5
Preliminary actual	1,901.9	469.6	432.8	36.8	1,423.3	1,034.2	398.1	1,467.0
1971:								
Implied goal [1]	2,185.0	577.5	510.0	67.5	1,607.5	1,145.0	462.5	1,655.0
Low estimate	2,230.0	585.0	525.0	60.0	1,645.0	1,225.0	420.0	1,750.0
High estimate	2,480.0				1,895.0	1,475.0		2,000.0

[1] Obtained by averaging goals for overlapping fiscal years.

TABLE II.—HOUSING PRODUCTION—FISCAL YEARS

	Total production				Starts				Rehabs.			
	1969	1970 [1]	1971 [2]	1972 [2]	1969	1970 [1]	1971 [2]	1972 [2]	1969	1970 [1]	1971 [2]	1972 [2]
Total subsidized	191,603	334,813	532,330	695,450	163,631	302,610	480,660	622,290	27,972	32,203	51,670	73,160
HUD	155,852	283,603	437,100	594,500	137,739	261,463	401,700	536,000	18,113	22,140	35,400	58,500
USDA	35,751	51,210	95,230	100,950	25,892	41,147	78,960	86,290	9,859	10,063	16,270	14,660
1 to 4 family—total	48,118	126,530	263,800	326,900	31,540	107,069	234,000	288,400	16,578	19,461	29,800	38,500
HUD	15,047	78,578	173,800	230,900	7,980	68,984	160,000	206,800	7,067	9,594	13,800	24,100
Sec. 235	7,980	69,393	164,000	221,100	7,980	68,984	160,000	206,800		409	4,000	14,300
Secs. 115/312	5,751	7,712	9,800	9,800					5,751	7,712	9,800	9,800
Sec. 221(h)	1,316	1,473	(3)	(3)					1,316	1,473	(3)	(3)
USDA	33,071	47,952	90,000	96,000	23,560	38,085	74,000	81,600	9,511	9,867	16,000	14,400
Multifamily—total	143,485	208,283	268,530	368,550	132,091	195,541	246,660	333,890	11,934	12,742	21,870	34,660
HUD	140,805	205,025	263,300	363,600	129,759	192,479	241,700	329,200	11,046	12,546	21,600	34,400
Public housing	69,514	96,616	100,000	95,000	63,589	89,524	94,000	90,000	5,925	7,092	6,000	5,000
Conventional	35,659	29,303	33,000	20,000	35,659	29,303	33,000	20,000				
Turnkey—leased	33,855	67,313	67,000	75,000	27,930	60,221	61,000	70,000	5,925	7,092	6,000	5,000
Sec. 236	997	51,392	124,300	235,100	925	49,124	111,900	211,600	72	2,268	12,400	23,500
Rent supplement	16,637	22,520	20,400	31,000	16,637	22,520	19,300	25,300			1,100	5,700
State-assisted projects	3,105	1,799	(4)	(4)	3,105	1,799	(4)	(4)				
Sec. 221(d)(3) BMIR	43,587	26,864	17,400	2,500	38,538	23,678	15,300	2,300	5,049	3,186	2,100	200
Sec. 202	6,965	5,834	1,200		6,965	5,834	1,200					
USDA	2,680	3,258	5,230	4,950	2,332	3,062	4,960	4,690	348	196	270	260
Unsubsidized starts	1,436,900	1,056,000	1,120,000 1,170,000	1,180,000 1,650,000	1,436,900	1,056,000	1,120,000 1,170,000	1,180,000 1,650,000				
Total starts	1,600,500	1,358,600	1,600,000 1,650,000	1,180,000 2,270,000	1,600,500	1,358,600	1,600,000 1,650,000	1,800,000 2,275,000				
Mobile homes	368,690	401,030	420,000	420,000								
Total production	1,997,200	1,791,900	2,070,000 2,120,000	2,295,000 2,765,000								

1 Preliminary.
2 Estimated.
3 Included in 221(d)(3) BMIR.
4 Included in 236.

Note: Details do not necessarily add to totals because of rounding.

TABLE III.—HOUSING PRODUCTION—CALENDAR YEARS

	Total production				Starts				Rehabs.			
	1968	1969	1970 [1]	1971 [2]	1968	1969	1970 [1]	1971 [2]	1968	1969	1970 [1]	1971 [2]
Total subsidized	191,774	229,344	469,648	584,890	163,697	200,969	432,829	523,775	28,077	28,375	36,819	61,115
HUD	155,544	185,863	400,825	486,800	138,528	167,449	375,605	440,950	17,016	18,414	25,175	45,850
USDA	36,230	43,481	68,823	98,090	25,169	33,520	57,179	82,825	11,061	9,961	11,644	15,265
1 to 4 family, total	38,365	77,498	193,818	304,000	23,522	58,950	170,361	271,150	14,843	18,548	23,457	32,850
HUD	4,806	36,986	128,170	211,000	637	28,127	116,200	193,150	4,169	8,859	11,970	17,850
Sec. 235	637	28,182	117,340	202,300	637	28,127	116,200	193,150		55	1,140	9,150
Secs. 115/312	3,425	6,907	10,338	8,700					3,425	6,907	10,338	8,700
Sec. 221(h)	744	1,897	492	(3)					744	1,897	492	(3)
USDA	33,559	40,512	65,648	93,000	22,885	30,823	54,161	78,000	10,674	9,689	11,487	15,000
Multifamily, total	153,409	151,846	275,830	280,890	140,175	142,019	262,468	252,625	13,234	9,827	13,362	28,265
HUD	150,738	148,877	272,655	275,800	137,891	139,322	259,450	247,800	12,847	9,555	13,205	28,000
Public housing	75,438	72,407	106,007	96,600	68,193	67,061	99,184	91,100	7,245	5,346	6,823	5,500
Conventional	42,240	27,598	32,331	26,500	42,240	27,598	32,331	26,500				
Turnkey, leased	33,198	44,809	73,676	70,100	25,953	39,463	66,853	64,600	7,245	5,346	6,823	5,500
Sec. 236		10,515	109,769	142,500		10,168	104,820	124,550		347	4,949	17,950
Rent supplement	16,901	18,350	24,467	25,300	16,901	18,350	24,467	21,900				3,400
State assisted projects	796	2,881	11,126	(4)	796	2,881	11,126	(4)				
Sec. 221(d)(3) BMIR	51,005	37,301	18,420	10,600	45,403	33,439	16,987	9,450	5,602	3,862	1,433	1,150
Sec. 202	6,598	7,423	2,866	800	6,598	7,423	2,866	800				
USDA	2,671	2,969	3,175	5,090	2,284	2,697	3,018	4,827	387	272	157	265
Unsubsidized starts	1,381,800	1,298,600	1,032,600	1,225,000 1,475,000	1,381,800	1,298,600	1,032,600	1,225,000 1,475,000				
Total starts	1,545,500	1,499,600	1,465,400	1,750,000 2,000,000	1,545,500	1,499,600	1,465,400	1,750,000 2,000,000				
Mobile homes	317,950	412,690	398,100	420,000								
Total production	1,891,500	1,940,700	1,900,300	2,230,000 2,480,000								

[1] Preliminary.
[2] Estimated.
[3] Included in 221(d)(3) BMIR.
[4] Included in 236.

Note: Details do not necessarily add to totals because of rounding.

Representative MOORHEAD. Mr. Secretary, you mentioned various restrictions on housing, in your statement you mentioned building codes as an inhibition against expanded construction. Does the Department have any proposals toward rectifying that situation, because I see none in your testimony?

Secretary ROMNEY. Yes. As a matter of fact one of the major purposes of Operation Breakthrough is to come up with performance standards for housing. Performance standards are being developed by the Bureau of Standards and National Academy of Sciences, and these performance standards can be relied on by the code organizations, by State governments and local governments in establishing building codes. Thus instead of varying code requirements based on the size of a piece of lumber or the type of pipe used or other more specific standards of that type, there can be performance standards that will open up the housing industry to the use of a greater variety of materials and also permit housing units to be built and shipped more widely.

Now, that is one of the most important things we are doing. We have also been working with State and local units of government to get them to overcome these restrictive building codes. Since we started this effort nine States have adopted laws that provide for statewide inspection of factorybuilt houses. This means that once the unit is inspected in the factory then it can be used throughout that State without regard to local building requirements. That is one means of overcoming the building code restriction as it relates to the industrialized housing unit.

We would like to see that widened. We are hopeful more States will adopt it, and we are hopeful that interstate agreements will be reached so that we can have the type of free flow in interstate commerce that we think we ought to have of the latest technology, latest materials in housing production.

Representative MOORHEAD. I quite agree with you, Mr. Secretary. I think that one of the problems is to have a mass market for housing that we don't have now in large part because of local building codes.

Secretary ROMNEY. That's right.

Representative MOORHEAD. Is there any program of either forcing or some real bait that can be used to encourage this project which, I gather now, is just encouragement and pleading with the localities and the States, is there anything that you can do?

Secretary ROMNEY. We are working with them to bring this about. Fortunately there seems to be an increasing State awareness of the need for improvement. Most States now have someone designated as a breakthrough representative to work with us and one of the areas is in this area of eliminating these code restrictions. Whether it is going to be possible to open up the housing market adequately on the basis of State action or whether it is going to take Federal action I think remains to be seen. In any event, we are still placing our hopes at this point on adequate State action.

There is legislation pending again in Congress that would open up interstate commerce as it relates to housing. I personally see no reason why there shouldn't be a free flow in interstate commerce of those things that will benefit people in meeting their housing needs.

Representative MOORHEAD. Thank you, Mr. Secretary.

Mention has been made of the possibility of a freeze or a limit on wage increases in the construction industry.

Would this action of the administration be taken under the provisions of the law passed by Congress last year or based on other legislation?

Secretary ROMNEY. If it is taken, as far as I know, that is the only authorization that would permit it to be taken.

Representative MOORHEAD. Is it your understanding of the construction of that law that you could select out one industry and only the wages, and impose a selected freeze on that one industry?

Secretary ROMNEY. It is not my understanding of it—well, let me answer the question in two parts. No. 1, as far as I know, and I don't consider myself a legal expert, so my opinion is not worth very much as a layman, but from what I have been told and so on——

Representative MOORHEAD. You are the Secretary and we were lawschool classmates.

Secretary ROMNEY. As far as I know, you gave the President pretty much of a blank check and you didn't restrict how it should be applied. So he could be quite selective, so far as I understand it.

Now, as far as I know, there has been no consideration given to just freezing wages.

Representative MOORHEAD. The consideration—just to finish this thought, Mr. Chairman—then is if you freeze or limit construction wage increases that you would also impose some form of price and profit control on the houses built, is that true?

Secretary ROMNEY. Well, again there has been no decision in this area. Let me say his, that I am confident that if it were decided to take any action it would certainly include salaries and other forms of compensation in addition to wages.

Representative MOORHEAD. And prices?

Secretary ROMNEY. I think you have to deal with both aspects of the problem.

Representative MOORHEAD. Thank you, Mr. Chairman.

Chairman PROXMIRE. Senator Javits.

Senator JAVITS. Mr. Secretary, I regret very much that I was not here during your testimony but I had other vital committee responsibilities. I have gone through it and it seems to be the usual Romney job of very thorough coverage of our situation and very frank-speaking.

I would like to ask within the 10 minutes, I gather——

Chairman PROXMIRE. Five minutes.

Senator JAVITS. Five minutes, just a few questions of you.

I notice that you have spoken about housing starts in terms of 2 million and subsidized housing in terms of an increase in budgetary requests from $530 to $560 million. Would you in each case tell us whether you consider those to be optimum figures or satisfactory figures and if not, what you would consider satisfactory?

Secretary ROMNEY. Well, Senator, let me answer it this way: I don't always get what I ask for. But, on the other hand, let me add this to that response, I am personally becoming concerned at the extent to which we are trying to solve the housing problem by subsidization and by financial methods. We have been trying to do that since 1937. It hasn't worked.

As a matter of fact, as Senator Proxmire pointed out, we are not achieving the volumes of housing output that we need.

Now, the problem, the basic problem, really, isn't the amount of subsidization. We are going to get the volume that you are talking about for low- and moderate-income families through subsidization.

There are a lot of other problems other than getting the units too because it is perfectly clear we have not done an adequate job in providing the funds or the organization to counsel these poor families who are going into home ownership for the first time. There are a lot of other problems we experience but that part of the problem is going to be dealt with.

The part we are not dealing with and the part that is absolutely fundamental is this part that is affected by these costs that are completely out of hand.

I just want to say this additional thing to this committee. It is not a factor that just affects housing. It affects the whole economy. The hard facts are, as I have pointed out, basic industries are moving out of this country, basic industries are no longer expanding in America, and one of the basic reasons is because the construction costs are too high.

I have been associated with three industries in my lifetime, the aluminum industry, the automobile industry, and the appliance industry. You can produce all three of those products outside of the United States today much cheaper than you can produce them inside of the United States, and I have had major producers in every one of those areas tell me in recent weeks they will no longer increase their capacity in the United States. It will be increased outside of the United States.

Now the hard facts are that what I am faced with in housing in trying to get housing volume to meet the needs of the American people is affecting the whole economy of this country. We have got to step up to this fact that costs are out of control. And they are out of control basically because we have not modernized our labor laws or our antitrust laws, either one, and you have got to deal with both of them, in my opinion.

Senator JAVITS. Mr. Secretary, do you feel——

Secretary ROMNEY. This affects housing as well as the others, so, Senator, I can't just leave it with the subsidization. Forgive me.

Senator JAVITS. That is all right. But you still have not answered my question. I gather the implication is that the overall number is inadequate, 2 million, and the overall subsidization is inadequate, $560 million, but that you are doing the best you can especially as costs are cutting down the numbers.

Secretary ROMNEY. Actually, Senator, those figures that you have there from the unit standpoint are less than they will be because as a result of the reduction in the interest rate we will be getting 550,000 subsidized units in this calendar year and better than 600,000 units in the next fiscal year. That exceeds the housing goal so far as subsidized housing is concerned. So again I can't get too concerned about that area unless we are going to continue to increase the scope of the subsidy in order to compensate for our failure to deal with the more fundamental problems that effect the housing industry.

Senator JAVITS. Let's get to the labor costs which I would like to ask you about. Isn't the key to the labor costs the fact that the construction trades have established such a standard to which naturally, because they are all political just like we are, other unions try to repair, that it has distorted the whole American labor cost structure?

Isn't that directly to be laid at the door of the construction industry?

Secretary ROMNEY. Well, there ins't any question but that these exorbitant increases in the construction industry have had a distorting influence on the whole economy. They particularly distorted the position of the construction industry because, as the cost of housing has gone up faster than the cost of other products or as the wages of construction workers having gone up 2½ times as fast as the wages of people in manufacturing plants, why obviously the people in manufacturing plants have been less able to buy housing or do other things.

Senator JAVITS. Well, now, workers in those industries say that, in answer to that argument, that they are not on an annual wage basis, and because of the layoffs due to weather and the sporadic nature of construction they really don't do any better than other workers of similar skill in other industries. Is that true, in your judgment?

Secretary ROMNEY. Well, there is a seasonal factor in construction that certainly should be taken into consideration in establishing the wage rates. But this is not a new factor. This has been in the picture for years, and it has been reflected in the wage differentials for years. And, as a matter of fact, the seasonal factor is less of a factor today than it used to be because there are modern methods of protecting against the seasonal factor in construction work. But the differential as between the construction worker and the other workers has been increasing at an alarming speed so that the seasonal factor, in my opinion, is not one that justifies what we have experienced here each year.

Senator JAVITS. Mr. Secretary, one last question, if I still have time for it, under these circumstances if this represents an impact upon the total economy, don't you think—if you can't answer, say you can't answer—that here is a case which requires direct Presidential intervention by the use of a law which he has on the books? Now, it may be you couldn't justify such use in a discriminatory way for one industry, but in the face of your conviction, which I think is justified that this has its—this is distorting the total economy, isn't this a case where instead of trying to control the whole economy, which obviously he may not have to do, he ought to seek to control this branch of the economy either with the law he has or by asking for special law?

Secretary ROMNEY. Well, a month ago today he convened a meeting of the construction industry, including the members of the Collective Bargaining Commission in the construction industry, and directed the Commission to come back within a month with a recommendation for a wage stabilization program for the construction industry. That time expires today. The President has decided to make one last effort by asking the Secretary of Labor to make another appeal to the building trades unions to enter into a voluntary agreement for wage stabilization.

Now what he will do beyond that remains to be determined. But in any event it is clear that the President does recognize that there is need for special action with respect to the construction industry because of this abnormal wage and cost situation, and it applies more broadly than to just wages.

Senator JAVITS. My time is up, Mr. Chairman. Thank you.

Chairman PROXMIRE. Senator Bentsen.

Senator BENTSEN. Thank you, Mr, Chairman.

Mr. Secretary, in talking about some of the determinations of Davis-Bacon, you call for review of the act. Isn't this within the authority of the Labor Department itself, and isn't it a situation where determinations are made by the Labor Department on what is a prevailing wage?

Secretary ROMNEY. There is some responsibility there and some opportunity to deal with it and there has been some fruit. As a matter of fact, since we took office we have persuaded the Department of Labor to make use of wage data that FHA develops as a menas of getting more accurate information with respect to the prevailing wage in housing construction. But you still have the fact that the basic impact is the impact of the union wage scale on the construction industry in a given area.

Senator BENTSEN. Well, the union wage scale, along with the nonunion, has to be considered in arriving at a prevailing wage; so it would seem to me, within the authority of the law as it is now, that the authority is there for the Labor Department to find what is the true prevailing wage.

Secretary ROMNEY. Well, there is a 30-percent rule in the administration of the act. The determination of prevailing wage for 30 percent of the people in the area permits the establishment of the overall prevailing wage, and this permits the use of the union wage level as a means of establishing the prevailing wage.

Now the hard facts are the way the act has been administered has been in the manner I have indicated.

Senator BENTSEN. So, again, we are getting to administration primarily, it appears to me.

Secretary ROMNEY. No, Senator, I think the basic concept is wrong. After all——

Senator BENTSEN. The foundation of the prevailing wage?

Secretary ROMNEY (continuing). You have been a businessman and you know the competitive marketplace is a good place to establish the prevailing level. This is a substitution of an arbitrary determination for the operation of the market. And there are only two ways to discipline the situation. One is through arbitrary decisionmaking, the type involved in this, or the competitive approach.

Senator BENTSEN. So, you argue against the concept of accepting what is the prevailing wage on Federal projects or federally assisted ones?

Secretary ROMNEY. Sure. As a matter of fact, this was adopted back during the depression when you had an abnormal situation as far as labor was concerned, because at that point there was obviously a surplus of labor. Consequently, the competitive impact of a surplus of labor was very depressing on the wage situation. I don't have any question about the action having been justified at that time. But now we have the opposite situation where there is actually a shortage of construction workers in terms of need, in terms of what we ought to be building in this country. Consequently, the purpose of the act is gone.

Senator BENTSEN. Let me ask you about another one, then. You speak of going back to the mayors and to the local officials to get their advice and counsel as to the best utilization of resources in the area. I think of projects under 221, housing on rental subsidy, and in that instance, as I recall, the Congress put in a limitation that you had to counsel with the local officials as to placements. Under 235 and 236, where you have interest subsidy for single houses—but for multiple houses you do not—yet you have the authority to do this under the act. I can understand limitations might have to be placed for civil rights protection, but would this be the type of thing where you would go back to the local officials and you would anticipate a change in the approach of your Department?

Secretary ROMNEY. No, sir. As far as the housing programs are concerned, there is no change of the type you describe. The President is not proposing under his revenue-sharing proposals, either the general or the special revenue-sharing proposals, to make any changes in the housing program.

Now, we have as a Department recommended to the Congress a consolidation, a simplification of the programs. But that does not affect this question of the relationship between the Federal, State, and local officials with respect to housing.

Now, Senator, there is one of the housing subsidy programs that we have where such consultation is called for by statute and that is the rent supplement.

Senator BENTSEN. That is 221 as required under the appropriations.

Secretary ROMNEY. I don't know what it is. It is in an appropriation but I don't know whether it is 221. There are 50 of these, as a matter of fact, of housing subsidy programs, and I would like to get them reduced and simplified.

Senator BENTSEN. Can you tell me the justification why in the one instance you would have to go to the local officials and in the other you would not?

Secretary ROMNEY. No, I can't see any justification for doing one and not the other.

As a matter of fact, Senator, what I really think we ought to have in the housing picture is a requirement that in the metropolitan areas there be an areawide program to meet the housing needs rather than this present situation where you have to deal with it on the basis of every little general purpose government that exists in the metropolitan area. This is one thing I would very much like to see.

Senator BENTSEN. Thank you, Mr. Secretary. Thank you, Mr. Chairman.

Chairman PROXMIRE. Senator Sparkman.

Senator SPARKMAN. Mr. Secretary, although I got in a good part of your testimony, I missed part of it, but I shall read it later.

I want to ask you a few things with reference to the budget request for this year, that is for fiscal 1972. I am looking at a table that comes out of it, a "Review of the President's 1972 Budget in the Light of Urban Needs and National Priorities by the United States League of Mayors and the National League of Cities," and I note that in the community development area the appropriation for fiscal 1971 for all of those items, urban renewals, model cities, water and sewer grants, rehabilitation loans, community development grants, there is a total of $2,160 million.

I note the budget request, according to this, for fiscal 1972 on these same items comes to exactly, comes to $1,640 million. In other words, it is $520 million less than the appropriation that was made in fiscal 1971.

I don't understand this dropoff. I realize there is involved the new proposed community development grant involved in the proposed revenue-sharing. But I wonder if you could comment on that?

Secretary ROMNEY. Yes, I am glad you asked the question because, as you know, and other Members of Congress know, you really have to take a look at not just appropriations but also program levels that are authorized and funded and also outlays to see really what the level of activity is going to be for the coming fiscal year.

Now, the figures you have cited are correct as far as appropriations are concerned. But if you take the program levels that we will undertake, as the result of funding and authorization to undertake—this year, our program level for the overall community development program is $1,604 million, whereas next year it will be $2,020 million, in other words $416 million more than in the current fiscal year. So in terms of the actual program level there will be a 20-percent increase.

If you take outlays, and that is what we are going to actually make available to the cities, the money that they will get, the outlays for 1971 will be $1,649 million, for 1972 they will be $2,106 million, in other words about a $550-million increase over the current fiscal year.

So in putting the budget together it was obviously recognized that on the basis of previous actions of Congress both the program level and the outlay level were such that we wouldn't have to ask for a greater appropriation level in order to sustain both a program and payment level well in excess of the current fiscal year.

Senator SPARKMAN. Are you in effect saying that there is actually no decrease in the activity?

Secretary ROMNEY. That is correct.

Senator SPARKMAN. In community development?

Secretary ROMNEY. That is correct. I am saying the activity will be up and that the activity will be up between 20 and 25 percent. In actual payments made in the money that the cities will receive they will get 25 percent more money in the 1972 fiscal year than they will get in the 1971 fiscal year.

And, furthermore, Senator, on the basis of the proposals that are made, the special revenue-sharing proposal that the President has made, as this is applied if enacted, which I hope it will be inacted, as of January 1, 1972, it will be possible to make that billion dollars of money available to the cities much faster through the new special revenue-sharing program than it would be possible to make it available through our present categorical assistance programs because the bulk of that money under the proposals that will be submitted to Congress will flow automatically and you won't have a 15-month delay between the availability of the money and the receipt of it by the city. So obviously there is going to be a much greater increase as a result of the adoption of the special revenue-sharing program than I projected.

Senator SPARKMAN. I wonder if, in connection with your statement there, and it is a very interesting statement, you could have prepared something spelling out a little more in detail and put that in the record as a part of your answer?

Secretary ROMNEY. Yes, sir.

(The following information was subsequently supplied for the record:)

The table below shows program levels, appropriations, and outlays for Community Development Programs for fiscal years 1970, 1971, and 1972.

Since the date of the Secretary's remarks before the Joint Committee, there has been a reprogramming of requirements for Model Cities obligations. This resulted from the further development of policies subsequent to the publication of the 1972 Budget concerning the period of changeover from the categorical grant approach to special revenue sharing. The table below on Community Development Programs program levels, therefore, reflects the revised amounts for the Model Cities program.

COMMUNITY DEVELOPMENT PROGRAMS

[In thousands]

	Actual, 1970	Estimate, 1971	Estimate, 1972
Program Levels:			
Urban renewal programs (reservations)	$977,796	$1,029,388	[1] $800,000
Rehabilitation loans (approvals)	41,872	50,000	[1] 50,000
Model cities programs (obligations)	315,070	523,600	[1] 287,700
Grants for basic water and sewer facilities (reservations)	150,363	150,043	[1] 100,000
Community development grants (proposed legislation) (obligations)			1,000,000
Subtotal	1,485,101	1,753,031	2,237,700
Open space land programs (reservations)	75,147	75,130	200,000
Grants for neighborhood facilities (approvals)	39,999	40,002	40,000
Public facility loans (approvals)	39,959	40,041	65,000
Total, county development	1,640,206	1,908,204	2,542,700
Appropriations:			
Urban renewal programs	1,000,000	1,200,000	600,000
Rehabilitation Loan Fund	45,000	35,000	40,000
Model cities programs	575,000	575,000	
Grants for basic water and sewer facilities	135,000	350,000	
Community development grants (proposed legislation)			1,000,000
Subtotal	1,755,000	2,160,000	1,640,000
Open space land programs	75,000	75,000	200,000
Grants for neighborhood facilities	40,000	40,000	40,000
Public facility loans [2]	(40,000)	(40,000)	(65,000)
Total	1,870,000	2,275,000	1,880,000
Budget outlays:			
Urban renewal programs	1,043,187	1,082,000	1,300,000
Rehabilitation loans	35.035	47,000	36,000
Model cities programs	85,794	380,000	[3] 450,000
Grants for basic water and sewer facilities	109,011	140,500	170,000
Community development grants (proposed legislation)			[3] 150,000
Subtotal	1,273,027	1,649,500	2,106,000
Open space land programs	43,414	72,000	100,000
Grants for neighborhood facilities	23,408	33,000	38,000
Public facility loans	40,489	45,513	36,494
Total outlays, community development	1,380,338	1,800,013	2,280,494

[1] Amounts proposed for first 6 months of the fiscal year.
[2] Non-add because Public Facility Loans are financed by Treasury borrowings.
[3] Subject to upward revision.

Senator SPARKMAN. My time is up but I would be glad also if you could explain this, and that is, I am referring particularly to the 235 and 236 programs, there is authorized for 1972, $225 million in each one of the programs but—no, I believe you are asking for that full amount.

Secretary ROMNEY. No. In 1971, you have authorized $25 million more for each of those two programs than we have thus far requested, and you have authorized $75 million in the case of public housing that we have not yet requested. Now, I don't know whether we are going to request those amounts or not. The reason I don't is this: After all we have more than doubled housing production with almost the same number of people in our organization that we had when we were at a much lower level. Obviously we have problems that have arisen as a result of factors that are new and new programs, social problems as well as other problems. We don't think it is just a question of getting the volume of housing but it is also a question of making certain that these programs are properly administered.

So just what we will do in terms of asking for supplemental funds remains to be seen. Actually that authorization wasn't available until December 31, because our appropriation bill wasn't signed.

Senator SPARKMAN. Thank you very much.

Secretary ROMNEY. Let me just add one other thing because I know, Mr. Chairman, the committee is deeply concerned about meeting housing needs and meeting it on a sound basis. I think the Congress ought to begin to take a look at what the impact of the currently authorized subsidized program is going to be once we get to the point where we have 6 million subsidized units.

Now, when we get to the point where we have 6 million subsidized units in 1978 the budget is going to have to carry $6 billion to pay for that subsidization, $6 billion. It has been a pretty easy thing to get this built up but we are going to have to pay for the subsidization. I think it is time the Congress is going to have to ask itself about putting that money in and whether there will be further money for subsidization. In other words, how much more are you going to put in for housing subsidy. I think these are some of the questions we need to begin to address ourselves to and we are going to have to begin to outline some of these considerations in our goals reports because I really think we are at a point where we need to begin to decide whether we meet this housing need primarily through further subsidization and federalization of the housing industry or whether we meet it by confronting this cost situation which is completely out of hand.

I just want to add one other thing, in conclusion. I have been in the automobile business long enough to see America's superiority in automobile production disappear in terms of costs. If you want a good example of what is happening to this economy of ours take a look at the new cars introduced this year by the "Big Three," by the two "Big Three" companies. One is the Pinto, built with imported parts from Germany and England, except for the sheetmetal. The guts of the car, the engine, the transmission, the differential, the driveshaft, axels, the things that cost money in the car, those things are all imported.

Now, the Vega produced by General Motors with the latest technology, a much more automated plant than other plants, is also on the market, and there is a $200 price difference between the Pinto and the Vega, and the imports are increasing.

Now I was Governor of a State that saw its economic base eroded as a result of not facing economic realities. And my concern as an American is that the Nation is failing to face its economic realities, and, as a result, the economic base of this Nation is eroding.

We have a steel industry that is dependent upon voluntary quotas by Japan and Europe. You can produce aluminum a lot cheaper outside the United States than you can in the United States, and to build a plant in the United States costs two or three times as much as what it costs to produce, build it somplace else.

Chairman PROXMIRE. Well, that was a very interesting statement and excellent response. Unfortunately, I am sure all us would like to ask you additional questions, I would like to question you on title V of the Emergency Home Finance Act.

Secretary ROMNEY. You mean 243?

Chairman PROXMIRE. Also I think I can argue with you on the wage-cost argument, the myth that wages are going up more rapidly in other countries than they are here, but that is something we can get into at a later time.

We want to thank you very, very much, Secretary Romney. You have done an outstanding job, as you always do.

Secretary ROMNEY. Thank you, sir.

Chairman PROXMIRE. Our witness who has been most patient is the distinguished Secretary of Commerce and, I might say, Mr. Romney, we are going to, we would ask you to respond to questions that we would submit for the record if you would when you correct your remarks.

Secretary ROMNEY. Yes, sir.

(The following information was subsequently supplied for the record:)

MARCH 1, 1971.

Hon. GEORGE ROMNEY,
Secretary of Housing and Urban Development,
Washington, D.C.

DEAR MR. SECRETARY: The following question was submitted by one of the members of the Committee for transmittal to you with the request that you respond for the official record. The question is as follows:

"During your testimony before this Committee, you made reference to 'FHA wage data.' Could you please supply a brief description of this data, including the method of collection and the extent of coverage?

"Please supply also whatever information you have available on the following questions:

"What percentage of construction workers are unionized?

"What is the average hourly wage for all construction workers? The average annual income?

"What is the average hourly union wage? Non-union wage?"

Sincerely,

JOHN R. STARK, *Executive Director.*

RESPONSE OF HON. GEORGE ROMNEY TO ABOVE LETTER, DATED MARCH 1, 1971

Question 1. During your testimony before this Committee, you made reference to "FHA wage data". Could you please supply a brief description of this data, including the method of collection and the extent of coverage?

Answer. The "FHA wage data as referred to in the testimcny consisted of surveyed hourly wage rates for residential construction. The rates are obtained personally by FHA Personnel, from builders and contractors in the area where an FHA or Public Housing Project is to be built. This information is then forwarded to the Department of Labor for their use in establishing a prevailing wage determination typical of residential construction.

Question 2. Please supply also whatever information you have available on the following questions:

(a) What percentage of construction workers are unionized?

(b) What is the average hourly wage for all construction workers? The average annual income?

(c) What is the average hourly union wage? Non-union wage?

Answer. Our Department is not the best source for this type of information Such information as is readily available to us is as follows. The Department of Labor may be able to supplement these answers.

Information relating to the degree of unionization among construction workers is not available for all classes of construction workers. However, with respect to residential construction workers the publication "Profilè of Builder and His Industry 1970" published by the National Association of Home Builders contains information resulting from a number of surveys. The latest of these involving a sampling of over 9,000 builders indicated that 55.9 percent of all single family home builders are open shop while 39.3 percent of all multifamily builders are in that category. In some regions of the country open shop runs as high as 91 percent. The lowest is the Pacific Region where only 25.1 percent of all residential builders are open shop.

As reported in the Department of Labor's publication, "Employment and Earning's Report" dated February 1971, average hourly earnings of construction workers in the contract construction industry was $5.22 in 1970. We do not have data on average annual income.

According to the Department of Labor's News' Release 71-052, the average hourly union wage as of January 4, 1971 was $6.39 excluding fringe benefits and $7.23 including fringe benefits. We have no data reporting average hourly non-union wages.

RESPONSE OF HON. GEORGE ROMNEY TO ADDITIONAL WRITTEN QUESTIONS POSED BY SENATOR JAVITS

Question 1. Is it feasible to initiate an annual wage in the construction industry? That is, the unions would give the housing market a break by not charging as much for projects in return for some sort of guaranteed annual wage. What are the possibilities for this type of agreement?

Answer. In my opinion, an annual wage is feasible only where a reasonably high degree of continuity of employment can be anticipated. I think the possibilities for success of annual wage plans in the construction industry are very limited because of the peaks and valleys in employment in that industry. Undoubtedly, the leveling of the peaks and valleys would be one of the goals of the anuual wage, but I suggest another approach to that goal. I recommend that we strive for reasonable wage rates in order to increase employment, and increase housing production. In many localities, the employment of union labor prevails on general building construction, while the employment of non-union labor prevails on housing construction. The enclosed chart shows comparative wage rates in a few of the many localities in which the Department of Labor found that the wage rates which prevail on housing construction are lower than those which prevail on general building construction. Some unions now realize that if they wish to compete in the housing field, they must include a lower wage rate for residential construction in their bargaining agreements. The wage rate on the enclosed chart for Bricklayers in the City and County of Baltimore, Maryland, is an example of such action. Similar action has been taken by the Carpenters and Electricians in some localities, and we are endeavoring to promote such action in additional localities and by additional trades.

Question 2. Could you clarify your position on public housing? Are you planning to commit the entire amount of your contract authority in public housing under the 1970 Housing Act?

Answer. The Low Rent Public Housing Program has accelerated rapidly in the past several years and the President's Budget for fiscal 1972 would continue the program at approximately the same level. During the ten fiscal years ending with 1968, public housing program levels averaged less than 35,000 units a year. By contrast, during the four-year period ending with fiscal 1972, more units will be added to the program than in the previous decade—a total of almost 400,000 units, or about three times the previous annual average. In the current fiscal year we have budgeted for 90,000 additional units, and for fiscal year 1972 we have proposed an additional 95,000 Low Rent Public Housing units. These units together with an additional 100,000 units to be placed under program reservations in 1972 represent full utilization of the production authority provided by the Housing and Urban Development Act of 1970.

It should also be noted that, during this period of time, there were important additions to the array of assisted housing programs within the Department. The Rent Supplement Program was enacted in 1965 and became operational late in fiscal 1966. The Section 235 Homeownership Assistance and the Section 236 Rental Housing Assistance Programs were enacted in 1968 and became operational in 1969. The Rent Supplement Program by statute serves the same low income range as the public housing program, while the programs under Section 235 and 236 are directed by statute to both the low and moderate income areas. Taken together, these three new programs will provide, in round numbers, for an additional 355,000 units in fiscal year 1971 and an additional 400,000 units in fiscal year 1972.

From the standpoint of the Administration and the Department, it is important to develop a budget program in which the amounts allocated for the production of housing contribute to a well-balanced housing program consistent with the attainment of the National Housing Goals. We do have this kind of a program in the 1971 and 1972 Budgets.

Question 3. Would you please provide the following additional information on Operation Breakthrough:

Question 3.1. The names of the 22 housing producers involved, and a brief description of the technical design characteristics of each housing proposal;

Answer. Enclosed is a copy of "Operation Breakthrough: A New Approach is Being Taken in the United States to Improve the Process of Producing and Providing Housing," a paper delivered by Assistant Secretary Finger before the Economic Commission for Europe's Committee on Housing, Building and Planning. Attached to the Assistant Secretary's remarks is a section which includes a graphic representation and brief description of the technical design characteristics of each of the 22 housing systems selected for development in the BREAKTHROUGH program. Also attached is a section which includes a graphic representation and brief description of the planning concepts employed on each BREAKTHROUGH prototype site. Although some details of the site plans have changed, the innovative concepts applied in the development of the plans are still evident and are discussed in these addenda.[1]

Question 3.2. A short statement of the criteria that were used in awarding the contracts to the selected producers;

Answer. In response to its Request for Proposals, the Department received 236 Type A proposals for total housing systems. These were evaluated by a 14-member Proposal Evaluation Board on the basis of 21 evaluation factors stated in the Request for Proposals. A list of these factors is set forth below.

Briefly, the evaluation of the Type A proposals was structured along four general areas, each dealth with by a committee: (1) building system; (2) site system; (3) management; and, (4) business and finance. In addition, an Ad-hoc Committee on Marketability was appointed to review the top-rated proposals and advise the Board on this aspect of the total housing systems.

RFP EVALUATION CRITERIA

A. *Building System Concept*

1. Ability of the system and its designs to provide a marketable quality environment within the unit and among units.
2. Flexibility of the system design, insofar as it permits application to varying types of housing and to varying site considerations.
3. Flexibility of the system design, insofar as it provides the ability to adjust or modify unit sizes and arrangements, either during project design or after construction.
4. Projected costs of "housing in place" in full production, with particular reference to housing for low- and moderate-income families.
5. Potential rate of housing production in full-scale effort.
6. Efficiency in the use of materials and labor, with respect to cost in place, the conservation of scarce materials, and the effective use of a spectrum of labor skills, including unskilled or semiskilled local labor. Potential for "self-help" application.
7. Cost and time projections for prototype production.
8. Selection of materials for durability and ease of maintenance.
9. Degree of completeness of system design, evaluation and testing.
10. Concepts for the effective use of land and environment.

[1] The information referred to in this paragraph may be found in the committee files.

B. Organizational Capabilities

1. The management structure and organization staff plan of the proposed team.
2. The quality and diversity of management and professional talent proposed as "key individuals."
3. The financial capability and soundness of the proposed organization.
4. The production capability, experience and "know-how" of the proposed organization to implement the production, project development and erection requirements of the program.
5. The ability to meet planned staff development for the various phases of the program.
6. Management plan to insure that all elements of the work are performed.

C. Program Plan

1. Understanding of the entire program, including the function of the various phases and the requirements to use differing talents as the program plan evolves.
2. Proposed program for recognizing user needs in living unit design and site and community planning.
3. Prototype construction plans, with particular reference to the testing and evaluation aspects.
4. Large-scale production plans, including considerations of shipping and plant location factors.
5. Financial plan, including innovative concepts.

Question 3.3. The estimated per unit costs of each project in the demonstration phase and the estimates of what it will cost in mass production;

Answer. We are currently conducting negotiations for the second phase of the BREAKTHROUGH program, prototype construction. The per unit costs by system and site are, of course, a major element of these negotiations. Therefore, these estimates are not available at this time.

Estimated per unit costs for each system in volume production will be one of the first tasks required of each housing system producer under his Phase II contract. The producers will develop these cost figures and submit them to HUD before they are given Notice to Proceed with any prototype construction.

Question 3.4. The justification for not testing the feasibility of mass producing industrialized housing by awarding contracts for larger numbers of units at this time.

Answer. The Operation BREAKTHROUGH program is intended to create a working relationship among Federal, State and local governments, labor, industry, the financial community, the homebuilding industry, and consumers. The role of the federal government in creating this partnership is that of a catalyst.

The decision to select as many housing systems and sites as possible within our budget resources was based on this kind of federal role. It was decided that the impact of BREAKTHROUGH on the housing industry would be greater by assisting the development of a relatively large number of housing systems. In addition, selection of more than a few systems provided opportunities for different kinds and sizes of firms and consortia to enter or expand their participation in the housing industry and for demonstration of a greater variety of housing types to meet varying consumer needs. It was not our intent to initiate and support two or three major industrialized housing producers, but rather to encourage the growth and development of the industry by providing some development assistance to a greater number of firms who would then have developed the capability to successfully enter volume housing production on their own.

Due to budget reductions for the Office of Research and Technology in this Fiscal Year, we have had to cancel two prototype site developments, which has, to some extent, reduced the number of BREAKTHROUGH prototype units which will be erected. We do not, at this time, have the resources to increase the number of prototype units without, to some degree, sacrificing what we view as our role in fostering the development of this industry.

WAGE RATES FOR SELECTED OCCUPATIONS INCLUDED IN RECENT WAGE DECISIONS ISSUED BY THE DEPARTMENT OF LABOR FOR THE LOCALITIES LISTED

	"Residential" schedule (walkup housing)	General building construction schedule
Cobb, Dekalb and Fulton Counties, Ga.:		
Bricklayers	$3.25	[1] $5.75
Carpenters	2.50	[1] 6.565
Electricians	3.25	[1] 6.99
Laborers (common or unskilled)	1.60	[1] 2.65
Plumbers	3.50	[1] 7.43
Sheet metal workers	3.25	[1] 6.33
City and County of Baltimore, Md.:		
Bricklayers	[1] 5.60	[1] 7.82
Carpenters	3.50	[1] 6.67
Electricians	3.50	[1] 7.05
Laborers (common or unskilled)	2.00	[1] 4.40
Plumbers	3.75	[1] 6.95
Sheet metal workers	2.75	[1] 7.05
Shelby County, Tenn.:		
Bricklayers	3.75	[1] 6.92
Carpenters	3.00	[1] 5.77
Electricians	3.00	[1] 6.80
Laborers (common or unskilled)	1.60	[1] 3.025
Plumbers	5.00	[1] 6.64
Sheet metal workers	2.50	[1] 6.97
Washington, D.C.:		
Bricklayers	6.11	[1] 7.65
Carpenters	5.60	[1] 6.92
Electricians	4.46	[1] 7.47
Laborers (common or unskilled)	2.85	[1] 5.27
Plumbers	4.50	[1] 8.12
Sheet metal workers	4.53	[1] 8.12

[1] Includes fringe benefits.

Response of Hon. George Romney to an Additional Written Question Posed by Representative Brown

Question. Could you indicate some of the advantages of revenue sharing to small communities which have neither the resources nor the patience required to seek funds under categorical grants available to them?

Answer. The present system of Federal categorical grants-in-aid has tended to fragment local programs of community improvement. The proliferation of categorical assistance has brought into being counterpart independent, local bureaucracies, which frequently operate outside the control of elected local officials. Each community now makes a series of separate and extensive applications to a series of Federal officials for a stipulated purpose—and for nothing else. This, inevitably, has distorted and fragmented local effort, since local officials have fit their programs and projects to meet both the formal requirements and the informal preferences of Federal officials. Thus, the excessive Federal control which has accompanied the categorical system has limited the variety and diversity of community development programs.

Revenue sharing, both general and special, will allow local general purpose government—of all communities, no matter their size—to use Federal assistance according to locally established priorities and on the basis of locally determined needs. In the case of Special Revenue Sharing for Urban Community Development, localities will be able to plan activities to fit into overall, community-wide development strategies. Neither the time nor funds of localities will be wasted in preparing and filing complex Federal applications and meeting detailed Federal requirements. Smaller communities which may lack the matching resources required by most categorical grant programs will find relief in Special Revenue Sharing which has no requirement for local matching funds.

Our Department now has a field structure including 10 Regional Offices with the same boundaries as the other domestic departments and with offices in the same 10 cities. This arrangement facilitates contact between local officials and Federal officials. More significant, however, has been the creation within our Department of 39 Area Offices staffed to administer our programs within a smaller jurisdictional area. Under Special Revenue Sharing, the larger metropolitan cities would receive grants automatically by formula. This will leave the staff in these Area Offices more time than in the past to work closely with smaller communities in providing needed technical assistance. The Area Offices will also have decision-making authority under the newly decentralized operations and will have greater knowledge of local conditions and needs than Federal officials in the 10 Regional Offices or in Washington.

Smaller communities will be eligible for assistance under Urban Community Development Special Revenue from the Departmental funds reserved for discretionary use (up to 20 percent of the total) plus the $100 million additional funds requested by the President in the first full year for use *exclusively* by smaller communities. If the smaller community is inside a Standard Metropolitan Statistical Area (SMSA), then it is *also* eligible for funds allocated exclusively for use within that metropolitan area. If it is outside a SMSA, then funds would be available from the $1 billion requested for Rural Community Development Special Revenue Sharing for distribution by the Governors to communities outside of the metropolitan areas.

Chairman PROXMIRE. We welcome you, Secretary Stans. As you are well aware, we have already heard from three administration witnesses on the state of the economy. Frankly, I was hardly reassured by last week's witnesses. The President's Economic Report and the testimony of Mr. McCracken and of Mr. Shultz point to—in one sense—a rather optimistic outlook for business and the economy as a whole. I say "in one sense" because they have projected a GNP of $1,065 billion for 1971, far above the estimates put out by most private forecasters.

However, in a more fundamental sense, the economic picture for 1971—as painted by the administration—is far from rosy. Indeed, even if the target set by the President were to be met, we would still have heavy unemployment and continuing inflation by the year's end. And I think we must reconsider right now an economic policy which is so heavily dependent on fiscal-monetary policies.

I presume that the administration is seriously considering other steps at this time. One such measure would be the institution of wage-price guidelines or controls. I further presume that the Commerce Department would play a central role in such a policy development. I hope you will be able this morning to give this committee, which is responsible to Congress on economic matters, your views on this and other vital matters.

Since time is short, I hope you will confine your oral statement if you can to 10 or 15 minutes so the members of the committee will have a chance to carry on a dialog with you. Your fully prepared statement will be placed in the record.

Would you like to identify the distinguished gentlemen who accompany you this morning? We would appreciate that for the record.

STATEMENT OF HON. MAURICE H. STANS, SECRETARY OF COMMERCE, ACCOMPANIED BY HAROLD C. PASSER, ASSISTANT SECRETARY FOR ECONOMIC AFFAIRS; ROBERT McLELLAN, ASSISTANT SECRETARY FOR DOMESTIC AND INTERNATIONAL BUSINESS; LAWRENCE A. FOX, DEPUTY ASSISTANT SECRETARY FOR INTERNATIONAL TRADE POLICY; AND MICHAEL BORETSKY, OFFICE OF POLICY DEVELOPMENT

Secretary STANS. Thank you very much, Mr. Chairman. I will try to follow your guidelines.

I would like to introduce the people who are here with me. Mr. Harold C. Passer, Assistant Secretary for Economic Affairs; Robert McLellan, Assistant Secretary for Domestic and International Business; Lawrence Fox, Deputy Assistant Secretary; and Michael Boretsky, who is an economist in the Office of Policy Development.

Mr. Chairman, rather than go over the ground of the other administration witnesses who have appeared here, I have submitted a prepared statement dealing almost exclusively with the subject of our current trade policy and the position of the Uuited States in the field of trade. Since that is in the record I would like just to review it very briefly and then submit to your questions in that respect or on any other subject.

Chairman PROXMIRE. We would appreciate that very much, and, as I say, the entire prepared statement will be printed in the record as if read.

Secretary STANS. Thank you.

Our trade balance in the early years of the 1960's ran in the range of $5 or $6 billion in our favor. Then in 1968 it fell to less than a billion dollars; in 1969, it was a little better; and in 1970 it improved to $2.7 billion.

We are greatly concerned about this state of affairs. We believe that 1971 will not improve over 1970. We expect it to be less favorable, and in the long range we see a considerable number of factors that indicate a potential deterioration in the trade balance to a much greater extent.

Because of that we made some special analyses, in ways which have not previously been done, so that we could present them to this committee as information bearing on the problem and get your counsel and advice as to what we can do beyond that which is now being done.

First, I would like to say, however, that some people have indicated that they think that our lower trade balance in 1968, 1969, and 1970 was due to inflation and that, when the inflation is removed and we are on a more stable price level, our trade balance is going to come back to the level of the mid-1960's. From our analysis, I think that is not the case. Inflation has undoubtedly had some effect on our lower trade surpluses, but I think a very important factor is the structural shifts that are taking place in the trade patterns, and it is that factor that leads us to believe that restoring a satisfactory trade balance will be very difficult and may require more tools than we now have.

I would like to refer the committee to table 2 of my prepared statement because this shows the basis of some of our concerns and the direction in which our trade has been moving.

If you look at the table, you will see that we have broken down our trade in a number of different years into four categories. The first is agricultural products, which is an easily definable term, and includes both food and nonfood items produced through agriculture.

The second category is raw materials, which includes such items as minerals, oil, unprocessed fuels, iron, and steel scrap, and so forth.

The third category is manufactured products that are not technology intensive. This includes items such as steel and other metals, textiles, textile products, shoes, paper and a wide variety of industrial and consumer goods that do not depend heavily on technological research.

And the fourth category I called technology intensive manufactured products which includes machinery, computers, transportation equipment, jet planes, instruments, chemicals, nuclear power plants and things of that type.

Now, if you look at the figures which are stated here in four different years—1957, 1964, 1969 and 1970—they show that in agricultural products there has been very little net change over the years.

There was a slight increase in 1970 over 1957, but most of the favorable trade balance indicated for agriculture is accountable for by noncommercial transactions under the Public Law 480 program.

It is not likely, considering what the underdeveloped countries are doing to improve their agriculture and the heavy price support programs in Europe, that our agricultural trade balance is going to increase significantly enough to give us any expectation that our overall trade picture will improve materially.

Now, if you look at raw materials, we are in a deficit position and have been so in all the years listed here, with a tendency toward some increase in the deficit. Again, in view of our requirements for increased oil imports as time goes on, our requirements for increased raw material mineral imports, there is not much likelihood that this situation will improve. I would foresee rather an increase in our deficit position in raw materials.

Then when you go to manufactured products that are not technology intensive, you will notice a very significant change. We went from a trade balance of $1.1 billion in 1957 progressively through the years to a trade deficit of $6.1 billion in 1970, and here I see nothing likely except further deterioration in our position because we do not have any technology advantage. The other countries of the world can match our technology in these products, and many of them benefit from lower wages.

It is only in the field of manufactured products that we call technology-intensive that we have had a significant trade balance growing from about $7 billion in 1957 to about $9 billion in 1970. But from 1964 to 1970, there has been no increase of any significance in our trade balance in this category and the rate of increase of imports has been much faster than the rate of increase of our exports. Here is where we ought to be doing our best and here is where we find more concern almost than in any other category because we are not gaining enough to overcome the deterioration in the other categories.

Figure 1 of my prepared statement contains some charts that show the same thing. It indicates that agricultural products generally have maintained a narrow range of advantage of exports over imports which decreased in 1969 and increased slightly in 1970.

In raw materials through the years there was some gradual deterioration in our net position until 1969 but in 1970 there was a slight improvement.

In the goods that are not technology-intensive, manufactured products, the import line is growing, as you can see, much faster than the export line, although the exports do show some increase.

In technology-intensive manufactured products the lines are running fairly parallel. Exports and imports in dollar amounts are going up at about the same rate but imports are increasing at a higher percentage rate than exports.

This is the basis of our feeling that we may be headed for serious difficulties in our balance of trade over the years.

As I said, we don't expect an improvement in 1971 over 1970.

We expect a slowdown in the growth of our exports, and a faster climb for imports and, in general, our best guess at the moment is that our 1971 trade surplus will be about $2 billion.

Table 3 in my prepared statement, is a table showing our foreign trade balance by major trading areas. You will see that we do show a good, favorable trade balance with Western Europe and that it increased in 1970 over 1969.

We show a substantial trade deficit with Japan which has been about the same the last 2 years.

We show a substantial deficit in our trade with Canada which increased to $2¼ billion in 1970.

With the rest of the world, which includes, of course, a great many developing countries, we show a favorable trade balance of about $3 billion in 1970, somewhat above 1969.

I would like to tell you some of the things we have been doing and some of the things that we think ought to be done in order to improve our trade position and then wind up my statement with a few conclusions. One of the great problems we have in the field of trade is the nontariff barriers that are imposed by our trading partners in other countries. These barriers cover a tremendous range of hundreds of categories and items. We have been trying through the GATT and the OECD and individually in discussions with other countries to achieve a reduction in these barriers, but I would have to say that, although there have been frequent discussions over the last few years, we can't yet report any significant progress in reducing these obstacles to our trade.

One of the major obstacles is the common agriculture policy in the European Community. Another is the communities' preferential agreements with nonmember countries, primarily in the Mediterranean and African areas. Another is the significant number of import restrictions that are maintained by Japan, despite the fact that their trade balance with us is very favorable to them. We think that it is necessary for us to continue to urge Japan to liberalize its trade, and to continue to urge the European Community, which is now the world's largest trading entity, to help us in our responsibilities for maintaining a liberal free world trading policy.

As an administration we are committed to the principle of freer trade. But it is very difficult for us to continue to adhere to that principle when our trading partners pursue inward looking policies and do not play a more positive role in trying to eliminate their trade barriers.

Now, a few words on what we have been trying to do in the Department of Commerce especially. We have been increasing our programs, with budget support, in commercial activities overseas, in trade missions, in marketing assistance, in marketing information, in international business assistance, and in improving the effectiveness of our overseas services through the embassies and the commercial officers.

The Export-Import Bank has adopted a much more aggressive trade policy in the last few years, and has increased substantially the the amount of exports that it finances directly or indirectly.

We have, under new legislation passed by the Congress in December 1969, taken steps to liberalize our trade policies with the Communist countries. We have eliminated restrictions on over 1,300 commodities, and we see some possibility of improvement of trade there. The industrial West last year sold about $8 billion worth of goods to Eastern Europe, excluding Yugoslavia, and only $350 million of that came from the United States. It is a market where we think American goods are needed and wanted, and one that we are ideally suited to satisfy to a considerable degree without adding to the military capability of the Communist countries. We only have about 4 percent of the trade with the Communist countries.

We supported, in the Congress last year, a proposal to allow the Export-Import Bank to liberalize its lending policies further and to remove the Bank from the budget so that it will be uninhibited in its desires and efforts to finance any export transaction with other countries.

We also supported very strongly a proposal of the administration to create tax incentives for exporters through the so-called DISC proposal, Domestic International Sales Corporations, which would permit corporations organized and operated exclusively for foreign trade to defer paying income taxes on their profits so long as they reinvest those profits in export trade.

In summary, export expansion is an integral part of our international economic policy. We are giving all possible emphasis to it. I would have to say that our concerns at the moment exceed the potentials of the programs that we have underway.

We are unable to avoid the conclusion that the outlook for increasing our trade balance is far from satisfactory unless we somehow do more than we are now doing to build exports.

I think it is important that as a nation we realize how serious this problem is. It, of course, is one of the key elements in our balance of payments. If we can take the right steps to increase our exports we will have a chance to improve our balance-of-payments. If we succumb to the developing trends, we shall face large deficits that will magnify the difficulties in our balance-of-payments.

Now, beyond this in my statement I would like to say that Secretary Romney obviously laid a good foundation for some of my comments on trade by the illustrations he gave. Productivity increase in the United States is the only means of offsetting some of the wage disadvantages that we have in competing with other countries.

Now, Mr. Chairman, this concludes the summary of my statement. I merely want to repeat again the fact that I feel that our foreign trade situation is a subject that poses considerable evidence of probable deterioration in the years to come, and I certainly believe we need all the help of this committee and the Congress in finding ways of coping with the trends that seem to be evident.

(The prepared statement of Secretary Stans follows:)

PREPARED STATEMENT OF HON. MAURICE H. STANS

Rather than duplicate the testimony of other Administration witnesses who have appeared here, I will devote most of my attention today to our current trade policy and the position of the United States in foreign trade, since the trend of our trade balance is a matter of great concern.

The 1971 outlook for U.S. foreign trade is not very encouraging. 1970 was a year of considerable improvement, with our gross trade surplus increasing to $2.7 billion from an average of only $1.0 billion in 1968 and 1969. Nevertheless, the $2.7 billion surplus for 1970 was lower than for any year of the past decade prior to 1968.

The deterioration of our trade balance since the mid-1960's has become of such concern that we have undertaken a number of special analyses to determine the underlying factors and the extent to which they may persist.

It would be easy to conclude, as some observers have, that the massive increase in U.S. imports in 1968 and the further strong gains in 1969 and 1970 were due to inflation in the United States. According to this line of reasoning, once inflation is curbed, our trade balances will revert to the levels of the mid-1960's.

I think this is not the case. Although inflation has been an important factor in our lower trade surpluses, structural shifts in our trade patterns are also major importance. Our analysis of these shifts, in which we look back a number of years, leads to the conclusion that restoration of a satisfactory trade balance will be difficult to achieve and requires more tools than we now have.

To establish this conclusion, I want to show you a number of statistical tables that indicate significant trends in our exports and imports. For this purpose, we have deviated from the normal classifications of trade commodities and have classified exports and imports into four categories:

1. Agricultural products: Both food and nonfood items.
2. Raw materials: Minerals, crude oil and unprocessed fuels, and other nonagricultural raw materials such as iron and steel scrap.
3. Manufactured products not technology intensive: Steel and other metals, textiles and textile products, shoes, paper, and a wide variety of other industrial and consumer goods.
4. Technology-intensive manufactured products: Machinery (including computers), transportation equipment (including jet planes and automobiles), instruments, and chemicals.

The agricultural and raw material categories are self-explanatory and need no further elaboration. The distinction in manufacturing between products that are or are not technolagy intensive is based on two specific measures—employment of scientific and engineering manpower and expenditures for research and development. The technology-intensive industries account for over 80 percent of all U.S. nondefense industrial R. & D. and about 60 percent of all U.S. scientific and engineering manpower employed in manufacturing outside the ordnance industry.

Our exports, imports, and trade balance in 1969 and 1970 classified according to the four categories are shown in the following table:

TABLE 1.—U.S. FOREIGN TRADE BY COMMODITY GROUP

[In billions of dollars]

	1969			1970		
	Exports	Imports	Balance	Exports	Imports	Balance
Agricultural products	5.9	4.9	+1.0	7.2	5.7	+1.5
Raw materials	4.8	8.1	−3.3	6.1	8.4	−2.3
Manufactured products not technology intensive	6.2	11.7	−5.5	6.8	12.9	−6.1
Technology-intensive manufactured products	20.6	11.3	+9.3	22.6	13.0	+9.6

Table 1 indicates that the trade balances in agricultural products, raw materials, and technology-intensive manufactured products improved in 1970 while the trade balance in manufactured products that are not technology intensive deteriorated. The expansion in industrial production abroad in 1970 stimulated the demand for U.S. raw materials while the economic slowdown in the U.S. moderated our imports of these products.

U.S. agricultural exports were strong to all major areas, outweighing the gain in imports. Short supplies of manufactured products abroad as a result of pressures on foreign capacity—as in the case of steel, for example—boosted our exports of manufactured products that are not technology intensive, but imports of such items as textiles and shoes rose strongly, thus leading to a larger trade deficit in this category.

In technology-intensive manufactured products, our exports of computers, other types of machinery, and jet planes were strong enough to outweigh a large rise in imports of machinery and autos.

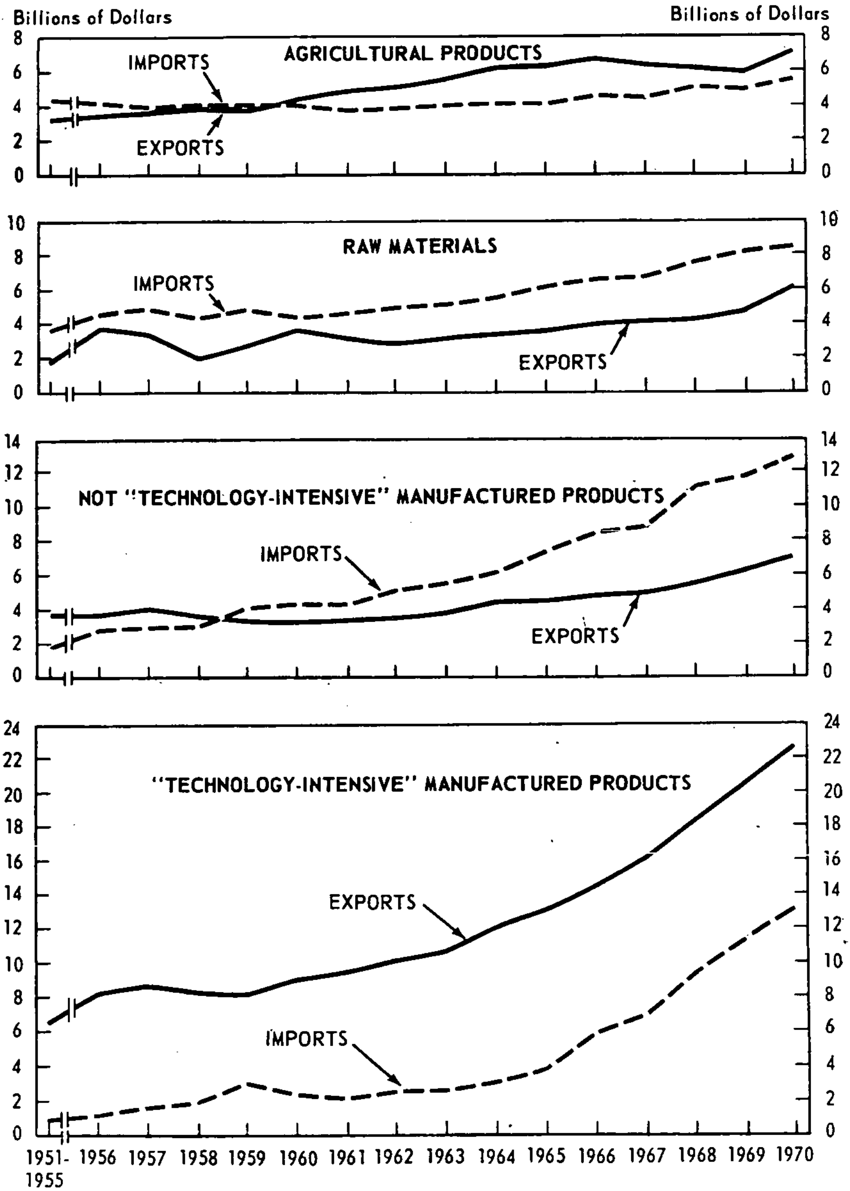
Table 2 and Figure 1 show the trends in our foreign trade over a longer interval—from the 1950's to 1970. Agricultural exports have generally been higher than imports during the past decade or so, with no tendency for the modest favorable balance to change very much.

TABLE 2.—TRENDS IN U.S. FOREIGN TRADE

[Dollars in billions]

	1957	1964	1969	1970
Agricultural products:				
Exports	4.7	6.3	5.9	7.2
Imports	3.9	4.1	4.9	5.7
Trade balance	+0.8	+2.2	+1.0	+1.5
Raw materials:				
Exports	3.3	3.4	4.8	6.1
Imports	5.0	5.5	8.1	8.4
Trade balance	−1.7	−2.1	−3.3	−2.3
Manufactured products not technology intensive:				
Exports	4.0	4.4	6.2	6.8
Imports	2.9	6.0	11.7	12.9
Trade balance	+1.1	−1.6	−5.5	−6.1
Manufactured products technology intensive:				
Exports	8.8	12.1	20.6	22.6
Imports	1.6	3.1	11.3	13.0
Trade Balance	+7.2	+9.0	+9.3	+9.6

Figure 1 **TRENDS IN U.S. FOREIGN TRADE**



In raw materials, there has been a persistent trade deficit which, over the years, has widened slightly. In 1970, however, the trade deficit in this category improved by a billion dollars. This improvement is in all probability only temporary, related as it was to capacity shortages abroad and the economic slowdown in the United States.

In manufactured products that are not technology intensive, the trade balance has moved unfavorably for two decades. The gap has widened at an accelerating pace since the mid-1960's.

In technology-intensive manufactured products, the trade balance improved until the mid-1960's, when it levelled off at about $9 billion. It has not increased out of the $9–$10 billion range because imports of these products have been increasing at a rate more than twice as fast as exports since 1962. If this ratio continues, the traditional surplus we have enjoyed in technology-intensive goods will soon begin to decline.

This sector-by-sector approach does not reflect all factors determining our trade performance. Business cycle developments, at home and abroad, are obviously relevant. I believe, however, that this approach gives proper emphasis to the important structural changes in our trade position that are often overlooked.

PROSPECTS FOR 1971

I now turn to the outlook for U.S. foreign trade in 1971 and the factors that make the outlook less encouraging than last year. A smaller trade surplus has already been signalled by the reduced trade balance in the second half of 1970. Imports continued to increase throughout the year, but the rise in exports was sharply curtailed after mid-year.

As we look ahead to 1971, a slowdown is indicated in the growth of U.S. exports, and a faster climb is likely for imports. Since economic activity in some industrialized countries will be less buoyant than last year, and the unusually large gains from shipments of farm products are not likely to be repeated, the growth in U.S. exports will probably be reduced to around 10–12 percent, somewhat less than the 14 percent gain in 1970. The more favorable domestic business conditions that are developing point to a larger advance in U.S. purchases of foreign products than the 11 percent recorded in 1970, probably in the 12 to 14 percent range. Given this probable faster advance in imports than in exports, the 1971 merchandise trade surplus will likely decline from the 2.7 billion recorded last year to the neighborhood of $2 billion.

Nonagricultural products are expected to account for virtually the entire expansion in U.S. exports in 1971, but the rate of growth in these shipments will probably fall short of last year's 13 percent rise. Technology-intensive products will again be in the forefront of the advance. Machinery sales should continue to rise, although the expected deceleration in foreign economic growth will have some impact on our shipments.

Continuing last year's pattern, sales of computers, especially the recently introduced "mini-computers," will climb significantly again, as will exports of semi-conductors and other electronic components. Another good year is also in sight for materials-handling equipment—mainly forklift trucks and conveyor belts.

Aircraft sales will not rise as rapidly as in 1970. Although more of the new jumbo aircraft will be exported this year than last, there will be fewer deliveries of the smaller jets. A continued advance is expected in exports of chemicals, but it will probably fall short of the exceptional 1970 increase. Plastics and pharmaceuticals are forecast to show further strong rises, but the downward trend in exports of manufactured fertilizers is likely to continue this year as foreign production grows.

TABLE 3.—U.S. FOREIGN TRADE BY MAJOR TRADING AREAS

[Dollars in billions]

	1969			1970		
	Exports	Imports	Balance	Exports	Imports	Balance
Western Europe	12.2	10.1	+2.1	14.3	11.2	+3.1
Japan	3.5	4.9	−1.4	4.6	5.9	−1.3
Canada	9.0	10.4	−1.4	8.8	11.1	−2.3
Rest of world	12.9	10.6	+2.3	14.9	11.8	+3.1

Table 3 shows our foreign trade in 1969 and 1970 by the major trading areas. The improvement in our total trade balance in 1970 occurred in our trade with Western Europe and the "Rest of World". There was little change in the trade deficit with Japan, but the deficit with Canada increased.

In 1971, demand for our exports will vary among our major trading partners. Our shipments to Canada should pick up this year, because expansionary Canadian economic policies are expected to stimulate growth in the consumer and investment sectors, both of which were sluggish through most of 1970, and because of the revised exchange rate. Exports to the United Kingdom should register a sizable gain; favorable factors are an expected rise in capital spending and the termination of the import-deposit scheme.

Sales to our other major industrial markets will probably grow at a slower pace than in 1970. In the European Economic Community, which accounted for about one-fourth of the increase in U.S. exports last year, a slackening in economic growth is forecast. The combined real gross national product of the EEC is expected to rise by an estimated 4½ percent, compared with about 6 percent last year. Accordingly, it is likely that the increase in U.S. exports to the Community will be much smaller than the 20 percent gain recorded in 1970.

Although Japan's economy will continue to expand at a rapid rate, some slackening is expected in capital expenditures and industrial production, which will probably dampen import demand. Thus, while U.S. exports to Japan should post another large rise, the increase will not be as large as 1970's exceptional gain of one-third.

Finally, another rise is likely in shipments to the developing countries but, because of intensified competition from European and Japanese producers, the rate of growth will probably be more moderate than the climb of one-sixth recorded last year.

On the import side, we believe that continued gains in spending by U.S. consumers and the firmly established position of foreign manufacturers in certain major product lines insure another substantial increase in arrivals of consumer goods.

Despite current projections of a slower increase in U.S. plant and equipment expenditures in 1971, imports of capital goods will probably show another large gain. In recent years, imports have steadily increased their share of U.S. expenditures for producers' durable equipment.

Although U.S. industrial production declined in 1970, imports of industrial materials climbed by about 5 percent. The recovery in production in 1971 will stimulate a further rise in these purchases. Steel imports will be especially strong because the tight supply situation in Europe is easing and because steel users here will build inventories as a hedge against a possible work stoppage in August. European deliveries of steel have lagged below the quantities specified in the steel import agreement two years ago, so that a sizable expansion is permissible under that agreement.

TRADE POLICY AND TRADE BARRIERS

I think we all recognize that today's world is different from that in which our trade policy of the past several decades was developed, and that a fresh approach to our trade policy is required. We also recognize that continued adherence to a progressive trade policy that seeks to remove barriers to world trade is in both our domestic economic interest and our foreign policy interest.

Increased international competition and widely available technology have brought direct pressure on many of our industrial products in their own home markets. Workers and firms in the U.S. now confront a serious foreign competitive challenge. Clearly, there are burdens as well as opportunities in open world trade, and these too, must be acknowledged. We must provide adequate measures for assisting domestic industries and labor in the effort to adjust to this foreign competition. The remedies our trade laws have long contemplated and provided for in theory must be made to work in fact. We can meet part of the problem through revision of our own trade laws; but some of the problem finds its source elsewhere.

We have become increasingly concerned, for example, by the fact that our trading position is jeopardized by the maze of rules, regulations, tax discriminations, import restrictions, export subsidies, preferential trading arrangements and investment restraints which confront our businessmen around the world. The U.S., of course, has trade restrictions of its own, and to realize the benefits of freer world trade it will be necessary to put our restrictions on the table in order to strike a reciprocal, mutually beneficial bargain with our trade partners.

This Administration has shown its desire to move in this direction. It supported trade legislation that would maintain the momentum toward a more liberal trade system, and among other things sought the elimination of the American Selling Price System of valuation of certain chemical imports. Through the General Agreement on Tariffs and Trade (GATT) and the Organization for Economic Cooperation and Development (OCED) we are continuing our efforts with other major nations to reduce or eliminate nontariff trade barriers. However, progress in this effort has been slow, not only because nontariff barriers are difficult to deal with, but also because there is a general reluctance on the part of some of our important trading partners to participate actively in the effort.

Another major irritant is the issue of the European Community's Common Agriculture Policy, *CAP* for short. We believe that the CAP system heavily disadvantages U.S. agricultural exports to the Community and subsidizes their agricultural exports to third countries. The problem of the Community's preferential arrangements with nonmember countries, primarily in the Mediterranean and African areas, is also troublesome. These pacts are inconsistent with the most-favored-nation principle, the cornerstone of a progressive trade policy.

Japan is our second largest trading partner and the primary purchaser of our agricultural exports. Despite some recent progress in removing import restrictions, Japan still maintains the highest general tariff structure of the major industrialized countries and preserves a number of important trade and investment restrictions that were erected while it was attempting to recover from wartime destruction, but which we feel are out of place today.

That is why I believe that the time has come for other major trading countries, such as the European Community, which is now the free world's largest trading entity, to share more fully with us the responsibility for maintaining a liberal free world trading regime. This applies to Japan as well. This Administration is committed to the principles of freer trade, but the extent to which the U.S. can continue to adhere to these principles depends in large part on whether our trading partners pursue outward looking policies and play a more positive rolei n seeking ways and mean of reducing their trade barriers.

Export promotion

The major shifts in trade patterns of the past twenty years, the fast-paced growth of world trade—about 11 percent a year over the past five years—our high rate of import growth, our inadequate trade surplus and our shrinking share of world markets—all these developments have accented the importance to the U.S. of accelerating our export growth.

The U.S. drive for promoting sales of American goods overseas is spread among various Executive Branch departments, two of which—Agriculture and Commerce—support promotion programs of significant size. In addition, the Export-Import Bank is providing a major export stimulus through its export credit and insurance programs.

Last year, the Department of Commerce spent some $16 million to promote sales of manufactured goods with high export potential. I am sure that this is small in comparison to what other countries spend in proportion to their export sales, especially countries like the U.K. and Japan. But while the amount is relatively little, it is put into programs where we feel there are maximum results. Here are some examples of what the Commerce Department does in the way of export expansion:

Commercial Exhibits Overseas.—The Department maintains permanent trade centers in major world capitals. Eight are now in operation. A new initiative—establishment of trade development centers—is being undertaken for developing countries. The Department also mounts exhibits in some 20 international trade fairs each year.

Trade Missions.—The Department takes part in about 50 trade missions a year to promote sales abroad of U.S. products. Most of those missions are organized and operated by industry groups. We furnish marketing information and technical support.

Marketing Assistance.—Specific assistance is provided to American exporters seeking distribution outlets overseas or contracts for major construction and procurement.

Marketing Information.—Detailed export market information on both countries and individual products is furnished to stimulate the export efforts of U.S. companies.

International Business Assistance.—This service informs U.S. firms of specific large foreign projects that could involve significant U.S. exports and assists those firms in competing for such projects. It also helps firms that encounter government related problems on major export transactions.

Overseas Services.—U.S. Government commercial officers overseas, though in our opinion inadequate in number to meet the demand for their services, furnish support to the Department's exhibits and market opportunities programs and also give assistance and counsel to companies and businessmen who are seeking to sell in the countries where they are located.

These export promotion efforts can do only part of the job. The main thrust of our efforts must be to improve the general export environment, particularly for those companies that account for the bulk of U.S. exports. That environment can be improved by strong efforts to put emphasis on opportunities for export sales, by providing adequate export financing and reasonable tax conditions, and by other efforts to raise the level of motivation to export.

East-West trade

One area of potential for expanding U.S. exports lies in an increase of our trade with Eastern Europe. This is an area as yet little explored by U.S. businessmen, but heavily exploited by commercial interests of every other major industrial country of the West.

The East-West market is growing fast. Merchandise trade with Eastern Europe has been expanding at a rate of 15 percent a year. Last year, we estimate that the industrial West sold over $8 billion worth of goods to Eastern Europe (including the Soviet Union but excluding Yugoslavia), about $350 million of which came from the United States. This is a market where American goods are needed and wanted, and one that we are ideally suited to satisfy.

The Export Administration Act of 1969, under which U.S. exports to Eastern Europe are controlled, is less restrictive than earlier regulations and indicates a desire on the part of Congress for a liberalization of such controls. In 1970, the Office of Export Control in the Department of Commerce reduced export restrictions on about 1300 commodities, including more than 350 types of electronic instruments, machinery and transportation equipment; 300 classes of metal and metal products; and 470 chemicals.

But, as I indicated earlier, the U.S. share of East-West trade is only about 4 percent of such total trade of the industrial West.

Several of the obstacles to this trade result from our own laws and policies. Two in particular are the absence of most-favored-nation treatment by the United States and the legal restraint on the Export-Import Bank, which at present cannot guarantee export loans to Eastern Europe. However, should we decide to seek the removal of these obstacles, the rate of growth in U.S. trade may be relatively slow at first, because of Eastern Europe's lack of hard currency, the unsuitability of its products for the American market, and our inexperience in the area as compared with that of Western Europe and Japan. We feel, however, that a potential is there and that opportunities for wider trade should be given serious consideration as soon as our general relations justify a change in our present policies.

Export financing and domestic constraints

U.S. exporters are, I believe, seriously disadvantaged compared with their foreign competitors in export financing. Improved Ex-Im Bank programs will soon be supplemented by additional provate means, through the Private Export Finance Corporation (PEFCO). Despite these major improvements, our exporters are still unable to obtain the quantity, cost, terms and speed of export financing, which are available to their competitors. The Ex-Im Bank's liberalized lending policies and removal of the Bank from the budget, as endorsed by the Administration, will help redress the balance.

Moreover, our exporters often are placed at a disadvantage by preferential tax treatment, which some governments extend to their export sector. In an effort to put our exporters on a more equal footing, the Administration has proposed that our exporters be given tax treatment more comparable to that available to exporters in many foreign countries and to the treatment accorded U.S. subsidiaries operating abroad, through establishment of Domestic International Sales Corporations—usually known as the DISC proposal. Our antitrust policies need to be reviewed, particularly with respect to their application to the overseas operations of U.S. industries and to joint efforts by our exporters to enter foreign markets. Our patchwork maritime transportation policy has also left exporters with antiquated, confusing rate schedules and documentation requirements, as well as discriminatory rates, which sometimes make it as much as twice as costly to ship from the U.S. to a foreign destination as to ship the other way.

In summary, export expansion is an integral part of our international economic policy to which President Nixon is giving increasing emphasis. The latest evidence of this emphasis is the creation in the White House of a Council on International

Economic Policy to provide a clear, top-level focus on international economic issues.

THE OUTLOOK FOR THE U.S. TRADE BALANCE

When we analyze our trade trends by the four categories described earlier, we are unable to avoid the conclusion that the outlook for the U.S. trade balance is far from satisfactory, unless we somehow do much more than we are now doing to build exports.

In agricultural products, many countries in the world are trying to expand their production, often on an uneconomic basis. To assist this domestic expansion, many have erected barriers to agricultural imports. In this category, therefore, the U.S. trade balance cannot be expected to improve significantly, and could deteriorate, unless this trend can be reversed.

In raw materials and fuels, the long-term trend has been for a continuous deficit, which has tended to increase moderately. A continuation of this trend is to be expected as the U.S. uses up its own resources and must increasingly turn to foreign sources of supply to meet the growing needs of its expanding economy.

In manufactured products that are not technology intensive, the trade deficit seems certain to grow, because many countries of the world are increasing the pace of their industrialization. Using the most modern technology but paying lower wages, producers in these countries can undersell U.S. producers in many product lines.

In manufactured products that are technology intensive, the U.S. has continued to maintain a leading position in world trade. This position, however, has not been strong enough in recent years to make up for the rising deficits in other goods. The fact that our trade balance on technology-intensive goods has remained in the $9–$10 billion range for five years indicates that our technological superiority is slipping. Since 1962, imports of these products have increased more than twice as fast as exports and I fear that it is just a question of time before this trade balance begins to deteriorate.

As a nation we need to realize how serious this problem is. If we can take the right steps to increase our exports, we will have a chance to improve our balance of payments by increasing the trade balance. If we succumb to the developing trends, we shall face large deficits, which will magnify the difficulties in our balance of payments.

Chairman PROXMIRE. Thank you very, very much, Secretary Stans.

I welcome you as kind of a kindred spirit, because you and I are both alumni of the same investment banking firm, at somewhat different levels. I worked for Glore Forgan Co. when I was a junior in college, and my salary was not quite the same as yours.

Secretary STANS. I came in after inflation, Mr. Chairman. [Laughter.]

Chairman PROXMIRE. I wish that were the only real difference.

I would like to give you the opportunity, in view of the fact that this is, of course, an open public hearing that is covered by the press, an opportunity if you would care to do so, to respond to just one question on the release that you made this morning, Wednesday, February 17, earlier this morning, in connection with your relationship with Glore Forgan, Staats & Co.

As I understand it, it was a very clear and strong statement, and it appears that the alleged conflict of interest is based entirely on the fact that you were given a notification, along with 65 other participating partners, of when there was a transfer of stock in the so-called Great Southwest Corp. to your blind trust.

Was that an inadvertent slip or mistake that should not have been done?

Secretary STANS. I would say it was an inadvertent slip on the part of the partnership to send me the notice.

I knew, of course, that I had a group of securities in my trust, but I was not aware until the summer of 1969 of the conversion of some of them into Great Southwest stock by a merger. I did not know the number of shares I was entitled to, of course, until I received that notice.

I directed immediately that the securities to which I was entitled be delivered to the trustee under my blind trust.

When the subject of possible government involvement in the affairs of Penn Central took place, I disclosed the fact that my trust had received these shares. I did not have any way of knowing whether they were still in the trust in whole or in part, but because of the fact that they had been delivered to the trust and might still be there, I informed my associates in the Cabinet at a meeting at the White House on June 3, and said that if it appeared that there was going to be any government involvement in the Penn Central situation, I would disqualify myself. I did so the next day when I found out it was unlikely that the private bankers were going to provide funds to Penn Central without a government guarantee, and that they were looking to the Government for help.

Chairman PROXMIRE. And you have taken steps to be sure that in the future the blind trust will be respected as a blind trust, you would not be notified of any transfer of assets into or out of the trust; is that correct?

Secretary STANS. Mr. Chairman, I took all steps I thought were necessary at the beginning. I do not know what is in the blind trust today. I do not know what the trustee has sold or what he has bought, and it is as blind as it can possibly be.

They make out my tax returns. I furnish the additional information about salary and contributions, and things like that, and I know nothing else that goes on.

Chairman PROXMIRE. All right, sir.

I would like to ask you about the inflation situation because, of course, your Department has a very crucial economic role to play with our Government, and you give us much of the statistics, and you have very, very competent economists who make their own analyses, and so on.

Assistant Secretary Passer, as I understand it, said in a speech last September that the acceleration in price increases has been stopped and turned around, and we are moving in the right direction, although inflation is not under control. He said that we seemed to be moving in the correct direction.

Now, when you look at what the facts are since that statement, I just wonder if this can still be supported.

The GNP deflator, which most people regard as the best evidence of an indication of inflation, went up more in the fourth quarter of 1970 than in the third quarter. The Consumer Price Index went up more in the fourth quarter than in the third quarter. The Wholesale Price Index went up more in the fourth quarter. There were further substantial increases in both wholesale and consumer prices in January; and, furthermore, productivity declined in the fourth quarter. And, of course, productivity is at the heart of getting control of inflation.

Do you still argue that the rate of inflation is tapering off; and, if so, where is the evidence?

Secretary STANS. Senator, since you mentioned Mr. Passer as the source of the statement, and since he is at my left, I will ask him, if you would permit me, to answer the question directly.

Chairman PROXMIRE. Very good. I should have said wholesale industrial prices went up, not wholesale prices.

Mr. PASSER. Senator, in regard to this point, I still think that the figures show that as we progressed through 1969 and 1970 that the rate of inflation moderated.

In regard to the GNP deflator in the fourth quarter, this was very specially affected by the auto strike. The GNP deflator in the first quarter, when that becomes available in several months, will show a very modest increase, which will not be——

Chariman PROXMIRE. What evidence is there to show that? The prices continued to go up in January. It should not have had this sharp increase that we had in January.

Mr. PASSER. In terms of the GNP deflator, this is affected by the components of gross national product.

Chairman PROXMIRE. I gave you other statistics, the Consumer Price Index, the wholesale industrial prices.

Mr. PASSER. Right; but I just wanted to cover that point. But the GNP deflator is affected by these changing weights, and the reason it went up so much in the fourth quarter was that autos were a smaller part of it. Autos will be a big part of it in the first quarter. The GNP deflator will show only a small gain. This will be artificially small just as it was artificially large in the fourth quarter.

In terms of the Consumer Price Index and the Wholesale Price Index, the question is over what timespan you look and how you interpret the month-to-month changes.

If you look, for instance, at the second half of 1970 versus the first half of the year, or going back to 1969, you find that, in fact, the rate of increase was less for, say, the second half as a whole.

A specific number is that in the second half of 1970 the CPI went up at a 4.9-percent annual rate. In the first half of 1969, a year and a half earlier, it went up at a 6.3-percent rate, and the same kind of change also took place in the Wholesale Price Index—2.1 percent in the second half of 1970 versus 5.3 percent in the first half of 1969.

Chairman PROXMIRE. Well, you just take—I take the quarters and you took the last half of the year. If you take the last half of the year you can get a little better picture. But my point is there does not seem to be any clear-cut evidence that we can say with assurance, that we can say inflation has turned the corner, is now under control, the escalation in price rises is moderating. That does not seem to be borne out very clearly because there are contradictory statistics. Do you agree with that?

Mr. PASSER. Well, I would agree that we would all like to see more evidence of it. We certainly would like to see that.

I do feel that the evidence that there is shows first that the acceleration, which was on continuously from 1965 through 1969, has ended. I think that is absolutely clear, and there is no possible disagreement on that.

Chairman PROXMIRE. There is disagreement here.

Mr. PASSER. I think that you could not disagree on the acceleration because there are no rates recently that have been higher than those rates that have taken place at the peak.

Now, the question is how much have the rates come down, and I think this is the question you are raising. But here there is, I think, some pretty good evidence that it has. I, of course, would like to see a lot more evidence of this kind.

Chairman PROXMIRE. My time is up.
Mr. Brown.
Representative BROWN. Mr. Secretary, I understand our import-export figures as we figure in this country do not take into account some specific parts of the figures that, perhaps, might change their impact. For instance, the cost of insurance and of freight is great in foreign aid to these various parts of the world that you list in these figures. Could you explain the impact of this on the figures, and whether it shows them up to be better or worse than in these figures, and whether these figures are actually as appropriate as they might be.
Secretary STANS. Well, Mr. Congressman, there are several ways of figuring the trade balance, and I used the method traditionally used by the United States.
Some countries, in calculating their imports, calculate them on a c.i.f. basis, which means landed on their shores, and thereby add to the invoice costs of the imports the cost of insurance and delivery. If you add that to our import data, you add $2.5 billion to the cost of imports in 1970, and instead of $40 billion, it becomes $42.5 billion.
Now, you raise the question of aid programs and so forth. This relates to the export side of the equation, and the export figures do include amounts of goods that are sent overseas on what we call noncommercial transactions. These are aid program exports financed by the United States, or Public Law 480, agricultural goods financed by the United States, and in this case the exports include $2.1 billion in 1970.
Now, if you subtract that from the total exports, the commercial exports that remain amount to $40.8 billion.
If you take both adjustments together, adjust both the imports with the incoming freight and insurance costs, and adjust the exports to take out the noncommercial transactions, you get a deficit of $1.7 billion in 1970 instead of a surplus of $2.7 billion.
Now, I would have to say to you that economists differ on whether or not that is a better method of calculation, but I must say that it certainly does not give us any comfort in the figures, and it does present a much worse picture than in the traditional way of reporting the trade statistics.
Representative BROWN. Well, suffice to say the American taxpayers are paying for the foreign aid portion, so that does not give us any advantage in that area.
Mr. Secretary, to go on to the low technology or nontechnology-incentive area that you have cited as one of the areas of the problem, can you give me some reaction as to the impact on this situation of low technology import-export unfavorable balance, U.S. minimum wage laws, restrictive labor practices in this country like union monopolies and racial restrictions, and even the U.S. immigration laws which keep our labor supply under pretty tight wraps?
Secretary STANS. Well, all of these really come under the heading, I think, of productivity in the United States.
To the extent there are work restrictions of one kind or another, certainly they tend to reduce the rate of productivity in this country, and collectively the factors that you cited unquestionably do have an effect on our ability to export. How much effect, I think no one could possible compute.
It certainly suggests, as I said in my statement, that we need to do everything we can to raise productivity in this country. We need

to do it by reexamining all work practices and work restrictions, and we need to do it by, perhaps, taking another look at our technology and seeing what we can do to encourage increased technological development and research in the United States to produce new products and to advance the state of the art for existing products.

Representative BROWN. Secretary Romney has suggested that the cost of building has an important impact. I would assume the cost of labor does, too, and the cost of Government, the impact of taxes in this country, and it appears what is happening is we are having, to a degree, the flight of American capital abroad where these problems are not as severe as they are in the United States.

Let me ask you about one of the technology-intensive areas. Can you give me some analysis, short-range or long-range analysis, of what the sale of the Concorde, what effect it will have on the SST insofar as the United States is concerned, and the failure of U.S. technology to be competitive on our own?

Secretary STANS. The Department of Commerce has taken the position that it supports the development of an SST by reason of the potential trade advantages that it might provide or the trade disadvantages that it might prevent. I cannot give you any idea of how many Concordes we would import in units or dollars if we did not develop our own SST nor can I estimate at this time the number of SST's we might export in competition with the Concorde if we might develop one.

The only statistic that I can give you is that, in 1970, we exported almost $2 billion worth of aircraft of all sizes. There is a very substantial growing market for aircraft in the world. We have a technological superiority in the wide-bodied jets and our other jets, and I would think that it would be well worthwhile for us to continue the development, certainly of the two prototypes, to determine the economic feasibility, the cost factors, and the potentials in exporting if we were to go into mass production, So for that reason we have supported the SST program.

Representative BROWN. I would like to suggest further that I think the whole development of the faster transport has an advantage in developing new markets in the underdeveloped parts of the world, and that is one aspect of it which has not been given very much attention.

I think it is very significant because you suggested that is where a lot of our trade advantage may lie in the future, in your testimony.

My time is up, Mr. Secretary. Thank you.

Chairman PROXMIRE. Senator Pearson.

Senator PEARSON. Mr. Secretary, you made mention of tax incentives as a means of stimulating trade and improving our balance—I cannot find that in your prepared statement now—but you have long been one of the administration who has endorsed the use of tax incentives for some programs of development in this country.

We spoke earlier on rural revitalization. You alone, I think, came out and endorsed the concept of tax incentives. But I think you have been a little bit alone in this administration.

Is there any change of policy in relation to tax credits to improve our trade balances or to promote programs within this country?

Secretary STANS. Well, Senator, the statement to this effect is in my prepared statement.

Senator PEARSON. Yes, I see it.

Secretary STANS. It was last year that the administration first made a proposal to provide incentives to exporters through the DISC idea.

As I said earlier, it would allow a corporation formed in the United States exclusively for export trade purposes to defer the payment of any income taxes on its profits so long as those profits were used to increase export trade. When they were withdrawn by the parent company they would be subject to normal income taxes.

That provision was included in the trade bill passed by the House last year. It was not adopted by the Senate Finance Committee when it reported out the trade bill.

We certainly hope that this proposal or something equivalent to it or something better, if we can develop one, will be presented again to the Congress in 1971, and that it will be enacted because it is one of the things that is necessary to make us competitive with other countries. They do have tax incentives of various types on their exports, including their border tax provisions which are rebated—these are indirect sales taxes—and, if we can provide this kind of measure or something like it, it can only help employment in the United States because the more we increase exports, the more jobs we save here or create here for the workers of this country.

Senator PEARSON. Let me ask just one additional question. You made reference in a specific way to the trade restrictions both by the Common Market and Japan and also with reference to aircraft sales.

We have some restrictions here in this country which relate to foreign policy judgments, it seems to me, and the only way I know how to answer this question is to make reference to a given circumstance or problem.

The Secretary may recall some time ago there was a prospect of the sale of small aircraft to South Africa. The Department of Commerce approved that sale. The State Department, because of the pending resolution in the U.N., prohibited the sale of some aircraft, Beechcraft, Cessna, to South Africa.

Later the sale was made by Italy or France or England. Do you see any improvement in the policy position of this administration or the foreign policy considerations which won't make us go through that sort of a wringer again?

It is terribly hard to explain to Cessna and Beechcraft in Wichita, Kans., I assure you of that.

Secretary STANS. These policies are constantly under review. In the case of South Africa, the administration, as a whole, did approve some orders for Lear jets, I remember, but once the orders were approved for export they never developed. The South Africans did not buy them.

Now, I know there are proposals tentatively being made by South Africa for the purchase of other aircraft. When they get to the point of a specific order or proposals, they will be considered by the administration. I think the policy is quite clear. So long as they do not lead to capability of the South African Government to engage in warfare of any kind, we will sell them the planes.

Senator PEARSON. I thank you, sir.

Chairman PROXMIRE. Senator Javits?

Senator JAVITS. Mr Secretary, in the first incident that Senator Proxmire asked you about, the matter of your family trust investments in the so-called blind trust, do you feel in any way morally incapable of carrying on the high responsibility which you have been entrusted with; or do you feel that what has occurred and your understanding of it leaves you free and in the same position that you were in when the Senate confirmed you for this very high post?

Secretary STANS. Senator, I have no reservations on that point whatever. The information that developed in the news stories contained two inferences: One, that my blind trust was not blind, that I knew what was going on. I think I have refuted that very fully in the statement I released to the public today.

The second inference was that I had a conflict of interest in dealing in the administration with proposals to help finance the Penn Central Railroad when it got into financial trouble last year.

I made it very plain that I did not. I gave the specific date of June 3, when I disclosed to the Secretary of the Treasury, the Attorney General, the Director of the Bureau of the Budget, the Chairman of the Council of Economic Advisers, and the Chairman of the Federal Reserve Board that stock of a subsidiary of Penn Central had gone into my blind trust, and while it was possible that it was no longer there I did not know that for a fact, so that I could not and would not participate in any decisions involving the Government with Penn Central under those conditions.

Senator JAVITS. So that you feel morally perfectly justified in carrying on as you always have.

Secretary STANS. I certainly do, Senator.

Senator JAVITS. Now, I think that is important because a man's opinion of himself is the most important generally of enabling him to do what the people have appointed him to do.

Is there any change in the administration's policy, Mr. Secretary, regarding trade legislation or does the administration still favor some form of quota for textiles and apparel of manmade fibers and otherwise the trade legislation recommended by the President in the absence of a voluntary agreement with Japan?

Secretary STANS. Senator, the administration has not yet sent trade legislation to the Congress in 1971. I am sure that the proposals that were sent up by the administration in its trade bill last year are still favored by the administration.

On the matter of textiles, we only sent up textiles last year when our negotiations with the Japanese and other countries failed to reach some kind of voluntary agreement for reasonable restraints. The Senate did not get around to passing the bill last year, although it did pass the House.

The negotiations with the Japanese have continued intermittently up to the present time looking toward a voluntary agreement on their part. They have not as yet been successful.

I would say if we succeeded in reaching a voluntary agreement with the Japanese on a reasonable basis, and were able to extend that agreement to cover three or four additional countries that are heavy exporters of textile goods to the United States, that legislation would not be necessary.

Senator JAVITS. Would the administration consider it in the highest national interest that such legislation should not be——

Secretary STANS. I would say if it is possible to reach voluntary agreements, there would be no necessity for the legislation.

Senator JAVITS. As a national policy, would the administration by obviating that need, serve better the national interests of the United States than by finding it necessary to support regulated textile quotas?

Secretary STANS. Yes, I would agree with you, Senator, providing the means of obviating the need is some kind of voluntary restraint on the part of the exporting countries.

Senator JAVITS. I understand that. All I was trying to do was to set priority in the national interests, something that sometimes the administration may feel it has to do, something which it does not feel is the most conducive to the national interests. The most conducive would be to obviate the need for this legislation by a suitable agreement.

Secretary STANS. Yes. But the need for some type of restraint is very apparent because last year I am told there were 113,000 jobs lost in the textile and apparel industries.

Now, even granting that some of those occurred by reason of the economic circumstances, it is evident that the massive imports had a very material effect on employment and forced the closing of a number of textile plants. As an illustration, Senator, last year the imports of textiles and apparel made from manmade fibers increased 53 percent.

Now, any concept of free trade which you and I both believe in would not assume that it would be possible for a country, I think, to adjust to that kind of a tidal wave without serious loss of employment and capital investment. This is what we are trying to prevent by seeking a voluntary agreement with the Eastern countries and, failing that, I see no course except to come back for legislation.

Senator JAVITS. Well, I would not want to debate the issue with you on this textile field generally because there are aspects of it and individual parts of the textile business that may differ from others. You know this is not a subject with which I am unfamiliar, but I did want to get your response. So I just leave that debate for another appropriate moment, but I did want to get the national priority question settled.

I just have one other question, if I may ask it. Is there any machinery by which the interest of the consumer is assessed in the administration in determining its policy on textiles and other matters?

Secretary STANS. Well, I would say, Senator there is no question but what the interest of the consumer is evaluated in this respect. It enters into all of our discussions of trade policy and enters into our discussions on textiles.

We have to accept the fact, however, that the employees in this industry are also consumers, and under the circumstances it is a case of balancing one interest against another, and this is where we come out to the principle that we can accept an annual increase in the imports of textiles, but we cannot accept one at the rate that has been occurring.

Senator JAVITS. Mr. Chairman, I thank you very much, Mr. Secretary. I ask unanimous consent that I may propound written questions.

Chairman PROXMIRE. Oh, yes, without objection, it is understood.

You do have in your office, in the Department of Commerce, I should say, Mr. Secretary, some of the outstanding business economists and forecasters we have in our Government, some of the very best.

The administration has predicted that the gross national product will increase very rapidly in the coming year as compared with what some of the private economists predict, and a great deal hangs on that.

If the economy expands as much as they expect, if it goes to $1,065 billion then we will have a deficit of $11.6 billion, we will have unemployment declining around down to 4½ to 5 percent.

If this does not work out, if the economy does not go that much, then unemployment will remain rather high, the deficit would be in the area of $17 or $18 billion.

Now, the administration has based its estimates on a monetary model, and we have been able to elicit from them not a very clear or complete description of what this monetary model represents. We did get a breakdown finally on Saturday from the Chairman of the Council of Economic Advisers of what he estimated would happen to consumption, and so forth.

I would like to ask you, No. 1, how do you and your experts feel about the reliability of the method of forecasting based on a monetary model and not based on the kind of careful and comprehensive statistics which the Department of Commerce has used in the past.

Secretary STANS. Well, I think, Mr. Chairman, that this is a good question for me to ask my experts right now, and if you don't mind I will ask Mr. Passer to reply.

Chairman PROXMIRE. Yes, sir.

Mr. PASSER. Mr. Chairman, I would like to say I think it is important to recognize that the forecasting game is, of course, an uncertain matter. We are never sure just what will develop in the economy in the year ahead.

It is true that the private forecasters on the average have forecast a lower number than the $1,065 billion.

Chairman PROXMIRE. Well, all of them have, without exception—well, one, Turner forecasted a $1,070 billion, but his growth, his real growth, was lower. There was not a single private forecaster who estimates that we will get real growth as much as the administration does in this magical monetary model they have, which seems curious.

Mr. PASSER. I think there are some private forecasters who also use monetary-type models.

Chairman PROXMIRE. I am sure of that.

Mr. PASSER. Which results pretty much in that same neighborhood; in other words, on the high side of the average private forecasts.

Chairman PROXMIRE. The administration seems to be all alone.

What I would like to ask, you have your own forecasting model, as I understand it, which you distribute within the Government. What does that estimate the gross national product will be?

Mr. PASSER. Yes, you are right. We do have an econometric model in the Office of Business Economics.

Chairman PROXMIRE. Right.

Mr. PASSER. We have a run that was made, a computer run of this.

Chairman PROXMIRE. Yes.

Mr. PASSER. Let me see, this is dated February 5, so this was about 2 weeks ago, and this, interestingly enough, is right in the median or the middle of the range of the private forecasting models.

Chairman PROXMIRE. So it predicts what, about $1,045 billion?

Mr. PASSER. Yes, $1,045 billion.

Chairman PROXMIRE. That is very interesting. We have the agency which, in my view, has had more experience and has very able people estimating some $20 billion below what the Council of Economic

Chairman PROXMIRE. That is very interesting. We have the agency which, in my view, has had more experience and has very able people estimating some $20 billion below, what the Council of Economic Advisers and the Director of the Office of Management and Budget are relying upon.

Mr. PASSER. I would like to say that this model is more a traditional fiscal type of model and has only a few monetary equations. There are several monetary-type equations relating to interest rates.

Chairman PROXMIRE. There are some real advantages in not having monetary in it. It is awfully hard to know what the monetary influence will be, and I think when Mr. Burns comes up on Friday he will tell us he cannot tell what the increased money supply is going to be. They tried to increase it at the end of the last quarter last year, but they ended up with a much lower rate than most people thought, 4½ percent, in January 3 percent, and this is in spite of the effort of the Federal Reserve Board.

As you know better than I do, you are a very competent economist, this is not something they can just determine. They cannot say it is going to be an increase of such and such. It depends on what the banks and business wants to do.

Mr. PASSER. Yes; and I think it is interesting the way the monetary forces enter into this model which is through the interest rates, and these have, of course, declined quite substantially——

Chairman PROXMIRE. When you say "this model," you mean your model?

Mr. PASSER. Yes.

Representative BROWN. If the chairman will yield, I wonder if I can ask what has been the record of accuracy of the prediction of the Office of Business Economics. There was some suggestion by Budget Director Shultz that private forecasts in a rising market tend to fall below by a rather significant percentage of what occurs. What has been your history?

Mr. PASSER. I think that this model has experienced the same general history as other models of this type which, in the inflationary and strongly expansionary years of, say, 1968 and 1969 tended to run on the low side.

Chairman PROXMIRE. Isn't it also true, however, that the underestimates were largely based on an underestimate of inflation and not an underestimate of real growth? For example, as I recall, in 1969 the generality of economists overestimated the growth but they underestimated the inflation, so that the administration may well be right, they may be the only boy in town who is in step, everybody else may be out of step, but they may be right because they can come up with a lot more inflation than they estimated and, of course, this would be a terrible disappointment for all of us, including, I am sure, the Council.

Let me ask you further, last October, Mr. Stans, you were quoted as saying, and I quote:

> Estimates of a deficit of from $15 billion to $20 billion made by so-called economic experts outside the Administration are highly speculative and, in my opinion, grossly exaggerated.

Were these estimates for fiscal year 1971?

Secretary STANS. Yes.

Chairman PROXMIRE. I presume you do not now consider the estimate grossly exaggerated.

Secretary STANS. Well, Senator, I was expressing an opinion on circumstances based on October. We had had only a short period of the General Motors strike. It continued much longer than some of us expected. That had an impact on a number of economic factors, and it is obvious under those conditions I underestimated the budget deficit for the year.

Chairman PROXMIRE. So that $15 billion to $20 billion was just about on the nose. It is turning out to be about $18.5 billion, you think; is that right?

Secretary STANS. That is the current projection of the Office of Management and Budget, $18.6 billion, I think, for the fiscal year.

Chairman PROXMIRE. Would you have any estimate of what the deficit would be for fiscal 1972, assuming a gross national product of what your shop expects, $1,045 billion this calendar year?

Secretary STANS. Senator, I am not as familiar with all the aspects of the budget as I was at one time in the Eisenhower years when I was Director of the Budget. It is pretty hard for me to second-guess the Office of Management and Budget on their estimate of a deficit of $11.6 billion. I would like to say one thing, and that is that I have been around in Government long enough to come to the conclusion that when times are on the decline the budget figures get a lot worse than people expect them, and when times are on the upswing they get a lot better than people expect them to be.

This was the case in fiscal 1959 when we were, the administration was, constantly increasing its estimates of the deficit through the year and fiscal 1960 when we were accused of all kinds of chicanery for forecasting a $70 million budget surplus. When the year was was over, we had a surplus of a $1¼ billion on the administrative budget.

Chairman PROXMIRE. Of course, it was not true in 1968 when we had that terrible deficit of $26 billion with a fantastically prosperous year and because, of course, the administration made a serious mistake in neither cutting spending drastically nor imposing taxes. That was a year in which they had a gross underestimate.

One question more. That was an arithmetic question I asked you, if, on the assumption that—you may be wrong—your shop is right, we have a $1,045 billion gross national product, and what do you assume would be the deficit? It would not be in the area of $16 or $17 billion.

Secretary STANS. I would like to give you two answers to that. One is if the gross national product is only $1,045 billion, the deficit is obviously going to be considerably higher than $11.6 billion, but I do not know the arithmetic and I have not attempted to calculate it. Perhaps it will be $5 billion or more above that.

Chairman PROXMIRE. That was the general response.

Secretary STANS. I want to give you another answer to indicate we are not as far off from the administration's $1,065 billion figure as might be implied from what has been said up to now.

On Saturday, January 23, a week before the Economic Report was issued, and on my own, I made a speech in Florida stating that I thought the gross national product in 1971 would be up more than 8 percent, and more than half of that would be real growth.

I was basing that on reviews of the figures and the discussions that Mr. Passer and I had, analyzing all the potentials, and without reference to any information of the Council of Economic Advisers, and our conclusion was that the growth rate would be somewhere between 8 and 8½ percent.

At eight and a half percent, you would get a figure of $1,060 billion, which would be just $5 billion under the estimate of the Council of Economic Advisers. I cannot guarantee that that is any more accurate than $1,065 billion, but I do not want the record to show that the only figure we had in the Department of Commerce was $1,045 billion.

Chairman PROXMIRE. Mr. Brown.

Representative BROWN. I just want to ask one question about this estimate by the Office of Business Economics. Is that based on current patterns, does it account for acceleration later in the year or any change in the rate of acceleration? How does that work?

Secretary STANS. Well, the gross national product estimate does assume acceleration in the course of the year starting from the level of January and moving up progressively to a higher rate in the last quarter.

Representative BROWN. So that is taken into account in our assessment?

Secretary STANS. That is taken into account; yes.

Representative BROWN. Thank you.

Chairman PROXMIRE. You are Secretary of Commerce, Mr. Stans, and one of the foremost apostles of free enterprise, the competitive system, and in opposition to Government interference or influence in private economic decisions. Under these circumstances, I have often wondered why your voice is not heard more loudly against the $1.5 billion subsidy for the SST, against the continuous increase in funds over and above any contractual obligations for the C–5A, against bailing out the Penn Central Railroad Co.; could you explain what appears to be a schizophrenic behavior on your part, that you are a rugged individualist and a believer in free enterprise, on the one hand, but when it comes to these big business operations and subsidies for big corporations, you seem to have kind of a socialistic weakness.

How do you explain that?

Secretary STANS. I shudder at that thought, Mr. Chairman.

Chairman PROXMIRE. I thought you would.

Secretary STANS. And I am not sure that I can agree with the inference at all. I think my policy would be that the private sector ought to do all of the things that it can do, and do well, and only when the private sector cannot undertake an activity should the Government step in.

Now, the SST involves a research and development cost that I do not believe any of our airplane companies or any combination of them could possibly afford. It does require the Government to step in, and I would hope that my private enterprise views would be clear when I say that as the airframe companies manufacture and sell SST's they ought to pay back some or all of the Government's investment.

Now, in the Penn Central Railroad, there are a number of considerations that, I am sure, affected the administration. I was not in on any policy decisions, but certainly the question of preventing bankruptcy for the Penn Central was a logical one considering the impact on the economy of the failure of a very large institution.

Here again it was beyond the competence of the company, and it was not in a competitive industry where there were substitute services. It is rather inconceivable that a railroad institution like Penn Central would fail to exist.

Chairman PROXMIRE. Let us take those two cases, let us take the last one first. The *Penn Central* case, as you know, the administration did seem tentatively to want to bail out Penn Central before they went through bankruptcy. What happened was that Wright Patman, the vice chairman of this committee, objected, as did some other Members of Congress, and the administration backed off and decided to let them go through bankruptcy.

Now, you have a situation in which the Federal funds available to Penn Central have first claim. The railroad has been able to run, the jobs are preserved, the service is preserved, but you do not have a situation in which a management, which has been so incompetent and so wasteful that they had been vigorously criticized, has not been removed. It has been removed now.

Why isn't this procedure of just letting nature take its course, letting the laws of free enterprise work, why doesn't that make sense in that case? Then we will come to the SST.

Secretary STANS. Well, I suppose there are a lot of factors involved, one of which is that it is a regulated industry. Perhaps the Government shares some responsibility for the overall plight of the railroad industry by the type of regulations that has existed. Perhaps more consideration should be given to some of the recommendations that we hear from time to time publicly of freeing the rates in transportation to the market. I think it is well worthy of consideration.

But the Congress itself recognized after Penn Central went into bankruptcy that the railroads have to continue to operate, and passed legislation permitting some financing, and I think that reflects the same view that I have, that you must continue the service to the people.

Chairman PROXMIRE. Oh, yes, I do not deny that Congress did take some action. But my point is, No. 1, the Penn Central was permitted to go through bankruptcy so that the management which had been in authority could be eliminated.

No. 2, the funding by the Federal Government was given a prior claim. As I understand it, the initial proposal by the administration would not have done that. The taxpayers would have taken a subordinate claim to some of the private debts of the Penn Central Corp.

Secretary STANS. Well, Senator, I am a very poor one to answer that question, because, as I said, I disqualified myself from the discussions at a very early point, and I was not in on the considerations as to whether or not the Government should finance the Penn Central or guarantee its loans, and I am not aware at all of the reasoning whereby the Government withdrew at the last minute, so I beg off the question entirely.

Chairman PROXMIRE. Let us get back into the SST very quickly. I have two points on that. The first point is that the same song was sung to us in the fifties when Senator Monroney said you cannot have a subsonic jet operation without having Federal subsidy of research and development direct. The Senate believed that and passed legislation providing the money. The House had the good sense to deny it and turn it down, and the House prevailed. No subsidy was provided.

The predictions were, if we did not provide this kind of subsidy, we would lose our leadership in aviation in the world.

What happened? What happened was that the private capital market moved in, private enterprise moved in, did a whale of a job. We now dominate the world in aircraft production. Our subsonic jets have been vastly superior to those of other countries, which have heavy Federal subsidy.

It seems to me that on the basis of that experience we should be pretty cautious about saying that we cannot have private capital market finance such an operation. It seems to me the real deterrent here is not the amount. We have had huge amounts privately financed in the past, it is the great risk involved, and the great risk, of course, is there is a very serious question as to whether or not there is the kind of reliable market for a supersonic transport at the present time, and I submit until there is, until the private market will support it, I cannot see any reason why the taxpayers should be required to take that risk.

Especially—this is my second point—I am concerned about the contract we have in which if we sell, say, 130 or 140 supersonic transports the private manufacturer comes out with a profit, gets his money back, the airlines come out with a profit, substantial profit and get their money back, and the taxpayer is left holding the bag. He gets nothing.

If you sell 500 of these, and there is a very handsome profit to the manufacturer and to the airlines, the taxpayer will get back his money, but without the interest that he has to pay for his money. So this seems to be, No. 1, a very bad contract for the taxpayer and, No. 2, to be a rather foolish thing for the Federal Government to substitute its estimate of whether or not there is going to be a requirement for this plane for that of the private economic forces in view of our experience with subsonic jets.

Secretary Stans. Well, Senator, you have done more homework on this subject than I have, and I yield to your statistics.

I just want to make a couple of comments. One, I would suspect that the earlier developments of the subsonic jets benefited very greatly from military expenditures.

Chairman Proxmire. And the supersonic transport can do exactly the same. We have a supersonic B–1 bomber on which we are spending hundreds of millions of dollars, the supersonic bomber. There is no reason why the fallout effect cannot be very similar to the benefits which flowed, as you are absolutely right, to the subsonic jets from the military, it is the same thing.

Representative Brown. Are you suggesting, Senator, that we ought to go ahead and subsidize it? It is just a difference of how we do it, is that it?

Chairman Proxmire. I am saying we are proceeding with a supersonic B–1 bomber. I happen to be against that supersonic bomber, but my position did not prevail, the Congress went ahead with it. They are authorizing and appropriating funds, a great deal of money. You have that research and development going on. You should get precisely the same kind of fallout benefits for a supersonic private plane in that case as you got with the subsonic jet.

Representative BROWN. I do not know that that follows.

Secretary STANS. There are witnesses who can testify much better than I can on this subject, Mr. Chairman.

I replied earlier that my expression of support was based on the economic aspects of our trade balance; that if this is a potentially economic venture, and if the SST can be economically effective, then I would like to see the United States build them and sell them to other countries instead of other countries building them and selling them to us.

Chairman PROXMIRE. All right.

Mr. Stans, let me ask you about this other one, the C–5A. In business, a contract is a contract. Lockheed is reminding Rolls Royce of that, or was. They said, after all, Rolls Royce has an overrun on the engines for their L–1011 airbus. A contract is a contract, and Rolls Royce had better come through with the amount that they agreed to produce those engines.

Now, in the C–5A case the Government had a contract, a fixed-price contract. The Lockheed got the bid for one reason only, that was because they had a lower price. As a matter of fact, the Air Force preferred the Boeing design, but Lockheed had a lower price.

Now, Lockheed says they cannot produce for that price, the Federal Government will have to come along and provide at least three-quarters of the loss, $600 million of the $800 million additional cost, and I do not hear from a man who has a fine reputation for dedication to free enterprise and the sanctity of contracts, any complaints. Why not?

Secretary STANS. Senator, perhaps I ought to take a more serious look at the Lockheed negotiations. It is a procurement contract between Lockheed and the Department of Defense. The subject of overruns has come up many, many times, and they have always been negotiated. I have not considered it a matter of concern for the Secretary of Commerce. I think the Department of Defense is knowledgeable enough as to the need for the aircraft, as to the factors that caused the costs to increase, as to the need for a competitive airframe industry, and under the circumstances I really cannot second-guess the situation.

It is possible that Assistant Secretary McLellan may have something further to add to this.

Mr. McLELLAN. Mr. Chairman, I would like to make just the additional comment that the relationship of Lockheed to the Department of Defense on the C–5A contract was an entirely different business environment than its relationship to Rolls Royce and the procurement of the RB–211 engines. Just the provision for renegotiation that exists in the Defense contracts, of course, makes it an entirely different arrangement; so I really think you cannot liken the two.

The arrangement that Deputy Secretary of Defense Packard worked out with Lockheed on the C–5A, as Secretary Stans says, we certainly would not second-guess. We presume that was done, that has been done, in the best interests of the country.

With respect to the Lockheed-Rolls Royce problem, Lockheed obviously is trying to determine whether Rolls Royce, under the jurisdiction of the British Government, will be able to fulfill the obligations of that 211 engine contract, and in that case certainly a contract is a contract, and we would hope that the British Government would see fit to put Rolls Royce in a position of following through on the obligations they undertook.

Chairman PROXMIRE. There is just one other question that comes to mind, and I just cannot resist asking it because it just seems to me so very hard to justify.

As you recall, President Nixon asked a group of prominent Cabinet officers, including yourself and others, Cabinet Departments, to evaluate the supersonic transport in 1969, and they overwhelmingly indicated reasons for caution on it or opposition. One of the few exceptions was the Department of Commerce.

Now, I notice that Mr. Magruder in the Department of Transportation, who is in charge of promoting the SST and selling it to the Congress, has appointed the Department of Commerce people as the head of the Environmental Commission to evaluate the environmental effects of the SST. Interior is left off. They are supposed to know nothing about the environment. HEW, their knowledge of health, I guess, is not so important. The Department of Commerce has a representative who is the chairman of this commission, and I have great admiration for the ability of your department, and you have demonstrated that this morning and other times, but you do not, as you indicated this morning, you do not have a particular competence in the area of the SST and, particularly, with respect to the SST's environmental effect expect except, of course, that you are for the SST and you are one of the few departments that is.

Is there any other reason you were put in this position?

Secretary STANS. Well, I think you are referring to what we call the CTAB panel, Commerce Technical Advisory Board. These are groups of scientists that we pull together from the private sector to study specific scientific questions that relate to positions that we take on various matters. We have had them in various pollution questions, we have them in atmospheric matters, and so forth. If that is what you are referring to, it was a perfectly normal thing for us to convene a special panel of the Commerce Technical Advisory Board to advise us on the aspects, the technical aspects, of the SST.

Chairman PROXMIRE. Well, was it the environmental aspects rather than the technical or commercial or trade aspects.

One other question: if you are serious about containing the cost-push inflation, which seems to be the principal problem we have with inflation, how about eliminating import quotas on steel, oil, textiles, and give us your estimate of what a serious move toward a more liberal trade policy would have on inflation restraint.

Secretary STANS. At the present time we have import restrictions only on cotton textiles. We do not have them on textiles made from other fibers like wool and synthetics, and I have already pointed out the serious effect upon employment in the United States of not having restrictions on them.

Now, on oil, here is an entirely different problem, and it is a matter of national security. The President's position has been based on national security considerations.

Chairman PROXMIRE. Canadian oil is not secure and safe?

Secretary STANS. Canadian oil has a very high measure of security for the United States, but Canada does not produce enough to satisfy all our requirements.

Chairman PROXMIRE. They will be secure in what they do produce.

Secretary STANS. At the present time, we believe it is important to try to create a supply in the United States by our own type of development and production, and the more of that we can develop the less we have to buy from anyone.

Chairman PROXMIRE. How about steel?

Secretary STANS. Steel is a type of problem, Senator, that is hard to simplify. Our steel mills were somewhat late in moving to the basic oxygen process. They now have moved into it substantially. The Japanese and some other countries are in some cases technologically superior by reason of that new process.

Our steel mills are continuing to modernize. Their problem is almost entirely a differential in the labor costs.

Now, it is entirely possible, if we extend the steel agreement for a few more years and the steel industry is able to modernize, that it may be able to compete in world markets on its own. I do not know whether it will be or not, but I do think that the steel industry is an important element of national security, as well, and I think we would be in a deplorable condition if we did not maintain an adequate steel industry to take care of national emergencies.

Chairman PROXMIRE. Mr. Brown.

Representative BROWN. I would like to respond to a couple of comments and ask a couple of questions with reference to the SST.

I hate to say it as directly as this, but I think; in the vernacular of the television program that my children watch, that it is a nonfact that few departments supported the SST. I think every major department of the Federal Government has supported the SST and, I think, it is on record.

Chairman PROXMIRE. Will the Congressman yield on that?

Representative BROWN. Mr. Secretary, would you know, weren't you solicited by the Department of Transportation with reference to the environmental report on the SST for your views, and didn't every one of the other departments of the Federal Government favor the SST development or the development of two prototype SST's on the basis of that environmental report?

Secretary STANS. I think you have stated it right. I do not know for a fact that every department of the Government supports it. Most of those that I know about do support it, and you are right, the Department of Transportation did urge us to set up a panel of scientists on the environmental effects.

Chairman PROXMIRE. Will the Congressman yield just on that one point? The fact is I was talking about 1969 before President Nixon had taken a position on the SST. They got adverse reports from Interior, Office of Science and Technology, HEW, and the Council of Economic Advisers.

Then the President took a position, and then all the departments went ahead and supported his position, as they should have.

Representative BROWN. I misunderstood.

Now, the question of Rolls Royce, isn't that involved in the tradeoff, a matter we have in all the areas, or is that not involved in that? In other words, don't we, in many of our areas of overseas sales, get ourselves in a position where we have to purchase a portion of the product abroad where, in order to sell the completed product, get some components of the product made abroad?

Mr. McLELLAN. This is certainly the case, Congressman Brown, in various kinds of transactions. But in this particular case the British Government, of course, gave Rolls Royce great encouragement in the sale of its engine; and part of that encouragement took the position of where the British Government would purchase the airplane, and the arrangements were such whereby Lockheed bought the engine, so there was that kind of a trade-off anticipated in that kind of an engine in which the Government would buy the plane.

Representative BROWN. That does becomes sort of a trade-off in the trade arrangement, does it not, or am I misreading it?

Mr. McLELLAN. In that particular case, yes; it was a well-designed transaction between the sale of aircraft engines to the United States anticipated and the purchase of Lockheed Aircraft with those engines back by the British.

Representative BROWN. Now, with reference to the passion for the free enterprise system which has been discussed here this morning, I would just like to observe that urban mass transit over the next 5 years is going to get something like $3.1 billion out of the Federal Government so we can develop systems for improving the mass transportation of people in the urban areas. This is one area of free enterprise, of the free enterprise system, that I frankly am not overly concerned about, and I doubt if the Senator is.

I think in the merchant marine fleet area, for instance—am I correct, Mr. Secretary—that we have spent more so far in the 1960's or in the last decade on the subsidization of the U.S. merchant fleet than we have in the development of the SST; isn't that correct? Isn't it something like $800 million that we have spent on the subsidization of our merchant fleet?

Secretary STANS. Over the last 10 years, it is much more than that. I would guess, over the last 10 years, it is something like $3 billion that we have spent in subsidizing the construction and operation of ships in the merchant fleet.

Representative BROWN. So the free enterprise argument in the development of our transportation facilities in this country, going back to the canals and railroad days, is just not a very significant argument, is it?

I was interested in the opening phrase of your response to the Senator with reference to the Federal Government doing that for society in this country which private enterprise and individuals cannot do for themselves. That sounds like a phrase from a Lincoln Day speech, and it is that season of the year, but is seems an appropriate response to the question because this business of the free enterprise system being in some way bruised or damaged by Federal involvement in the development of transportation in this country just does not wash.

I would like to check, want to make—I do not want to make a statement that is not true on the record, but I think there is some misunderstanding of what the Environmental Panel we are talking about is. I am under the impression that the Environmental Panel To Study the Effects of the SST includes people from the Department of Health, Education, and Welfare, and the Department of Interior, but I would just like to challenge the statement that it does not. But I won't say that it is incorrect until I have had a chance to check the record.

Secretary STANS. Mr. Congressman, the Department of Commerce is currently participating in two different committees involved in evaluating the environmental effects of the SST.

At the request of the Department of Transportation, the Commerce Technical Advisory Board in September 1970 agreed to establish a panel to study environmental questions regarding the SST. In line with past practice, funding for this study is being supplied by the interest requesting it—in this case the Department of Transportation. The panel, composed of distinguished nongovernment scientists and engineers, will complete its study by September 1971.

An interagency SST environmental committee was established in July 1970 to advise the SST Director of the Department of Transportation on matters relating to environmental pollution and radiation. This committee was initially chaired by Mr. Myron Tribus, Assistant Secretary of Commerce for Science and Technology, until his departure from Government and is now chaired by Mr. Fred S. Singer, Deputy Assistant Secretary of the Interior. The committee membership is largely from the Government agencies, including HEW, which have the greatest scientific expertise in the atmospheric and radiation sciences. Mr. White and Mr. Machta of the National Oceanic and Atmospheric Administration now represent the Commerce Department on this committee.

In addition to its involvement with these two committees, the Commerce Department has provided advice and counseling to the SST Office on a continuing basis since 1965 with respect to the possible weather modification aspects of large-scale commercial supersonic flight.

In order to make the record complete, I would like to submit the following for the record: One, the charter and membership list of the Commerce Technical Advisory Board Panel on SST Environmental Research and the press release of Wednesday, February 3, 1971, announcing its establishment; and two, the charter and membership list of the Interagency SST Environmental Advisory Committee.

(The information referred to follows:)

PANEL ON SUPERSONIC TRANSPORT ENVIRONMENTAL RESEARCH

To determine potential environmental pollution and radiation hazards associated with proposed supersonic aircraft.[1]

To determine whether supersonic aircraft would create significantly increased world weather and climatic hazards with particular (but not necessarily exclusive) reference to the following:

An increase in upper air water content.

A decrease in upper air ozone content with subsequent increase in ultraviolet radiation.

A change in atmospheric temperature through disturbance of the thermal radiation balance.

An increase in cloud cover through contrails.

To determine whether SST passengers and crew will experience ionium radiation exposure problems.

For each of these questions, and other related environmental questions which the panel may identify, advice and recommendations should be given concerning:

Whether enough information is available to provide definite answers at this time.

Whether adequate research programs are underway, in the United States or in foreign countries, to cover subjects for which inadequate information exists.

Whether planned research programs are designed to produce definite answers prior to appropriate decision points in the U.S. SST program.

[1] Noise pollution problems will be considered by another group.

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Dr. Richard S. Miller, professor of forest ecology, School of Forestry, Yale University, New Haven, Conn.

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Dr. Martin A. Pomerantz, director, Bartol Research Foundation, The Franklin Institute, Swarthmore, Pa.

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Mr. Robert W. Rummel, vice president, planning & research, Trans World Airlines, Inc., New York, N.Y.

Chief Engineer, TWA, 1943, Vice-Pres, Engr, TWA 1956, Vice-Pres, Planning & Res, TWA, 1959, Member, Res & Tech Advisory Committee on Aeronautics, NASA.

DEPARTMENT OF COMMERCE,
OFFICE OF THE SECRETARY,
Press Release, February 3, 1971, Washington, D.C.

SECRETARY STANS NAMES PANEL TO STUDY RESEARCH ON SST ENVIRONMENTAL EFFECTS

Secretary of Commerce Maurice H. Stans today announced the establishment of a Panel on Supersonic Transport Environmental Research, to study certain potential environmental concerns associated with the SST. The panel will analyze weather, climate, and radiation data and will report to the Secretary by September.

"The environmental aspects of supersonic flight have received major attention and millions of dollars of research attention over the past 12 years," the Secretary said. "Based on information from past and ongoing research, no significant effects on the weather and climate due to the SST program have been identified. However, in the absence of complete data, and because sufficient uncertainties exist, I believe that additional information should be obtained and analyzed."

William M. Magruder, director of the Department of Transportion's SST program, supports this view, and in fact approached the Department of Commerce for assistance, Secretary Stans said. At the Secretary's request, the Commerce Technical Advisory Board, consisting of non-government scientists and engineers, established this panel and named Dr. Frederick C. Henriques, an atmospheric photochemist and chairman of the board, Technical Operations, Inc., Burlington, Mass., as chairman.

The Secretary said that he expects the Panel to determine whether existing research efforts, both here and abroad, plus the planned Department of Transportation research program, are adequate to produce definitive and timely answers to environmental questions. The panel plans to meet with British, French, and Russian governmental authorities and scientists.

Secretary Stans also announced six other members of the panel: Dr. Harriet L. Hardy, assistant medical director, Massachusetts Institute of Technology, Cambridge; Dr. Joseph O. Hirschfelder, professor of chemistry, University of Wisconsin, Madison; Dr. Paul B. MacCready, Jr., meteorologist, Altadena, Calif.; Dr. Thomas F. Malone, dean, Graduate School, University of Connecticut, Storrs; Dr. Martin A. Pomerantz, director, Bartol Research Foundation, The Franklin Institute, Swarthmore, Pa.; and Robert W. Rummel, vice president, planning and research, Trans World Airlines, New York.

Additional panelists will be named soon, Secretary Stans said.

SST Environmental Advisory Committee

CHARTER

To advise the SST Director, Department of Transportation on matters pertaining to environmental pollution and radiation.

The SST Environmental Advisory Committee, composed primarily of scientists and science administrator actively participating in atmospheric research programs on-going within the U.S. Government, will serve as a continuing advisory body to the SST Director throughout the SST Development Program. The Committee will:

Meet periodically at the call of the SST Director and/or the Committee Chairman.

Provide guidance, advice and scientific assistance for the planned SST Environmental Research Program.

Provide a safeguard role in making sure that positions taken by the Government as concerns the environmental issues related to the SST are sound, factual and unbiased.

MEMBERS

Dr. S. Fred Singer (Chairman [1]), Deputy Assistant Secretary, Department of the Interior.

Dr. Myron Tribus, Senior vice president for research and development, Xerox Corp.

Dr. William W. Kellogg, Associate Director, National Center for Atmospheric Research.

Dr. Lester Machta, Director, Air Resources Laboratory, National Oceanic and Atmospheric Administration.

Mr. H. J. Mastenbrook, atmospheric physicist, U.S. Naval Research Laboratory.

Mr. George Chatham, aeronautics and space specialist, Legislative Reference Service, Library of Congress.

Dr. Harald Rossi, professor of Radiology physics, Columbia University and Chairman, FAA Committee on Radio Biology Aspects of the SST.

Dr. Paul Tompkin, Chairman, Federal Radiation Council.

Dr. Robert M. White, Acting Administrator, National Oceanic and Atmospheric Administration.

Dr. S. J. Gerathewohl, Chief, Research Planning Branch, Office of Aviation Medicine, FAA.

Dr. Arthur H. Wolff, Deputy Assistant Administrator for Research and Development, Environmental Health Service, HEW.

[1] Chairman will designate additional members as required.

Representative BROWN. The Senator and I continue our difference on the SST.

Secretary STANS. I suspect you would.

Chairman PROXMIRE. Congressman Brown is a very fine opponent, one of the best.

I want to thank you very, very much, Mr. Secretary. We have other questions we would like to submit for the record. You have been most patient. The hour is late. You were patiently waiting and were very responsive and helpful in your testimony. Thank you very much.

Tomorrow morning we will reconvene to hear the Secretary of Agriculture, Mr. Hardin, at 10 o'clock.

(Whereupon, at 1:10 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, February 18, 1971.)

(The following information was subsequently supplied for the record:)

RESPONSE OF HON. MAURICE H. STANS TO AN ADDITIONAL WRITTEN QUESTION POSED BY CHAIRMAN PROXMIRE

Question. In December 1968, the Executive persuaded European and Japanese steel producers to voluntarily restrict their exports to the United States. From 1960 through the end of 1968 wholesale prices for iron and steel products increased 5.5 percent. But from December 1968 through November 1970, wholesale prices for these products rose 13.8 percent, more than twice the amount in the previous nine years. In the light of these facts and the recent 6.8 percent rise in the price of structural shapes, will the Administration oppose renewal of this voluntary arrangement when it expires?

Answer. During the years in question industrial wholesale prices followed a pattern of relative stability until the mid-1960's, with substantial increases since then in response to inflationary demands and the rapid rise in labor and other costs. Thus, the behavior of steel prices in recent years has reflected the broad economic forces at work, as well as the many special circumstances of the industry.

The Administration is now in the process of discussing extension of the Voluntary Restraint Arrangement (VRA) with the major foreign exporters of steel to the United States.

We are continuously following price developments in the U.S. steel industry and expressed our concern at the price increase originally announced by the Bethlehem Steel Corporation, which was later modified. But not all steel prices have increased. A number of particularly hard pressed specialty steel producers have lowered prices on some of their items in order to remain competitive. These price cuts have come at a time when imports of these items have already taken close to 40 percent of the domestic market. Furthermore, it is not clear that the price cuts will prevent further increases in imports.

The profit position of the steel industry is weak at the present time and some important sectors of the industry are experiencing serious difficulties. Despite higher average prices in 1969 and 1970, steel industry profits after taxes declined, because of cost increases. Total revenue reached a record level of $19.4 billion in 1969 (up 4.8 percent) but profits fell by 14.3 percent to $850 million—4½ percent of revenue compared with 5½ percent in 1968. Profits for the first nine months of 1970 fell by an additional 31 percent and were only 2.9 percent of sales.

Steel industry profits have been on a downtrend since the mid-1950's. As a percent of sales, profits declined from about 8 percent in 1955 to 4½ percent in 1969. As a percentage return on equity, steel industry profits were about the same as all manufacturing in the mid-1950's. By the mid-1960's, the steel industry return on equity had declined to about 70 percent of the return in all manufacturing. By 1969, this ratio had dropped to less than 60 percent, and was even lower in 1970. At the same time that profits have been declining, the industry has continued to modernize its plant and equipment, spending over $2 billion annually in the last several years.

Against this background, it is clear tha much of the increase in steel prices in the past several years can reasonably be attributed to causes other than the VRA. Worldwide demand for steel increased sharply in this recent period and in the last two years the VRA limits themselves were not filled by Common Market producers. Nevertheless, imports continue to represent a significant part of our domestic steel market, and at this juncture we think that some restraint on these imports is required.

The process of obtaining an appropriate extension of the VRA will continue. At the same time we are engaged in a further review of the long range prospects for the steel industry including the import question and the interests of steel users.

RESPONSE OF HON. MAURICE H. STANS TO ADDITIONAL WRITTEN QUESTIONS POSED BY SENATOR JAVITS

Question 1. On p. 21 of your statement, you say "Our antitrust policies need to be reviewed, particularly with respect to their application to the overseas operations of U.S. industries and to joint efforts by our exporters to enter foreign markets." What specific measures do you think we should take to change these antitrust laws?

Answer. Probably no other major industrialized nation gives as little assistance to, or places as stringent restrictions on its export trade as we do. This Department has received many complaints from American businessmen who feel particularly handicapped by our antitrust laws in their efforts to compete with their foreign counterparts for a fair share of the overseas markets.

In that light, the Department of Commerce has undertaken a review of the impact of U.S. antitrust policies on overseas operations of American business. We are assessing the U.S. business experience under the Webb-Pomerene Export Trade Act. Beyond that, we are studying such areas as joint bidding for construction services abroad, foreign licensing programs, other distribution programs, and the like. From this study, we hope to draw conclusions as to the actual impact of U.S. antitrust legislation on those U.S. companies which face competition abroad in contexts rather different from our home markets, and to make specific recommendations so that these companies may become more competitive in the future.

I believe that any proposals to amend our antitrust laws should await the completion of this study.

Question 2. What remedies do you suggest that the Congress consider that would buttress our superiority in technology-intensive goods so that our export margin could exceed the $9–10 million range? Does the answer lie in giving greater incentives and support to research and development; does it lie in further revision of depreciation schedules, etc?

Answer. Sustained improvement in our foreign trade position requires action on many fronts. Export expansion efforts, to be truly effective, require a more competitive American economy vis-a-vis foreign countries. The first requirement is to cool our domestic inflation. I believe there is evidence that the rate of inflation here is slowing and some evidence that inflation rates abroad are now outrunning the rate in the United States.

Within this improved economic environment, I believe that the greatest opportunity, is to maximize export growth in our most innovative, capital-intensive industries. Export tax incentives, of the type recommended by the Administration through the Domestic International Sales Corporation (DISC) program, can clearly be of major value in improving our export position. In addition, there is no question that more effort needs to be made in the export credit field, so that the terms and conditions of Export-Import Bank financing of exports are more competitive with terms supplied by foreign credit institutions. This is especially important in the capital goods sector where international credit competitiveness of the United States has until very recently lagged. Removal of present budgetary constraints on the Eximbank would be very helpful in this regard.

I would not be prepared to propose new tax or other government incentives in the field of industrial research and development at this time. At some future time it may be necessary to consider this alternative, especially in view of the cutback in government-supported R & D in the Defense-Aerospace area.

I also think some further consideration of depreciation schedules may be desirable. Other governments are known to provide tax advantages of this type to help the establishment and expansion of high technology industries in their countries, especially if there is an import-saving or export-growth interest to be served. In certain respects, for example, the computer industries in the UK, France and Japan have benefitted by direct government programs to facilitate the establishment of a computer manufacturing capacity in these countries. However, I do not feel that sufficient study has thus far been given this subject in the United States to conclude that further revision is warranted.

RESPONSE OF HON. MAURICE H. STANS TO AN ADDITIONAL WRITTEN QUESTION POSED BY REPRESENTATIVE BROWN

Question. Could you indicate to us how much of the increase in unemployment during 1970 was attributable to (*a*) jobs lost because of increased competition from imports into the U.S., (*b*) jobs lost because of defense cutbacks, and (*c*) jobs lost to or temporary unemployment created by prolonged strikes?

Answer. It is always difficult to attribute a rise in unemployment to specific causes in a precise quantitative fashion. Changes in unemployment are invariably the result of multiple causes that interact extensively and cannot be separated empirically. Furthermore, even when unemployment is stable, changes in the composition of the unemployment—both voluntary and involuntary—take place continuously, with job losses and job gains offsetting each other.

Although the rise in unemployment in 1970 cannot be pinned down to certain causes, it is possible to say something about the impact on employment of rising imports, defense cutbacks, and strikes. No overall estimate is available of the number of jobs lost because of increased competition from imports (nor of job gains from exports). Some industries have been hurt significantly, however. Last year, I am told, there were 100,000 jobs lost in the textile and apparel industries, some very substantial part of which can be traced to the large rise in imports in this area. Another example is consumer electronics, where for many product lines the domestic market has been substantially captured in recent years by foreign products. From 1969 to 1970, U.S. employment in this industry declined by 19,000 workers (16½ percent) as shipments declined 26 percent while, at the same time, imports of these products increased 27 percent.

As the 1971 *Economic Report* emphasized, jobs are created by exports. In 1969, nearly 4 percent of the private labor force was directly or indirectly dependent upon exports for employment. It is also important to note that wages in export industries are usually higher than in import-competing industries.

The impact of the cutbacks in defense on employment during 1970 were discussed in *The Annual Report of the Council of Economic Advisers* (pp. 42–49). The Armed Forces were reduced by about 400,000 during 1970, and civilian employment in the Defense Department declined by nearly an additional 100,000. Private employment related to defense may have been reduced by 600,000. All told, therefore, the Council estimates that there was a decline of 1.1 million jobs attributable to the decline in Department of Defense expenditures during 1970.

Information on the direct influence of strikes is readily available; the Bureau of Labor Statistics estimates that strikes totaled 62 million idle man-days in 1970, up 45 percent from 43 million in 1969. The indirect effect of prolonged strikes is not easy to determine, however. The 1970 automobile strike resulted in substantial temporary layoffs in supplier industries, such as the tire and rubber industry, and among salesmen and other employees of automobile dealers. The Department of Labor has been able to identify over 300,000 workers (other than strikers) who were laid off because of the strike. If we could measure the full impact of the auto strike on employment, it is quite likely that the total number of workers laid off was as much as double that 300,000 estimate.

THE 1971 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 18, 1971

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

The committee met, pursuant to recess, at 10:05 a.m., in room 1202, New Senate Office Building, Hon. William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Bentsen, Javits, Miller, and Pearson; and Representatives Widnall and Brown.

Also present: James W. Knowles, director of research; Loughlin F. McHugh, senior economist; John R. Karlik, Richard F. Kaufman, and Courtenay M. Slater, economists; Lucy A. Falcone and Jerry J. Jasinowsky, research economists; and George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig and Leslie J. Barr, economists for the minority.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. Our witness this morning is the Honorable Clifford M. Hardin, Secretary of Agriculture.

Agriculture is the most basic sector of any economy. In a modern industrial economy, it is also in many ways the most puzzling. For many years now, the marvelous productive capacity of our agricultural sector has given us the ability to produce far more food than the population of the United States possibly can consume.

I might point out that the efficiency of our agriculture is so dramatic and gives us such a tremendous advantage in the world that it just has not been appreciated or realized. If we compare, for example, the manpower required to produce our food with that of the Soviet Union, we find that they take seven times as many people to produce 20 percent less food, and of course, this frees our vital resource of manpower for other things and is, in my view, the principal reason for the substantial superiority the United States has over the Soviet Union economically.

Yet surpluses accumulate while people go hungry. Clearly the fault must lie in the inadequacies of the marketing and distribution system.

In fiscal 1971 we are spending an estimated $4 billion in farm income stabilization programs. If distributed equally this would be about $1,000 for each of the Nation's 4½ million farmers in 1970. Surely an expenditure of this size should be adequate to achieve its dual purpose of providing an adequate income for the farmers and an adequate food supply at stabilized prices for the consumer.

Yet 1970 was not a good year for agriculture. Net income per farm from farming declined in real terms and in the fourth quarter was more than 10 percent below its year earlier level. More than 20 percent of farm families had incomes below the poverty level.

Prices received by farmers at the end of 1970 were about 7 percent below their year earlier level. For a time, there were hopeful signs that the price decline might be reflected in lower retail food prices, but retail food prices began to rise again in December. Just recently, the Agriclulture Department released its estimate that 1971 would register further increases in retail food prices.

So what we have is a farm program that is tremedously expensive, yet far from successful in achieving its objectives. We have a Federal program that pays out enormous Federal subsidies to a few wealthy farmers, yet leaves the average farmer with an inadequate income. We need a better farm policy.

Secretary Hardin, we welcome you before this committee, and we invite you to explain to us both what our current farm policy is and how it might be improved.

Go right ahead.

I understand the distinguished gentleman with you is Mr. Paarlberg, who is one of the outstanding economists in our Federal Government and is your chief economist with the Department of Agriculture.

STATEMENT OF HON. CLIFFORD M. HARDIN, SECRETARY OF AGRICULTURE, ACCOMPANIED BY DON PAARLBERG, DIRECTOR, AGRICULTURAL ECONOMICS, DEPARTMENT OF AGRICULTURE

Secretary HARDIN. Yes; that is correct, Mr. Chairman.

I appreciate the opportunity to appear before your committee and to comment on the President's Economic Report as it relates to agriculture and to rural America. I will confine my remarks to five central topics: the state of the agricultural economy, which you have referred to already, Mr. Chairman; service to consumers; geographic distribution of the population; environmental protection; and timber supply.

STATE OF THE AGRICULTURAL ECONOMY

The figures I have, Mr. Chairman, differ slightly from those that you have, but I think we do not disagree on the fundamental point Our most recent data show that realized net income per farm in 1970 averaged practically the same as the record level of 1969. Note, we are talking per farm. It was 82 percent above the 1960 level. The per capita disposable income of the farm population from all sources, farm and nonfarm, in 1970 was 139 percent above 1960. This compares with a gain of 67 percent during the 10-year period for the nonfarm population. In 1960, per capita disposable income of the farm population was only 55 percent of the income of the nonfarm population. Last year farm people got 78 percent as much income as nonfarm people. This was a substantial gain for the decade, but far too many farm people still have far too little income. Though farm incomes have improved, the fact that they continue low relative to incomes of nonfarmers remains the No. 1 problem of agricultural policy.

Income from nonfarm sources is becoming a larger component of the net incomes of farm people. Off-farm jobs of various kinds are the chief source of such income. In 1970, the per capita disposable incomes of people on farms averaged a record $2,633. Almost half of this (47.7 percent) was from nonfarm sources. These dollars are as useful in buying goods and services as those earned from farming operations also.

The year 1970, found crop prices rising and livestock prices falling, although since the end of the year, there has been some bounceback in livestock prices. The net result was an increase for 1970 in prices received by farmers of 2 percent above the 1969 level. The decline in livestock prices was primarily due to the large increase in pork production, accompanied by continued large supplies of beef, poultry, eggs, and milk. The rise in crop prices was due mainly to higher prices for feed grains, wheat, and soybeans, reflecting the smaller 1970 grain crop. Corn blight cut the yield of that crop by approximately 15 percent. Adding to the price strength for grain was an expanding domestic and export demand for both grains and soybeans.

Agricultural exports in 1970 hit a record $7.2 billion, 22 percent above the previous year and 4 percent above the previous record in 1966. Much of the advance was attributable to the poor grain harvest in Eastern European countries and Western Europe and the strengthening demand for grain and grain products for livestock feeding as diets improved in other developed nations. We achieved some export gains through trade concessions that we were able to negotiate and especially so with Japan.

Agricultural imports continued to expand in 1970, with most of the increase accounted for by gains in animal products, fruits, vegetables, sugar, and coffee or cocoa. Agriculture showed a net excess of exports over imports of $1.5 billion during the year, thus helping to improve the Nation's overall trade balance. With the comparative advantage enjoyed by much of American agriculture, we should be able to improve our performance even more—if we can keep export markets open and if we can gain further concessions.

In the year ahead, agriculture faces substantial change as supply conditions adjust and demand improves. Large supplies of livestock and livestock products may hold farm product prices below the highs of last winter, particularly in the case of pork. But there has been this recent recovery, and beef prices are running above the level of last year at this time. But with the general economy improving, we are looking for farm product prices to strengthen by around midyear as livestock production tapers off a bit.

For 1971 as a whole, cash receipts from farm marketings are expected to show an increase. Realized gross farm income should run slightly above the previous record.

Although there has been a decline in the ratio of prices received to prices paid by farmers, there is still a cost-price squeeze. It is important to recognize the limitations of this measure as an indicator of farmer well-being. The development and application of new production technologies; rapid changes in the size, structure, and organization of production units; and the further integration of production and marketing processes have yielded very rapid gains in productivity in the postwar years. As a result, it is more meaningful to examine trends in income per farm and in per capita income of farm people.

SERVICE TO CONSUMERS

The average American family purchases its food supply with only 16.7 percent of the family income. Never before has this percentage been so low, and never before has the quality of the food supply been so high.

This remarkable achievement, never before attained anywhere in the world, is a tribute to the great efficiency of American farmers. During the last 10 years, efficiency—that is, the amount of output per unit of input—has been advancing about twice as rapidly in agriculture as in the rest of the economy.

To the degree that the relatively low share of the income spent for food results from agricultural efficiency, farmers can take pride. But to the degree that it results from inadequate returns to the labor, management, and capital employed in the production of food, there must be concern. All of these elements are in the picture.

GEOGRAPHIC DISTRIBUTION OF THE POPULATION

The geographic distribution of population and employment opportunities is an issue of growing national significance. We know from the census of last year that about half of all counties in the Nation (most of them rural) lost population over the decade of the 1960's and that another one-quarter grew slowly. The countries losing population experienced net outmigration, and most often the outmigrants were young adults beginning their most productive years of life. In such States as North Dakota, South Dakota, Nebraska, Kansas, Montana, and West Virginia, over three-quarters of all counties lost population.

Yet, there are growth centers in most of these States where the rate of population increase equals that of the metropolitan centers.

One of the major challenges before us now is to combine these two forces—the decline and stagnation of large areas and the growth and vitality of nearby centers—in a manner that is mutually supportive. Or adding to that, to help to create more of these active growing points in the towns and smaller cities of ruralAmerica.

The increased use and support of planning and development districts will help place the issue in the areawide context that is needed. It will also help Federal agencies bring their efforts into more effective, more complementary relationships at the local level. With the prospect of localities having access to noncategorical grants in the form of federally shared revenues, these institutions take on even greater potential stature.

A subcommittee of the Domestic Council has been examining the need for a national growth policy, with particular attention to the development of nonmetropolitan areas. Much of this work is underway. Several of the Federal agencies have increased their programs that are pointed in the direction of rural America, and we are hopeful soon that this entire policy can be made more explicit with a more clearly articulated statement.

ENVIRONMENTAL PROTECTION

On environmental protection the Department of Agriculture has a long and outstanding record. Among the many notable accomplishments are the:

Abatement of the Great Dust Bowl problem through soil conservation.

Reduction of flooding and related damages through upstream conservation.

Control of forest fires on national forests and on private lands. I note parenthetically at this point that after many years of reduction of forest fires, we did have a bad year in 1970, which destroys the direction of the curve a little bit.

Improvement of the landscape and stabilization of soils through cooperative tree planting programs.

We must not, however, permit past successes to make us complacent as to present and future needs, which are many. We cannot solve all our environmental problems overnight. It will take a deliberately programed effort over time to realize the improvements that are desired. In some cases we will have to wait for standards to be established and for technological improvements from research. In other situations, new or expanded authorities may be needed. The cooperation of public and private efforts will also be an important ingredient. Nonetheless, we are determined to make progress on the entire breadth of the environmental front.

The Department of Agriculture's environmental program for the 1970's, as it is now taking shape, will include five major elements. The first will involve the identification, retention, and protection of land for agricultural production. Again, I want to comment parenthetically, we are particularly concerned on the grade A or class 1 and 2 land, the very best agricultural land, of which there is a limited supply in the Nation.

Second, we are designing new approaches to the use of land released from agriculture for esthetic and recreational purposes and especially around the population centers.

A third element will be to stimulate selected small and medium size growth centers around the Nation, largely in response to local initiative in this instance.

As a fourth element, we are intensifying our efforts to determine the determine the capacity of land to absorb wastes and to design means of converting wastes into beneficial uses.

Finally, a fifth element involves modifications in the use of agricultural chemicals. We are, for example, already beginning to use a number of biological control mechanisms to replace the more toxic chemicals.

TIMBER SUPPLY

Concerning timber supply, as a result of tight money supplies and housing starts of less than 1.4 million in fiscal year 1970, softwood lumber and plywood prices declined from the very high levels they had reached the previous year. However, demands for lumber and plywood are expected to expand sharply over the next decade in response to projected demands for housing. At present levels of timber management and production, these demands will give rise to significant increases in timber prices.

By acting now to increase timber supplies, we can reduce the impact of rising demands on softwood lumber and plywood prices and housing costs. We have the capability to do this. Within the next decade or so, this capability will be concentrated largely on national forests.

Over the longer run, we will have to depend more on private timber ownerships to meet the rising demands.

In the recent past, public lands have provided some 40 percent of the softwood sawtimber harvests. Industrial forest lands have accounted for almost one-third of the harvests, and the remainder have come from holdings of farmers and other private landowners. As demand increases, the forest industry has usually increased harvest on private lands. However, as a result of past cuttings, this source of supply has been reduced. We must not delay further in the development of privately owned forests. Time lost cannot be regained.

The President, in his response of last June to the findings and recommendations of an interdepartmental task force on softwood lumber and plywood, directed me to formulate plans to improve the level and quality of management of public forest lands to permit the increased harvest of softwood sawtimber, consistent with sustained yield, environmental quality, and multiple-use objectives. Among other steps, the President also directed me to develop programs to increase the production and harvesting of timber on State and private lands, consistent with the maintenance of environmental quality.

In response to these directives, we are developing plans to accelerate reforestation and timber stand improvement work and to reduce the management planning and inventory cycle from 10 to 5 years. The latter improvements will make future allowable cut levels more quickly responsive to investments for increased growth and to management changes.

I have tried, in this brief statement, to anticipate your interests. I may not have done so. To the best of my ability, I shall be happy to respond to your questions.

Chairman Proxmire. Thank you very much, Mr. Secretary. There are some very good things in this statement. I notice, for example, you stress, and I think it is a very wise and good stress, the point that the American people are now able to buy their food for 16.7 percent of their income, which is an all time record and far lower than any other country, far, far lower. This just can't be said often enough. We hear a lot of complaints, understandable complaints, about the rise in the cost of food. But the fact is when you include the entire cost of the farm program, when you include what the farmer gets and what the marketing and distribution system receives, the American family is getting the best bargain any people have ever gotten in history. I think this is something that, as I say, you rightly and properly stress and have good reason to be proud of.

I am concerned, however, as I indicated to you just before you started to speak when we were discussing this informally, with the openining statistics that you give on the improvement that the farmer has enjoyed since 1960. Because I think this is a serious distortion of what is actually happening. You do say further down in the paragraph that his income is still substantially less than those off the farm. But what puzzles me and concerns me about these figures is the fact that the income of the farmer did go up, it is true, from 1960 to about 1966 or 1967. And I am delighted you picked that period. It shows that you are making a nonpartisan approach this morning, because of course, this is the period when the Democratic administrations were in office. In the last year or so, this has not been such a good time for the farmers on that basis.

Let me point out, for example——

Secretary HARDIN. May I intercede there?

Chairman PROXMIRE. Yes, sir.

Secretary HARDIN. 1969 and 1970 are record levels in absolute dollars.

Chairman PROXMIRE. You mean not corrected for inflation. Is that what you mean?

Secretary HARDIN. That is correct.

Chairman PROXMIRE. Well, if you correct them for inflation, you get quite a difference, dramatically different picture.

Secretary HARDIN. With that I agree.

Chairman PROXMIRE. In other words, in real income, the farmer is worse off.

Take this past year. In 1970, net income per farm at current prices went from $5,850 in the first quarter—I am talking about per farm income—to $5,680 in the second quarter, and in the third quarter, to even less, $5,540, and to $5,270 in the fourth quarter, still less. That is particularly dramatic at a time when farms are diminishing and the size of the average farm is increasing and farm population is dropping. What is your explanation, or what do you think caused this tremendous drop in farm income?

Secretary HARDIN. Particularly disturbing has been the drop in pork prices as a result of the 25-percent increase in pork supplies.

Chairman PROXMIRE. What we overlook, of course, in your statement when you point out the substantial increase the farmers have enjoyed since 1960, is that most of it is coming from off-farm work—off-farm work—which the Department of Agriculture, either under the Freeman administration or the Hardin administration, can hardly take credit for. In fact, because the farmers are in such desperate plight, they find they have to work off the farm to supplement their income. Isn't this true?

Secretary HARDIN. Mr. Chairman, let me say that I am not trying to give credit or take credit at this point. I am merely trying to report the facts as they exist, and it is a fact that the nonfarm income has increased.

Chairman PROXMIRE. Onfarm income?

Secretary HARDIN. Nonfarm income.

Chairman PROXMIRE. That is right. What has happened is that since 1960, you have had marginal farmers drop out, farmers that just could not make it, disappearing. You have had a consolidation of farms so the farms are bigger, the farmer has to have a much bigger investment, he has to work greater acreage. This gives you a statistical picture of an improving lot for the farmer which, it seems to me, is not fair or accurate.

Secretary HARDIN. During this entire period the Department of Agriculture has placed considerable stress on the economic development of rural America and the creation of job opportunities off the farm, so that most of the work and most of the accomplishments are due to the efforts of local people. These efforts have been encouraged and should be encouraged more by various Federal agencies, including the Department of Agriculture, that have attempted to help those communities that were willing to organize and help themselves.

Chairman PROXMIRE. I am sure it has helped some. But I am sure you would agree with me that the overwhelming amount of this has been the initiative taken by the farmer himself. In my State, I have noticed so many farmers working in a number of plants. I think something like 40 or 50 percent of our farmers work off the farm in full-time jobs.

Secretary HARDIN. This is correct.

Chairman PROXMIRE. I notice also that since 1960, the figures I have are that national income almost doubled—went up from $414 billion to $801 billion, while farm proprietor income, which seems to me a better indication of what the farmers are getting as farmers, went from $12 billion to $16 billion.

Secretary HARDIN. That is right.

Chairman PROXMIRE. In other words, you had national income up about 100 percent and farm income up only about 35 percent.

Secretary HARDIN. Farm income does need to be adjusted for the number of farm units, which have been reduced.

Chairman PROXMIRE. That is true, but even adjusting, as I pointed out, for farm units in the last year or so, the farmer hasn't done so well.

Secretary HARDIN. We agree on the basic point, which is that farm income is still low, still inadequate in terms of the rest of the economy. Or to put it another way, the farmers have not shared equitably in the rising income and rising standards of living of this Nation.

Chairman PROXMIRE. I am concerned about the most recent figures that I have seen on productivity on the farm. I noted in my opening remarks that this has been the great strength of the American economy, that we have economized on our agricultural manpower dramatically as compared with the Soviet Union. On the other hand, most of this improvement seemed to come in the 1930's, the 1940's, and the 1950's. Since about 1960, the increase in farm productivity has not been very great and the statistics I have here indicate that in the last couple of years, it has increased very, very little. Now, do you have statistics or figures that will contradict that?

Mr. PAARLBERG. Your figures are correct, Senator. The modest gains in efficiency in this past year have been due in large part to the corn blight which cut yields and hence the amount of output. We believe that this is really a temporary thing, that it does not indicate any real termination in the efficiency advances that the farmers have been producing.

Chairman PROXMIRE. I am talking about not just the last year, I am talking about the increase in efficiency or productivity since 1960. Let me just give you some statistics I have here. Perhaps you can help us with them. This is according to the Economic Report on page 293.

The 1960 index number was 97—I am talking about the output per farmer—and the 1970 index number was 99. That is over a 10-year period. This is in sharp contrast to the very large gain in productivity which this index shows, as I said, for the preceding 30 years.

Mr. PAARLBERG. It is correct that in recent years, the rate of efficiency gain has not been as great as earlier. Our analysts are not convinced that this is a fundamental change in trend. It may well be things of a temporary and passing nature but that will not be possible to determine until some future date.

Chairman PROXMIRE. Well, in view of the great benefits for our economy and the fact that Mr. Hardin properly stressed, that people have to pay far less of a proportion of their income for food here than in any other country or any other time, it seems that if we can't continue to improve our farm productivity, we are not going to be able to improve this advantageous position that we have. What are you doing to try to get at this and to try to continue improvements in farm productivity?

Secretary HARDIN. Yes, Mr. Chairman. The research programs that have been, behind the scenes, responsible for, or that have made possible the gains in efficiency that farmers have made, have been very ingenious in this process for these years. But much of the gain will depend upon new technology developed. Wheat yields, with the development of the new varieties as they are adapted to particular localities, will add another factor of efficiency. We think there are significant gains that can still be made with the soybean crop in terms of yields and efficiency in production.

Chairman PROXMIRE. It will be hard to get much more milk per cow; you are getting so much more now than you used to get.

Secretary HARDIN. That is an interesting point. I used to live in Wisconsin, too, Mr. Chairman. We have thought many times that we had reached the limit on production of milk per cow, but the figure still keeps rising a little bit each year. But I suspect we are fairly close to the maximum on that. I think we have to assume any further increases will be modest, indeed.

Chairman PROXMIRE. I notice you are cutting back in you requests for agricultural research. Is this consistent with the concern which the Department of Agriculture had shown in the past for improving productivity and the enormous benefits for the economy in that kind of productivity?

Secretary HARDIN. I wasn't aware that we had actually reduced our request for research.

Chairman PROXMIRE. The figures I have here, the 1971 estimate is $279 million; in 1972, $274 million. It is a limited cutback, but is a cutback.

Secretary HARDIN. I suspect there is no significant increase involved. There has been quite a bit of shifting in the program, and I suspect that, without having the details before me, those adjustments may fall in the construction accounts and not in programs. There have been a number of Federal laboratories under construction, and that caused considerable fluctuation in the figure.

Chairman PROXMIRE. Will you review that for us and when you correct your remarks, give us a complete response on it?

Secretary HARDIN. Yes.

(The following was subsequently supplied for the record:)

U.S. DEPARTMENT OF AGRICULTURE, FISCAL YEAR 1972 BUDGET ESTIMATES COMPARED WITH FUNDS AVAILABLE FOR FISCAL YEAR 1971; AGRICULTURAL RESEARCH SERVICE AND COOPERATIVE STATE RESEARCH SERVICE

A. Agricultural Research Service:

Funds available for research in this agency in FY 1971 totaled $173,639,000, compared with budget estimates for FY 1972 of $168,037,000, a reduction of $5,602,000. The latter amount was mainly attributable to two items, as follows:

(1) Elimination of items other than staffing and equipping of research laboratories—amount, —$1,840,000.

(2) Non-recurring construction in 1971—amount, —$4,580,000.

B. Cooperative State Research Service:

Funds available for research programs administered by this agency in FY 1971 total $68,476,000. Budget estimates for FY 1972, as indicated in the President's budget, total $74,325,000, an increase over 1971 of $5,849,000. Of the total increase, $3,800,000 would go toward meeting increased costs of conducting research at State Agricultural Experiment Stations and eligible Schools of Forestry. An additional $2 million would go toward the support of expanded research at the so-called 1890 land-grant colleges.

In the case of the other Department agencies having research responsibilities, including Forest Service, Economic Research Service, Farmer Cooperative Service, and Statistical Reporting Service, the differences between funds available in 1971 and budget estimates for 1972 are too small to be significant.

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

Senator Miller.

Senator MILLER. Thank you, Mr. Chairman.

Good morning, Mr. Secretary.

Secretary HARDIN. Good morning, Senator Miller.

Chairman PROXMIRE. I might say we are very honored to have Senator Miller on this committee, with the witness we have this morning. As you know, he is the ranking member of the Senate Agriculture Committee and he is extremely well-informed in this area.

Senator MILLER. Thank you, Mr. Chairman. As long as we are passing aroung compliments, I will commend you for your long and kind and very active interest, especially in the dairy area. It has been a pleasure to join with you on programs and bills in that area.

Mr. Secretary, I am sure you are familiar with a constant complaint in the farm community that there is a time lag between lower prices for farm products—I am thinking, for example, of pork prices—received by farmers and the lower prices for the consumer in the marketplace. You are familiar with those complaints?

Secretary HARDIN. Yes, I am, sir.

Senator MILLER. And you recognize that there is delay. Do you feel that either the Congress or your Department should investigate the reasons for that delay? Or have you done any investigating on it?

Secretary HARDIN. Yes, Senator Miller, it is a matter that we have had under study. As a matter of fact, Mr. Paarlberg has met with the representatives of retail food organizations within the past 2 months and discussed this very fact with respect to pork margins. Whether it was a result of the conversations or whether it would have happened anyhow, I cannot say, but there was some improvement in the weeks since then. But you are absolutely right, when the pork prices began to drop, there was not a corresponding drop in the retail prices of pork, which would have helped to move the supplies at that time and cushion the drop.

We are convinced at this point that it is not primarily a matter of profit margins among the food companies, but rather their pricing policies, and they do price, as you well know, many thousands of items. For some reason or other, their management techniques have not made them quickly responsive to the changes in the costs at wholesale. This is a matter that we intend to discuss further with them, and at this stage, I am not prepared to say that we need either Federal statutes or new regulations. But it is a matter that is under study.

Senator MILLER. Well, of course, as you know, there are some allegations that there have been some monopolistic practices in this respect. Have you had occasion to discuss this matter with the Department of Justice or the Antitrust Division?

Secretary HARDIN. We have not, Senator Miller.

Senator MILLER. Now, in your judgment, what is the future of the International Grains Arrangement? It appears to many of us that it is not really being adhered to by many of the signatories, so it is a question of whether or not we ought to just get out of it instead of just staying in it when it is really not being followed.

Secretary HARDIN. The International Grains Arrangement, as you know, does expire June 30 next. During the past several months, there have been a number of international moves among the members of the agreement and discussions of what, if anything, should replace it when it does expire. It is true that there has not been final agreement on a new program. I suppose that if I were to make a guess as to what the outcome will be, it would be something more on the order of, if there is an agreement, the former International Wheat Agreement, which did not attempt to deal specifically with minimum prices or maximum prices as the International Grains Arrangement did.

Senator MILLER. Now, as you know, one major farm organization circulated some reports that a member of the Council of Economic Advisers had stated that it was the policy of this administration and of the Department of Agriculture to eliminate the family farm and to promote corporate agriculture. I wrote to this particular member and asked him about it, because I received a copy of the newspaper article containing such an allegation, and he sent me a copy of his response, which he had made to the paper in question in my own State of Iowa, but unfortunately, it never appeared in the paper. In any event, as you well know, the denial never gets as much publicity as the allegation. Would you care to give this rumor a proper burial?

Secretary HARDIN. I would like to because it definitely is not the policy of this administration to abolish the family farm—rather, it is the opposite. It is our belief, and I think our data support it, that the most efficient unit in American agriculture, particularly across the great Midwest and South, is that family farm that is as large as one man can handle himself with some family and seasonal labor. That is the most efficient unit we have. We think that because it is the most efficient, it will continue to be the dominant type of farm in American agriculture, and certainly the policies that we are sponsoring in this Administration and the new farm legislation are directed to support of the family-type operation.

Senator MILLER. Thank you.

In your statement, Mr. Secretary, you are referring to agricultural exports, but you did not say anything about exports under the food-for-peace program, Public Law 480. Could you tell us how those fit in with the rest of your statement and especially to what extent they are contained in it or taken into account, I should say, in the net excess of exports over imports of one and a half billion dollars to which you refer?

Secretary HARDIN. Yes. The food-for-peace program has been maintained at about the billion-dollar level over the past few years. It was slightly less in 1970 than in previous years, but was still approaching a billion dollars. All other sales are for cash dollars, so that the net excess figure, if you disregard the food-for-peace program, which now does involve harder terms than in the previous period, is still a half-billion-dollar favorable trade balance.

Senator MILLER. You mean one and a half?

Secretary HARDIN. It is one and a half total. If you take out the food-for-peace program, it is still in excess of half a billion dollars.

Senator MILLER. So from the commercial standpoint——

Secretary HARDIN. Incidentally, the demand for the food-for-peace program among the governments of the world continues to be very, very strong and we are, of course, attempting to accomplish several things with it. One is the obvious humanitarian aspect, which continues to be important, particularly periods like our efforts last year in Pakistan, and in other parts of the world where there have been catastrophes. But also, it is being used increasingly to develop cash markets for the future, and I think it is a good and strong tool for us in future world market development.

Senator MILLER. Now, in your statement, you referred to the excessive advantage enjoyed by much of American agriculture and we should be able to improve our performance even more. Then you said, if we can keep our export markets open. I wonder if you would elaborate on that, because I detect some concern on that point.

Secretary HARDIN. Yes, I am very glad, Senator Miller, to elaborate on this item.

As you well known, we have enjoyed expanding export opportunities in Japan. We have been able to gain significant concessions from them over the past year and a half. I think there will be more coming. They have, as everyone knows, a very strong expanding economy, a rising level of living, and an increasing need for the types of products that we produce.

Furthermore, they enjoy a favorable balance of trade with us, approximating $1½ billion a year. They enjoy a favorable balance in their trade with many of their other partners. They are accumulating foreign exchange. They recognize that they are in a position in which they are going to buy more; and we, of course, make a plea that they should buy more from their best customer, the United States.

In Europe, we have some rather grave concerns. The European Economic Community, as a unit, is our largest export market. Japan is our largest single-country market. But total exports to the six countries of the Community together are larger than exports to Japan. We have been very much concerned with the current agricultural policy as it has developed in Europe and with the efforts there to combine a social program with a farm program using high internal prices to, in a sense, subsidize very small farmers. This situation has resulted in tremendous surpluses being developed on the Continent, which have over the past few years increasingly been moved into international trade channels, with heavy subsidies behind them, and which have interfered with our markets in third countries—in Japan, in Taiwan.

Senator MILLER. Are you referring primarily to wheat?

Secretary HARDIN. Wheat and barley. Now, because the crops were less this last year, the amount of this activity has been lessened in the past 12 months. But the general policies have not changed. This program is protected by a system of variable levies, which means that any reduction in world prices of feed grains, for example, and they are a large market for feed grains, does not get through to the farmers in Europe. The levies are raised or lowered in response to world prices in order to hold interim prices constant.

We have tried to convince the people in the Community that their farmers and their consumers would all be better off if somehow they can go to a different system. A different system would permit some fluctuation, or at least some decrease, in their internal feed prices, and would promote an expansion of their livestock feeding endeavors, which they very much want and very much need because the domestic demand for meat in Europe is rising. This is especially true in Italy and is becoming increasingly so in France and Germany as the earning ability of the people expands.

We have also been concerned with the special preference agreements that the Community has negotiated with Spain, Morocco, Algiers, and Israel, which we believe are in violation of our rights under the GATT, the General Agreement on Tariffs and Trade. We are protecting these rights. They are now under adjudication, going through the various steps that are necessary.

We have been concerned with a new program announced a few months ago concerning the buying premium for domestic tobacco production, and are protesting this item.

We have also been concerned with the announcement by the British Government that they plan to move some distance in the direction of the Community pattern of import levies and higher internal prices.

In summary statement, then, we will say that our exports to the Community are still large, they are significant. They are not as large as we think they should be and that they can be. We have indicated to the Community that we do have a comparative advantage in the production of several of these commodities, especially feed grains. It is not enough for us just to maintain our level of sales to them, but we regard this as a growth industry for export and a growing area for contribution to balance of payments, the same as they look on cars with engines in the rear from Germany, or Scotch whisky from Britain, or machine parts or other products from other parts of the Community.

Senator MILLER. What you are really saying, in summary, from the way it sounds to me, is that when you say if we can keep export markets open, you are implying that if protectionism and protectionist measures do not grow in such areas as the Common Market—isn't that about it?

Secretary HARDIN. That is right. It is the policy of this administration to do everything it can to develop an atmosphere of liberal trade in the world, recognizing that this has to be a two-way proposition. Being liberal can't just be one way; there is no future in it. And we are hopeful that we can develop this kind of atmosphere, and we always recognize—it is the first premise of trade—that it does not take place unless it benefits both parties. So, what we are proposing is that it be beneficial for our trading partner as well as us.

Senator MILLER. Thank you, Mr. Secretary.

Chairman PROXMIRE. Senator Bentsen.

Senator BENTSEN. Mr. Secretary, we have the sugar contract up for renewal this year. As I recall it, it has two major components—one, the subsidy for the local producer, and the other, the requirement for the purchase of sugar at some 7 cents a pound, which is about 2½ cents above our domestic price. Now, the act says that it is to help our local production, to help our export, and to provide fair prices to consumers, in effect. Since about 45 percent of our sugar consumption is imported, this would result in something in excess of a $200 million foreign aid program. I wonder about the justification of it.

Secretary HARDIN. I am not sure that I am the one to attempt to defend the sugar law. It has been in effect now for some years.

The facts of the report, I think, are true, with the possible exception, I believe, of the fact that by statute something like 55 percent shall be produced domestically and 45 percent imported. This gets adjusted a bit with the Puerto Rican quota, and so on. But it has been the policy of this country to maintain a subsidy above world prices to some 20 countries from whom we buy sugar. I guess historically that this arises out of the concern that we have had in times of war, going back to World War II and World War I, when there was an extreme shortage in this country and there was need for domestic production. If you go back through history, I think you will find that that is how this program evolved through the years.

We do have a very sizable sugar industry, covering almost every State in the Union, including Hawaii and Puerto Rico, that is a stable source of supply. I think that is about all I can contribute, Senator.

Senator BENTSEN. Can you tell me what the administration will propose this year in this regard?

Secretary HARDIN. The administration's position with respect to the Sugar Act has not yet been prepared.

Senator BENTSEN. Mr. Secretary, I would like to touch on one other question, then.

The objectives of the feed grain program, as I understand them, are to maintain farm income, stabilize grain prices, and divert land for conservation purposes. Yet, I know that the General Accounting Office, in their study in January of this year, said—on the basis of sampling some 14 counties in six States—that payments for the diversion of land to conservation purposes were not being met; that instead, you had payments that were being diverted, that land was being diverted, in fact to use for residential and construction purposes, for firing ranges, for the selling of top soil, and for garbage dumps. Sampling just these 14 counties that were examined, you had a diverting of payments in just those 14 counties of $708,000. Now, for the commitments that the Department has made to conservation purposes, what steps are being made or taken to try to stop this?

Secretary HARDIN. Yes, this is a program that has apparently been going on, and most of these items that you mentioned go back to the beginning of the 1965 farm program, when these payments began. We have referred to this category of land colloquially in the Department as "junk land," land that really isn't available for agriculture anyhow and should not be converted for these acres. That is the reason that in our new set of regulations, we proposed that no land should be available for the conversion of diverted acres unless it had been farmed in the past 3 years. I think this is still a good policy, except that, as so often happens with Federal programs, it affects some communities differently than others. We did find a great variation, involving some of your constituents, sir. It was having an unfortunate, differential, bad effect on some of the farmers who had put land in permanent pasture, and that was going to put them in a position where they were going to have to plow some of it up. Some of it had been put in with Government help through the years as part of the Great Plains program, the Dust Bowl elimination program, and so on. This seemed a mistake. That is why we set that regulation aside.

In the meantime, we have instructed State and county committees to make a special effort to locate any of these lands that, by any definition, are not agricultural lands and to eliminate them from the diverted acre program. That effort is underway now.

Senator BENTSEN. Thank you, Mr. Secretary.

Chairman PROXMIRE. Senator Pearson.

Senator PEARSON. Mr. Secretary, because the market price of wheat snd soybeans and feed grains relates so much to export, I would like to ask you to continue to amplify the line of questioning by Senator Miller as to export prospects to Great Britain if she should come into the Common Market, and also in relation to the prospect of exporting to the Communist bloc nations. I am new on this committee, but the staff memorandum indicates that there was some testimony a few months ago by several witnesses testifying as to the advisability of expanding our trade with Communist bloc nations.

Secretary HARDIN. First, Senator Pearson, on the matter of trading with Communist bloc nations, there is some trading going on with the Eastern European countries—Rumania, Yugoslavia, Poland, and so on. It is our judgment that there will continue to be opportunities for some trade, but that it will not be a large volume of trade. For one reason, they simply do not have the foreign exchange. So we are again going to continue to sell them the products that they are willing to buy, but we do not anticipate large future expansion to Eastern Europe.

At this moment, the proposals by the British to raise their import levies or establish a system of import levies would not bring their prices above the world prices for feed grains or for wheat, simply because world prices are higher than they were last year. But if these levies were imposed at a time when world prices were at last years' levels, then it would mean that there would be a deterrent to the quantity that we would sell to the British. And this is the reason that we are expressing concern; we think it is the wrong direction for them to go.

I do not know how to add any more to it. Britain is a very, very important market for this country. We are continuing in close negotiation with the British because what they have proposed, we believe, is in violation of trading rights that we negotiated under the GATT that become effective again on July 1 when the international grains arrangement expires. We are taking every step that we know how to take to try to insure that those rights will be maintained and that they be observed.

Senator PEARSON. Thank you, Mr. Secretary.

Let me ask you this: We hear that the parity formula may be changed, and I guess this is at the direction of the Office of Management and Budget, from the base period of 1910–14 to 1967. Is the parity concept still a useful one? I know that there is some apprehension among the farmers about this. Of course, you have heard a great deal about that.

Secretary HARDIN. Yes, there is apprehension and it is a mistaken apprehension, I think—well, I know. First of all, the computation of parity is directed by statute to a 1910–14 base. We will continue to compute this. The new wheat program is tied to this concept of parity. So there is no change contemplated or advocated.

However, the Office of Management and Budget has directed that all current indexes of economic conditions be reported on a 1967 base. So we are also reporting the ratio of prices paid to prices received on that basis. This is so that data governmentwide and nationwide can be compared more easily.

Senator PEARSON. So you will compute it both ways?

Secretary HARDIN. Both ways.

Senator PEARSON. Well, I was very interested in your comments about rural revitalization and I am a little bit concerned about it. I recall that in the first days of your administration, we had some hearings in the Finance Committee about the Rural Job Development Act and at that time, the administration had a pretty rigid policy against tax credits. Your Department did not take a position on that legislation. The President later appointed a Commission and they have written a very fine report. I believe we have gotten some ideas from that and put in some more legislation. I know the President in his state of the Union message last year talked about population balance, and for the first time, I think, that any President has addressed himself to this subject. And I understand that Secretary Stans last year had something to say favorably about tax credits for rural revitalization and you have had a very high level committee working—I think you made reference to the domestic council—about some sort of program in this field. Yet we do not have a program.

Then, I do not know how reliable it is, but U.S. News and World Report about 6 or 9 months ago had a short article that said that really, the practical problem of stopping the great migration from the rural to the urban areas was just something that was really not quite doable and that the administration may have abandoned its attempt to come forward with a real solid program in this particular field.

With that rambling sort of question, I wonder if you could comment generally on what you are doing. Are we going to have a program, is it something we ought to give up on, or can we do something about it?

Secretary HARDIN. Senator Pearson, I am very pleased to respond to this series of comments.

First of all, I doubt if we will ever have something that we can call a rural development program—something that is a single item of appropriation that you can talk about.

I would rather think of rural development as a process, a process that is going on and is going on increasingly, with increased attention from various Federal agencies. As an example, in the agricultural budget in the 1971 fiscal year, compared with fiscal 1969, there is more than a billion-dollar increase in expenditures in the rural development area. Most of that, however, is for farm and rural housing, but some of it is for water systems, sewer systems for these smaller municipalities across rural America. We estimate that there are currently 44,000 communities that do not have central sewage systems and 30,000 or more that do not have central water systems. We have helped over the past few years something on the order of 10,000 communities with one or the other of those types of installations, mostly through loans and grants. This program, I think, will expand.

There have been activities in other parts of the Government; other agencies are involved—the Economic Development Administration, for one—and in housing and urban development, there have been other activities in the rural parts of the country.

I think if you will look at the record closely you will find that over the past 2 years there has been a considerable increase in activity of these types of programs generally in response to requests and initiatives of local communities and States.

I think it was significant that the President, in his revenue-sharing program, made one of the six major categories of special revenue-sharing rural development. And this, of course, was done deliberately and for a purpose, and is in recognition of the set of facts that you have just described.

Without question, it is still the belief of this administration that we can over the next years bring about a reversal of the migration from rural areas to the urban centers and create a countermigration. What this means, we are convinced, and I know you agree with it, is that this will not happen unless job opportunities, good job opportunities, are created in increasing numbers and in growing numbers of places across middle America and the South and the other sparsely populated areas.

But I, as I mentioned in my testimony, am really encouraged because the 1970 census data show that even in these States that have lost population, your and my farmer States, there are communities that are growing just as fast as metropolitan areas. So behind the averages, the reverse trend has really begun. What we have to do is to create a set of conditions that will encourage more of these communities to become growing centers. And we have discussed this much with corporate industry, firms that are in position to locate in these communities and build additional plants. We are getting a very good response in picking smaller cities and towns across this group of States for the location of industrial plants. Industrial firms that have done so already in general have had a good experience and they are receptive to looking at other possibilities during the decade of the 1970's.

Senator PEARSON. Thank you, Mr. Secretary. My time is up and I am going to submit a question to you about the President's Reorganization Plan as it affects the Department of Agriculture. I hope you would submit that for the record.

I thank you.

Chairman PROXMIRE. Congressman Brown.

Representative BROWN. Mr. Secretary, yesterday, when we had Secretary Romney before us, he pointed out a number of areas with respect to housing which were critical in the adequate development of low-cost housing. He suggested that this included the cost of land, the cost of money or the availability of money, the availability of land, labor practices, labor supply for construction, zoning code regulation, and so forth. I suggested to the Secretary at that time that in rural areas, and in many cases, rural areas not very far removed from metropolitan centers, that he might find the advantages he was seeking with reference to housing because in such rural areas and rural community centers, small towns and small cities, land tends to be cheaper; there is more of it; there are less restrictive labor practices and more labor sophisticated in building trades, if not sophisticated at least experienced; perhaps more money available in small community banks at cheaper interest rates. At least this has been my observation in my congressional district, which encompasses everything from agricultural area to metropolitan area—and less restrictive code and zoning regulations in rural communities and rural cities, certainly in rural areas. Transportation now has opened these rural towns and cities which would provide the core areas for housing expansion to the extent that I think both he and you should look more aggressively into this possible development. Would you concur in that assessment of the situation?

Secretary HARDIN. Yes; I am not familiar with all the details. I did not hear Secretary Romney's statement. But I have discussed this very issue with him in recent weeks. We are agreed that as part of the total effort to increase the number of housing starts in the next calendar year, there are great opportunities in the rural part of the country outside the metropolitan centers in both areas you described—around the cities, but also in the smaller cities and towns. This is one of the reasons that we have in the past 2 weeks been able to add or restore to our Farmers Home Administration housing program in excess of a half million dollars to be spent between now and July 1 in loan funds to further encourage rural housing. I would hope that this could be further increased next year, but that remains with the appropriations.

Representative BROWN. I am not sure what the definition of rural housing is, but my own home community is a community of about 12,000 people, about 40 minutes and a comparable number of miles from a metropolitan center. The reason for the two figures being about the same is because interstate highways are now serving the area pretty generally. It has been my observation that every time there is any kind of housing development it is snapped up very quickly and it is not the local community, it is people coming back to the local area or to the small community area some distance from a metropolitan center. I think there is in the more heavily populated parts of the country this opportunity to restore the rural area.

Secretary HARDIN. We would not be involved in your city because until very recently, by statute, we were limited to towns of 5,500 population. Now I think that has been increased to 12,000. We are just in the process of getting the new program off the ground.

Representative BROWN. Well, whether it is you or Secretary Romney, I am interested and pleased that you are both cognizant of the situation and aggressively concerned about it.

I would like to move into the proposed reorganization plan of the President for departmental reorganization with a couple of observations and questions to you in that area.

Given the kind of community which I described, which is surrounded by a substantial agricultural area where the Extension Service has been very active, I would like to commend the President's reorganization plan for your consideration and ask for your reaction to it, in this regard: It seems to me that the Extension Service has been very effective in rural areas in teaching people in rural communities or on the farm how to stretch their dollar through homemaking arts, how to make the most out of resources they may have on their farm or both in agriculture and nonagricultural ways. In my area, at least, they are moving somewhat more aggressively into the small cities with an effort to help the purely city dweller who in some areas, may live in ghetto conditions, and have done so with some success, perhaps even more success than some of the programs aimed at those city center dwellers who are at poverty level. Now, I would like to suggest that this reorganization plan might use the advantage of the Extension Service's administrative ability in this kind of training for people who have worked directly with ghetto poverty problems. Because, I think, they have done an excellent job in the rural area. The parity ratio mentioned a moment ago, I think, ought to be updated because it does not take into account the fact that many rural people are better at stretching their inflated dollars than are many city people.

Would you care to comment? Would you care to comment on that feeling about the Extension Service working in the ghetto centers?

Secretary HARDIN. Yes. Of course, I think this program you refer to is the program that has been developed principally over the last 2 years. It was initiated in late 1968, but actually put into effect in 1969 and 1970. It is a program for which the Extension Service has taken the responsibility for training now 7,000 nutrition aides, about half of whom are working in the cities and most often in the inner city. These aides are calling on households and teaching them food budgeting and food preparation, and are helping with a number of household problems, generally involving food and economics.

I think it is significant that a large portion of these nutrition aides are people who did not finish high school; some of them did not attend high school. Some of whom were on welfare at the time they were employed, but they have been really unusually successful in teaching people to make better use of resources that they do have.

You are quite right that this is using some of the techniques that have been developed in the farm areas of the country through the decades by the Extension Service, and taking this group of people with intensive training and using this technique in the cities. It is successful enough that we think that it should be looked at—I think this is the point you are getting to—for training of other types of persons to accomplish other tasks.

Representative BROWN. In the organization plan in which the President proposed it, it is my understanding that that kind of Extension Service activity which deals with human resources primarily but also collaterally with the natural resources of our society would go into the human resources department, and the Extension activities dealing with the natural resources would remain in the natural resource area. Is that correct?

Secretary HARDIN. I do not think that has actually been worked out in detail. First of all, we have to realize that the executive program is largely a State program, with Federal financing a part of it. It is also a part of the President's proposal that the Extension funds, Federal Extension funds, be a part of the package, which would make these decisions the direct responsibility of the State government.

Representative BROWN. Well, I would like to commend that thought to you, because I do think it is a very appropriate kind of division of responsibility. It seems to me that your effort in the land-use activity also is a divisible kind of effort into the resources area that deals with the natural resources, the land, and the resource use that deals with human resources and how those of us who have different uses for the land other than agriculture might benefit from the proper allocation of land use.

Secretary HARDIN. Right.

Representative BROWN. Similarly, the industrial and other non-agricultural development efforts, with reference to finding employment for those people who are either not interested or not economically able to get into the agricultural activities—that also, it seems to me, is a visible effort.

You mentioned in your conversation with Mr. Pearson the difficulty of East-West trade because of the unacceptable currency situation, the lack of hard currencies, and the difficulties of exchange in that regard. Yesterday, when we had Mr. Stans before us, he said the East-West market is growing fast. Merchandise trade with Eastern Europe has been expanding at the rate of 15 percent a year. Last year, we estimated that the industrial West sold over $8 billion worth of goods to Eastern Europe, including the Soviet Union, but excluding Yugoslavia, about $350 million of which came from the United States. This is a market where American goods are needed and wanted and one that we are ideally suited to satisfy.

It occurs to me that Western Europe, apparently, if they have the bulk of that $8 billion, has either made some accommodation with reference to the Eastern bloc currencies or, what is more likely, perhaps, the Eastern bloc has been willing to deal with Western Europe on a hard-currency basis.

Now, I am under the impression that while they may not use the hard currencies, the Communist nations do in certain instances have the hard currencies available for trade in commodities in which they are seriously interested. Can you square this with your comment to Senator Pearson about the market exchange?

Secretary HARDIN. I was speaking primarily of agricultural market potential. We, of course, intend to respond and encourage all the sales we can make to this group of countries. I was merely saying that in my judgment, because of a scarcity of foreign exchange and the very high demand or pressure that they have on their own priority system for industrial goods—I did not add that in my previous comment—that I did not foresee any huge increase in our agricultural exports to those countries.

Representative BROWN. That clarifies it, I think. In other words, what you are saying is that the Eastern bloc nations are more interested in industrial goods and are willing to yield up hard currencies in order to get basic industrial goods, but are not willing to yield up hard currencies to get agricultural goods?

Secretary HARDIN. Yes. There has been some exception to this in Romania in the past year. As a result of the flood, the food supply of the people was severely shortened. They have elected to buy much larger quantities of food from outside areas, including the United States, in the past 12 months as a result of that than they would have before. They had programed moneys for industrial purchases which they then converted to feed and food items in the emergency. I think that demonstrates their priority system quite well.

Representative BROWN. Mr. Chairman, I would like to ask for the opportunity to submit some written questions with reference to corn blight and farm productivity and development of hard-wheat markets.

Chairman PROXMIRE. By all means. I would ask the Secretary to answer them for the record when he corrects his remarks.

Secretary HARDIN. We would be happy to do so, Mr. Chairman.

Chairman PROXMIRE. Congressman Widnall.

Representative WIDNALL. Thank you, Mr. Chairman.

Mr. Secretary, at a time when inflation is something that we are all mindful of and fearful of, we did seem to be making some progress. Then a most discouraging barometer has shown just in the last couple of days a marked increase in wholesale prices of food. Now, to what do you attribute this when the farmers' income continues to go down?

Secretary HARDIN. To the extent that there has been an increase in retail or wholesale prices of food, it has been principally the result of widening marketing margins, a major component of which are labor and wage costs. As these advanced, they have had a very definite influence on marketing margins. Earlier I also referred to the pricing policies of some of the food companies, and in my exchange with Senator Miller expressed the hope that we could convince the retail firms in particular to so structure their pricing techniques and policies that they could be more responsive timewise to drops or changes in the farm price or wholesale price of food items.

Representative WIDNALL. Well, it seems perfectly obvious to me in shopping, and I do do quite a bit of shopping for my own family, that the retail prices are subject to all kinds of manipulation, while farm prices are not. Definitely, the farmer is still unorganized as against every other segment of the industry and the economy where they can actually, by economic blackmail, force increases to themselves; and the farmer can't do that.

Secretary HARDIN. There is no question about it.

Representative WIDNALL. What do you think is the answer to that?

Secretary HARDIN. Well, you have described the situation that has existed for many years and continues to exist. The farmer generally sells his product in a competitive market. He buys his supplies for both farming purposes and for his family's needs on a market that he has no control over, so that if there is a change in retail demand, the marketing margins tend to remain stable. If there is a drop in retail price, it tends to be all passed back to the farmer because of the free market situation under which he sells. It is a situation that has existed; it does put the farmer, in a period of changing price levels like we have now, in a very disadvantageous position, at the whip end of the economic process. In a few commodities, the farmers have been able to band together and improve their situation through bargaining and the use of contracts. In other instances, especially crops, the market orders as administered by the Department of Agriculture have been useful in protecting the farmer in this economic situation in which he finds himself.

Representative WIDNALL. Is not Government helping to force a lot of this by spending hundreds of millions of dollars on bringing new land into production that does not have the natural chemicals in it that existing farmland has, that creates a concentration in one or two States of the mass growing of vegetables and the elimination of many other sources, that means that the transportation of that food to the market is going to become much more expensive in the end and you will have monopolies in just a few States? If anything goes wrong weatherwise, we have nothing to fall back on.

Now, I deplore what is happening in New Jersey. There is some of the richest farmland in the United States that does not need all kinds of sweetness put in by way of chemicals in order to grow vegetables being lost for housing, for industry, and other things. And the water table is going down in the State because of the drain on the water. That is creating a lot of problems, too. It seems to me that we are very shortsighted if we allow these pockets throughout the United States of grade A farmland to be abandoned for farming purposes and then spend hundreds of millions to try to bring into production sour land and land that is really not fit for agriculture.

Secretary HARDIN. I agree with you that we need to give more attention to land use, and I hope that as we develop a national land use policy and the individual States develop land use programs in the next few years, increased attention will be given to it. Our grade A agricultural land, as you point out, is definitely limited in this country. I suppose it would be fair to say that there are situations in which we would have little choice.

I think of Des Moines, Iowa, Senator Miller, which is going to grow. If it grows in any direction, it is going to use some grade A agricultural land, because that is all that is there. When you put in an interstate highway between Des Moines and Omaha, which has been done, there is no way you can route that highway that will not use up some grade A agricultural land.

But there are situations in which there are choices. The location of a nuclear powerplant would be a case in point. It might well be that the cheapest place to locate such a plant would be on grade A land because of the level grade and other factors. But it might not be in the best interest, in the long run, of the Nation for that kind of facility to use up grade A land.

I would hope that as the States develop their land use plans, and as your State does, they would make choices around some of the expanding urban communities where choices are possible; move the city into the less desirable agricultural lands, where it is possible; and try to save the grade A lands for future food production, which I am convinced we will need somewhere in the future of this country.

Representative WIDNALL. I have seen a lot of excellent vegetables grown in New Jersey during my lifetime. We used to grow some of the highest grade cantaloupe, asparagus, and also we had a tremendous number of fruit trees that had excellent fruit. This has been going down almost to the minus point, while we see vegetables coming into the market that are marked Mexico, Spain, foreign countries, but not the United States. Actually, they are not as good quality as we used to have fresh from the natural resources within that State.

I think on some of our programs, we seem to be spending millions to encourage the development and growth of production in areas that are not natural for that growth, while we concentrate on the things that mean something immediately in cash to people who want to develop. Some of the problems, I think, with the heartland and the cities is the fact that they not only have the people of nonfarm areas bidding for what they consider are better paying jobs, they create the complexities of the transportation that we have, the tremendous need for the roads in between, and there are some people who are beginning to realize that they may make a little less out in the farm areas, but it is a darned sight healthier place to live, the air is better, and everything else about it. I think we have to start concentrating on proving to the American people that it is wiser for them and better for them if they will live out in some of those areas rather than the great cities.

This is no plea against the great cities. They have tremendous problems and we all have to share in solving them. But I hope that as government continues to be involved more and more in all of these things, they will wisely do the planning and just do not take out of production some of the best lands in the United States.

Thank you.

Secretary HARDIN. I share your concern, sir.

Chairman PROXMIRE. Senator Javits.

Senator JAVITS. Thank you.

Mr. Secretary, first, I express my pleasure at your being here and our association with you. There are a few things I would like to ask you about. If I do not finish, as I must be on the floor in about 10 minutes, would you be good enough to answer the questions which I will submit in writing for the record?

Secretary HARDIN. I will be very happy to, Senator.

Senator JAVITS. Mr. Secretary, I am attracted by your statement, in which you say that combining the decline and stagnation of large areas and the growth and vitality of nearby centers in a manner that is mutually supportive—you consider to be a major challenge because you point out that half of the farm, rural peoples' income is coming from nonfarm sources. Now, yesterday, the chairman of the Chase Manhattan Bank, David Rockefeller, suggested that American business could make available $10 billion credit for the development of over a hundred new cities in this country. They would be located in rural areas and they go to the point which was just made, that you do not like to see good agricultural land preempted for city purposes. Obviously, it would take a lot more land than an atomic power plant that we are talking about.

Do you consider both those goals reconcilable? In other words, do you think that on the basis of 30-year planning, which is what we ought to be doing, the United States should now want to do its utmost for the cities?

And incidentally, I would like to point out that you can put a new city in a city. For example, we are now developing in Staten Island, N. Y., which is one of the five counties of New York City, a new city, because there is a lot of vacant land there. In addition, you could put a new city in Harlem or in Bedford-Stuyvesant or in the south Bronx. You have all the utility and all the streets and all the fire departments and you might just as well bulldoze the rest of the town for all it's worth, and you could put a new city there.

So leave that aside as to the possibility of new cities and existing cities, but go to the concept of leapfrogging the problem of the big cities with new cities in rural areas, which would have an economic impact which you described yourself, a social impact which you described, but would take agricultural land. Now, give us your view on that. If you do not feel you can answer it now, this is important enough so you can, with the Chair's permission, write us a paper on it. I think it is critical what is the answer to this question.

Secretary HARDIN. I would not be as concerned with the conflicts there. I think the quantities of land involved would not be large for just an expansion of the smaller cities and towns. This is something that I think we would want to encourage. But I would make a plea that beyond that point, in locating roads and special facilities—airports and so forth—we look at the choices between grade A and low grade land. But I think we will just have to recognize that for the next few decades, cities will have to expand where they are or towns will have to expand where they are because of the economic conditions that make it possible. I would not regard that as an area in which we would have conflict.

Senator JAVITS. Mr. Secretary, I think it would still be useful, with the permission of the Chair, if you will give us a critique on the David Rockefeller proposal of new communities in the United States. Will you do that?

Secretary HARDIN. I will be very glad to do so. In fact, I have not heard about it.

(The following was subsequently supplied for the record:)

NEW TOWNS

The concept of new towns has long appealed to Western man. Starting anew is often seen as the happiest way of avoiding past mistakes. And the idea of towns and communities planned to match the terrain; built in stages to ensure necessary transportation, communication, and other public facilities; and with careful attention to architectural and aesthetic considerations is as exciting today as it was when L'Enfant planned our capital city. The techniques of building new towns are mostly untried and deserve testing. To this end, the concept of linking private and public capital would appear to have merit.

But it is necessary to sound a note of caution regarding new towns and new communities. As Mr. Rockefeller observes, we cannot ignore present rural and urban problems in our efforts to build new towns. New towns propose happy alternatives for some future problems, but only limited assistance for others. One hundred new towns of 100,000 residents each could accomomdate 10 million persons and 10 additional towns with one million residents each would double that figure. Assuming we completed the huge task of building the 110 new towns as envisioned by the National Committee on Urban Growth by the end of the Century, they would accommodate less than ⅓ of the anticipated population increase—around 20 million of the 75 million expected.

Certainly a well planned environment for 20 million Americans is a worthy goal, but in perspective, the achievement of such a goal would solve but a small part of our rural and urban development problem. My note of caution is that we must maintain the appropriate perspective.

I would rather think of new towns as a complement to the core effort of rebuilding our cities and rural areas—as but one of several approaches in the context of Mr. Rockfeller's discussion. These efforts will focus on the task of building jobs and housing and helping people organize to provide better community services throughout rural and urban America. Mr. Rockfeller says our towns and cities show their "piecemeal" origins and that is true. But few towns and cities in this country are stagnant. Most are growing but some are declining. The myriad difficulties involved in these processes is the framework for our approach to these problems. The new towns concept is one complementary part of this approach and this perspective.

Senator JAVITS. He made the speech—I put it in the Congressional Record yesterday. My reason for saying it is so significant is because if they can find $10 billion to leapfrog the big cities, why can't they find another $10 billion to do something for the big cities and make it $20 billion and really take us from now until the end of the century, instead of leapfrogging the next 10 years?

Secretary HARDIN. Well, of course, we are going to need both of these developments, as you imply. If we are magnificently successful in developing new growing points throughout rural America, in my judgment, we cannot do enough to take care of all of the increase in population. The major metropolitan centers are going to continue to grow. What we would hope to accomplish is to remove some of the pressures so they do not have to grow as much.

Senator JAVITS. Then I am very interested in what Bill Widnall said about the good life. I thoroughly agree with him. We are beginning to learn that the good life is just as important as survival.

Now, my other point relates to exports and imports, Mr. Secretary. I am very impressed with export and import figures. I do not want to entrap you in any position against the administration's policy in trade. But I would greatly appreciate any comment you could make on what you would consider to be the impact on agricultural exports should we adopt a quota policy in major items of trade. We're talking now about textiles, apparel and shoes.

I think it is very important for every element of the economy to explain the significance to it of such policy.

Secretary HARDIN. I will be very glad to do that, Senator Javits. I will be glad to discuss it now or put it in the record as you desire.

Senator JAVITS. Well, I think if you said a word about it and them amplify it for the record.

Secretary HARDIN. I did develop this position rather completely for one of the House committees a few weeks ago when the Mills bill was under discussion, so it is prepared. In that presentation, we did express great concern with what the effect would be on international trade of a system of rigid import quotas and what the effect upon agricultural trade might be in terms of inviting retaliation from other countries.

Senator JAVITS. Will you furnish that for the record?

Secretary HARDIN. I will be pleased to.

(The following was subsequently supplied for the record:)

Mr. Chairman, I had expected to talk with you today mainly about our agricultural export situation—the current situation and the year ahead. I had assumed that we would be considering a trade bill proposal that would include repeal of the American Selling Price (ASP), the Mills Textile provisions, as amended, and some further strengthening of the escape clause. But I find that the trade bill proposal now before us is much different. I understand that the ASP provision has been eliminated; that shoes have been added to the textile provisions, and finally, that quantitative guidelines for applying quotas have been added.

I realize that we have a special problem with textiles which must be dealt with and hopefully this can be done in a manner that will not provoke retaliation. But now I am concerned. I think there is now no question that our agricultural exports would suffer severe retaliation from our major trading partners as a result of these added provisions.

We must all recognize, also, that the European Community has been looking for an excuse to restrict our soybean trade. If this bill passes, I am afraid we will have given them the excuse they need to take such action. Our trade with them in soybeans and products is now running $500 million plus annually. Their trade with us in shoes and textiles is running at about the same figure. They will certainly tell us that if we choose to solve our problems in this way, they will have no choice but to solve their own political problem in similar fashion. And I must tell you that I honestly believe this bill will give them the excuse to take the action they have been wanting to take ever since I have been in office.

The Japanese are the fastest growing export market for our farm products. Our sales to them of agricultural products will reach a record level this year of $1.1 billion. Included in these totals are products from most of our agricultural states. In textiles and shoes, the Japanese sell us $577 million annually. I think there is no question that they will find it necessary to restrict their imports of our farm exports for what they consider unnecessary restrictive action on our part. And they have ways to do this which may be difficult to detect. The Government of Japan controls imports of wheat and tobacco. They could very easily turn to other sources of supply, claiming for example, that they are disenchanted with the quality that we offer. And I have heard it whispered that they might decide that they have been buying too much American cotton. Unfortunately there are other sources of supply for Upland cotton.

I must say that the provision for use of quantitative guidelines in the quotas is an example which can be easily duplicated by other countries. We have markets in the world where we are supplying more than 15 percent of consumption and we have markets where our exports have grown more than 15 percent a year. If we are going to introduce this concept into our system, we must expect others to do the same thing. There is no magic about 15 percent. Others could decide that an even lower percentage could meet the test of the disruption.

Without any question, if the Community had this provision in its system it would have acted against our soybeans and products already. I would suspect that our exports of tobacco and lemons to Japan could also qualify for protection.

Our agricultural exports have turned upward this past fiscal year. They will total almost $1 billion more than the previous year, and our commercial exports reached the highest level ever. But I cannot foresee the same favorable situation continuing because we are telling our principal customers that we are about to embark on a new wave of protectionism in the United States—one which has the most serious consequences—not only for our agricultural trade, but for our entire trade policy.

Senator JAVITS. My last question, Mr. Chairman.

I hope that you can make any observation that you wish or furnish for the record what has happened with respect to the food stamp and food distribution policy? A previous Secretary of Agriculture sat in the very chair you are in, named Freeman, and I had a terrific row with him about hunger in America a few years ago. I think our situation has very materially improved. I deeply believe that some summing up of what has taken place could be very valuable as coming from you. So if you would be good enough to do that.

Secretary HARDIN. Yes, sir.

(The following was subsequently supplied for the record:)

The following table is a month-by-month summary of the number of needy people getting food stamps and USDA donated foods, together with dollar value of "bonus" food stamps issued.

Month	Participation		Bonus stamps
	Food stamps	Commodities	
1968: December	2,821,867	3,659,804	$18,401,237
1969:			
January	2,869,435	3,816,718	18,577,612
February	3,019,638	3,789,438	20,671,629
March	3,179,070	3,773,389	21,637,288
April	3,205,013	3,713,592	21,596,242
May	3,192,781	3,662,415	21,082,171
June	3,224,233	3,538,537	21,586,225
July	3,317,469	3,521,194	22,399,334
August	3,343,806	3,533,285	22,308,989
September	3,417,660	3,563,731	23,133,480
October	3,447,246	3,579,445	22,960,044
November	3,490,645	3,634,871	23,331,192
December	3,645,202	3,724,179	24,604,685
1970:			
January	3,795,455	3,916,821	26,873,101
February	4,416,450	4,038,310	54,856,541
March	5,074,560	4,069,030	70,794,057
April	5,629,377	4,128,885	80,302,489
May	6,070,248	4,038,442	86,493,273
June	6,469,946	3,977,342	91,591,972
July	6,947,599	3,822,922	98,098,155
August	7,171,290	3,850,966	100,234,744
September	8,200,000	3,500,000	117,000,000
October	8,800,000	3,500,000	120,800,000
November	9,300,000	3,600,000	124,600,000
December	9,500,000	3,700,000	128,500,000

Senator JAVITS. Finally, if you will also be good enough, because some of us in the cities worry about agricultural programs which involve heavy subsidation, if you could sketch any major changes that have occurred in the farm situation which you can trace to the Agricultural Adjustment Act of 1970, that would be helpful to me.

Secretary HARDIN. Yes, sir, just bear in mind, if I may say this much at this point, that the Agricultural Act of 1970 is just now going into effect for the first time, with the 1971 crop. Any changes that will occur as a result of that are in the future. So far, up until right now, we have been working under the 1965 act.

Senator JAVITS. How long will it take us to get some evidence of the experience with the 1970 act?

Secretary HARDIN. We really will not have very much prior to the close of harvest in 1971.

Senator JAVITS. Which means the late fall of 1971?

Secretary HARDIN. That is right.

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

Chairman PROXMIRE. Mr. Secretary, I notice that the Department of Agriculture will once again increase the number of employees. It goes up almost 2,000 employees between 1971 and 1972, according to page 532 in the budget. This is most discouraging to me in view of the fact that at Health, Education, and Welfare, for example, the number of employees will diminish at the Office of Economic Opportunity, though the number of employees remain the same. Now, we have fewer farmers, yet every year the number of employees in the Department of Agriculture goes up.

Let me give you a little history on this. In 1952, there were 9 million farmers and we had 64,000 people in the Department of Agriculture responsible for carrying out our Federal functions with respect to farming. In 1972, we are certainly going to have less than four and a half million. The trend is down. We might have 4.2 or 4 million farmers, but we will have 87,000 people in the Department of Agriculture. In ratio, in 1952, we had 140 farmers for every one Department of Agriculture employee and now in 1972, we are going to have 30 farmers for every one employee. When are we going to get to a point where we have more employees in the Department of Agriculture than we have farmers? In this administration, or are we going to have to wait a little while for it?

Secretary HARDIN. That question, of course, has been posed many times and it is a matter of rhetoric, I may say.

Chairman PROXMIRE. No; it is a matter of real concern here.

Secretary HARDIN. Let me answer the question. I am going to answer it now and I would like to have permission to record it in ample form later.

Chairman PROXMIRE. This isn't partisan. This has been going up in every administration.

Secretary HARDIN. The increase proposed here deals mostly with the food programs—food stamp and food distribution programs—which are not a part of the farm program at all. They deal with food, but they deal with the distribution of food to urban consumers. A part of it is in the regulatory area for meat and poultry inspection, where, as a result of congressional action, the Federal responsibility in meat and poultry inspection has been greatly increased and there has been no choice but to simply put on more inspectors to carry out the direction of the bill. I will put this in the record so you can see it, and differentiate these special programs from the agricultural programs themselves.

(The following was subsequently supplied for the record:)

The employment data referred to by Senator Proxmire is based on the table on page 532 of the 1972 budget and relates only to full-time permanent employment. It does not include part-time, temporary and intermittent employment.

The following summary tabulation reflects the total number of full-time employees in permanent positions at the close of the fiscal year. The estimates for 1971 and 1972 are projections since final employment ceilings for the various agencies have not yet been determined. The Department of Agriculture has many responsibilities beyond administration of the farm program, such as the management of more than 180,000,000 acres of national forest lands, inspection of meat and poultry, loans for housing in rural areas (a major portion of which is for non-farmers), loans and grants for water and sewer facilities, and administration of food programs. This summary analysis indicates that the employment in the Agricultural Stabilization and Conservation Service, which is primarily responsible for administration of the farm programs, has been reduced substantially.

As a result of our employment ceilings, total employment dropped in 1969 and 1970. It is expected to increase in 1971 and 1972 principally for inspection of meat and poultry, Forest Service, administration of the food programs, and rural housing and community development loan and grant activities by the Farmers Home Administration.

	1968	1969	1970	Estimated 1971	Estimated 1972
Agricultural Stabilization and Conservation Service	4,198	4,130	4,018	4,045	4,045
Forest Service	22,109	21,530	20,914	21,230	21,800
Meat and poultry inspection	7,293	7,509	7,779	8,550	9,750
Food and Nutrition Service (administration of food programs)	1,428	1,469	1,684	2,050	2,050
Farmers Home Administration	6,641	6,539	6,879	7,715	7,700
Soil Conservation Service	15,410	14,874	14,497	14,465	14,465
Agricultural Research Service (including plant and animal disease and pest control)	14,750	14,143	13,858	13,775	13,790
All other programs (including Extension, Statistical Reporting Service, Economic Research Service, Foreign Agricultural Service, Crop insurance and REA)	13,568	13,231	13,283	13,770	13,700
Total	85,397	83,425	82,912	85,600	87,300

Chairman PROXMIRE. What would happen, Mr. Secretary, if the Congress should set a ceiling and say that you had to cut back 10 percent of your employees?

Secretary HARDIN. They have done that, sir.

Chairman PROXMIRE. What would happen if we did it this year? What would be the consequence? Do you have low priority programs which you could ration in such a way that you wouldn't have a devastating effect on farm income? Or would it be, in your judgment, seriously adverse to farm income?

Secretary HARDIN. I think that a further sharp cut could have adverse effects. However, I am not going to sit here and say that some cuts can't be made because we are making some.

Chairman PROXMIRE. Having seen that table, it is most discouraging, as you look at the table and see fewer farmers and far more people in the Department of Agriculture.

Secretary HARDIN. It is a case where, again, sometimes there are facts other than you see in looking at just the total figures.

Chairman PROXMIRE. Why was the special milk program left out of the budget?

Secretary HARDIN. Are you referring to the 1972 budget?

Chairman PROXMIRE. The school milk program, yes, sir.

Secretary HARDIN. This is because the administration feels rather strongly that we should concentrate the resources that we have available to do the utmost for the needy children and not just subsidize all of the children, many of whom have adequate means of their own. The school special milk program is made available to all youngsters regardless of their economic status. We would like to put those resources into a special program for needy youngsters. I am currently visiting with some of the dairy people themselves to see if there is not some way that this program can be redesigned to focus on needy youngsters.

Chairman PROXMIRE. The fact is that this program at the present time does provide a full subsidy for needy youngsters in school milk. They get their milk without charge. The fact is further that it is false economy to eliminate the program because if you do not provide this milk to the schoolchildren, it means that under the price support program, as long as we have the present supply and demand situation, you are going to have to buy the milk, store it, buy it in the form of cheese and store it. The net saving, as we calculate it, for this $103 or $104 million program is only about $14 million by abolishing it. When you consider the dietary benefit to literally millions and millions of children, it is hard to say that simply because a child is not in the poverty class, he gets a balanced diet—all these dietitians tell us the opposite.

For these reasons, why does not the administration recognize that as long as you have a price support program, this is a good supplement?

Secretary HARDIN. What you say about the price support program, the offset, is absolutely true. There is an offset—not a complete one—but there is an offset. We would get the same offset if we could concentrate it for the needy youngsters.

Chairman PROXMIRE. As I say, the needy youngsters get it under the special program their milk. I don't see any conflict or contradiction. What I am saying is in addition to the milk provided for those who are in a poverty category, if you provide it for others, too, you move milk from costly storage into the stomachs of children who could use it.

Secretary HARDIN. If we assume Federal dollars are unlimited, what you say is virtually true.

Chairman PROXMIRE. I certainly don't make that assumption, but I would assume this is a priority program that could be helped.

Let me ask you this: With respect to the dairy import situation, recently a Presidential proclamation under section 22 set dairy import levels on certain products substantially higher than the levels recommended by the Tariff Commission. What is the current impact of imports on the dairy price support program?

Secretary HARDIN. Well, the action that the President took under section 22 dealt with four items, Mr. Chairman. They did vary a bit from the Tariff Commission's recommendations. But the largest item was ice cream or ice cream mix, and I believe that that was reduced approximately 95 percent instead of 100 percent, as recommended by the Tariff Commission. The impact of those imports on dairy programs wil be very small indeed as a result of this action. But there are some other items that are of concern, and I cannot give you the total effect at this sitting. I am thinking particularly of the imports in cheese, that are priced at above 47 cents, where there has been a substantial increase in the past few years, and which is under study at this point.

Also that does have, perhaps indirectly, some impact on price support program.

Chairman PROXMIRE. That is, you are thinking of adjusting the 47 cents upward?

Secretary HARDIN. We are studying it. I am not sure that is the solution.

Chairman PROXMIRE. That would reduce the impact on the program undoubtedly, if you increased the 47 cents.

Secretary HARDIN. That is right, and this is under study. The other item which is not as clear and may not have an impact on the dairy program being studied is the import of lactose made from whey, which I notice you are interested in. Imports have been increased. Our whole production has been increasing very sharply in recent months.

So far, we have not been able to demonstrate a direct connection between that and the dairy price support program, but it is also under study.

Chairman PROXMIRE. Let me ask you, at what rate are dairy imports coming in now?

Secretary HARDIN. Mr. Paarlberg tells me that the present level amounts to about 1.9 billion pounds of milk equivalent.

Chairman PROXMIRE. That is in increase, is that correct, over the last year, or is it about the same?

Secretary HARDIN. It is a little increase. And that is against the total domestic production of approximately 117 billion pounds. So it is in the rank of something above 1 percent.

Chairman PROXMIRE. Do you have any plans to limit imports further through initiating section 22 action?

Secretary HARDIN. Well, as I say, whether it will be section 22 or some other action, we are currently studying the matter of cheese imports and the matter of lactose. I do not know as of today what our recommendations will be.

Chairman PROXMIRE. Now, you were asked briefly—I would like to get into the 1972 budget for revenue sharing for rural community development. How much of that $1 billion is new money?

Secretary HARDIN. May I have just a minute for clarification?

I don't believe this has been tied directly to the 1972 budget; has it, Mr. Chairman?

Chairman PROXMIRE. You see, what I am getting at is whether this is coming from on-going Department of Agriculture programs or whether it is in addition.

Secretary HARDIN. I think it is not tied in specifically with the 1972 budget. But I am going to answer it in this way: There are the items in the rural development program in the special revenue-sharing program—yes, the special revenue sharing program. Isn't it $1 billion for rural development?

Chairman PROXMIRE. That is my understanding.

Secretary HARDIN. All of the items in the special revenue sharing add up to about $10 billion and there is an additional $1 billion recommended over and above the existing programs for all of the six major areas in the present outline. I cannot give you the exact figure that the President has recommended that should apply to the rural development item, but it is a substantial figure of additional funds that are to go along with the billion dollar package for rural development.

Chairman PROXMIRE. I wanted to know how much is being shifted from the former block grant programs. Can you provide that for the record?

Secretary HARDIN. Well, if we take all of the block grant programs together, they add up to $10 billion. There is $1 billion additional that goes with it.

Chairman PROXMIRE. Oh, this is a supplement. This is all new money then, is that right?

Secretary HARDIN. Yes, on top of the 10.

Chairman PROXMIRE. On top of the——

Secretary HARDIN. The 10. There are three components.

Chairman PROXMIRE. We are talking about something else. The $10 billion, then an additional $1 billion of new money. I am not talking about that. I am talking about the rural development program by itself. I want to know with respect to that particular program whether or not you have reduced part of the program you have had in 1971 so that 1972 could make up for this billion dollars going into the rural community development program. You will have new money, or is this the money you had before?

Secretary HARDIN. Well, both.

Chairman PROXMIRE. Yes, I understand that, but I want to know how much of it was new?

Secretary HARDIN. I think I can supply that for the record.

(The following was subsequently supplied for the record:)

Almost all USDA programs contribute to the economic and social development of rural areas. One of the key features of the Department's rural development programs is the close cooperation and involvement at the State and local level. USDA State Rural Development Committees are working with State and other Federal agencies in all States. There are approximately 9,000 USDA field employees at the State and local level with at least one in practically every county working with rural development programs. Also, over 2,000 manyears of Cooperative Extension Service personnel devoted to community development are jointly provided by USDA, State, and local funds.

The programs specifically oriented toward rural development objectives in FY 1972 involved an estimated $2.7 billion. This does not include the farm commodity programs, farm loan programs, Food Assistance programs, and that part of the research and extension programs dealing with agriculture and timber production and recreation on the National Forests—all of which can have important impacts.

The principal rural development programs are:

	Program level (millions)			
	Actual		Estimate	
	Fiscal year 1969	Fiscal year 1970	Fiscal year 1971	Fiscal year 1972
Farmers Home Administration community loans and grants for water and sewers, recreation, flood prevention, etc.	$229	$211	$238	$256
Farmers Home Administration rural housing loans	543	875	1,641	1,780
Rural Electric Administration telephone and electric system loans	483	485	485	486
Soil Conservation Service resource conservation development, watershed, and flood prevention projects	95	109	120	118
USDA and Land Grant College's community improvement and housing research	5	5	8	9
Extension Service community development program	9	9	10	14
Forest Service shared revenue from national forests	53	79	73	83
Total	1,417	1,773	2,575	2,746

Chairman PROXMIRE. You see on page 38 of the budget, it appears that $921 million is from the old program, only $41 million is new. On a 4-month basis, it would be $71 million new, but on the fiscal 1972 basis, it would be only $41 million. I wanted your comment on that. It didn't seem like much of an addition to the rural community development program.

Secretary HARDIN. I will have to check that, Mr. Chairman. I don't know the correct figures.

Chairman PROXMIRE. You are a former chancellor, I understand, of the University of Nebraska.

Secretary HARDIN. That is correct.

Chairman PROXMIRE. And a distinguished educator. A resolution of the Nebraska Legislature opposes the proposal to abolish the Department of Agriculture and scatter its functions. Do you have these changes charted out well enough to give us your opinion of what effect if any these would have on the income of farm people; rural development efforts of the Department of Agriculture initiated by True D. Morse and expanded and so forth under the Kennedy and Johnson administrations, or any other consequences that you might tell us about this morning?

Secretary HARDIN. I will just make a general statement, Mr. Chairman. I would not anticipate that the reorganization plan as proposed would have any detrimental effect on agricultural income or programs. It is possible that by combining some of the programs, the effectiveness might be increased. I think a change would be a plus.

Bear in mind that the President did not propose the abolition of any programs or agencies, but rather an administrative restructuring. I should think that agricultural constituent groups who have been working closely for years, as many of them have for particular agencies or individuals, would find themselves working with the same groups in the future under the reorganization plan. I can see an advantage, for example, if the Foreign Agriculture Service were to work in closer proximity with the international trade group in, say, the Department of Commerce, that there could be strength in this total endeavor by having them work even more closely together.

Chairman PROXMIRE. You say that the President does not plan to abolish any programs. I am sure he does not intend to abolish services. But there is an abolition, it seems, of at least an explicit responsibility.

Let me call your attention to the program of Federal assistance to forest fire prevention and suppression, for the control of forest insects and diseases. I would like your explanation of why these programs seem to be abolished with respect to the direct responsibility along with grants for tree planting and your thoughts on how you think abolishing these programs will assist State, local, and private forestry efforts. Is it your notion that the funds will be provided and that they can get into these areas if they wish? If they wish to apply their funds elsewhere, they will do so?

Secretary HARDIN. In the States?

Chairman PROXMIRE. Yes.

Secretary HARDIN. What the President is doing here is moving these funds to the States and they would have the responsibility of making the decisions. They could enhance or abolish, as they chose, within those areas.

Chairman PROXMIRE. That is what troubles many of us very deeply, the fact that this would seem to be of national interest and national concern, a national goal, to preserve our forests and extend our forests. The States might have a different view that might not be as national in scope and perhaps, in a sense, might not be as farsighted.

Secretary HARDIN. Of course, the response of the States, I am sure would vary greatly across the country. I would suspect that in Wisconsin and in the Southeastern States, where there is great interest in softwood timber production, we might see an enhancement of reforestation programs. But in Nebraska, where forests do not grow as well and where there is not really a large commercial forest or timber industry and probably will not be, we might have a different set of priorities. It seems to me this is good.

Chairman PROXMIRE. Senator Miller.

Senator MILLER. Mr. Secretary, I noted the other day that one Member of Congress had charged this administration with disregarding the needs of the American farmer in informing farmers of the exact details of the new program. Unfortunately the article merely printed the allegation and did not have anything in there by way of a response. I do not suppose you were given a chance to respond. I thought you might like to respond at this particular time.

Secretary HARDIN. I would be very pleased to respond, Senator Miller. I suspect that they were not anymore concerned about the delays in announcements than I was. There is a very simple reason for it: We did not have the farm bill through the final steps in the Congress until December. There was a tremendous amount of work that had to be done following enactment and signing in the way of preparation of detailed regulations. Once they were prepared, then the States and local committees had to be fully apprised of the new regulations; documents had to be printed. It simply was not possible to work any more rapidly than we did.

In fact, we have not had enough time to, if I may use the phrase, debug all of the operations. If there has been one thing that has concerned me in the past 2 years, it has been the great difficulty in setting up national regulations that do not penalize some particular community, State, or area of the country inadvertently. When you work with averages, work with broad geographic areas, it is very easy to overlook local situations. We have been attempting, as we developed these new regulations, to test them out on an individual farm basis in very many different types of farming areas. There has not been enough time to do all of this.

Earlier I referred to the regulation requiring diverted acres to come from land that had been farmed at least one season during the past 3 years. After this was announced, we found that it was producing hardships that had not been intended and we had to withdraw this. These are the types of things we confront.

Furthermore, we did deliberately wait a few days until the January crop intentions report had become available as a further guide before all of the regulations were announced earlier this month.

Senator MILLER. You are referring to that planting intentions report the results of which were published on January 25?

Secretary HARDIN. That is correct.

Senator MILLER. I suppose there were some who wondered about the delay from that time until the day of the finalization of your program. And I can understand why you were a little concerned about it, because I was. I recall that I was contacting some of your people over there about it.

But in order to finalize this, I understand that there were several things that had to be gone into quite apart from the planting intentions results, such as I do know you were considering very seriously the possibility of doing something with respect to small farms. I suppose that took quite a bit of analysis. And I am sure you wanted to analyze the most current export estimates and the Commodity Credit Corp. stock estimates, including, for example, the free corn supply, the possible calling in of some of the CCC loan crop for purposes of establishing normal amounts of free corn for the next marketing year carryover; and wheat supplies especially. In other words, I got the impression that you were painstakingly trying to do the best job you could.

But I can still recall that during the Agriculture Committee conference on the farm bill last year, shortly before the elections, how much the Department was asking, literally pleading, for prompt action so that you could get moving on all of these regulations and information programs so our farmers would know what was going on. And we, after quite a few sessions, produced a conference report, and the House took action promptly. I suppose that this particular Member of Congress to whom I referred having come from the House, felt somewhat aggrieved because, frankly, the House did a job. But unfortunately, it did not happen that way in the Senate and in the face of repeated urging and requests from your Department and from many of us in the Senate, it was just put over until after the elections, which meant about a month delay in the whole thing.

Is that not about what you are saying?

Secretary HARDIN. That is exactly what we are saying, Senator Miller, That month would have been extremely useful to us and to the farmers of the Nation. We have done the very best we could. I do not believe it would have been possible to have gotten the final regulations in any less time than we did. I can tell you that the staff put in a great deal of nightwork, as they are quite willing to do in order to make the special effort required.

Senator MILLER. Now, that is all over with and we have a 3-year program. Would it be your purpose to get all of these announcements out at a considerably earlier date for the 1972 season?

Secretary HARDIN. Oh, definitely. We will not have the time problem for 1972 and 1973, and those will be started with enough leadtime to get them out in good time for publishing them as planned.

Senator MILLER. There was a further change in this same article without any opportunity for response that this administration is backing down on its pledge to promote agricultural conservation, resulting in less liming of soil, for example. What would be your answer to that?

Secretary HARDIN. I would guess—I do not know the specific article—that this refers to some modifications in the agricultural conservation program and the change in emphasis that has been given to this program as it has been redefined to place more emphasis on the environment; on those practices that will reduce pollution, and the silting of our streams and lakes; more emphasis on farm waste disposal, feed lots waste, and things of that nature; and less emphasis on annual practices that might more properly be defined as, really, regular production items. It is a matter of emphasis, however, and not a matter of absolute elimination of any of the items, because the authority still resides with the county committees to draw up the schedule of practices that will be sponsored under the Reed program.

Senator MILLER. What you are really saying is that with respect to the liming of the soil activities, while there may be some cutback there, there is an increase in other areas pertaining directly to agricultural conservation and the environment?

Secretary HARDIN. That is correct.

Senator MILLER. Thank you, Mr. Secretary.

Now, I have a couple more questions. Perhaps Mr. Paarlberg might like to answer this question.

Net realized farm income in 1970 was $15.8 billion, down from $16.2 in 1969, which is about $400 million less. Would it be true that you will find that $400 million loss in net farm income by just taking a look at the increase in farm costs of production?

Mr. PAARLBERG. Yes, sir; that would be correct, Senator.

Senator MILLER. And inflation in the economy would have a great deal to do with that, would it not?

Mr. PAARLBERG. That is correct. You can account for that in several ways by the increasing costs, as you say. You can account for it in the declining prices of hogs, for example. You could account for it in several ways.

Senator MILLER. I suppose you might just account for it by the drop in hog prices in my own State of Iowa.

Mr. PAARLBERG. It has been a massive drop.

Senator MILLER. I have been saying for years, as you probably know, that when you have a cost problem because of inflation that aggravates the cost-price squeeze of agriculture, probably the agricultural economy feels the results of inflation through these increased costs more than any other segment of our economy because their prices do not go up accordingly. It happens in many other industries. Is that a correct observation?

Mr. PAARLBERG. That is very true. And our mail and our contacts with farm people indicate their very deep concern and indeed, resentment about the rising costs that they face.

Senator MILLER. Now, Mr. Secretary, as you recall, U.S. imports of meat, subject to the meat quota law, rose by 8 percent during 1970 over 1969. During the early part of last year, imports of these meats were up almost 50 percent over the previous year, causing the President—and I am sure at your urging and recommendations—to impose limits on imports for the balance of 1970. What do you foresee for 1971? For example, how can we prevent a repetition of this abnormal amount coming in early this year, and have the exporting countries agree to voluntarily level out their shipments over to this country?

Would you care to comment on that problem?

Secretary HARDIN. I will comment as far as I can, Senator Miller. The voluntary agreements with the importing countries——

Senator MILLER. You mean the exporting countries?

Secretary HARDIN. The exporting countries to this country. Those agreements are still being negotiated. I am hopeful that they will be completed in the next 3 or 4 days. But it would be my prediction now that there will be no increase in imports of meat in 1971 over 1970. I do not think we will have a repetition of the problem we had in early 1970 because the President has delegated me the power to stop the practice. The most flagrant one in early 1970 was the transshipment of meat from Australia and New Zealand, which did come across the border and which resulted in a significant increase in imports. We now have the authority, and have exercised it already this year, to prevent those transshipments. So, I do not think we will have that problem in 1971. I hope that we will have an announcement with respect to the anticipated import levels within the next week.

Senator MILLER. I am pleased about your action with respect to the transshipment problem. As you know, many of us over here did urge you and the President to do something about that. But transshipment problems notwithstanding, the amount of the imports during the first part of last year was very abnormal. I am wondering if, in these negotiations, there is a strong effort being made to encourage these countries that export to the United States to level their exports to us so that we do not run into another one of these problems all over again?

Secretary HARDIN. There have been suggestions made that the agreements should be developed on a quarterly basis so that this orderly shipment would be regulated specifically. This is not anticipated. But there have been discussions with respect to developing an orderly flow, and it is our judgment that it will be much more uniform in 1971 than it was in 1970.

Senator MILLER. Well, I hope so, because if it isn't, as you know, there are bills pending right now, there were bills pending last year, and there was action taken in the Senate Finance Committee on one of the bills, on the trade bill, to force quarterly quotas. If our trading partners are not willing to do something by way of voluntary arrangements, I am afraid it is going to come to legislation. So I hope you are successful in this.

Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

Chairman PROXMIRE. I just have one question, and it is apropos of a speech you appear to have made yesterday. At any rate, it was at Dallas, Tex., to the 29th annual meeting of the National Electrification Cooperative Association.

Let me read the lead: "U.S. Secretary of Agriculture Clifford Hardin has expressed a hope for higher consumer food prices during 1971. This is not a prediction, Hardin told a news conference Wednesday, 'but I hope the housewife can expect higher food prices this year.' "

Now, in view of the administration's efforts to fight inflation and the fact that, of course, food prices are right at the heart of inflation, I would like to ask you this: The farmer, as I understand it, gets about 40 cents of the housewife's dollar. You just responded earlier today to a question, saying that the reason why food prices had gone up last year while farm prices had not, or had gone up far less, was because the margin had increased so much, the margins obviously for the middleman and distributor. Why can't we crack down but good and hard next year to make it possible to provide a better income for the farmer without a significant increase in the food prices to the housewife?

Secretary HARDIN. It may be possible. The context in which this question was asked at the press conference was would I be in favor of holding down farm prices so the consumers could have cheaper food. My response was that in view of the situation with respect to farm prices, I hope they can go up in 1971; and sir, I hope they do, and improve this income situation in agriculture.

Chairman PROXMIRE. Well, now, you were recorded not as saying you hoped that farm prices go up, you hoped that consumer food prices go up. There may be a difference.

Secretary HARDIN. And if this meant an increase in consumer food prices, I went ahead to elaborate that the consumer should be prepared to accept this and should not complain about it, in view of the bargain that food is in this country today.

I agree with you completely that we can accomplish this by improving the margin situation. This would be preferable. But I certainly am not going to, as Secretary of Agriculture, suggest that we should have lower farm prices in order that we could still further reduce consumer expenditures.

Chairman PROXMIRE. You should, as Secretary of Agriculture, fight hard for higher farm income. We all know we need it. Anybody who has studied this and has any kind of a feeling for justice and fairness knows that the farmer is not getting what he ought to get. But at the same time, I am just not satisfied that this means automatically that the food prices that the housewife has to pay are higher. This committee recently had testimony by a very distinguished food expert, Mr. Danzansky, who testified that they can greatly improve and intend to improve very quickly the efficiency of food distribution in many kinds of ways, by automating their supermarkets.

We just had testimony this morning that we have had an unfortunate slowdown of efficiency on the farm, which is another way that the farmers can get a better income without as sharp an increase in their prices as they would otherwise have. So I would hope the thrust of your efforts is going to be to help the farmer get higher food prices and do all we can to do that, consistent with avoiding too much of an inflationary impact on the housewife.

Secretary HARDIN. There is nothing inconsistent with my views and your statement.

Chairman PROXMIRE. No problem.

Secretary HARDIN. I am very glad you brought it up because I am glad to have this opportunity to clarify it.

Senator MILLER. Would the chairman yield?

Chairman PROXMIRE. Senator Miller.

Senator MILLER. I appreciate his bringing this matter up to give the Secretary an opportunity to clarify it. I must say I have long been aware that the farmers do not receive fair and decent prices. It is going to cost the consumer more in the long run—maybe not tomorrow, but looking down the road—if our farmers do not receive fair increases in prices. Then you are going to find more of them going out of business, and you are going to find less quality and less food for the consumer in the long run. We hope that the margin is going to be such that the farmer can get an adequate price without increased consumer costs; but if you do not have any choice because of certain economics in the power structure, then we had better let the consumers know that they had better pay some increased consumer prices now, because if they do not, they are going to have even greater costs in the long run.

Is this not about the basis of what you are saying, Mr. Secretary?

Chairman PROXMIRE. Mr. Secretary, when was the last investigation, let alone action, by the Department of Agriculture of the margin between what the farmer gets and what the housewife has to pay?

Secretary HARDIN. Mr. Paarlberg points out that this is done constantly, but there was a special effort made in December.

Chairman PROXMIRE. December just past?

Mr. PAARLBERG. That is right.

Chairman PROXMIRE. What was the result of it?

Mr. PAARLBERG. The result of it, Senator Proxmire, was that we released to the press the figures that showed the widening margins, both in the processing and in the retailing, both for beef and for pork. This was very widely publicized. We talked with the people in the trade and told them about our concern regarding that matter. Since that time, as the Secretary earlier said, these margins have narrowed. Whether this was the result of our publicity on this point and the jawboning that we did—I guess you can call it that—or whether it came from other things, I am not sure.

Chairman PROXMIRE. I appreciate that you have done this, but I try to follow these things closely. I think this would be a good example, a good case for the President of the United States to publicize this. It is important enough and vital to the interests of fighting inflation and the interest of the farmer and the housewife if the President of the United States would call attention to this in a dramatic way. It would seem to me if the Department of Justice could move in and act where it is clear that this margin is not based on economic factors—and I am sure on the basis of my experience, and I think you would agree that this may well be the case, we could do something about this very serious margin. But the fact that the Department of Agriculture releases another report to the press when the press is so busy with all the things going on abroad and home and so forth, in my view is not really enough to focus sharp, clearcut, effective attention on it so that we can have action.

Senator MILLER. I thoroughly subscribe to what you said, Mr. Chairman. I think public attention needs to be focused on such action. And you call it jawboning and it is jawboning in a way. But I think a great many people indicate that they want to see more action and if jawboning is part of the picture and if you have been doing it, I think it ought to be publicized more.

Chairman PROXMIRE. Will you make that report available to this committee?

Mr. PAARLBERG. Yes, sir.

Chairman PROXMIRE. We will put a summary of the report in the record at this point and we would like a full report for the files.

Mr. PAARLBERG. We will be happy to do it.

(The following information was subsequently supplied for the record:)

STATEMENT OF DON PAARLBERG, DIRECTOR OF AGRICULTURAL ECONOMICS

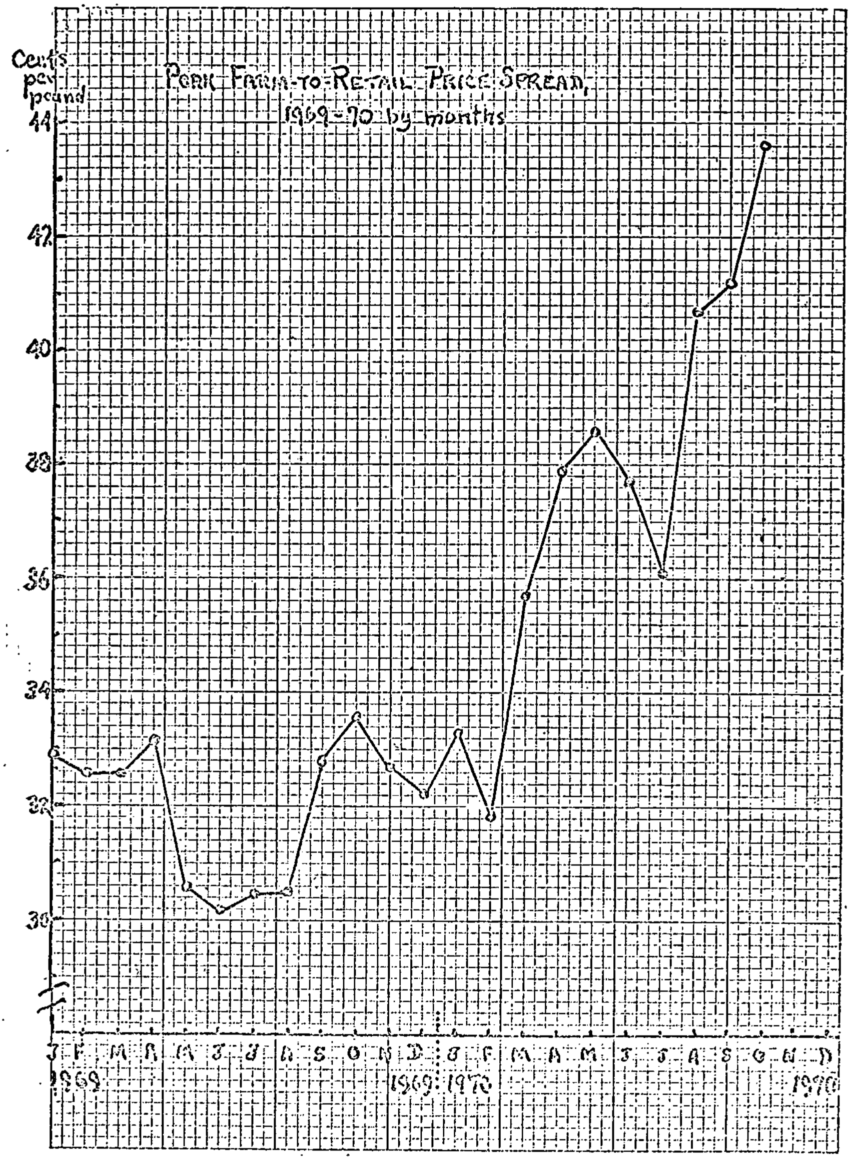
The year 1970 has seen one of the sharpest declines ever in the farm price of hogs. In January the price was 27.5 cents per pound; by October the price had fallen to 17.8 cents (weighted average price of 180–220 pound barrows and gilts at 7 principal markets). Thus from January to October of 1970, prices received by farmers for hogs *fell* 9.7 cents a pound. During that same period the farm-to-retail price spread *increased* 10.2 cents a pound. Had there been no change in the farm-to-retail price spread between January and October, taking into account the difference between live and dressed weights, the farm price of hogs in October would have been 22.9 cents instead of 17.8 cents. Thus about half of the precipitous decline in the farm price of hogs since January is accounted for by the widening marketing margin.

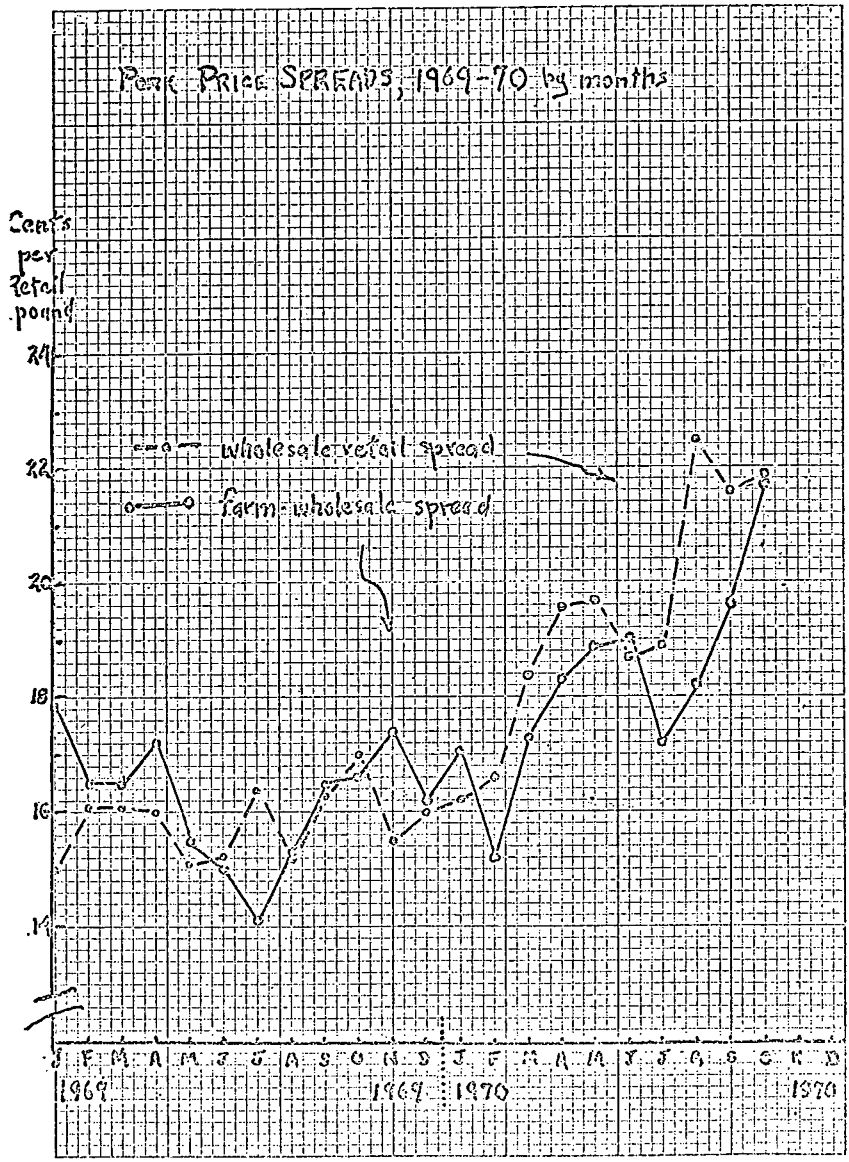
Most of this widening, 5.7 cents of it, occurred in the retailing of pork. The remainder, 4.5 cents, occurred in the packing and processing process.

The widening of margins at a time of falling prices for live animals is not an unusual situation, though the magnitude of the current change makes it more dramatic than usual. On the other hand, it is customary for margins to narrow when live animal prices increase. Margins widen when the farm price falls and narrow when it rises. The net effect of these changes is to amplify the magnitude of price fluctuations at the farm level and to induce alternating over-and-under supply of pork—and to cause wild gyrations in incomes of farmers.

This perverse pricing policy results from the laggard manner in which the food trade adjusts its selling prices. Selling prices of particular items, such as pork, are not quickly or fully adjusted to reflect acquisition price of these items. At a time of falling acquisition prices, retail prices are kept high. Thus consumers are not made fully aware of the abundance, new buyers are not attracted to the market, and the period of distressed farm prices is prolonged. The tendency in the food trade is to figure the margin on the mix of all products handled rather than on the individual items. No conspiracy is inferred. Overall margins continue reasonable. The difficulty is for particular items, in the current case pork.

Hog farmers understandable object, when experiencing a price decline, and particularly with as sharp a price drop as this year, to the added burden of carrying the cost for merchandising the other items in the store.


Cents per pound
PORK FARM-TO-RETAIL PRICE SPREAD, 1969-70 by months
44
42
40
38
36
34
32
30
J F M A M J J A S O N D J F M A M J J A S O N D
1969
1969 1970
1970



PORK PRICE SPREADS, 1969-70 by months
Cents per Retail pound
24
22
20
18
16
14
wholesale-retail spread
farm-wholesale spread
J F M A M J J A S O N D J F M A M J J A S O N D
1969
1969
1970
1970

COMPOSITE VALUES AND PRICE SPREADS FOR HOGS AND PORK, 1969

	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
Retail weight equivalent [1] (cents per pound):												
Retail value [2]	67.9	68.6	69.0	69.1	71.6	75.0	76.9	78.3	78.9	78.7	78.1	79.7
Wholesale value [3]	52.9	52.5	52.9	53.1	56.5	59.8	60.5	63.1	62.6	61.7	62.8	63.7
Gross farm value [4]	37.4	38.7	39.2	38.6	44.0	48.0	49.8	51.5	49.6	48.8	49.2	51.5
Byproduct credit [5]	2.4	2.7	2.8	2.7	3.0	3.2	3.4	3.7	3.5	3.7	3.8	4.0
Net farm value [6]	35.0	36.0	36.4	35.9	41.0	44.8	46.4	47.8	46.1	45.1	45.4	47.5
Farm-retail spread [7]	32.9	32.6	32.6	33.2	30.6	30.2	30.5	30.5	32.8	33.6	32.7	32.2
Wholesale-retail spread [8]	15.0	16.1	16.1	16.0	15.1	15.2	16.4	15.2	16.3	17.0	15.3	16.0
Farm-wholesale spread [9]	17.9	16.5	16.5	17.2	15.5	15.0	14.1	15.3	16.5	16.6	17.4	16.2
Liveweight hog price [10] (dollars per cwt.)	19.77	20.41	20.69	20.38	23.14	25.16	26.05	26.91	25.97	25.52	25.77	26.93

[1] All values at different market levels are shown in retail weight equivalents in order to allow direct comparisons. It takes 1.07 pouhds of wholesale pork products to make 1 pound of retail pork cuts and 1.97 pounds of live hog to make 1 pound of retail pork cuts.
[2] The retail value represents the composite average value of the retail cuts at their respective retail prices weighted to include the effect of specials.
[3] The wholesale value represents the composite average value, converted to retail weight equivalent, of wholesale cuts at wholesale prices (1.07 pouhds wholesale cuts).
[4] The gross farm value represents the average value of 180- to 220-pound hogs at 7 principal markets after conversion to a retail weight equivalent (1.97 pounds live hog), less farm marketing costs.
[5] Byproduct credit represents the value of inedibles, lard, etc. which are not sold as pork.
[6] The net farm value represents the farm value of the pork sold at retail from the live hog. It is obtained by subtracting the byproduct credit from the gross farm value.
[7] The farm-retail spread is the difference between the retail value and the net farm value.
[8] The wholesale-retail spread is the difference between the retail value and the wholesale value.
[9] The farm-wholesale spread is the difference between the wholesale value and the net farm value.
[10] The weighted average price of 180- to 220-pound barrows and gilts at 7 principal markets.

COMPOSITE VALUES AND PRICE SPREADS FOR HOGS AND PORK, 1970

	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
Retail weight equivalent [1] (cents per pound):												
Retail value [2]	82.1	81.8	81.4	79.9	80.0	80.0	80.7	79.7	76.7	74.4		
Wholesale value [3]	65.9	65.2	63.0	60.3	60.3	61.3	61.8	57.2	55.1	52.5		
Gross farm value [4]	52.7	54.1	50.0	45.9	44.8	45.6	48.0	42.3	38.6	33.6		
Byproduct credit [5]	4.0	4.1	4.3	3.9	3.4	3.3	3.4	3.3	3.1	2.8		
Net farm value [6]	48.7	50.0	45.7	42.0	41.4	42.3	44.6	39.0	35.5	30.8		
Farm-retail spread [7]	33.4	31.8	35.7	37.9	38.6	37.7	36.1	40.7	41.2	43.6		
Wholesale-retail spread [8]	16.2	16.6	18.4	19.6	19.7	18.7	18.9	22.5	21.6	21.9		
Farm-wholesale spread [9]	17.2	15.2	17.3	18.3	18.9	19.0	17.2	18.2	19.6	21.7		
Liveweight hog price [10] (dollars per cwt.)	27.52	28.26	26.18	24.07	23.50	23.94	25.15	22.24	20.36	17.81		

[1] All values at different market levels are shown in retail weight equivalents in order to allow direct comparisons. It takes 1.07 pounds of wholesale pork products to make 1 pound of retail pork cuts and 1.97 pounds of live hog to make 1 pound of retail pork cuts.
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[9] The farm-wholesale spread is the difference between the wholesale value and the net farm value.
[10] The weighted average price of 180- to 220-pound barrows and gilts at 7 principal markets.

U.S. DEPARTMENT OF AGRICULTURE

McDavid DU 8-4026 Washington, Dec. 30, 1970

USDA Official Comments on Beef Prices and Marketing Margins:

A U.S. Department of Agriculture official today released a statement in which he urged the food trade to give both farmers and consumers a "better break by holding their marketing margins more steady."

Don Paarlberg, USDA's Director of Economics, said that meat packers and grocery chains generally follow the practice of increasing their margins when prices of live animals fall, and decreasing their margins when live animal prices rise.

"This perverse pricing policy aggravates price gyrations at the farm level," he said. Results are undeserved losses for farmers, as now; uneven rates of earnings in the food industry; alternate cutback and overstimulation of livestock production; and uneven flow of food to the consumer.

Dr. Paarlberg said he meant to imply no collusion. "Such pricing in the food trade appears to be the result more of inept policies than illegal actions," he said.

Marketing margins for beef have increased sharply, while the price of live cattle rose less and recently has been falling, according to USDA figures. During 1968 and 1969, the price of choice steers fluctuated considerably, averaging 29.08 cents a pound for the 24 months. For the first 11 months of 1970, steer prices averaged 30.5 cents, but in December of 1970, prices fell to 27.48 cents.

The retail price of choice grade beef averaged 91.4 cents a pound during 1968 and 1969, 99.0 cents a pound during the first 11 months of 1970, and 95.9 cents a pound during December 1970.

When allowance is made for dressing loss and for by-product value, it is possible to calculate the marketing margin. This rose steadily, from 32 cents per pound during 1968-69 to 37 cents during the first 11 months of 1970, to 41 cents during December of 1970.

Dr. Paarlberg said that of the 9.0 cents per pound increase in overall margin from 1968-69 to December of 1970, 1.7 cents occurred in packing and wholesaling, while 7.3 cents occurred in retailing.

"Farmers and ranchers are concerned," he said, "when their price goes down and marketing margins go up. Consumers are offended when retail prices fail to reflect the increased supply of meat."

The break Dr. Paarlberg called for from the food trade "is entirely apart from the question as to the size of the marketing margin over a period of time."

"A steadier margin," he said, "would be more equitable for all parties and would introduce greater stability in the supply of meat."

Dr. Paarlberg's statement is attached.

STATEMENT ON BEEF PRICES AND MARKETING MARGINS

Marketing margins for beef have increased sharply while the price of live cattle rose less and recently has been falling.

During 1968 and 1969, the price of choice steers fluctuated considerably, averaging 29.08 cents per pound for the 24 months. For the first 11 months of 1970, steer prices averaged 30.50 cents. But in December of 1970, prices fell to 27.48 cents.[1]

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When allowance is made for dressing loss and for by-product value, it is possible to calculate the marketing margin. This rose steadily, from 32 cents per pound during 1968-69 to 37 cents during the first 11 months of 1970, to 41 cents during December of 1970.

Of the 9.0 cents per pound increase in overall margin from 1968-69 to December of 1970, 1.7 cents occurred in packing and wholesaling, while 7.3 cents occurred in retailing.

Farmers and ranchers are concerned when their price goes down and marketing margins go up.

Consumers are offended when retail prices fail to reflect the increased supply of meat.

[1] 3-week average.

Meat packers and grocery chains generally follow the practice of increasing their margins when prices of live animals fall, and decreasing their margins when live animal prices rise. This perverse pricing policy aggravates price gyrations at the farm level. The unfortunate results are:

Undeserved losses for farmers, as at present;
Uneven rates of earnings in the food industry;
Alternate cutback and overstimulation of livestock production;
Uneven flow of food to the consumer.

The food trade could give both the farmers and the consumers a better break by holding their marketing margins more steady. This is entirely apart from the question as to the size of the marketing margin over a period of time. A steadier margin would be more equitable for all parties, and would introduce greater stability in the supply of meat.

It is not alleged that collusion occurs; pricing policies in the food trade appear to be more inept than illegal.

PRICES AND PRICE SPREADS FOR CHOICE BEEF

Item	1968	1969	1970 First 11 months	1970 December[1]
Choice steers, Chicago, dollars per cwt	27.74	30.42	30.50	27.48
Farm value, cents per pound	56.7	62.2	62.0	54.9
Carcass value, cents per pound	63.1	68.7	68.7	63.0
Retail value, cents per pound	86.6	96.3	99.0	95.9
Spreads, cents per pound:				
Farm—carcass	6.4	6.5	6.7	8.1
Carcass—retail	23.5	27.6	30.3	32.9
Farm—retail	29.9	34.1	37.0	41.0

[1] 3-week average.

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

The committee will stand in recess until tomorrow morning at 10 o'clock, when we will reconvene in this room to hear the Chairman of the Federal Reserve, Arthur Burns.

(Whereupon, at 12:20 p.m., the committee recessed, to reconvene at 10 a.m., Friday, February 19, 1971.)

(The following information was subsequently supplied for the record:)

RESPONSE OF HON. CLIFFORD M. HARDIN TO ADDITIONAL WRITTEN QUESTIONS POSED BY SENATOR JAVITS

Question 1. Can you give us a brief account of what the Administration has done with respect to food stamps and food distribution programs?

Answer. A year and a half ago, in May 1969, President Nixon said "the moment is at hand to put an end to hunger in America itself for all time." At that time, he established a new agency, the Food and Nutrition Service, with the responsibility of administering the Federal food assistance programs. In December, the White House Conference on Food, Nutrition and Health provided additional stimulus to improving our food programs.

Much has been accomplished in ending hunger in America during the past year. A year ago, there were:

7 million people under our family feeding programs,
2,869 project areas with a family program, and
4½ million children receiving free or reduced price lunches.

As of November 1970, preliminary data indicate there were:

13 million people served by our family assistance programs,
3,080 areas with a family program, and
5½ million children receiving free or reduced price lunches.

At the present time, there remain only 10 counties and independent cities without a family feeding program and without immediate plans to begin one. The Food Stamp Program has been liberalized so that benefits per person are twice as large as a year ago. The Commodity Distribution Program has also been improved.

Expansion of this program into new areas and additional participation in existing areas has held participation about stable despite the transfer of New York City and several other areas to the Food Stamp Program.

The Supplemental Food Program now reaches over 170,000 pregnant women, infants, and their mothers, more than double that of a year ago. A Food Certificate Program was implemented in February 1970 and now is operating in five areas reaching 11,000 people.

The School Breakfast Program now reaches over 700,000 children, twice that of a year earlier. The Special Food Service Program now provides food to over 130,000 children on a year around basis, double that of a year earlier. Last July, an additional 440,000 children were reached in the Special Summer Feeding Program.

Question 2. Could you sketch the major changes in the farm program that come from the Agriculture Act of 1970?

Answer. The Agricultural Act of 1970 amounts to a basic reform of U.S. farm programs. It represents a giant step toward a more market-oriented agriculture that recognizes the economic and political realities of the 1970's. Specifically, this bill would:

1. Remove the production control features of bases and allotments for—
   a. wheat
   b. feed grains
   c. cotton
2. Remove marketing quota penalties that would otherwise be applicable to producers of cotton and wheat who overplant their allotment.
3. Through the set aside feature, provides the Secretary a powerful tool to deal with excess capacity in U.S. agriculture and to maintain a reserve of cropland in conserving uses.
4. For the first time, provides for a realistic limit on the amount of payments going to a producer for each crop. ($55,000)
5. Provides for adequate control of government costs which would otherwise escalate year by year.
6. Through the features of (1) and (2) above, provides the flexibility farmers need to adjust their planting patterns to market conditions and thereby maximize their net returns.
7. Provides for a minimum loan rate of $1.25 for wheat and $1.00 for corn.
8. Provides much-needed flexibility as well as new tools for dealing with the many problems of cotton.
9. Phase out gradually feed grain and cotton payments now being made to "producers" who have long since ceased to plant these crops.

Response of Hon. Clifford M. Hardin to an Additional Written Question Posed by Senator Pearson

Question. As you know there is great interest among farm groups about the effect which the Administration's executive reorganization program would have on the ability of the farmer to be heard at the highest levels of government. Under the Administration's plan, most food programs would be placed in the Department of Human Resources; such programs as rural housing and rural water and sewer projects would be placed in the Department of Community Development. Under the present arrangement, your position as Secretary of Agriculture—coupled with your long and distinguished career in agriculture, the land-grant college system, banking, and public service—serves as a logical focal point for farm interests to be represented in the cabinet itself. Do you believe that either a Secretary of Community Development or a Secretary of Human Resources could do as good a job?

Answer. I am naturally pleased that the Senator recognizes the achievements of the Department of Agriculture in serving the purposes for which it has been established. I truly believe, in answer to your question, that the Secretary of Community Development or the Secretary of Community Resources will be men chosen for their broad vision and capacities and that they will equally serve the farm interests for which they are responsible. It is important to remember that the President's proposals do not call for the elimination of any program or the people who operate them so I envisage continued service to our farmers and rural communities with the same dedication.

It also seems to me that the President's reorganization plan will better permit Agriculture farmers and rural America to come into its own. As things exist presently, substantially more than one-half of the appropriation to the Department of Agriculture provides direct benefits to non-farm people. Yet these expenditures are often labeled as benefits to farmers and Agriculture. This reorganization program offers an opportunity to identify the programs that directly relate to the farmers of this Nation. It should result in directly related costs for this sector of our population and economy as it affects the taxpayer. As such, it affords a greater opportunity to point out the benefits that accrue to the total population and economy of the United States from the accomplishments of our farmers and the Agricultural community.

I am confident that the Secretaries of our new purpose-oriented Departments will assure that our farmers who constitute the largest single industry of this Nation will be served so that they continue their great contribution to our Nation's overall growth. It is of more than passing interest that this vital sector of our population and economy has since 1950 increased its efficiency, in terms of output per man hour, at about twice the rate of the industrial sector. As a result of this great contribution by our American farmers, the American consumer is spending less of his income dollar for food than consumers in any other country of the world.

The President's reorganization in the purpose-oriented Departments should result in the Agricultural community and its business being more clearly identified for their contribution and further enhance their growth and accomplishment.

Response of Hon. Clifford M. Hardin to an Additional Written Question Posed by Representative Widnall

Question. Are you satisfied with the consultative arrangements which have been worked out to keep this Government informed as to developments in the British-Common Market talks which would affect the U.S.?

Answer. A number of the comments that I made previously bear on this question, including my recent trip to Europe and a discussion held in London the early part of February in which Assistant Secretary Palmby was a senior participant. In addition, we will be meeting with Dr. Sicco L. Mansholt, Vice President of the Commission of the European Communities in Washington in early March. I would say we have satisfactory procedures to be informed as to the progress of developments in enlargement discussions. I would hasten to add that this does not necessarily mean that we will get satisfaction with respect to our own trade problems. That is not so much a matter of the channels of information and communication as it is the ability of the two sides to agree on the right solution. We are making as effective representations as we can to protect our trade interests in this situation, and we will continue to do so.

Response of Hon. Clifford M. Hardin to Additional Written Questions Posed by Representative Brown

Question 1. What effect on this year's price and production does USDA anticipate the recent corn blight will have?

Answer. The effect of corn blight on production and prices in 1970 is difficult to appraise. Although corn blight has been a major factor, dry weather in the Western Corn Belt also influenced production and prices of corn and other feed grains. Prices received by farmers for corn during October-January this year have averaged \$1.35 per bushel, or 25¢ higher than in that period last year. In order to reduce the effect of blight in 1971, the feed grain program does not provide for voluntary acreage diversion this year and offers farmers more flexibility in planting corn and other feed grains than in recent years.

In January farmers indicated their plans to increase corn acreage about 6% over 1970, with greatest increases in the Western Corn Belt. Should blight conditions be similar to those of 1970, but with more favorable weather in the Western Corn Belt, production on the planned acreage could be around 8 to 10% above the 1970 crop, or around 4.4 or 4.5 billion bushels. While this would still be a little below the record usage in 1969/70, it would be close to the anticipated use of about 4.5 billion bushels in 1970/71.

Question 2. Your testimony on soft wood timber growth and marketing management indicates the importance of timely action. But what about hard wood timber development and management in which we have export advantages but declining supplies?

Answer. In 1968 hardwood log exports totaled 95 million board feet—more than double the volume of imports. This is a rather sharp contrast to 1950 when imports were more than 5 times exports.

The largest part of the log exports move to Canada. However, shipments to West Germany, Italy, and other Western European countries have been growing. Although the volumes of these exports have not been large in comparison with U.S. hardwood log production, they have had some important effects. For example, walnut log exports (21.8 million board feet in 1968) have added substantially to the demands for this scarce species and contributed to a very rapid increase in walnut log prices.

The logs exported to Western Europe, and most of the imports, are composed of high-quality logs suitable for use in the manufacture of furniture and interior paneling where attractive appearance is an important consideration.

Imports of hardwood logs, lumber, plywood, and veneer in 1968 totaled 275 million cubic feet. This was 34 percent above the volume imported in 1967 and about 4 times the average annual imports in the early 1950's. There has been some increase in lumber and veneer imports. Plywood, however, has accounted for the largest part of the growth since 1950.

Net imports of all products in 1968—237 million board feet—composed 16 percent of the roundwood equivalent of all hardwood lumber, plywood, and veneer consumed in the country. This is in sharp contrast to 1950, when net imports were less than 3 percent of consumption.

The large increase in imports has been caused largely by a rapid post-war expansion of low-cost hardwoods, especially from the Philippines, and a resulting reduction in import prices. There is a relative scarcity of high-quality hardwood timber of preferred species in the United States. However, the hardwood timber situation has been steadily improving in the last few decades. As a result, it is now estimated that the cut of sawtimber sized material could be increased by possibly 2 to 3 billion board feet. This, along with projected increases in growth resulting from some further intensification in forest management, suggests that most of the projected growth in demand for hardwood lumber in the next decade could be met from domestic forests.

The outlook for hardwood plywood and veneer is different. If the price of imported hardwood plywood and veneer can be maintained without much change, as it has since 1950, it seems likely that most of the projected increases in demand in the next decade will continue to be supplied by imports.

Beyond the next 10 years or so, projected demands for hardwood timber may rise more rapidly than projected supplies, with resulting upward pressure on prices. This means that the United States may eventually turn to an increasing degree to the tropical hardwood forests as a source of supply for high-quality hardwood lumber, as well as plywood and veneer.

The longer run outlook is based on the assumption that recent trends in management will continue. The hardwood forest lands in the United States have the capability under intensive management of producing enough hardwood timber to meet projected demands at prices close to recent levels for several decades.

Intensified management would involve substantial increases in investments in such measures as planting, thinning, stand improvement, and increased protection against destructive agents. In addition, it would involve an acceleration of research programs designed to invent new technology and ways of increasing the efficiency of timber production and utilization.

Question 3. Please relate trends in U.S. agricultural productivity to trends in agricultural productivity abroad. Have we reached optimum mechanization, economic unit size and technological development (in cow mile production) while other nations are just beginning to develop their productivity and will eventually become competitive? If this is true, what are the trade implications and what is the time frame?

Answer. U.S. agricultural production increased about 1.5 percent a year during the 1960s compared with nearly 3 percent in other industrial countries and nearly 3 percent in the less developed countries (LDC's). Our agricultural output rose only a little more rapidly than our population. In other industrial countries, total agricultural output rose about twice as fast as total population. Less developed countries (which account for about two-thirds of the world's population) increased total agricultural production slightly more than total population.

U.S. has been a leader in achieving technological advances in agriculture, but other industrial countries like Canada, Australia, and New Zealand have not been far behind. West European countries were a little slower in adopting new technology. Rapid growth in agricultural production in West European countries during the 1960's resulted from new technology, higher crop yields, and greater use of fertilizer and other inputs. But increased protectionism and high prices for farm products also were very important factors stimulating agricultural output growth in Western Europe. Only in the United States were farm programs established to limit expansion in agricultural production.

Most LDC's found it difficult to expand food output rapidly enough to keep pace with rising population growth rates during the 1950's and early 1960's. Food grain production has increased greatly in some of these countries in the last 2 years with the use of new high-yielding varieties, and greater use of fertilizer and other purchased inputs, and irrigation improvements. But population growth rates are high in most LDC's and still are increasing in some.

Our foreign agricultural trade has grown significantly in the last decade. U.S. agricultural exports increased from $5.2 billion in the early 1960s to around $6.5 billion in the late 1960s. They likely will total about $7.5 billion in FY-1971. Our commercial dollar sales have grown from $3.5 billion a year in the early 1960s to $5.7 billion in FY-1970 and likely will total $6.5 billion in FY-1971. Our share of world total agricultural exports has been relatively constant at around 16-17 percent a year.

Looking ahead, we can expect further growth in our agricultural exports provided foreign industrial countries do not increase their tariff and non-tariff barriers to agricultural trade. Also, we need to maintain price advantage over foreign products so that we are competitive in world markets. How rapidly our agricultural exports expand will depend heavily upon price and trade policies of other industrial countries. Economic potentials for increasing agricultural production are as large in the United States as in most other nations. We could produce much more feed grain, soybeans, and other crops for export by bringing into productive use approximately 55 million acres now lying idle under government programs.

Recent increases in wheat and rice production in India, Pakistan, and some other LDC's have reduced their import requirements for food grains. Our agricultural exports under government programs decreased to less than $1 billion in FY-1970 compared with a high of $1.6 billion in FY-1962 and 1965. Because of rapid population growth and low food consumption levels, most LDC's will consume at home most of their growth in agricultural production. Many LDC's maintain prices for agricultural products that are higher than those in the industrial countries and therefore will find it difficult to compete in export markets.

Question 4. Can you pinpoint commodity areas adversely affected by U.S. imports and indicate what has been done to resolve problems of foreign dumping and other trade practices harmful to domestic commodity markets in the U.S.?

Answer. There have been several commodity areas in which imports are of serious concern to our domestic producers because of the impact which these imports have on our domestic market.

Although we have had import quotas on dairy products since 1953, it has become necessary at various times since that date to extend the list of controlled items. At present, most dairy products are subject to quotas.

In recent years, the pressures created by a world dairy surplus and the attractiveness of U.S. prices have three times required recourse to section 22. Typically, imports of non-quota products of traditionally small trade importance increased substantially, or new products—mainly for processing use—entered the market. As a result, overall dairy imports rose to levels which interfered or threatened to interfere with the dairy price support program. In each case, section 22 was invoked and imports were reduced to a tolerable level.

The most recent extension of import controls was by Presidential Proclamation 4026 of December 31, 1970 which placed quotas on ice cream, animal feeds containing milk or milk derivatives, low-fat (5.5 percent or less), chocolate crumb, and low-fat (0.5 percent or less) cheese. As a result of this action, imports in 1971 are expected to be below 1970.

The U.S. has become a major importer of meat. Rising imports of fresh, chilled, and frozen meat have not become a serious problem because we have been able to limit the imports of such meat into the U.S. through voluntary agreements with major supplying countries. In the absence of such agreements, we would have the authority to restrict imports of such meats under the provisions of the Meat Import Act of 1964.

In recent years, there has been growing concern with the rise in imports of certain horticultural products, primarily from Mexico, for example, tomatoes and strawberries. We have not yet come up with a clear solution for the problems these imports could cause, but we are maintaining a continuing surveillance over the situation and engaging in discussions and close consultations with Mexican officials, with the view of arriving at arrangements which would reduce the impact of imports on U.S. markets.

59-591—71—pt. 1——16

Another area of concern has been the dumping of certain agricultural products into the U.S. market by foreign suppliers, or with benefit of export subsidies. In 1968, the Treasury Department imposed countervailing duties on canned tomatoes and tomato concentrates from Italy and canned tomato paste from France to offset government export subsidies. The Treasury Department currently has under investigation, pursuant to the countervailing duty statute, imports of tomatoes, tomato paste and tomato juice from Greece, canned hams from Denmark, and barley and molasses from France.

Within the past year, an antidumping duty has been applied against dried whole eggs from the Netherlands.

THE 1971 ECONOMIC REPORT OF THE PRESIDENT

FRIDAY, FEBRUARY 19, 1971

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

The committee met, pursuant to recess, at 10:05 a.m., in room 1202, New Senate Office Building, Hon. William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Javits, Miller, and Humphrey; and Representatives Bolling, Griffiths, Moorhead, Widnall, and Conable.

Also present: James W. Knowles, director of research; Loughlin F. McHugh, senior economist; John R. Karlik, Richard F. Kaufman, and Courtenay M. Slater, economists; Lucy A. Falcone and Jerry J. Jasinowsky, research economists; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig and Leslie J. Barr, economists for the minority.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The committee will come to order.

We have with us today, as we continue to survey the state of the economy, one of the outstanding economists of the country, a long-standing leader of economic policy formulation for this Nation, a confidant of Presidents, and today, the Chairman of the Board of Governors of our central bank. In this latter capacity, he is architect of monetary policy, the critical policy element on which the present administration is depending to achieve recovery to full employment in the near-term. And when I say "near term," it has become increasingly obvious that the administration is thinking not of this year, but of next year or later.

Mr. Burns, I am not asking you to accept my interpretation of what the administration witnesses have told us so far. But to me, the import is clear: the policy implication is that monetary policy will have to bear the burden of getting us back to full employment by 1972. What the administration witnesses have told us brings us to the inescapable conclusion that fiscal policy will be only a little more than neutral in its impact over the next year or so. There is considerable confusing rhetoric in this respect: talk of a self-fulfilling full employment budget. But the evidence is most clear—fiscal policy will not be vigorously stimulative in 1971–72.

Now, as to the monetary policy proposed by the administration, I'm not clear. Let me once more say I am not asking for a confrontation here. But can you tell us what monetary policy would be called for if we are to achieve full employment before mid-1972? Is it possible for monetary policy alone to do the job?

Now I want to stress that the committee has criticized sole dependence on fiscal-monetary measures. Your prepared statement indicates support for an incomes policy. I want to ask you whether you can be more specific. Specifically, I hope we will have a chance to go into such approaches as:

Comprehensive voluntary guideposts;

Wage-price controls in construction;

More widespread controls; and

Credit allocation measures to achieve most desirable economic goals.

Mr. Burns, the floor is yours.

STATEMENT OF HON. ARTHUR F. BURNS, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. BURNS. Thank you very much, Mr. Chairman. Perhaps I can start first by reading my statement. Is that satisfactory?

Chairman PROXMIRE. Yes, sir. I might say if you abbreviate it in any way, the full statement will be printed in the record.

Mr. BURNS. Thank you.

I appreciate the opportunity to meet with this committee once again to present the views of the Board of Governors on the condition of our national economy.

Our overall economic performance during the past year has left much to be desired. Unemployment rose to more than 6 percent of the civilian labor force by year end. Idle industrial capacity increased. Business profits deteriorated further. The price level continued to rise sharply. Our balance of payments remained in an unsatisfactory condition. These frustrations and disappointments cannot be overlooked; but they also must not be allowed to blind us to the progress that our Nation has been making toward the restoration of its economic health.

Underneath the surface of aggregate economic activity, major changes took place during 1970, and they have been—on the whole—in harmony with the aspirations of the Congress and the American people. Thus, the defense sector of our economy has continued to shrink, with employment in this sector—when the reduction of the armed forces is counted in—declining three-quarters of a million during the past year. Also, the protracted investment boom in business fixed capital—whose continuance would have necessitated a major retrenchment later on—has tapered off. Meanwhile, the homebuilding industry has in recent months been experiencing a great upsurge of activity. And our trade surplus—which had plummeted from 1965 to 1960—began to recover as our exports rose relative to imports. These several developments have imparted better balance to our national use of resources, and thereby promise to contribute to economic and social progress.

Another highly significant development of the past year was a dramatic change in business attitudes toward the control of costs. As product markets became more competitive and costs continued to mount, business managers in increasing numbers finally recognized that their profit margins, which had been gradually eroding since 1965, would drop sharply further unless ways were found to improve efficiency substantially. Vigorous efforts to eliminate loose and wasteful practices resulted by the second quarter of 1970 in a renewed increase of output per man-hour, ending a stagnation which had lasted nearly 2 years. The rate of advance in unit labor costs therefore moderated last year, even though wage rates continued to rise at an undiminished pace.

The new attitude toward cost controls had its counterpart in business financing. The speculative mood of the later years of the 1960's had given rise to loose financing practices that posed a threat to financial stability. This became abundantly evident last summer, when conditions approaching crisis prevailed for a time in some of our financial markets, notably in the commercial paper market.

These developments served as a pointed reminder to the business and financial community that canons of sound finance are still relevant in our times. Chastened by experience, many firms have of late been reducing their exposure to risk by funding short-term debt or by enlarging equity cushions. In turn, many lenders have been screening loan applications with greater care and upgrading their investment portfolios. Households, too, have been placing greater emphasis on liquidity and safety in the management of their financial assets. The prospects for maintaining order and stability in financial markets during the years immediately ahead have thus been enhanced.

The processes at work in our financial markets during the past year have strengthened the prospects for recovery in economic activity this year. The liquidity of commercial banks and of other financial institutions has improved markedly. Credit has become more readily available to prospective homebuyers, State and local governments, and small businesses, as well as to the larger industrial and commercial enterprises. Interest rates have tumbled. Indeed, the decline in long-term interest rates since the middle of 1970, has been the largest and most rapid of the postwar period. Even interest rates on consumer loans and mortgage interest rates—which often display downward inflexibility—have declined during the past several months. And the decline of interest rates brought, of course, welcome relief to a badly depressed bond market.

As bond prices rose and cost-cutting by business firms continued investors began to look forward expectantly to renewed expansion in business activity and earnings. Interest in common stocks therefore revived, and share prices—particularly of "blue chips"—have staged a spirited recovery. With the financial underpinnings of the economy improved, housing starts have already risen briskly and State and local construction projects—delayed earlier by tightness in credit markets—are being financed more readily and at much lower cost.

Thus, when we look beneath the surface of aggregative measures of economic behavior, we find that a large part of the foundation needed for an enduring prosperity was rebuilt during the past year. Let me turn next, therefore, to the role that monetary policies played in fostering this achievement.

Monetary policies during 1970 at first sought to create an environment in which progress could be made in unwinding from the inflationary excesses of the past, while providing sufficient stimulus to prevent economic weaknesses from cumulating. As the year advanced, the Federal Reserve gave increasing attention to liquidity problems and to the need for establishing the financial basis for a resumption of economic growth.

At the beginning of 1970, as this committee knows, monetary restraint reached its peak of intensity. The monetary policy pursued during the preceding year had become increasingly restrictive because of the urgent need to curb inflation. During the latter half of 1969, the narrowly defined money supply—that is, currency plus demand deposits—had grown by an annual rate of only 1 percent, while time deposits of commercial banks actually declined sharply. Bank liquidity was at a very low level; heavy deposit withdrawals were draining funds from mutual savings banks and savings and loan associations; the supply of mortgage credit had shrunk severely; many State and local governments were unable to arrange financing of their construction projects; even some of the largest business enterprises were having difficulty in satisfying their financing needs; interest rates were at or soaring toward historic peaks; and confidence in financial markets was waning.

As I have already indicated, conditions in our money and capital markets have since then changed dramatically. Confidence in financial markets and institutions has been restored; liquidity positions have improved; credit has become both cheaper and more readily available to a broad spectrum of borrowers; and all this was accomplished with a moderate—and I believe a prudent—rate of monetary expansion.

Last year, the narrowly defined money supply rose by 5½ percent. This is by no means a low rate of growth by historical standards. Indeed, it was exceeded in only 4 years during the postwar period—1946, 1951, 1967, and 1968, each a year of intense inflation. However, when the economy is sluggish, and when very unusal demands for liquidity are encountered, as they were in 1970, a rate of monetary expansion that is appreciably above the historical average is not inappropriate.

Broader measures of the money supply indicate even more clearly the rather expansive course of monetary policy during 1970. For example, if the concept of the money supply is broadened to include commercial bank time deposits other than large denomination certificates of deposit—CD's—we find that growth in money balances during 1970 was at an 8-percent rate—accelerating from 6 percent in the first half to more than 10 percent in the second.

An assessment of recent monetary policy requires, of course, attention to numerous financial variables besides the money supply, whether defined narrowly or broadly. By the second half of 1970, the increase in total funds available for lending and investing by commercial banks had risen to an annual rate of 10 percent. Of course, this high rate of expansion partly reflected some rechanneling of borrowing from financial markets to banks after the ceiling rates of interest that banks could pay on short-term CD's were suspended. Allowing for this factor, the increase in available bank funds was still far above the growth of demand for bank loans. Consequently, banks added substantially to their holdings of short-term Treasury securities, and became aggressive buyers of State and local government bonds. They also took steps to encourage additional borrowing by bank customers. Commitments of funds to the mortgage market rose, and growth in real estate loans picked up toward the close of the year. The prime rate of interest on bank loans was reduced in a series of steps from 8½ percent at the beginning of last year to 5¾ percent presently. Other lending policies too were relaxed, as banks began actively to seek out prospective loan customers.

The effects of these easier monetary policies gradually spread from the banking system to financial institutions at large. At life insurance companies, the drain of investable funds through policy loans decreased over the course of the year, encouraging larger commitments to corporate borrowers. At nonbank thrift institutions, the rate of inflow of deposits rose by the final quarter of last year to levels not seen since the early 1960's—except for a brief period in 1967. Exceptionally high rates of deposit inflow have continued in recent weeks. Indeed, with the supply of mortgage money temporarily outrunning the demand, some institutions find themselves unable to acquire the volume of real estate loans they desire.

These are the indications, I believe, that the monetary policies pursued last year have created the financial conditions needed for a sustained expansion of production and employment. Underlying economic trends have been obscured in recent months by the effects of the prolonged auto strike. Nevertheless, some major economic series suggest that a general recovery of business activity may already be underway. For example, stock prices have been rising briskly for a number of months, as I noted earlier. The increase in residential building activity that began last spring has gathered momentum. New orders for durable goods rose in December, and the ratio of inventories to unfilled orders for durable goods declined for the first time since April 1969. In January, initial claims for unemployment insurance fell somewhat further; the length of the factory workweek increased for the third time in 4 months; industrial production rose again; and the demand for business loans at commercial banks strengthened measurably.

These indicators suggest that either a real recovery in production and employment is actually underway or that such a development is likely to occur in the near future. A review of trends in several of the major categories of spending points to the same general conclusion.

Let us consider first the principal economic sectors that may display weakness in 1971. Defense spending is one of these. Judging by the January budget message, the outlook is for little change in outlays for defense in the year ahead, which would imply some decline after allowance for price increases. Other Federal expenditures, however, will be rising substantially in the course of the year, thereby adding to the disposable income of consumers and strengthening the financial position of State and local governments.

Business capital spending is also likely to remain sluggish, at least during the early months of this year. Thus far, the recovery since last spring in new orders for capital equipment has been modest, and surveys of business investment plans do not suggest an early upswing in outlays for plant and equipment. Nevertheless, it would not be surprising to see some strengthening in business spending for equipment as 1971 progresses—the encouragement coming in part from the recent liberalization of depreciation allowances.

In contrast to the relative weakness in the defense and business capital sectors, outlays for State and local construction and for residential building should rise vigorously this year. With housing vacancies at a very low level, the decline of mortgage interest rates spreading, and the likelihood of overall economic recovery high and rising, the expansion in the homebuilding industry should continue;

housing starts in the fourth quarter were at the highest level since the early 1950's. We can be reasonably confident also that a substantial revival in State and local government capital outlays will occur this year, although—as this committee well knows—many municipalities are facing serious shortages of funds. These financial difficulties may be relieved by Federal grants, and in any event they are much less likely to limit capital spending than the operating programs of State and local governments.

Changes in the rate of inventory investment typically play a strategic role in the course of a business recovery. At present, ratios of factory stocks to sales and to unfilled orders are still quite high in many durable goods lines. This, however, is characteristic of the early stages of recovery. A pickup in the tempo of economic activity in the months ahead would encourage businesses to increase inventories in anticipation of a rising trend of sales. I would not rule out the possibility that a rise in the rate of inventory accumulation will contribute materially to increased production and employment this year.

Ultimately, the shape of business conditions during 1971 will depend on what happens to spending in the largest sector of our economy—the consumer sector. For many months, the mood of the average consumer has been cautious, if not pessimistic. The personal savings rate has remained high, and consumer liquid assets have been built up at an unusually rapid rate. No one can foretell how soon this mood will change.

The caution of the American consumer is due in part to greater awareness of the hazards of unemployment. But a more important factor may well be the steady erosion of the real value of his income and his savings through inflation. Since he sees no effective way to hedge against inflation, the consumer seems to respond to rising prices by increasing his current rate of savings in an effort to stretch the paycheck far enough to cover tomorrow's higher living costs. The consumer's lack of confidence is thereby communicated to the business community. For when consumer buying patterns are weak, businessmen often lack the confidence to undertake new ventures to expand markets, introduce new products, or increase productive facilities.

The strength of economic expansion during and beyond 1971 will depend, in my judgment, principally upon our success in restoring the confidence of consumers and businesses in their own and the Nation's economic future. Restoration of confidence must be a central objective of economic stabilization policies in 1971.

In the present economic environment, there can be no doubt that monetary and fiscal policies must for a time remain stimulative, as they have been recently. The degree of stimulus coming from the budgetary policy announced by the President is, it seems to me, broadly consonant with the needs of an economy operating well below full employment. However, if past experience is any guide, actual expenditures might run above those currently projected, and we must therefore be extremely careful not to let Federal expenditures again get out of control. To do so would seriously undermine confidence at a time when we need to do everything in our power to increase confidence.

An appropriate monetary policy for the months ahead probably would require sufficient growth in the reserves of the commercial banking system to foster continued expansion in monetary and credit aggregates at rates above their long-term averages.

Let me assure you, in this regard, that the slowdown of the past few months in the growth rate of the narrowly defined money supply does not reflect a change in Federal Reserve policy. Provision of bank reserves through open market operations during this period has, in fact, been quite generous. The public, however, has chosen to hold additions to its deposit balances in the form of time accounts rather than demand deposits. Most recently, in fact, growth of a more broadly defined money supply—that is, currency plus demand deposits plus commercial bank time deposits other than large CD's—has actually accelerated to an average annual rate of over 12 percent during the months of December and January. Short-term variations of this kind in the public's preferences for demand and time deposits are not uncommon. We do not understand them fully, but we should not let them distort judgment of the course of monetary policy.

Continuation of a monetary policy that is consistent with economic recovery will enlarge the supply of available funds, and borrowers should therefore find it easier to obtain credit. Later this year we might perhaps see interest rates somewhat lower than they are now—particularly on mortgages and longer term securities. In areas where monetary policy affects credit conditions with a rather long lag—for example, in the Nation's smaller communities and in the credit terms available to smaller businesses and consumers—we could look forward to seeing more evidence of the effects of monetary stimulation as the year progresses. And as easier monetary and credit conditions work their way through the financial system, we could anticipate cumulative effects on spending, on production, and on employment.

Financial developments of this kind might have adverse effects, in the short run, on our balance of payments—in the form, particularly, of a net outflow of interest-sensitive funds. The extent of this outflow may be limited, however, by measures such as those taken recently. These involved discouraging the repayment of Euro-dollar borrowings by our banks to their branches abroad, or the recapture of these funds through the sale of special securities to the foreign branches.

More fundamentally, I am convinced that policies which promise a healthy and prosperous domestic economy are essential to long-run improvement in our international payments position. To be competitive in international markets, our economy must operate with a maximum of efficiency and a minimum of inflation. A prosperous domestic economy will encourage American citizens to invest more at home rather than abroad. Moreover, some forms of capital inflow will be stimulated by economic recovery. Thus, the rate at which foreigners invest here by buying corporate securities or establishing affiliates has risen since the middle of last year, and might well increase further this year.

In view of the interest rate differentials that have recently emerged between the United States and other countries, as well as because of the persistence of inflation, closer attention will need to be given by our Government to the balance of payments. I do not expect, however, that these considerations will prevent us from pursuing the course of monetary policy needed to achieve a good recovery in employment and production in 1971, especially if further progress is made in moderating inflationary pressures.

Past experience supplies some broad indications of what the appropriate course of monetary policy might be. We know, for example, that while a high rate of growth of the narrowly defined money supply may well be appropriate for brief periods, rates of increase above the 5 to 6 percent range—if continued for a long period of time—have typically intensified inflationary pressures. We also know that periods of strong cyclical recovery in production and employment in the postwar period haye typically been financed with relatively modest increases in the money supply. In such periods, the income velocity of money—that is, the ratio of GNP to the money stock—has risen substantially, reflecting the more intensive use of cash balauces by the public. Following each of the past three postwar recessions, for example, the income velocity of money rose during the first four quarters of recovery by amounts ranging from 5½ percent to nearly 7 percent.

We cannot, of course, be confident that history will repeat itself. If the income velocity of money does not rise in 1971, in line with past cyclical patterns, then relatively larger supplies of money and credit may be needed. One of the great virtues of monetary policy is its flexibility, so that adjustments can be made rapidly to unexpected developments. The Federal Reserve will not stand idly by and let the American economy stagnate for want of money and credit. But we also intend to guard against the confusion, which sometimes exists even in intellectual circles, between a shortage of confidence to use abundantly available money and credit, on the one hand, and an actual shortage of money and credit, on the other.

I can assure this committee that the Federal Reserve will continue to supply the money and credit needed for healthy economic expansion. But I also wish to reaffirm the assurance that I gave to this committee and the Nation a year ago—namely, that the Federal Reserve will not become the architects of a new wave of inflation. We know that the effects of monetary policy on aggregate demand and on prices are spread over relatively long periods of time. We are well aware, therefore, that an excessive rate of monetary expansion now could destroy our Nation's changes of bringing about a gradual but lasting control over inflationary forces.

We recognize also, as do an increasing number of students around the world, that the problems of economic stabilization policy currently plaguing us cannot be solved by monetary policy alone, nor by a combination of monetary and fiscal policies. Monetary and fiscal tools can cope readily with inflation arising from excess aggregate demand. But they are ill suited to dealing with a rising price level that stems from rising costs at a time of rising unemployment and excess capacity.

During the past year, despite an increase in unemployment of 2 million persons, we have once again witnessed advances in wage rates substantially above the growth of productivity. In industries such as retail trade and finance, wage-rate increases have slowed somewhat. In others, such as manufacturing and construction, the rate of advance in average hourly earnings has not diminished. Wage settlements granted in major collective bargaining agreements during 1970 were, in fact, considerably larger on the average than in the previous year. For the first year of the new contracts, they averaged 8 percent in manufacturing and 18 percent in the construction industry.

There have been earlier instances in our history when price increases have continued for a time despite weakness in business activity. But, as far as I know, we have never before experienced a rate of inflation of 5 percent or higher while the unemployment rate was rising to recession levels. Continuation of this situation much longer would, I am afraid, sap the confidence of the American people in the capacity of our Government and in the viability of our market system.

We are thus confronted with what is, practically speaking, a new problem. A recovery in economic activity appears to be getting underway at a time when the rate of inflation is still exceptionally high. The stimulative thrust of present monetary and fiscal policies is needed to assure the resumption of economic growth and a reduction of unemployment. But unless we find ways to curb the advance of costs and prices, policies that stimulate aggregate demand run the grave risk of releasing fresh forces of inflation.

In view of this new problem, it is the considered judgment of the Federal Reserve Board that, under present conditions, monetary and fiscal policies need to be supplemented with an incomes policy; that is to say, with measures that aim to improve the workings of our labor and product markets so that upward pressures on costs and prices will be reduced.

The administration has already taken significant steps in this direction. Public attention has been called pointedly to areas in which wage and price changes are threatening the success of our battle against inflation. Restrictions on the supply of oil have been relaxed. Part of the recent increase in prices of structural steel has been rolled back as a result of governmental intervention. And the President has clearly conveyed to the construction industry that the Government will no longer tolerate the runaway labor costs that are destroying construction jobs and depriving so many of our families of the opportunity to buy a home at a price they can afford to pay.

These steps have put our Nation's business and labor leaders on notice that the Government recognizes the character of the present inflationary problem, and that it is serious in its intent to find a cure. If I read the national mood correctly, widespread public support now exists for vigorous efforts to bring wage settlements and prices in our major industries within more reasonable bounds. Such efforts should bolster consumer and business confidence, and thus contribute materially to getting our economy to move forward once again.

Chairman PROXMIRE. Thank you very much, Mr. Burns.

Mr. Burns, you and the administration seem to differ sharply on what we need to stimulate the economy and get unemployment down to provide the jobs we need. In your statement, you seem to feel that there is a stimulus, significant and sharp stimulus, perhaps, in the fiscal policy of our Government, Now, when Mr. McCracken appeared before us, he told us that in his judgment, changes in the full-employment surplus from period to period, from year to year, is what is important. He told us further that there has been no change between 1970 and 1971. He said that the full-employment surplus was just about the same; therefore, the budget should have about the same stimulus in both years, with no change.

That is why it is hard for me to understand your statement, when you indicate that you think that the present fiscal policy is consonant with the requirements of an economy operating at high levels of unemployment. What is your answer to that? Where will the stimulus come from?

Mr. BURNS. Senator, I think that the fiscal policy of the administration is a stimulative policy. I don't think it is a sharply stimulative policy, but it is a stimulative policy. The fact that the stimulus in the coming fiscal year may be no larger than the stimulus occuring this year does not alter the fact, as I see it, that the administration's fiscal policy overall is stimulative.

Now, the question you put to me is: Is it stimulative enough? Well, I do not know the answer to that question. It looks reasonable to me. I would watch developments; and depending on developments, I might want to see fiscal policy change.

Chairman PROXMIRE. The difficulty is that last year, it was not stimulative in its effect, in its consequences. We all know we had the same kind of a full-employment surplus, we had a $18 billion deficit, as we all know; unemployment increased steadily throughout the year, ended up at 6.2 percent. So the results last year were not good.

Furthermore, we have the assertion by Mr. McCracken, very recently—as a matter of fact, it is in the Wall Street Journal of either today or yesterday—that if our economy is not moving along the basic track as it ought to, our policy will have to be adjusted further. He said and I quote: "We hope any additional stimulus could be primarily in the monetary and credit area; it is quite difficult to change the budget in the short run."

Now, would you share that view, that whatever additional stimulus we are going to get, if the economy is to move ahead, will have to come from your shop, the Federal Reserve Board, have to come from more credit?

Mr. BURNS. I think the Federal Reserve has done a pretty good job, Senator, in laying the foundations for the resumption of economic growth. Banks are flooded with money now, hunting for customers. What we have in this country is a shortage of confidence, not a shortage of money. But the Federal Reserve will continue to supply money and credit at a reasonable rate. The job facing the country is to rebuild confidence.

Chairman PROXMIRE. I would agree with that. It would seem to me, however, that what this seems to tell us in that there is not a great deal our Government can now do. Fiscal policy, as you have indicated, while stimulative, is not greatly stimulative. You say the Federal Reserve has done its job—done it—past tense—and the money is available. Now we have to rely on what the public is going to do. The Government, it seems to me, has said, this is it; if the economy does not move ahead, there is nothing more we can do. Is that fair or unfair?

Mr. BURNS. You are never unfair, Senator.

Chairman PROXMIRE. Well, unwise?

Mr. BURNS. You are never unwise. But you know and I know that governmental policy is not confined to fiscal and monetary matters. I think there is a great deal that Government can do in the area of wages and prices, in the area of markets, that can help to restore confidence. And, perhaps, there is something the Government ought to do in the field of taxes that it is not yet doing, or which is not included in the President's budget.

But I would lay primary emphasis on a governmental policy designed to improve the workings of our markets. Our fiscal policy as of today looks pretty good to me. Needless to say, I think our monetary policy looks good to me. But we have been much too slow in recognizing the need to improve the workings of our commodity and labor markets.

Chairman PROXMIRE. Well, I want to be sure I understand now. Your position seems to disagree with that of Mr. Shultz, who indicated to us that he felt that a sufficiently stimulative monetary policy could do the job. Do you think there is a monetary policy which will guarantee us, assure us, of 4½-percent growth in real output in 1971?

Mr. BURNS. I know of no such monetary policy. But I am also not quarreling with Mr. Shultz.

Chairman PROXMIRE. Well, if you are not quarreling with Mr. Shultz on that score, let me see if I can get you into a quarrel with him on something else.

Predictions of most economists, as you know, are that the gross national product will be about a trillion 45 billion dollars during this year. And a great deal hinges on the administration's proposal that it will not be at that level, but at a trillion 65 billion dollars. If it is that high the deficit will be less, unemployment will be less, and the economy will be growing at a good rate.

Wednesday we had the Department of Commerce appear and their top experts told us that in their judgment, the administration is wrong—they said the Council of Economic Advisers and the Office of Management and Budget are wrong; the Commerce model indicates that they expect the economy to be about a trillion 45 billion dollars.

Now, you have some of the ablest economists in the Government on your staff. I think it is well that we know what the Federal Reserve Board thinks is likely to be the result of our fiscal policies in 1971 in GNP.

Mr. BURNS. Senator, when you speak of this or that economist disagreeing with another in this or that area, you are speaking of a situation that has existed in Government for many years and will exist as long as you and I do. And when one economist speaks of another economist as being wrong about the future, let us all remember that good historians are often uncertain about what happened in the past.

Now, to come more directly to your question, Senator, I think the administration's projection may be viewed either as a target or as an outright prediction. Viewed as a target, I think it is admirable.

Chairman PROXMIRE. So do I.

Mr. BURNS. Viewed as a prediction, I consider it optimistic.

Now, you would like to know what the able economists in the Federal Reserve System think. They think the administration's projection, viewed as an outright prediction, is very optimistic. And perhaps I have said enough in answer to your question.

Chairman PROXMIRE. Well, you have said a great deal, but I would like a figure; can you tell us, give or take $3 or $4 billion?

Mr. BURNS. I do not think it would help very much to give you a figure. In the first place, I could not give you a single figure. The Federal Reserve economists are so discriminating and they have such an awareness of their own limitations that they present a range of projections, you see.

Chairman PROXMIRE. Well, give us the range.

Mr. BURNS. They have more than one mark.

I am an economist myself, as you know. My projection differs from that of staff. I see no advantage in telling you what the worksheets presented to the Federal Reserve Board look like. I have indicated that the estimates of the staff are below the administration's projections. If it will make you just stop asking me further questions along this line, let me say that the projections by the Board's economists are in the neighborhood of the projections that are currently being released by business economists over the country.

Chairman PROXMIRE. Thank you. That is about a trillion 50 billion dollars.

You speak in your statement of the improvement in productivity due to the elimination of loose and wasteful practices. The main reason for the improvement of productivity in the second and third quarters was the decline in employment. Is it a loose and wasteful practice to keep people on the job rather than lay them off?

You see, the productivity trend was reversed in the fourth quarter and that reversal was too sharp to be accountable just by the auto strike. I am wondering if you are not a little optimistic in your notion that our productivity is being improved sharply enough so that this aspect of the inflation problem we are getting under control.

Mr. BURNS. Let me deal first with the arithmetical point. I have looked into the fourth quarter change in productivity and I have had a special study made of it at the Bureau of Labor Statistics. The study suggests—it does not demonstrate, Senator, but it suggests—that the automobile strike was entirely responsible for the decline of productivity in the fourth quarter.

Now, to turn to the more fundamental aspect of your question, business profits have been falling. Indeed, they have been falling very sharply. The average rate of business profits began eroding in late 1965. It has eroded year after year since then, and it dropped very sharply last year. Indeed, last year, the rate of profit in American industry was lower than at any time since the end of World War II.

As long as we had a strong inflation going and business was prosperous, the monetary illusion—looking at dollar volumes without allowance for price increases—kept these facts somehow from being adequately recognized by the business community. But when sales fell off rather sharply in some of our industries last year many businessmen finally realized that even their solvency may be at stake, and an extensive cost-cutting campaign got underway.

My impression, Senator, is that businessmen during the past year have paid more attention to costs and ways of improving efficiency than they have in many a year. I think that a general revival in productivity is underway and I attribute this revival to the hardtimes that many of our businesses have been experiencing.

When I was a student in college, I took a course with John Dewey, which largely dealt with the subject of "How We Think." That is where I learned a little about the process of thinking. John Dewey taught his students that we think only under conditions of necessity. We go along in our own way, not really using our brains until we have to. Last year businessmen had to use their brains and they did.

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

Mr. Widnall.

Representative WIDNALL. Thank you, Mr. Chairman.

Mr. Burns, you certainly made a very fine statement and I think, in many ways, a good appraisal of the actual economy at the present time. I think one of the extremely important things you said, at the tag end of your statement, concerns the considered judgment of the Federal Reserve Board that under present conditions, monetary and fiscal policies need to be supplemented with an incomes policy—"that is to say, with measures that aim to improve the workings of our labor and product markets so that upward pressures on costs and prices will be reduced."

You discuss then some of the steps the President has taken on an ad hoc basis to deal with the specific industry problems. Do you see the need for a more comprehensive plan or approach to the incomes policy question and what sort of program do you see?

Mr. BURNS. Well, I would welcome a more comprehensive approach; yes. I would welcome it very much.

I have no offhand views on this subject. I want to see movement, I want to see progress, and I am willing to grant that the other fellow may have better ideas than I have in this area.

To give you my views, I feel disturbed that we have had great excesses in the construction industry. What is happening in that industry is spreading to other industries, and special measures with regard to that industry are therefore necessary.

Second, I am inclined to think that it would be helpful to our country at a time such as this to establish a wage and price review board which would deal with industry problems generally. That review board would not have enforcement powers, but it could initiate inquiries into specific wage adjustments or into specific price adjustments. It could hold hearings on such developments at the request of the President or the Council of Economic Advisers.

I would expect that after several months such a wage and price review board would evolve, through a process akin to case law, guidelines for prices and wages. I think it is difficult to set forth guidelines that would be workable without some actual experience.

I would look in these two directions, particularly. There are some others that I listed in a speech that I gave at Pepperdine College on December 7. I would be glad to include, if you so wish, a more detailed statement drawn from that speech.

Chairman PROXMIRE. Without objection, that will be included in the record.

(The information referred to follows:)

The Pepperdine speech suggested these steps that might reduce inflationary pressures by improving the functioning of markets;

1. Liberalization of import quotas on oil and other commodities.
2. More vigorous enforcement of antitrust laws.
3. Expansion of Federal training programs to provide more skilled workers where wages are rising exceptionally fast.
4. Establishment of local productivity councils to increase efficiency.
5. A more aggressive pace in establishing computerized job banks.
6. Liberalization of depreciation allowances to stimulate plant modernization.
7. Suspension of the Davis-Bacon Act to help restore order in the construction trades.
8. Modification of the minimum-wage laws to open up more jobs for teenagers.
9. Establishment of national building codes to clear the way for modern production techniques in the construction industry.

10. Compulsory arbitration of labor disputes in industries that vitally involved the public interest.

11. Establishmentt of a high-level Price and Wage Review Board which, while lacking enforcement power, would have broad authority to investigate, advise, and recommend on price and wage changes.

Representative WIDNALL. Do you believe that in order to reduce the cost-price inflation in some of our more concentrated industries, it would be necessary to undertake some basic revisions of our antitrust and labor laws?

Mr. BURNS. I think the time for a very thorough rethinking of our antitrust laws is very much in order. Quite apart from the labor problem, some of my attorney friends tell me that antitrust law now is in a state of great confusion and that business would be aided by some clarification. The possibility of extending antirtust laws to the labor area should be evaluated fairly and responsibly. We should not rush into it, but we ought to think about it. And certainly, very strict enforcement of our antitrust laws—perhaps stricter enforcement than we are getting—would be especially important at a time like this.

Representative WIDNALL. In your testimony before this committee last February, you stated that as inflationary expectations abate, we should see a significant reduction in the overall tensions in the credit markets, one aspect of which would be a downward movement of interest rates toward historically more normal levels. We of course in the last few months have had a very substantial drop in interest rates. However, can this drop be attributed in any significant degree to abatement of inflationary expectations? Does not the drop in interest rates really reflect the severity of the business lull and the short money supply?

Mr. BURNS. It reflects the sluggishness of business activity and it reflects some of the things the Federal Reserve Board has been doing as well.

Representative WIDNALL. I think that is all at this time.

Thank you.

Chairman PROXMIRE. Congressman Bolling.

Representative BOLLING. Mr. Burns, it is always a pleasure to have you before us. I remember somewhat vividly your first appearances before the committee when you were Chairman of the Council of Economic Advisers. I think at that time we had some disagreement as to the manner of appearance, some question as to whether it would be public or private or semiprivate or semipublic. But in any event, I have great admiration for your abilities, and I have great confidence in the difficult but important division of powers between the Executive, the Congress, and the Federal Reserve in the whole area of the semimanagement of the economy. So I start out not intending to try to exacerbate any differences that may exist between the Board and the Executive.

You mentioned two things in your comments—not in your formal statement but in your comments in answer to the questions of the chairman—that I would like you to expand upon a little, though these are not the main points I want to get at.

First, you mentioned the problems of our markets, and you thought that something should be done about that, I gathered. You made yourself very clear on labor, but I am curious whether the only thing that you feel needs to be done about markets has to do with the antitrust laws.

You also mentioned taxes, and perhaps something should be done about that, but it was not suggested by the Executive. I would like you to comment briefly upon those two points in the way of expansion.

Mr. BURNS. Yes. With regard to markets, in the first place, I think it would be very helpful either to eliminate—it is hard to do, I recognize—or at least to enlarge our import quotas. I think this would improve the workings of our commodity markets. A little more competition is uncomfortable, but it can release forces tending to dampen inflation.

Also, as far as commodity markets are concerned—I did not cover that in my statement, but I did refer to it in oral testimony—I would like to see a wage and price review board. I would have prices as well as wages reviewed by that board.

As to taxes, what I have in mind are just some thoughts that I think the Congress should consider. One is with regard to increasing the base of the social security tax. There is legislation before the Congress now which would raise the base of the social security tax from $7,800 to $9,000. That would be retroactive to January 1.

It is not clear to me that this ought to be done now. I would be inclined at this time not to do that. In any event, this is a subject that I would recommend for congressional discussion.

Another tax subject that I would recommend for congressional discussion is reconsideration of the investment tax credit.

Representative BOLLING. Mr. Burns, I am not interested, as I said at the beginning, in trying to create a conflict on this particular issue, but I am curious as to whether the Federal Reserve Board or its staff have done any work—and I hope I define this professionally enough to make it understandable—on the possible general economic impact of any form of revenue sharing. To try to make clear what I am talking about, the Federal Government and various agencies, including your own, have a significant impact on the economy. One of the reasons that the Executive and the Congress have some impact is that despite claims to the contrary, we can do a good deal, both in theory and in fact, to determine the aggregate expenditure as opposed to receipts, in other words, the budget's balance or imbalance. We can, with much greater flexibility, dry up, slow down, or stop the expenditure of funds in a wide range of areas.

Now, of course, there are a number of areas where we cannot do a thing. It has occurred to me that in becoming committed to a significant sharing of Federal revenues—and for the sharing of revenue to have any significance one would have to assume an iron clad commitment—one of the problems would be a marked lessening of the ability of the Executive and the Congress to have a sound, really distinct impact on the direction of the economy. I have heard nothing said about this. I have heard almost no discussion about it. I am curious as to whether the Federal Reserve Board, which is usually a good deal more judicious than some other agencies, has given some thought to this particular aspect of the problem; or is it a problem?

Mr. BURNS. Well, you ask a very good question, Congressman Bolling. If I may refer to my experience in the 1950's, you have been very consistent in that respect.

Let me say first of all that I am not aware of any studies of revenue sharing at the Federal Reserve Board. However, I should inform you also that I had something to do with the revenue-sharing proposal made by the President. In fact, I had a good deal to do with it in an earlier year when I was Counselor to the President. I worked out the details of the plan. The magnitude of the plan, though not its structure, has changed considerably since I left the White House.

Let me give you my version of revenue sharing, if you will bear with me. It is not a proposal that I came to lightly.

We now have in our country something like 500—that is the order of magnitude—specific categorical grant-in-aid programs. I do not think we have 500 social objectives in our country. I do not see how, Congressman, one can evaluate programs that are so numerous. If you have a governmental scheme which you cannot evaluate, which you cannot grasp intellectually, then it is very doubtful whether you have good government any longer.

It is from this set of considerations that I approached revenue sharing. And the conclusion that I reached was that consolidation of specific categorical grants was eminently desirable. It would make for greater efficiency in government. It would enable Congress and the public to evaluate what was happening to the governmental process. But if you asked me the question, how far would I go on the path of consolidation, the only honest answer I could give you is that a strong trend toward bloc grants, toward consolidation of grants, would be desirable. The ultimate of consolidation, of course, is what we have come to call, a little inappropriately, revenue sharing—in other words, a single grant without any strings.

Now, whether you need go that far or how far you need go is a matter for individual opinion and political compromise. I do not think any man knows. I certainly do not know what the optimum level or degree of consolidation should be. So, I am very much in favor of moving toward bloc grants vigorously, but I have no strong or fixed opinions about the intensity or degree.

As far as the present problem facing the economy. and I take it this is what you have in mind—revenue sharing—is not the ideal form of expenditure. It has the kind of inflexibility that you suggested. Moreover. I think there may be another difficulty. That is, after the Congress does its work, assuming that it goes in the President's direction, I am not at all sure that the money can be spent very quickly.

So there are two conflicting considerations. One is the long overdue improvement in the process of the Government. In my opinion, the President's thrust—never mind the details—is entirely sound and desirable.

There is the second question. What should the structure of expenditures be from the viewpoint of energizing the economy presently? From that viewpoint, I think, revenue sharing leaves something to be desired.

I agree with you that revenue sharing would introduce an element of inflexibility in the overall scheme of Federal expenditures. I would not stress that point, however, as you seem to do—well, that is not fair; you asked a question only. I would think that while an element of inflexibility would be introduced, quite enough flexibility would be left in other parts of the vast expenditure programs of the Federal Government.

I have given you an excessively long answer, but this is a subject that I have reflected on a good deal. I could not suppress a professorial desire to lecture.

Representative BOLLING. I am glad you found it impossible to suppress it, but my time is up.

Chairman PROXMIRE. Congressman Conable.

Representative CONABLE. Thank you, Mr. Chairman.

Mr. Burns, you do have some revenue sharing with your member banks in the Federal Reserve System; do you not?

Mr. BURNS. Well, we get along; yes. We share our trials, and also our successes.

Representative CONABLE. I would like to ask you, sir, some questions about the gross national product. First of all, the chairman in his opening statement stressed the fact that there was some question as to whether or not our fiscal policy was sufficiently vigorously stimulative. He implied that a big burden was going to be put on monetary policy as a result. Now, for the laymen present, and I am one, I wonder if you could tell me how our fiscal policy could be more vigorously stimulative?

Mr. BURNS. Well, our fiscal policy could be more stimulative if taxes were reduced or reduced further or if expenditures were increased further. I would urge, as I did in responding to Mr. Bolling's question, that some attention should be given to the structure of taxation and expenditures as well as to the level or amount of expenditures.

Representative CONABLE. The general answer, though, would have to be to increase the size of the deficit, is that not correct?

Mr. BURNS. In the short run, that would be the answer. There is no escaping that.

Representative CONABLE. The deficit is figured at least partially on the basis of the size of the gross national product, is it not?

Mr. BURNS. That is right.

Representative CONABLE. And so if there is optimism, as you suggest, in projections of gross national product, inevitably, our fiscal policy is more stimulative than it appears, is it not?

Mr. BURNS. You are asking me whether the prospective deficit may not be larger than the budget message suggests. It may well be larger.

Representative CONABLE. It what?

Mr. BURNS. It may well be larger than the budget message suggests.

Representative CONABLE. Now, I was interested in a speech made yesterday by Maurice Mann. He said this:

> I suggest it would not be the best of all possible worlds if the economy were literally pushed to a $1,065 billion GNP in 1971. Such an achievement would imply the floodgates had been opened and that monetary policy had become much too easy. Moreover, if you were to achieve a $1,065 billion GNP, it is likely that the composition of the advance would be laregly dominated by inflation at the expense of real growth.

Let me ask you, sir, do you agree with this statement, or do we have such unused productive capacity and sufficient potential for growth so that it is possible to achieve a $1,065 billion GNP without substantial inflation?

Mr. BURNS. It is a very hard question to answer. My present judgment is that the answer is in the affirmative. I have made some calculations, although I can't tell you how accurate they are. They suggest that if we achieve a gross national product of $1,065 billion this year, the unemployment rate would drop, but it would not drop below 5 percent, this level being reached by the end of the year.

That suggests, if the calculations are nearly right, that we do have sufficient slack in the economy to be able to accommodate the kind of increase that has been predicted.

Now, as for Mr. Mann's warning that we must not drive toward that figure regardless of consequences, I think it is very wise. It is a very wise warning, I would say. The administration's figure is a good target to work toward, but let us watch the consequences as we move along.

Representative CONABLE. Now in an unrelated subject, sir, yesterday the Ways and Means Committee, on which I serve, considered the debt ceiling once again and decided, among other things, on the exception of about $10 billion of financing from the interest ceiling on long-term securities. Do you have any comment on that? Is that a desirable step? Is it likely to have any major impact on interest rates?

Mr. BURNS. Mr. Conable, I must apologize. My mind wandered for a moment. Would you be good enough to repeat your question?

Representative CONABLE. Well, I am talking about action taken in the Ways and Means Committee yesterday relating to the raising of the debt ceiling.

Mr. BURNS. Right.

Representative CONABLE. We planned the exception of a figure of $10 billion from the interest ceiling on long-term securities. I wondered if this would have any impact on interest rates generally, if you had any comment on it. Obviously, it is a desirable step from the point of view of debt management.

Mr. BURNS. Yes.

Representative CONABLE. Do you have any comment to make about this approach?

Mr. BURNS. In the absence of complete lifting of debt ceiling, I would consider this a desirable thing to do because the Treasury is boxed in under existing legislation and the taxpayer bears an unnecessary heavy burden of interest charges. The Treasury time and again has had to borrow in the short market when it could have borrowed in the long market at lower rates of interest. So, giving the Treasury some more flexibility, I think, is eminently desirable. The proposal made to the Ways and Means Committee would go some distance in achieving that objective. I might favor something else still more, but that does not matter.

Representative CONABLE. Do you expect it to have an impact on interest rates other than the cost of funding the national debt?

Mr. BURNS. At the moment, my answer is no, but I would want to reflect on that question before answering you with full assurance. If I find that my off-the-cuff comment is misleading, I would like the privilege of inserting a sentence or two in the record.

Chairman PROXMIRE. Without objection.

Representative CONABLE. That is all I have, Mr. Chairman. Thank you.

Chairman PROXMIRE. Congressman Moorhead.

Representative MOORHEAD. Thank you very much.

Mr. Burns, I enjoyed very much your testimony. I think it is extremely helpful. I admired the way you adroitly addressed yourself to the projected gross national product.

I want to ask you about something that appeared in yesterday's Wall Street Journal. The headline was "Federal Reserve Quietly Explores Aiding Lockheed." It refers to a regulation V loan provision for defense contractors. Is there any basis to that story, sir?

Mr. BURNS. None whatever.

Representative MOORHEAD. Thank you. I am very pleased to hear that.

If you were requested to come to their assistance, that would be under the provisions of the Defense Production Act, would it not?

Mr. BURNS. That is correct.

Representative MOORHEAD. And the function of the Board would be to give a credit report as to the applicant for a guarantee. Is that correct?

Mr. BURNS. Entirely right, yes.

Representative MOORHEAD. It is my understanding, also, that we changed the law of the Defense Production Act last year to put a $20 million limit subject to further approval by the Congress. Is that correct, sir?

Mr. BURNS. Entirely right.

Representative MOORHEAD. Thank you.

Mr. Burns, I was very much interested in your statement about an incomes policy, because legislation is scheduled to come before the Banking and Currency Committee of the House next week on this subject. I notice that you recommend the creation of a Wage and Price Board but with no mandatory powers. Do you thiuk that it would be advisable to give, let us say, to the President reserve powers so that he would have the shotgun in the corner in case the parties before the Board ignored their recommendations?

Mr. BURNS. I am a conservative economist, Congressman, a little too old to change. The thought of mandatory controls except in time of war or great national emergency just frightens me. I have come to believe, and I have taught thousands of students to believe—I hope I taught them to believe—that the free market system is this country's greatest economic asset. Therefore, I look with great misgivings on any proposal for mandatory controls.

But I am also a realist, and I think we may be approaching an emergency in our country. I must confess to you that there are times when in the dead hours of night, I find myself even thinking about a price and wage freeze. But when I rise and have a cup of coffee, I still don't want it.

Representative MOORHEAD. My mind goes back to before the automobile strike when the President, properly authorized by the Congress, could have called in the parties and said, I don't like wage and price controls; I am philosophically opposed to them. But if you make too unreasonable a settlement on the wage side and expect an unreasonable, therefore, price increase, I would feel forced to use it. I think the existence of the power might even prevent its use.

Mr. BURNS. Well, let me just make two observations.

First, before we go to any mandatory controls, we certainly ought to try milder measures—measures that are more in harmony with our national traditions and that promises some success. True, a Wage and Price Review Board may turn out to be ineffective. But I would try it, along with some other measures that the President and the Congress may take.

Second, if the Congress feels differently, then the Congress should consider legislating to impose price controls directly.

Let's put it a little differently: You are giving too much power to the President under this legislation. You are giving the President virtually dictatorial power. Do you really want to give any man that much power? That worries me. I can see some advantages, and you have pointed them out. I have considered them, and I do not dismiss them lightly.

But let me say this: If you do give this power to the President, if you do extend this authority beyond March 31, I hope you will do so only for a very brief period, because you will be giving dictatorial powers to the President, and you ought to do that with the greatest of caution.

Representative MOORHEAD. I am inclined to agree with you, Mr. Burns. I think the proposal, as I understand it, will be for a 2-year extension of this power.

Mr. BURNS. I would say a 2-week extension would be better than 2 years. If we give any man dictatorial powers for 2 years, where might we be?

Representative MOORHEAD. Would you think, say, 6 months would be more reasonable?

Mr. BURNS. No; too long. After all, if Congress wants to do this, you can do it for a short period. You can then extend it pretty easily, by joint resolution, for another 4 weeks or another 2 months.

Representative MOORHEAD. I think that is a very valid suggestion. I think we should review the economic situation and the proper or improper use of this power at frequent intervals.

Mr. Burns, I would like now to ask for some professorial advice, if you will, about how money affects the economy. One group seems to say that increase in the money supply lowers interest rates, which in turn stimulates investment. The other is that the increase in the money supply means more money in the hands of the consumers and they will simply go out and spend more. How do you think the money supply affects the economy?

Mr. BURNS. I think both schools are right, and I think both schools tell an incomplete story. An increase in the money supply will, to be sure, tend to stimulate spending. But this process is likely to work in indirect ways. If cash balances increase faster than the transaction needs of the public, the money may be invested in securities rather than spent on consumer goods. If individuals buy corporate bonds rather than automobiles, this will help to lower interest rates and encourage businesses to borrow funds to spend on plant and equipment, for example. But this process takes time, and thus the effects on production and employment will be longer in coming.

This economic process, I think, is being very much simplified. I wish economists would stop warring with one another and attend to the substantive problem rather than look for the simple answers that so many are searching for and presenting this committee with. Both schools are right, but neither school has told the complete story, in part because the complete story is not fully understood.

Representative MOORHEAD. Mr. Burns, some of the people in the banking community believe that interest rates may decline over the next few weeks or months, but toward the end of the year, they will start up again. I take it from your testimony that this is not your view of the future or probable future of interest rates?

Mr. BURNS. Well, Mr. Moorhead, you have now entered the territory where a central banker must speak with the utmost caution. In fact, he should not speak on this subject at all, and by tradition he has not spoken on this subject. Nothing in my testimony should be interpreted as being consistent with the view you presented or as being inconsistent with it.

Representative MOORHEAD. I thank you for that veracity.

Chairman PROXMIRE. Senator Javits.

Senator JAVITS. Mr. Burns, I am gratified, as are my colleagues, that you are here. I think the country is better off and has a feeling of greater confidence because of your presence here.

I note that you have been asked a good deal about this incomes policy question. I gather that you rest the need for—I would not like to say restoration, but perhaps a stimulation of confidence in the American economy on the part of the consumer on two scores—the incomes policy, and I thoroughly agree with you on that, including the kind of board that we should have now, and productivity. Is that correct?

Mr. BURNS. That is substantially correct, Senator.

Senator JAVITS. Now, before we get into productivity, which is something that I am especially interested in, can we say on the incomes policy that you do not exclude, even though you would like to dispell the idea after morning coffee, the possibility of a freeze in whole or in part as a start for an incomes policy?

Mr. BURNS. That is correct. I no longer exclude it from my thinking, but I would proceed most cautiously.

Senator JAVITS. Certainly. So that really, the suggestion you have is a twin suggestion. It is a suggestion of a methodology, to wit, some form of a wage-price board, and you have expressed yourself on that, or if the President should permit us a freeze—should permit it; not necessarily that it will happen—in whole or in part, and a continuing set of criteria and some authority by exhortation or, if necessary, by firmer authority to carry out its recommendation.

Mr. BURNS. I would agree with all that, except I would not at this time give the wage and price review board the authority for the freeze.

Senator JAVITS. You would not, however, exclude ancillary methods, as, for example, the policy pursued in Government procurement?

Mr. BURNS. Oh, no; by no means.

Senator JAVITS. Or release of raw materials from Government stocks?

Mr. BURNS. No; that could be very salutary.

Senator JAVITS. Now, on the productivity side, as Mr. Burns knows, I am proposing introduction of a measure which I first sponsored in 1963, in an effort to establish a national productivity council and local productivity councils, very much on the basis of the War Production Board experience in World War II. I have a letter from Mr. Burns, generally speaking favorably to that point of view. Would you mind if I put it in the record?

Mr. BURNS. I would be delighted, Senator.

Chairman PROXMIRE. Without objection.

(The letter referred to follows:)

CHAIRMAN OF THE BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, D.C., February 18, 1971.

Hon. JACOB K. JAVITS,
United States Senate, Washington, D.C.

DEAR JACK: I'm writing in response to your request for comments on your bill to establish a National Productivity Council. You mentioned that even though you introduced it in 1963 it seems up to date in many respects. I would say the proposal is even more timely now. The need for increasing productivity is more pressing, and the prospects of achieving it through local councils seem better.

Management and labor face a common problem today. Demand for goods is weak. Consumers, concerned over the continued increases in living costs, are cautious about spending. This is a typical reaction to inflation of the kind we have been experiencing. As a result, production has fallen and unemployment has increased. This is not a situation in which aggregate demand must be curbed to stop a demand-pull inflation. We have passed that stage. Now we have to find a way to bring a lingering cost-push inflation under control to clear the way for a resumption in consumer spending, which will bring with it more efficient use of our resources.

Continued wage increases in excess of productivity gains will only mean continued price rises and continued unemployment. Yet workers will not be satisfied for long with paychecks that shrink in buying power. A major part of the solution, of course, is to find ways to increase productivity so that profits and wages both can rise as inflation subsides.

During World War II labor-management committees were established in thousands of war plants as a means of getting maximum production out of resources that were fully utilized. The program worked, because management and labor shared a common interest in solving a problem of paramount importance to the country. In 1944, W. Ellison Chalmers, then Chief of Staff, War Production Drive Headquarters, described the results as follows:

"(1) They are improving production. The files of War Production Drive Headquarters contain thousands of instances of production increases which have resulted from committee recommendations and from workers' suggestions, brought forth in response to the joint labor-management program, This has come in part from the development of individual suggestion systems. Many of these had existed before but took on new life when they were sponsored and directed by the Labor-Management Committees. Several million ideas have come in through these systems and hundreds of thousands of them have been adopted. Nearly 6000 of them, indeed, received, national recognition from the War Production Board.

> "This industrial teamwork has meant greater production by the collective ideas of the main committee and especially its departmental subcommittees, at work on the bottlenecks in each plant.
>
> "The committees have done more than 'expand' production. They have also improved quality, cut down waste, reduced the use of critical materials, and salvaged scrap. It is particularly important to note these production accomplishments, for they demonstrate that a production committee has a job to do even then schedule changes or material shortages force a downward revision of output."

Today, while the circumstances are different and the challenge is not so dramatic, the problem is real and pressing for the country as a whole and particularly for employers and workers.

I understand that you are exploring with Administration officials various alternative methods of organizing this effort and fitting it in with other Federal activities. Whatever housekeeping arrangements are ultimately decided upon, I enthusiastically support the objective of setting up local committees as a means by which management and labor can join together in increasing productivity, thereby fighting inflation and unemployment at the same time.

Sincerely yours,

ARTHUR F. BURNS.

Senator JAVITS. Now, Mr. Burns, would you be kind enough to give us your view upon the importance of the issue of productivity to which you have already referred in terms of foreign trade, and the relevance of activity on a council level, nationally and locally?

Mr. BURNS. Improvement in productivity is the foundation of improvement in our standard of living. One of the great costs of the recent inflation has been a certain stagnation in productivity. Last year, as Senator Proxmire pointed out, productivity improved. As productivity rises, it is possible to pay higher wages. That has been the true source of higher wages in our country.

Go back to the 19th century. We had all kinds of fluctuations in the price level during the 19th century. But the broad trend of the price level was horizontal. What about wages? Wages kept on rising steadily in the 19th century. Why? Because the Nation's productivity kept increasing.

To pay higher wages and yet have a stable price level, we need to have rising productivity. The more rapid the rise in productivity, the larger can the wage increases be, together with a stable price level and satisfactory profits. So that in emphasizing productivity—as you have, Senator—you have focused on one of the most vital things that we in our country can do and should be doing.

We now have a National Productivity Commission set up by the President. Well, that is a good thing. But it is not going to accomplish very much unless we establish through it or in some other way productivity councils at a local level. Improvements in productivity, after all, take place in the individual factory, in the individual store, in the individual unit of government.

We had a wonderful experiment during World War II, to which you referred. The War Production Board set up local councils throughout the country. There were thousands of them. From reports that I have seen, and the letter that you referred to summarizes that experience, it appears that the effectiveness of these local productivity councils was enormous.

Now conditions are different. At that time, you could inspire people to strive for greater efficiency, to make whatever suggestions for improvements were in their power. You could appeal to patriotism. That important source of inspiration is not at our disposal now. However, people are concerned, terribly concerned, about inflation. People do want to improve their living standards. If we set up machinery for establishing productivity councils on a community level, on a plant by plant level, and if we supplement that machinery with a good educational program, I think we may be able to accomplish a great deal and we certainly ought to try.

Senator JAVITS. Thank you very much, Mr. Burns. Just one other question.

You mentioned the point of motivation. It is a fact that this is a critically important component. Would you say, therefore, that the crisis of motivation or identity, or whatever the name that analysts or psychologists call it in our country, is also a critical factor, in being able to inspire our people to higher productivity, no matter what we do about the machinery, such as recently invoking the depreciation allowance, et cetera?

Mr. BURNS. Yes, we have to motivate people. We need leadership to inspire people and each of us should try to play a larger role in that respect.

Senator JAVITS. And the goals, of course, are peace and a stable economy. The pursuit of these goals ought to be done in terms of peace and the welfare of mankind which should be an adequate motivation if we can get it across. Is that not so?

Mr. BURNS. They should be. Whether they will be I don't know. But even if they are not, it is a very good thing to do, Senator.

Senator JAVITS. Thank you very much.

Thank you.

Chairman PROXMIRE. Congresswoman Griffiths.

Representative GRIFFITHS. Thank you very much, Mr. Chairman. It is nice to see you, Mr. Burns. I would like to ask you some questions about banking.

How many banks have failed in this country this year? I mean how many have been taken over by some other bank? I know we do not really let them fail anymore, but how many this year?

Mr. BURNS. Well, you have asked me an embarrassing question. It is a handful. I can't give you the exact number.

Representative GRIFFITHS. Will you supply it for the record?

Mr. BURNS. Yes, I certainly shall. The number is a very small.

Representative GRIFFITHS. And how many last year?

Mr. BURNS. Again, a very small number.

(The following information was subsequently supplied for the record:)

As the table below shows, three commercial banks insured by the Federal Deposit Insurance Corporation failed in the first two months of this year. During 1970 seven banks failed.

INSURED BANKS REQUIRING DISBURSEMENTS BY THE FEDERAL DEPOSIT INSURANCE CORPORATION DURING 1970[1]

Name and location	Class of bank	Date of closing or deposit assumption	Disbursements
State Bank of Prairie City, Prairie City, Iowa	Nonmember	Feb. 21, 1970	$3,640,287
Peoples State Savings Bank, Auburn, Mich	do	Apr. 15, 1970	8,342,751
Farmers Bank of Petersburg, Petersburg, Ky	do	June 25, 1970	1,177,465
Eatontown National Bank, Eatontown, N.J	National	Aug. 7, 1970	13,530,172
First State Bank of Bonne Terre, Bonne Terre, Mo	Nonmember	Aug. 22, 9170	5,537,825
City Bank of Philadelphia, Philadelphia, Pa	do	Sep. 3, 1970	8,851,685
Berea Bank & Trust Co., Berea, Ky	do	Oct. 8, 1970	5,298,660
Total disbursements			46,378,845

INSURED BANKS BECOMING INSOLVENT JAN. 1, 1971, TO MAR. 1, 1971[1]

Sharpstown State Bank, Houston, Tex	Nonmember	Jan. 27, 1971	(2)
Birmingham Bloomfield Bank, Birmingham, Mich	do	Feb. 11, 1971	(3)
Farmers State Bank of Carlock, Carlock, Ill	do	Feb. 17, 1971	(2)

[1] Preliminary data.

[2] Unavailable, still in process of liquidation.

[3] Liabilities assumed by newly formed bank; extent of FDIC disbursements has not yet been determined.

Source: Federal Deposit Insurance Corporation.

Note: The Annual Report of the Federal Deposit Insurance Corporation for 1969 indicates that during the past 10 years, 1960 through 1969, the Corporation disbursed $120,829,000 to depositors of 43 failed banks and as of Dec. 31, 1969, the estimated loss on these disbursements would approximate $23,869,000. This indicates that, on the average, the FDIC collects about 80 percent of the disbursements on failed banks through the liquidation of assets of the banks.

Representative GRIFFITHS. I would like to ask you also, is there any pattern to such bank failures? That is, as you look over the bank, can you recognize the names of lenders in one failed bank that appeared also in other banks?

Mr. BURNS. The situations vary, of course, as you know, but there is a certain pattern. Some of the banks that have failed had speculated in State and local securities, and in the process suffered huge losses. This has happened in a number of instances.

Representative GRIFFITHS. Are there some of these banks where the employees might be the same?

Mr. BURNS. Where the employees?——

Representative GRIFFITHS. In one failed bank may be found again in another one? Have you ever observed that?

Mr. BURNS. Well, there has been some community of interest, yes.

Representative GRIFFITHS. Is there some pattern in the fact that some of the banks are small town banks?

Mr. BURNS. Small town banks are more apt to fail than the large banks. Management is often less good. But there is also another factor. The Government will go to greater lengths to prevent a large bank from failing.

Representative GRIFFITHS. Well, now, in your judgment, I discovered that we have local laws that make it a felony to question the integrity of a bank or to say a word concerning it. I understand that in one failed bank the person who had been responsible for the loans turned up quite shortly on a little larger bank, with the responsibility of making loans. And when the bank was questioned about this, when both groups of managers were questioned, they said, of course, you know, we can't say anything. In the records, we were not permitted to say anything under the laws of this State, because he was never prosecuted in the first action.

Would you think that it is possible that at the present time, we have too much silence concerning the management of banks? While it may have been golden for bankers once, is it not now operating to help the looters?

Mr. BURNS. In all honesty, I have not studied this question. What you say disturbs me greatly. The next time before I appear before your committee I will have definite views on this subject. If you like, I can look into this more promptly. What you say disturbes me. I have not been aware of these laws. I can see reason for them, but I can also see possibility of abuse. You awaken a new concern.

(The following information was subsequently supplied for the record:)

The Michigan banking laws include the following provision:

> Any person who shall wilfully and maliciously make, circulate, or transmit to another or others any statement, rumor or suggestion, written, printed, or by word of mouth, which is directly or by inference derogatory to the financial condition or affects the solvency or financial standing of any incorporated bank, savings bank, banking institution, or trust company doing business in this state, or who shall counsel, aid, procure, or induce another to start, transmit, or circulate any such statement or rumor, shall be guilty of felony.

Similar statutes are in force in other States. It is true that some persons might be deterred from supplying information to bank supervisors because of uncertainty about the meaning of such a statute and its possible application to them. Insofar as supervision of State member banks is concerned, however, experience does not suggest that this is a serious problem. Since the statute is violated only where there is wilful and malicious defamation of a bank, it does not apply to situations where information is furnished in good faith to supervisory authorities. We hope that good citizens will continue to cooperate with bank supervisors, and we will do what we can to make sure that knowledgeable people do not withhold facts because of any misapprehension as to liability under such statutes.

Representative GRIFFITHS. I have always thought that the Federal deposit law was one of the greatest things that ever happened. The guaranteed depositors.

Mr. BURNS. Yes.

Representative GRIFFITHS. And it made it impossible, or made it improbable that you would have those long lines forming in front of the small local banks.

Mr. BURNS. Yes.

Representative GRIFFITHS. But as the years went on, it seemed to me that those lines really ran a test on who could bank and who could not. And that test is gone now. There is not any way to test.

But now I discover——

Mr. BURNS. Well, there is a test through the financial markets.

Representative GRIFFITHS. Right. But now I discover that in addition to the protection that the banker has, we have all these laws of silence concerning the banks which probably once were desirable and probably are no longer necessary at all. But you now are protecting the looters. Would it be too much to say that possibly within the last few months, $200 million have disappeared through these banks?

Mr. BURNS. I cannot answer that.

Representative GRIFFITHS. Would you check that?

Mr. BURNS. I will do my best, yes.[1]

Representative GRIFFITHS. And if that is true, is there any method by which you can check where that money went? It did not pay taxes.

Mr. BURNS. No.

Representative GRIFFITHS. In fact, maybe they were taking tax deductions; the people who received it were getting tax deductions for paying interest.

Mr. BURNS. I will inquire about that.

Representative GRIFFITHS. I would appreciate it very much.

Then I would like to ask you one other question and I would like to tell you that I came to Congress a real young gung ho free trader. If we enlarge import quotas, in your judgment, would it tend to drive down prices, wages, and profits, or just wages, or just prices?

Mr. BURNS. I would think that in the short run there would be problems, and they would require special measures.

Representative GRIFFITHS. What would it do to employment?

Mr. BURNS. Employment in the short run, unless we provided for adjustments, would suffer. All of which means that we ought to proceed in this area as in some others, cautiously—set a target for ourselves, but not try to get to that target tomorrow, and allow for some adjustments, particularly on the part of working people.

I would move very gradually and have special adjustment machinery during the period of transition, but I would move in that direction.

Representative GRIFFITHS. Thank you very much.

Thank you, Mr. Burns.

Chairman PROXMIRE. Senator Miller.

Senator MILLER. Thank you, Mr. Chairman.

Good morning, Mr. Burns.

Mr. Burns, the administration has set some targets for fiscal 1972 in the form of reduced unemployment rates, reduced inflation rates, and a deficit of $11.5 billion. We have had testimony before this committee indicating that these laudable targets rest on some premises: A premise of the accuracy of the estimate of the gross national product, to wit, $1,065 billion, a premise regarding the qualitative makeup of the GNP; and a premise regarding the accuracy of the estimated

[1] See table, p. 260.

revenue to be derived therefrom. Additionally, there are certain assumptions including the assumption that the monetary supply will be increased sufficiently to generate the $1,065 billion GNP and at the same time, not to aggravate the inflation picture; the assumption that those in control of the Congress will keep the spending within the limitations of the President's budget; and the further assumption of reasonable stability on the international and domestic scene.

Would it be fair to say that we will need some luck to have all these premises and assumptions work out so that the objectives I mentioned will be obtained?

Mr. Burns. It might even be fair to say that we will need a good deal of luck.

Senator Miller. Now, in that connection, with respect to the monetary supply premise, we received testimony that a 6-percent increase in the money supply could generate a 9-percent increase in the GNP. What troubles me is that in your testimony you pointed out that last year the money supply rose by five and a half percent. Yet, we didn't have anywhere near a 9-percent increase in GNP. Would you care to comment on what appears to be a little inconsistency?

Mr. Burns. Well, you are getting some simplified economic thinking put before this committee and before the Nation. Not many years ago, we had fiscalists running up and down the country, telling us that if governmental expenditures increased at a certain rate or if we had a governmental deficit of a certain size, they could tell more or less precisely what the gross national product would be—even if they ignored everything else. Now, we have some economists telling you that if we only look at the money supply—indeed, look at the money supply measured in an arbitrary way—you will not need to look at or think about anything else. In other words, the growth of the gross national product will be determined by the money supply defined in that particular way.

Well, I wish the economic world were that simple. I would have less to do and you would have less to do, and we would be a happier nation. My old teacher, John Dewey, would still be right; we would still have to think only under conditions of necessity. The special difficulty might be in the world of art and that would stimulate our thinking. But our economic problems would be easy; the money machine would grind out the gross national product. Unhappily, the world is not that simple.

As I pointed out in my testimony, the arithmeticians and great simplifiers are overlooking, first, the variety of experience; second, they are overlooking the income velocity of money—the fact that when recovery gets underway, money balances are used more intensively.

You have pointed to the rate of increase in the money supply of 5.5 percent during the past year when the gross national product declined somewhat in real terms. And, of course, you are right. That in itself is an indication that there is no simple, one to one correspondence between the rate of increase of the money supply, however defined, and growth in real output and employment.

I would add only that the increases in the money supply that took place last year will be doing some work this year for us. There is a lag here that must not be ignored.

Senator MILLER. Thank you very much. What you say causes me to suggest that if other factors turn out the right way, we might have a 3-percent increase in the money supply and still attain the 9-percent increase in GNP, and on the other hand, we might have to have a 12-percent increase in order to have the 9-percent increase in the GNP because of all these other factors that are involved, including the velocity that you referred to.

Mr. BURNS. I agree with you in principle, but the figure of 12 percent frightens me.

Senator MILLER. Now, with respect to another premise that I referred to, that those in control of the Congress will keep within the spending limitations of the President's budget, would it be fair to say that if they do not, and the spending limitations are substantially exceeded, that we might well expect to find a counterreaction in the Federal Reserve Board with respect to the money supply and interest rates?

Mr. BURNS. I do not think I would want to predict what the Federal Reserve will do. The question is much too hypothetical, Senator. We try to cooperate to the best of our ability and we work at it most conscientiously with the Executive and with the Congress. There are so many developments that one can't foresee that I think it would be entirely unwise for me to try to project what we might do in the kind of circumstances which you envisage.

Senator MILLER. I will not press you any further on that.

In this morning's newspaper, I find this statement. "The Fed increased its holdings of Government securities by $3.8 billion in the past week." Would you tell us what economic significance that has?

Mr. BURNS. Well, it so happens that this is a momentary aberration. The increase of reserves is not permanent. Most of that increase took place through repurchase agreements, which have a 1- or 2-day effect only. What happened was that we had a 4-day holiday and a bad projection on reserves held by the banks. Then the New York Federal Reserve Bank, which manages the open-market operations for the Federal Reserve, had to pump in a great amount of reserves on a repurchase agreement basis to prevent interest rates from shooting up temporarily. But it is a momentary aberration and has no significance.

Senator MILLER. Thank you.

Now, the article goes on to say that net borrowed reserves during the same week widened to $285 million, compares to an average of $65 million the previous week. What would be the economic significance of that?

Mr. BURNS. I would say it has no economic significance.

Senator MILLER. Next the article says number of bank borrowings from the Federal Reserve System averaged $564 million in a week, up from $248 million.

Mr. BURNS. That is because of the temporary shortage of reserves that occurred. We had a miscalculation, a bad projection. That kind of thing is not uncommon and has no lasting significance.

Senator MILLER. Then finally, the article says: "The Nation's money supply"—they are using a definition of currency plus time deposits—"average $216.1 billion in the weekend of February 10, up sharply from $214.8 billion the previous week."

Mr. BURNS. Yes.

Senator MILLER. "For the 4 weeks ending February 10, the money supply averaged $214.9 billion." What is the economic significance of that?

Mr. BURNS. From October through January, the rate of growth of the money supply was low, something like 3.5 percent. In the month of January, the rate of growth was at an annual rate of only 1.1 percent. That figure has been revised down progressively. This month, apparently, if the money supply remains at the last reported level, it will have an annual rate of growth for the month of 7 percent.

Such shortrun variations always keep occurring and the causes are complex. But they usually do not have any lasting significance.

The spurt in this particular month may—and I would want to accent the word "may"—mean that business loans are picking up and that a little more activity is stirring than before.

Senator MILLER. You referred to a short time. Would it be proper to say that a 2- or 3-month period would be a reasonably good period to look at for a significant trend?

Mr. BURNS. I would look at a somewhat longer period—say 4 or 5 months.

Senator MILLER. Thank you very much, Mr. Burns.

Chairman PROXMIRE. Senator Humphrey.

Senator HUMPHREY. Mr. Burns, I want you to know I have read very carefully your statement and it is a splendid statement. I am deeply concerned about the subject matter that Senator Miller was discussing and I want to come to that matter of money supply in just a moment.

First, I wish to join in expressing a very active interest in the administration establishing an incomes policy along the lines you have outlined for us now and in previous statements: A wage-price board with powers at least of persuasion, public opinion pressures, productivity concepts, and the many things that have been mentioned here this morning of what the Government can do in terms of procurement, release of supplies, the powers of persuasion on the part of the President and other officers of Government. I think that without an incomes policy, from what you have said in our statement and in your testimony now and in the past, we are not going to have any control over inflation; we are going to find ourselves with the deepened problem you have discussed so well in your statement. You say, "We are thus confronted with what is, practically speaking, a new problem. A recovery in economic activity appears to be getting underway at a time when the rate of inflation is still exceptionally high." You still have below capacity plant utilization, unemployment continues to rise, demand is really not excessive, yet the inflation spiral continues and unemployment continues at unacceptably high rates.

In this situation I would hope you would continue insisting upon an incomes policy, because I feel that without it, all of these prognostications that the administration has made and that others have made will be for naught.

Coming, therefore, to—by the way, on wage-price freeze, I was pleased that you got that cup of coffee. I worry about a wage-price freeze over any extended period of time. I think we ought to try most assiduously other methods before we resort to what you might call the final treatment. The patient may be ill, but I doubt that it is at that critical a point right now.

I want to join with limited extension of powers to the President. I tend to agree that those powers of wage-price controls ought to be reassessed by this Congress very often and not over long periods of time. I think that power is as important, right now, as the continuing debate about the power of the President to commit troops. We would like to restrain him on the commitment of our Armed Forces. I think we ought to have some surveillance over the use of the economic powers of the Government.

Now, Mr. Burns, on monetary expansion, I have discussed with the Chairman of the Council of Economic Advisers, Mr. McCracken, his testimony of a few days ago—the testimony of February 5. The testimony of Mr. McCracken relating to the $1,065 billion economy was predicated in a large measure upon the rate of the increase of money supply. Let me read it:

> Over the post-war period, the amount of money, people have wanted to hold other peoples' incomes as they declined, with the result that GNP has in fact risen faster than the stock of money. From 1952 to 1970, the annual rate of increase of GNP was about 3 percentage points higher on the average than the annual increase of the money stock. If this relationship continues, a 6 percent increase of the money stock between 1970 and 1971 would produce the desired 9 percent increase of GNP.

You may recall that the 9 percent figure is the one that is now being discussed in order for the so-called full employment budget. [Continues reading:]

> In recent years, GNP has risen less rapidly relative to the money stock. From 1967 to 1969, the annual rate—and I underscore—the annual rate of increase in GNP was 1.8 percentage points a year more than the money stock. On this basis, an increase of 7.2 percent in money would, of course, be needed to provide an increase of 9 percent in the GNP in 1970–71.

Now, I discussed this with Mr. McCracken, pointing out that in recent months, as you have indicated, the Federal Reserve has had an increase of money supply of around 3.5 to 4 percent. You have indicated that it went down to slightly over 1 percent in January, up again to approximately 7 percent in February. I believe that most of us understand that there are these variables and these gyrations which are inevitable.

Then in your statement today you say:

> I can assure this committee that the Federal Reserve will continue to supply the money and credit needed for healthy economic expansion. But I also wish to reaffirm the assurance that I gave to this committee and to the Nation a year ago—namely that the Federal Reserve will not become the architects of a new wave of inflation.
>
> We are well aware, therefore, that an excessive rate of monetary expansion now could destroy our Nation's changes of bringing about a gradual but lasting control over inflationary forces.

Mr. Burns, looking at it on averages and on an annual basis, what would you consider to be a reasonable, relatively noninflationary money supply for the coming year or at least one not dangerous to the economy?

Mr. BURNS. I want to thank you, Senator Humphrey, very much indeed, for your very clear statement and particularly for your support of incomes policy. It may mean a great deal.

Now, let me try to deal with your very difficult question. I must say first a few words by way of prelude to my answer.

When I think of an economic policy, I differ a little from many of my colleagues in the economics profession, and I might differ from the thinking of some members of your committee. I am conscious every moment of my limitations of knowledge, of my inability to predict the future. Therefore, while I make what I consider to be a reasonable guess, I remember that it is only a guess and I am ready to reconsider it day by day, literally, as I learn more and as economic conditions unfold.

Now, as far as fiscal policy is concerned, as far as monetary policy is concerned, and as far as ordinary housekeeping policies—to the extent that they affect the economy—are concerned, as far as market-oriented wage and price policies are concerned, I think that all that we can do at any given time is to make guesses. But we must not permit these guesses to become frozen in our minds. We have to remain in a flexible position.

I think this is especially true of monetary policy. Fiscal policy in some ways tends to get frozen in. It is not so easy to adjust. Monetary policy, on the other hand, makes possible an ultimate degree of flexibility. That is its great virtue. And I think it would be very unwise, really, even improper, to suggest what the rate of growth of money supply, in any of its various definitions, or the rate of growth of bank credit, should be over the entire year.

I think that the policy that we have pursued in the past few months is pretty much on track. My evidence is that the banks are full of money; they are hunting for customers. Interest rates have tumbled and the foundation for a return of prosperity has been laid.

Looking just a short time ahead, we will continue that policy. But as the year unfolds, we may become a little more stimulative or a little less and any of the various policy instruments that we have may be used. It is really impossible for me to answer your question responsibly. I hope you understand.

Senator HUMPHREY. I do, Mr. Burns. The point of my question was not based on predictions by the witnesses from the Council of Economic Advisers nor from the administration's. In other words, a rate of money supply which is selected out at a minimum of 6 percent, an increment or a period up to 7 percent, and an experience that we have within recent months of anywhere from 3 to 4 percent down to one and up to 7. This fluctuation is what leads me to this question on your general testimony.

You have given us some very good information about some of the inner strengths of the economy. I am glad to get that. I do not believe in preaching despair and doom. I think that is too high a price to pay for political success. I personally believe that the economy has—we have to have some faith and confidence in the economy. But I think we also have to give reasons for it. You say in your statement:

> The strength of economic expansion during and beyond 1971 will depend, in my judgment, principally upon our success in restoring the confidence of consumers and businesses in their own and the Nation's economic future.

Now, in your testimony, you have buttressed that sense of confidence by certain statistical information and changes that have taken place in the economic structure. I think you would agree, therefore, that central to this problem is for the people to have confidence in the economic policies of its Government. Do you think that the confidence of consumers and business firms, financial instutitions, will be improved by unsubstantiated or exaggerated statements of economic improvement in 1971? In other words will not such exaggerations add to the credibility problem between the Government and the people and therefore destroy confidence?

Mr. BURNS. They could have that effect. Whether they will, or not, I have no way of knowing.

Senator HUMPHREY. Mr. Burns, I read, for example, or heard just a month ago, that things were going to be considerably better. Then I read 2 days ago that the wholesale price index, even adjusted, had gone up six-tenths of 1 percent, and that the manufacturers' wholesale price index had gone up four-tenths of 1 percent, and at a time that we are being told the rate of inflation is being held. It seems to me that may be a little less talk about what is happening in terms of controlling inflation might give some time factoring and trends with which we could paint a broader picture to look at and thereby help restore some of their lost confidence.

Mr. BURNS. Now and then I have given similar counsel myself.

Senator HUMPHREY. Thank you very much.

Chairman PROXMIRE. I would like to follow up what Senator Humphrey has been asking. There seems to be in the administration a conviction that there is a stable, fixed relationship between the increase in the money supply and the increase in the gross national product. The Federal Reserve Board seems to disagree. I would like to quote to you from an economist, an eminent economist in the Office of the Budget, Management and Budget, Mr. Laffer. Just one short quote and I would like to get your reaction on this:

> Monetary supply as represented by changes in the conventionally designed money supply has an instantaneous and permanent effect on the level of gross national product. For every dollar increase in the money supply, GNP will rise by about four or five dollars and not fall back in the future. Alternatively, every one-percent change in the money supply is associated with a one-percent change in gross national product.

Now, this has had such an effect on Director Shultz that he came to us and said that his prediction of the $1,065 billion economy was based on the model which, as I understand it, Mr. Laffer—that is his name, I guess—Mr. Laffer was the man who was responsible for it. What is your reaction?

Mr. BURNS. I have not as yet had the opportunity to study Mr. Laffer's model thoroughly. All I can say at this moment is, first, that I am surprised by his conclusions; second, that a very thorough appraisal of his model is now underway at the Federal Reserve. I will postpone more definite comment until that study is completed.

Chairman PROXMIRE. Will you give us your conclusions when that study is completed?

Mr. BURNS. I can give you more than the conclusions; I will give you the study.[1]

Chairman PROXMIRE. Great. When do you expect that to be, Mr. Burns? A month?

Mr. BURNS. A month or less. I hope it will be less.

Chairman PROXMIRE. Would you or would you not agree that you do not think that there is a fixed and stable relationship between the increase in the money supply and the gross national product?

Mr. BURNS. No, I do not think that conclusion is correct.

Chairman PROXMIRE. Now, yesterday, an outstanding expert on Wall Street, from the Langston Corp., said, "Surely the Fed's efforts

[1] A discussion of the "Laffer" model, a critique by James L. Pierce of the Federal Reserve Board staff, and a rejoinder by G. Fekelekuty and R. D. Ronson appears on pp. 279, 300, and 312, respectively.

to push money market rates lower must soon come to an end." He noted that the money rates of the United States were no longer competitive with those abroad.

This seems to me to be a very good point and a very serious point. I wonder how you would meet that kind of a problem in the event the economy does not pick up and it appears that additional amounts of money supply would tend to reduce interest rates and obviously, have a clear and immediate effect on our balance of payments? The outgo of capital would seem to be automatic.

Mr. BURNS. It is hard to visualize just what the Federal Reserve Board will do or might do. Let me only indicate that we have certain instruments at our disposal for dealing with a problem of this sort, if the need should rise. To some degree, instead of supplying reserves by buying Treasury bills, we can buy coupon issues and that would help a little at the short-term money end.

Second and more importantly, we can take special measures to deal with outflow of capital. We have done that to some degree already in changing our regulations so as to induce the banks to hold off on repaying loans from their branches abroad. We have also taken some steps to intercept the flow of Euro-dollars from the branches of our banks to European central banks. And we can do more of that. In short, there are special devices that we can employ.

Chairman PROXMIRE. You are confident those devices would be effective? I notice there have been times in the past when they have not been.

Mr. BURNS. Well, these are devices that have not been tried in the past. These are new devices. I do not have absolute confidence, no. But I have reasonable confidence that we can deal with that problem.

Chairman PROXMIRE. What do you think of instituting controls on one relatively small sector of the economy, to wit, the construction industry; the President, of course, has the power. Legislation which I introduced and Congressman Reuss amended gives him the authority by law to provide for a freeze on wages and prices in the construction industry. What is your reaction to that?

Mr. BURNS. Well, he has that power. He also has power under the Davis-Bacon Act. The President can suspend the Davis-Bacon Act by declaring an emergency. No change in legislation by the Congress would be necessary.

Chairman PROXMIRE. Does it make economic sense, however, to institute an incomes policy on one sector, even though you can make a case, I presume, that wages have risen very rapidly and prices have risen rapidly?

Mr. BURNS. We have had extraordinary developments in the construction industry. We have a very special problem there. The average wage increase under collective-bargaining settlements for the first year of the contract, as I pointed out in my testimony, was 18 percent in 1970. The year before, it was 13 percent. The acceleration is continuing. In the third quarter of last year, the average rate of increase was 22 percent, in the fourth quarter, 21 percent. Now, these are enormous increases. And remember, these are average figures—which means that in some communities the increase was very much larger.

Chairman PROXMIRE. Will it work? I am assuming you can make a strong case for it? Will it work to apply it to only one industry?

Mr. BURNS. I think that it would have some effect on that industry, yes. I think also that it would have some influence on other industries by way of indicating that the Government is not powerless and that if similar excesses occur in other industries the Government will move.

Chairman PROXMIRE. Would it take enforcement machinery? Would it require an appropriation by the Congress, in your view, to provide people to actually enforce it, or can the President simply declare it?

Mr. BURNS. You are speaking of a freeze, I take it, now?

Chairman PROXMIRE. Well, either a freeze or a guideline.

Mr. BURNS. Well, if a freeze were to extend for any length of time, enforcement machinery would be required. On the other hand, if the freeze were limited to a month, let us say, or 6 weeks, then the industry would have a period of time in which to come up with a voluntary program. If industry did that, the chances of its proving viable would be all the better.

Chairman PROXMIRE. That may well be. I am wondering if a mandatory program would be effective. Your answer, as I get it, is that for a short period, it might be, for a longer period, you would probably require enforcement machinery?

Mr. BURNS. I am afraid so.

Chairman PROXMIRE. In your December speech, you made some very far-reaching suggestions when you suggested 11 possible steps that might be taken by the Government to slow inflation. I have the 11 points here. It seems to me the administration has done almost none of them. Your first point, they did a little bit, liberalization of import quotas on oil and other commodities. They did it slightly.

On more vigorous enforcement of the antitrust laws, they did nothing.

On expansion of Federal training programs to increase the supply of skilled workers where wages are rising with exceptional rapidity, I didn't know of any such program. The President vetoed that action.

On creation of a nationwide scale of local productivity councils to seek ways of increasing efficiency, no action.

On a more aggressive pace in establishing computerized job banks, nothing.

Liberalization of depreciation of allowances to stimulate plant modernization, yes, they have done that.

Suspension of the Davis-Bacon Act, no, they have not done that.

Modification of the minimum wage laws in the interest of improving job opportunities for teenagers, no.

Establishment of national building codes to break down barriers—that is unlikely; no action taken.

Compulsory arbitration of labor disputes in industry that vitally involve the public interest, no action, it seems to me again unlikely.

Establish a price and wage review board, we have discussed that this morning. I agree that is an excellent suggestion, but there doesn't seem to be any indication of the administration supporting that.

How can you say, as you do in your statement that the administration has taken steps when they have so feebly put into effect what you have spelled out for us?

Mr. BURNS. Well, when a baseball player bats, .300 he is considered pretty good.

Chairman PROXMIRE. When he bats .100, he has to be quite a glove man.

Mr. BURNS. I have no answer to that.

Chairman PROXMIRE. Last year, you indicated the Federal Reserve Board was launching a major study on ways to influence the housing industry and on the impact of tight money. What is the result of this study and when can we expect results?

Mr. BURNS. The study has been delayed because of unusual problems that we had to deal with last year. I am responsible for the delay, Senator. I kept the staff so busy because of the unusual financial problems we had last year. It was an extraordinary year.

The study is going forward and it may be delayed until midyear.

Chairman PROXMIRE. We want that urgently.

Mr. BURNS. I know you do and so do I.

Chairman PROXMIRE. Well, because as you know, the principal adverse impact in the long run of monetary policy has been in housing. It has been devastating. You are very sympathetic and sensitive to that.

Mr. BURNS. Yes.

Chairman PROXMIRE. But we would like to get this study as rapidly as we can.

One other question. The Senate Banking and Currency Committee has before it legislation to remove the Export-Import Bank from the Federal budget. I happen to be opposed to that. Can you give us your comment on the legislation?

Mr. BURNS. Well, you and I agree on many things, Senator. I am opposed to it. I think the Export-Import Bank should be subjected to ordinary budgetary review just as other agencies of the Government are.

Chairman PROXMIRE. Does it not restrain—I beg your pardon.

Mr. BURNS. I have great sympathy with Mr. Kearns' problem. He is trying awfully hard to stimulate exports and that is important to us. But rather than take the Export-Import Bank out of the budget, I would consider another way of dealing with this problem, privatizing the Bank, just as we did with FNMA. As long as it is part of the Government, I think its outlay should be subjected to congressional budget review.

Chairman PROXMIRE. As I understand this, if they proceeded to take it out of the budget, it would mean they would be much freer to expand loans to finance export at precisely the time when the Federal Reserve Board might be trying to restrain business activity and much as we need exports under all circumstances, it seems to me it would be a frustration of the inflationary policy.

Mr. BURNS. It could be.

Chairman PROXMIRE. And I place a higher priority on housing than I would on exports.

Mr. BURNS. This is a difficult question for me. If I look at the problem from the narrow viewpoint of the Federal Reserve, I would say give the Export-Import Bank what it wants, because that would make it easier for us to handle the Eurodollar problem. Recently, the Export-Import Bank put out an issue of a bilion dollars; it used it to mop up Eurodollars. There may be other such issues. Give the Bank more freedom to raise funds, free it from budgetary controls, and then you can do more in this direction. I would welcome that, were it not for broader considerations.

I think we have to adhere to principles of good government. I see no more reason for excluding the Export-Import Bank from budgetary review than excluding, let us say, Mr. Romney's department. You regard the latter as being more important, and I think that a case could be made for that.

Chairman PROXMIRE. Senator Miller.

Senator MILLER. Along the line of questioning of Senator Proxmire, I think that a simplistic reaction to this suggestion on wage and price controls in the construction industry is the reaction of a number of people who think in terms of a house that may have cost $20,000 and perhaps the average wages were $5 an hour and the price was $20,000 and if we do not do something about that, that house is going to cost $22,000. So I think they have a vision of freezing in the average wage, say, of $5 an hour and keeping the house at $20,000.

But if you keep that price at $20,000, I think we can see how the price of lumber can continue to go up, the price of cement, the prices of construction equipment, the prices of plumbing fixtures, the prices of other materials. It seems to me that within not too very long a time, we would be literally forced into going to wage and price con- in those other industries. Then if we get into those other industries, they have a related input. It just seems to me that it could go on and on and on until you have the whole country under a wage-price control system. But I am particularly concerned about the construction industry.

I am also concerned about what continued price increases in these related items are going to do to any wage-price freeze or even guidelines in the construction industry. Do you share that concern? Or an I wrong in my estimate of the impact?

Mr. BURNS. I can't say that you are wrong, but I do not think the impact would be very strong on other industries. After all, what are we talking about? Realistically, wages in the construction industry will continue to go up. But for heaven's sake, let us try to shape a world in which we will no longer have wage increases of 22 percent, on the average. If we permit that to continue, the very effect which you fear will take place. Thus, if I am an electrical worker and a member of a construction union, I will get one wage. If I am an electrical worker and work for a manufacturing plant, I will get a much lower wage. In the latter event, I am going to be very unhappy and I am going to press for a wage that is comparable to that of a construction union worker. By this process, what is happening in the construction industry spreads out to other industries.

Of course, you also have the force of example. A trade union leader in a manufacturing industry will be told by his people what construction workers have gotten, and then he has to try to do as well for his employees. Therefore, some control over what has been happening in the construction area is, I think, vital.

That does not mean that we have to go the route of a freeze. It does not mean that even remotely. There are other ways of preventing an uncontrolled wage-price spiral.

Senator MILLER. One last question. There has been a lot said about what the President could do, that he can put in wage-price controls, that he can do something about repealing, or rather suspending, the Davis-Bacon Act, and so on. But is it not just as true that if Congress feels strongly enough about it, Congress can pass a law putting such things into effect?

Mr. BURNS. Yes; by all means.

Senator MILLER. Do you have any recommendations to the Congress on this point?

Mr. BURNS. Well, I would make two suggestions to the Congress. First, that you consider legislation under which contracts that call for exclusive hiring of labor through the trade union halls be declared illegal. I think such legislation deserves consideration by the Congress. That would tend to break up the little monopolies in the construction trades, or it would tend to weaken them.

Second, you might consider legislation on the secondary boycott, along the lines of some bills that were introduced last year, one of them by Senator Goldwater.

Senator MILLER. Thank you very much. It is always a pleasure to have you before this committee.

Mr. BURNS. Thank you, Senator.

Chairman PROXMIRE. Senator Humphrey.

Senator HUMPHREY. I do not want to spend my time discussing baseball, even though I am quite a fan. My testimony has come up to the playoffs. That is about our average out in Minnesota. We get into the playoffs, but we do not come through on the finals.

Mr. BURNS. You have gone beyond them, Senator.

Senator HUMPHREY. I see where you feel if you bat .300, it is pretty good. I have to tell you, Mr. Burns, having run for office, that one-third of the vote is not enough. You have to do better in politics than that. That makes my point.

Mr. BURNS. I wish we could.

Senator HUMPHREY. On the matter of the subject discussed by Senator Proxmire, our chairman, and Senator Miller with reference to the building trade, it seems to me that what has happened here is that the administration has focused on an area that has had a great deal of public attention and in which there has been a considerable degree of wage and price increases. I think we have to keep in mind that in this area, there is a great pass along of whatever happens.

Mr. BURNS. Yes.

Senator HUMPHREY. But in my experience with working people, with unions, I find they react very quickly to fears and apprehensions over the economy. Workers are laid off before the money runs out of the bank, you know. When you tell management they have to improve productivity and must do this or that, they take a look at that balance sheet, the first thing they do is start to lay off some workers.

Now, Mr. Worker, whether he is in the construction trades or in the service trade, says to his business agent and his union leader, "Look, that price is going up—inflation!" He is not going to think about the inflation where he works; he is thinking about the inflation where he buys. And he says, "Look, I may lose my job; let's hedge." Just like you pointed out in here that people are saving money in financial institutions; they are hedging. They are hedging against inflation. And at least they have cash and they want to have a good supply on hand. This is a lot of just plain horsesense about what is is going on, even though it adds up to some trouble. Wage increases are hedges on an inflation of prices that a man and a woman see in household expenses and around them or around the family. There are also hedges on unemployment.

Now, there have been large numbers of carpenters unemployed. Everybody is not building an office building in New York City.

One of the curses of this country is that most of the information emanates right out of this city and out of New York. I have been out home in Minnesota and seen hundreds of tradesmen without jobs—no jobs. And when they get ready to bargain, they say, "Look, I want to have a job that pays enough so that if they are going to lay me off for 4 months, I can still have a living." You know, it is reasonable for a man to be thinking in those terms, plus the fact that it is cold out in some parts of the world, where you can't work all day. You work everyday when you are an office worker or a Senator or a banker. You can be inside and work. But we have a great deal of seasonal unemployment in the building trades.

I do not think this argument has been well presented to the public, and I do not think the workers' argument is well presented to the public. Most contracts that you read about today are 2- or 3- year contracts; and they will say, for example, 45-percent increase in wages, which is 15 percent a year. It is not 45 percent. It is 15 percent, hedging on the future, And my limited study of economics over the past, and that is all I can draw from, is that at the end of a contract period, there are two people that are always behind—Mr. Farmer and Mr. Worker. They never quite catch up to the price increases. They never quite catch up to what is going on in the economy. They get a little headstart. They run fast the first quarter, the first and second quarters. But on that mile run for the year or the 3-mile run for the 3-year contract, they end up just a little behind at the end of the time. This is why a great deal of the negotiation today is related to the future.

And as long as we are unable to have an incomes policy that put some damper upon inflation, we are going to have these wage increases. Of course, it is one chasing the other. I realize that. I am not unaware of the fact that the excess wage increases help precipitate an inflation. But it is the fear of the inflation, the fear that nothing is being done, that has caused much of what appears to some people to be excessive wage increases.

And I think it all started, Mr. Burns, when the Government said that they were no longer going to have any involvement in wage-price decisions. When you announce as a Government policy at a time of rising inflation—and this administration inherited inflation from the other. I do not hold Mr. Nixon accountable for all of our problems. I think we have to be eminently fair here. But when they saw that problem and then announced that there would be no encouragement, to use the modern words now, in the wage-price structure, I think it was just opening the floodgates to trouble.

So I have to speak up on this, because—by the way, I do not agree with limited price freezes. I think that Senator Miller and I might disagree on these matters, but I think that to put a price squeeze on one segment of the economy will precipitate more trouble both in enforcement and violations than anything I can think of. I think there are other things that the Government can do. I think it needs to be done. I think the problem is here, but it is not a matter now of applying, it is not a matter of applying cobalt. This is not cancer. This is a very obtrusive wart that you are dealing with. And I do not think we ought to give the cobalt treatment, the final treatment, before we used other types of treatment to this problem.

Now, having given my speech, Mr. Burns, I want to ask you a little problem. I come from the Midwest and I have a little family drugstore and I know a little bit about borrowing money and what you pay for it. Everything that you read about what you pay for it is not what you pay for it at all. Not for the little guy. That is all for the big-shots. They can always get the money to build an office building. They can always get money when nobody else can get it. I suppose there is a reason for that, too, but I have never agreed with it.

In Arizona where monetary policy affects credit conditions with a rather long—for example, in the Nation's smaller communities and in the credit terms available to smaller businesses and consumers—we could look forward to seeing more evidence of the effects of monetary stimulation as the year progresses.

What you have said in substance is that it is always later for the man down the street to get any effect from the relaxation of money policy. It is true in housing, it is true in small business, it is true in agriculture.

Now, Mr. Burns, I am chairman of a committee on rural development. The last part of this country to get any help is a part of the country that needs it the most. How are we going to have a policy that makes available the end product of the relaxation of monetary policy? How can you get money, in other words, out to Spink County, S. Dak., or Wright County, Minn., to a small town merchant that maybe wants to stay in business and can provide a dozen jobs? In our little business, we provide for six families. That is not many. But I can guarantee you that if we go out of business, that is six families that are not going to have jobs; six families that are going to be on Government relief. How can we provide credit for them instead of how are we going to provide credit for Mr. Big? He will get it some way or other.

I think this is the major economic problem we have today, that the fellow who needs it for low-income housing—we are building housing. We're not building low-income housing today. We are not even building low- middle-income housing with all these starts. We are not helping many farmers or many people that ought to be staying out there where they can make a living, instead of jamming into these big cities, where they must come to the Government again and say the cities now require revenue sharing and huge subsidies. We have a loused-up, fouled-up economic policy that just does not help where it ought to help.

Now, untangle it for me, would you please?

Mr. BURNS. Senator, you always make an effective and moving statement and I agree with much of it. Let me just make two observations. Number one, this is a large country and there are enormous local differences. In my new capacity, I have been meeting with many bankers from the individual States—I do not see only the big city bankers. And I recall back in February, March, April, being told by one small-town banker after another that plenty of money was available in his community, that there was no shortage of credit, that his bank was in fact lending money at a very high and profitable rate of interest to the big-city banks. And, of course, that was true. A great Federal funds market developed that was financed in large part by the small-town banks.

Thus conditions vary in our communities. My second observation is that there are lags here that it will be very difficult to overcome. Take the interest rate that needs to be paid by a large corporation on a bond issue. Well, that interest rate will respond pretty promptly to changes in monetary and credit conditions. Why? Because you have people throughout the world making purchases and sales in the New York bond market. As bond prices go up, long-term interest rates decline, and then a new issue may come along by one of our larger corporations, and it will benefit at once from the lower rate. However, it is entirely impossible for a small-town businessman to get access to that market. He is too small.

Well, that merely redefines the problem. And, unfortunately, that is all that I am able to do. I think we need greater attention to rural development. I have said so for years. I think that much of our difficulty in the cities stems from failure to pay adequate attention to our rural communities. People have been leaving rural communities and intensifying social and economic problems in our cities. I think that this country has suffered from rural neglect, neglect of rural communities by the Government.

Now, we have attended to the farm problem—I think, badly—but we have attended to it. But rural communities have been a stepchild in our country and I very much hope that this committee, along with other committees of the Congress, will devote some of its energy to this problem, which—if properly and promptly handled—may go a long distance in relieving the problem of the cities.

I wish I could be more helpful, Senator, because what you have defined is a very major area of concern.

Chairman PROXMIRE. Mr. Burns, we may agree or disagree with your answers, but you have done a magnificent job this morning. This was real vintage Burns. In my view, you are the Brooks Robinson of the economic profession. Well, you have batted a thousand. Thank you very much for a fine job.

We will be hearing on Monday from Senator Humphrey, Congressman Reuss, and Secretary Weidenbaum.

Mr. BURNS. Thank you very much, Senator.

(Whereupon, at 12:50 p.m., the committee recessed, to reconvene at 10 a.m., Monday, February 22, 1971.)

(The following information was subsequently supplied for the record:)

RESPONSE OF HON. ARTHUR F. BURNS TO ADDITIONAL WRITTEN QUESTIONS POSED BY SENATOR JAVITS

Question 1. From time to time proposals are made to give incentives to invest in certain areas, for example, housing and inner city areas. Most of the proposals center around giving tax advantages, or even outright subsidies, for such activities. What would be the feasibility of using the Fed route: i.e., lowering the reserve requirements for banks which make a certain percentage of their loans in, say, housing or inner city development activities?

Answer. Fluctuations in the level of required reserves resulting from shifts in the kinds of loans banks are making would complicate the task of achieving the general objectives of monetary policy. To induce banks to make mortgage loans, for example, reserve requirements would have to be set in a way that would mean lower required reserves for banks that increased their mortgage lending than for those that did not. As a result, reserves would be absorbed or released, depending on the extent to which the differential in reserve requirements succeeded in its objective. It is already difficult enough to judge how much the money stock, for example, will grow as a result of a given injection of reserves through System open market operations. The possibilities of error in that judgment would be increased by adding another uncertainty, since the Federal Reserve's action in adding to reserves could be magnified or minimized, depending on whether member banks were or were not adding to their mortgage portfolios.

From a broader point of view, I question the feasibility of vesting in a central bank responsibility for determining social priorities. Congress can and does make such judgments in establishing and funding Federal programs. But a central bank is ill equipped to make them. The Federal Reserve System has the responsibility for seeing that the overall supply of money and credit grows at a rate that will "promote maximum employment, production and purchasing power", to use the language of the Employment Act of 1946. To ask the System to decide how this supply of money and credit should be allocated among the various competing demands for funds would make it more difficult for us to meet our overall responsibilities. More importantly, it would entail judgments that only the elected representatives of the people can properly make.

Question. 2. In your testimony last year, you pointed out—most accurately, it appears in retrospect—that we should not be optimistic about slowing the advance in the consumer price level. Could you lend us your wisdom on this subject again this year, with regard to consumer prices in 1971?

Answer. I believe that the rising trend in consumer prices, which moderate from a rate of about 6 percent annually in the first half of 1970 to about 5 percent in the second half, will slow somewhat further this year. But I fear that the price rise will continue to be much too large on average, for the longer-run good of our economy.

Price trends in an advanced industrial economy such as the United States are to some extent influenced by supply conditions in food and basic commodities. Thus if the production of foodstuffs and raw materials is high, the overall rise in prices of goods and services may be substantially dampened. Such developments, for good or bad, are influenced greatly by the vagaries of the weather and conditions (over which we have little control) in producing countries abroad. But when a large proportion of all output reflects value added by manufacture, distribution and service, as in the United States, far and away the most important factor influencing prices is the trend in productivity compared with the trend in wage rates. Rates of pay cannot long exceed rates of gain in productivity without being reflected in the prices that people must pay.

The outlook for 1971 seems to be a little brighter than during the past two years. Businessmen quite generally have tightened up on their cost controls—due to poor profits—and a catchup in productivity appears to be taking place. Productivity typically grows at a better than average rate during recoveries also, just as it rises more slowly late in the expansion phase and during the subsequent period of production adjustment. Thus productivity gains this year should come closer to matching the rate of increase in wages, making possible a significant reduction in the rise of unit labor costs. But we need to do more to increase productivity, through measures such as the local productivity councils you have proposed, and which I enthusiastically support. At the same time, we need to take other steps, such as those I have mentioned elsewhere, to halt wage-price escalation through a multi-faceted incomes policy.

Question 3. What sort of accord, if any, does the Federal Reserve have with the central banks of other countries with regard to the converting of dollars into gold? Can you give any assessment about the foreign demand for dollars, which apparently would affect any foreign government's propensity to cash in dollars for gold?

Answer. Conversions of dollars into gold by the central banks of other countries take place under a U.S. Treasury policy of standing ready to sell (and buy) gold at $35 an ounce for international monetary purposes. It is in this way that the United States fulfills its obligations regarding exchange stability under the Articles of Agreement of the International Monetary Fund.

Against the background of U.S. military expenditures in Germany, in 1967 the President of the German Bundesbank and the Chairman of the Federal Reserve Board exchanged letters concerning the Bundesbank's reserve policy. The Bundesbank, with the approval of the German Government, made known its intention to continue its practice of not converting dollars into gold from the U.S. Treasury as part of a policy of international monetary cooperation.

In general, each foreign country (or its central bank) makes its own decisions about the composition of its international reserves. Policies in this regard differ from country to country. At one end of the range, there have been countries that have never sought to convert dollar accruals into gold or other reserve assets. At the other end of the range, there have been countries that have placed strict limits on their dollar holdings and have quickly sought to convert dollars acquired above these limits. In general, dollars that are converted into gold or other reserves represent new additions to dollar holdings, usually reflecting a U.S.

balance of payments deficit. In the last few years, there have been no cases of countries cashing in outstanding dollar balances for gold in order to change significantly the composition of reserves. There is widespread understanding among central banks and governments that policies concerning the composition of reserves must take account of the needs of the international monetary system as a whole.

In the discussions that took place in the International Monetary Fund and in meetings of the Finance Ministers and Central Bank Governors of the Group of Ten, leading to the institution of Special Drawing Rights and other amendments of the Fund's Articles of Agreement in 1968, the governments and central banks of the leading industrial countries made it clear that they wished to modify the international monetary system in such a way that monetary reserve needs could be met in considerable part by a new international instrument, the SDR, rather than mainly by unplanned accretions of dollar reserves resulting from balance-of-payments deficits of the United States.

Success of the SDR system will permit a continuing place for dollars in the aggregate monetary reserves of other countries. But an excessive supply of dollars, reflecting continued large U.S. deficits, could undermine present monetary arrangements. There can be no doubt that over the next few years the average annual demand for additional dollars to be retained in reserves will be far less than the $7 billion sum that was added last year to reserves held as dollar claims on the United States.

Question 4. On page 11 of your statement you state that "Restoration of confidence must be a central objective of economic stabilization policies in 1971." And on page 19, speaking of incomes policy-type efforts, you state, "Such efforts should bolster consumer and business confidence * * *." Does this mean that implementation of a broad incomes policy should become the central objective of economic stabilization policies this year?

Answer. The state of consumer and business confidence will be the most important factor influencing the strength of economic expansion in the period ahead. Many elements affect the state of confidence, and a broad incomes policy—while it could make a significant contribution—is only one of a number of factors that may work in a strengthening direction.

Confidence is typically impaired by feelings of uncertainty. An important factor in the present setting is the uncertainty about what a family's accumulated savings and expected income will buy in the future, which makes people cautious about spending, particularly on large items. Unemployment is another factor, as are the uncertainties generated by riots, business bankruptcies, and fears of war. In general, therefore, confidence should be increased to the extent that we take effective measures against inflation and unemployment, and establish conditions that may lead to a more tranquil social environment.

Question 5. You say in your statement that much of what happens to business conditions in 1971 is dependent upon a change in consumer sentiment from its present cautious status. You indicate that you are optimistic that this will occur. Is there any evidence from the Michigan Consumer Sentiment or any other survey to support your feelings?

Answer. Although the latest surveys indicate that households are still in a cautious buying mood, there are some suggestions of an improvement in attitudes in the most recent consumer surveys. The latest Census and National Industrial Conference Board surveys reported slight rises in the percentage of respondents expecting income increases. The Conference Board survey also found more households expecting better business conditions over the 6 months immediately ahead. Buying plans for houses and autos, moreover, showed some improvement in the January Census survey. Buying plans for new houses were up from both the previous survey and a year earlier, and the index of expected unit car purchases in the next 6 to 12 months (seasonally adjusted) was at a very high level, although deferred purchases resulting from deliveries delayed by the GM strike are probably responsible in part for this result.

More broadly, I would like to point out that consumer sentiment can at times change very rapidly. The Michigan index of consumer sentiment, for example, recovered in the quarter of the cyclical trough in 1958 and spending on durable goods picked up in the next quarter. If in the coming months, good news about the economy outweighs bad news, as I expect it will, consumer confidence may take a decided turn for the better.

SELECTED CONSUMER SURVEY RESULTS

INCOMES EXPECTATIONS

	Year ago [1]	Previous survey [2]	Latest survey [3]
Census:			
Probability of substantial:			
Increase	20.1	16.7	17.2
Decrease	6.3	7.3	6.7
Difference	13.8	9.4	10.5
Conference Board:			
Per cent of households expecting:			
Increase	29.7	23.5	24.0
Decrease	5.8	7.8	8.1
Difference	23.9	15.7	15.9

BUSINESS CONDITIONS

	Year ago [1]	Previous survey [2]	Latest survey [3]
Conference Board:			
Per cent of household expecting:			
Better	18.6	21.9	25.3
Worse	9.4	10.8	13.7
Difference	9.2	11.1	11.6

CENSUS BUYING INTENTIONS (SEASONALLY ADJUSTED)

	Year ago [1]	Previous survey [2]	Latest survey [3]
Index of expected unit car purchases, (January to April 1967 equal 100):			
All households	106.0	103.8	107.9
Households, above median incomes	104.3	103.4	110.4
Index of expected house purchases (January to April 1967 equal 100)	93.6	95.6	96.3

[1] January 1970 for census and November to December 1969 for NCB.
[2] October 1970 for census and September to October 1970 for NCB.
[3] January 1971 for census and November to December 1970 for NCB.

A Formal Model of the Economy Prepared for the Office of Management and Budget by Arthur B. Laffer and R. David Ranson

> Persecution is used in theology, not in arithmetic, because in arithmetic there is knowledge, but in theology there is only opinion. So whenever you find yourself getting angry about a difference of opinion, be on your guard; you will probably find, on examination, that your belief is getting beyond what the evidence warrants.
>
> —Bertrand Russell,
> *Unpopular Essays.*

I. Introduction and Methodology

Econometric models are used for many purposes. The chosen purpose of a model dictates, to a large extent, both the method of constructing the model and the data required for estimating its parameters.

Unfortunately, models are sometimes applied to purposes other than those for which they were developed. Often, the model-builder fails to specify the purposes clearly, and confusion results.

The purpose of the model described in this paper is to develop statistical relationships which "explain" a number of key economic variables. In so doing, we are able to test a number of statistical hypotheses that arise from economic reasoning. However, it is worth emphasizing at the outset that we make no attempt to estimate the parameters of any *a priori* structural model. No claim is made that the direction of cause-and-effect relationships can be inferred from the numerical results. For this reason, the only forecasts that can be produced from this model are those which are conditional on the assumed *ex post* behavior of chosen variables.

In the same vein, macroeconomic data are employed for specific ends. Here, too, confusion has resulted because of a failure to specify clearly the purposes of these data. Some care is necessary in choosing the data that are appropriate to statistical hypothesis testing of the kind reported here.

A. *Preadjustment versus "Coadjustment" of the Data*

When describing current conditions or making comparisons, it is not only reasonable, but highly commendable to adjust the original data in order to eliminate unusual or transitory aberrations. The more fundamental changes or differences are thereby displayed in greater prominence. Assuming that the adjustment procedures are well thought out and accurately implemented, it is eminently reasonable to correct time series data for recurrent seasonal fluctuations—fluctuations due to strikes and holidays, and so on—in order to illustrate cycles and trends.[1] The general public and most policymakers are not capable of eliminating these transient variations as effectively as are professional statisticians. Such adjusted data are also suitable for econometric models whose purfose is to simulate the implications of *a priori* hypotheses.

For the purpose of forecasting, and especially of hypothesis-testing, seasonally adjusted data are inappropriate for several reasons. First, seasonal adjustments which are arrived at in part through smoothing the original data tend to remove some of the behavioral covariance in the guise of seasonality. Second, seasonal adjustments, because of their averaging aspects, tend to introduce autocorrelation into the data. This can obfuscate the timing of statistical relationships. Third, hypothesis tests which use seasonally adjusted data do not take account of the inevitable loss of degrees of freedom. In fact, for many preadjustment procedures, it would be no easy task to estimate just how many degrees of freedom have been lost. In such cases, the precision of the model in which the data are used, as well as the significance of its parameters, could be seriously overestimated.

The case against using data which have been adjusted for seasonality (accurately or not) is impressive in the context of hypothesis-testing.[2] In any case, preadjustment for seasonality is not necessary. Many adjustment procedures can be developed in a single set of calculations with the process of estimating the model ("coadjustment"). Intuitively, the most appealing method of coadjustment is the use of dummy variables, the coefficients of which will reflect the net seasonality in the equation.[3] In this way, the number of degrees of freedom lost is minimized (equal to the number of dummies required). Moreover, the statistical significance of the net seasonality can itself be examined directly If one is concerned that the parameters themselves may vary seasonally, this possibility too can be tested by introducing additional dummies into the equation.[4]

The amount of information lost in the process of preadjustment may be small. It may, however, be substantial. The actual amount of information lost depends upon the specific situation. We do not know *a priori* how great the differences in the estimates will be. However, we do know which set should be chosen if a difference exists.

Although these issues are well-known to statisticians, virtually every quarterly macroeconomic model to date has been estimated using preadjusted data.[5] These models are currently being used for hypothesis-testing and forecasting purposes in addition to their legitimate purpose of simulation. In view of the above problems, the published results must be treated cautiously.

In this paper, the original data have been coadjusted using dummy variables in the course of estimating the model developed below. The principal purpose of the exercise has been to construct a set of empirical relationships which describe the post-war United States experience.

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[1] Although the accuracy of seasonal adjustment procedures is not the concern in this paper, it is interesting to note a paper, "Some Problems in Estimating Short-Term Changes in GNP," by Roseanne Cole. This paper was prepared for the Allied Social Science Association meetings on December 27-30, 1970.

[2] Cf. Lawrence Klein: *An Introduction to Econometrics*, Prentice-Hall, 1962, p. 35; E. Malinvaud: *Statistical Methods of Econometrics*, Rand McNally, 1966, p. 402ff; Michael Lovell, "Alternative Axiomatizations of Seasonal Adjustment" *J. Am. Stat. Assn.*, September 1966, p. 800ff; and George Ladd: "Regression Analysis of Seasonal Data," *J. Am. Stat. Assn.*, June 1964, p. 402ff.

[3] In the context of applying least squares to linear equations, it would be most convenient for computational purposes to use additive dummies. However, there is no requirement that any such specific functional form be adopted.

[4] Cf. Lawrence Klein: *A Textbook of Econometrics*, Row Peterson, 1953, p. 316.

[5] For an exception, see Lawrence Klein et al: *An Econometric Model of the United Kingdom*, Blackwell, 1961, esp. Ch. III.

B. Theoretical Underpinnings

In the literature on model-building, there is often a failure to distinguish between hypothesis-testing and hypothesis-forming.[6]

Explicitly or implicitly, a body of data will often be allowed to serve as the basis for the formation of a hypothesis and will also be used to test the validity of that same hypothesis. This procedure is invalid. In order to test a hypothesis, a fresh body of data should be used. Hypothesis-formation and hypothesis-testing must, to the extent that it is possible, be kept separate.

In light of this issue, only those general hypotheses that existed immediately after World War II were considered. By this means, the actual formation of the testable hypotheses and the test data have, to the best of our ability, been kept separate. One major exception is the use of an alternative empirical counterpart to the definition of money recently made popular by Milton Friedman—the sum of demand deposits, currency, and time deposits. It is possible to justify the inclusion of this series on the grounds that the hypothesis is based upon nineteenth century data.[7]

The three basic theoretical constructs represented in our equations are the traditional Keynesian, Quantity Theory, and Efficient Markets points of view. Within the Keynesian framework, budget outlays are allowed to compete with two more traditionally acceptable variables, viz., Government purchases of goods and services and Federal tax receipts. Within the Quantity Theory framework, the money supply plays the prime role. As adherents of either the Quantity Theory or the Keynesian positions would find appropriate, the rate of unemployment is included to allow for the difference between price and real output responses to economic stimuli.

Efficient Markets theory holds that, at any moment in time, all market transaction prices reflect the best currently available information.[8] All extraordinary anticipated profit opportunities are presumed to be bid away by private interests. This theory is the very essence of profit maximization. One implication is that the current market value of all equities represents, in part, the present value of unbiased efficient forecasts of future economic returns. Another implication is that interest rates, in part, reflect an unbiased efficient forecast of the future rate of inflation.[9] To the extent that market participants possess information about the future, adherents of the Efficient Markets position hold that the value of this information will already have been incorporated into stock prices and interest rates as well as other prices.

C. The Equations

With respect to the development of the OMB model, the data are as free as possible to tell their own story. Many of the models in the literature are constructed subject to constraints which represent the *a priori* theoretical beliefs of the model-builders. They possess some of the characteristics of simulations as well as the characteristics of hypothesis tests. The OMB model does not fall into this category. Constraints on the form and nature of the equations have been held to the minimum necessary to allow construction of explicit relationships.

The model consists of three distinct equations. The first and second relationships are the nominal income growth equation and the inflation equation, respectively. The third relationship deals with the rate of change of the rate of unemployment. When combined, the first two equations can be used to provide conditional forecasts of real GNP. These forecasts can then be used in the third equation to develop forecasts of changes in unemployment.

The following section describes the formal properties of the model. The third and final section summarizes the findings.

II. THE FORMAL MODEL

One purpose of a formal model of the kind reported here is to display in a systematic manner the statistical relationships among different economic variables. Although most of the attention is focused on those associations which are econom-

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[6] For an enlightening discussion of this issue, see J. Richard Zecher, unpublished doctoral dissertation Ohio State University, Columbus, Ohio.

[7] It was felt that subtraction of certificates of deposit would be analytically inappropriate even if empirically more reasonable.

[8] For a review of some of this literature, cf. Eugene Fama: "Efficient Capital Markets: A Review of Theory and Empirical Work," *J. Finance*, (March 1970).

[9] Cf. Arthur Laffer & Richard Zecher: "Anticipations and Changes in the Value of Money—Much Ado about Nothing," unpublished paper, University of Chicago, (August 1970).

ically meaningful and statistically significant, some of the more interesting observations pertain to relationships which are widely alleged to be significant, but which, it turns out, are not.

A formal model can also provide statistical "explanations" for certain key variables. Such "explanations" may then be used to obtain estimates for these variables given the values of a limited number of other variables. The key variables for which conditional forecasts could be made by means of this model are nominal GNP growth, the inflation rate, real GNP growth, and changes in the rate of unemployment. These variables are, of course, among the most important economic magnitudes which concern policymakers.

A. *Selection of relationships, variables, and estimation periods*

By definition, the growth rate of nominal GNP less the rate of inflation equals the growth rate of real GNP.[10] Because of this identity, it is possible for two separate equations to provide an "explanation" for three variables—nominal GNP growth, the rate of inflation, and real GNP growth. We chose to concentrate our efforts on nominal GNP growth and the rate of inflation (Equations A and B, respectively, below). The results of internally consistent estimates should be independent of which two variables happen to be selected. The results are virtually independent of the decision to omit real GNP growth from direct estimation (Equation D vis-a-vis Equation A minus B).

The time intervals used in estimating each of the equations ended with the forth quarter of 1969. They began with the first quarter of 1948 for the nominal GNP growth equation, and the second quarter of 1948 for the rate of change of the unemployment rate equation (Equation C below). The first observation for the inflation equation was the first quarter of 1952. Selection of these periods was based upon the availability of reliable and representative data.[11] In all cases, the data used were quarterly observations and, wherever possible, they were on a seasonally unadjusted basis.[12] The estimation technique employed was ordinary least squares.

In estimating the equations, quarter-to-quarter changes in the natural logarithm of the published series were used for most of the data—viz., GNP, the GNP price deflator, both money supply series, the unemployment rate, the S&P Index, Government receipts, and both series of Government expenditures. The market yield on Treasury bills was converted into a quarterly rate continuously compounded. The other variables which were left untransformed were the three quarterly dummines, and the change in the man-hours-lost-due-to-strikes variable.

Two prior constraints were placed on the formal model presented here. The first consisted of the pre-selection of variables to be considered for use in the model. The second was the selection of the functional form in which these variables were "tested."

Preselection of variables was based upon their *a priori* relevance in simple Keynesian, Quantity Theory, or Efficient Markets models. Naturally, certain institutional variables were also considered. In order to represent a Keynesian-type model, we considered both the current and lagged values of Government purchases of goods and services, Government receipts, and budget outlays. For a Quantity Theory position, we considered current and lagged values of two money supply variables. In order to help separate real from nominal effects of changes in "aggregate demand," we included the unemployment rate in the inflation equation.

Stock market prices, according to Efficient Markets Theory, reflect future real income. Interest rates, in the same vein, reflect anticipated changes in the price level. Thus, both of these variables were considered. For institutional reasons, we also considered a variable representing the number of man-hours lost due to strikes, quarterly dummies, and certain lagged values of dependent variables.

The functional forms chosen for the equations reflected conventional economic reasoning so far as this was consistent with reasonable simplicity.

Once the series and the forms in which they were to be entered were selected, our methodology was to permit each independent variable to "explain" as much of the variation of the dependent variable as it could in competition with the other variables. Those variables which contributed little to the explanatory power of the equation, and which, in addition, were statistically insignificant, were omitted from the final equations.

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[10] All "growth rates" discussed in this paper are relative rates of change continously compounded (i.e., first differences of natural logarithms).

[11] Rates of inflation prior to 1952 display far greater variation than those in later years. If they had been included in the calculations, they would have swamped the relationship. Results for the complete time period from 1947:IV through 1969:IV are, however, reported below for the sake of completeness.

[12] The most important exception is the GNP price deflator which exists solely on a seasonally adjusted basis. This need cause little concern, since price series in general display little seasonal variation.

B. The basic results

The table below displays the results of the tests.[13]

In each of the three equations, it is extremely difficult to distinguish the pattern of the residuals from that which one would expect from a nominal distribution. This is especially true for the nominal GNP growth equation and, therefore, for the real GNP growth equation. For the inflation and unemployment growth equations, a slightly greater preponderance of residuals is found in the central region of the distribution.

Earlier studies of price movements (stock market as well as goods prices), have found them to follow a stable Paretian distribution with a characteristic exponent in the upper range between one and two.[14] Distributions of the stable Paretian

[13] Computations were performed via time-sharing on a Burroughs 550 system operated by Data Resources, Inc., Lexington, Mass. On this machine, 5 significant digits of accuracy are stated to be guaranteed under all circumstances.

STATISTICAL RESULTS

(A.)
$$\Delta LY = \underset{(4.9)}{.032} - \underset{(12.1)}{.098\ D_1} + \underset{(2.6)}{.025\ D_2} - \underset{(4.1)}{.030\ D_3} + \underset{(5.5)}{1.10\ \Delta LM1}$$
$$+ \underset{(6.9)}{.136\ \Delta LG} - \underset{(3.3)}{.069\ \Delta LG_{-1}} - \underset{(1.9)}{.039\ \Delta LG_{-2}} - \underset{(1.2)}{.024\ \Delta LG_{-3}}$$
$$- \underset{(3.7)}{.046\ \Delta SH} + \underset{(2.2)}{.068\ \Delta LS\&P_{-1}}$$

Interval: 1948:I to 1969:IV

$R^2 = .958$; $F = 198.5$; D-W $= 2.15$; SE of E $= .0131$

(*B.)
$$\Delta LP = \underset{(0.1)}{.000059} + \underset{(2.7)}{.30\ \Delta LP_{-1}} + \underset{(2.0)}{.22\ \Delta LP_{-2}} + \underset{(1.7)}{.038\ \Delta LM1} + \underset{(2.7)}{.31\ i_{-2}}$$

Interval: 1952:I to 1969:IV

$\bar{R}^2 = .443$; $F = 15.1$; D-W $= 1.79$; SE of E $= .00272$

(C.)
$$\Delta LUR = \underset{(0.8)}{.041} + \underset{(2.2)}{.20\ D_1} - \underset{(2.5)}{.17\ D_2} + \underset{(1.3)}{.12\ D_3} - \underset{(2.2)}{.42\ \Delta LS\&P_{-2}}$$
$$- \underset{(6.0)}{2.8\ \Delta Ly} - \underset{(4.2)}{2.0\ \Delta Ly_{-1}} - \underset{(0.7)}{.34\ \Delta Ly_{-2}} - \underset{(3.7)}{1.8\ \Delta Ly_{-3}}$$

Interval: 1948:II to 1969:IV

$R^2 = .809$; $F = 46.4$; D-W $= 1.77$; SE of E $= .0771$

(D.)
$$\Delta Ly = \underset{(5.6)}{.038} - \underset{(12.0)}{.10\ D_1} + \underset{(1.7)}{.017\ D_2} - \underset{(4.4)}{.034\ D_3} + \underset{(4.0)}{.91\ \Delta LM1}$$
$$+ \underset{(5.6)}{.14\ \Delta LG} - \underset{(2.8)}{.067\ \Delta LG_{-1}} - \underset{(0.9)}{.020\ \Delta LG_{-2}} - \underset{(0.6)}{.012\ \Delta LG_{-3}}$$
$$- \underset{(3.7)}{.046\ \Delta SH} + \underset{(1.8)}{.063\ \Delta LS\&P_{-1}} - \underset{(1.4)}{.46\ \Delta LP_{-1}} - \underset{(0.7)}{.22\ \Delta LP_{-2}} - \underset{(0.8)}{.39\ i_{-1}}$$

Interval: 1948:I to 1969:IV

$\bar{R}^2 = .956$; $F = 146.3$; D-W $= 2.16$; SE of E $= .0133$

* Over the longer period 1947:IV to 1969:IV, the results are as follows:

$$\Delta LP = \underset{(1.0)}{.0012} + \underset{(5.0)}{.52\ \Delta LP_{-1}} + \underset{(0.7)}{.076\ \Delta LP_{-2}} + \underset{(2.4)}{.085\ \Delta LM1} + \underset{(0.7)}{.10\ i_{-1}}$$

$\bar{R}^2 = .355$; $F = 13.1$; D-W $= 2.00$; SE of E $= .00508$

KEY TO VARIABLES

ΔLY = Quarterly change in the log of nominal GNP.

D_1 = Seasonal variable for the first quarter.

D_2 = Seasonal variable for the second quarter.

D_3 = Seasonal variable for the third quarter.

$\Delta LM1$ = Quarterly change in the log of the conventional money supply (currency plus demand deposits*) [revised].

$\Delta LM2$ = Quarterly change in the log of the conventional money supply plus time deposits adjusted.* [revised]

ΔLG = Quarterly change in the log of Federal Government purchases of goods and services.

ΔLR = Quarterly change in the log of Federal Government receipts.

ΔLE = Quarterly change in the log of total Federal Government expenditures.

SH = A measure of the proportion of industrial man-hours lost due to strikes (man-days idle as a result of strikes and lockouts, divided by total manufacturing employment**).

ΔSH = Quarterly change in SH.

$\Delta LS\&P$ = Quarterly change in the log of Standard and Poor's Composite Index of Common Stock Prices (the "S&P 500"*).

ΔLP = Quarterly change in the log of the GNP price deflator.

i = Market yield on 13-week Treasury bills (percent per annum*), converted to continuous compounding at a quarterly rate by means of the formula log (.91 I/360+1), where I is the published figure.

LUR = Log of the unemployment rate, percent (the number of unemployed divided by the total civilian labor force**).

ΔLUR = Quarterly change in the log of UR.

ΔLy = Quarterly change in the log of real GNP.

$\Delta LDJF_{-5/3}$ = Quarterly change in the log of the Dow Jones index of farm commodity futures prices (5 months maturity), based on middle-of-month daily data, lagged 5 months.

*Quarterly data are means of seasonally unadjusted monthly figures.

**Numerator and denominator of the quarterly ratio are means of seasonally unadjusted monthly figures.

[14] A characteristic exponent of one describes the Cauchy distribution, and an exponent of two describes the Normal distribution. For some empirical evidence on the statistical structure of prices changes, see Eugene Fama, *op. cit.*

type other than the normal distribution tend to produce more residuals in the central region than the normal distribution

It is also interesting to note that the GNP equation described above is virtually as efficient as any derivative GNP equation using "generalized least squares." The optimal autoregressive parameter "rho" was estimated to be .979, (insignificantly different from one). For the inflation and unemployment rate equations, the generalized least squares procedure did not prove to be very successful. However, although convergence was not achieved, deviations of the "rhos" below unity did not materially affect the precision of the equations.

The table below lists the percentage of "explained" variance attributable to each variable for the three primary equations.

PERCENTAGE OF VARIANCE EXPLAINED[1]

	Percent
(A) GNP growth:	
D_1	33
D_2	4
D_3	9
$\Delta LM1$	14
ΔLG	19
ΔLG_{-1}	6
ΔLG_{-2}	2
ΔLG_{-3}	1
ΔSH	8
ΔLS and P_{-1}	3
Total	100
(B) Inflation:	
ΔLP_{-1}	33
ΔLP_{-2}	18
$\Delta LM1$	15
i_{-1}	34
Total	100
(C) Percent change in unemployment rate:	
D_1	7
D_2	9
D_3	2
ΔLy	36
ΔLy_{-1}	21
ΔLy_{-2}	1
ΔLy_{-3}	17
ΔLS and P_{-2}	7
Total	100

[1] Each percentage represents the square of the partial correlation coefficient of each variable as a ratio to the sum of squares of all partial correlation coefficients.

As stated earlier, a number of variables other than those included in the final equations were tested. In the tables below are lists of all those variables considered, their respective coefficients, and the "t"-statistics of those coefficients. The exclusion of each variable (or group of variables) from a final equation was based either on the "t"-statistic(s) or on the actual versus the *a priori* sign of the coefficient(s). In several cases, two highly collinear variables were tested simultaneously, and the one with the higher "t"-statistic was selected for inclusion in a final equation.

The final equations were also tested for temporal stability. In each case, the estimation period was divided into two subperiods of equal length, and the equation was tested to determine whether there had been a significant structural shift from one sub-period to the other. In the first two cases, there was no evidence that a significant shift had, in fact, occurred.

In the case of the nominal GNP growth equation, only two slope coefficients could be interpreted as being somewhat different between the two sub-periods. The third-quarter dummy variable appears to be more negative in the latter of the period and the coefficient of the lagged stock index variable also may have decreased in size. These observations are not sufficiently important to justify an alteration of the full-period estimate.

With respect to the inflation equation, there was no evidence whatever of any intertemporal shifts within the period of estimation. The unemployment rate equation does, on the other hand, appear subject to substantial instability in the individual coefficients. The seasonal pattern of the dummies is radically altered, as is the pattern of the growth rates of real GNP. However, the sum of each group of these coefficients does not appear to have changed. It is quite conceivable that the highly multicollinear variables have taken on different portions of the variance with little or no overall effect.

EQUATION A: $\Delta LY = \underset{(4.9)}{.032} - \underset{(12.1)}{.098}\, D_1 + \underset{(2.6)}{.025}\, D - \underset{(4.1)}{.030}\, D_2 + \underset{(5.5)}{1.10}\, \Delta LM1 + \underset{(6.9)}{.14}\, \Delta LG - \underset{(3.3)}{.069}\, \Delta LG_{-1}$

$- \underset{(1.9)}{.039}\, \Delta LG_{-2} - \underset{(1.2)}{.024}\, \Delta LG_{-3} - \underset{(3.7)}{.046}\, \Delta SH + \underset{(2.2)}{.068}\, \Delta LS\&P_{-1}$

Interval: 1948:I to 1969:IV; SE of E = .0131

Variable	$\Delta LM1$	$\Delta LM1_{-1}$	$\Delta LM1_{-2}$	$\Delta LM1_{-3}$	$\Delta LM1_{-4}$	$\Delta LM2$	$\Delta LM2_{-1}$	$\Delta LM2_{-2}$	$\Delta LM2_{-3}$	$\Delta LM2$
In place of	$\Delta LM1$					$\Delta LM1$				$\Delta LM1$
Coefficient estimate	1.05 (4.4)	-.39 (1.6)	.46 (1.9)	-.31 (1.3)	.29 (1.2)	.63 (2.7)	-.58 (2.0)	.59 (1.9)	-.056 (0.2)	.45 (2.6)
SE of E	.0127					.0145				.0148
Interval	1948:II to 1969:IV					Same as A				Same as A

Variable	ΔLY_{-1}	ΔLY_{-2}	ΔLY_{-3}	SH	SH_{-1}	ΔLE	ΔLE_{-1}	ΔLE_{-2}	ΔLE_{-3}
In place of	(In addition)			ΔSH		ΔLG, ΔLG_{-1}, ΔLG_{-2}, & ΔLG_{-3}			
Coefficient estimate	-.046 (0.6)	-.024 (0.3)	-.14 (1.7)	-.034 (2.4)	.057 (4.0)	.056 (1.9)	-.098 (3.3)	-.0064 (0.2)	-.029 (0.9)
SE of E	.0130			.0130		.0159			
Interval	Same as A			Same as A		Same as A			

Variable	ΔLR	ΔLR_{-1}	ΔLR_{-2}	ΔLR_{-3}	$\Delta LS\&P$	$\Delta LS\&P_{-1}$	$\Delta LS\&P_{-2}$	$\Delta LS\&P_{-3}$	LUR_{-1}
In place of	ΔLG, ΔLG_{-1}, ΔLG_{-2}, & ΔLG_{-3}				$\Delta LS\&P_{-1}$				(In addition)
Coefficient estimate	.086 (4.3)	.016 (0.9)	.049 (2.6)	.059 (3.3)	-.033 (1.0)	.075 (2.1)	.0044 (0.1)	.0024 (0.1)	.0077 (1.2)
SE of E	.0149				.0132				.0130
Interval	Same as A				Same as A				1948:II

EQUATION B: $\Delta LP = \underset{(0.1)}{.000059} + \underset{(2.7)}{.30}\, \Delta LP_{-1} + \underset{(2.0)}{.22}\, \Delta LP_{-2} + \underset{(1.7)}{.038}\, \Delta LM1 + \underset{(2.7)}{.31}$

Interval: 1952:I to 1969:IV; SE of E = .00272

Variable	$\Delta LM1$	$\Delta LM1_{-1}$	$\Delta LM1_{-2}$	$\Delta LM1_{-3}$	ΔLP_{-1}	ΔLP_{-2}	ΔLP_{-3}
In place of	$\Delta LM1$				ΔLP_{-1} and ΔLP_{-2}		
Coefficient estimate	.027 (0.9)	.031 (1.0)	-.015 (0.5)	.014 (0.5)	.40 (3.4)	.15 (1.4)	.056 (0.5)
SE of E	.00275				.00263		
Interval	Same as B				1952:II to 1969:IV		

Variable	Constant	D_1	D_2	D_3	ΔSH	ΔLY	$\Delta LM2$
In place of	Constant				(In addition)	(In addition)	$\Delta LM1$
Coefficient estimate	-.000086 (0.6)	.0017 (1.1)	.00069 (0.4)	.00081 (0.6)	-.00016 (0.1)	-.0080 (1.4)	.013 (0.4)
SE of E	.00273				.00274	.00270	.00278
Interval	Same as B				Same as B	Same as B	Same as B

Variable	$\Delta LM1$	LUR_{-1}	LUR_{-2}	LUR_{-3}	LUR_{-4}	$\Delta LDJF_{-5,3}$
In place of	$\Delta LM1$ & i_{-1}	(In addition)				i_{-1}
Coefficient estimate	.048 (2.1)	-.041 (0.8)	-.039 (0.7)	.016 (0.2)	.021 (0.3)	-.0059 (0.5)
SE of E	.00285	.00271				.00286
Interval	Same as B	Same as B				Same as B

EQUATION C: $$\Delta LUR = \underset{(0.8)}{.041} + \underset{(2.2)}{.20}\,D_1 - \underset{(2.5)}{.17}\,D_2 + \underset{(1.3)}{.12}\,D_3 - \underset{(6.0)}{2.8}\,\Delta Ly - \underset{(4.2)}{2.0}\,Ly_{-1}$$

$$- \underset{(0.7)}{.34}\,\Delta Ly_{-2} - \underset{(3.7)}{1.8}\,\Delta Ly_{-3} - \underset{(2.2)}{.42}\,\Delta LS\&P_{-2}$$

Interval: 1948:II to 1969:IV; SE of E = .0771

Variable	ΔSH	$\Delta LM1$	ΔLG	ΔLG_{-1}	ΔLG_{-2}
In place of	(In addition)	(In addition)	(In addition)		
Coefficient estimate	-.097 (1.3)	-.15 (0.1)	.049 (0.4)	.11 (0.8)	-.036 (0.3)
SE of E	.0768	.0776	.0781		
Interval	Same as C	Same as C	Same as C		

Variable	$\Delta LS\&P$	$\Delta LS\&P_{-1}$	$\Delta LS\&P_{-2}$	$\Delta LS\&P_{-3}$	ΔLP	ΔLP_{-1}	ΔLP_{-2}
In place of	$\Delta LS\&P_{-2}$				(In addition)		
Coefficient estimate	-.23 (1.2)	-.16 (0.8)	-.37 (1.8)	.028 (0.1)	-1.8 (1.0)	-2.1 (1.1)	.66 (0.4)
SE of E	.0770				.0761		
Interval	Same as C				Same as C		

Variable	ΔLy	ΔLy_{-1}	ΔLy_{-1}	ΔLy_{-2}	ΔLy_{-3}	ΔLy_{-4}
In place of	ΔLy, ΔLy_{-1}, ΔLy_{-2}, ΔLy_{-3}		ΔLy, ΔLy_{-1}, ΔLy_{-2}, & ΔLy_{-3}			
Coefficient estimate	-2.4 (4.9)	-2.1 (4.0)	-1.6 (2.6)	-.29 (0.5)	-.99 (1.8)	.22 (0.4)
SE of E	.0827		.0932			
Interval	Same as C		Same as C			

C. Policy requirements

To the extent that the OMB model can be used for policy purposes, certain conditions should be met.

First, if monetary policy is to be effective in controlling nominal GNP growth, then one has to presume that the policymakers do, in fact, directly influence the growth of the quantity of money and have influenced this growth in the past to the same extent. Likewise, if fiscal policy is to be effective, a similar presumption must be made. There is, of course, a great deal of evidence to suggest that policies do, in fact, influence the growth of both Government purchases and the money supply.

No change in the methodology of this study would be warranted even if the money supply and Government purchases were completely endogenous—e.g., both passively responding to changes in GNP. The statistical relationships found would still be valid. On the other hand, the extent to which these variables are endogenous does, of course, reduce the usefulness of these results to policymakers.

Second, policy use of these statistical relationships must also assume that the relationships among the variables are basically the same now as in the past.

Both of these requirements are necessary conditions for this model to be an effective policy tool.[15] Each of these requirements, of course, applies equally to other formal models. For many other formal models, a great many more conditions are required.

It is also important to recognize that a model becomes less and less reliable the further the explanatory variables deviate from their historical means. Thus, inferences from the OMB model as to the outcome with, say, an 8% growth in the money supply or other extreme observations, may be highly unreliable.

D. Interpretation of findings

The following inferences can be drawn from the above results:

Fiscal policy, as represented by Federal Government purchases of goods and services, provides a temporary stimulus to the level of GNP. After three quarters, the cumulative effect is insignificantly different from zero.[16] Interpreting the results

[15] They are not sufficient conditions. Statistical misspecifications and measurement errors in the data may still result in estimates that are not efficient enough to make the model reliable as a policy aid.

[16] This finding, in a slightly different context, was reported earlier by Anderson and Carlson, the originators of the extremely important model popularized by the Federal Reserve Bank of St. Louis. Cf. Léonall Anderson and Keith Carlson: "A Monetarist Model for Economic Stabilization", *Fed. Res. Bank of St. Louis Review*, April 1970, p. 7 ff.

differently, a one-dollar increase in Government purchases is associated with approximately a one-dollar increase in current GNP and a reduction in GNP of one dollar in the future three quarters. We assume, for the purposes of this discussion, that the Government can and has controlled its purchases.[17]

Monetary policy, as represented by changes in the conventionally defined money supply, has an immediate and permanent impact on the level of GNP. For every dollar increase in the money supply, GNP will rise by about four or five dollars, and not fall back in the future. Alternatively, every one percent change in the money supply is associated with a one percent change in GNP. Again we assume, for expositional purposes, that the Government has controlled and does control the money supply.

Movements in the S&P Index provide reliable forecasts of future changes in GNP. The average lag is approximately 3 months.

The Treasury bill rate provides a reliable forecast of the future rate of inflation.

The conventional money supply data are empirically superior to data for the conventional money supply plus time deposits. Government purchases are also empirically superior to either budget outlays or receipts.

There is no evidence in support of a significant relationship between the rate of change of the GNP price deflator and the rate of unemployment. The results do not confirm the existence of a "Phillips Curve."

Labor-hoarding hypotheses are provided with empirical support by our finding that changes in the rate of unemployment are closely related to lagged changes in real GNP.

E. The "Lag" in Effect of Monetary Policy

Perhaps the most striking result of our tests is the absence of any significant relationship between lagged growth rates of the money supply and the growth rate of nominal GNP. Even though several other writers have been unable to find a lag, the presumption of lags is still perhaps the most well-entrenched tenet of the modern Quantity Theory school.[18] In fact, there are some observers who contend that a failure to find the lagged relationship would be important evidence against the Quantity Theory premise that changes in the money supply are a cause of changes in nominal GNP.

Actually, there is no necessary linkage between temporal precedence and causality. Examples of the contrary are available. Given that high interest rates precede high rates of inflation, it is still eminently reasonable that rates of inflation are the direct "cause" of high interest rates. In a similar vein, stock price movements can precede changes in profits, and yet still be "caused" by these profits. More generally, Tobin and Brainard[19] describe "reasonable" structural models with built-in causation. They then show how these models can provide a complete menu of lead and lag relationships in the actual data.

In order to help dispel some of the doubts associated with our findings of no lagged money relationships, several additional experiments were performed.

First, the annual growth rate of GNP was related to eight consecutive quarterly growth rates of the money supply.

$$\sum_{t=T-3}^{t=T} \Delta LY_t = \text{intercept} + \sum_{j=1}^{j=7} a_j \Delta LM_{T-j} + \text{error},$$

where ΔLY_t represents the change in the log of nominal GNP from quarter t–1 to quarter t, and

(a) $T=11, 15, 19, \ldots$
(b) $T=10, 14, 18, \ldots$
(c) $T=9, 13, 17, \ldots$
(d) $T=8, 12, 16, \ldots$

Interval: 1949 to 1969; $T=1$ corresponds to 1947:II

To help interpret this equation, the change in log GNP from 1963:III to 1964:III, for example, was estimated as a function of the following quarterly relative changes in log money: 1964:II to III, 1964:I to II, 1963:IV to 1964:I,

[17] In the St. Louis model, the dependent variable is the change in GNP, and not the change in the log of GNP. From a functional standpoint, the St. Louis form appears preferable. Fortunately, the differences in results are insignificant.

[18] Other writers who have failed to find evidence of a significant lag include Ernest Tanner: "Lags in the Effects of Monetary Policy: A Statistical Investigation," *Amer. Econ. Rev.*, December 1969, p. 794 ff; Julius Shiskin, "Economic Policy Indicators and Cyclical Turning Points," *Business Economics*, Vol. 5, Number 4, September 1970; and Geoffrey Moore in unpublished papers.

[19] James Tobin and William Brainard: "Pitfalls in Financial Model Building." *American Economic Review*, May 1968, p. 99ff. Cf. especially pp. 120–22; James Tobin: "Money and Income: *Post Hoc Ergo Propter Hoc*," QJE May 1970, pp. 301–317.

1963:III to IV, 1963:II to III, 1963:I to II, 1962:IV to 1963:I, and 1962:III to 1962:IV. In other words, the first four of the quarterly money supply variables overlapped exactly with the annual GNP variable; the second four overlapped exactly with the corresponding GNP variable for the preceding year.

This test was carried out four different ways, representing the four alternative annual quarter-to-quarter changes possible for GNP.

Annual change in log GNP, quarter to quarter	Average of the coefficients of the 4 concurrent variables	Average of 4 lagged coefficients
(a) 4th to 4th	16.9	−0.80
(b) 3d to 3d	.67	.17
(c) 2d to 2d	.84	.04
(d) 1st to 1st	.84	.18
Average	1.01	−.10

All in all, these results don't demonstrate the existence of a lag.

In another experiment we partitioned the difference between the St. Louis "lag" results and our results. The basic differences between the St. Louis procedures and ours are a) the use of the Almon lag procedure; b) the use of seasonally adjusted data; and c) the functional form, etc. The various lag structures obtained are as follows:

PERCENTAGE OF TOTAL EFFECTS OF MONEY ON GNP BY QUARTER (TESTED ON REVISED DATA)

	t	t−1	t−2	t−3	t−4
Original St. Louis	0.24	0.34	0.28	0.14	0.00
Ex Almon St. Louis	.40	.07	.43	.16	−.06
Ex seasonally adjusted and ex Almon	.83	−.72	1.05	−.45	.29
OMB results	.96	−.36	.42	−.28	.26

As is readily apparent, the concurrent money supply variable picks up additional strength as the Almon lag procedure is dropped, as we move to seasonally unadjusted data, and, finally, as we go to the OMB form. The coefficient of the concurrent variable is very close to unity by the time the Almon procedure and seasonal adjustments have been removed.

With the full St. Louis technique, the first lag carries the largest coefficient, but it declines when the Almon procedure and seasonal adjustments are moved. It is still negative with the OMB procedure, but quite a bit larger. Except when seasonally adjusted data or Almon lags are used, the lagged values of changes in the money supply almost exactly offset each other.

It is conceivable that someone might feel that the stock market variable is acting in some sense as a proxy for lagged money supply changes. This view is not supported by the empirical evidence. Even when the stock market variable is omitted, the sum of the coefficients of the lagged money supply variables remains slightly negative.

F. Exogeneity or endogeneity of money

Statistical correlations do not demonstrate casual flows any more than-lead-and lag relationships. From results presented earlier, it could just as well be that money supply changes result from changes in GNP as the reverse. Although, in general we are unable to answer this question of cause and effect, we can respond to three of the more common routes suggested.

It may be argued that the money multiplier acts as an offset to variations in the effective reserve base/GNP ratio. Although the Federal Reserve may control the effective reserve base, it is often argued that it cannot control the money supply because the money multiplier is free to move.

On *a priori* grounds, this specific view of endogeneity is somewhat suspect because part of the money multiplier is clearly affected by policies of the Federal

Reserve (the discount mechanism, Regulation Q, and so on).[20] On empirical grounds, it is even more suspect.

In the first place, changes in the log of effective reserves are not very highly correllated with changes in the log of the money multiplier. An even more convincing exercise arises when we substitute the effective reserve base for the money supply in the GNP equation.

$$\underset{}{\Delta LY} = \underset{(8.7)}{.049} - \underset{(12.3)}{.11}\,D_1 - \underset{(0.9)}{.006}\,D_2 - \underset{(7.4)}{.049}\,D_3 + \underset{(3.3)}{.76}\,\Delta LMB^*$$
$$+ \underset{(6.2)}{.135}\,\Delta LG - \underset{(3.5)}{.081}\,\Delta LG_{-1} - \underset{(1.5)}{.034}\,\Delta LG_{-2} - \underset{(0.7)}{.016}\,\Delta LG_{-3}$$
$$- \underset{(3.0)}{.041}\,\Delta SH + \underset{(3.5)}{.11}\,\Delta LS\&P_{-1}$$

(Same interval as equation A)

$\bar{R}^2 = .949$; $F = 161.3$; $D-W = 2.34$; SE of $E = .0144$.

*ΔLMB equals change in the log of effective reserves (based on quarterly means of seasonally unadjusted monthly data). These data were furnished us by the staff of the Federal Reserve Bank of St. Louis.

As is apparent from the above equation, effective reserves have a powerful effect even when we do not hold the money multiplier constant. From this, one could infer that, even allowing for offsets due to the money multiplier, there is still a statistically significant effect for changes in effective reserves.

The second route via which the money supply may be thought to be endogenous is through co-seasonal variation. The argument proceeds along the following lines: Because GNP has a distinct seasonal variation and the Federal Reserve has historically followed an "even-keel" interest rate policy, changes in the money supply represent a response of the Federal Reserve to GNP, and not the reverse.

Surprising as it may be, the seasonal variations of GNP and the money supply are not the same. In the table below is a list of the seasonal deviations of each series and their "t"-statistics.

PERCENTAGE SEASONAL VARIATION: GROSS NATIONAL PRODUCT AND MONEY

	Quarter			
	1st	2d	3d	4th
Gross national product	−9.66%	3.40%	−0.16%	6.44%
	(22.5)	(7.9)	(0.4)	(15.0)
Money	−0.64%	−1.60%	0.17%	2.07%
	(4.0)	(10.0)	(1.1)	(12.9)

GNP and money move in the opposite direction two out of four quarters. The magnitudes of their movements, even when they do move in the same direction, are quite different. From a purely seasonal point of view, more evidence is clearly required to push the case that it is seasonal variations that give rise to the correlation between GNP and money.

Perhaps somewhat more convincing evidence against this suggested seasonal route for endogeneity was found in the section of "Lags." The relationship between annual changes in GNP and changes in the money supply was found to be almost identical to that found for the quarterly relationships. "Seasonal" fluctuations can hardly be a major cause of annual relationships.

Incidentally, as far as seasonal variations and endogeneity are concerned, the case appears far stronger for Government purchases of goods and services. GNP and Federal Government purchases of goods and services have almost the same seasonal pattern.

There is another problem of interpretation that arises from the possibility that the money supply variable and the Government purchases variable are causally related. In fact, the adjusted coefficient of determination, $\bar{R}^2$, between the concurrent magnitudes of the two policy variables is about 10 percent, and the slope coefficient of the purchases variable, .052, is significantly different from zero. However, when three lagged terms in Government purchases are included, the sum of the slope coefficients is .01, which is not significantly different from zero.

[20] Work on this topic has been reported by investigators at the Federal Reserve Bank of St. Louis, and by Karl Brunner and Allan Meltzer.

These results are unambiguous. Assuming that Government authorities control fiscal variables, they cannot permanently affect the level of GNP without constantly shifting the share of GNP devoted to Government purchases of goods and services.

It is again important to note that the results can only show statistical correlations and do not purport to show cause and effect. This section has attempted to make somewhat less plausible three of the more commonly hypothesized routes for endogeneity.

G. Precision

For each of the equations, an estimate of "goodness-of-fit" was obtained. On a quarterly basis, the standard error of estimate, the figure reported, gives some indication of the accuracy of the model over the estimation period. Additional tests were performed in order to give a sense of the accuracy of this model in relation to other models. As a further test of precision, we were also able to present a forecast generated by the model outside the sample period, viz., the four quarters of 1970.

The table below presents three columns of figures. The first column is the standard error of estimate for each of the quarterly equations reported above. The second column is the expected standard error of estimate of a year's data based upon the assumption that the errors are normally distributed. This column is calculated by multiplying the first column by the square root of the number of periods averaged, i.e., by the square root of 4, or 2. The third column is the measured standard deviation of the annual average error based upon actual experience.

All of the above measures of precision are computed for each of the four equations:

COMPARISON OF ESTIMATION ERRORS

	Quarterly (1)	(1) x $\sqrt{4}$ (2)	Standard error of annual estimates [1] (3)
A. Nominal GNP	0.0131	C.0262	0.0219
B. Inflation	.0027	.0054	.0058
C. Unemployment	.0771	.1542	.1130
D. Real GNP	.0133	.0267	.0202

These figures are based upon 4th-quarter-over-4th quarter comparisons, and are adjusted for degrees of freedom.

The annual standard errors of estimate in column (3) are slightly different from those which one would expect from the quarterly equations [21] (column (2)). It is possible that these discrepancies result from divergence from normality, or from some higher order serial dependence in the residuals.

One other important test of a model of this or any other type is to evaluate medium-term forecasts during the sample period and see whether the model behaves in a "reasonable" fashion. Starting with the actual fourth quarter figures for the preceding year, annual estimates were made, assuming knowledge of all exogenous or pre-determined variables other than lagged values of dependent variables from the other equations. The forecasted values of the dependent variables were used. In the table below, we have listed the actual and forecasted values by year for nominal GNP, the GNP deflator, Real GNP, and the Unemployment rate. From this table the reader should have a clear picture of the accuracy of the model. In the GNP equation, any forecast error tends to be carried forward over time as a random walk. There is little evidence of drift. However, the GNP deflator, because of the autoregressive structure of the equation, is subject to errors which tend to grow with the span of the forecast.

[21] Standard errors of estimate for year-over-year comparisons would be somewhat smaller.

EX-POST FORECASTS OF THE OMB MODEL

	Nominal GNP		Inflation (at annual rate) (percent)		Real GNP		Unemployment rate (percent)	
	Actual	Forecast	Actual	Forecast	Actual	Forecast	Actual	Forecast
1948	$258	$252						
1949	257	258						
1950	285	276						
1951	328	328						
1952	345	346	1.8	2.1	$395	$394	3.0	3.5
1953	365	367	1.1	1.8	413	411	2.9	2.8
1954	365	371	1.6	0.6	407	418	5.6	4.1
1955	398	395	2.0	1.0	438	437	4.4	4.3
1956	419	420	4.1	1.9	446	454	4.1	4.1
1957	441	436	3.2	2.6	452	449	4.3	4.8
1958	447	459	2.1	1.9	448	460	6.8	5.8
1959	484	482	1.5	2.0	476	474	5.5	5.5
1960	504	502	1.8	1.8	488	486	5.5	6.0
1961	520	529	1.1	1.7	497	503	6.7	6.5
1962	561	552	1.1	1.8	530	520	5.5	6.0
1963	591	604	1.4	2.0	551	561	5.7	5.2
1964	633	637	1.7	2.3	581	583	5.2	5.2
1965	685	684	1.7	2.5	618	614	4.5	4.6
1966	750	742	3.4	2.7	658	655	3.8	3.7
1967	794	807	3.4	3.3	675	685	3.8	3.8
1968	865	860	4.0	4.0	707	702	3.6	4.1
1969	931	921	4.9	4.3	727	722	3.5	3.6
Mean absolute error	$5.4 (1 percent of mean).		0.66 percent p.a. (27 percent of mean).		$5.1 (1 percent of mean).		0.3 percentage points (7.2 percent of mean).	

Because our GNP growth equation is predicated upon original data while other models use seasonally adjusted data, it is difficult to compare quarterly errors of estimate. In any case, the larger GNP models have few, if any, degrees of freedom left, so that it would hardly be appropriate to compare the precision of their estimates with that of ours. Were we able to duplicate their forecasts outside of the sample period, a comparison of our model with any model would be valid. However, we question whether it would be worth the expense to re-estimate the larger models and generate forecasts outside of the same period.

The only study of the precision of large-scale econometric models with which we are familiar is that by Charles Nelson. [22] In this study Professor Nelson presented a great deal of evidence which suggests that the conditional forecasting properties of one of these large-scale models outside the sample period are scarcely better than extrapolations of purely stochastic linear processes devoid of economic meaning. For some variables (such as GNP, the GNP deflator, and the unemployment rate), the naive model has a smaller mean error even within the same period. Nelson's findings are even more remarkable when we bear in mind that actual knowledge of exogenous data was employed in his comparisons. Extensive tests of our model against these large-scale models would be prohibitively expensive, both financially and in terms of time. We do not feel the effort can be justified after reading Professor Nelson's paper.

Fortunately, the St. Louis model is of a much lower order of complexity than the large-scale models. The precision of nominal GNP growth model can be compared, albeit imperfectly, with that of a pair of St. Louis-type models.

In order to make the comparison, we need to examine the annual standard errors of estimate and the annual standard deviations of both the seasonally adjusted and unadjusted data. It is probably not well-known that the process of seasonal adjustment tends to reduce the standard deviation of annual percent changes in GNP measured on a quarter-to-quarter basis. The difference averages about 1 percent over the postwar period. Evidently, these so-called seasonal factors operate so as to smooth even annual data. Thus, even if the percentage of variance explained by each model were the same, the model which uses seasonally adjusted data would have a lower standard error of estimate.

The first comparison is with the St. Louis model itself over the period of estimation selected by St. Louis, 1953:I to 1969:IV. Both the formal model presented here and the St. Louis model include a current money supply variable and current

[22] Charles Nelson: "Evaluation of Predictions from the FRB-MIT-Penn Econometric Model," paper given to the Business Economists' Conference, University of Chicago, (April 1970).

and lagged values of Government purchases of goods and services. The St. Louis model includes several lagged money supply terms, whereas our model includes the lagged stock index variable and an allowance for strikes.

In spite of the fact that the unadjusted data series is more volatile than the seasonally adjusted series, the standard error of estimate for our model is almost 10 percent smaller than for the St. Louis model, .0037 as opposed to .0041. When calculated over the full time period, our model shows an even greater superiority over St. Louis.

The second comparison is between our model and what we shall refer to as the St. Louis *optimum optimorum.* The latter was estimated over the full time period, using seasonally adjusted data. The variables are in the form of changes in logs and the equation includes three lagged money supply terms, as well as all the variables found to be influential in the OMB model. The coefficients of the lagged money supply variables were completely free to take on any value. Needless to say, the entire process—plus the use of seasonally adjusted data—gives the *optimum optimorum* model a substantial advantage over ours. In the table below, we have listed the annual standard errors of estimate for both the *optimum optimorum* model and for our own. These calculations have been carried out for each of the four alternative annual quarter-over-quarter changes:

	IV over IV	III over III	II over II	I over I	Average
Optimum	0.0212	0.0217	0.0215	0.0191	0.0210
OMB	.0195	.0211	.0233	.0192	.0208

In spite of the significant handicaps, the OMB model is at least equal in precision to the *optimum optimorum* which we constructed.

A final point of interest is the short, but important, interval following our sample period. Due to the fact that the OMB model requires seasonally unadjusted data for inputs, we restricted the length of our original estimation period to the fourth quarter of 1969. Since that time, we have been able to estimate the seasonally unadjusted data by quarter for the year 1970.[23] The table below contains a comparison of the estimated actual data with our conditional forecasts for nominal GNP, the rate of inflation, real GNP, and the unemployment rate. The forecasts are those which would have been made at the end of 1969, assuming the *ex post* behavior of the policy variables, strikes and the stock market.

	Nominal GNP		Inflation (at annual rate)		Real GNP		Unemployment rate	
	Actual	Forecast	Actual	Forecast	Actual	Forecast	Actual	Forecast
1970 (quarters):								
1st	228.8	229.7	6.2	5.0	172.6	173.8	4.5	4.7
2d	244.2	242.5	4.2	4.9	182.3	181.2	4.7	4.3
3d	246.1	245.3	4.5	4.9	181.6	181.1	5.2	4.6
4th	257.5	261.2	5.5	5.0	187.4	190.4	5.4	4.9
Total year	976.6	978.6	5.13	4.96	723.9	726.5	4.94	4.61

Note: Where concurrent or lagged dependent variables appeared in these calculations, the forecasted and not the actual values were used. (Example: lagged inflation, real GNP growth.)

III SUMMARY AND CONCLUSIONS

A. *Review of findings*

1. Fiscal policy, as represented by Federal purchases of goods and services (assumed exogenous), provides a powerful temporary stimulus to GNP. Over a year, the cumulative effect is near zero.

2. Changes in the conventionally defined money supply (for expositional purposes assumed exogenous) have an immediate and permanent impact on the level of GNP. Additional search yields no evidence of lags.

3. Movements in the stock market provide reliable forecasts of future changes in GNP.

4. The market rate of interest provides a reliable forecast of the future rate of inflation.

[23] Official figures were not available at the time of this exercise.

5. The conventional money supply data are empirically superior to data for the conventional money supply plus time deposits.

6. Government purchases are empirically superior to either budget outlays or receipts.

7. The nominal GNP equation possesses greater precision than the St. Louis model, and is most likely a better conditional forecaster than the well-known large-scale models.

8. The results with respect to the GNP deflator do not confirm the existence of a "Phillips Curve."

9. Labor-hoarding hypotheses are supported by the finding that changes in the rate of unemployment are closely related to lagged changes in real output.

B. Goodness of fit

In each of the three graphs below, we have constructed two plots. The first plot compares actual and the predicted values by year over the estimation period. The second is a scatter diagram of the actual and the predicted values. A pair of plots is provided for each of three variables: the growth rate of nominal GNP, the rate of inflation, and the rate of change of the unemployment rate.[24]

The accuracy of the equations is readily visible from the plots. In addition, the lower set of plots shows quite clearly the absence of "underestimation bias." It is a well-known and well-documented fact that a large number of forecasting models tend to underpredict large changes.[25] They gravitate toward the mean. This does not appear to be the case for this model. We can see little evidence of any underestimation bias in our forecasts.

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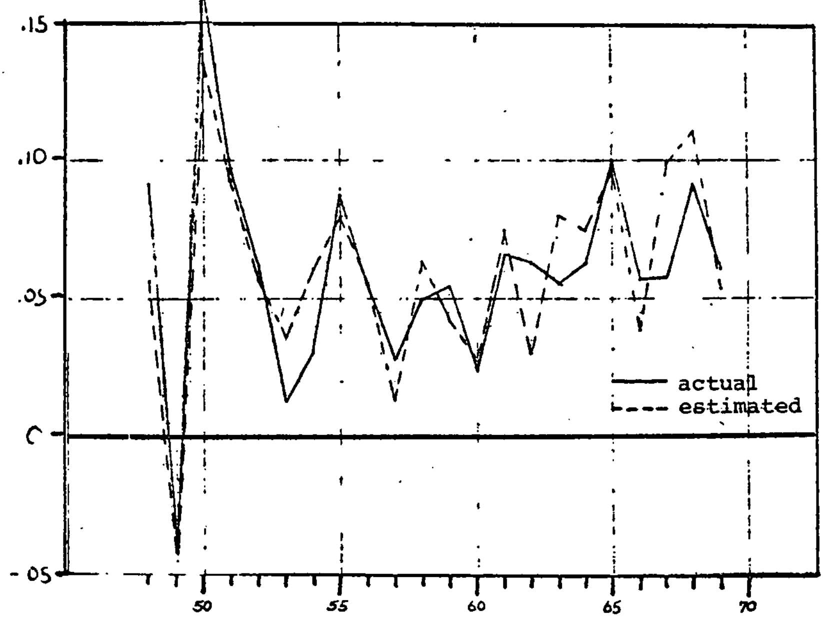
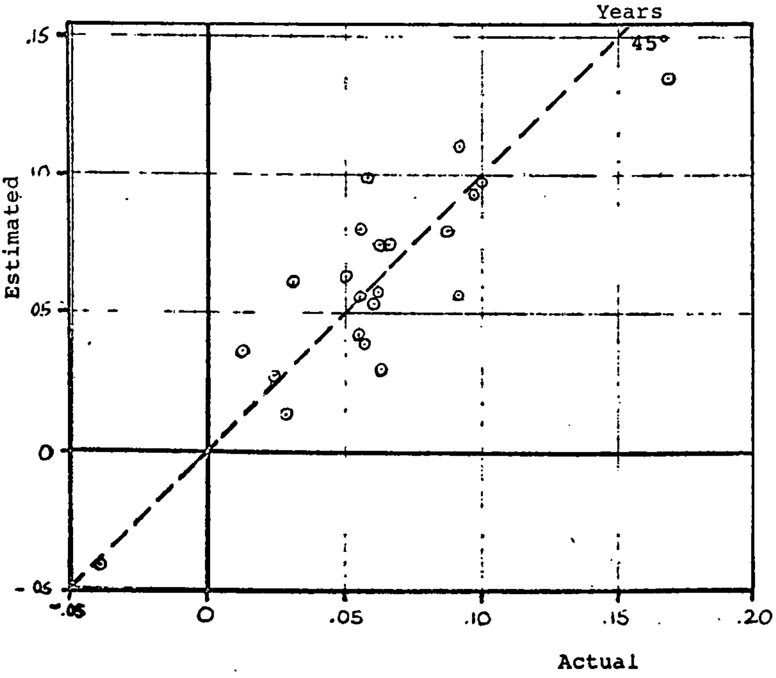
[24] Growth rates are fourth quarter to fourth quarter, measured at annual rates.

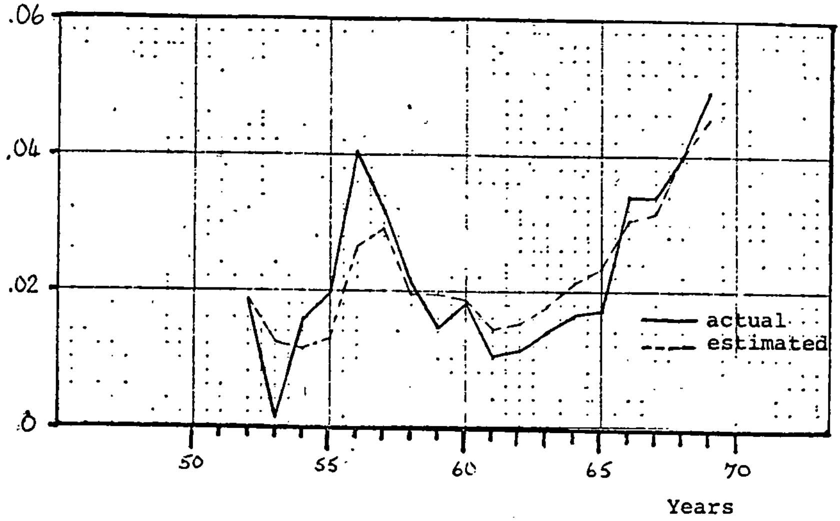
[25] Cf. Henri Theil: Applied Economic Forecasting, North-Holland/Rand McNally, 1966, p. 14 and Ch. 2.

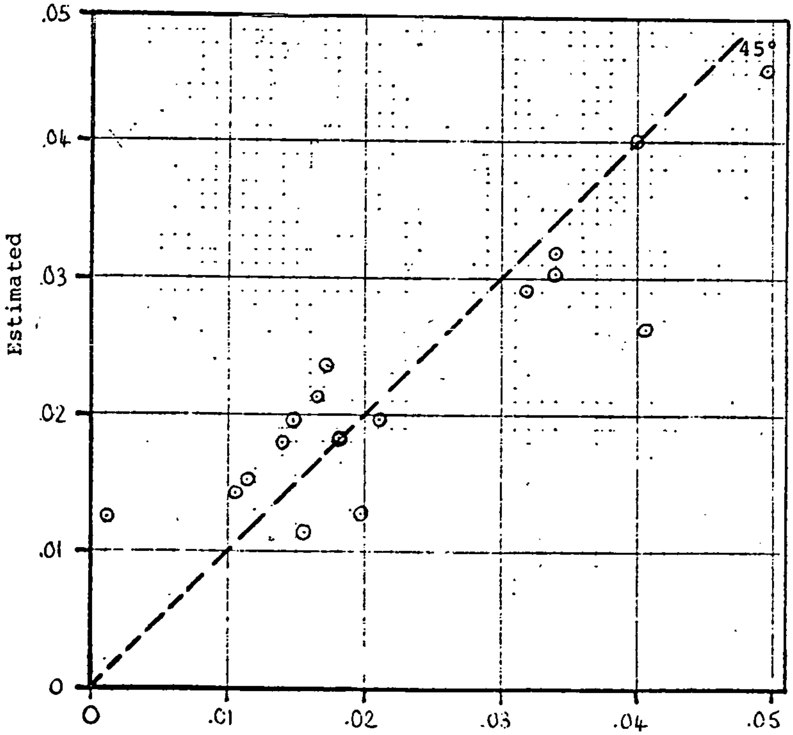
A. GROWTH RATE OF NOMINAL GNP



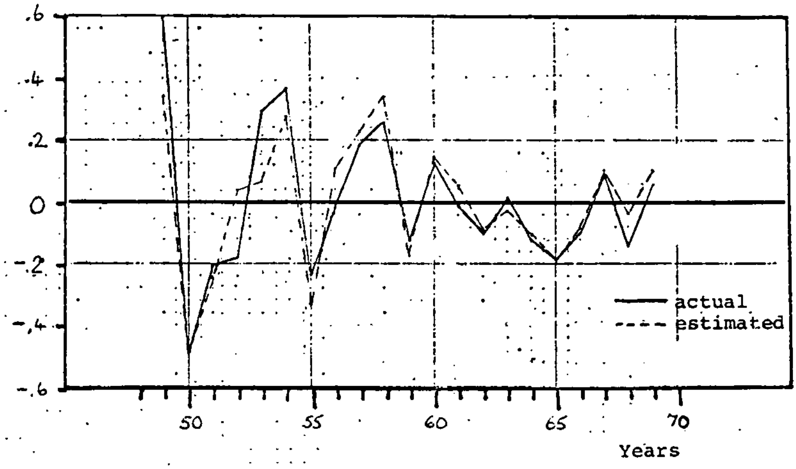


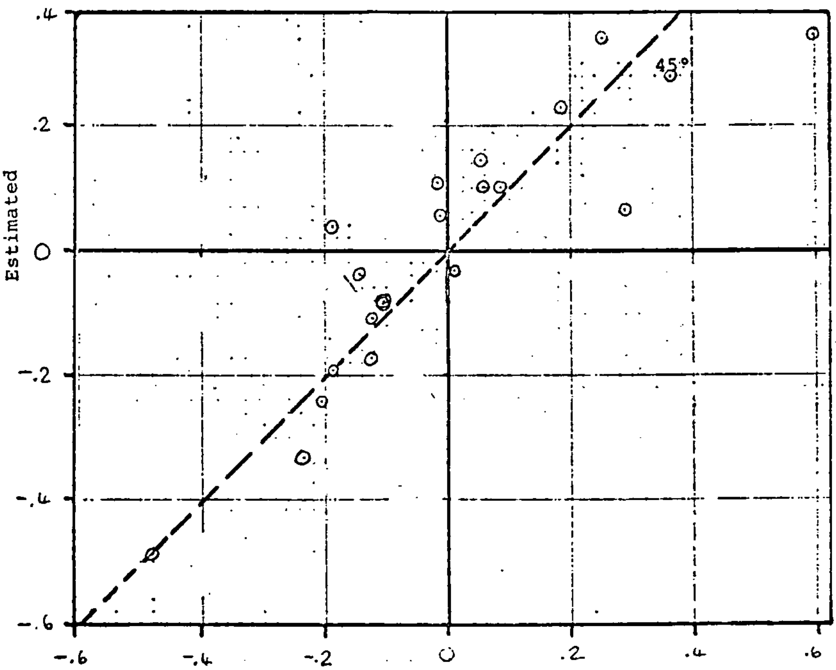
B. RATE OF INFLATION





C. RATE OF CHANGE OF THE UNEMPLOYMENT RATE





APPENDIX: THE DATA

GROSS NATIONAL PRODUCT AT QUARTERLY RATES, UNADJUSTED FOR SEASONAL VARIATION

1947: 1	53.4	55.9	57.5	64.5
1948: 1	59.4	62.1	65.3	70.7
1949: 1	61.8	62.2	64.5	68.0
1950: 1	64.0	66.8	73.5	80.5
1951: 1	76.6	79.9	83.2	88.7
1952: 1	82.0	83.3	85.7	94.4
1953: 1	87.4	91.3	90.3	95.6
1954: 1	86.5	89.7	90.0	98.6
1955: 1	92.6	97.4	100.4	107.6
1956: 1	98.6	102.9	104.1	113.7
1957: 1	104.4	109.1	110.6	117.0
1958: 1	103.9	108.8	111.7	123.0
1959: 1	113.1	121.4	119.3	129.9
1960: 1	120.5	125.6	124.6	133.1
1961: 1	120.6	128.2	129.1	142.2
1962: 1	131.3	139.6	138.1	151.5
1963: 1	137.8	146.1	146.5	160.2
1964: 1	148.5	157.1	156.3	170.6
1965: 1	158.2	169.1	168.9	188.7
1966: 1	176.2	187.4	186.3	199.8
1967: 1	186.5	197.2	198.4	211.7
1968: 1	199.9	217.3	215.8	232.0
1969: 1	217.5	232.4	234.8	246.5

MONEY SUPPLY (DEMAND DEPOSITS PLUS CURRENCY) MEANS OF DAILY DATA UNADJUSTED FOR SEASONAL VARIATION

1947: 1	110.3	109.9	112.2	114.7
1948: 1	113.7	110.5	111.8	113.3
1949: 1	111.9	109.8	110.5	112.5
1950: 1	112.7	112.1	114.3	117.5
1951: 1	118.1	116.7	118.6	123.4
1952: 1	124.7	123.1	124.5	128.7
1953: 1	128.8	127.0	127.3	130.3
1954: 1	130.3	128.1	129.3	133.4
1955: 1	134.7	133.0	133.5	136.5
1956: 1	136.8	134.7	134.6	138.0
1957: 1	137.9	135.7	135.8	137.6
1958: 1	136.9	136.5	137.9	142.2
1959: 1	142.7	141.8	142.5	144.2
1960: 1	142.0	139.2	139.7	142.7
1961: 1	142.3	141.5	142.1	146.7
1962: 1	146.5	145.1	144.5	148.8
1963: 1	149.3	148.5	149.9	154.9
1964: 1	154.8	153.5	155.7	161.2
1965: 1	160.9	159.5	161.4	168.3
1966: 1	169.5	168.9	168.2	172.6
1967: 1	172.6	173.0	176.7	183.7
1968: 1	184.2	185.2	188.7	196.1
1969: 1	197.2	196.9	197.1	199.3

FEDERAL GOVERNMENT PURCHASES OF GOODS AND SERVICES AT QUARTERLY RATES, UNADJUSTED FOR SEASONAL VARIATION

1947: 1	2.9	3.3	3.1	3.3
1948: 1	3.0	3.8	4.2	5.5
1949: 1	4.9	4.7	5.1	5.5
1950: 1	4.7	3.7	4.3	5.7
1951: 1	6.7	8.4	10.7	11.9
1952: 1	11.6	12.5	13.4	14.3
1953: 1	13.9	14.5	13.5	15.2
1954: 1	12.6	12.0	10.9	11.9
1955: 1	10.6	10.4	11.1	11.9
1956: 1	10.6	11.5	10.8	12.7
1957: 1	12.1	12.1	12.1	13.2
1958: 1	12.4	13.0	13.3	14.9
1959: 1	13.1	13.4	13.1	14.1
1960: 1	12.7	12.8	13.8	14.2
1961: 1	13.5	14.0	14.1	15.8
1962: 1	15.2	15.9	15.3	17.1
1963: 1	15.7	15.4	16.0	17.1
1964: 1	15.9	16.6	15.8	16.8
1965: 1	15.4	16.2	16.2	19.0
1966: 1	17.6	18.9	20.1	21.2
1967: 1	21.5	22.5	22.3	24.4
1968: 1	23.0	25.5	24.3	26.6
1969: 1	24.5	24.9	26.0	26.0

STANDARD & POOR'S COMPOSITE INDEX OF STOCK PRICES MEANS OF DAILY DATA

1947: 1	15.4	14.6	15.4	15.3
1948: 1	14.4	16.1	16.0	15.6
1949: 1	15.0	14.5	15.2	16.2
1950: 1	17.1	18.3	18.3	19.8
1951: 1	21.6	21.8	22.8	23.2
1952: 1	23.9	23.9	25.0	25.1
1953: 1	26.0	24.5	24.0	24.4
1954: 1	26.0	28.4	30.8	33.5
1955: 1	36.3	38.4	43.2	44.1
1956: 1	45.4	47.0	48.0	46.1
1957: 1	44.3	46.5	46.1	40.6
1958: 1	41.5	43.6	47.5	52.3
1959: 1	55.5	57.5	58.7	57.8
1960: 1	56.3	56.1	55.7	55.3
1961: 1	62.0	66.0	66.8	70.3
1962: 1	69.9	62.2	57.8	59.6
1963: 1	65.6	69.7	71.0	73.3
1964: 1	77.5	80.3	82.9	84.8
1965: 1	86.6	87.4	86.9	91.8
1966: 1	91.6	88.1	81.4	79.8
1967: 1	87.1	91.7	94.4	94.5
1968: 1	91.6	98.0	99.9	105.2
1969: 1	100.9	101.7	94.5	94.3

MAN-DAYS IDLE DUE TO STRIKES AND LOCKOUTS IN MILLIONS, MEANS OF MONTHLY DATA UNADJUSTED FOR SEASONAL VARIATION

1947: 1	1.223	6.410	2.820	1.066
1948: 1	2.801	4.570	2.437	1.561
1949: 1	1.620	3.260	3.587	8.373
1950: 1	5.063	3.060	2.973	1.851
1951: 1	1.640	1.837	2.353	1.807
1952: 1	1.440	9.463	6.300	2.471
1953: 1	1.240	3.863	2.820	1.700
1954: 1	1.132	1.873	3.317	1.205
1955: 1	0.892	2.977	3.050	2.480
1956: 1	2.147	2.153	5.697	1.037
1957: 1	0.782	1.883	1.967	0.860
1958: 1	0.746	1.630	2.240	3.353
1959: 1	1.477	2.760	12.143	6.610
1960: 1	1.313	2.330	1.830	0.897
1961: 1	0.612	1.418	1.787	1.612
1962: 1	0.899	2.223	1.850	1.220
1963: 1	1.408	1.306	1.382	1.269
1964: 1	0.918	1.823	1.777	3.127
1965: 1	1.650	2.093	2.670	1.352
1966: 1	1.143	2.563	2.750	2.003
1967: 1	1.344	3.960	4.449	4.288
1968: 1	3.485	6.235	3.914	2.705
1969: 1	2.717	4.407	3.380	3.786

MANUFACTURING EMPLOYMENT IN MILLIONS, MEANS OF MONTHLY DATA UNADJUSTED FOR SEASONAL VARIATION

1947: 1	15.62	15.49	15.42	15.65
1948: 1	15.71	15.50	15,63	15.50
1949: 1	14.97	14.45	14.27	14.07
1950: 1	14.40	14.94	15.59	16.03
1951: 1	16.41	16.52	16.35	16.31
1952: 1	16.46	16.38	16.48	17.22
1953: 1	17.62	17.79	17.66	17.14
1954: 1	16.67	16.31	16.95	16.22
1955: 1	16.48	16.86	16.98	17.21
1956: 1	17.28	17.27	17.07	17.36
1957: 1	17.41	17.31	17.16	16.84
1958: 1	16.23	15.70	15.81	16.04
1959: 1	16.47	16.85	16.71	16.69
1960: 1	17.12	16.96	16.72	16.40
1961: 1	16.11	16.24	16.39	16.55
1962: 1	16.73	16.89	16.90	16.89
1963: 1	16.89	17.00	17.03	17.06
1964: 1	17.11	17.20	17.36	17.43
1965: 1	17.71	17.92	18.18	18.44
1966: 1	18.78	19.15	19.39	19.54
1967: 1	19.56	19.39	19.35	19.50
1968: 1	19.63	19.75	19.81	19.94
1969: 1	20.10	20.21	20.25	20.13

GNP IMPLICIT PRICE DEFLATOR (1957-59 EQUALS 1)

1947: 1	0.7300	0.7370	0.7490	0.770
1948: 1	.7820	.7920	.8060	.8030
1949: 1	.7970	.7910	.7880	.7890
1950: 1	.7830	.7900	.8080	.8230
1951: 1	.8480	.8540	.8560	.8670
1952: 1	.8670	.8710	.8770	.8830
1953: 1	.8840	.8830	.8840	.8840
1954: 1	.8950	.8960	.8950	.8900
1955: 1	.9020	.9060	.9100	.9160
1956: 1	.9260	.9340	.9460	.9540
1957: 1	.9640	.9710	.9800	.9850
1958: 1	.9930	.9970	1.0010	1.0060
1959: 1	1.0110	1.0150	1.0190	1.0210
1960: 1	1.0260	1.0310	1.0350	1.0400
1961: 1	1.0430	1.0450	1.0450	1.0510
1962: 1	1.0550	1.0560	1.0580	1.0360
1963: 1	1.0670	1.0700	1.0720	1.0780
1964: 1	1.0820	1.0850	1.9010	1.0960
1965: 1	1.1020	1.1070	1.1100	1.1150
1966: 1	1.1239	1.1349	1.1450	1.1536
1967: 1	1.1617	1.1682	1.1798	1.1935
1968: 1	1.2030	1.2165	1.2290	1.2425
1969: 1	1.2568	1.2722	1.2897	1.3052

MARKET YIELD ON 13-WEEK U.S. TREASURY BILLS, MEANS OF DAILY DATA

1947: 1	0.380	0.380	0.737	0.907
1948: 1	0.990	1.000	1.050	1.140
1949: 1	1.170	1.170	1.043	1.077
1950: 1	1.103	1.153	1.220	1.337
1951: 1	1.367	1.490	1.603	1.610
1952: 1	1.567	1.647	1.783	1.893
1953: 1	1.980	2.153	1.957	1.473
1954: 1	1.060	0.787	0.883	1.017
1955: 1	1.227	1.483	1.857	2.340
1956: 1	2.327	2.567	2.583	3.033
1957: 1	3.100	3.137	3.353	3.303
1958: 1	1.760	0.957	1.680	2.690
1959: 1	2.773	3.000	3.540	4.230
1960: 1	3.873	2.993	2.360	2.307
1961: 1	2.350	2.303	2.303	2.460
1962: 1	2.723	2.713	2.840	2.813
1963: 1	2.907	2.937	3.293	3.497
1964: 1	3.530	3.477	3.497	3.683
1965: 1	3.890	3.873	3.863	4.157
1966: 1	4.603	4.580	5.030	5.200
1967: 1	4.513	3.657	4.293	4.743
1968: 1	5.040	5.513	5.197	5.580
1969: 1	6.087	6.190	7.010	7.347

CIVILIAN WORKERS UNEMPLOYED, IN MILLIONS, MEANS OF MONTHLY DATA UNADJUSTED FOR SEASONAL VARIATION

1948: 1	2.254	2.239	2.288	2.324
1949: 1	2.825	3.581	4.118	4.325
1950: 1	3.946	3.459	2.898	2.618
1951: 1	2.182	1.923	1.983	2.111
1952: 1	1.914	1.853	2.005	1.750
1953: 1	1.707	1.642	1.715	2.334
1954: 1	3.338	3.689	3.813	3.421
1955: 1	3.015	2.832	2.698	2.790
1956: 1	2.679	2.798	2.763	2.741
1957: 1	2.642	2.722	2.829	3.317
1958: 1	4.223	4.994	4.975	4.316
1959: 1	3.944	3.493	3.630	3.855
1960: 1	3.557	3.652	3.889	4.400
1961: 1	4.785	4.928	4.764	4.348
1962: 1	3.957	3.872	3.931	3.809
1963: 1	4.128	4.085	4.964	4.036
1964: 1	3.970	3.835	3.660	3.640
1965: 1	3.602	3.475	3.260	3.079
1966: 1	2.879	2.889	2.862	2.820
1967: 1	2.883	2.968	2.995	3.062
1968: 1	2.891	2.831	2.805	2.689
1969: 1	2.693	2.806	2.945	2.925

CIVILIAN LABOR FORCE, IN MILLIONS, MEANS OF MONTHLY DATA UNADJUSTED FOR SEASONAL VARIATION

1948: 1	60.23	60.54	60.93	60.84
1949: 1	60.97	61.07	61.51	62.03
1950: 1	61.65	62.22	62.36	62.26
1951: 1	62.08	61.82	61.94	62.23
1952: 1	62.19	61.96	62.10	62.36
1953: 1	63.54	62.95	62.87	62.87
1954: 1	63.63	63.65	63.74	63.67
1955: 1	63.83	64.48	65.45	66.10
1956: 1	66.24	66.56	66.71	66.83
1957: 1	66.74	66.80	67.04	67.20
1958: 1	67.17	67.74	67.95	67.81
1959: 1	67.88	68.27	68.50	68.78
1960: 1	68.77	69.71	69.91	70.24
1961: 1	70.52	70.53	70.43	70.31
1962: 1	70.34	70.45	70.81	70.87
1963: 1	71.28	71.72	71.96	72.29
1964: 1	72.59	73.24	73.13	73.30
1965: 1	73.80	74.38	74.62	74.80
1966: 1	75.10	75.48	75.93	76.46
1967: 1	76.74	76.88	77.63	78.18
1968: 1	78.28	78.73	78.82	79.17
1969: 1	80.11	80.36	81.03	81.58

CHAIRMAN OF THE BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, D.C., April 15, 1971.

Hon. WILLIAM PROXMIRE,
U.S. Senate, Washington, D.C.

DEAR SENATOR PROXMIRE: In accordance with your request of February 19, when I testified before the Joint Economic Committee, I am enclosing an analysis of the econometric model by Messrs. Laffer and Ranson. This analysis was prepared by Mr. Pierce of the Board staff.

Neither I nor the Board has participated in any way in the preparation of the enclosed study by Mr. Pierce.

Sincerely yours,

ARTHUR F. BURNS.

Enclosure.

CRITIQUE OF "A FORMAL MODEL OF THE ECONOMY FOR THE OFFICE OF MANAGEMENT AND THE BUDGET" BY ARTHUR B. LAFFER AND R. DAVID RANSON [1]

The "Formal Model of the Economy" developed by Arthur B. Laffer and R. David Ranson is one of the most recent of many efforts that have been made to express the essential characteristics of the U.S. economy in the form of an econometric model. Because of its significant implications for both monetary and fiscal policies, and some of its novel elements, it deserves careful scrutiny.

This critique of the Laffer-Ranson model is divided into five sections: a general summary presentation of the nature of the model and its empirical results; a discussion of its analytic characteristics; an evaluation of its statistical properties; a review of its predictive accuracy and its forecasting performance; and, finally, a series of comments on its implications for policy.

I. SUMMARY OF LR MODEL

The Laffer-Ranson model (henceforth called the LR model) is a reduced form model of the United States economy.[2] In a reduced form model, variables predicted by the model—the endogenous variables—such as GNP, prices, or employment, are related directly to variables which originate outside of the model—the exogenous variables—such as money stock and Government spending. Actually, for the endogenous variables to be determined by any particular combination of exogenous variables, an intermediate process must take place. This process—which consists of a complicated interaction of supplies and demands in the economy—is left unexplained in a reduced form model. By contrast, so-called structural models of the economy seek to explain these economic processes in varying

[1] This critique was prepared by James L. Pierce of the Federal Reserve Board staff. He wishes to acknowledge the advice and assistance of H. Farr, L. Gramley, M. Graves, J. Kalchbrenner, W. Poole and D. Wyss.

[2] This critique is based on two versions of the paper describing the model—one received at the Board in early February, and the second in about mid-March. Where specific remarks refer to only one of these two versions, the text so indicates.

degrees of detail. Users of the reduced form approach apparently believe that they can do a better job of predicting movements in the economy's endogenous variables by this technique than by attempting to estimate the linkages through which policy variables influence the economy.

In the LR model, the exogenous variables are a mixture of some variables that can and some that cannot be controlled by economic policy makers. The money stock and Government spending are taken as exogenous. In principle, they can be manipulated by monetary and fiscal policy makers.[3] Certain other variables, taken to be predetermined, are also included in the estimating equations to improve the explanation of the endogenous variables.

The authors maintain that their model reflects a composite of the Keynesian, quantity theory, and efficient-markets approaches to macro-economic theory. The first two schools of thought are fairly well known, but the last may need some additional explanation. The authors interpret the efficient-markets hypothesis to mean that market prices accurately reflect future economic events. For example, stock prices are assumed to provide the best (unbiased and minimum variance) forecasts of future real income, and interest rates are assumed to offer the best forecast of future rates of inflation.

The Keynesian view of income determination is represented in the model by including Federal purchases of goods and services as a fiscal policy variable. Two other fiscal variables—total Federal budget outlays and total Federal receipts—were tried in the estimating equations, but were rejected on the grounds that they yielded poorer results. The quantity theory is represented by the inclusion of the results. The quantity theory is represented by the inclusion of the narrowly-defined money stock, M_1 (demand deposits plus currency); M_2 (defined to include all time deposists) was also tried and rejected on the grounds of poorer fit. The efficient-markets hypothesis is represented by the inclusion or the Standard and Poor's index of common stock prices and the 3-month Treasury bill rate.

Anyone who is concerned about the nation's health probably looks first at three primary economic variables: gross national product, prices, and unemployment. It is the behavior of these three variables—and only these three—that the LR model attempts to explain. Actually, the model contains four reduced form equations which explain quarterly rates of growth of nominal GNP, the GNP deflator, the unemployment rate, and real GNP. As Laffer and Ransom recognize, the last equation is redundant; real GNP can be computed from nominal GNP and the deflator.

In the first equation of the LR model, the quarterly rate of growth of nominal GNP depends on the growth in the money stock in the same quarter, the growth of Federal purchases in the same and the previous three quarters, and the growth in stock prices lagged one quarter.[4] There is also a variable representing manhours lost due to the effects of strikes, as well as seasonal dummy variables.

The second equation in the model is for the GNP deflator. The rate of change of the GNP deflator is explained by the rates of change in the deflator during the previous two quarters, the growth in the money stock in the same quarter, and the level of the Treasury bill rate lagged one quarter.

In the third equation of the LR model, the rate of change in the unemployment rate is explained by growth in real GNP in the same and the previous three quarters, the rate of change in stock prices lagged two quarters, plus seasonal dummy variables.

Coefficients for the model's equations were estimated by applying ordinary least-squares regression techniques to seasonally unadjusted data. This data choice is unusual inasmuch as most macro-econometric models are constructed from seasonally adjusted data. The author's arguments for using seasonally unadjusted data are discussed in a subsequent section.

The authors draw several principal conclusions from their regression analysis. The most striking is that there is no lag in the relation between changes in the money stock and changes in nominal GNP. Their results show that a one per cent increase in the rate of growth of money results in a one per cent increase in the rate of growth of nominal GNP. With the ratio of GNP to the money stock presently at a level of about 5, this means that a one dollar increase in the money stock would, under present circumstances, result in a five dollar increase in nominal GNP. But the more startling conclusion is that *all* of the change in GNP occurs in the *same* quarter as the change in money. There are no subsequent effects because the impact of money upon nominal GNP is exhausted within a single quarter.

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[3] The extent to which these policy variables are exogenous in a statistical sense is discussed later.

[4] More specifically, rates of growth in the model are represented by differences of the natural logarithms of the variables.

Laffer-Ranson also find that an increase in the rate of growth of Federal purchases of goods and services has a relatively small, though statistically significant, effect upon the rate of growth of nominal GNP in the same quarter. However, in the three succeeding quarters, the effect is reversed. Over a span as long as one year, a change in fiscal policy (represented by Federal purchases) has no effect upon nominal GNP.

A conclusion that fiscal policy has no lasting effect on nominal GNP is consistent with an extreme monetarist view that the ratio of nominal GNP to the money stock is largely independent of changes in the level of Federal spending or taxation (and also of changes in private propensities to spend). Empirical results supporting this view, found by the St. Louis Federal Reserve Bank, have been widely discussed recently. However, most econometric models, especially structural models, do not substantiate this view.

In the LR model, the importance of changes in the rate of growth of money on the growth rate of the GNP price deflator is quite small—and it is not statistically significant. The unemployment rate was also found to be an insignificant determinant of growth of the GNP deflator. The authors dismissed it from the equation and concluded that a "Phillips Curve" (tradeoff between prices and unemployment) does not exist.

On the basis of an inspection of the various goodness-of-fit measures for the equations within the sample period, and the accuracy of the forecasts for the four quarters of 1970 (outside the sample period), the authors conclude that their model is unusually accurate.

II. ANALYTIC CHARACTERISTICS OF THE MODEL

A simple but useful means of evaluating an empirical model is to examine its properties and implications to see if they are sensible. The LR model does not receive a very high score on this test.

Effects of Monetary Policy

The most unusual finding of the LR model is that changes in the money stock work all of their effects on nominal GNP in the same quarter. While proponents of the Keynesian and quantity theory approaches often disagree about the length and variability of the lags in the economy, there is general agreement that lags do, in fact, exist. Statistical estimates of the response of nominal income to changes in the money stock range from several calendar quarters to several years. The Laffer-Ranson results thus differ sharply from the theoretical and empirical conclusions reached by most economists.

There are strong *a priori* reasons for believing that a substantial period of time is required for a monetary change to work out its total impact on the economy. It is widely agreed that a change in the money stock exerts its influence on spending through its impact on the composition of wealth in the economy. When the money stock is increased, interest rates, prices and income must change sufficiently to induce households and businesses to hold the additional money balances. A single household, for example, may achieve equilibrium fairly rapidly simply by spending the money on consumption, or saving it in the form of some real or financial asset. But such spending by one individual economic unit raises the money balances of some other household or business above its desired level, so that further adjustments are required. For the economy as a whole, the adjustments undertaken by many individual households and businesses produce changes in interest rates, prices and income. Indeed, it is changes in these endogenous variables which allow a new equilibrium to be achieved. As the economy starts to adjust to a larger money stock, interest rates initially fall. The decline in interest rates encourages additional spending and thus generates more income. The rise in income encourages more consumption and investment while raising the quantity of money demanded. A macro-equilibrium can only be achieved when all households and firms have restored their portfolio balance—relating stocks of physical and financial capital to flows of income and consumption. This new equilibrium is achieved when interest rates, prices and incomes have changed sufficiently to equate the demand for money with the larger supply.

This movement to a new equilibrium takes time. Spending does not respond instantly to interest rates, which themselves often adjust slowly. A substantial amount of time is needed to build houses, to add to the stock of machinery and equipment, to build new shopping centers and so on. It seems reasonable to suppose that nominal GNP continues to respond to the initial monetary expansion over a substantial time period, as the economy works toward a new equilibrium. Laffer and Ranson do not seek to explain how these processes can all be completed within a 3-month period.

Existing empirical evidence, in addition to common sense, strongly supports the view that a long period of time is required for the conomy to adjust completely to a change in monetary policy. For example, Milton Friedman concludes from his quantity theory studies that the lags between a change in money and the complete impact on nominal income are not only long, but variable as well.[5] The monetarist model developed by the Federal Reserve Bank of St. Louis indicates that five quarters are required for a change in money to register its total impact on nominal GNP.[6] The large-scale structural model developed by economists at the Federal Reserve Board, MIT and the University of Pennsylvania—now called the SSRC-MIT-Penn (SMP) Model—provides evidence of even longer lags.[7] Because many of the lag structures in the model decay at an exponential rate, it is not meaningful to talk about the total length of the lag in this case. The SMP model does indicate, however, that approximately 50 percent of the total impact of a change in money on nominal GNP is felt within seven quarters (although this will vary depending on initial conditions). Thus, on both theoretical and empirical grounds it is difficult to accept the conclusion that changes in the money stock affect nominal GNP with no lag.

Effects of Fiscal Policy

The implications of the LR model for the role of fiscal variables as determinants of nominal GNP are also puzzling. As noted above, the Laffer-Ranson results suggest that fiscal policy has only a transitory effect on nominal GNP. Most economists probably would not accept this contention, and would cite an abundance of empirical evidence supporting the view that fiscal policies have more than transient effects on current dollar GNP. There is, however, a theoretical basis for the judgment that a rise in Government spending—unless accompanied by an increase in the money stock—eventually "crowds out" an equal amount of private spending, leaving the aggregate of private and government expenditures unchanged. And there is, as indicated above, some support for this view in the econometric model of the Federal Reserve Bank of St. Louis.

The traditional rationale for the "crowding out" hypothesis of the monetarist school relies upon interest rate changes to neutralize the effects of government spending on nominal GNP. Increased Federal spending—given unchanged tax rates and a constant money stock—results in larger borrowings by the Treasury. The consequent upward pressure on interest rates curtails private expenditures on investment or consumption.[8]

At this point, however, it becomes relevant to determine the conditions necessary for rising Government expenditures to "crowd out" an equal amount of private spending. Rising interest rates do tend to curb private expenditures. But higher interest rates also provide individuals and firms with incentives to economize on their holdings of money. A higher level of spending can thus be financed through a rise in the income velocity of money. As long as velocity varies positively with interest rates—and there is a vast body of literature to show that it does—increases in Government spending will not be fully offset by reductions in private spending.

There is no disagreement that when resources are fully employed, an increase in *real* Government spending must necessarily "crowd out" an equal amount of *real* private spending. At full employment, one sector can only obtain more real resources at the expense of other sectors. If resources are not fully employed, however, the rise in velocity (stemming from rising interest rates) triggers the activation of idle resources. The end result is to allow total real output to rise in response to an increase in Government spending.

In the LR model, the process by which rising Federal purchases "crowd out" private expenditures is left unexplained. Evidently, changes in interest rates are not the mechanism. Interest rates should not and do not appear in the nominal GNP equation, but the Treasury bill rate does appear in the equations for real GNP and the deflator. From these two equations, it appears that rising bill rates have little effect on nominal GNP. A rising bill rate is associated in the LR model with an acceleration in inflation, but the effect on nominal GNP is offset by a nearly equal deceleration in the growth of real GNP.

The model thus seems to imply some unusual conclusions concerning the financial effects of fiscal policy. For example, if rising Federal purchases of goods

[5] Milton Friedman, *The Optimum Quantity of Money and Other Essays*, Aldine, Chicago, 1969, Ch. 11.
[6] Federal Reserve Bank of St. Louis *Review*, April 1970.
[7] A description of this version of the SMP model is not yet available. For descriptions of earlier versions see the Federal Reserve *Bulletin*, January 1968 and June 1969. Documentation and the computer program necessary to operate the version of the SMP used in this critique can be obtained from Wharton EFA, Inc., University of Pennsylvania.
[8] See, for example, Milton Friedman, *Capitalism and Freedom*, Chicago, University of Chicago Press, 1962, Chapter V.

and services pushed up interest rates on Treasury bills, aggregate real income would be reduced while prices would be increased. Because real income growth enters the unemployment equation, unemployment would rise. It is difficult to provide a reasoned argument for such a novel sequence of developments.

The treatment of fiscal policy in the LR model, if taken literally, seems deficient on yet another basis. The role of fiscal ploicy as a determinant of both real and nominal GNP is represented by Federal purchases of goods and services. Other Federal expenditures play no role, nor do Federal taxes. Presumably, Laffer and Ranson would not wish to argue seriously that changes in rates of Federal taxation, or in Federal expenditures other than purchases of goods and services, have no effect whatever—even in the short run—on real or nominal aggregate income. These variables were omitted from consideration on statistical grounds—that is, on the basis of goodness of fit. This means, however, that there are major areas of fiscal policy whose macro-economic effects cannot be analyzed within the framework of the model.

The Phillips curve

A third principal conclusion of the LR model relates to the "Phillips curve," that is, the tradeoff between unemployment and prices. Their results, the authors contend, do not confirm the existence of such a tradeoff. This conclusion is drawn from the fact that the unemployment rate did not enter significantly into the estimating equation for the GNP deflator. It is a bit difficult to interpret precisely what the authors infer from this conclusion.

There has been considerable debate among economists in recent years as to whether there is any permanent tradeoff between the rate of unemployment and the rate of increase in prices. A reasonable, though disputed, case can be made for the view that, over the long run, public policy cannot achieve a rate of unemployment below the level consistent with price stability. Efforts to maintain a lower unemploymen rate would lead to an accelerating rate of inflation.[9] There is, however, a large amount of empirical evidence that supports the existence of a tradeoff between the rate of unemployment and inflation in the short run.[10] In fact, to deny such a proposition would come close to ruling out any possibility of controlling inflationary pressures through aggregate demand management.

Because of the way the LR price equation is constructed, it does not provide a meaningful test for rejecting the short-run Phillips curve hypothesis. The LR price equation is an autoregression—that is, it relates the current growth rate of the GNP deflator to the deflator's rate of growth in previous quarters. Autoregressions are often useful forecasting devices, but it is well known that they are a highly unsatisfactory means for determining the role other variables may play. It is quite possible, for example, that the effects of the unemployment rate on the growth of prices are represented in lagged values of the price variable. Furthermore, the inclusion of the Treasury bill rate in the estimating equation further obscures the relation between prices and unemployment, since interest rates and the rate of unemployment display cyclical covariation.

This is an example of the pitfalls of trying to accomplish so much with so little. Laffer and Ranson maintain that they are testing propositions from the Keynesian, quantity theory, and efficient market hypotheses. How this wealth of theory was boiled down to three or four reduced form equations is far from clear. Since the underlying structure of the economy was not specified by the authors, it is very difficult to know how the signs and magnitudes of the reduced coefficients relate to the underlying theories. This can be a significant source of error in making decisions concerning the reasonableness of estimated coefficients.

It may be worthwhile to make one additional analytical point before turning to a discussion of the model's statistical properties. In the LR model, the relationships specified are linear in the rates of change of the variables. For the nominal GNP equation, this specification implies the same response of nominal GNP to changes in the independent variables regardless of the existing state of the economy. That is, initial conditions, such as existing unemployment rates, which can be taken into account explicitly with a nonlinear formulation, are of no importance in the LR model. It also implies that policy variables can be changed slightly or by very large amounts without affecting the estimated relationships between nominal GNP and money or government expenditures.

[9] See, for example, Milton Friedman, "The Role of Monetary Policy," *American Economic Review*, March 1968.

[10] See, for example, George L. Perry, *Unemployment, Money Wage Rates, and Inflation*, Cambridge, Massachusetts, MIT Press, 1969.

The implications of a linearity assumption are somewhat unusual. For example, in the LR model the response of real GNP to monetary change is the same when the economy has substantially unemployed resources as when resources are fully employed. This is certainly not a generally accepted proposition. Further, this linearity also implies that the "crowding out" effect of government expenditures, common to the LR model and the St. Louis model, is the same regardless of the state of the economy. This also seems unlikely.

It is possible to view the linear specification as an approximation to reality, valid for relatively small changes in the independent variables (such as money or Government expenditures) and for initial conditions approximating those prevailing, on average, over the sample period. But acceptance of this interpretation would suggest that the model would do a poorer job of forecasting (i) when initial conditions diverge sharply from the average conditions in the sample period, and (ii) when relatively large changes in policy variables occur. Laffer and Ranson recognize and acknowledge these shortcomings.

III. STATISTICAL PROPERTIES OF THE MODEL

An econometric model should be constructed in such a way as to avoid problems of statistical bias. Unfortunately, in the LR model statistical bias is introduced by the author's choice of the ordinary least aquares method of estimation, as well as their choice of seasonally unadjusted data.

The problem of statistical bias arises in the LR model because the money stock was not an exogenous variable during most of the sample period. That is, it was not wholly independent of the variable it is helping to explain—nominal GNP. As a consequence, the estimated coefficient for money stock growth in the nominal GNP equation obtained by the ordinary least squares method of estimation measures not only the impact of money on GNP but also the impact of GNP on money. The positive response of money to GNP is a source of an upward bias in the coefficient of the money stock variable.

This element of bias does not mean that the money stock cannot be controlled by the Federal Reserve. It is one thing, however, to say that the Federal Reserve is capable of controlling the money stock and another to say that, in fact, the Federal Reserve did set the money stock—quarter by quarter—independently of nominal GNP in the same quarter. Over nearly the entire sample period covered in the LR model the Federal Reserve did not implement its policies by setting planned values for the money stock; rather, it aimed at money market variables such as Federal funds rates, Treasury bill rates, or free reserves. In setting such money market targets, the money stock was, in the short-tun, free to vary with changes in aggregate demand. If nominal GNP rose, the demand for money increased, and interest rates started to rise; commercial banks increased their borrowing both from each other and from the Federal Reserve, and reduced excess reserves. When the Federal Reserve was following a money market target, it responded to this process by providing reserves to moderate the rise in interest rates and the changes in free reserves. Pursuit of such a short-run policy strategy does not mean, of course, that the money stock was free to vary over longer periods with every change in public demand for money. But it does mean that for relatively short periods, such as a quarter, the money stock did respond to changes in demand.

This response of money to GNP introduces a statistical bias into the estimate of the coefficient relating GNP to money. The bias raises the coefficient on the current quarter's money variable. The bias overstates the role of the money stock in the current quarter and thus understates the impact of lagged money variables.

For the same reasons, measures such as total reserves or the monetary base respond positively to changes in GNP. Laffer and Ranson attempt to circumvent the problem of an endogenous money stock by substituting the monetary base for the money stock in their equation for nominal GNP. However, as long as the Federal Reserve pursues a money market target, the same problems exist; the new procedure is no more valid than regressing GNP on the money stock.

It appears that the use of seasonally unadjusted data in the LR model introduces additional elements of statistical bias that would not have been present with seasonally adjusted data. Before turning to that issue, however, it is appropriate to raise a question as to the validity of Laffer and Ranson's attachment to the use of seasonally unadjusted data in the first place.

The authors contend that the use of seasonally adjusted data is "inappropriate" for both hypothesis testing and forecasting. They also suggest that their conclusion that changes in money affect GNP without a lag stems from the use of the "superior" seasonally unadjusted data. But since most earlier reasearchers have used seasonally adjusted data, it is essential that LR explain why the use of such data is inappropriate.

In their early February version the authors cite a paper by Nerlove, among others, by evidence that commonly used seasonal adjustment techniques produce improper seasonal adjustment.[11] In that paper, Nerlove established a number of criteria for evaluating seasonal adjustment procedures by means of spectral analysis. Based on those criteria, he concluded that the Bureau of Labor Statistics variant of the ratio-to-moving average technique of seasonal adjustment did poorly—it tended to remove more than just seasonality from a series, and produced distortion of the timing of nonseasonal movements in the series. Similar results were found by other studies for the Census Bureau variants of this method of seasonal adjustment.

However, in a more recent article by Grether and Nerlove,[12] the earlier criteria were rejected. An optimal method of seasonal adjustment (minimum mean square error) was developed for achieving various aims of the seasonal adjustment procedure. This method was then applied to a simulated series with known properties. The resulting adjustments were therefore more "optimal" than could be hoped for with any actual time series. Even under these conditions, the results of the spectral analysis were similar to those found earlier for the BLS and Census adjustment procedures.

At a minimum, these results indicate that evaluation of seasonal adjustment procedures by means of spectral analysis is extremely difficult and uncertain, given the current state of knowledge. At most, they imply that earlier conclusions concerning the low ratings attributed to ratio-to-moving average methods of seasonal adjustment were wrong, as Grether and Nerlove candidly acknowledged.

There have been other tests of conventional techniques of seasonal adjustment. For example, a recent study by Stephenson and Farr,[13] applying a regression method of seasonal adjustment and the Census Bureau X–11 method to several simulated series, finds that X–11 does a reasonably satisfactory job of seasonal adjustment, with the possible exception of series that have a large random component.

Further, an article by Jorgenson [14] suggests that while parameter estimates obtained using seasonally adjusted data are biased, the simple expedient of using seasonal dummy variables—as the LR model does—leaves the problem unsolved. The dummy procedure also produces biased estimates of the parameters of a system of equations unless appropriate simultaneous estimation techniques are used.

Therefore, a good case supporting the use of seasonally unadjusted data in regression analysis as generally inately superior simply has not been made. To the contrary, in the LR model, additional problems ensue from using such data; namely, the use of seasonally unadjusted data causes an upward bias in the coefficient on money in the equation for nominal GNP.

Because of the evolving seasonal payment patterns in the economy, it is unlikely that a single set of additive dummy variables captures all the co-seasonality of money and GNP. The failure to remove co-seasonality completely produces a seasonal in the impact of GNP on money, which imparts an additional element of bias to the coefficients on money. Thus, one would expect the coefficient on money to be larger using seasonally unadjusted data than for adjusted data.

To test this, the Laffer-Ranson equation for nominal GNP was fit to seasonally adjusted data using the same time span. The results, reported in Table I, look much like those found by Laffer and Ranson for seasonally unadjusted data, except that the coefficient for money falls from 1.10 to .713. It is interesting to note that while the coefficient on money is reduced, it is within the range of coefficients obtained using seasonally unadjusted data over alternative sample periods reported at a later point in the paper.

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[11] M. Nerlove, "Special Analysis of Seasonal Adjustment Procedures," *Econometrica*, July, 1964.

[12] D. M. Grether and M. Nerlove, "Some Properties of Optimal Seasonal Adjustment," *Econometrica*, September, 1970.

[13] J. A. Stephenson and H. T. Farr, "Seasonal Adjustment of Economic Data by Application of the General Linear Statistical Model," Unpublished, 1970. A copy of this paper may be obtained by writing to H. T. Farr of the Federal Reserve Board Staff.

[14] D. Jorgenson, "Seasonal Adjustment of Data for Econometric Analysis," *Journal of the American Statistical Association*, No. 62, 1967.

TABLE I.—EQUATION FOR NOMINAL GNP, USING SEASONALLY ADJUSTED DATA

Variable	Coefficient	t-statistic
Constant	0.0096	6.5
$\Delta LM1$	.713	4.3
ΔLG	.105	4.1
ΔLG	—.011	.3
ΔLG^{-1}	—.069	2.3
ΔLG^{-2}	—.023	.9
ΔSH^{-3}	—.047	4.9
$\Delta LS\&P_{-1}$	.059	2.6

NOTES

Interval 1948I—1969IV.
$\bar{R}^2$=.54. D-W=1.3. SE of E=.00925.

It is also of considerable interest to note the results of including lagged growth rates of the money stock in the nominal GNP equation when seasonally adjusted data are employed. Table II shows that individual coefficients of the money stock variables are not statistically significant for either current or lagged growth rates in money. However, the collective contribution of the current and lagged money variables are extremely important. This is evident when an F test—a test for statistical significance—is made.

TABLE II.—EQUATION FOR NOMINAL GROSS NATIONAL PRODUCT WITH CURRENT AND LAGGED MONEY GROWTH AS EXPLANATORY VARIABLES, USING SEASONALLY ADJUSTED DATA

Variable	Coefficient	t-statistic
Constant	0.0079	5.0
ΔLM	.347	1.6
ΔLM	.252	.9
ΔLM^{-1}	.354	1.2
ΔLM^{-2}	.008	0
ΔLG^{-3}	.094	3.8
ΔLG	—.008	.3
ΔLG^{-1}	—.060	2.1
ΔLG^{-2}	—.028	1.2
ΔSH^{-3}	—.050	5.4
$\Delta LS\&P^{-1}$	.006	2.9

Interval $\bar{R}^2$=0.58. 1948I–1969IV: D-W=1.4; SE of E=0.0089.

Laffer and Ranson maintain that the co-seasonality of money and income is weak. Their evidence that supports this premise is comprised of observing that money and income move together seasonally in only two of four quarters. This is a deficient test for two reasons. First, the relative movements of money and GNP are much larger in the two quarters when they move in the same direction. Since the movements enter their regression as the squares of the deviations from their means, these two quarters receive much higher weight. Second, the source of the bias is not co-seasonality *per se* but rather changing co-seasonality. If seasonal patterns in money and nominal GNP change over time, the use of seasonal dummies inadequately deals with co-seasonality.

Because it is not possible to observe the "true" seasonal factors for nominal GNP and the money stock, the extent of the bias that is due to changing co-seasonality of money and GNP cannot be measured. But it is possible to provide some evidence on the bias.

The techniques used by the OBE and the Federal Reserve to obtain seasonally adjusted values for nominal GNP and the money stock allow the seasonal factors to vary over time. If it is assumed that the seasonal factors calculated by OBE and the Federal Reserve are good estimates of the true factors, some information can be obtained on the extent to which the dummy variables in the LR model have failed to account fully for the co-seasonality of money and nominal GNP. This is accomplished by regressing the seasonal factors used by OBE in calculating seasonally adjusted nominal GNP on the set of additive dummy variables used by Laffer and Ranson *and* the seasonal adjustment factors used by the Federal Reserve to calculate the seasonally adjusted value of M_1.[15]

[15] The seasonal factors for both nominal GNP and the money stock were obtained by dividing seasonally adjusted data by seasonally unadjusted data. The official sources for this published data are the Office of Business Economics and the Board of Governors of the Federal Reserve System, respectively.

This regression is reported in Table III below. The positive and statistically significant coefficient for the money seasonal factors indicates that the dummy variables have not removed all co-seasonality of money and GNP and that seasonal movements in nominal GNP are positively and very significantly correlated with seasonal movements in money.

TABLE III.—REGRESSION ON SEASONAL FACTORS FOR NOMINAL GNP

Variable	Coefficient	t-statistic
Constant	−1.519	3.52
D1	.080	23.99
D2	.003	.30
D3	.009	.96
Money seasonal factors	2.497	5.72

NOTES

Interval: 1948I—1969IV.
R^{-2}=.959. D-W=2.3. SE of E=.00715.

IV. ACCURACY OF THE MODEL

Econometric models sometimes predict well, even though they may lack a certain amount of elegance and fail to observe statistical niceties. It is relevant, therefore, to evaluate the prediction performance of the LR model.

One important measure of the goodness-of-fit of a model is found in the standard error of estimate. This measure is presented for each of the four LR equations in Table IV. Column 1 shows the standard errors of estimate for predictions a single quarter ahead, expressed in terms of quarterly rates of growth of each variable. Column 2 converts these figures to levels based on current values of the variable.

TABLE IV.—SINGLE QUARTER ESTIMATION ERRORS

	Growth rates	Levels
A. Nominal GNP	.0131	$13,000,000,000
B. GNP deflator	.0027	.38
C. Unemployment	.0771	[1] .46
D. Real GNP	.0133	$9,500,000,000

[1] Percent.

Before discussing the results, it may be useful to recall that standard errors reflect the prediction accuracy of each individual equation under the assumption that the values of all the variables and coefficients on the right-hand side of that equation are known with certainty. For example, in the equation explaining the rate of unemployment, it is assumed that the actual growth rate of real GNP—one of the explanatory variables—is already known in the quarter of forecast.

The size of these standard errors suggests that the LR model leaves something to be desired in terms of predictive accuracy. The standard error of estimate for predictions of the percentage change in nominal GNP one quarter ahead, for example, is .0131. Given the present size of the economy, 1.3 per cent of GNP is about $13 billion. This means that there is a probability of about .67 that actual GNP one quarter in the future will be in the range of plus or minus $13 billion around the point estimate. By standards prevailing among forecasters, errors of this magnitude in predicting current-dollar GNP one quarter ahead would be considered very large.

An additional test of predictive accuracy—and one that is particularly relevant for policy decisions—relates to the performance of the model in predicting over longer periods. Laffer and Ranson examine this aspect of their model by calculating the standard errors for predictions four quarters in advance. These calculations assume that all the right-hand side variables are known, and are therefore meaningless if the equations contain lagged values of the dependent variables in the right hand side as explanatory variables. The values of these dependent variables cannot be known with certainty four quarters ahead. For three of the four equations in the LR model, this problem exists. In the discussion that follows, therefore, attention is given only to the standard errors for nominal GNP, which are free of this particular problem.

The standard error of prediction for the percentage change in nominal GNP four quarters ahead is .0262.[16] In dollar terms, given the present size of the economy, 2.6 per cent of GNP would be approximately $26 billion. This indicates a probability of about .67 that the nominal GNP four quarters hence will fall in a range plus or minus $26 billion from its predicted value. Most forecasters would also regard this magnitude of potential error as unacceptably high. It should be noted, furthermore, that this degree of accuracy could be achieved with the LR model only if *all* parameters are known with certainty and if it were possible to predict with complete accuracy the numbers of manhours lost due to strikes and the level of stock prices three quarters ahead.

Predictions beyond the period of fit

Standard errors of the kind discussed above reflect the predictive characteristics of the model within the period of estimation. A crucial test for a model, as Laffer and Ranson are well aware, lies in its ability to forecast beyond the period of estimation. In this respect, the authors sought to test their model—which was fit to data through 1969—by predicting 1970 and comparing their results with the actual values of the variables.

The nominal GNP equation did well in predicting 1970—with an error of only $2 billion. The quarterly errors were somewhat larger—the root mean square error was $8.5 billion (annual rate)—but the errors tended to be offsetting.

As a means of examining the predictive powers of the model further, the nominal GNP equation was reestimated for the period 1948 through 1966. These results were then used to forecast 1967, 1968 and 1969. The coefficients obtained from the estimation for this shorter period were relatively similar to those for the full period 1948 through 1969.[17]

The results suggest that the LR success in forecasting 1970 GNP was fortuitous.[18] The forecast for 1967 was $15 billion high; for 1968, $6 billion low; and for 1969, $15 billion low. In terms of four quarter changes, the error made in estimating the seasonally unadjusted change in nominal GNP from the fourth quarter of 1966 to the fourth quarter of 1967 was $44 billion; the error from 1967IV to 1968IV was $22 billion; and from 1968IV to 1969IV, it was $13 billion.

For comparative purposes, the same test was made on the reduced form nominal GNP equation in the St. Louis Federal Reserve Bank Model.[19] That is, the St. Louis equation was also reestimated through 1966 and based on those results, forecasts for 1967, 1968 and 1969 were made.

In order to make the quarterly forecasts of nominal GNP for both models comparable, certain adjustments were necessary. The St. Louis model employs seasonally adjusted data, while the LR model does not. To make the results comparable, the forecasts from the LR model were adjusted by applying the seasonal factors used by OBE in seasonal adjustment for the period.[20]

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[16] The size of this standard error was incorrectly reported by the authors in the version of their paper received at the Board in early February. In the table on p. 32 of that version the second column was obtained by dividing the first column by $\sqrt{4}$ when in fact the correct procedure required multiplication by $\sqrt{4}$. In the mid-March version of the paper, this error was corrected without comment by the authors.

[17] The reestimated equation is:

$$
\begin{aligned}
\Delta LY = {} & \underset{(4.6)}{.0317} - \underset{(11.7)}{.1006}\, D_1 + \underset{(2.3)}{.0254}\, D_2 - \underset{(3.4)}{.0263}\, D_3 \\
& + \underset{(5.4)}{1.235}\, \Delta LM_1 + \underset{(6.2)}{.1216}\, \Delta LG - \underset{(3.3)}{.0669}\, \Delta LG_{-1} \\
& - \underset{(1.3)}{.0272}\, \Delta LG_{-2} \quad \underset{(1.2)}{.0241}\, \Delta LG_{-3} - \underset{(4.1)}{.0484}\, \Delta SH \\
& + \underset{(2.5)}{.0813}\, \Delta LS\&P_{-1}
\end{aligned}
$$

[18] The forecasts reported here were obtained from four quarter simulations beginning with the initial conditions of the fourth quarter of the previous year. The LR model predicts growth rates; to convert to levels, initial values of the levels are needed. Because the forecasting horizon is only one year in these exercises, the initial levels were reestablished each year. Thus the actual level of nominal GNP for 1966 IV was used to project 1967. Similarly, actual levels of nominal GNP for 1967 IV and 1968 IV were used to project levels of GNP in 1968 and 1969, respectively. A similar procedure is used in testing the St. Louis model, discussed below.

[19] The SMP model was not included in this exercise because some of its equations were fit beyond 1967. Its errors over the 1968–1969 period are generally lower than for the other two modesl, but this may simply be the result of using equations fit to data which include 1968 and 1969. Given the size of the model, it would be impractical to reestimate the parameters of the equations for the shorter time period.

[20] The annual forecasts for the LR model shown in the table, however, were derived by adding the four seasonally unadjusted quarterly forecasts.

TABLE V.—NOMINAL GNP, SEASONALLY ADJUSTED

[In billions of dollars—errors shown in parentheses]

	Actual	St. Louis	LR
1967:			
I	774.4	780.1 (5.7)	770.3 (−4.1)
II	784.5	789.1 (4.6)	785.2 (.7)
III	800.9	801.1 (.2)	820.4 (19.5)
IV	815.9	816.0 (.1)	858.8 (42.9)
1968:			
I	834.9	835.0 (.1)	818.3 (−16.6)
II	858.1	858.9 (.8)	829.1 (−29.0)
III	875.8	882.8 (7.0)	875.0 (−.8)
IV	891.4	904.4 (13.0)	912.1 (20.7)
1969:			
I	907.6	909.7 (2.1)	897.9 (−9.7)
II	923.7	926.9 (3.2)	902.8 (−20.9)
III	942.6	943.1 (.5)	925.1 (−17.5)
IV	951.7	958.1 (6.4)	939.1 (−12.6)
Annual totals:			
1967	793.9	796.6 (2.7)	808.9 (15.0)
1968	865.0	870.3 (5.3)	858.8 (−6.2)
1969	931.4	934.5 (3.1)	916.0 (−15.4)

It is apparent from Table V that the errors of the LR model are considerably larger than for the St. Louis model in almost every quarter. Furthermore, the errors in annual forecasts are also much larger. On the basis of this test, it would appear that the performance of the LR model outside the sample period is weak.[21]

Temporal Stability of the Model

As another test of predictive performance, temporal stability of the LR model should be examined. That is, the following question should be asked: if the model were fit to a different time period, would the results be significantly different? Laffer and Ranson contend that their results are not sensitive to the sample period used for estimation. This conclusion was reached by breaking the initial period of estimation into two subperiods of equal length, and testing for structural shifts.

To investigate further the question of temporal stability, the model was reestimated for two other time periods and compared with the original time period used by Laffer and Ranson. In the LR model, the choice of time periods varies according to the equation: for nominal GNP, the period is 1948 through 1969; for prices, 1952 through 1969; for unemployment, mid-1948 through 1969; and for real GNP, the authors selected 1952 through 1969 in the early February version and 1948 through 1969 in the mid-March version. In each of the two reestimations performed for this stability test, the same two periods were used for all equations; 1952 to 1969 and 1955 to 1969. The choice of the 1952–69 period was based on the desire to estimate all of the LR equations over the same time span. The 1955–69 period was chosen to eliminate the possible effects of the Korean war and its aftermath on the relationships among the variables of the model.

The results are particularly interesting for the nominal GNP equation. These are shown in Table VI below. Aside from a seasonal dummy variable, only the coefficient for the growth rate of M_1 is significantly different for the two subperiods than for the total period. The coefficient for the growth in money changes markedly—from 1.1 when the model is estimated over the period used by Laffer and Ranson to .67 when the estimation period begins in 1955. The constant term, which is composed of both seasonal and trend effects, rises as the time interval is shortened. The value of the constant term for the 1955–69 subperiod is significantly higher than the value obtained over the full 1948–69 period. Thus, while the money multiplier falls from 1.1 to .67 the implied growth trend in nominal GNP and velocity rises.

[21] The longer-run dynamic properties of the two models are also quite different. An experiment was conducted in which the two models were again started in 1967, but were allowed to run two years, rather than one, without stopping. In terms of seasonally adjusted data, projected GNP for the fourth quarter of 1968 was $13 billion too high for the St. Louis model and $69 billion too high for the LR model.

TABLE VI.—EQUATION FOR NOMINAL GNP, USING DIFFERENT PERIODS OF FIT

	1948–69		1952–69		1955–69	
	Coefficient	T-statistic	Coefficient	T-statistic	Coefficient	T-statistic
Constant	0.0320	4.9	0.0391	5.1	0.0466	4.9
D1	−.0975	11.9	−.110	10.7	−.114	9.1
D2	.0256	2.6	.0215	2.0	.0125	1.0
D3	−.0294	4.0	−.0379	4.2	−.0470	4.1
ΔLM	1.106	5.4	.808	3.5	.667	2.5
ΔLG^{1}	.136	6.9	.136	3.7	.134	2.7
ΔLG	−.0688	3.3	−.0022	.1	−.034	.7
ΔLG^{-1}	−.0399	1.9	−.0298	.9	−.048	1.0
ΔLG^{-2}	−.0235	1.2	−.0527	1.7	−.042	.9
ΔSH^{-3}	−.0461	3.7	−.0365	2.6	−.021	1.2
$\Delta LS\&P^{-1}$	.0680	2.2	.0628	1.9	.0623	1.7
R^{-2}	.958		.964		.961	
D-W	2.14		2.07		2.09	
SE of E	.013		.012		.013	

The significance of changes of this magnitude in the coefficients for the money variable may perhaps be best appreciated by considering their implications for forecasts of nominal GNP in 1971. In Table VII the coefficients for the money variable for each time interval are shown along with the implied forecasts for nominal GNP in 1971. In all three forecasts it was assumed that during 1971 there would be a 6 percent annual growth rate in the money stock and a 10 percent annual rate of growth in stock prices. (This was one set of assumptions used by Laffer and Ranson to make conditional forecasts for 1971 GNP in the early February version of their paper).

TABLE VII.—NOMINAL GNP, LR MODEL RESULTS, CHANGING PERIOD OF FIT

	Original Laffer/ Ranson	1952-69	1955-69
Coefficient of the money supply	1.1	.81	.67
GNP forecast for 1971 (billions)	$1,065.2	$1,048.8	$1,046.4

These results indicate that the relationship between changes in the growth of money and changes in the rate of growth of GNP, at least in the simple form in which these variables are related in the LR model, has been highly unstable.[22]

V. IMPLICATIONS OF THE LR MODEL FOR ECONOMIC POLICY

The analysis thus far raises disturbing questions about the analytical characteristics of the LR model, its statistical properties, and its predictive performance. These deficiencies impose serious limits on the use of the LR model for economic policy making.

The usefulness of any econometric model for predicting the impact of change in economic policy variables hinges crucially on the degree to which care has been taken to avoid the problems of statistical bias discussed at length in a previous section. Laffer and Ranson are apparently aware that this problem exists. They note at one point that their results ". . . can only show statistical correlations and do not purport to show cause and effect." [23] Also, they state that ". . . policy use of the statistical relationships must also assume that the relationships among the variables are basically the same now as in the past." [24]

This is the crux of the issue, and it is particularly pertinent to an evaluation of the use of the LR model for predicting the effects of monetary changes. It was argued above that the statistical correlations of quarterly changes of nominal GNP and the money stock found in the LR model reflect a line of causation running from GNP to money as well as the reverse. If that is true, then a policy

[22] Even though there is a dramatic change in the values of the money coefficients, the change in the GNP forecasts for the two subperiods is quite small. This is because the decline in the money coefficient is offset by the rise in the trend term.

[23] p. 31, mid-March version of the Laffer-Ranson paper.

[24] p. 21, mid-March version of the Laffer-Ranson paper.

strategy that entails setting the growth rate of the money stock at a predetermined level—in the expectation of achieving a desired growth path of nominal GNP—could not be expected to yield the outcome predicted by the LR model. Because such a strategy prevents money from responding to GNP, it would violate the precept that ". . . the relationships among the variables are basically the same now as in the past."

Another serious limitation of the LR model for economic policy is the sparse amount of information it conveys about the effects of economic stabilization policies on prices. The price equation in the LR model relates current changes in the GNP deflator to past changes in the deflator, to the level of the Treasury bill rate, and to changes in the money stock. The effect of changes in the money stock on the deflator, however, is not statistically significant. Changes in the Treasury bill rate do exert a statistically significant effect on prices, but the bill rate is taken as an exogenous variable in the model. How the instruments of economic stabilization policy affect the bill rate is not specified by Laffer and Ranson.

The LR model thus provides little information on how aggregate demand policies might be employed to influence the rate of inflation. Such a deficiency might be considered unimportant if the economy were operating far below its full employment potential, and if prices, on average, were showing little tendency to change. But it is a serious shortcoming in a model designed to assist policy makers through a period in which inflation is a major national economic problem.

Like other monetarist models, the LR model gives much greater weight to the role of monetary policy—and much less weight to fiscal policy—than many economists would consider appropriate. Unlike other monetarist models, however, the LR model implies that the full effect of monetary policy is immediate. Thus, in the LR model, fine tuning of the economy is not only quite possible, but highly desirable as well. If nominal GNP growth differs from its desired value, it can be corrected within a quarter. If the money stock grows insufficiently in any one quarter, the effects of the shortfall can be completely offset in the next quarter. Since there are no lags in monetary processes, there is no need for concern that policy actions today may have undesirable effects 6 months or more later.

If, however, the LR model is incorrect, and there are substantial lags between a change in money and its ultimate impact on the economy, pursuit of the fine tuning policy strategy could be seriously destabilizing. Thus, if the value of nominal GNP is below its desired level the LR model suggests that it is possible to make up the deficiency completely by increasing M_1 by the amount the model indicates. Since the model does not recognize lagged effects of changes in money, policy makers would be encouraged to increase the growth rate of the money stock still more—if, in subsequent quarters, the growth of nominal GNP was still below the desired rate. But if monetary processes work with a considerable lag, the ultimate effect of the monetary expansion on GNP, once realized, would turn out to be much larger than expected, and might occur at a time when economic stimulation was no longer desirable. Reliance on a model that offers false hope for easy correction of past mistakes could lead to economic disaster.

EXECUTIVE OFFICE OF THE PRESIDENT,
OFFICE OF MANAGEMENT AND BUDGET,
Washington, D.C., April 26, 1971.

Hon. WILLIAM PROXMIRE,
Chairman, Joint Economic Committee,
U.S. Senate,
Washington, D.C.

DEAR SENATOR PROXMIRE: Enclosed is a copy of the rejoinder to the James Pierce paper prepared by Geza Feketekuty and David Ranson of the Office of Management and Budget staff. This rejoinder addresses itself to the specific issues raised by Mr. Pierce's critique of the Laffer-Ranson paper. It is submitted for inclusion in the record of the hearing.

Sincerely yours,

GEORGE P. SHULTZ, *Director.*

A Rejoinder to the Pierce Critique by G. Feketekuty and R. D. Ranson

SUMMARY

This rejoinder consists of an opening summary and three detailed sections. The first section discusses the five major issues raised by the Critique of the Laffer-Ranson (LR) paper prepared by James Pierce, as follows:

A. Interpretation of evidence on the monetary lag;
B. Methodology of seasonal adjustment;
C. Accuracy of conditional forecasts;
D. Statistical biases in the equations; and
E. Temporal stability.

The second section deals with specific points of fact and interpretation found in the Critique. The issues raised in this section although individually not very important, when taken together are quite important.

The final section of this rejoinder discusses the nature and purposes of empirical models with specific reference to the discussion in the Critique.

Overall, we find the Critique subject to many factual errors, errors of interpretation, and errors of omission. In each of the five major issues in the first section of this rejoinder, the arguments advanced by the Critique are undermined by critical factual and methodological mistakes. We, on average, do not feel that the Critique by Pierce gives either a fair or a balanced picture of the LR model.

In a more specific vein, there are a number of important shortcomings which pervade the Critique's discussion of the LR paper.

OVERSTATEMENT AND IMPRECISION

We find overstatement both in interpretation of the LR paper and in presentation of criticisms. In the use of words, the marhsaling of data, and in making technical distinctions, the Critique fails to be precise.

INCONSISTENCY

Criticisms are raised at different points throughout the Critique which are sometimes inconsistent with each other. For example, arguments which in some places are criticized along with the LR paper are in other places cited as evidence against it.

Confusion of theory with empirical investigation. The Critique generally fails to distinguish between theoretical suppositions and empirical results, as well as the proper functions of each.

We are, however, happy to note that Mr. Pierce has not drawn attention to any errors in the empirical results reported by Laffer and Ranson.

I. MAJOR ISSUES

A. Interpretation of evidence on the monetary "lag"

One aspect of the LR model to which the Critique devotes itself at great length is the relationship between the rate of monetary growth and the rate of change of GNP. First, the Critique attributes to the LR paper the statement that *"there is no lag,"* when in fact the LR paper finds *"no evidence of lags."* As we see it, there is a difference between a universal statement and an empirical observation on a specific set of data.

Second, the Critique asserts that "the Laffer-Ranson results thus differ sharply from the theoretical and empirical conclusions reached by most economists." Three studies are cited as providing evidence for lags ranging "from several calendar quarters to several years." They are Friedman (1961), the St. Louis Model, and the SMP Model. A closer examination will reveal that the evidence provided does not in fact support the Critique's conclusion of a sharp difference. Moreover, the Critique does not mention a number of studies which, like the LR paper, find lags of less than one quarter in average length. The studies cited by the Critique are discussed below.

Friedman (1961)—As the Critique points out, Friedman found that the "lags between a change in money and the complete impact on nominal income are not only long, but variable as well." However, this is not the correlation tested by LR.

For the relationship discussed in the LR paper (that between changes in money and *changes* in income), Friedman found "a lead for money of three to six months," on the basis of "not very satisfactory correlations." [See Friedman: "The Lag in Effect of Monetary Policy," *The Optimum Quantity of Money and Other Essays*, page 253.]

St. Louis—By the criterion suggested by the Critique (the length of time necessary for 50 percent of the impact to be felt), the St. Louis model shows an average lag of *less than one* calendar quarter. According to the St. Louis results, almost 90 percent of the effects are felt by the time two quarters have elapsed.

The Critique fails to mention a number of other studies on the same topic. For example:

Tanner—[*AER* 12/69] finds that "the implied lag in monetary policy is extremely short. In fact, the impact effect of a change in the money supply is about equal to the long-run effect. The initial change in the money supply is over 95 percent of the required long-run equilibrium change."

Bonomo and Schotta [*Proc. A.S.A.*, 1968] using spectral analysis techniques, stated their conclusions as follows:

"The Tau statistics for the long-run cycle frequencies indicate that changes in IP [industrial production] tend to lag changes in M1 or M2 by two months (2.38 and 1.74 months, respectively). The Tau statistics for the other two widebands indicate very short lags—only nine days or less. Given the digital interval of our data, one month, we are inclined to view these very short lag estimates (for the medium and short-run frequencies) with some suspicion, in spite of the fact that the hypothesis that the true Tau lies in a confidence interval containing zero can be rejected at the .95 probability level."

Shiskin and *Moore*—The LR paper also made reference to empirical findings reported by Julius Shiskin and others by Geoffrey Moore, neither of whom uncovered a significant lag relationship between the rate of change of money (M1) and the rate of change of GNP.

On the basis of this evidence, we cannot agree with the Critique that the LR results "differ sharply" from the conclusions reached by most economists. Moreover, as with all empirical studies, the findings relate to the time period used for estimation, the other variables included, the functional form selected, etc.

In addition to its examination of the empirical evidence, the Critique pursues at great length a number of plausible theoretical arguments for a lag. However, none of the casual theorizing outlined in the Critique makes an exclusive *a priori* case for a lag of any specified duration. The existence of a long causal chain, for instance, does not necessarily imply that considerable time must elapse between the initial cause and the final effect in the chain.

B. Methodology of seasonal adjustment

The author of the Critique criticizes the LR paper for using seasonally unadjusted data. His arguments are not supported by the literature. We also find a number of technical and methodological mistakes in his discussion of the seasonal adjustment problem.

The Critique argues "that the use of seasonally unadjusted data in the LR model introduces additional elements of *bias* that would not have been present with seasonally adjusted data." (Our italics) This allegation is contradicted by a body of literature some of which was cited in the LR paper. Quotations from a few of these references include the following:

> *Lovell, J.A.S.A.* 12/63, p. 1005
>
> In conclusion, it must be conceded that nothing in this paper has ruled out the possibility that there exists some alternative class of stochastic model for which the ratio to moving average procedure is preferable; but surely it behooves any econometrician who would use data adjusted by this more popular technique to demonstrate that this is indeed an appropriate approach to the problem of estimating the parameters of his model."
>
> *Lovell, J.A.S.A.* 12/66, p. 800
>
> It is argued that dummy variables rather than data subject to prior seasonal adjustment should be employed when time series are utilized in estimatthe parameters of a linear economic model.
>
> *Godfrey and Karreman*, "A Spectrum Analysis of Seasonal Adjustment," Chap. 24 in (Martin Shubik, ec.): *Essays in Mathematical Economics in Honor of Oskar Morgenstern*, p. 368.
>
> If the data are to be used for the estimation of econometric models, it is normally assumed that the seasonal variation is of interest and its contribu-

tion to the explanation of the variation of the dependent variables is provided for through the use of seasonal variables and the application of the model to unadjusted data.

Klein, An Econometric Model of the United Kingdom, Klein, Ball, Hazlewood, and Vandorne, Chapter III, p. 40.

There is, however, always a doubt in the statistician's mind after he has corrected or adjusted a series for seasonal variation whether he has, in a quantitative sense, taken too much or too little on this account. Moreover, the problem of seasonal adjustment is an estimation problem, and most of the adjustment techniques, being non-parametric in character, it is doubtful how many degrees of freedom have been used up in the process. . . . An advantage of [the use of explicit seasonal variables] is that we can see clearly how many degrees of freedom are used up in taking account of seasonal influences.

Malinvaud's econometrics textbook makes a similar statement on the degrees-of-freedom problem.

In fact, we have been unable to find a single econometrics textbook that states a preference for seasonally adjusted over unadjusted data.

In support of the allegation that bias is "caused" by the use of seasonally unadjusted data, the Critique makes the following *a priori* argument: "Because of the evolving seasonal payment patterns in the economy, it is unlikely that a single set of additive dummy variables captures all the co-seasonality of money and GNP."

How this relates to the question of bias is explained on page 23: "The source of the bias is not co-seasonality *per se* but rather changing co-seasonality." One might think that the existence of significantly changing seasonality would be a testable hypothesis rather than a logically deducible fact, but the Critique provides no empirical evidence in support of its speculations.

The author goes on to assert that "if seasonal patterns in money and nominal GNP change over time, the use of seasonal dummies inadequately deals with co-seasonality."

This argument is misleading. More flexible dummy variable specifications can be developed to take account of moving seasonality, and statistical tests for temporal change in the net seasonality can be made. Such a test was reported in the LR paper, and the differences were judged too small to justify a change in specification. To carry the point even further, the GNP equation was rerun with a flexible set of dummy variables. The results showed that there is no perceptible change in the concurrent money coefficient, and the evidence for significant lagged terms, if anything, becomes even weaker.

Finally, the Critique does not dicuss LR's reference to a paper written by Rosanne Cole. To illustrate her point, we place side by side two series of quarterly changes in seasonally adjusted GNP, one calculated by OBE (official) and the other by the X-11 method (used for seasonally adjusting the money series). These are sharp and serious discrepancies.

QUARTERLY CHANGES IN GROSS NATIONAL PRODUCT, 1948-69

	I		II		III		IV	
	OBE	X-11	OBE	X-11	OBE	X-11	OBE	X-11
1948	5.9	8.4	7.6	7.6	6.9	4.8	1.4	4.0
1949	−5.4	−6.8	−3.3	−1.2	1.9	1.2	−2.1	−4.0
1950	11.0	12.8	9.4	7.6	17.7	19.6	11.4	9.6
1951	13.5	14.0	7.8	8.8	7.0	7.2	4.1	2.0
1952	2.6	4.0	−0.4	−0.4	6.5	5.6	12.1	12.8
1953	6.5	4.4	3.3	8.4	−1.7	−6.0	−5.0	−3.2
1954	−0.1	−1.6	−0.3	3.6	4.3	0	8.7	8.4
1955	12.8	13.6	8.2	8.4	8.1	11.2	6.3	1.2
1956	1.8	4.4	5.6	4.8	4.4	4.0	8.9	9.6
1957	7.4	6.0	3.0	5.2	6.4	5.6	−4.8	−5.2
1958	−6.8	−6.8	3.6	4.4	13.1	12.4	13.0	12.8
1959	9.6	8.4	12.9	16.0	−2.9	−5.6	6.5	7.6
1960	12.5	12.8	1.7	0.8	−0.5	0.8	−0.9	−2.8
1961	0.3	2.4	11.3	9.2	9.3	10.4	13.5	13.2
1962	10.1	11.2	9.4	10.0	7.2	2.4	7.6	12.0
1963	5.4	12.8	6.8	8.0	10.5	11.2	11.1	11.6
1964	11.9	13.2	10.3	7.6	10.9	7.2	6.2	13.2
1965	17.7	12.4	12.9	14.8	15.4	9.6	18.9	34.8
1966	19.5	14.4	13.8	13.6	12.6	5.6	41.8	10.4
1967	3.7	13.2	10.1	9.2	16.4	14.8	15.0	10.4
1968	19.0	20.8	23.2	24.0	17.7	3.2	15.6	23.2
1969	16.2	10.4	16.1	23.2	18.9	18.8	9.1	6.0

C. The accuracy of conditional forecasts

In evaluating the accuracy of the LR model, the Critique disregards evidence presented in the LR paper. Moreover, the comparisons made are inadequate and present a misleading picture.

Three important tests on the accuracy of the model all showed encouraging results.

Conditional forecasts of annual growth rates over past data.

The year 1970 (described as "fortuitous" by the Critique).

Absence of underestimation bias. It is well-known that a large number of forecasting models tend to underpredict large changes.

The comparisons of quarterly GNP predictions made in the Critique are inappropriate. The Critique compares quarterly predictions generated by the LR and St. Louis models. The two models work with different dependent variables. Since the LR model is designed to predict seasonally unadjusted GNP growth rates, while the St. Louis model is designed to predict seasonally adjusted changes in GNP, a comparison of GNP predictions on a quarterly basis is entirely meaningless.

The imposition of *ex post* seasonal adjustment factors to the unadjusted GNP predictions of the LR model does not make them comparable with the St. Louis predictions. The problem of seasonality in quarterly data is best avioded by comparing annual predictions, as was done in the LR paper.

For annual comparisons, the LR model is more accurate than the St. Louis model on growth rates. However, it is true that over the 1953–1969 period the St. Louis model is somewhat more accurate on the level of GNP. It is nonetheless strange that a model which in most respects is very similar to the LR model is itself used as the standard of comparison. This is particularly interesting sinec the St. Louis model is criticized heavily throughout the rest of Piece's Critique.

The same non-comparability also arises in a comparison of the respective standard of errors of estimate for quarterly GNP. This is why the LR paper made compairons between annual standard errors of estimate. If a quarterly comparison must be made, a more reasonable comparison would be to standardize for the standard deviation of the dependent variable. Based on the measures of accuracy descirbed in the LR paper this means an equivalent error of $2.8 billion as opposed to the $13 billion claimed by Pierce.

We see no basis for the statement in the Critique that "by standards prevailing among forecasters, errors of this magnitude in predicting current dollar GNP one quarter ahead would be considered very large."

D. Statistical biases in the equations

On page 16 of the Critique and elsewhere, the statement is made that estimates of the correlation between the GNP and money variables may include "cause and effect" relationships in both directions. This statement is correct and was explicitly mentioned by LR many times.

All in all, there is no wholly satisfactory method of eliminating the problem raised by the simultaneity issue. In order to solve the problem, complete *a priori* knowledge of the true structure of the world would be necessary. No such claim was made in the LR paper. The LR paper did attempt to discuss several of the more plausible routes of endogeneity without finding important endogenous elements.

In referring to purely empirical relationships, statements such as "the positive response of money to GNP is a source of an upward bias in the coefficient of the money stock variable," and "the bias overstates the role of the money stock in the current quarter and thus understates the impact of lagged money variables," are incorrect. The question of simultaneity bias arises only when the equations are interpreted as estimating the parameters of a structural model. The LR paper emphasized on many occasions that this is not its purpose. However, even if the relationship were interpreted as estimates of a structural model, the above statements made in the Critique are unproven, and, we believe, as general propositions unprovable.

A somewhat different issue is raised on page 14 of the Critique where Pierce states "authoregressions are often useful forecasting devices, but it is well-known that they are a highly unsatisfactory means for determining the role other variables may play." In substantiation of this point, it behooves the Critique to present additional tests, together with citations to the literature. In Johnston's *Econometric Methods* (p. 212) in referring to equations with lagged dependent variables, we found the following statement: "The answer is that the least-squares estimates will be biased, though if the disturbance term follows a normal distribution, they will tend to have the desirable 'asymptotic' properties of consistency and efficiency."

Another allegation of bias, perhaps "the inclusion of the Treasury bill rate in the estimating equation further obscures the relation between prices and unemployment," does not seem to be borne out by the data. Omission of the bill rate still leaves the unemployment rate with a statistically insignificant coefficient.

E. Temporal Stability

A fifth major issue raised by the Critique concerns the question of temporal stability of the coefficient estimates. The author selects two shorter time intervals over which to reestimate the GNP equation, and draws attention to what he asserts to be "the significance of changes . . . in the coefficients for the money variable."

Unfortunately, he fails to make the appropriate significance test for a shift in the money coefficient. When the correct test is carried out, the difference in the estimates is *not significant*, given the standard error.

At a later point referring to the same shift, the Critique admits that "even though there is a dramatic change in the values of the money coefficients, the change in the GNP forecasts for the two subperiods is quite small." Thus on statistical and other grounds it is hard to see why this shift is "significant."

II. SPECIFIC ERRORS OF FACT AND INTERPRETATION

In addition to the major issues raised by the Critique which were described earlier, there are a number of smaller errors and weaknesses. Although the less importance, these errors are important in evaluating the quality of the author's analysis.

1. Perhaps the most blatant misstatement is in footnote 17 on page 26:

"The size of this standard error was incorrectly reported by the authors in the version of their paper received at the Board in early February. In table on p. 32 of that version the second column was obtained by dividing the first column by $\sqrt{4}$ when in fact the correct procedure required multiplication by $\sqrt{4}$. In the mid-March version of the paper, this error was corrected without comment by the authors."

As a matter of fact, the size of the standard error was not incorrectly reported. A careful reading would have shown that the "standard error" in the first draft of the LR paper was the "measured standard deviation of the annual average error, measured at quarterly rates," while in the second draft it was referred to as the "measured standard deviation of the annual average error." The difference is also made clear in the column headings of the two respective tables.

Another factual error is found in the statement on the top of page 27: "The standard error of prediction for the percentage change in nominal GNP four quarters ahead is .0262."

As reported in the LR paper, the standard error of prediction in nominal GNP four quarters ahead is .0219. The difference between this and the .0262 figure was explained in the LR paper.

2. In the first several pages of the Critique, two incorrect statements are made about the nature of the LR model.

First, on page 1 it is referred to as a "reduced form model." A reduced form model is one where the endogenous variables are regressed on the exogenous variables. The LR model is not reduced form model.

On the following page, the statement is made that "the money stock and Government spending are taken as exogenous." At several points in their paper, LR made special note to say that they were unable to determine whether Government spending or the money stock are, in fact, exogenous or endogenous. Section F, "Exogeneity or Endogeneity of Money" (pp. 28–32) of the LR paper discusses this point at length and concludes that "It is again important to note that the results can only show statistical correlations and do not purport to show cause and effect." Obviously the money stock and Government spending are *not* taken to be exogenous in the LR paper.

3. On page 13, the Critique states that "to deny such a proposition [a tradeoff between unemployment and inflation in the short run] would come close to ruling out any possibility of controlling inflationary pressures through aggregate demand management." A finding that the results "do not confirm the existence" of the

tradeoff surely does not permit such far-reaching interpretations. It is an empirical statement. The statement does not rule out the possibility that perhaps inflation responds to factors other than unemployment only.

4. On page 5, the Critique states:

"Laffer-Ranson also find that an increase in the rate of growth of Federal purchases of goods and services has a relatively small, though statistically significant, effect upon the rate of growth of nominal GNP in the same quarter. However, in the three succeeding quarters, the effect is reversed. Over a span as long as one year, a change in fiscal policy (represented by Federal purchases) has no effect upon nominal GNP.

"A conclusion that fiscal policy has no lasting effect on nominal GNP is consistent with an extreme monetarist view that the ratio of nominal GNP to the money stock is largely independent of changes in the level of Federal spending or taxation (and also of changes in private propensities to spend)."

These comments do not accurately reflect the role of the explicit fiscal policy variables in the LR paper. On page 16, LR show that in terms of percentage of explained variance the concurrent fiscal policy variable is more important than the money stock variable. The same statement holds in terms of "t" tests of statistical significance. When all the fiscal variables are grouped together, they explain about twice as much of the variance as does the money variable. In this respect, fiscal policy has had a substantial effect on the velocity of money—as would be expected.

5. On page 4, the Critique incorrectly states as follows: "The authors interpret the efficient-markets hypothesis to mean that market prices accurately reflect future economic events. For example, stock prices are assumed to provide the best (unbiased and minimum variance) forecasts of future real income and interest rates are assumed to offer the best forecast of future rates of inflation."

The LR actual statement was:

"Efficient Markets theory holds that, at any moment in time, all market transaction prices reflect the best currently available information. All extraordinary anticipated profit opportunities are presumed to be bid away by private interests.

"This theory is the very essence of profit maximization. One implication is that the current market value of all equities represents, in part, the present value of unbiased efficient forecasts of future economic returns. Another implication is that interest rates, in part, reflect an unbiased efficient forecast of the future rate of inflation. To the extent that market participants possess information about the future, adherents of the Efficient Markets position hold that the value of this information will already have been incorporated into stock prices and interest rates as well as other prices."

Upon careful reading, the difference between these two statements proves to be quite substantial.

6. On pages 11 and 12, the Critique pursues a fairly lengthy discussion of interest rates, inflation and Government spending. The argumentation doesn't seem to recognize the distinction between real rates of interest and nominal rates of interest. In asserting that "rising interest rates do tend to curb private expenditures," the author should be referring to real rates, but in pointing out that the "Treasury bill rate does appear in the equations for real GNP and the deflator," he should be referring to the inflation premium.

Moreover, it is somewhat contrived to speculate about the role of interest rates and then in two consecutive sentences to say:

"Evidently, changes in interest rates are not the mechanism. Interest rates should not and do not appear in the nominal GNP equation. . . ."

Finally, we must re-emphasize that the LR paper is empirical. Over the period of analysis, the growth rate of nominal GNP and the concurrent rate of change of the GNP deflator are for all practical purposes uncorrelated.

7. The Critique in one section states that "it appears that the use of seasonally unadjusted data in the LR model introduces additional elements of *bias* that would not have been present with seasonally adjusted data." In direct contradiction to this statement found two pages later the Critique states "Further an article by Jorgenson suggests that while parameter estimates obtained using seasonally adjusted data are biased. . . ."

III. THE NATURE AND PURPOSE OF EMPIRICAL MODELS

A major shortcoming of the Critique is the failure to distinguish between empirical and theoretical models and their respective purposes. The LR paper presented an empirical model which provides a means of estimating and testing statistical relationships among key economic variables for the postwar U.S.

economy. By nature, an empirical model should not contain complicated relationships—however, desirable they may be for theoretical completeness—if they cannot be tested with the available data.

In order to provide a broader basis for interpreting the results of an empirical model, elements of correspondence were established with theoretical models. Theoretical models are logical constructs that provide a framework for relating a number of variables to each other.

In order to be judged successful, the elements of an empirical model should meet the prespecified standards for statistical acceptance, and should also be consistent with theoretical models that satisfy basic logical principles. While consistency with other empirical observations and theories would be reassuring, the lack of such consistency does not invalidate the results. Rather, it should provide a basis for investigating the reasons for such differences.

In light of the above, the Critique is off the mark in a number of ways. The LR model was not an attempt to "boil down" the "wealth" of complex theoretical relationships encompassed by the Keynesian, quantity theory, and efficient markets literature into three or four reduced form equations, as the Critique contends. The three bodies of theory provide a broad framework for the construction of empirical hypotheses that are within the reach of statistical testing. These same bodies of theory then provide the logical equipment for interpreting the empirical results obtained. The computations did not constitute tests of the theories themselves. Essentially, the model brought to our attention statistical relationships among economic variables which are considered important by policymakers.

Data limitations provide a powerful argument for simplicity in constructing empirical models. Since the context of the postwar U.S. economy provides less than a hundred quarterly observations on the growth rate of GNP and other variables, an empirical model based on this period has only a limited number of degrees of freedom with which to work. Moreover, the data are subject to measurement error. Within these limitations, it is hard to see how any purely empirical investigation could capture any large or complex set of relationships among these variables.

Empirical models by themselves cannot show causal relationships among the variables, but only statistical correlations. The Critique credits the LR paper with recognizing this qualification which has to be considered when interpreting empirical models such as the LR model. Nonetheless, the discussion of this issue elsewhere in the Critique is carried on as if LR had failed to make this point clear and thus leaves the impression that somehow LR are guilty of making extravagant claims.

The inability to demonstrate causal flows between policy variables and variables that serve as proxies for economic objectives, makes it inappropriate to place sole reliance on any empirical model. However, because sole reliance should not be placed on empirical models does not mean that they are useless to the policymaker.

For the economist and policymaker alike, a model is only one device among many in helping to understand and interpret economic events. A great deal of unquantifiable information should and will naturally be brought to bear in utilizing the statistical results of any empirical model.

In the Critique, mention was made that if the empirical results of the LR model were not to continue and if policy followed the LR implications, then economic "disaster" could result. The reverse is likewise correct. If the LR results are correct and policymakers ignore the implications less than optimum behavior could result.

As the Critique sees the U.S. economy, lags between changes in the money supply and changes in GNP do exist. It also argues that monetary policy has been passively responding to current changes in aggregate demand "over nearly the entire sample period covered by the LR model." If these two statements are true, a rise (or fall) in aggregate demand would lead to an increase (decrease) in the money supply which after a time would elicit a further rise (fall) in aggregate demand and so on. The money supply would, in effect, be chasing GNP, which would run faster because of the chase. This sequence of events presents a picture of imposed economic instability.

If Mr. Pierce's description is correct, his paper stands as a damning criticism of postwar monetary policy.

O