THE 1972 ECONOMIC REPORT OF THE PRESIDENT

541

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

NINETY-SECOND CONGRESS

SECOND SESSION

PART 1

FEBRUARY 7, 8, AND 9, 1972

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

76-150 WASHINGTON : 1972

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price $1.00

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CONTENTS

WITNESSES AND STATEMENTS

MONDAY, FEBRUARY 7, 1972

TUESDAY, FEBRUARY 8, 1972

WEDNESDAY, FEBRUARY 9, 1972

SUBMISSIONS FOR THE RECORD

MONDAY, FEBRUARY 7, 1972

TUESDAY, FEBRUARY 8, 1972

WEDNESDAY, FEBRUARY 9, 1972

THE 1972 ECONOMIC REPORT OF THE PRESIDENT

MONDAY, FEBRUARY 7, 1972

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, Javits, and Percy; and Representatives Patman, Reuss, Griffiths, Moorhead, Conable, and Brown.

Also present: John R. Stark, executive director; 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., and Walter B. Laessig, minority counsels; and Leslie J. Bander, minority economist.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The committee will come to order.

As the Joint Economic Committee begins its first day of our hearings on the President's 1972 Economic Report, I would like to review briefly the legislative history under which this committee operates. The act which establishes both the Council of Economic Advisers and the Joint Economic Committee is the Employment Act of 1946. Earlier versions of this bill were titled "The Full Employment Act." The word "full" was dropped during the process of debate and compromise which preceeded the final enactment of the Employment Act. However, there can be little question that the paramount concern of the Congress in passing this act was with employment. This act represented a conscious commitment to use active government policies to keep employment high and unemployment low.

It is useful to remember that this commitment had not always been present. It is not something that we can take for granted. In 1921, President Harding, addressing the President's Conference on Unemployment, stated:

> There has been vast unemployment before and there will be again. There will be depression and inflation just as surely as the tides ebb and flow. I would have little enthusiasm for any proposed remedy which seeks either palliation or tonic from the Public Treasury.

That was in 1921. In 1931, President Hoover, a humane man and a serious student of the economic thought of his day, raised taxes in the midst of a great depression. This was the era which you, Mr. Stein, in your excellent history of U.S. fiscal policy, have dubbed "prerevolutionary fiscal policy."

The commitment of the Employment Act of 1946 to use Federal policies to foster high employment gave expression not only to a new concern with employment as a national goal but also to a new understanding of the use of Government policy, especially fiscal policy, to attain this goal.

Despite this now almost universally accepted commitment to high employment, we have not done well over the intervening years. In only three of the last 26 years has the unemployment rate averaged within one-half a percentage point of the 3 percent which, in this committee's judgment, represents an acceptable level. In 11 of these 26 years, unemployment has averaged over 5 percent—far too high by anybody's standard.

There is an implication that because we have so often tolerated high unemployment, it should not bother us too much to tolerate it a little longer. There isn't anything we can do about it, so we might as well get used to it. Our economic system is not designed to produce full employment in peacetime—or at least not without creating intolerable inflation.

This line of reasoning must be emphatically rejected. The goal of full employment—and I define this as an unemployment rate close to 3 percent of the labor force—remains a valid goal. Instead of abandoning it we should redouble our efforts to achieve it.

We will discuss many aspects of economic policy during these hearings—inflation, productivity, the balance of payments, priorities in Federal spending, efficiency in resources allocation, and others. All of these are important. But the paramount area of concern is employment. The number one problem in this country today is jobs. We must not be distracted from its solution. Other aspects of economic policy must be discussed in the context of their contribution to achieving and sustaining a full employment economy.

Before you proceed, Mr. Stein, I want to commend you on what I think is a very honest, realistic economic report. I think it is one of the best reports I have seen. As has been remarked in the press and elsewhere, it is an improvement in terms of realism, certainly, from the reports we have had in the recent past. I want to comment that I find, however, this year's Economic Report, not your statement this morning which deals directly with it but this year's Economic Report, surprisingly silent on the question of job creation. I find no major new policies designed to create the jobs we need. I cannot accept your prediction that unemployment will reach the neighborhood of 5 percent by the end of this year as being very likely, not even if your optimistic forecast for output growth is realized. That is, I find the prediction unlikely unless I accept the interpretation that the "neighborhood" surrounding 5 percent is a very large neighborhood—possibly extending up to the present 6 percent rate.

I hope that in your statement this morning you can explain to us the administration program for bringing unemployment down rapidly. If the program is there and I have simply overlooked it, I will take great pleasure in standing corrected.

Mr. Stein and Mr. Solomon, we are very happy to have you here this morning. I am sorry that your new colleague, who is even more beautiful than you gentlemen are, Mrs. Whitman, cannot be here this morning. We look forward to meeting her soon.

I am going to ask the vice chairman of the committee, the man who has been chairman of this committee in the past and will be in the future, Congressman Patman, if he has a statement to offer.

Representative PATMAN. Mr. Chairman, I appreciate your views. I share your views on most of what you have said.

This series of Joint Economic Committee hearings on the President's economic message to Congress and his proposed budget for the coming fiscal year is unprecedented. For the first time in the Nation's history broad controls are being imposed on what is essentially a peacetime economy. The effectiveness of these controls during the months ahead is central to these hearings and the administration's economic and budget projections. How the President exercises the authority granted him under the Economic Stabilization Act, as amended, will largely if not entirely determine the rate and degree by which restoration of the Nation's economy is achieved.

Frankly, I am not optimistic. Everyone connected with the effort to realize stabilization of the economy has repeatedly said that public confidence and support of the program are essential to its success.

If this is true, and I firmly believe that it is, phase II of the President's economic program stands in danger of failing because it is completely out of balance in terms of equality of sacrifice and control. This is an essential requirement of the Economic Stabilization Act and failure to recognize and respond to this provision has moved the program down a needlessly complex and confusing path.

Moreover, the administration, in my judgment, is deliberately refusing to comply with certain essential requirements of the act and this in turn has led to further confusion, lack of confidence and outright public animosity. For example:

The Administration has refused to regulate interest rates and finance charges despite the fact that the cost of money for most of the Nation's borrowers remain at near record levels. Indeed, the administration has said in effect that it is satisfied with the situation so long as new and even higher interest rate levels are not set—and I am not confident that even this would be too disturbing to those running phase II. They have been set too high. We are paying 36 percent, the consumers are, all over America today. For the administration to say that it is satisfied with the present level of interest rates is endorsing 36 percent, which is pretty high.

Notwithstanding the clearly stated intention of Congress to the contrary, the administration has refused to exempt most of the Nation's working poor from phase II control of wages.

As a result, the effort to achieve economic stability is ironically being waged at the expense of people struggling to lift themselves above a near-poverty standard of living.

By the same token, the administration has made a shambles of the possibility that consumer surveillance—which the administration itself has loudly advocated—could be an effective enforcement tool for price regulation compliance on the part of the Nation's largest retail merchants. No practical standard has been provided the public by which to determine whether or not price violations are occurring.

Moreover, 75 percent of the Nation's retail establishments have been freed of price regulation control, as has 40 percent of the Nation's rental housing.

Throughout all of these ill-advised decisions, public hearings which the Economic Stabilization Act requires to be held in such circumstances, have been conspicuous by their absence. As a result, the people of the Nation have been deprived of a forum in which they could make their views known to the officials who are supposed to be representing their interests.

In effect, the administration has all but crossed over the threshold marking the point at which the authority granted by the Economic Stabilization Act is converted from a powerful tool designed to safeguard the economic well-being of the Nation's people into a mechanism which victimizes most of the Nation's population. Common decency and a sense of justice mandates a reversal of this trend.

The effect of this situation can be seen in a recent poll which indicates that more than half the working people in the Nation are dissatisfied with the way wage-price controls are working—or to be more accurate—the way wage-price controls are not working.

Surprisingly, most of the people who were queried said they were not in favor of loosening or eliminating controls. They said they wanted more stringent controls. The basic reason for this position was the widespread opinion that wage-price regulations were not in themselves bad, but that the system as it is now being administered works against the little man and in favor of the rich. It takes no gift of prophecy to see that Phase II cannot long endure under rapidly diminishing public confidence.

There is also another element which is central to these hearings and places them in a unique category. The administration has projected deficits totaling $65 billion for this fiscal year and the next. Of this total, more than $38 billion applies to the current fiscal year, the highest annual deficit in history. And we may well find the deficits for the life of the Nixon administration total something close to $100 billion.

In any event, Treasury borrowing during the months ahead is going to have enormously unfavorable impact on the market if it is not handled in the right way. Unless the proper measures are taken, a series of interest rate increases are in all likelihood going to be triggered by unprecedented Federal borrowing and this, in turn, will tend to defeat all the effort that has so far been made to achieve economic stability. A return to the record high interest rates of 1969 and 1970—and we haven't got far to go to return to some of them—would make Phase II nothing more than a disasterous charade.

The only way to avoid this situation is to require the Federal Reserve Open Market Committee to support the Government bond market. In essence, the Federal Reserve and the Treasury must coordinate their market sales and purchases in order to establish reasonable interest rate levels for Federal securities and maintain these levels.

This must be done for the sake of the Nation's taxpayers, who not only face the prospect of paying unnecessarily high interest rates for Federal borrowing, but in addition, will be confronted with the prospect of being priced out of the market for mortgage loans and loans for business and industrial purposes. The State and municipal bond market would also evaporate. All of this adds up to an even higher rate of unemployment.

By the same token, coordination between the Federal Reserve and the Treasury resulting in the maintenance of reasonable rates of interest for Federal securities will assure that other equally vital forms of borrowing will be done at reasonable rates and this in turn will allow economic recovery to move forward.

There is nothing new in a coordinated Federal Reserve-Treasury approach to the money market. Historically, this is the way Federal securities were marketed throughout the 1930's and 1940's when the interest rate on long-term Federal bonds did not exceed 2.5 percent.

Abandonment of this approach in the early 1950's has resulted in the payment of $497.2 billion in excess interest on the public and private debt by Americans since that time. This is to say that if the Federal Reserve-Treasury partnership which maintained reasonable interest rates throughout the money markets had continued to date, Americans would have paid nearly $500 billion less on public and private borrowing.

During House Banking and Currency Committee hearings on Federal Reserve System practices and policies in 1964, I predicted the public debt would double and go from $300 billion to $600 billion in 16 years unless the Federal Reserve and the Treasury returned to their market policy of the 1930's and 1940's. Well, 8 years have passed and the public debt has increased more than 41 percent. As of last December it totaled $424 billion. Unfortunately, I was not wide of the mark.

Only the large commercial banks and wealthy investors would be harmed by a return to such an approach. The people and the Nation as a whole would have much to gain.

In welcoming Mr. Stein and Mr. Solomon to our hearing, I wish to express the hope that they will address themselves to the issues I have described, especially since Mr. Stein these days is generally identified as the architect of the President's economic stabilization program.

Thank you very much, Mr. Chairman.

Chairman PROXMIRE. Thank you, Mr. Patman.

Senator Percy.

Senator PERCY. Mr. Chairman, I will summarize my statement because we are anxious to hear our witnesses.

I would like to very much welcome Mr. Stein in his new role as chairman, and also Mr. Solomon, and to indicate that we look forward to working with Mrs. Whitman. I think it is quite appropriate that we recognize the contributions of women economists on our own committee staff. Inasmuch as women are supposed to control and spend most of the wealth in this country, and are therefore more sensitive to price increases, Mrs. Whitman will be a most welcome member of the Council.

Chairman PROXMIRE. And they also cast most of the votes.

Senator PERCY. Fifty-two percent, to be exact.

We look forward very much to these annual hearings because they are the best opportunity for the Congress and the country to review the economic events of the year. They give us the opportunity to take stock and form judgments and give advice on economic policy needs for the coming year.

This year I think the hearings are particularly significant because throughout the country economic issues are now rated as foremost in the minds on our citizens. I have found this to be true in my own State.

For that reason, the hearings this year are crucially important. The economic measures that have been initiated in the past 6 months by the administration have been historic and momentous. I commend the administration for the creativity and boldness of those initiatives.

The President has taken unprecedented actions affecting the domestic and international economy. Congress has passed both the new tax law and new wage-price control legislation. It is now vitually important to evaluate our current situation and to look again at the fundamental forces at work in our economy.

Mr. Stein, you have addressed yourself in the last topic in your statement to the problem of productivity. I think this is an extremely important element, and I hope all of our witnesses in these three days of hearings will address themselves to this problem which is fundamental to our economic health and well-being in this country.

Stagnating U.S. productivity was one of the most important elements responsible for the new economic policy announced by the President on August 15. U.S. productivity growth rates during the past several years have been lower than those of any of our major world competitors.

In 1971, the United States fell to fourth place behind the Soviet Union, Germany, and Japan in the installation of new machine tools, an event I thought would never occur in the economic history of the United States.

We need to create plant-wide productivity councils, I believe, to eliminate obstacles to increased output.

Senator Javits sponsored an amendment, and I was a cosponsor along with our Chairman, to create productivity councils. I think we can learn a great deal from our Japanese competitors who base their phenomenal productivity record on close cooperation between management and labor.

At the same time we must find more imaginative ways to create productivity growth and to give workers a meaningful stake in their success. This approach is being tried by the steel industry. Both management and labor, I believe, deserve encouragement and wide attention.

We should also note that today under existing law, as amended per my proposal of December 1971, there is absolutely no ceiling or control on wage increases directly resulting from productivity increases.

The amendment removed from the Wage Board jurisdiction any wage increases that are related to productivity increases. No one, including this Government, is trying to hold down wages. What we are trying to do is to hold down prices. If wages go sky-high, it doesn't matter so long as prices don't have to follow with them. I think more attention is being given by labor and management to that particular provision of the law law today, which the President signed into law on December 22, 1971.

Last fall I indicated on the Senate Floor that our wage and price controls would be for naught unless we were able to solve our basic problem and raise productivity levels.

Recently, C. Jackson Grayson, Chairman of the Price Commission, saw it similarly. He said renewing, revitalizing, re-establishing our productivity growth is perhaps the only real lasting alternative to controls as a weapon against inflation.

For these reasons, I want to express my deep appreciation to our Chairman, Senator Proxmire, for his concurrence that hearings on productivity should be held by our Subcommittee on Priorities and Economy in Government. These hearings are planned for April 17, 18, and 19. Witnesses will be invited to discuss the revolutionary change in attitude towards traditional industrial jobs and the serious problems of increasing productivity in the growing service sector, including Government.

I discussed these hearings yesterday with the new designee for Secretary of Commerce, Peter G. Peterson. He concurs that this is a vital matter and will be of deep concern to him in his new position.

I look forward to these hearings because I think they can form the basis for increasing productivity. I trust that our witnesses in the next few days can help us shed light on this most perplexing problem in American industry.

The whole economy of this country—our reserve position and our currency position abroad—depends on our ability to maintain our traditional exports which is the only real way to stem the heavy flow of imports into this country. We can't do it by restrictive barriers without disrupting our trade channels. We have to do it through increased competitiveness and productivity of American labor and management.

I believe, Mr. Stein, you and Mr. Solomon can shed new insight into this problem for us today.

Thank you.

Chairman PROXMIRE. I think the only other Member who has a brief comment, I believe, is Congressman Moorhead.

Representative MOORHEAD. Thank you. While I welcome Mr. Stein and and his colleague, I would also like to welcome Mrs. Whitman, from the University of Pittsburgh in my District. Please give her my best regards.

Chairman PROXMIRE. Our apologies for detaining you so long. Please go right ahead.

STATEMENT OF HON. HERBERT STEIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, ACCOMPANIED BY EZRA SOLOMON, MEMBER

Mr. STEIN. Thank you, Mr. Chairman.

I want to thank you, Mr. Chairman, for your kind remarks about our Economic Report, and I will overlook your sexist reference to our new member.

I certainly agree with you that the key issue today is the unemployment and employment issue, certainly it is the key issue before this committee. I must say, however, that I am staggered at your suggestion that the Administration has no program to deal with this problem. In fact, it has been my view that we have an exceedingly strong program. I will say it is the strongest program that any administration has ever put forward to deal with the problem of unemployment in this country.

Speaking of the economy in 1972, the President said: "The great problem is to get the unemployment rate down from the 6 percent level where it was in 1971."

I shall talk about the program that has been presented for dealing with this problem. This program and other forces at work in the economy will significantly reduce unemployment this year.

We shall devote most of this statement to the unemployment problem. However, it is obvious that the reduction of unemployment is one of several related objectives, and that the choice of means to reduce unemployment must be influenced by the existence of these other objectives. This does not conflict with any recognition that unemployment is our number one problem.

These other objectives include reasonable price stability, a balance in our international economic position, and an increase of productivity, which is the only durable source of an increase in the real incomes of workers. Senator Percy has referred to the increase in productivity.

In recognition that there are several objectives, the administration's policy consists of a package of measures intended to complement each other.

The main items are as follows:

1. An expansive budget and monetary policy, to speed up the growth of total demand for goods and services.

2. A temporary price and wage control system to restrain inflation and assure that the growth of demand increases real production and jobs rather than prices only.

3. A major realignment of exchange rates to improve the U.S. balance of payment positions and, as a by-product, to increase employment in the United States by raising our exports relative to our imports.

4. Expanded manpower and unemployment insurance programs to help reduce structural unemployment and cushion the burden of unemployment for those who suffer it.

5. Steps to contribute to rising productivity, notably by encouraging business investment and research and development.

This combination of policies is unprecedented in scale, scope and cohesiveness.

I would like to emphasize this because I think there is not general recognition in the country, of the magnitude of what has now been undertaken. But if one looks back in history to find a time when anything of this scale and scope was done before, one might think a possible parallel was in the action taken by Franklin Roosevelt in 1933. His program, which was addressed to unemployment, did contain some elements of what we have done. So I think one can be quite serious in saying that these policies that we now have are unprecedented in scale and cohesiveness.

THE COMPOSITION OF UNEMPLOYMENT

Before we elaborate on policies for dealing with unemployment let us look briefly at the composition of unemployment in recent months. This is relevant to the choice of appropriate policies for reducing unemployment. The main lesson to be derived from examining the composition of unemployment is that it consists to an unusually large degree of the unemployment of young people and of women.

This has two probable implications. One is that rapid expansion of the demand for labor runs into a greater danger of generating bottlenecks and inflation than if the unemployment were more normally distributed. The other is that there is an unusually great need for special measures to assist inexperienced young workers, or women reentering the labor force, in making job connections. That is, we do not simply have the problem of reexpanding the economy to permit experienced workers to be reemployed in the jobs they had before, although that is part of our problem and a part to which we are very seriously addressing ourselves.

In 1971, 48 percent of all unemployment was the unemployment of people aged 16 to 24, as compared with 35 percent in 1949, when the total unemployment rate was the same as in 1971. Persons 16 to 19 years of age constituted 25 percent of the unemployed in 1971 as against 16 percent in 1949 as shown in table 1.

The rise in the proportion of unemployment accounted for by young people results from both an increase in their unemployment rates relative to the unemployment rates of older people and an increase in the proportion of the labor force that is in the younger ages. The rise in their relative unemployment rates is shown in table 2.

(Tables 1 and 2, referred to above, follow:)

TABLE 1.—COMPOSITION OF UNEMPLOYMENT BY AGE AND SEX, SELECTED YEARS, 1949–71

Age and sex	1949	1954	1963	1971
Unemployment rate, all workers (percent)	5.9	5.5	5.7	5.9
Percent distribution:				
Total	100.0	100.0	100.0	100.0
Males	70.7	66.4	60.7	55.6
25 years of age and over	47.7	48.3	38.7	29.1
20 to 24 years	13.3	9.3	9.7	12.7
16 to 19 years	9.7	8.8	12.3	13.8
Females	29.3	33.6	39.3	44.4
25 years of age and over	17.8	23.2	23.4	23.3
20 to 24 years	5.4	5.0	6.4	9.7
16 to 19 years	6.1	5.4	9.4	11.4

Note: Components may not add to totals due to independent rounding.
Source: Department of Labor.

TABLE 2.—TOTAL UNEMPLOYMENT RATES BY BROAD AGE GROUPS, SELECTED YEARS, 1949–71

[Percent]

Years of—	Total	Both sexes, aged— 25 years and over	Both sexes, aged— 16 to 24 years	Ratio 16 to 24 years/25 years and over
High unemployment rates:				
1949	5.9	4.8	10.8	2.25
1954	5.5	4.7	10.6	2.26
1963	5.7	4.3	12.2	2.84
1971	5.9	4.0	12.7	3.18
Medium unemployment rates:				
1955	4.4	3.6	8.7	2.42
1965	4.5	3.2	10.1	3.16
Low unemployment rates:				
1951	3.3	2.8	5.7	2.04
1969	3.5	2.2	8.4	3.82

Source: Department of Labor.

Mr. STEIN. The rise in the relative unemployment rates of young people may be related to the increase in the share they constitute of the labor force. That is, the proportions in which employers use young and mature workers may not have adopted to their relative numbers, perhaps because of failure of their relative wages to adapt.

Another factor probably involved is an increase in the proportion of young jobseekers who are also in school. Such jobseekers tend to have exceptionally high unemployment rates because the range of jobs they find acceptable is narrow. In 1971, the unemployment rates of 16- to 21-year-olds who were both in school and in the labor force was 19.9 percent, whereas, for those in the labor force but not in school, the rate was 13.6 percent.

The fact that the unemployment rate of young people, say 16 to 21 years of age, is around 15 percent is well known. However, the picture often conjured up by this number is mistaken. In 1971, only a little over half of the 16- to 21-year-old population was in the labor force, and the proportion of the total 16 to 21 population unemployed was less than 8 percent. The proportion of the 16- to 21-year-old population unemployed and not in school was 5.5 percent, and the proportion unemployed, not in school and seeking full-time work was 4.6 percent. (See table 3.)

Table 1 above also shows the rise in the proportion of unemployment accounted for by females and table 4 shows the tendency for their unemployment rates to rise relative to the rate for males.

(Tables 3 and 4, referred to above, follows:)

TABLE 3.—EMPLOYMENT STATUS OF PERSONS 16 TO 21 YEARS OF AGE, 1971

[Number of persons in thousands]

Employment status	Total		
	Both sexes	Male	Female
Total noninstitutional population	22,392	11,296	11,096
Total labor force	12,713	7,363	5,349
Percent of population	56.8	65.2	48.2
Civilian labor force	11,629	6,300	5,330
Employed	9,880	5,341	4,539
Unemployed	1,750	959	791
Percent of population	7.8	8.5	7.1
Percent of labor force	15.0	15.2	14.8
Looking for full-time work	1,120	612	508
Looking for part-time work	629	347	283
Major activity—Going to school:			
Civilian labor force	2,663	1,493	1,169
Employed	2,133	1,185	948
Unemployed	529	308	221
Percent of labor force	19.9	20.7	18.9
Looking for full-time work	80	43	36
Looking for part-time work	450	265	185
Major activity—Other:			
Civilian labor force	8,967	4,806	4,161
Employed	7,746	4,156	3,590
Unemployed	1,221	650	570
Percent of labor force	13.6	13.5	13.7
Looking for full-time work	1,041	569	472
Looking for part-time work	180	82	98

Source: Department of Labor.

TABLE 4.—TOTAL UNEMPLOYMENT RATES BY SEX, SELECTED YEARS, 1949-71

[Percent]

Years of—	Total	Male	Female	Ratio females/males
High unemployment rates:				
1949	5.9	5.9	6.0	1.02
1954	5.5	5.3	6.0	1.13
1963	5.7	5.2	6.5	1.25
1971	5.9	5.3	6.9	1.30
Medium unemployment rates:				
1955	4.4	4.2	4.9	1.17
1965	4.5	4.0	5.5	1.38
Low unemployment rates:				
1951	3.3	2.8	4.4	1.57
1969	3.5	2.8	4.7	1.68

Source: Department of Labor.

Mr. STEIN. Partly reflecting the large proportion of young people and women in the ranks of the unemployed, the proportion of the unemployed who have lost their last job is low. In January, for example, 5.9 percent of the labor force was unemployed. Of that number, 2.5 percent of the labor force had lost their last job, 0.7 percent had left their last job, 1.9 percent had reentered the labor force and 0.9 percent had never worked before.

POLICY TO EXPAND DEMAND

Impressed though we are with the structural aspects of our present unemployment problem, our first line of attack on the problem is through the expansion of demand. It is a truism faintly reminiscent of President Coolidge to say that the way to reduce unemployment is to raise employment.

After I wrote that slightly supercilious remark, I found myself quoted, for the first time I think, in the New Yorker, which usually pays no attention to me, under the heading "Straight Thinking Department." There is a quotation from U.S. News & World Report which says:

> Brighter Future: Looking ahead, Herbert Stein, Chairman-designate of Economic Advisers, noted that the rise in total employment since June has been the largest five-month increase since the boom year of 1955. Mr. Stein's outlook quotes: "There is no doubt that the employment gains, if continued, will reduce unemployment."

The New Yorker evidently thought that was very funny, not having heard, I suppose, of the growth in the labor force, or the fact that unemployment will decline as employment rises only if employment rises faster than the labor force. However, that is not to be expected from our more sophisticated journalists.

Employment has been rising rapidly. From July to January, it increased by 1.3 million (after allowance for a statistical adjustment made in January). This is a rate of increase of employment which substantially exceeds the probable long-run growth of the labor force and will, if continued, significantly reduce unemployment.

The primary objective of policy in 1972 is to continue and even somewhat accelerate the rise of employment. To achieve that we shall need a rapid rate of growth of demand for goods and services. In the fourth quarter of 1971 real demand for output rose at an annual rate of 6 percent. A moderately more rapid rate during 1972—from the beginning to the end of 1972—seems to us feasible, and appropriate for reducing unemployment substantially while not reviving inflation. In fact, we project a rise of real demand and output of 6 percent between calendar 1971 and calendar 1972, which would imply a more rapid rate between the end of 1971 and the end of 1972. This growth of output would, we believe, reduce the unemployment rate by the end of 1972 to the neighborhood of 5 percent.

An increase of real output of 6 percent from year to year would imply an increase of about 9½ percent in the money value of output, because inflation will be continuing, although at a reduced rate. This would be the increase of about $100 billion in the GNP that we and many others foresee.

We will not go into all the ingredients of this projection here. They are explained in our report and we will be glad to answer questions about them. However, we should explain the role of budget policy in this projection, since it has not been entirely understood.

Since we are talking about changes in the economy between calendar years, it is convenient also to look at budget changes between the calendar years. For this purpose, we can look at Federal receipts and expenditures in the national income accounts, a concept well known to this committee. As our report indicates, there will be an increase of $29 billion, or 13 percent, in expenditures between calendar 1971 and calendar 1972. There will also be a net reduction of close to $4 billion in tax receipt due to changes in tax laws and regulations between the 2 years. Thus, in a crude way we can say that there is a fiscal stimulus of about $33 billion, or about one-third of the expected increase in GNP.

Another way of looking at this same phenomenon is through the estimates of the receipts and expenditures that would be realized if the economy were operating at full employment. This relationship has a little different timing in terms of the unified budget. In national income account terms there would be a swing from an excess of receipts of about $5½ billion in calendar 1971 to an excess of expenditures to $6½ billion in calendar 1972. This swing would be a strong stimulus to the economy. All of this swing would occur by mid-1972. Thereafter, the full employment budget in NIA terms would move back onto balance. This return to balance would be economically appropriate as rises of inventory investment, business fixed investment and net exports take over the lead in boosting the economy.

This path for the NIA budget is, we believe, consistent with the strong, steady expansion of the economy that should be our goal in 1972. Achieving this budget pattern will require great effort and skill by the administrative agencies in managing their activities. It will also require cooperation by the Congress. On the one hand, certain legislation will be required to bring about the early expansion of outlays; on the other hand, self-restraint by Congress will be required to keep expansiveness in fiscal 1973 from bursting the bounds consistent with economic stability.

THE PRICE-WAGE CONTROL SYSTEM

The increase of Federal expenditures between 1971 and 1972 will be larger than in any previous year since World War II. That is one of the reasons for calling the present economic program unprecedented. Another, of course, is the comprehensive price-wage control system that has been put in place since August 15, 1971. A primary motive for this is to slow down the rate of inflation. But one of the main results we expect from that is a rise of employment and reduction of unemployment. We wanted to get off the treadmill in which measures to expand demand only raise prices without raising output and employment.

We are not so naive as to think that for the first time in history we have devised a price-wage control system that is perfectly effective, fair, and efficient. But we do think the system that has been set up has accomplished a great deal and will accomplish a great deal more. The fourth quarter of 1971 illustrates the accomplishment of the results we seek. In that quarter GNP rose at an annual rate of 7.7 percent; of that total increase, 6.1 percent was an increase of real output and 1.5 percent was an increase of prices. This was the largest proportion of increase in real output in the total GNP increase since the fourth quarter of 1965.

We don't expect to keep the inflation rate down to 1.5 percent in 1972. As we have explained many times, some bulge of prices was inevitable after the freeze ended on November 14. However, we believe that the price-wage control system, operating in an economy without excess demand, will return the inflation rate to the 2 to 3 percent zone before the end of 1972. In our report we present an analysis of the relation of the standards of the price-wage control system to that goal.

I would like at this point to comment briefly on the remarks made by Congressman Patman about the price and wage control system. He called attention first to the failure of the administration to impose mandatory ceilings on interest rates.

As you know, the extension of the Economic Stabilization Act provided that mandatory interest rate ceilings should not be imposed unless the President made a finding of certain facts. That is, the act gave the President discretion to make a decision about this on the basis of his evaluation of certain facts.

The condition which had to be discovered was whether the interest rates prevailing in the absence of ceilings would be consistent with orderly economic growth. I don't remember the exact words, but it is something like that.

The President did make such a finding with our advice and the advice of others. We called attention to the fact that interest rates are now lower than they were when the freeze first went into effect. They are lower than they were on May 25, 1970, which is generally the lowest limit to which the act permitted prices and wages to be restricted.

Also, the most important part of the argument is that we believe that the present level of interest rates and the prospective course of rates is consistent with the orderly economic growth that we project. Certainly, it has been our expereince in the past that one of the most obvious and direct influences of interest rates on the course of economic growth is through their effect on new housing.

We have been having an all-time record level of new housing starts, reaching enormous numbers in the fourth quarter of 1971, and over 2 million for the year 1971, and we project still higher starts in 1972.

In any case, if interest rate prospects or developments were not consistent with the orderly expansion of the economy, which is very unlikely in my opinion, the most effective solution to that problem would not be to put ceilings on rates. We have found in the past that the existence of ceilings on interest rates for mortgages only had the effect of driving funds out of the mortgage market, and we did not get more houses built.

With respect to the definition of the working poor, the Cost of Living Council, which made the decision, tried very hard to interpret the intent of Congress in that respect. Congress, of course, could have put into the law that no wage rates could be controlled unless they were in excess of $3 or $3.50 or $4, or whatever else it might have thought was appropriate.

However, Congress did not do that. It only left us some rather ambiguous language about the working poor. We did our best to interpret what that could reasonably have been intended to mean. We did not think that it could reasonably have been intended to mean that we would have a wage control system that would exempt from control half of the workers in the United States.

There is no unique way of finding a figure, but we did approach this from a number of directions, and the figure at which we finally arrived at, $1.90, seems consistent with a variety of ways of looking at the problem.

Congressman Patman has indicated that the system of price control we now have does not permit ready surveillance by consumers of the compliance with the ceilings of retail establishments or other sellers. That is quite correct.

But there is no way of making it easy for consumers to discover what is the legitimate ceiling price, item by item and store by store, without an enormous policymaking machinery which would make national decisions about the appropriate ceiling prices for each item. We have an effective price control system which will achieve what its objective is, namely, to hold down the rise in the average price of things bought by consumers without requiring prior determination, item by item, of what the legitimate prices are.

So the fact is that surveillance will have to operate through the administrative machinery, and consumers can only serve the function of calling to the attention of the administrative machinery what looks like possible violations. The determination of whether there have in fact been violations will have to be made by a more precise method.

As the Congressman said, 75 percent of retail establishments have been exempted from control. We did not regard this as a reduction in the effectiveness of the controls. On the contrary, we regarded this as an important step to increase the effectiveness of the control. Seventy-five percent of the retail establishments that were exempted do about 15 percent of the retail sales. They would have accounted for, if kept under control, an enormous drain on the administrative machinery, and they would have put enormous demands on it. These stores that were exempted were stores with $100,000 or less of annual sales. They usually have no employees but are often operated by their owner and his wife.

We were confident that to concentrate the administrative machinery and the Internal Revenue Service agents that we have available on the bigger stores, rather than spreading them thinly over the approximately million and a half small establishments, would make the system more effective rather than less.

This is especially true in view of the fact that these exempted establishments are all in competition with the bigger ones that do 85 percent of the business. We are sure that this will effectively prevent the smaller ones from exploiting the situation.

The Congressman referred to the fact that half the people are dissatisified with the way the price control system is working. I haven't seen that particular poll and I am not able to comment on its accuracy. Nevertheless, the fact is that the exception that most people have to the way it is working cannot be derived from their own experience but must be derived from what they hear responsible public officials say about it.

Having embarked upon what everybody recognizes as a very difficult although very necessary process, it would be helpful if the criticism of it was confined to what could be realistically supported by the evidence.

As for a timetable regarding the retention of controls we can only repeat what was stated in the report: The control system will be retained as long as is necessary to achieve its goal. This is a condition of the economy in which we can have a significantly lower rate of inflation without controls than we were experiencing in the first half of 1971. We do not wish to keep the controls a day longer than is necessary, but having embarked on this course, the administration has no intention of a premature abandoment of controls that would bring on a resumption of inflation or would require the reimposition of controls.

MANPOWER POLICIES AND UNEMPLOYMENT COMPENSATION

The third element in the administration's attack on the unemployment problem—along with actions to boost demand and control inflation—is a package of measures to help workers adapt to the condition of the job markets and to assist those who remain unemployed.

One way to summarize the magnitude of the effort on this front is to note that in fiscal 1972 expenditures in the unified budget for manpower programs and unemployment compensation will be over $10 billion. If unemployment in this fiscal year should be 5 million, this would amount to an expenditure of $2,000 per unemployed person.

These programs, of course, have a long history. However, they have been substantially expanded during this administration. Exclusive of unemployment insurance programs, we expect to spend $5.1 billion on Federal manpower programs in fiscal 1973. That is an increase of about 20 percent from fiscal 1972 and a doubling of outlays since 1970. Working with the Congress we have developed many programs to minimize the dislocations caused by the transition from defense employment and inflation to high peacetime employment without inflation.

For all unemployed and potential employers, we have enlarged and mechanized the placement and information services of the Employment Service.

For the experienced unemployed, we have increased coverage of unemployment insurance programs and provided extended benefits under two new programs, which permit workers in States with particularly acute unemployment to receive benefits for as long as a full year.

For Vietnam veterans, we have launched a comprehensive program of labor market services which appears to have stemmed the rise in their joblessness; also, we have provided greater opportunity for education under a much improved GI bill.

For some 44 communities in 22 States and Puerto Rico with special employment problems arising from defense readjustments, we have or are providing comprehensive aid in the transition back to a civlian-based local economy through a special, highly effective Interagency Committee directed by the Secretary of Defense.

For disadvantaged workers in general and to the benefit of the society as a whole, we will be spending about $2.1 billion on skill training programs to increase the productivity and employability of an anticipated 1.4 million new enrollees in fiscal 1973.

For communities in need of improved services and for workers in need of transitional training on the avenue to careers, we will be spending about $1.85 billion in fiscal 1973 to provide work-support job slots for an estimated 874,000 new enrollees. Many of these are public service jobs.

Although there have been numerous improvements and innovations in recent years, we have still not achieved the full potentialities of the money that is being spent, or might be spent, for manpower programs. The administration recommended over a year ago the consolidation of important parts of the Federal effort into a manpower revenue sharing program which would make the expenditures more productive. The President is sending the Congress a message today repeating that recommendation. We hope this recommendation will receive prompt and favorable consideration.

STRENGTHENING THE UNITED STATES IN THE WORLD ECONOMY

For more than 10 years, the U.S. economy has operated under the shadow of its balance-of-payments deficit. Last summer, when the need to achieve more rapid economic expansion in order to reduce unemployment became clear, it was also clear that decisive action had to be taken to correct the deficit. Confidence in the dollar had sunk too low to allow the deficit to persist without clear indication that correction was on the way.

If a more expansive domestic economic policy, with some danger of more inflation, had been injected into that picture, confidence would have disappeared. Therefore, the policies adopted had to contain steps not only to expand the economy and to check inflation but also to eliminate the balance-of-payments deficit.

The basic method chosen for doing this was a major currency realinement, reducing the price of the U.S. dollar relative to the price of other currencies. This has now been achieved. The results, in terms of correction of the balance of payments, will be some while in coming.

The current volume of exports and imports result from arrangements made before the realinement, and will only change with some lag. Meanwhile, the realinement itself has the effect of raising the dollar prices of some of the things we import. Thus, there may be a period in which the balance of payments, at least on trade account, gets worse before it gets better. However, there can be little doubt that the realinement will profoundly improve our position.

The administration's choice of means for bringing the balance of payments into adjustment is highly significant. It rejected the route of depressing the U.S. economy. It rejected the route of more controls on trade and capital. Instead, it chose the route of exchange rate realinement because that route will increase our exports relative to our imports while leaving Americans maximum freedom to buy what they want where they want to buy it.

This is a classic case of choosing the efficient instrument which will achieve what is desired—an increase in our net exports—without achieving what is undesired—more Government control over trade in particular goods.

RAISING PRODUCTIVITY

Our recent problems have been superimposed on an economy that is very strong. An outstanding characteristic of the economy is the high level of productivity—of output per hour of work—and its vigorous long-term growth. This growth is the source of the long-run improvement of the real income of the average American worker and family. There is no other possible source.

In the long run the rise of workers' real compensation per hour tracks very closely with the rise of real output per hour. In the short run certain regular disparities are evident. When the economy is rising, both output and compensation per hour tend to rise more than the long-run average, and output per hour tends to rise relative to compensation per hour. When the economy is at its ceiling and therefore growing slowly, or when it is declining, both output and compensation per hour tend to rise less than the long-run average and compensation tend to gain on productivity.

These patterns are evident in the record of the past decade. During the long expansion from 1961 to 1968, productivity in the private nonfarm sector rose by 3.2 percent per annum, while real compensation per hour also rose rapidly but not quite that rapidly—2.7 percent per annum.

In 1969 and 1970 the rate of productivity growth fell off—to about three-tenths of 1 percent per annum. The rise of real hourly compensation also slackened, but not so much, to about 1¼ percent per annum. In 1971, both rose again—productivity by 3.4 percent and real hourly compensation by 2.5 percent. For the 3 years 1968–71, the rise of real hourly compensation was about 1.7 percent per annum and the rise of productivity was 1.3 percent per annum.

Short-run variations in productivity growth are important for the inflationary process and in other respects. Here we want to emphasize the significance of the long-run trend rate of productivity growth. It more than anything else determines the improvement of economic well-being from one generation to the next. Differences of a tenth of a percent may seem trivial and get overlooked in the political process, which tends to be myopic, but they add up to a great deal in 20 or 30 years.

It was to highlight the importance of raising productivity, and to enlist support from all quarters in doing so, that the President established the National Commission on Productivity. Director George Shultz of the Office of Management and Budget has been Chairman of the Commission. Since he will be testifying here tomorrow we shall not undertake to describe its work and plans. We only want to emphasize here the need to be careful not to allow preoccuption with short-term problems to distract us from attenion to our long-run needs.

In conclusion, we would return to the point that the administration made a decisive change in economic policy about 6 months ago. This change was not action for action's sake. It was a response to problems which although often exaggerated in the public discussion were nonetheless real. The choice of policies was, we believe, openminded and uninhibited by traditional dogmas. We believe our policies are constructive, coherent and will be effective. The problems to which they are addressed are problems of the Nation, not just of the administration. The solution should come from the Nation, not just from the administration. In that spirit, as partners in a common effort where no one can claim exclusive virtue or wisdom, we welcome your questions and suggestions.

Thank you.

Chairman PROXMIRE. Thank you, Mr. Stein.

Mr. Solomon, have you a separate statement?

Mr. SOLOMON. No, sir.

Chairman PROXMIRE. You concur in the statement which has been delivered?

Mr. SOLOMON. Completely.

Chairman PROXMIRE. Mr. Stein, I want to commend you on hitting what I think is the number one economic problem. We seem to agree, stressing that unemployment is our No. 1 economic problem and hitting it so forthrightly and forcefully.

You say in your statement that the administration has initiated the strongest program to reduce unemployment there has ever been in this country.

I just can't accept that. It seems to me that the new economic program has been designed primarily as an anti-inflation program. It has set up institutions, both the Pay Board and the Price Commission, to cope with inflation. It set a goal on inflation which it did not set on unemployment. It seems to have concentrated a great deal of its stress in the area of inflation.

I don't fault them for that, because inflation is a problem. But there doesn't seem to be any really comparable effort that I can see to cope with unemployment.

You stress as the cornerstone of the effort to promote employment and diminish unemployment, the fiscal stimulus in the revised 1972 budget. The trouble is, Mr. Stein, as you know, that that stimulus will be temporary. It reaches its peak in the first half of calendar year 1972, that is, by July 1, and then it declines.

I certainly question whether the unemployment problem will be brought under control so quickly that we should begin to move toward budget restraint 6 months from now. Budget timing is spelled out in your statement.

One other point before I ask you to respond. The initiatives we have had have come from Congress, not from this administration. The public service employment program was a congressional initiative which the President actually vetoed the first time around.

I am afraid I don't see this initiative acknowledged anywhere in the Economic Report. Can you specify the job-creating expenditures in the budget?

Mr. STEIN. I think all the expenditures are job creating, Mr. Chairman. We have submitted a budget with a $38.8 billion deficit. I don't think you should belittle that.

Chairman PROXMIRE. I am not trying to belittle that.

Mr. STEIN. I think we are entitled to say that we have given the economy a very important fiscal stimulus. In fact, I was looking through the record and probably the last peacetime year in which we had a deficit which was as large a share of the national income was 1936. I took some comfort from the fact that the administration which survived that deficit carried 46 States at a time when there were only 48.

I find it difficult to respond to a statement which says that all you have given us is a fiscal stimulus when we have given you a $38.8-billion deficit.

Chairman PROXMIRE. The point I made was that the fiscal stimulus stops in 6 months and shifts.

Mr. STEIN. This is a classic prescription for getting an economy out of the doldrums, out of a dull spot, and moving along the path toward full employment. We have incorporated a budget which has these characteristics into our projections. We have incorporated into our projections a budget which reaches its maximum stimulus, as measured by the actual deficit or by the full employment deficit, in the second quarter of 1972, and that deficit diminishes thereafter. Of course, in forecasting the economy you have to add up all the pieces, not just the fiscal piece.

As we see it, after we pass the first half of 1972, we will be having an increase in business activity and investment in plant and equipment. We would expect that the rise in the economy in the first half of this year will generate a higher rate of investment expenditures. We expect, and with good reasons, I think, that the steps we have taken on the international front will be giving us a rise in our net export position. So we will have other forces coming into play in the economy which will generate continued expansion of demand.

Moreover, I think it is too one-sided to say that the price-wage control system is only a system for restraining inflation. An important reason for adopting the price-wage control system, as we say many times in the report and in our testimony, was to assure that as we expanded demand we got out of that expansion an increase in output and employment and not just an increase in prices.

Moreover, we think that the price-wage control system by itself contributes to an increase in demand. We were told repeatedly last summer before August 15 that the economy was suffering from great anxiety about inflation and that the reason consumers would not buy and the reason the businessman did not invest was that they felt they had been left alone by the Government. The Government, we were told, was not intervening as forcefully as it should in restraint of inflation.

Well, we have intervened in the most forceful way that the Government has ever done in peacetime in this country. Furthermore, I think we should not leave out of account in this balance sheet the steps that have been taken on the international side, which are really very powerful. It is a combination of these measures, all of which I would describe as pro-employment, anti-unemployment measures, that adds up to this package.

Chairman PROXMIRE. You concede that the fiscal stimulus is confined, at least as far as it being stronger, to the first 6 months of this year and then it diminishes.

You seem to rely on an increase in business investments in plant and equipment at a time when we are operating at 75 percent capacity or less. It is hard for me to place much reliance on that.

Then you rely to some extent on a shift in foreign trade, that we will be exporting more and importing less. That is likely, but it is unlikely, it seems to me, to be very great in view of what seems to be happening on the basis of the reactions to the exchange adjustment. We will get something there.

You rely on the greater confidence on the part of the public because of the anti-inflation program. There may be something to that, but as long as unemployment is 6 percent we have counterveiling and pessimistic effect.

What would you think, Mr. Stein, and give me your reaction, as to the effects of this? Suppose President Nixon should go on television tomorrow night and call on Congress to enact a program which would provide for 100,000 new jobs by the Federal Government, Federal Government funding, per month until unemployment is below 5 percent. Suppose you had that kind of specific, direct method of getting unemployment down? What would be the effect in terms of inflation, in terms of stimulating the economy? Would it be sound or unsound?

Mr. STEIN. Considering the reaction of the Congress to his previous recommendation, for him to go on television and ask Congress to do that would probably have no effect. We have quite a number of recommendations now before the Congress which have not been acted upon.

Chairman PROXMIRE. On something like that, I think I would certainly disagree. I think there would be a tremendous response. We have proposals to provide for a half million public jobs in the Senate and I think in the House, too, supported by many Members of Congress, with no administration support for them, and it is probably less likely that they will be enacted. Let's assume the President could accomplish this. What would be the effect on the economy?

Mr. STEIN. I think the fiscal program we have put before you is more powerful than that. Now you want to add something which I roughly expect would raise the annual rate of Federal outlays by $12 billion. We have just proposed an increase in the annual rate of Federal outlays of $29 billion. We think that will give us an orderly path of expansion. To add another $12 billion would be a little excessive, starting with a deficit of $38.8 billion. I am not one who makes a fetish about deficits, but there is no sense adding $12 billion on top of $38.8 billion.

I don't know that this would go over very well. I had some grilling before the House Appropriations Committee about the deficit we have. Whether the effects of the added spending would be a plus or a minus when you consider the reaction in the economy at large, I don't know.

I think we have a program that is going to reduce the rate of unemployment at a rate that is consistent with the achievement of our other objectives. This will be rated as a substantial achievement when it is done.

It is really a question of arithmetic. At some point more expansion becomes excessive. We have concluded, on the basis of some arithmetic, that a $29 billion increase in expenditures between calendar 1971 and calendar 1972, plus a $4 billion tax reduction, is quite a large, effective, and ample fiscal stimulus. I think another $12 billion would be too much.

Chairman PROXMIRE. You may have to eat those words, but with the President performing the way he has been, he has surprised us before.

We have only one big issue, in my view, or one economic issue, or may have, and that is unemployment. The President can steal it from us any time he does this, and we have nothing left.

Mr. STEIN. We welcome your advice.

Chairman PROXMIRE. You may be coming in saying this is the most inspired, new, vigorous program for unemployment the country has ever seen.

Mr. STEIN. We adopted a position of flexibility, sir.

Chairman PROXMIRE. My time is up.

Senator Javits.

Senator JAVITS. Thank you, Mr. Chairman.

Mr. Stein, I am very interested in the relationship of the $100 billion projected increase in GNP and the deficit. In other words, we project a $100 billion increase. Is that or is it not reflected in the $38-billion expected deficit?

Mr. STEIN. It is really reflected in both directions. The deficit contributes to the $100 billion increase and the $100 billion increase contributes to the reduction of the deficit in the second fiscal year. Of course, the revenues will expand. One of the reasons we have a decline in the deficit in the unified budget from $38.8 billion in fiscal 1972 to $25.5 billion in fiscal 1973 is that the economy will be rising and will be closer to its potential in fiscal 1973 than in fiscal 1972. The $100 billion cannot be derived as a simple multiple of the $38.8 billion. It does depend on how we get the $38.8 billion.

But in our projection of the approximately $100-billion increase, we are taking account of the fact that, as we explained at more length in our Economic Report, there will be a certain increase in Federal Government direct purchases of goods and services; there will be an increase in purchases by State and local governments as a result of a big increase in grants-in-aid, including perhaps revenue sharing; and there will be an increase in consumer expeditures as a result of the tax reductions and increased benefits of various kinds.

So these things all add up and contribute, in this year very powerfully.

Senator JAVITS. Why should we rely on that estimate when your last estimate was wide of the mark?

Mr. STEIN. I hope you will not rely on my estimate. You will have other witnesses before you. You have our facts before you. You can make your own judgment. We recognize that last year's estimate was mistaken. The size of the mistake has been kind of grossly exaggerated. It was a little larger than the average error of estimates made by councils of economic advisers in the past 10 years, but not much larger. We think this is an estimate in which more confidence can be placed because what we are predicting is a rather different thing than we were predicting a year ago. A year ago we were saying that the targets of policy should be to wrench the economy out of its rather stagnant course and make it move much more rapidly than it had been moving and much more rapidly than anybody thought it would move, except for us.

We recognized that this would be a difficult task for policy. For reasons which we explained in the report, we did not make the change of policy in time to achieve this result in view of the conflict with other objectives. This time what we are forecasting is really an extension of the present course of the economy.

We are making a forecast, which I believe you will find as these hearings progress, that is very much like that made by a lot of other people. No drastic change in the path of the economy is required to achieve this result, only a continuation and slight acceleration of the rate of increase we had in the fourth quarter.

But I hope you will form your own judgment.

Senator JAVITS. Thank you. Now I would like to ask you about productivity. As you know, this has been a major activity of my own. I notice you rely on it very heavily here in what you feel is charting a constructive economic course for the country. I would like to juxtapose two statements and ask you about them. You say in your statement, "These objectives include reasonable price stability, balance in our international economic position, and an increase in productivity which is the only durable source of an increase in the real incomes of workers."

I thoroughly agree.

Then in your statement you say, "Steps to contribute to rising productivity, notably by encouraging business investment in research and development."

I look in vein for any question of dealing with the stimulation of productivity by the individual worker. We read, for example, sensational news the other day about the General Motors Vega plant where there was a slowdown by young workers because of lack of motivation.

The Congress provided $10 million in the Economic Stabilization Act for the National Productivity Council to endeavor to raise the morale of the workers, efficiency, absenteeism, alcoholism, and many others. Is the administration planning anything on that score as, for example, the local Productivity Councils on a plant or regional basis that we had in World War II?

Mr. STEIN. Senator, I did not go into this for the reason explained here that George Shultz has been the chairman of the National Commission on Productivity, and he will present a full-dress statement on this subject when he appears here tomorrow. I was not able to attend the last meeting of the National Commission, which was last week, because I was in Europe. I am sure that they plan to implement the program which the legislation you presented will authorize; he can explain that in more detail.

Senator JAVITS. My last line of questioning relates to exports and imports: You say that our position is going to be improved in a major way if we have an excess of exports over imports, and that this may be a reasonable expectation as the effects of the currency realinement slowly work their way through the international system.

I would like to commend the administration for its decision to submit the bill increasing the price of gold this week, as we understand. I, for one, have been much opposed to holding it up as a hostage for trade concessions. The danger of this negotiating tactic was reflected in the recent instability of the world's money markets.

As you see the situation now, do you feel that the weakness in the gold market may indicate that we are overstaying our market on approving this agreement and that we will face very soon the need for another devaluation because of the weakness of the dollar?

Mr. SOLOMON. May I respond to that?

Senator JAVITS. Surely.

Mr. SOLOMON. It will give Chairman Stein a little rest.

All sorts of things affect the gold market. The slightest rumor that the United States may change the price of gold by more than the $3.00 to which they have agreed could be enough to set it off. It is a very thin market. I don't think we should worry too much about that.

On the basic underlying factors, it is perfectly clear that the positive things working for us will take time. The reevaluation or realinement of the dollar relative to other currencies will probably not have its full effect until 2 years have passed. It will only begin to have an effect this year.

The other major thing we can count on is that the deterioration in America's relative competition position, measured in terms of unit labor costs, or any similar numbers, has turned around. The U.S. position improved greatly between 1961 and 1965. It began to go downhill between 1965 and 1969, relative to our major trading partners. It has turned around again and is improving very rapidly now. So in terms of relative costs and prices, the combination of realinement and this basic improvement in our performance is going to produce a strong long-term improvement in our position.

In the short run we are suffering from two adverse factors. In the first place, we are expanding much faster than our normal rate of expansion, which means that our imports will rise faster. Our major competitors, outside of Canada, will be expanding in 1972 much slower than their long-term rates of expansion. Germany, I am told, is expecting real growth of 2½ percent in 1972. As a result, the short run factors are against us.

I would imagine that our net export position, which became negative in the fourth quarter, will start improving and that the rate of improvement will be very strong by 1973. I think then we may well hear the opposite of all the things we are hearing now.

Senator JAVITS. At any rate, you anticipate an excess of exports over imports in this year?

Mr. SOLOMON. No. I think the improvement takes us from a negative position towards a positive position. For the year as a whole it may turn out to be very close to zero.

Senator JAVITS. Just one further question, if the Chair will let me ask: How high a priority does the Council of Economic Advisers give passage by the Congress of this bill increasing the price of gold?

Mr. SOLOMON. I give it high priority. I think it is part of a settlement. The sooner it is done, the better.

Senator JAVITS. Is it the highest priority in our international economic situation?

Mr. SOLOMON. It confirms the rates settled in December, the final confirmation of them.

Senator JAVITS. Would you give it the highest priority of any international economic measure?

Mr. SOLOMON. I think so.

Senator JAVITS. Thank you.

Mr. STEIN. May I add something? The Senator referred in passing to the possible need for further change in the exchange rates. I should say that at a meeting which I recently attended in Paris, where the governments of the 22 leading industrial countries discussed the international financial and economic situation, there was no thought whatever that the arrangements reached in December needed to be revised in any way. Nor was there any suggestion that any evidence had accumulated since December 18 to indicate a possible desirability of reconsidering the pattern of relative exchange rates established there. I think it is important to note that.

Senator JAVITS. You think that agreement is solid right now?

Mr. STEIN. Absolutely.

Senator JAVITS. Thank you.

Chairman PROXMIRE. Congressman Patman.

Representative PATMAN. Mr. Stein, do you think the administration made a mistake by waiting so long to impose price and wage controls after having been given the power to do so 12 or 14 months before they were actually imposed?

Mr. STEIN. I don't find it very fruitful to reconstruct history.

Representative PATMAN. I can't hear you.

Mr. STEIN. I don't find it very fruitful to reconstruct history or easy to tell what would happen if we did something other than we did. I think we had very good reasons for not taking the step before we did. I think we have an obligation to try to make this system work, to give it every opportunity to work, and not to make so crucial a decision on the basis of weak and uncertain evidence.

I think this view was shared by the Congress, because Congress obviously had the opportunity twice to impose these controls, to take action to make the controls mandatory, and didn't take those opportunities. So I think the decision was made, considering the drastic character of the decision, when a sufficient body of evidence was available.

Representative PATMAN. You personally were opposed to even Congress giving you the power to control prices and wages, were you not?

Mr. STEIN. I don't remember I had a concern about their giving the power to us.

Representative PATMAN. You were quoted in the press as being opposed.

Mr. STEIN. I was certainly opposed to the controls. At the time Congress passed the legislation, I was certainly opposed to imposing price and wage controls.

Representative PATMAN. However, if you had imposed them then when you had the first authority to do so, you would not have had some of the major problems about dating back the wage increases and things like that, would you?

Mr. STEIN. I think maybe if we had imposed them then we wouldn't have them now. The classic problem about controls is that if they are given too big a job to do they simply break down. If they are imposed in situations in which the forces toward increasing wages and prices on the demand side and on the cost side are both too great, they do not survive very long nor leave much of a trace.

I think we have imposed the controls in circumstances where they confirm the trend of the economy and help it to achieve the situation which it otherwise haltingly would have achieved. I think that was the proper thing to do. I don't think one can simply predict that if you had put them on on May 25, 1970, they would now have been doing a good job for us.

Representative PATMAN. I would like to turn to the subject of why you did not impose controls over interest rates. In the law, 203(e), whenever the authority of this title is implemented with respect to significant segments of the economy, "the Presidient shall"—not may, but it is "shall"—"require the issuance of regulations or orders providing for the stabilization of interest rates and finance charges, unless he issues a determination accompanied by a statement of reasons that such regulations or orders are not necessary to maintain such rates and charges at levels consonant with orderly economic growth."

Do you have a copy of the order that the President issued?

Mr. STEIN. I don't have it, but the Cost of Living Council issued such a statement.

Representative PATMAN. Would you put it in the record at this point?

Mr. STEIN. Certainly.

(The document to be furnished follows:)

EXECUTIVE OFFICE OF THE PRESIDENT,
COST OF LIVING COUNCIL,
Washington, D.C., December 22, 1971.

DETERMINATION AND STATEMENT OF REASONS REGARDING INTEREST RATE REGULATIONS

The large volume of borrowing and lending at declining interest rates which has occurred during the past year indicates that credit market conditions are making a significant positive contribution to economic growth. During the first three quarters of 1971, net borrowing by households and nonfinancial business units was more than 30 percent larger than the 1967–1970 average, a greater increase than the 17 percent growth of Gross National Product over the same period.

These large credit flows have financed a sharp increase in spending in three credit-dependent areas—residential housing, consumer durables, and state and local government. Moreover, the large volume of capital market financing by business has improved corporate debt structure and liquidity positions and laid the groundwork for a sizable expansion in business capital outlays next year, a prospect that is confirmed by recent business anticipation surveys.

The appropriate level of interest rates consistent with orderly economic growth changes in response to a number of complex influences, including inflationary expectations, the supply of savings, and the pressure of credit demands. The Committee on Interest and Dividends has been directed to maintain close surveillance of interest rate developments and, working with the Cost of Living Council, is formulating and preparing to implement a program for obtaining voluntary restraints on interest rates. It will pay particular attention to those rates most directly affecting the American family, including interest rates on mortgage and consumer loans. The Committee will make a special effort to ensure that rates in these areas reflect lower costs of funds in the credit market. Although, as economic expansion accelerates in the months ahead, interest rates generally may rise somewhat, rates on mortgage and consumer loans should nevertheless be at a level that permits the American family to obtain on equitable terms the credit necessary for a rising standard of living.

Recent interest rate experience has reflected the abatement of inflationary expectations and an ample flow of savings. In security markets, interest rates on new high quality corporate bonds are now only slightly above 7 percent in contrast to more than 9 percent in mid-1970 and 8 percent in mid-August 1971. Municipal bond rates have declined from 7 percent in mid-1970 to 5¼ percent with nearly half of the change taking place since mid-August 1971. Rates on home mortgages, which averaged 8.5 percent in 1970, recently have been around 7.8 percent. The bank loan rate to prime customers, an indicator of the cost of business borrowing, was 8½ percent in early March 1970, had fallen to 6 percent by mid-August, and has been between 5¼ and 5½ percent most recently.

In view of the above, and in accordance with the requirements of Section 203(e) of the Economic Stabilization Act of 1970, as amended, the Cost of Living Council hereby determines that the issuance of mandatory regulations and orders providing for the stabilization of interest rates and finance charges is not necessary at this time to maintain such rates and charges at levels consonant with orderly economic growth.

By direction of the Council.

PAUL W. McCRACKEN,
Vice Chariman.

Representative PATMAN. The Council of Economic Advisers has issued a statement purporting to explain why they did not choose to control interest rates and finance charges. The statement, in effect, said that as long as market rates were going down, there was no reason for control. Mortgage interest rates, which have remained high, were hardly mentioned, and consumer loans and installment purchase rates were not mentioned at all.

Legislative history going to the act makes it clear that all interest rates and finance charges shall be controlled. In lieu of a decision not to control, a full explanation is required, and the explanation shall go into all interest rates and finance charges.

The Council failed to do this. How could you, in good conscience, say that you are in favor of people continuing to pay 36 percent interest when that means this: 36 percent interest means that the lender gets his money back, the whole amount, in 2 years and 8 months? In other words, he would get 200 percent back.

There is no oil well gusher in the United States that equals that kind of return. How can you expect poor people to get along and not be in poverty and have to pay as much as 36-percent interest?

The President didn't mention that, did he? He didn't mention 36-percent interest. Yet it is well-known all over the Nation. It is in the laws of some States. So it is just absolutely ignored. Twenty-four percent prevails in most of the States on installment purchasing and 18 percent on all others. Yet, notwithstanding these rates, that are such a burden on the poor, which hurts everybody, he just failed to impose them when the law specifically requires it, unless he can show that the rates charged are not extraordinary or not exorbitant. You are saying, in effect, that 36 percent is not exorbitant, 18 percent is not exorbitant.

Don't you think you are going rather far?

Mr. STEIN. Mr. Congressman, the law does not contain the words "extraordinary," "exorbitant," "unfair," "usurious," or any such thing. The law says that the President shall make a finding that the rates are not inconsistent with orderly economic growth.

Representative PATMAN. Not what?

Mr. STEIN. Not inconsistent with orderly economic growth. I didn't write that language. I assume it was written here. It is in the Economic Stabilization Act amendments.

Representative PATMAN. How are you going to pass on that orderly economic growth? Are you going to say that 36 percent is always good for orderly economic growth? That is what you are saying now.

Mr. STEIN. We have had lots of periods of orderly economic growth with 36-percent interest rates on the kind of loans you are talking about. Of course, as you say, the lender gets his money back in 2 years and 8 months, if he ever gets it back at all. You are also assuming that there is no cost of managing these accounts. It is quite obvious this is a very expensive kind of lending business to do. The people who are doing it are not getting fabulously wealthy. This is something one can go into if he wants to make loans to poor people at less than 36 percent.

Representative PATMAN. That was in the old days. Now it is in the hands of the experts.

Mr. STEIN. In any case, the law requires that the President make a determination that the rates are not inconsistent with orderly economic growth. We made such a determination. We determined that the interest rates that we have, say, on mortgages, are consistent currently with the very high rate of housing starts.

We made the determination that the kinds of rates we have on automobile paper, for example, are consistent with the very high rate of automobile production and sales. We had the highest rate of automobile sales in history. So we were not asked to make any finding of what is the just interest rate.

Representative PATMAN. Are you watching this interest rate business? You boast that the interest rates are going down. The other day, and this is typical of one of many banks in this country, a large bank reduced its prime rate by one-fourth of 1 percent, but immediately reduced the amount that the consumers were saving one-half of 1 percent. Of course, they are not making many housing loans where that one-fourth reduction is applicable.

But the one-half of 1 percent would give them several times as much as they would be taking a loss on, if it were a loss, on the one-fourth of 1 percent. So the trickle down theory which applies here means that very little goes down in the way of reductions. That is for the big people. The poor and the people who are fighting poverty are not helped substantially by it.

In other words, you are giving the advantage to the rich, plainly and simply, and not giving proper consideration to the poor. I think it is very evident and very plain.

Mr. STEIN. I don't accept that description of our policy, of course.

Representative PATMAN. I am not saying you accept it.

That is all, Mr. Chairman, for the present.

Chairman PROXMIRE. Congressman Conable.

Representative CONABLE. Thank you, Mr. Chairman.

Mr. Stein, I think it is a fine and comprehensive report you have given us this morning. I would like to inquire to a degree about inflation. I think one of the strengths of your report is the fact you have pointed out that unemployment is not a homogeneous matter, that it affects different groups in different ways. Inflation is pretty much the same thing, isn't it? It is not a homogeneous matter either. In other words, there are likely to be points of slack and of superheat in the economy that bring about distortions in price pressures; isn't that correct?

Mr. STEIN. Yes. Many of the consequences of inflation arise from the fact that it is not evenly distributed throughout the economy.

Representative CONABLE. And that is reflected in your expectation, that as time goes on you would be able to decontrol some areas of the economy while controls might stay on in other areas for a longer period of time. I note in your statement you say, "The control system will be retained as long as is necesary to achieve its goal." That doesn't mean that it is likely to be kept together as one piece. It is likely to be decontrolled piecemeal; isn't it?

Mr. STEIN. That has been my thought. Again, we have no commitments to decontrolling any part of it. But it has always been my thought that some sectors of the economy would be decontrolled before others.

Representative CONABLE. I wonder if you have made any analysis of where the areas of superheat in the economy might come as a result of the stimulation program you have embarked on. For instance, I recall it wasn't more than a couple of years ago that we repealed the investment credit, which is now reinstated, because of the fact that we had so much superheat in the area of capital investment at that time.

Have you considered the possible implications of the boom, for instance, in housing at the present time? I note in the New York Times this morning that there is considerable upward pressure on plywood and lumber prices.

Is that likely to be an area of trouble? If so, how do we cope with it? We have a mechanism for dealing with it, of course, in the flexible price control system that the President has imposed.

Would you care to comment on that type of problem?

Mr. STEIN. We think that housing construction activity is fairly near its peak and that starts are probably already around their peak. We expect the starts for the year of 1972 to be higher than for 1971, but not as high as the fourth quarter of 1971.

The problem of rising lumber and plywood prices has been with us off and on since 1969. I do think with the present control mechanism we have a better handle on dealing with it. But I don't think we are going to have a big problem there, because we are near the top of the housing construction.

Representative CONABLE. Are there other areas of potential problem that you might be willing to mention that are going to require special attention, or at least close watching?

Mr. STEIN. I do think that the expansion we see is quite well distributed around the economy. It is not highly concentrated. There are some areas where we will undoubtedly get higher than average price increases, and the public utility area may be one of those because rates have lagged.

The rise of rates to a level which will attract the capital required for meeting the needs of the country in the years ahead may be fairly substantial after a long period in which rate increases have been small. That is the one that stands out in my mind.

Representative CONABLE. What about textiles? We have recently concluded textile agreements. I am by no means convinced that voluntary quotas are any sounder than involuntary quotas, as an economic device. I acknowledge the political necessity of achieving this if we are not to have a hook on which a lot of protectionist type legislation can be hung. But can we expect an upward movement of prices in the textile field as a result of the limitation of the most effective, some would say the most destructive, competition that has come from abroad previously?

Mr. STEIN. I am not really able to comment on that in any detail. Textile prices will be under control. During the freeze the prices of some textiles were caught in the situation where contracts providing for increases in prices in the future could not be honored by virtue of the freeze, and there was a kind of cost-price squeeze for the domestic textile industry. I assume this squeeze will be somewhat relieved during phase II.

I will submit something on this subject for the record.

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

TEXTILES

Export Restrictions on Manmade and Woolen Textiles

Last fall, the U.S. negotiated agreements for restrictions on exports of these products effective October 1, 1971. (Cotton textiles and apparel imports have been under restrictions since 1962). The agreement called for exports to the U.S. of wool products to be restricted to an increase of one percent annually and manmade yarns and textiles to the following levels:

Annual rate of increase

	Percent
Japan	5.0
Hong Kong	7.1
Taiwan and Korea (higher rates in first 3 years)	7.5

Since these countries had been increasing manmade textiles exports to the U.S. at an annual rate of 61 percent in 1971, this represented a very sharp reduction. In fact, in order to get down to the new rate, shipments have had to be absolutely reduced from the final months before the agreement. Commerce Department sources believe that the agreement has already had a stimulative effect (partly psychological) on the U.S. textile industry.

Price Behavior of Textiles

Apparel commodities as reflected in the consumer price index (CPI) have shown a slower rate of price increase in the 12 months ended in December 1971 (2.2 percent for women's and girl's and 1.7 percent for men's and boy's apparel) than have the total CPI (3.4 percent) or non-food commodities (2.3 percent). Other price changes in textiles and apparel products at both the wholesale and retail level are shown in the attached table.

The December price data are probably too early to show any significant effects of the new export agreement.

Employment and Output

Employment data for the textile and apparel industries in recent periods are shown in Table 3. The decline of recent years appears to have reversed in the 12 months ending in December 1971. Textile and apparel output as measured by the Federal Reserve Board's indexes of industrial production are shown in Table 4. The fact that output has risen 5 percent from December 1970 to December 1971 while employment is up less than one percent indicates substantially increased productivity.

Financial Performance

The return on equity in both the textiles and apparel industries tended to improve in 1971 as the most recent survey data show:

	Profits after taxes as percentage of stockholders' equity	
	Textile mill products	Apparel and other finished products
1968	8.5	12.3
1969	7.7	11.9
1970	5.1	9.5
1971:		
January-March	4.6	5.5
April-June	7.2	10.9
July-September	6.5	12.5

Source: Federal Trade Commission; Securities and Exchange Commission.

TABLE 1.—CONSUMER PRICE INDEXES, APPAREL COMMODITIES

[Seasonally adjusted; 1967=100]

	Men's and boys	Women's and girls
1970:		
Annual average	117.1	116.0
December	118.9	119.0
1971:		
August	120.3	120.0
December	120.9	121.6
Percent change December to December	1.7	2.2
Percent change August to December (annual rates)	1.5	4.1

Source: Department of Labor, Bureau of Labor Statistics.

TABLE 2.—WHOLESALE PRICE INDEXES—TEXTILE PRODUCTS AND APPAREL

[1967=100]

	Textile products and apparel (03)	Cotton (031)	Woolen (032)	Manmade (033)	Apparel (035)
1970:					
Annual average	107.2	105.6	99.4	102.1	111.0
December	106.7	106.9	96.8	97.5	111.9
1971:					
August	109.7	112.5	92.7	103.1	113.6
December	110.6	113.6	91.5	104.3	113.8
Percent change December-December	3.7	6.3	−5.5	7.0	1.7
Percent change at annual rate August-December	2.5	3.0	3.8	3.5	.5

Source: Department of Labor, Bureau of Labor Statistics.

TABLE 3.—TEXTILE AND APPAREL INDUSTRY—EMPLOYMENT

[Seasonally adjusted]

	Employees in thousands		
	Textile mill products	Apparel and other textile products	Total
1970:			
Annual average	978	1,372	2,350
June	972	1,371	2,343
December	961	1,360	2,321
1971:			
Annual average	962	1,361	2,323
June	956	1,357	2,313
December	977	1,349	2,326

Source: Department of Labor, Bureau of Labor Statistics.

TABLE 4.—INDEX OF INDUSTRIAL PRODUCTION—TEXTILE, APPAREL, AND LEATHER (SEASONALLY ADJUSTED)

[1967=100]

	Textile, apparel, and leather
1970:	
Annual average	100.2
June	99.7
December	97.1
Percent change (SAAR), June-December	−5.1
1971:	
Annual average	100.6
June	102.4
December	102.0
Percent change, 1970–71	.4
Percent change (SAAR), June-December	−.8
Percent change December-December	5.0

Source: Federal Reserve Board.

Representative CONABLE. Is there evidence of adjustment by the domestic textile industry to international competition? These quota arrangements were set up, according to your report, at least in part, to give the industry time to adjust to international competition.

Mr. STEIN. I think there are two things: There is technological advance going on in the industry and style improvement which enables the industry to compete more effectively. Also, there probably is some trimming down of less efficient producers.

Representative CONABLE. One last question, sir: You mentioned the fact that it would take some time for the currency realignment to improve our balance of trade, because of arrangements previously entered into and because of the fact we will have to start competing in a whole new currency context.

Are we likely to have any distorting short-term flows of capital into or out of the country that could cause economic problems of some magnitude? I recall that during the last year we had some rather severe short-term flows that probably were the reason August 15 came on August 15, as a matter of fact.

Is there any short-term concern about this pending accommodation to the new currency alinement?

Mr. SOLOMON. No, Mr. Conable. The situation is very different this year than last. Last year there was widespread speculative reason for believing, and I don't mean speculative in the majority sense, that the value of foreign currencies would rise relative to the dollar. You could expect people to hold more money in foreign currencies and at the same time get a higher rate of interest. It is natural that people would do that, and they did no. This year, the only thing preventing a currency influx back across the Atlantic is that our interest rates are lower relative to European rates. They have been bringing theirs down but are unwilling to bring them down as fast as ours have been coming down.

On the other hand, we are unwilling to have a high interest rate policy just to accommodate capital flows. The system of controls that they have imposed against short-term capital movements from here to there are much more effective now than they were a year ago. Also, the long run situation is much more favorable to the United States.

Representative CONABLE. Is our relative rate of inflation good in comparison to theirs, as the interest rates are?

Mr. SOLOMON. Yes; I think one could say without any contradiction that the United States, in terms of price, output, unit labor cost will be the best performing economy in 1972, bar none. I am including Japan, Germany, and the United Kingdom.

Representative CONABLE. Thank you, Mr. Chairman.

Chairman PROXMIRE. Congressman Reuss.

Representative REUSS. Thank you.

Mr. Stein, on this subject of unemployment, particularly of young people, some 60 of us Democrats in the House are sponsoring a bill to provide 500,000 public service jobs now, federally funded, at the State and local level. It is very like the bill which President Nixon vetoed just 14 months ago.

Does the administration support or oppose our bill?

Mr. STEIN. I must say I hadn't heard about it.

Representative REUSS. Well, you know what it is about, having listened to me.

Mr. STEIN. Can you tell me how much it costs?

Representative REUSS. Insofar as it does what the bill that the President vetoed in December 1970 does, you are familiar with that?

Mr. STEIN. Yes.

Representative REUSS. He vetoed that, incidentally, saying things are going to get better. Actually, unemployment has increased a good deal since then. What is your answer?

Mr. STEIN. Unemployment has increased a good deal since when?

Representative REUSS. Since December 1970. It was then 5.7 percent and it is 5.9 percent now.

At any rate, will you tell me whether you support or oppose that legislation?

Mr. STEIN. Since I haven't heard about this previously, I cannot say what the administration thinks about it. I would oppose it. As I have indicated earlier, we have presented about as expansive a budget as we think is appropriate in the present circumstances. You haven't told me how much these 500,000 jobs would cost. I can hardly think of it costing less than $2.5 billion.

Representative REUSS. It doesn't.

Mr. STEIN. It doesn't cost less than $2.5 billion? Would you like to tell me how much?

Representative REUSS. Anyway, you are against it?

Mr. STEIN. Yes.

Representative REUSS. In telling us what you are doing about unemployment, in your statement, particularly, you say that in fiscal 1973 you are going to do very well, you are going to provide work support job slots for an estimated 874,000 new enrollees.

The fact is, is it not, that that is a decrease and that in fiscal 1972 you provided job slots for 950,000 new enrollees, so you are going downhill.

Mr. STEIN. The number of new enrollees is going down, but the total amount of money spent is going up. I would like to correct something that we said earlier about the unemployment rate having gone up from December 1970 to December 1971. That is not correct. The unemployment rate in December 1970 was 6.1 percent, and in December 1971 it was 6 percent which is not a very big difference, but at least we ought to get that on the record.

Representative REUSS. Anyway, you are not bragging about the fact that you are reducing the number of new enrollees from 950,000 in 1972 to 874,000 in 1973? From your statement, I thought you were proud of it, but now that I look at the budget you are going backwards, aren't you?

Mr. STEIN. We are not going backwards in terms of the number of persons enrolled in the program. We are reducing the number of new ones. We are increasing expenditures for the total manpower programs, as I have indicated. We have increased the budget by about 20 percent, which is about $1 billion.

Representative REUSS. Let me turn to the international side. Wherever I go and whatever I read, I find great interest in the fact that the United States now owes official short-term obligations on the order of $50 billion. There is great interest in the possible future convertibility of these sums. There is talk of the possible establishment of regional European monetary systems if we don't come up with some better way of financing our deficits.

I read the international section of the economic report, some 35 pages long, without finding a single word to indicate that you even recognize that there is this dollar overhang, that there is a problem of convertibility, a problem of the financing of deficits. There is a section on monetary reform which begins on page 163 saying, "The primary questions with which negotiators must deal are clear," but then you don't list anything about the overhang. It can't be just an accident that no mention of this important problem is made. Why is that?

Mr. SOLOMON. May I respond to that?

The reason we suspended convertibility was that the overhang already in existence on August 14 was larger than we could accommodate. Since then the overhang has increased greatly. Whether or not it is really an overhang we won't know for a while. At least up to the end of 1970 the rest of the world was not only willing but anxious to absorb these liquid dollars, and did not permit us very easily to take steps to remedy the outflow of dollars.

Representative REUSS. But starting last May their eagerness was quite restrained, wasn't it?

Mr. SOLOMON. Starting last May, their eagerness became restrained and our suggestion was very simple: A massive, realistic realinement that would cure the outflow of dollars once and for all. No amount of mathematical calculation will tell you the precise realinement required. Only the market could tell us.

In a sense, Europe wanted it both ways. They wanted us to accept numerically calculated realinements that might seem to be appropriate in everybody's opinion, but may not be appropriate at all. If they are not appropriate, then there will be continued outflows of dollars for a while.

Representative REUSS. Your assertion, then, is that the Europeans, the Japanese and the other holders of the roughly $50 billion of American liabilities will just have to sit tight on them for some years to come. There is no suggestion of a policy by this country with respect to them?

Mr. SOLOMON. On the contrary, I think that the question of the overhang, the question of what instrument shall provide future reserve assets, and just how the preferences of individual countries for alternative forms of reserve assets are satisfied all have to be settled in one large bundle in the future reform of the system.

We cannot separate out the issues one by one.

Representative REUSS. How do you account for the failure of the report, 35 pages in the international section, even mentioning this problem? It is a nagging and difficult problem, but that really shouldn't be a reason for not addressing ourselves to it.

Mr. SOLOMON. There wasn't much constructive that one could say about it. There are plans, literally from A to Z, named after their individual authors, on just how the problem should be treated and I could have produced a few more of my own. But this would not have been constructive. It is a matter for the IMF, the European countries and ourselves to sit down and, over the course of a year, find one set of plans acceptable to all. This will happen.

Representative REUSS. Thank you.

Finally, I want to respond to your request for suggestions. You keep saying, particularly to us Democrats when you talk about unemployment, in effect, "Look, what more do you want? We have a $39 billion budget deficit."

Speaking for myself, and I think for most people on this side of the aisle, thanks for nothing. We don't want that kind of a deficit at all. We don't think that enormous inefficient budget deficits were ever indicated by Lord Keynes. We don't think that endless giveaways to large corporate firms that don't need them, to banks which have overextended themselves on loans, or on the revenue side endless loopholes in the tax system—both creating horrendous and continuing budget deficits with no progress on current unemployment—is a good way to run the country.

My suggestion, very soberly offered, is that the administration reconsider its economic report and its budget. I think they are dead wrong.

Mr. STEIN. Are you suggesting we should balance the budget?

Representative REUSS. I certainly am not. I am suggesting that you should attack the unemployment problem efficiently rather than by the application vulgarized Keynesian deficits, you should reduce the deficit somewhat, and sharpen your expenditures and your revenues so as to do a job on unemployment.

I think your economic report and your budget are a disaster. My suggestion would be to go back to the drawing board and produce new ones.

Mr. STEIN. We have produced a policy which we believe incorporates what modern economics has to tell us. Lord Keynes is not a member of our Council.

Representative REUSS. The President has said that he is the Keynesian today.

Mr. STEIN. We did it all on our own. I cannot avoid historical recollection. It sounds like what the Republicans told FDR in 1936: That this deficit will not get you anywhere, why don't you do the thing that will inspire confidence, and so on. I think that is a blind alley.

Representative REUSS. But that is not what I am saying. I am not saying that deficits will get you no place. I am saying that deficits which are grossly excessive, because instead of zeroing in on the unemployment problem they concentrate on unnecessary giveaways that treat unemployment only in a remote and expensive trickle-down manner—I am saying that that is not a very good excuse for running a $39 billion budget deficit.

My time is up.

Chairman PROXMIRE. Congressman Brown.

Representative BROWN. Thank you, Mr. Chairman.

I am delighted to see the two of you here. I would have been even more delighted if the third new member had been here. As a matter of fact, that is what I came over for. But it is pleasant to see you, anyway.

In your statement, you spend a fair amount of space discussing the new distribution of unemployment with reference particularly to the fact that the unemployment rates among youngsters are higher today than they have been in comparable periods of unemployment in the past, and that the rates of unemployment among those above 25 years of age would seem to be lower in this particular period than has been the case in previous times of high employment.

Can you give me some information about the impact that an increase in the minimum wage would have with reference to this particular aspect of unemployment?

Mr. STEIN. I think a general increase in the minimum wage would be very harmful to the employment of young people. It would increase their unemployment rates. As you know, the Administration proposed a differential system in which the minimum wage of young people would be lower than that of mature workers. I think that was the most reasonable approach to this problem. The employer, after all, has his choice. He can hire mature workers or young people. If the minimum wage presents a discrimination in their relative wages, he is certainly going to hire the lower paid worker.

Representative BROWN. Is this rather sharp change here explainable by anything in particular in terms of either our laws or our Federal policies with regard to the employment of young people? I think if we assume that we want to get a low rate of unemployment, 4 percent or thereabouts, and if we note that our unemployment rate, as it is reflected now, includes a much higher percentage of unemployment in the young, then it would occur to me that we ought to have a policy which would encourage the employment of the young, or we ought to be a little more realistic in our judgment of what unemployment among the young actually means or actually is.

What accounts for this increase of unemployment in young people in times of current high employment, or in times of previous high employment?

Mr. STEIN. I am sure I don't know the answer to that. We suggested in the paper that the increase in the relative numbers of young people in the total labor force probably has something to do with the increase in their relative unemployment. But that does hinge on the fact to which you have already alluded; that is, the failure of their relative wages to respond properly in order to make the larger number of young people employable. I think that the minimum wage has had something to do with that. At least, some studies have observed a tendency for the unemployment rate of young people to rise rather sharply when the minimum wage level is raised and for their unemployment rate then to subside as the general course of increases in average wages and in prices erodes the effect of the minimum wage. Then we get another step in the minimum wage and another period during which the unemployment rates of young people are relatively high. That subsides again and the same process operates. But there are probably other factors at work directly affecting relative wages.

The other point made in our testimony was a larger proportion of the young population is in school than was previously the case.

Representative BROWN. I am sorry, I missed what you said.

Mr. STEIN. A larger proportion of the young people are in school than was previously the case. Young people who are in school and looking for jobs tend to have higher unemployment rates than young people who are not in school and looking for jobs, because the kind of jobs that they can effectively take are limited. So they are counted as unemployed, but they suffer from the fact that they are in school, if you can call it that.

Representative BROWN. Has anybody given any thought to the fact that we may be an increasingly technological society wherein an experienced workman has more value or merit in the economic program than one who is relatively inexperienced would have had in, say, an agricultural society? Similarly, therefore, the opportunities for young people who have not been trained in vocational skills or in the technological skills may be, in fact, reducing. Is that in the picture somewhere?

Mr. STEIN. Well, I think that is a possibility. There are a lot of possibilities. As we explained in our report, this is one of the things that we want to look into this year. One thing that apparently is happening is that the difference in educational attainment between the average person in the workforce and the ones now entering it for the first time is less than it formerly was. When educational attainment is rising rapidly, then the new people coming out of high school with 12 years of education are better educated than the average already in the labor force who may on the average have 8 years. Formerly new entrants had the advantage of higher levels of education than the ones already out there, but now this difference is diminishing.

Representative BROWN. It might make a worthy study for this committee sometime to see whether or not, in effect, we are being realistic in the count of unemployment among young people who are in school seeking employment versus, as you suggested, those who are out of school seeking employment, and what their relative position is in the labor market and how it is affected directly by increases in the minimum wage.

I feel to some extent the same thing may apply to minorities, which is the other very high rate of unemployment in our current situation.

In your statement, in referring to Federal expenditures in the 1972 budget, you suggest that certain legislation is going to be required to bring about the early expansion of outlays. How much of the President's proposed budget for fiscal 1973 requires additional legislation from the Congress?

Mr. STEIN. I am not able to answer that. That, of course, is a large number. I was referring to the early expansion of outlays and really had in mind the remainder of fiscal 1972 where the most important thing is revenue sharing. I could look up the answer to your other question, however.

Representative BROWN. Could you give me a generalized comment as to how much of this program is dependent upon legislation which is not yet approved by the Congress?

Mr. STEIN. If by legislation you mean the authorizing legislation, I think something like one-third of the fiscal 1973 expenditures will come out of funds still to be authorized.

Representative BROWN. Revenue sharing is an example of something that is included in the budget, which is not even through the one House of the Congress yet; isn't that correct?

Mr. STEIN. That is right.

Representative BROWN. On page 32 of the Economic Report of the President you note that there is a persistent high level of personal savings. Is there an anticipation of that, that savings rate is likely to modify, or is it your feeling that we have reached an era when a new norm may be appropriate to our consideration of the savings rate?

Mr. STEIN. Let me go back to your other question first. Of the outlays in 1973 of $246 billion, $127 billion would come from new authority still to be provided by the Congress. So it is not one-third but more like one-half.

Representative BROWN. Those are not necessarily all new programs, but some are programs which have to be authorized for continuation?

Mr. STEIN. That is right.

We do not count in our calendar 1972 projection on a reduction in the savings rate, partly because our observation is that when personal income after taxes rises very rapidly, the expenditures tend not to keep pace. This is a force that would be making for a rise. On the other hand, we do thing the situation affecting the consumer will become more favorable, and on balance what we look for is a stable savings rate in 1972.

With respect to the longer run future, there may be developments which would tend to make the personal savings rate higher, but I don't see that as probable at the moment. I think we will get back to a lower personal savings rate. Over long periods of time the savings rate in this country has been fairly stable under conditions of full employment.

Representative BROWN. I wonder if you could have someone search out for a response to the question I asked. I would like to clarify it, if I may. I would like to know what programs which are not now on the books are included in the expenditures that you have anticipated for the coming fiscal year that would require action by the Congress.

In other words, entirely new programs, not a continuation of existing programs that may just in this year be falling due for reauthorization but, rather, new programs.

Mr. STEIN. I will supply that for the record.

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

In fiscal year 1973 approximately $11,265 million of outlays will require action by the Congress. This amount includes only those programs classified as "new and expanded." A breakdown into categories is given in Table 16 of the Budget (page 540). No information exists which will differentiate between entirely new programs and expanded programs.

Chairman PROXMIRE. Mrs. Griffiths.

Representative GRIFFITHS. I would like to ask you about the total budget. Do you feel that the quarterly analysis of the budget on an NIA basis is preferable as related to full employment? Just supply that, if you wish.

Mr. STEIN. The finer the time period you ask for the less reliable the data.

Representative GRIFFITHS. Let's say quarterly.

Mr. STEIN. That is what you said. Would you please accept half-year figures?

Representative GRIFFITHS. Well, I will accept practically anything, but try to get something that makes it more realistic. It would be so much better to show it quarterly. Do the best you can, will you? It is really terribly difficult. When I began looking back through the budget, I didn't know exactly what happened sometimes. So I would like to look at them.

Mr. STEIN. I will supply that for the record.

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

NIA FULL EMPLOYMENT EXPENDITURES AND RECEIPTS

[Billions of dollars, SAAR]

Half years	Expenditures	Receipts	Surplus
1971—II	223.8	227.7	3.9
1972—I	244.8	235.4	−9.4
1972—II	250.1	246.1	−4.0
1973—I	257.6	256.7	−0.9
Fiscal year 1972	234.3	[1] 229.3	−5.0
Fiscal year 1973	253.9	[2] 249.9	−4.0

[1] Due to a social security tax base change January 1972, there will be a $2,300,000,000 difference between the average of the 2 seasonally adjusted ½ years and the unadjusted data (the latter being used for calculating the fiscal year totals).
[2] Due to the timing of personal tax payments other than withheld, there is a $1,400,000,000 difference between the average of the 2 seasonally adjusted ½ years and the unadjusted data.

Representative GRIFFITHS. How real are these budget estimates? You are showing a $10 billion expenditure before June 1, based on the passage of H.R. 1 and revenue sharing. How could we pass H.R. 1 and you get out any appreciable amount of money under that before June 1?

Mr. STEIN. H.R. 1 has been around for quite awhile, as I recall. I believe Congress has had no difficulty about authorizing retroactive payments.

Representative GRIFFITHS. Are you contemplating retroactive payments in welfare?

Mr. STEIN. For fiscal 1972 there are no expenditures under the new welfare program.

Representative Griffiths. You don't assume that any money is going out under the budget for H.R. 1?

Mr. STEIN. There are social security benefit increases.

Representative GRIFFITHS. But nothing under the welfare part for H.R. 1?

Mr. STEIN. Not in fiscal 1972.

Representative GRIFFITHS. What are you doing on the $1 billion that you show as an expenditure on public works projects authorized before 1964? What are those public works projects on which you are going to spend $1 billion? When are you spending it?

Mr. STEIN. That is a question that I am afraid you will have to ask Mr. Shultz tomorrow. I don't know the answer to that.

Representative GRIFFITHS. You can't supply the answer?

Mr. STEIN. Yes, I could, but he can.

Representative GRIFFITHS. Would you do it? I won't be here tomorrow.

Mr. STEIN. I will supply that for the record.

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

One billion dollars of funds for Public Works were authorized prior to 1964. This represents an accelerated Public Works Program. The funds for this project have been spent at the following times:

$884 million in fiscal year 1963, 1964, and 1965. $2 million in fiscal year 1972. Nothing in fiscal year 1973.

Representative GRIFFITHS. When do the States get the $1 billion on welfare, the advance payment, and under what circumstances?

Mr. STEIN. I can't answer that fully. We would expect that it would be paid in the second quarter of this calendar year.

Representative GRIFFITHS. I would like to ask you: Can you supply the answer on the amount of money that has gone, income-producing money, into the foundations, revenue-producing businesses and to other charitable areas during the past 10 years? Don't you have somebody who can do that?

Mr. STEIN. Do you mean from the private sector or from the Government?

Representative GRIFFITHS. From the private sector into foundations. What has been the growth?

Mr. STEIN. We will do our best with that.

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

Information on the growth of funds flowing into private foundations is not available. However, data on gross receipts, expenditures, assets and net worth are available for 1967. These were given in detail in *Tax Reform*, 1969 Hearings before the Committee on Ways and Means (Appendix I to Part 1, February 18, 1969).

The summary schedules are reproduced heree. It will be noted that, in 1967, foundations received approximately $285 million in contributions, gifts and grants.

Schedule 1.—Gross Receipts

	1967
Gross sales or receipts from business activities	$103, 730, 133
Gross profit from business activities	24, 818, 326
Interest received	191, 864, 575
Dividends received	411, 895, 504
Rents received	20, 475, 190
Royalties received	12, 665, 322
Gain (or loss) from sale of assets, excluding inventory items	263, 875, 992
Other income, excluding contributions, gifts, grants, etc	64, 108, 272
Total gross income, including capital gain (or loss)	989, 703, 171
Contributions, gifts, grants received	285, 378, 758
Total receipts, including capital gain (or loss) and contributions, gifts, grants, etc. received	1, 275, 081,934

Schedule 2.—Expenses, Excluding Grants, Etc. Paid Out

	1967
Compensation of officers, etc	$13, 107, 938
Other salaries and wages	106, 107, 598
Interest	2, 395, 214
Taxes	6, 736, 547
Rent	9, 490, 250
Depreciation (and depletion)	12, 748, 546
Miscellaneous expenses	102, 157, 294
Total expenses, excluding contributions, gifts, grants, scholarships, etc	252, 743, 381

Schedule 3.—Grants, Etc. Paid Out

	1967
Contributions, gifts, grants, scholarships, etc., paid out of current or accumulated income	$646, 273, 588
Contributions, gifts, grants, scholarships, etc., paid out of principal	107, 985, 012
Total contributions, gifts, grants, scholarships, etc., paid out of current or accumulated income and principal	754, 258, 600
Accumulation of income from date of organization (for purposes of comparison, the accumulated (unspent) income was over $1 billion at the close of 1960 and over $367 million at the beginning of the first accounting period for which the foundations submitted data to the subcommittee, usually 1951)	2, 029, 790, 175

SCHEDULE 4.—ASSETS

	1967	1951
Cash	$188, 865, 705	
Accounts receivable less allowance for bad debts	90, 807, 104	
Notes receivable less alowance for bad debts	164, 063, 661	
Inventories	14, 458, 128	
Investments in Government obligations:		
United States and instrumentalities	965, 410, 846	
State, subdivisions thereof, etc	112, 918, 935	
Investments in nongovernment bonds, etc	2, 128, 960, 553	
Investments in corporate stocks:		
Carrying values of investments in corporate stocks	6, 459, 630, 073	
Market values of investments in corporate stocks	13, 115, 132, 123	
Mortgage loans:		
Number of loans	441	
Total amount	87, 796, 578	
Other investments	385, 469, 863	
Depreciable (and depletable) assets less accumulated depreciation (and depletion)	221, 082, 836	
Land	286, 295, 919	
Other assets	102, 750, 590	
Total assets, with market values of stocks being used wherever available. (Where market quotations are unavilable, the stocks are shown at carrying values. Generally, assets other than stocks are shown at carrying values.)	17, 864, 072, 928	
Total assets based on carrying values	11, 208, 510, 865	$2, 879 514, 364

Schedule 5.—Liabilities and net worth

	1967
Accounts payable	$36,671,665
Contributions, gifts, grants, etc., payable	835,795,687
Bonds and notes payable	32,886,747
Mortgages payable	9,730,020
Other liabilities	112,873,241
Capital stock:	
Preferred stock	42,287,371
Common stock	121,111,273
Membership certificates	90,075,888
Paid-in or capital surplus	9,772,889,554
Retained earnings—appropriated	270,000,626
Retained earnings—unappropriated:	
Attributable to ordinary income	(1,119,894,644)
Attributable to gains from sales of assets	876,385,782
Less cost of treasury stock	------------
Total liabilities and net worth based on using carrying values of assets	11,163,710,291

Representative GRIFFITHS. What has been the growth of untaxed money going into pensions for the last 10 years? Can you supply that?

Mr. STEIN. We will try.

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

The table below gives employers' contributions to private pension funds as well as funds' total earnings for the past 10 years. Earnings are not subject to taxation. Employer contributions are untaxed since they are deductible as a business expense.

[Dollars in billions]

Year	Employer contribution	Total earnings
1960	$4.7	$1.6
1961	4.8	2.2
1962	5.2	2.0
1963	5.6	2.6
1964	6.4	3.5
1965	7.4	4.0
1966	8.2	4.0
1967	9.1	5.3
1968	9.9	6.0
1969	11.4	3.7
1970	12.6	2.7
Total	85.3	37.6

Note: Total untaxed=$122,900,000,000 (1960–70).

Representative GRIFFITHS. The truth is you are not collecting taxes. It isn't just the people who are out of work, although I think that is one of the great issues. It isn't that alone. There have to be some other reasons. I am asking the Treasury to supply me in another committee with the amounts of money they would collect if they taxed all welfare at the Social Security rate and then at an income rate. It seems to me that it is not unreasonable for someone to start considering this. I found out yesterday in talking with a person who has gone on unemployment after he got everything he could, was getting $20 more per month than when he was working. It seems to me we ought to start looking at some of these other things.

Mr. STEIN. I agree with you, but our deficit is not the result of those practices. Those practices have been going on for years and years, including years when we didn't have the deficit.

Representative GRIFFITHS. You are quite right, they have been going on for years and years. But this committee had hearings on pensions, and the step-up into the pension funds is tremendous, as is the step-up into foundations, as is the step-up of income-producing funds into other areas that are going untaxed. I don't think it is totally insignificant. I think we at least might as well look at these things.

Mr. STEIN. If I can get the information, I will supply it.

Representative GRIFFITHS. Why do you think interest rates went down?

Mr. STEIN. Interest rates went down for three reasons. I would think. It depends on what period you take. They went down first because the economy was soft and the private demand for credit was weak. They went down because in the first part of 1971 we had a considerable growth in the money supply. They went down, at least after August 14th, because there was a greater expectation that we would get back to reasonable price stability.

Representative GRIFFITHS. Do you anticipate they will go up this year?

Mr. STEIN. I anticipate that the short term rates will rise somewhat because business activity will rise. That is a characteristic of the behavior of interest rates in times of rising economic activity. I don't really expect the long term rates to rise. They will be subject to countervailing forces. On the one hand, the rate of inflation will be lower than it has been, and, on the other hand, there will be some increase in demand for funds. We also have the presence of a large deficit.

Representative GRIFFITHS. Can you pinpoint the anticipated rise in the building of houses?

Mr. STEIN. What do you mean pinpoint it?

Representative GRIFFITHS. Where is it going to occur? Is it going to occur, for instance, in the suburban areas, in central cities, or where?

Mr. STEIN. I am not able to answer that question. Our estimates are based on the relation of the total rate of housing starts in the past and recently to certain overriding factors which seem to determine how much housing activity we have, such as the state of the mortgage market and the state of vacancies around the country. Obviously, construction will not evenly be divided throughout the country.

Representative GRIFFITHS. Isn't it reasonable to look at some of the social reasons? The suburban areas of Detroit for a long time had the greatest boost in housing rates. The truth was the whites were fleeing the city. Isn't this now happening in Atlanta?

Mr. STEIN. I don't know.

Representative GRIFFITHS. I think it is. As all of this happens, and it is happening, how rapid do you expect revenue sharing demands to go up?

Mr. STEIN. All demands on the budget rise very rapidly. I don't know what the import of your question is. We have a demand from revenue sharing now which comes to us from the governors and from the cities. It is very strong. I expect we will get revenue sharing and no doubt when we have it the demands for it from States and localities will rise further.

Representative GRIFFITHS. But as cities go broke, and Michigan has two of them that are now in real problems over paying the police and fire department pensions, don't you presume that we are going to be bombarded with these requests?

Mr. STEIN. Certainly.

Representative GRIFFITHS. Do you have a plan for doing anything about such requests other than sharing revenue? For instance, let me suggest this: I have asked somebody, who never supplied the answer, if they could anticipate the cost of buying out the pension systems for social security. There will come a day when maybe you can make a real deal. In place of Mayor Lindsay's settling with the garbage workers for peace in his time, and half the income of a garbage collector at the end of 20 years is a pension forever, maybe you could settle fairly cheaply for social security, if the rest of us will have to pay for it. Do you have any plans on that, besides revenue sharing?

Mr. STEIN. We have a varied program of revenue sharing, and we also have a continuation of some categorical grants. You asked us whether we have a plan besides revenue sharing. We have a plan for revenue sharing. Let us get that and see what that does for the problem. That is our main contribution to a solution of this problem.

Representative GRIFFITHS. There is some question that revenue sharing really solves the problem. It creates its own additional problems. It is entirely possible that when some of these people begin explaining to their constituents in mid-America, the small towns, making $300 monthly, that they are being taxed to pay a 38-year-old garbage workers in the city of New York $9,000 in pensions, they will not be very happy.

Thank you very much.

Chairman PROXMIRE. Congressman Moorhead.

Representative MOORHEAD. Thank you, Mr. Chairman.

Mr. Stein, I compliment you on your statement. The major thrust of it is on the question of unemployment, and a great deal of its particularly on the youthful unemployed.

Looking at the economic indicators for December, it showed for the category of experienced wage and salary workers an unemployment rate of 5.9 percent, and for all workers 6 percent. That means that the inexperienced workers, according to these figures, would be only one-tenth of 1 percent.

Mr. STEIN. If the experienced, salary workers had a rate of 5.9 and the average was 6, then the inexperienced must have been something more than 6, depending on what proportion they are of the total. These things don't add up, but you have to average them. If there were just as many inexperienced as experienced, and the experienced were 5.9, then the inexperienced would be 6.1 percent, but since there are fewer inexperienced than experienced, their rate is considerably higher than that.

Representative MOORHEAD. So these figures are consistent with your testimony?

Mr. STEIN. Yes.

Representative MOORHEAD. The second point is this question somebody mentioned of belittling the budget deficit. I certainly don't want to put myself in that category.

In this connection, Mr. Solomon, you were quoted in the New York Times of February 2 saying that the Congress should not try to reduce next year's budget deficit significantly, not even by closing tax loopholes. Is that your position, sir?

Mr. SOLOMON. I was testifying before the Ways and Means and the alternatives being considered there were to tolerate the deficit or reduce it by cutting spending significantly or by increasing taxes significantly. I said that no significant increase in tax rates at this time was appropriate.

Representative MOORHEAD. This quote used the term tax loopholes. It would seem to me if we should have a $38.8 billion budget deficit or $25 billion for next year to stimulate the economy, loopholes which benefit the high income persons are not particularly stimulative, and that we should close those loopholes and either reduce the deficit or if we need a deficit of this size to spend additional money in increased expenditures for manpower programs and the like. Wouldn't that make more economic sense?

Mr. SOLOMON. Indeed, I went on to suggest that if there were choice loopholes to be closed, that either other taxes be cut or the amounts be used for expenditures, with no attempt being made to alter the balance between total revenues and total expenditures.

Representative MOORHEAD. So you would favor a program of cutting down on the tax loopholes that benefit the high income person and using the additional money either for expenditures or for reduced taxation in the lower brackets; is that correct?

Mr. SOLOMON. As a basic matter of principle, yes, I am in favor of that. But one must remember that one man's loophole is another man's divine right, and vice versa. I think tax reform is very important for our system. I just suggested that the problem of fiscal policy in the broad sense not get all mixed up with the problem of tax reform at this time.

Representative MOORHEAD. I would like to ask both or either one of you this question: The statement talks about a major realinement of the exchange rates. You refer to that as part of your program. I wasn't sure from your statement whether you think that that major realinement has taken place or that there will be future realinements.

Mr. STEIN. It has occurred. I think some place we say that it has taken place. The system that was adopted allows for a certain range of variation around the central rates that were established, so there will be fluctuations going on within that range. But basically the realinement has occurred.

Representative MOORHEAD. But in your report you indicate that now is the time to have a real reworking of the Bretton Woods Agreement and new international monetary practices; is that correct?

Mr. STEIN. Yes; we say that a discussion of this should start soon. We have a number of problems to settle, as Congressman Reuss indicated.

Representative MOORHEAD. Do you contemplate that arising out of that, or in connection with it, would be further realinements, or not?

Mr. STEIN. I would say no; that is not what is involved. I think what may be involved in the reform would be some further determination of the conditions under which exchange rates might vary, without any presupposition that this involves some change in the U.S. dollar in either direction, but just as a matter of the nature of the system. There would have to be some discussion about the conditions under which exchange rates could change.

Representative MOORHEAD. In the report on page 163, you say under what conditions should countries be permitted to let exchange values of the currency be determined by market forces. By that do you mean all nations or all nations except the United States?

Mr. STEIN. Of course, if it applies to all nations it applies to the United States. If they are all floating, then our relative rate will vary.

Mr. SOLOMON. The idea of a transitional float has been suggested for some time. When any individual nation, be it the United States or France, finds that its rate is out of line, the old method of approaching the problem had been to hang on, to defend the rate with your last bit of gold, deflate your economy, raise interest rates, pray, until the inevitable happened and you had to devalue. It generally happened on a Sunday night. When the government would fall.

Under the new system it has been suggested that the minute disequilibrium is recognized, and it ought to be recognized swiftly, let the rate float for a while, a transitional float, until you find a new rate. This method avoids all the trauma and speculation. It has been suggested strongly that this be part and parcel of any future mechanism for exchange rate realinement, the use of a transitional float.

Representative MOORHEAD. Can we have a floating market guided exchange valuation while this $50 billion overhang continues to exist, or should that be financed in some way before we can solve our international monetary exchange system on a semifloating basis?

Mr. SOLOMON. One can speak only of the past. We had a floating system between August 15 and December 15 and I didn't see any evidence of trade falling apart as badly as some people suggested. In fact the volume of trade increased enormously. Canada has been floating since May 1970. I see no evidence that Canadian trade with the United States has declined in any way, shape, or form. However, there seems to be a strong preference for posted rates of the variety we now have.

Representative MOORHEAD. I would have to agree with you. I think you should let the market, within some rules, tell us the value of money. I wanted to be sure it was your judgment that this was to be applied while we have the $50 billion overhang in existence. I gather your testimony is "Yes."

Mr. SOLOMON. This is one of the things that can be worked out, the freedom of individual nations, including the United States, to alter their exchange rates in the future. That will be part and parcel of the reform.

Representative MOORHEAD. Thank you.

Chairman PROXMIRE. Senator Percy.

Senator PERCY. I would like to ask you about the Hartke-Burke trade bill, Mr. Stein. I happen to think that the passage of such a measure would set us back decades. I think it would do irreparable damage to future opportunities for economic growth in this country. I very much would appreciate your expert opinion in this area.

Mr. STEIN. We think this would be a terrible setback. Starting with August 15 we made a decision to move in the direction of a more liberal trade policy and to move to solve our own international economic policies by ways and means that did not involve restrictions, protectionism, and so on. As one consequence of our movement, of our decision to close the gold window and other things that were done at that time, was an agreement on the part of other countries to initiate negotiations towards a further general liberalization of trade.

I am not talking about the things that have been going on in the last few days, but on a long-term basis. We think that the American economy has a great deal to gain from general liberalization. Particularly, we feel that the American farmer has a great deal to gain from it. This is a two-handed game we are involved in. We can't expect to erect protective tariff barriers around the American economy and not have retaliation. We have to have a continuation of the steps which have now begun.

I think it is the worst of times to be talking this way.

Senator PERCY. Mr. Solomon, do you want to add a comment?

Mr. SOLOMON. I agree with your wording of it. I think it would be a terrible step back. It would hurt the American consumer and it would hurt the American producer, in general. It does no good at all.

Senator PERCY. Last week I questioned Mr. Moore about a Conference Board report. I said at that time I would reserve further discussion of it for your appearance. The Conference Board submitted a background paper, entitled "The Industrial World Ahead," to the President in connection with the 3-day conference, which starts here in Washington today.

In this study the Board predicted it could take nearly 20 years to achieve a full employment goal of 4-percent unemployment because of our rapidly expanding labor market. The Board predicted that because of many young people entering the labor force—the phenomenon that you pointed out very clearly in your statement today—many of whom will be inexperienced and relatively unskilled, the unemployment rate will hover about 4.5 percent for the rest of the 1970's, ultimately dropping to about 4 percent in the 1980's.

Would you care to comment on the Board's estimates? Do you accept the principal assumptions upon which the Board bases its estimates, the basic assumptions on which it premises this report?

Mr. STEIN. I would like to say several things about that. Things that are submitted for a White House conference are often described in the press as having been submitted to the President, which exaggerates their status, at least in my mind. As I understand their report, these figures, a 4.5-percent unemployment rate in the 1970's and 4 percent in the 1980's, were assumptions used as a basis for making some other estimates, the main purpose of the study not being to project what full employment was either now or in 1980.

I don't think we should invest these figures with any great value. I think they are reflective of a certain condition which we have indicated in our report, the condition having to do with the proportion of young people and women in the labor force.

But there are other things at work in the economy. With respect to this whole matter of how far we can get unemployment down and by what means, I think it is not useful to make the target now for the 1970's. We are pushing to get the unemployment rate down now by all kinds of means, by overall economic expansion and by manpower policies. We shall continue pushing as long as it seems to be effective. How far this will get us I don't think we should determine in advance.

Senator PERCY. This past 10 days I have been back in my own State a great deal, and I have never heard so much talk about the fiscal situation or so much discouragement about deficit financing. My constituents feel that if this government—more conservative in fiscal policy than many others—can't balance the budget, what government ever can? If we accept the fact in the Conference Board report that we are not likely to get down to 4-percent unemployment for a decade at least, does that mean, then, that under the full employment budget concept, we are anticipating budget deficits and no surplus for the next decade? Is that the outlook that we have ahead of us?

Mr. STEIN. I tried to indicate that I don't accept the Conference Board study on that point as having any great value as evidence. Neither do I regard ourselves as committed for all eternity to 4 percent as the definition of full employment in the calculation of the full employment budget.

I would not want to predict the deficit in 1980 on the basis of these two pieces of information.

Mr. SOLOMON. May I add something, Senator?

Senator PERCY. Possibly you could comment on the question of what effect deficits have on inflationary pressures, how responsible were they for inflation between 1965 and 1968, for instance, when at least all of our Republican rhetoric said that that big $25 billion deficit had a lot to do with inflationary pressures that were put on the economy.

How much value do you give deficits as putting inflationary pressures on prices?

Mr. SOLOMON. I think one has to look at two other things, at least. The condition of the economy in the year in which a deficit takes place; whether or not you have any so-called full employment deficit, or not, and then the size of the actual deficit.

The first two are important. In 1965 we were getting very close to full employment, at least as measured by the rate of unemployment, say, of married men. In that context, a rapid increase in Federal spending, which was financed by a deficit, was both highly expansionary and highly inflationary. There is no question about it.

On the other hand, a deficit that is caused primarily by a shortfall of revenues due to less than full employment operations, is supportive, not powerfully expansionary and certainly not inflationary.

The present deficit in fiscal 1972, I think, is expansionary, because there is a full employment deficit. I don't think it is inflationary because we have a lot of excess capacity.

Senator PERCY. Mr. Stein, would you wish to comment?

Mr. STEIN. No; I don't believe so.

Senator PERCY. In light of the very useful statement that you have delivered us today on our unemployment condition, if we actually are entering a situation in which unemployment is high because of the growing number of inexperienced and unskilled workers, should the Federal Government then aim to reduce such unemployment not primarily through strong stimulative deficit spending policies but rather through manpower training and development policies which increase the skills in our labor force? What is the Government's role in this area?

In this regard, I would want to comment very favorably on the strong growth in the manpower expenditure proposed for fiscal 1973 which you described in your statement.

Mr. STEIN. We are not maintaining that the 6 percent unemployment rate we have been having is entirely a consequence of the structural characteristics of the economy. We think the economy has been suffering from a deficiency of demand and needs an increase in demand. That is our main reliance.

We are also pointing out that that is not a sufficient attack upon the unemployment problem that we need to have along with the increase in demand not only bigger but also, we would hope, more effective manpower programs.

We are not saying that we should have the manpower programs and forget about expanding the economy. We think the economy needs expansion and that we are giving it a big shot.

Senator PERCY. Mr. Chairman, do I have time for two more questions?

Chairman PROXMIRE. All right. I have to go to the Floor and I have some questions I would like to ask.

Senator PERCY. Just a quick comment on productivity. There is a misimpression that productivity increases actually will raise the unemployment because such increases reduce the number of workers required. Can you give us a statement as to the long-term effect of increasing productivity in regard to creating new job opportunities and expanding our employment market?

Mr. STEIN. This is the kind of superstition which has bedeviled economic policy ever since the Ludites tried to destroy the machinery in the 1820's, or thereabouts.

It is obvious, we have enormous demands in this country for real output. As our productivity increases we will be able to generate more real output and more real income. We have to supplement the increase in productivity with policies to increase demand, that is, with the monetary and fiscal policies, which will keep demand rising sufficient to absorb the output that will be produced.

That is what we count on doing. That is what we have done over our long history. We fall short of it from time to time, but on the average we do it very well.

Senator PERCY. I will reserve my remaining question for Mr. Shultz tomorrow.

Chairman PROXMIRE. Mr. Stein, I am concerned with the wide swings in the budget. According to the administration estimates we have built up to a very large deficit in the current half year and begun to move rather quickly to reduce that deficit. If I recall my economic history correctly we have made mistakes in moving quickly from stimulus in the past, the experience under Hoover and the experience under Roosevelt.

Can you be sure we will not make that mistake again?

Mr. STEIN. I don't think we will make that mistake again, partly because we know that history. We are still in the process of getting the expansive effects of the budget. As I say, we have been quite aware of this swing in making our forecast, and our forecast, nevertheless, yields us a continued expansion of the economy, not only through calendar 1972 but into 1973.

Chairman PROXMIRE. In view of the lags involved it would seem to give you a stimulus through 1972, all right, up until the electon, and after the election we would seem to be moving into a position where we might get another recession.

Let me give you the figures I have and you comment if they are correct. Our staff has worked up some half-year estimates in the Federal budget deficit as measured in the national income accounts.

These data are as follows: 1971, July–December, $27 billion; 1972, January–June, where we are now, $39 billion, a tremendous increase; July–December, $33 billion, a sharp cut. In 1973, January–June, only $23 billion, another sharp reduction.

Does that pattern that I have described here in the first place seem factual? Is that the description of the situation?

Mr. STEIN. We do have a very big increase between the second half of calendar 1971 and the first half of calendar 1972, and then continuing with decreasing deficits during the two halves of fiscal 1973. We think this is the appropriate policy for various reasons which I have mentioned. Now is the time when the economy is far below its potential and we think we ought to be trying to get the economy to rise money rapidly when it is this far below its potential.

We believe that there will then be an increasing generation of private forces, to which I have already referred. This will take over the process of keeping the economy rising. In fact, we do see the economy rising rather steadily through calendar 1972, and I am not quite sure but that the rate may slacken a little in calendar 1973. But we don't envisage a retardation of the rate of growth of the economy as a result of this swing of the deficit.

Chairman PROXMIRE. President Nixon made a big point of the principle of the full employment budget. The full employment budget, as I understood him to say, in his view, should be in balance, that while he would recognize we can't have our consolidated budget in balance, we shouldn't have, it is bad economics, the full employment should be in balance. Yet in this fiscal year the full employment budget will be about $8 billion in deficit on the national income accounts basis, which is the one which I take it most economists view as the best indicator of the effect of the economy.

How do you square that position? It seems to be politically self-serving inasmuch as the stimulus would come before the 1972 election.

Mr. STEIN. When is the election, Senator? I never heard of it.

Chairman PROXMIRE. I am sure.

Mr. STEIN. The full employment principle has been stated in varying degrees by different people in the administration, but we believe that it is a good standard and a useful standard on which to rely. But we don't believe that there are not any circumstances in which it is appropriate to depart from it. After all, we have departed from a number of things we thought were good principles for the economy, including the adoption of wage and price control policies.

Chairman PROXMIRE. You departed then even from the full employment, which was the new concept of many people, when President Nixon adopted it, including many people who have been conservative.

Mr. STEIN. We recognize that we are confronting a problem, and that we had to deal with it in ways that were, as far as possible, consistent with our basic principles, but that we would have to make some exception. With respect to the full employment budget in fiscal 1972, that is an exception which has been made in order to provide additional stimulus to the economy at the time it needed it most.

Chairman PROXMIRE. I am going to be as concise as I can. I come to a question, however, which is a little involved for Mr. Solomon.

You and I have recently had an exchange of letters in the New York Times on the question of an appropriate unemployment target. In your letter you stated I had quoted you incorrectly when I referred to your remark that the unemployment target of the 1950's certainly can't be correct now.

I was referring to remarks you made at the Institutional Investors' Conference last December. I would like to read from that transcript.

> If four was correct then as the unemployment rate, and I don't think it was correct, it certainly cannot be correct now because the structure of the labor force has changed dramatically, more women, more young people, more people looking for their first jobs, who generally make the unemployment rate a little higher because their search in time is longer. This would be by most calculations at least a half percentage point. So if 4 was correct then, it cannot be correct now, 4.9 to 5 is correct now. If 4 was too optimistic then, then even 4.5 is too optimistic now.

I raise this point not becasue I want to embarrass you over some remarks you made during a question and answer session, not because I want to pursue an argument as to whether I quoted you of context, but you subsequently explained that with the help on manpower programs the unemployment rate can be reduced below 4 percent. I appreciate that explanation and am glad you hold that view.

I raise this point because there are so many people both in the administration and in the economics profession who are making so much of this change in the age and sex composition of the labor force. I recognize there has been a change, but this is not the only change which has taken place in our economy since 1958. Educational levels have changed. The interest of women in holding well-paying career positions has surely increased. Import policies have changed. The degree of monopoly may have changed, and so forth.

Given all of these changes, so few of which have been analyzed, how can you be so sure that the level of unemployment which can be corrected by aggregate demand measures has increased by four-tenths of a percent as you assert in your letter?

Mr. SOLOMON. Let me clear two things. The first is the 4.9 to 5 number is totally a garbled version of what someone heard off a tape. I never said anything of the sort.

Chairman PROXMIRE. I read the transcript.

Mr. SOLOMON. The transcript and the tape were garbled. I was talking in terms of a half percentage point of difference. I was also speaking in the context of macroeconomic policies. That had been the prior discussion between Mr. Samuelson and myself. We both agreed on the so-called shift in the Philips Curve. The level to which you could get unemployment down, without running into the inflation problem had changed. I am not suggesting that we alter our target. I am suggesting that we change our choice of public policy tools to get that other one-half of 1 percent.

Chairman PROXMIRE. Will you state for the record what in your view constitutes an appropriate unemployment target, both short range and long range?

Mr. SOLOMON. Well, four is the most repeated one.

Chairman PROXMIRE. What do you think is the appropriate one?

Mr. SOLOMON. I don't think there is any way in which we can calculate it with exactness. It is a weighted rate of many subrates. If we do want to do a good job on this question we have to sit down and compute appropriate transition rates for each of the groups, depending upon job opportunities and search times.

Chairman PROXMIRE. It seems to me, with all respect, and I have great respect for you—I think you are an able and brilliant man—that you should be able to come before this committee and tell us what the target is, whether it is 4.5 or 4 percent. What is the appropriate target, short and long range?

Mr. SOLOMON. I am perfectly willing to buy the 4 percent that has been used in this country for computing the full employment budget. It has been in effect for 10 years. I see no reason to change that. It was always an interim and tentative target.

Chairman PROXMIRE. You call that the long range, I presume.

Mr. SOLOMON. No, not necessarily. I would speak of it as the rate we would like to get at the top of this upswing.

Chairman PROXMIRE. Do you think we could get to 4 percent without excessive inflationary pressures?

Mr. SOLOMON. Only if manpower policies are effective in reducing existing rates by about one-half of 1 percent while macroeconomic policies are moving us towards this target.

Chairman PROXMIRE. Can you describe briefly the manpower programs the administration is going to be following to try to get to that level? What are they recommending? Not what has been done so far, that hasn't worked, but what are they recommending that is going to get us there?

Mr. SOLOMON. They have done a number of things.

Chairman PROXMIRE. Not what they have done, what they are recommending in the future. What they have done hasn't worked.

Mr. SOLOMON. They have only begun to do it quite recently. Prior to the sixties we had no manpower programs worth very much in this country. We had the unemployment placement services, in effect. That is what it was. Since the early sixties we have added a very large number of programs, so large that I can no longer recall all the acronyms. But I have a list in front of me and I could read them, if you wish.

Chairman PROXMIRE. One measure of the emphasis here is the amount that is being expended.

Mr. SOLOMON. Yes.

Chairman PROXMIRE. The amount being expended on all manpower programs, not unemployment compensation which is a reflection of disaster, but on manpower programs, is about $2 billion. It has been about that level.

Mr. SOLOMON. The figures I have suggest it has gone up from $3.1 billion in 1971 to $5.1 billion in 1973. This is an increase of 60 percent in 2 years.

Chairman PROXMIRE. But that $5.1 billion includes the public service employment that was forced on the President by the Congress, after he vetoed it to begin with.

Mr. SOLOMON. Yes, it includes that. There has been a vast expansion in programs like veterans' training. These have doubled in 2 years.

Chairman PROXMIRE. I have other detailed questions that I will ask you for the record. I apologize for detaining you. The hour is late. I have one other question to ask Mr. Stein and then I will have some questions for the record.

Mr. Stein, this question is about the wage-price program. First, what is your view on the longrun need for some program of price-wage restraint or some form of an incomes policy?

You say on page 24 of the economic report the price-wage controls were meant to be emergency expedients, expected to fade away leaving no permanent change in the system.

I would like to see it fade away, but many of us feel we will have to have some kind of an incomes policy as a fairly permanent method of coping with our economic problems, especially with inflation.

Mr. STEIN. I don't want to take any dogmatic view of this problem. As we have indicated in our report, we are concerned with the possibility that we might encounter a situation in which the termination of controls would leave us with some persistent pressure towards inflation again, and we do want to devote a good deal of study this year to determining whether that is likely, and, if so, what could be done about it.

I don't believe that controls of the kind we now have could be a continuing feature of the American economy. At least elsewhere they have proved not to survive very well and I can't imagine them surviving here.

Chairman PROXMIRE. I would agree wholeheartedly with that. I think we should get rid of controls. Historically, we certainly can't rely on them. What I am talking about is an incomes policy with wage-price guidelines, an incomes policy similar to the one we had in 1962 through 1966.

Mr. STEIN. I am not in a mood to rule out any of these things at this moment. I think we have to see how the economy responds, and I think we also have to see whether there are fundamental characteristics of the economy which cause the problem.

I don't really have much confidence in the exhortatory kind of guidelines. But I think we want to look into steps that can be taken to increase the competitiveness of the system so that this kind of thing can be avoided.

Chairman PROXMIRE. Thank you, gentlemen. I have other detailed questions that I will ask you for the record, but, as I stated, the hour is late. I want to thank you very much. You are obviously both extraordinarily competent. I want to thank you for a fine, responsive job this morning.

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

RESPONSE OF HON. HERBERT STEIN TO ADDITIONAL WRITTEN QUESTIONS POSED BY CHAIRMAN PROXMIRE

Question 1. In 1971, 46.3 percent of the unemployed had lost their last job. Yet in 1969, a high employment year, workers who had lost their last job constituted only 36 percent of the unemployed. This would mean that as unemployment had risen in the past 2 years, a higher percentage have been workers who lost their last job. Don't these facts question the validity of a theory, currently popular in some circles, that claims that a larger percentage of unemployment is due to new or re-entrants into the labor force?

UNEMPLOYED PERSONS BY REASON FOR UNEMPLOYMENT

[In percent]

	1968	1969	1970	1971
Lost last job	38.0	35.9	44.3	46.3
Left last job	15.3	15.4	13.4	11.8
New entrant or reentrant into labor force	46.7	48.7	42.3	41.9

Source: Derived from data published in the "Handbook of Labor Statistics 1971."

Answer. We were not aware that anyone had advanced such a theory in quite this fashion. Cyclical increases in unemployment always have been more concentrated in the lost job category than in the entrant category. The real question is "Why are knowledgeable analysts of the labor market discussing entrant unemployment more now than in the past?" The obvious answer is that there has been an important long-run change in the composition of unemployment which has serious implications for national economic and manpower policies.

It is common knowledge that most recent labor force entrants are women and younger workers. It is not widely known, however, that since the end of World War II, the proportion of unemployment accounted for by women and young workers has increased relative to total unemployment. This pattern of a changing incidence of unemployment appears in years of high, medium, and low unemployment, as Chairman Stein's testimony showed. Superimposed on this secular trend are short-term cyclical changes in the composition of unemployment, such as that between 1969 and 1971, when unemployment arising from job loss naturally increases relative to total unemployment.

The trend toward higher unemployment among less experienced workers is not cited to minimize the importance of increased unemployment among experienced workers who have been displaced by changes in demand. Policies are now in place that should go far, toward alleviating this problem during 1972. Our concern with the secular shift in the underlying composition of unemployment centers on its implications for long-term program design and policy determination. More now than ever before, employment and manpower programs and policies must be closely tailored to our changing work force. To disregard the change in the composition of joblessness is to court failure in the attempt to establish and maintain full employment growth without inflation.

Question 2. On page 27 of the Annual Report, the Council states that "The possibility that the rise of the economy and the decline of unemployment might lag behind the estimates made today calls for readiness to take additional steps if this should turn out to be the case."

What contingency plans has the Administration formulated if unemployment does remain stubbornly high and if real GNP fails to grow as forecast?

Answer. What steps might be taken if developments turn out to be different from those forecast will depend, of course, upon the size, nature and cause of the differences. We have considerable confidence in the present policies and in the forecast, and do not want to give the impression that we are on the verge of some major change of policy.

A number of contingencies can be visualized, without attaching a high degree of probability to any of them:

1. The economy may not be rising as rapidly as forecast, and this may be associated with failure to achieve the expected increase of government expenditures and easing of monetary conditions. The probable first recourse would be to try to achieve the planned policy, unless there was some new reason to think this was impossible or undesirable.

2. Sluggishness of the revival might be associated with deficiencies of the price-wage control system, either because it is excessively squeezing profits or because it is permitting a revival of anxiety about inflation. In that case the system might be revised.

3. If demand seems to be growing too slowly, for reasons not included in the foregoing, consideration might be given to increasing expenditures, reducing taxes or further easing money, with attention probably concentrating on measures which would be adapted to the particular structural characteristics of the unemployment problem.

Question 3. On page 69 of your Annual Report, you discuss the fiscal elements in the new economic policy and point out that the net effect of the Administration's August 15 fiscal package was to reduce expenditures by about $1.2 billion more than the reduction in estimated receipts. You then go on to say that the program is intended and expected to be expansionary. Apparently the reason given for this rather startling conclusion is that the surcharge was expected to expand domestic production while the investment credit was expected to stimulate investment. What has happened actually? How much has investment been stimulated by credit and how much was accomplished by the surcharge in terms of domestic improvement? Will you elaborate on this?

Answer. The Administration believed that the job development credit proposal in its original two-tier (10–5) form would provide a very powerful stimulus to investment in its first full year. The incentive to move investment forward was thought to be very great because in effect the Administration was announcing a year in advance that a 5 percent tax-free subsidy would expire on August 14, 1972. Last August the CEA estimated that the tax credit would raise calendar 1972 investment by $2 billion to $4 billion of which about half reflected the speedup due to the two-tier system. No effect was expected in 1971. Such an estimate, however, was thought to be very rough because there was no past experience to use as a guide.

Subsequently the CEA estimated that the 7 percent credit would raise 1972 investment by about $2 billion. This figure, like earlier estimates, drew on studies made by Charles Bischoff.

This estimate must also be considered rough since alternative theories concerning the determinants of investment yield different figures, higher and lower than those cited. It is of interest that the Commerce-SEC survey published on March 6, 1972 is projecting a 10.5 percent increase in plant and equipment expenditures from 1971 to 1972, up from the 9.1 percent gain projected in the same survey in December. The latest government survey is a bit stronger than we had thought only a short time ago, and it is conceivable that the impact of the job development credit will exceed the rather modest expectations of the CEA for 1972.

There was even greater uncertainty last August concerning the impact of the import surcharge on stimulating domestic output. In any case very little effect was looked for in calendar 1971. We have some information pertaining to automobile sales. Sales of imported cars from September 1971 through January 1972 averaged 16 percent below their rate in the preceding 5 months while sales of domestic units averaged 15 percent higher. However, this outcome reflects many factors besides the import surcharge. For one thing, the dock strikes have probably held down sales of Japanese imports. In general, in view of the many factors affecting exports and imports it is much too early to evaluate the impact of the surcharge in any meaningful way.

Question 4. Presently pending before the Congress is a supplemental defense budget request for $254 million. We have had defense supplementals in the past, but they have traditionally been used for such things as annual pay rate adjustments or emergency situations like Vietnam. This supplemental, on the other hand, requests funds for a large number of new and on-going strategic and tactical systems.

(*a*) What made it impossible to foresee these needs in advance so that action could be taken in the original fiscal 1972 budget?

(*b*) The Department of Defense already has tremendous authority to reprogram funds from one project to another. Why couldn't it have used the reprogramming route, at least for those on-going projects which Congress has approved, instead of seeking additional funding?

Answer. The regular FY 1972 estimates, presented more than a year ago, involved deferral of certain weapons decisions until it was possible to gain a better picture of the precise direction and momentum of the Soviet threat and of progress in the Strategic Arms Limitation Talks (SALT). The Secretary of Defense emphasized this fact in his appearance before Committees of the Congress and in public statements as well. It was made clear that additional steps would be necessary if the rapid momentum of Soviet weapons programs did not diminish. In light of recent developments, which could not have been foreseen a year ago, the items covered by the supplemental request can no longer be deferred.

Funds are not available to meet these needs by reprogramming. It is necessary to recall that the Congress reduced the FY 1972 budget requests by more than $3.1 billion, thereby eliminating any possibilities of financing large additional requirements from available funds. Aside from the matter of fund availability, the flexibility available to the Department has been sharply curtailed by changes in the manner of appropriating for procurement and RDT&E programs—the type of funds that are involved here. Finally, and of greatest importance, the Administration—in view of the urgency and the significance of this requirement—chose to present this matter in a way that would involve action by the Congress as a whole.

Chairman PROXMIRE. The committee will stand in recess until 10 o'clock tomorrow morning when we will hear from Mr. Shultz.

(Whereupon, at 1 p.m., the committee recessed, to reconvene at 10 a.m., Tuesday, February 8, 1972.)

THE 1972 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, FEBRUARY 8, 1972

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

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

Present: Senators Proxmire, Bentsen, Percy, and Pearson; and Representatives Reuss, Moorhead, and Conable.

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

Opening Statement of Chairman Proxmire

Chairman Proxmire. The committee will come to order.

Other members are coming. They have indicated they will be a little late.

Today is the second session of our annual hearings on the President's Economic Report. Our witness is Mr. George P. Shultz, Director of the Office of Management and Budget. At our opening session yesterday, with the Council of Economic Advisers, certain areas of agreement were established. First, Mr. Stein and I found ourselves in agreement that unemployment is the most serious economic problem facing the country today, a problem that demands quick and effective solution.

Second, we agreed that a stimulative fiscal policy has an important role in restoring full employment. Unfortunately, contrary to the impression that apparently this committee gave yesterday, I am not sure that our agreement extends much beyond that point. There are a number of aspects of the administration's budget policy which I find disturbing, which I would like to discuss with Mr. Shultz.

First, the timing of the budget stimulus may be misplaced. There will be a sudden increase in the deficit during the current half year; following which, the deficit is slated to decline fairly sharply. I am not convinced that either such a sudden increase in the deficit is desirable, or that a move back toward restraint will be appropriate in the second half of this year.

The current evidence does not suggest that unemployment is a minor problem which can be solved so quickly and simply. The most disturbing aspect of our economic situation over the last year has been that employment has held down so persistently when so many have felt that it would decline and predicted its decline. It has held to a steady 6-percent rate.

Second, I am concerned about the composition of the deficit. It is not a matter of indifference whose taxes we cut or what expenditures we increase. Recent tax policy has been heavily oriented toward tax relief for business. Quite apart from the social priorities this reflects, its short-run stimulative impact is questionable. Business has little incentive to step up investments when manufacturing plants are already operating below 75 percent of priority.

The budget reflects heavy increase on increased defense spending. This shows up most clearly in the authorization for fiscal year 1973, which is $6 billion above the previous year. It may be true that defense spending boosts employment in the short run, but it is a shocking indictment of our economic system that this is the only way we can find to restore full employment.

Third, I am disturbed by this administration's attitude toward the question of public service employment. The administration expresses great satisfaction with the small existing program, a program which was begun under congressional initiative and indeed vetoed by the President the first time it was passed. However, Dr. Stein yesterday took a very dim view of an increase in this program. His explanation was that we are spending enough money already.

I agree that we may be spending plenty of money, maybe too much; I agree we may be spending plenty in some areas. But there is a pressing need to shift the pattern of spending toward measures that will create jobs while at the same time enabling us to meet some of the most obvious social needs. A well designed program of public service employment on a substantially larger scale than at present seems to me to be the best way of doing this.

Mr. Shultz, we are very happy to have you here today. I look forward to getting your views on these and other economic questions.

If you would, identify the very distinguished Americans who are with you at the table.

STATEMENT OF HON. GEORGE P. SHULTZ, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET, ACCOMPANIED BY CASPAR W. WEINBERGER, DEPUTY DIRECTOR; AND SAMUEL M. COHN, ASSISTANT DIRECTOR FOR BUDGET REVIEW

Mr. SHULTZ. This is Mr. Casper Weinberger, Deputy Director of the Office of Management and Budget, whose special responsibility is for the budget; and Mr. Sam Cohn, Assistant Director of the Office of Management and Budget in charge of our Budget Review Division.

I might say this is Mr. Cohn's 26th budget, so he has a certain amount of seniority in discussing it.

Before I read my statement, Mr. Chairman, I would like to make a comment on one of the items that you mentioned and reject categorically the notion that an increase in defense spending is needed in order to stimulate the economy. This economy does not need to be stimulated by defense spending. It is not dependent upon it. The increases in defense proposed by the President are for substantive defense reasons, not for stimulation of the economy. If it is just stimulation of the economy that we are talking about, there are plenty of other things to spend money on.

Chairman PROXMIRE. I welcome that, but it is such a sharp increase in obligational authority for defense, as you know, and it is a difference from what we have had in the previous 2 or 3 years. It comes at a time when we are cutting back in Vietnam, and it is very hard, it seems to me, for the American people to understand that or this Senator, to understand why we have to have a very sharp increase, though I recognize pay has gone up and there are inflationary factors and so forth.

Allowing for all that, it seems to me to be a very, very difficult increase to accept on the basis of the justification we had had so far.

Mr. SHULTZ. I am sure everyone is in favor of a strategy for peace. The question is what does it take to get there. The President's position is, and the position in this budget is, that you get there by being strong, and an increase in the defense budget is necessary in order to obtain that objective.

Mr. Chairman, I am pleased to appear before you today to discuss the President's budget for fiscal year 1973.

Chairman PROXMIRE. I must point out that I would agree with you wholeheartedly that we have to be strong militarily. I couldn't agree with you more. We don't live in a Sunday school world. I am not one of those who feels we can disarm unilaterally at all. I think we should be strong. But I feel we have areas of waste and misplaced military priorities which can be handled more efficiently. I don't want to get you off the point.

Mr. SHULTZ. Mr. Chairman, initially, I would like to offer some general observations on the budget and budget process as I did when I first appeared before this committee as Director of the Office of Management and Budget. I would then turn to the overall fiscal dimensions of the budget. Finally, I would like to discuss recent developments in the budget for Federal statistics that I know are of a special concern to this committee.

BUDGET PROCESS

The President's budget is simultaneously a financial expression of his objectives and priorities, an assessment of the proper role of Federal revenues and expenditures in economic developments, and a detailed and comprehensive accounting of program costs and sources of funds. In reviewing this massive document, it is all too easy to focus attention on detail and to lose sight of the fact that this document is but a part of a continuous decision-making process which has profound implications for resource allocation in our society, not only in the year ahead but for years to come. This committee is in an ideal position to resist the tendency to take a narrow and fragmented or short run perspective on the budget and to pursue a more meaningful line of inquiry with regard to the entire budget process.

The budget process itself must be a continuous one, since there are strong interrelationships among actions appearing at widely separated time periods. Actions taken this year will affect developments not only in fiscal year 1973 but in the years beyond. Programs, once begun, are reduced or terminated only with great difficulty, and the sources of future problems are often found in irreversible cures of past or current illnesses. Similarly, objectives for future years must be reflected in immediate budgets if these objectives are to be realized effectively. Thus, in considering our present budget situation, we must look at the year just completed and the years ahead, as well as at the budget of the curent year.

Further, the profound economic impact of the budget imposes a continuing obligation to keep the total picture in mind while working on the many and highly varying parts. Both the legislative and executive branches of Government are elaborately organized for specialization, which is necessary but which nevertheless encourages a preoccupation with the individual parts of the budget.

It is for this reason that the President has proposed legislation establishing a rigid ceiling on 1973 spending. We, in the OMB, are acutely aware of the importance of a means to force consideration of the relationship of specific program decisions to the overall budget picture. One of our jobs within the executive branch is to develop such a mechanism in order to fulfill our responsibilities in helping to develop Presidential budgets. This committee, with its overview responsibilities within the legislative branch, will, I hope, give serious consideration to the President's proposal in the interest of establishing a sound basis for a continuing review of the relationship of specific program decisions to the overall budget totals.

BUDGET TOTALS AND BUDGET POLICY

As President Nixon pointed out in his budget message, "The budget of the United States for fiscal year 1973 has as a central purpose a new prosperity for all Americans without the stimulus of war and without the drain of inflation." The budgets for fiscal years 1972 and 1973 reflects this administration's determination to attain a level of economic activity which has far less unemployment than the present 6 percent and rates of inflation far less than those experienced only a few years ago.

The basic objective of the President's budget policy is to provide a strong, immediate thrust to the economy to create more jobs. We thus have a large estimated deficit, $38.8 billion, in fiscal 1972. The 1973 deficit is also estimated to be large, $25.5 billion, but it is one-third less than in 1972. On an NIA basis, purchases of goods and services are very expensive. Whereas Federal purchases actually declined from fiscal year 1969 to fiscal year 1970, and from fiscal year 1970 to fiscal year 1971, they are expected to rise by over $7½ billion in fiscal year 1972 and by another $4 billion in fiscal year 1973.

While our first order of business is to insure an expanding economy by providing an expansive budget, we should also be conscious of the need to maintain a discipline on outlays. The full-employment spending guideline imposes such a discipline. An excessive level of outlays can easily lead to serious inflation problems in the years ahead. We should not permit the budget to get out of control as we move toward full employment.

As a deliberate policy act, full-employment receipts are roughly in balance with full-employment outlays in the President's fiscal year 1973 budget proposal. Fiscal stimulation remains high so long as it is needed. As the need for stimulation decreases, the actual stimulation diminishes. In this way the stimulus remains as long as excessive unemployment persists, but is automatically turned off as soon as the effects of stimulation begin to lead to inflation.

To make certain that the 1973 budget does not breach the full-employment principle, the President has proposed that the rigid ceiling on 1973 spending be $246.3 billion. The total outlays proposed by the President in his fiscal year 1973 budget are sufficient to provide the necessary stimulus to the economy. We must remember that this stimulus will reach the economy at a time when we believe we will be making substantial progress toward full employment.

We believe that unemployment will decrease in the months ahead, partly because the budget provides strong stimulus, and partly because the dramatic reduction in the number of defense-related jobs is largely a thing of the past. In fiscal year 1971, defense-related employment was 2.2 million below the 1968 peak of 8 million. We anticipate a further slight reduction this spring. Basically, however, defense-related employment is leveling off. Thus, this factor, which caused us so much difficulty in the unemployment arena over the past 3 years, is now behind us.

Long-range outlook

As we project full-employment revenues and outlays based on programs that are in place or have been proposed by the President, we see a picture that is somewhat different from the one that has usually appeared. Typically, as one looked 3, 4, or 5 years into the future, he used to see large openings for new spending or tax reductions within the revenues that would be generated by the tax system. That is not the case now. As we project out to 1976, there is only a tiny budget margin. The projected budget margin in 1977 of about $25 billion is attributable in large part to assumed increases in social security taxes. In the past, there has always been a question as to whether these increases would go into effect or, if they did, whether social security benefits would be liberalized to absorb the surplus.

We must face the longer range implications of current decisions. We cannot accept proposals because "they do not cost much in the first year." Whenever a newly proposed program is accepted, that program must be important enough to warrant a tax increase or important enough to substitute for some current program. The administration has measured its proposals against this exacting standard. I urge—as the President did—that the Congress engage in a similar self-discipline.

A note of special interest

Although I do not wish to burden you with the details of the budget, I would like to mention one point that is of particular interest to this committee: the implication of success in raising the level of military pay.

In order to achieve the objective of an all-volunteer armed force, the Defense Department must compete in the labor market and pay market rates. As all the members of this committee are well aware, conscripted youth was forced to pay a tax prior to the pay raises. This tax was grossly unfair to those conscripted and impelled to move toward an all-volunteer armed force. This shift has had a dramatic effect on Defense personnel costs. In 1973, about 57 percent of the Defense Department outlays will be devoted to civilian and military personnel costs as compared with only 43 percent in 1964.

Looking at this problem from another angle, a billion dollars funded 219,000 people at 1964 pay rates but at 1973 rates it will fund only 105,000 people—or less than half the 1964 number. Thus, from the standpoint of managing our defense and security forces, the problem of productivity—of increasing output per man-hour—must take on primary importance.

RECENT DEVELOPMENTS IN FEDERAL STATISTICS

The importance of better statistics to Government policy decisions and internal management has become widely recognized in recent years.

A major weakness in Federal statistics is that many statistical surveys, which are an important source of data, were designed when standards were far lower than today. In the light of present needs, we are reconsidering the design of the surveys for wages, consumer prices, unemployment, and other series. Redesign of these surveys requires substantial increases in sample sizes and the development of new techniques for processing and quality control.

A serious problem in policy formation is error in estimates of basic economic variables. I have included table 1 which provides some insight into the nature of this problem with respect to the measurement of GNP during 1971.

(The table, referred to above, follows:)

TABLE 1.—SUCCESSIVE ESTIMATES OF CHANGES IN GROSS NATIONAL PRODUCT

[Billions of dollars at annual rate, 1971]

	1st quarter (estimates)				2d quarter (estimates)				3d quarter (estimates)		
	April	May	July	January 1972	July	August	September	January 1972	October	November	January 1972
Gross national product	28.5	30.8	32.4	32.4	19.7	20.5	22.3	19.2	15.9	17.7	13.4
Percent change	12.0	13.1	13.8	13.8	8.0	8.3	9.0	7.7	6.3	7.0	5.3
Personal consumption expenditure	17.7	19.4	19.9	20.2	15.5	16.3	16.3	12.5	11.2	11.6	11.4
Nonresidential fixed investment	3.8	3.8	3.5	3.9	1.8	2.7	2.7	3.6	2.7	2.3	1.0
Residential fixed investment	3.2	3.6	3.6	2.6	2.9	3.3	3.3	4.6	2.0	3.6	2.7
Change in business inventories	−1.2	−2.2	−.5	−.6	1.5	2.5	2.5	1.5	−4.1	−4.6	−5.8
Net exports	.2	.7	1.5	2.0	−4.1	−6.4	−4.7	−4.6	0	1.0	−.1
Government purchases:											
Federal	−.1	.2	.8	.5	−.7	−1.0	−1.0	−.4	1.9	1.7	1.6
State and Local	4.9	5.2	3.6	3.7	2.7	3.0	3.0	3.0	2.3	2.3	2.6
Constant dollar GNP	11.3	12.4	13.8	13.8	6.6	7.3	8.7	6.1	5.2	7.1	4.9
Percent change	6.5	7.1	8.0	8.0	3.6	4.0	4.8	3.4	2.9	3.9	2.7
Implicit price deflator—percent change	5.2	5.6	5.3	5.3	4.2	4.1	4.0	4.2	3.3	3.0	2.5

Mr. SHULTZ. The January 1972 revision of the national income statistics is particularly revealing. Under that revision, GNP for the third quarter was revised down by $7.4 billion, and the real rate of growth from the first to the third quarter was reduced from 3.9 to 3.1 percent. The error in the original estimates limited our ability to tell what was happening to the economy at a time when we were making projections as a basis for policy decisions.

To overcome such problems a vigorous effort was begun 3 years ago to improve Federal statistics by increasing the overall budget for statistics, reorganizing Federal statistical activities, improving standards, and establishing rules to safeguard credibility.

In each of the past 3 years, the President's budget for principal statistical programs has risen substantially. Funds requested for the principal current statistical programs in the President's budget are $281 million for 1973, an increase of 37 percent above the actual obligations of $205 million in 1971. The top priority in allocating funds has been to improve the basic data for the system of national accounts (national income and product accounts, balance of payments, and so forth); to improve the accuracy and timeliness of current economic indicators; to organize a set of social indicators; and to develop State and local area data.

As a major step to improve the organization of Federal statistical activities, reviews have recently been conducted by the four Departments of the Government (Agriculture, Commerce, HEW, and Labor) with major statistical programs. As a result, the Commerce Department has reorganized its statistical activities, and the Labor Department is about to take the final steps in its reorganization. We expect progress soon from Agriculture and HEW.

A third major development has been improvement of statistical standards. Efforts since 1969 to improve the timeliness of data have speeded up the release of one-third of the principal economic indicators and 70 percent of other statistical reports. Recent steps include guidelines for striking a balance between the accuracy and timeliness of the principal economic indicators and the most comprehensive revision of the Standard Industrial Classification Manual since 1957.

Among the most important measures to improve Government statistics is the establishment of rules to safeguard credibility. In order to prevent the timing of data releases from becoming controversial, advance target dates for releasing about 120 principal indicators have been published for the past 2 years. To separate statistical reports from policy-oriented commentary, OMB now requires a 1-hour separation between the issuance of data by statistical agencies in a written press release and the release of commentary by administration officials.

CONCLUSION

Let me close by coming back to where we started. The budgets for 1972 and 1973 represent a strong commitment to expand the economy, to create more jobs, and to deal effectively with the unemployment problem. At the same time, we must continue to focus on both budget totals for fiscal year 1973 and the long-run implications of fiscal year 1973 budget decisions.

We must maintain control over the rise in Federal outlays. We know that out-of-control outlays help produce inflation, we know how difficult it is to slow down inflation once it starts accelerating, and we know the pains that accompany such an effort. We must keep the momentum of Federal expenditures from carrying them again beyond the revenues produced by the tax system at full employment. The increase in uncommitted resources between now and 1977 will be very small in comparison with the magnitude of the tasks that lie ahead. For this reason, the severe standard that I referred to earlier is inescapable. Whenever a new program is proposed, that program must be important enough to warrant taking something else out of the budget, or important enough to warrant a tax increase. I am confident that we can depend upon this committee's support in holding to this standard.

It seems to me that it is difficult to keep simultaneously before us what we are doing to parts of the budget and what the parts amount to, speaking of the budget as a whole.

From the standpoint of macroeconomic policy, the budget as a whole is especially important. And yet, both in the executive branch and in the Congress, we have a process in which we tend to specialize to such a degree that it is very difficult to keep the total before us as we go along.

It is now particularly important that we keep budget totals in perspective because as we look forward, say, for 5 years, at the balance of our revenues and outlays as one would project them in full employment, we see a very tight situation.

For procedural reasons and because of the tightness of the fiscal situation, the President has proposed an absolute ceiling on outlays, and has proposed that this action be taken early in the session, preferably before any appropriations are enacted.

I hope that this committee would have a particular interest in the President's proposal. Whether you think that the proposed outlay total of around $246 billion on a unified budget basis is the right number, some number of that approximate size should be used to express the outlay aspect of fiscal policy, given the tax system that we have in effect and the lack of any real prospects of changing that system during this session of the Congress.

This seems to me to be something especially relevant to the considerations of this committee.

As you know, we have provided specific language to the Appropriations Committees of both the House and the Senate. I believe a measure has been introduced in the Senate.

Chairman PROXMIRE. Yes, and I am cosponsoring that.

Mr. SHULTZ. I am very pleased to know that, Mr. Chairman.

Let me say also that insofar as Federal statistics are concerned, and I know you have a Subcommittee on Federal Statistics, we hope you might take a special interest in this subject. We work hard on the statistical budget. I know this committee, as a user of Federal statistics, shares our concern that the statistics we have be as good as possible.

We have made great efforts in this administration to improve the quality of Federal statistics, and we continue to.

There is, in the special analysis volume of the budget—Special Analysis F, beginning on page 87—a 10-page summary of what we are doing.

I won't attempt to go into that in any detail. I want only to highlight this problem and to suggest that if you look at table 1 in my statement that compares recent revisions in the GNP estimates, you see how really greatly we need improvement.

If we look at the gross national product figures, which are very important for us in our continuous review of what is happening to the economy. Let us take the percent change in constant dollars, or the real increase in GNP, as key indicators. In the second quarter, the first estimate had that increase at 3.6 percent, below what we would need to cut into unemployment. The next estimate had it at 4.0 percent. Well, that looked a little bit better. By the time September came around the estimate was up to 4.8 percent. That made us think that perhaps we were really getting somewhere. Then when, as a result of efforts to improve the quality of the statistics, we had a much better series on retail trade than we had had before, the next estimate, which is our most recent one, put us back down to 3.4 percent. The difference between 4.8 and 3.4 is gigantic. It portrays a totally different kind of economy.

I call your attention to that just by way of saying why it is so important to call attention to this problem and to improve the quality of the statistics we have and their timeliness.

With that, Mr. Chairman, I will stop; I will try to answer any questions you may have.

Chairman PROXMIRE. I agree with you wholeheartedly, that we should invest more resources in statistics. It is a very, very small investment, considering the enormous effects of having sound and accurate statistics when we can get them.

Did you say that there is no prospect of changing taxes in this year? You are saying, for instance, that the administration would not propose and wouldn't expect if they did propose that Congress would act on a value added tax, for example, this year?

Mr. SHULTZ. The administration has no intention of proposing a value added tax or any other kind of major tax proposal that would apply to the fiscal 1973 budget.

Chairman PROXMIRE. So you would expect in this session of Congress there would be no significant change in the tax laws that would affect revenue by several billion dollars?

Mr. SHULTZ. That is right, nothing that would affect the fiscal 1973 budget that I know of at this point.

Chairman PROXMIRE. That is very interesting to know. I hadn't heard that stated by a high official of the administration before.

Your reference to statistics I think is a good take-off point here because you concede, I take it, that there will be a very heavy stimulus for the economy in the first half of this year, and then we move to a point in the second half where the stimulus will be much less, dramatically less, is that correct?

Mr. SHULTZ. Well, there is a continued very heavy projected Federal outlay. The deficit will shrink, and that is largely because we expect revenues will rise as the economy expands. If the economy doesn't expand, then the revenues won't rise and the deficit will be larger than we anticipate.

But we have tried to make a realistic appraisal of the situation. We do see the deficit narrowing, but it is still a very large deficit in fiscal 1973.

Chairman PROXMIRE. The full-employment deficit, isn't that more expansionary in the first half of the year than the second half of the year?

Mr. SHULTZ. Yes.

Chairman PROXMIRE. That means regardless of what happens to the economy, that you get more stimulus in the first 6 months of 1972 than you get in the last 6 months, is that right?

Mr. SHULTZ. A little bit. I wouldn't say there is a tremendous difference.

Chairman PROXMIRE. You have indicated in your discussion of the statistics that estimates have been way off in the past. They may continue to be way off. The estimate by the administration last year on the size of the Gross National Product was way off. It was $1,065 billion and the generality was around $1,065 billion. If you made that kind of mistake again this year, it would suggest that in the second half of the year we may be having far too little stimulus and in 1973 we may be programing a recession.

Mr. SHULTZ. I think the difference between our original GNP estimate and the GNP as it turns out has not been understood well. First let me say that our estimate was clearly too high. I am not arguing that it wasn't. However, there were significant revisions in the statistics on Gross National Product amounting to almost $3 billion which revised 1970 down. Thus, the base from which you were going was moved down by about $3 billion. So if what we are talking about is estimating the increase, which is what we are talking about, then you have to subtract $3 billion from all of the various estimates in order to have them comparable to the figures that we are using.

In addition, the elimination of the automobile excise tax reduced the 1971 increase in GNP by nearly $1½ billion from what was expected a year ago.

The comparability, in other words, of the figures we were using and on which the $1,065 billion estimate was based, with the present one, is a question. One could justify subtracting from the $1,065 billion something on the order of $4 billion to $5 billion in order to have it comparable.

So there was an overly optimistic projection and goal, but it wasn't as wide a miss as has been widely interpreted. In any case, the forecasting error made in 1971 (1.5 percentage points) is smaller than that made by the CEA in the forecasts made for 1966 (1.7 percentage points) and 1962 (2.7 percentage points).

Chairman PROXMIRE. We can calculate from the various submitted reports the half-year figure for the various goods and services. Such calculations suggest that Federal purchases in fiscal year 1973 will be no higher than the rate of spending in the first half of this calendar year. That means beginning on July 1, it will be no higher. Prices will, however, average higher in fiscal 1973.

Doesn't this mean that the Federal Government will be exerting a downward pressure on total gross national product in fiscal 1973, or am I missing something?

Mr. SHULTZ. That is if you take Federal purchases as the sole and only Federal role. I recognize that many people feel that that is the dominent series. But there are other things going on as well, particularly in the transfer payment area.

Chairman PROXMIRE. Take the monetary effect. That is one of the other principal influences. You used to be or had a reputation as a monetarist. I don't know whether that is fair or not, but you certainly felt that the monetary policy had a profound effect on the economy.

Mr. SHULTZ. I did, and do.

Chairman PROXMIRE. A well-known model produced by the Federal Reserve Bank of St. Louis produced a pessimistic forecast for this year. That is because of the slow growth of the money supply in the second half of last year. They say if the money supply grows at a 9 percent rate this year, this model predicts a real GNP growth of less than 3.5 percent in the first half of this year.

Do you share that pessimistic outlook? If not, why not?

Mr. SHULTZ. I think the slow growth of the money supply, particularly in the last three months of the year, is something to worry about and to be concerned about. I think there is a real problem in interpreting monetary developments because the behavior of the money supply was so erratic during 1971 that it almost went outside the bounds of historical experience.

Under such circumstances, it is a little hard to use past experience to see what the future may bring. It is argued that a more rapid expansion in the first half of the year is somewhat compensated for in the latter half of the year. If that is the case, we may not get the kind of slowdown what a straight application would suggest.

But I would agree that the very slow growth in the money supply is something to give one pause.

Chairman PROXMIRE. Here we have a slow growth in the money supply. We have the other factor which you agreed was important. Federal purchases, the effect of that on the economy. It would seem to me that those would be two of the most important or the two most important elements of Federal policy influencing the economy, neither of which are expansive. We have 6 percent unemployement and have had it for the last 13 or 14 months.

Under these circumstances, how can we have an optimistic outlook on getting employment down to the administration's 5 percent goal?

Mr. SHULTZ. First of all, we must have some faith in the Federal reserve system and confidence that the money supply will increase, and, indeed, I think the figures, as we now look at them, suggest that that is going on.

So I would hope that we will have a monetary policy that is consistent with a strong and health expansion of the economy. Mr. Burns has made statements on the record along those lines a number of times in the past month or so.

Chairman PROXMIRE. There is a lag of 12 months or 18 months and perhaps some people think it is even longer before an increase in the money supply can have an effect out in the future.

The slowdown in the money supply over the last 7 or 8 or 9 months is likely to have an adverse effect in the coming year. Mr Burns will be here tomorrow.

Mr. SHULTZ. I think he is the appropriate person to quiz about the money supply. I think the question of the length of the lag is certainly an open one. I know of no evidence that would suggest that there is a 2-year lag between changes in the money supply and changes in real gross national product. If you are interested in the relationship between the money supply and the rate of increase in the consumer price index or something of that kind, then, obviously, that is another link down the line.

Chairman PROXMIRE. Mr. Moorhead just arrived, so I will yield to Senator Bensten.

Senator BENTSEN. Thank you, Mr. Chairman.

Mr. Shultz, I am particularly interested in one phase of the budget operations. You have had approximately $31 billion increasing in this fiscal year. I would assume this is Federal stimulation. I understand fiscal 1973 will be even greater.

Would you give me your analysis of such activities on total spending on the credit markets and on the interest rates? I am speaking particularly now of Federal activities in the credit and loan markets where we have seen that kind of an increase.

Mr. SHULTZ. I can't give you off the top of my head a detailed analysis of that. If I could, I would like to put a careful statement into the record.

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

The $31 billion to which Senator Bentsen referred is the expected increase in Federal and federally-assisted credit in fiscal year 1972. The question appears, therefore, to pertain to Federal and federally-assisted lending activities. These activities are discussed in Special Analysis E, a copy of which is attached.

Without any doubt, these credit programs are providing stimulus that is resulting in increased real output now. In general, they provide stimulus to the extent that they lead to the utilization of financial resources that would otherwise be idle, and to the extent this use of funds results (directly or indirectly) in new production rather than the acquisition of existing assets. In the context of today's conditions in both the economy generally and the credit markets, there clearly is net economic stimulus from these programs. If the economy were operating at full employment or if tight money conditions existed, the effect of these credit programs might be to generate pressures on price, interest rates, or both, rather than to stimulate real output.

As these observations imply, the Senator's question is a complex one that raises a number of others. More specifically:

(1) How many of these loans would have been made anyway, were it not for Federal assistance?

(2) How many of the borrowers under these programs displaced other potential borrowers from the market place.

(3) How many of these loans are for the purchase of existing assets rather than for new construction or production?

(4) How many purchases of existing assets indirectly facilitated demand for new production by the seller?

(5) To the extent that real stimulation could be identified, how much secondary stimulation is generated?

Senator Bentsen asked specifically for an analysis of these credit programs' on spending, the credit markets, and interest rates in fiscal years 1972 and 1973.

With respect to the impact of these credit activities on total spending, some direct costs are reflected in the current budget. There are also impacts on future budgets—from both long-term subsidy contracts, and from costs of administration and losses on guarantee programs. We do not have specific estimates of any of these cost factors, though Table E–4 in the special analyses volume of the budget provides illustrative present value estimates of future subsidies for guaranteed loan commitments. For commitments made in fiscal years 1971, 1972, and 1973, these are $3.3 billion, $5.4 billion, and $5.5 billion.

As to the impact on credit markets, this is best viewed from the borrowing rather than the lending side, and should be combined with direct Federal borrowing. Table C–9 (attached) in the special analyses volume provides totals of this type, and an accompanying chart (attached) shows this is historical perspective. A second chart (attached) shows this same data in the perspective of total flow of funds.

During the 1960's, Federal and federally-assisted demands on the credit markets averaged about 18% of the total funds raised in the credit markets. This share rose to 23% in 1970, to 27% in 1971 and is expected to be within a range of 35 to 50% in 1972 and 1973. But in dollar amounts, the flow of funds to the credit markets in 1972 and 1973 is expected to be adequate to accommodate the funds to be raised by non-Federal borrowers as well.

So long as financial savings flows remain high, and monetary policy remains accommodating these demands for credit will be met.

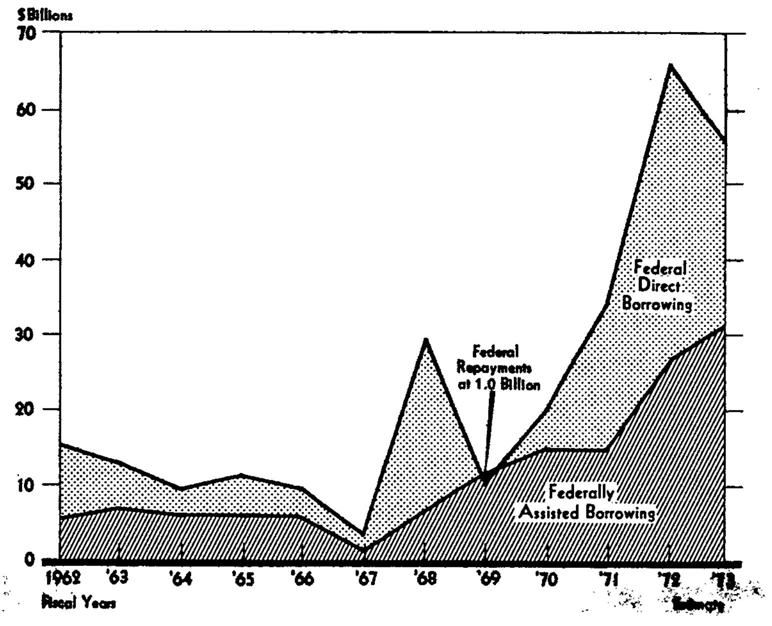
Under these conditions, we expect little appreciable impact on interest rates. And with the economy operating below the full-employment level, we also expect no appreciable impact on prices.

Table C-9. **NET BORROWING FROM THE PUBLIC BY GOVERNMENT, GOVERNMENT-SPONSORED ENTERPRISES, AND GOVERNMENT-GUARANTEED BORROWERS** (in billions of dollars)

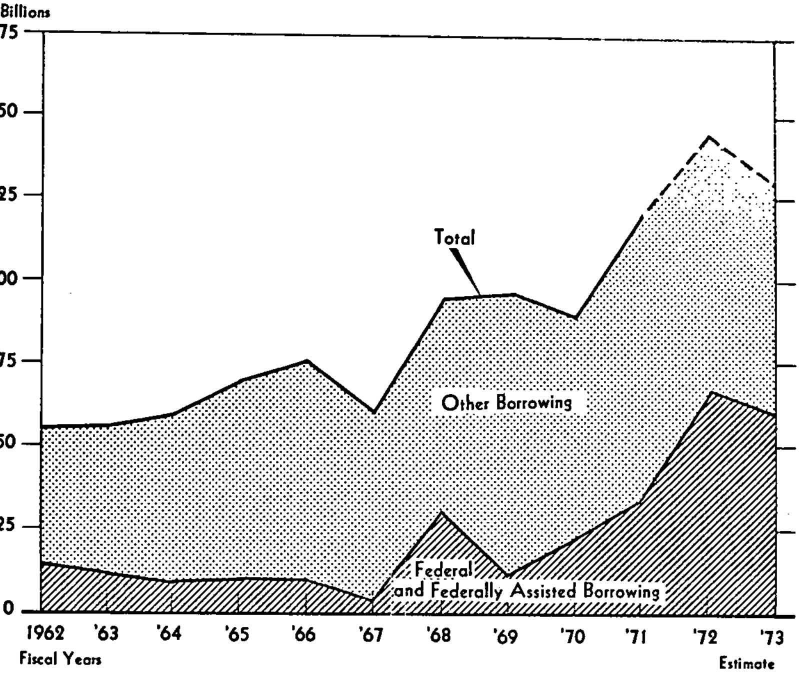
Description	Borrowing or repayment (−) 1971 actual	1972 estimate	1973 estimate	Debt outstanding end 1973 estimate
Federal borrowing from the public [1]	19.4	39.5	27.5	371.3
Borrowing by Government-sponsored enterprises [2]	1.5	8.6	9.2	55.1
Less increase in holding of Federal debt	−.7	.2	*	−3.8
Plus repayment of debt of Government-sponsored enterprises held in Government accounts	.1			
Net Government-sponsored borrowing from public	.9	8.8	9.2	51.3
Government-guaranteed borrowing by non-Federal borrowers [3]	16.1	23.3	25.9	189.4
Less borrowing from Government or Government-sponsored enterprises:				
Federal National Mortgage Association	2.2	4.9	4.4	24.9
Government National Mortgage Association	.3	−.1	−.6	4.4
Federal Home Loan Mortgage Corporation	.5	.5	.4	1.4
Export-Import Bank	−.1	−.1	−.1	.1
Net Government-guaranteed borrowing from public by non-Federal borrowers	13.3	18.1	21.8	158.6
Total, Federal and federally assisted borrowing from the public	**33.7**	**66.5**	**58.5**	**581.3**

*Less than $50 million. [1] See table C-1. [2] See table C-8. [3] See table E-3.

Federal and Federally Assisted Borrowing



Total Funds Raised in the Credit Markets



Mr. SHULTZ. Let me just say that clearly that is a method of stimulation, and it is certainly a Federal activity and a Federal impact on the economy. We do have in Special Analysis E an analysis of Federal credit programs, beginning on page 69 of the Special Analyses volume, which describes what has been going on. Perhaps that is what you were referring to.

Senator BENTSEN. Is the emphasis more on the long-term rates than short-term in this kind of activity? Would it affect long-term rates more than it might affect short-term rates?

Mr. SHULTZ. I am hesitant to sally into that. I don't feel competent to address that question now.

Senator BENTSEN. It is of concern to us, of course, as we have seen the drop in short-term rates but we have seen quite a lag in long-term rates, in the decrease of them. As a comment on what the chairman was speaking of a moment ago, the reports I get from the banks is that they are pretty well awash with money these days. The problem is to try to find places for loans, requests for loans.

Mr. SHULTZ. If your question is about interest rates in general as distinct from tracing through connections of Federal credit programs and interest rates, then let me comment on that broader question.

I think it is likely that long-term rates will come down. and I believe the principal reason is the prospects of success and continued success in the fight against inflation.

It seems to me that built into the long-term rates has been fairly substantial inflation premium. As we develop a situation where people have more and more confidence that the inflation problem is being brought under control, and we do have a balanced program to achieve this, I would expect that long-term rates would come down as they have.

As far as the question of credit institutions being awash with money is concerned—

Senator BENTSEN. I am referring to banks.

Mr. SHULTZ. I hear that statement frequently, but it seems to me that is what we are looking for—in order to get them to change their behavior and get money out working. The rate of change in the money supply affects economic activity. You say to the banks:

> You have this money, you want to get it out on loan. Instead of waiting around for people to come in as you have been accustomed to in the tight money era, get out, and get off your duff, drum up customers, cut your prices, cut your interest rates.

They don't like to cut their interest rates but the situation tends to force them to do that, and interest rates have been coming down.

Senator BENTSEN. I will not argue that at all. I find a concurrence with that. My concern is that you haven't seen the response from the business community in the application for loans for economic projects and capital investment, even though that short term money is available.

As to your other comment, I might differ somewhat with it when you tell me—and I well understand the argument—that the inflation factor is built into long term rates. But institutions, such as life insurance companies, such as savings and loan companies, have very narrow parameter within which they can invest their funds. They have very limited access to equity markets because of the investment laws under which they operate.

So they have to get their money out. I have yet to understand why, in the competition you have today, you don't see these long-term rates coming down when really they have to go to mortgages and they have to go to bonds. They don't have the freedom to go to stocks to any large percentage of their investments.

I think that competition should be bringing them down and yet it has not. I don't understand why. I don't accept that it is just the inflation factor.

Mr. SHULTZ. The fact is that they have been coming down. We would like to see them come down further. I think the sorts of things that you have been outlining are, in a sense, the reason why it is likely that they will come down.

Senator BENTSEN. I don't understand why they have not come down substantially more than they have.

Mr. SHULTZ. I would think that mortgage rates might fall a little further, but at any rate, the movement is in the right direction.

Senator BENTSEN. For the savings and those types of institutions?

Mr. SHULTZ. Yes.

Senator BENTSEN. The budget calls for a $1,150,000 program to conduct a weekly survey on unemployment. I understand that the refinement of the overall employment rate is desirable, particularly with unlimited funds available, but we don't. It seems to me a higher priority is to try to define the unemployment rates from States, that you don't have the appropriate correlation between the Federal Government and the States, but you have disparity in the standards utilized by the various States.

I wonder if that money couldn't have been better spent in that regard, rather than getting it down to a weekly basis on the Federal level. So much of our funds today from the Federal Government are allocated to States based on their particular problems on unemployment.

Mr. SHULTZ. I think that the provision of greater reliability of estimates for geographic areas, States and metropolitan areas, is desirable across the board in statistical programs.

We have pushed at that in various respects. In terms of the employment and unemployment estimates, the problem that we were addressing was not that of having estimates available once a month, but, rather, improving the reliability of the estimate and getting away from all sorts of somewhat random or chance factors that affect our employment and unemployment estimates, which are now based on a single week in each month. That is, if we have a reference week that happens to contain a serious strike, or unusually bad weather, or a holiday that does not fall in the same week each year, then we never know whether or not the estimate was correct or comparable with the previous year's estimate or the previous month's or the one succeeding one.

If the reference week comes early in a month that has a known change in labor force activity—as happened last year in early summer—you get a reading that you don't know quite what to make of.

So by taking our readings more frequently we tend to get away from that kind of problem. We felt that it would add to reliability of the estimates for employment and unemployment. I don't argue that greater geographical detail is not also desirable, but just that since we attach so much significance to the overall state of employment and unemployment, it is very important to make those estimates as reliable and understandable as we can.

Senator BENTSEN. I have no further questions.

Thank you.

Chairman PROXMIRE. Mr. Moorhead.

Representative MOORHEAD. Thank you, Mr. Chairman.

Mr. Schultz, the increase in the budget of this year for the Department of Defense is $6.3 billion over the previous year, is that correct?

Mr. SHULTZ. That is the increase in budget authority, not outlays.

Representative MOORHEAD. Is that distinction you just made the reason why, even though the budget calls for a $6 billion increase, you don't expect an increase and only a slight decrease in defense-related employment?

Mr. SHULTZ. That is correct. Outlays are more closely correlated with employment in defense-related industries, whereas budget authority gives a better index, so to speak, of what the outlays are likely to be 2 or 3 years from now. With budget authority we are essentially starting things that are going to take a while to unfold.

Representative MOORHEAD. Can we expect, then, because of the $6.3 billion increase in the budget this year, that in future years there will be a rise in defense-related employment?

Mr. SHULTZ. Some rise I would say, yes, but not anything like a huge surge. Some rise. I think the big point about defense-related employment is—and this is why I have some optimism about our ability to cut into unemployment that over the years since 1968, we have been carrying in the economy a very large drawdown year after year in defense-related employment.

Our estimates are that the decline in defense-related employment amounts to over 2½ million from 1968 to date. We now see that drawdown as leveling off.

It is also the case that practically at the same time there was a drawdown in outlays and employment as a result of the phasing out of procurement by NASA connected with the Apollo program. When all of that hardware was procured, there were very high expenditures; when that procurement declined, the expenditure level came down. NASA spending has come down by about $1½ billion since 1968. In many ways, the geographic areas and many of the occupational skills involved are the same as in the defense-related civilian employment.

So we have had those two problems to contend with over the last 3 years or so. Basically, we think those problems are behind us and we don't have to make up for them now in our general civilian economic picture.

Representative MOORHEAD. Therefore, you are saying to us that the $6.3 billion increase is not the administration's answer to this technological unemployment that has occurred as a result of past decreases in space and defense expenditures?

Mr. SHULTZ. It seems to me that when you are talking about something like defense spending, or for that matter, about any spending, that it needs to stand on its own feet. It needs to be justified before the appropriations process in the Congress in terms of its contribution to the defense of the country. That is the way it is positioned in the President's mind and in the President's budget.

Representative MOORHEAD. Mr. Schultz, what is your position on whether or not we should try to increase revenues by tax reform procedures, closing loopholes and the rest? Would you be in favor of increasing revenues by that route, or would you oppose it?

Mr. SHULTZ. My feeling is that we should have a moratorium, so to speak, on a discussion of increasing revenues by increasing tax rates. We should concentrate on holding down outlays. The outlays of the Federal Government are gigantic. Everybody has the idea somehow or other we just aren't spending any money.

In our fiscal 1973 budget, we are projecting outlays of $246 billion. The tax system—including proposed legislation that is now before the Congress—will generate another $100 billion per year by fiscal year 1977. That is a lot of money. Before we start figuring out how we can get more money into Washington and figuring out how to spend it, it seems to me we ought to concentrate on making the money that we have, count.

This is the very strong reason behind the President's call for a ceiling on outlays and for saying, "Let's concentrate on that side of the coin first and do the best job we can."

Representative MOORHEAD. I think you very skillfully turned my question a little bit. You said we shouldn't think about increasing revenues by changing tax rates. I said by tax reform, closing loopholes.

Does your answer that you don't want any more revenue also apply specifically to the question I asked?

Mr. SHULTZ. I think it is always a great idea to have reform and to close loopholes and to do all these things that are right and just. The question is whose loophole and whose reform are you talking about. As soon as you put the question of tax reform into the political process, it turns out to be a most contentious and difficult issue.

Generally speaking, what happens is not so much reform as reduction. That is what happened in 1969. It is good to be for reform, and maybe we should have a general change in the whole income tax picture. Joseph Pechman's study showed if we took out all the loopholes, exemptions, and so forth, we could change Federal income tax rates by a very large sum, and that is fine. But I think it is hard to imagine that that actually would take place.

Representative Moorhead. So your objections to this proposal are more the political difficulties rather than what the economic well-being of the country would be, is that correct?

Mr. Shultz. I think there are two different questions involved. One is do we need more revenue? Do we have to find some way to increase tax rates? My contention is that we are spending an awful lot of money. We do have a very large amount generated by the tax system that we have. Let us concentrate on using that money wisely and not try to raise more money.

Secondly, within any tax system I think there is always a fair question, and something to be studied and investigated, of how to make the tax system more equitable, how to make it more consistent with the kind of economic and social objectives the society may have. But it is my observation over the years that this is a very hard topic to work on.

Representative Moorhead. The proposal of the limit on spending, is that proposal the same as the total spending in the budget that you have submitted?

Mr. Shultz. The number in the expenditure control legislation proposed by the President is his proposed budget level of $246.3 billion on a unified basis for fiscal year 1973.

Representative Moorhead. Thank you, Mr. Chairman.

Chairman Proxmire. Senator Percy.

Senator Percy. Mr. Shultz, before commenting on your statement, I wonder if you would care to comment on the present dock strike and the sense of urgency that the administration feels about Congress acting and acting today on this situation. We have a Senate bill which was voted out of committee today and it will be on the floor today. It follows very closely the administration proposal.

In the House version, the Rules Committee is considering a somewhat different bill. I think the impact of the strike on the economy will be very big. Last year we lost $750 billion in agricultural exports alone which hurt our balance of payments badly.

If this dock strike continues it seems to me it is going to throw our economic health into a tailspin. Would you care to comment on the sense of urgency the President feels about this matter?

Mr. Shultz. I welcome the opportunity, Senator Percy, because I feel it is a very important matter to get settled. The negotiations have gone on and on and on. We have felt for months that it was on the verge of a settlement, but a settlement never seems to come. It would be nice if the parties did settle.

However, it seems to me that the uncertainty at this time ought to end. The only way to end it is to provide a solution, that is, something that has a sense of closure in it. The administration's proposal has that. The bill that the Senate Labor Committee reported out last night has that. We would prefer our bill, but they are very close. We have no objections to the Senate labor bill. We think it is extremely important that before you gentlemen go on vacation, you act and end this strike. It has hurt the farmer, it is hurting the farmer, and it will continue to hurt the farmers—not only in terms of the current situation, but in terms of the long-term outlook for sales of agricultural products as well. The uncertainties that recipient countries feel about getting our product tend to turn them to other countries and other matters.

So we are not only hurting ourselves in the short-term but hurting ourselves in the long term.This is not a matter of being trigger happy and overly nervous about strikes. They have had a 100-day strike. They had an 80-day Taft-Hartley. The had about a month additional time by agreement of the parties. Now they have been on strike again for another couple of weeks. The strike has just gone on and on and on, and I think the time has come to put an end to it.

Senator Percy. I am glad to have this reaffirmation. I trust the Congress will act today. I don't think any of us should put anything ahead of this emergency. Illinois is the largest exporting State so far as agricultural products are concerned. We know that we not only have lost export sales now, but some of them will be lost forever. Countries will not tolerate this condition of undependable suppliers. They will turn to other markets. There are spoiled crops. It is a horrible condition.

I hate to see the Government have to intervene and certainly none of us would want Government arbitralily or capriciously to move into the arbitration process. But at this stage the cost to the economy and the public is so great that we must act.

Mr. Shultz. Could I make one further comment, Senator Percy?

This situation highlights again the importance of the Congress coming to grips with this problem on a more general basis rather than as each crisis comes along and forces you to act in an ad hoc manner. We feel that it is high time to take up the subject of emergency disputes in transportation on a more general basis. The President has had a proposal before you for 2 years, and there has been no action.

There have been hearings in each House, but no bills reported out. No real push.

What does it take to show you that there is a real problem here, and one that you somehow must face up to? We have made a proposal. We think it is a pretty good one. But we don't say it is the last word. Let's have hearings. Let's hear what people have to say. Let's do something.

Senator Percy. It certainly provides the basis for finding longer term solutions. I sense a move now to want to act. I think the unanimous report of the committee on this emergency bill by the Labor Committee is evidence of that and I think the Senate will want to act on it quickly.

Mr. Shultz, you have been Chairman of the National Commission on Productivity. I understand the Commission did have a meeting last Wednesday with 30 out of 32 members present.

Could you tell us what the Commission's program will be? What elements of the productivity problem will it concentrate on?

Mr. Shultz. The Commission has been in existence for about 20 months, so it has developed a fair amount of work. Some of that will be ongoing and some new things will be undertaken.

At the first meeting of the Commission, a series of working groups were formed, one working on education, research, and development; another working on collective bargaining arrangements, labor-management arrangements, as they may affect productivity; another working on management organization and capital requirements; a fourth working on productivity in Government.

As a result of the efforts of those working groups, and a number of discussions with the President, I think the Commission was instrumental in really pointing up for the President the importance of research and development as an aspect of productivity work. It played an important role in the R. & D. initiatives that you see reflected in the budget that is now before you. We expect that that interest will continue.

We think that the exercise of going through the Government's R. & D. processes and their relationship to the private sector has been instructive to those of us in the executive branch, both in terms of content but also in terms of processes and the need to improve our processes.

So we are, I think, hoping the Productivity Commission will continue to take interest in that. I am sure it will.

The area of productivity in State, local and Federal Government activities has been identified by the Commission as a very important one, and our interest will continue very strong in that area. There are major studies underway in the Federal Government, interestingly enough, jointly by the Office of Management and Budget, the GAO, and the Civil Service Commission.

We think that those studies are fruitful. We have work being done by the Urban Institute on State and Local Productivity. As you noticed, the President added to the Productivity Commission about 6 months ago a Governor and a mayor because we felt that we were sitting around talking about State and local government productivity but didn't have any representatives there from those groups. So they have been added and have been helpful.

We in the Commission will be developing a work program. We haven't moved very far on this yet, but it is something we are moving into—the relationship of efforts to improve the environment and productivity.

There are all sorts of angles to this. There is the consideration of the effectiveness and efficiency with which we go about the process of improving the environment. There is the question of the impact of environmental measures on output per man-hour.

There are a host of questions having to do with the measurement of the results of our efforts to improve the environment; for example, if we spend a lot of money to clean up the air, have we produced anything? How should we count this activity? It should be counted, but it is very difficult to count. We are trying to work on these aspects of the productivity problem. There is a fairly extensive work program.

I think your legislation specifies that there be an annual report due by March 1 to the Congress. I suppose we could interpret that as meaning March 1, 1973, but we are choosing to say that we should make one right away. So we have a draft report in being and hope to have a full statement about the work of the Commission in your hands before the end of this month that will review what has been done and also will talk about the future work program.

Senator PERCY. In your judgment, did the 5,000 or so productivity councils that we had in World War II truly help in our national goal and objective of increasing our productivity at that time? Are we doing enough to get more councils of that same type started again now as authorized by legislation?

Mr. SHULTZ. I think they helped. They helped more in some cases than others. We had a parallel experience in Britain to look at. The councils do the most when they develop as a result of the desires of the parties themselves. They are less successful when they develop as a result of pressure from the Federal Government saying, "Well, you ought to do this, or if you want to get a wage increase, the way to justify it is to figure out some productivity gimmick of some sort for justification."

But where the general tenor and climate is such as to get people thinking about productivity, I think that getting things down into the local area can be very productive. We, as a Commission, have been working with and helping to stimulate, and hoping to learn from efforts in the steel industry, which were described at our last meeting. In this case, they are trying to get right down to the plants and work on productivity, with a very interesting effort. We also have a small group working in the construction industry field who seem to feel that that is a potentially productive area.

Senator PERCY. Thank you very much.

Chairman PROXMIRE. Congressman Reuss.

Representative REUSS. Thank you, Mr. Chairman.

Mr. Shultz, a prominent Democratic critic has made some charges about the good faith of those who increased the budget. He accuses the administration budget-makers of gimmickry and legerdemain in coming up with a huge $39 billion deficit for this current fiscal 1972, and then that goes down to a $25 billion deficit in fiscal 1973.

He points out that in order to get the deficit so big in 1972 and so small in 1973, general revenue sharing was included in 1972 retroactive to January 1; that an extra month's payment of grants in aid to State and local governments was included, and that there was manipulation of asset sales, revenues and expenditures to bring more spending into 1972 and vice versa in 1973.

He suggests that the reason for this is that by projecting a $39 billion deficit, now and then having it turn out to be some billions less, when they count up the final numbers next summer Mr. Nixon could claim credit for shrinking a projected deficit.

An alternative explanation he offers is Mr. Nixon may feel that a sizeable decline in the deficit between this year and next, $39 billion as opposed to $25 billion, would be a better pattern to take to the voters next fall.

My question to you is: Say it ain't so, Mr. Shultz. Is there any truth to this charge whatsoever?

Mr. SHULTZ. What is so is that the imaginations of our opponents are apparently limitless and they dream up all sorts of things.

The budget is quite straightforward and it is quite explicit. All the things in it are laid out very clearly for anyone to see. There is no trickery, legerdemain.

Let me just take the things that you mentioned.

First of all, I find it interesting and somewhat alarming that you characterize the $25.5 billion deficit as small. It was not very long ago when that was thought of as a fairly substantial deficit.

Representative REUSS. This was the critic's characterization, not mine.

Mr. SHULTZ. We would like to see it smaller than that. But at the same time, we would like to see it responsive to the same objectives that the chairman mentioned at the beginning, of wanting to see the economy expand, of accepting the fact that while large deficits of this kind may be better medicine, they are, nevertheless, medicine and will help the economy to expand. We can handle it all right as long as we don't take it in such a manner that it becomes addictive and we can't withdraw from it. So we think it is very important to get the withdrawal process into the picture.

As far as the particulars are concerned, the inclusion of revenue sharing effective January 1, there is nothing new about that proposal. The President first proposed revenue sharing in August of 1969. He feels, and I must say I certainly share in his view very strongly, that the fiscal problems of the States and the cities are great and that the malaise that you see in the country resulting from the tendency to pull everything in here to Washington and specify spending patterns in great categorical detail, has led to a failure of government in many instances. He feels that it is very important to return power to people, to return pieces of the action to the States and the localities.

So he has been advocating revenue sharing from very early in his administration. It was proposed on a broader scale in last year's budget. He recognized the reality of congressional inaction in his August 15 statement and moved the proposed effective date from October 1 to January 1, but has left it there.

Somebody may say, "Well, we are overestimating the outlays by $2.2 billion because revenue sharing is in there." Well, it is in there as part of the President's program. I suppose if it wasn't in there he would say, "Well, the President has lost interest in revenue sharing," and say that that was tricky. But it is very straightforward. It is in there. He wants it. It can be enacted if Congress will go ahead with it.

As far as the movement of welfare, a 4-week payment of welfare, that is something within the discretion of the administration to do and that is very direct. There is nothing tricky or hidden about it.

Our idea is that the States and cities are having their difficulties, fiscally, and this is something we can do that will help. Goodness knows, the mayors have been in here enough talking about their problem. It is something we can do that will help. It has little economic policy significance; it is, to some extent, a matter of bookkeeping. But it will help the States and cities in managing their fiscal affairs, so why not do it? We are doing it.

I fail to see what is so tricky about that.

Representative REUSS. An excellent answer. I have just one other question prompted by our colloquy with Mr. Moorhead about loophole-plugging tax reform on which you show, I guess, the same lack of enthusiasm that so many in the administration do.

Let me ask you this: If it were mandated to President Nixon that he had to come up here to the Congress in joint session on or before April 1, 1972, with a comprehensive and meaningful program for closing these preferences and loopholes in the tax system, and that if he didn't do that Congress intended to vote down the increase in the debt ceiling which would be necessary to have as of this June, under such circumstances the chances are good that Mr. Nixon would comply with the congressional mandate, are they not?

Mr. SHULTZ. Mr. Reuss, we have lots to do in the executive branch and the President has a full-time job. He is trying to do it as best he can. There are lots of people in the U.S. Senate, particularly, who think they can do it better. So be it. They are running for office to see whether they can have the job of discharging those duties. The Congress as lots to do, lots on its plate.

I say let the Congress do its work and let the President do his work. But let the Congress stop trying to tell the President how to do his job, whether it is on the question of ordering him to put forward tax proposals, whether it is on the question of trying to second-guess him constantly in his conduct of negotiations, or anything else. Let Congress do its job and the executive do its job.

Representative REUSS. Suppose, however, Congress disregards your political science preference, and does tell the President that part of doing his job is to come up here by April 1 with an honest-to-goodness, sincere, breaking-with-the-past tax reform proposal, and that if he doesn't do it then Congress proposes to deny him the increase in the public debt which is necessitated, in part at least, because of his failure to propose a revenue-raising, loophole-plugging program?

Under such circumstances, would the President comply with the directive of Congress, even though we can stipulate that this would be a case of Congressmen messing around with the President's business?

Mr. SHULTZ. The increase in the public debt is a result of the interplay of the tax changes, the economic conditions that have developed, and the policies that the President has followed and Congress has followed in addressing ourselves to the economic needs of the Nation.

There wasn't any mystery about the fact that when the President proposed and the Congress enacted tax changes in the latter part of last year that that was going to add to the deficit. And when you add to the deficit, that is going to mean an increase in the national debt. Everybody sees that process. The national debt is the end of the line. I think it is really not conceivable that Congress wouldn't raise the debt ceiling. That is a separate issue entirely from the issue of tax reform.

Representative REUSS. Do I interpret from what you said that as of now, as of this morning, at least, you aren't prepared to say whether the President would follow such an April 1 mandate or not, or are you sure he wouldn't?

Mr. SHULTZ. The question of taxes is something that is basically handled by the Treasury Department. They are continuously studying various possible tax rearrangements.

I imagine you have Secretary Connally scheduled as a witness before this committee and I would suggest you put your question to him about just what the Treasury is studying so far as tax reforms are concerned.

Representative REUSS. I will tell Secretary Connally that you suggested I ask him.

Chairman PROXMIRE. Secretary Connally will be before the committee on Wednesday, February 16.

Mr. Conable.

Representative CONABLE. Mr. Shultz, I am sure you are as pleased as I am to learn how significant the President's recommendations are in the deliberations of the Ways and Means Committee. I am certain that this suggestion of the majority party concerning tax reform will be considered in the Ways and Means Committee, as well as the other proposals made by the President which are pending there at the present time.

I would like to ask you a little something about the deficit, sir.

We have heard a lot of talk—and admittedly it is political probing in different directions in order to find what might become political soft spots—we have heard a lot of talk about the size of the deficit.

There is no question about it. We have a very substantial deficit for fiscal 1972 and proposed for fiscal 1973. Could you tell me what the real alternatives are to this size deficit at the present time? You are probably most familiar of any man in the country with the details of the budget. What are the alternatives available to us in the budgeting area as far as the deficits are concerned?

Mr. SHULTZ. The fiscal 1972 deficit is at this point pretty well foreordained. That is, whatever the revenues turn out to be, that is what they are going to be, and what the Congress or the President does will not affect that, as far as fiscal 1972 is concerned.

The estimate may be right, it may be a little wrong, high or low, that remains to be seen.

There are a number of proposals before the Congress that will affect the 1972 budget on the outlay side. One we have talked about already, namely revenue sharing. There the President continues to advocate revenue sharing for reasons that I have already described and he accepts the fact that enacting revenue sharing will make the deficit higher than it would be otherwise. The deficit will be smaller if revenue sharing is not passed.

We think that the fiscal stimulus that is implied by the overall deficit is appropriate to the current circumstances and, as the Chairman said, it is very important to stimulate the economy. The deficit is one contribution, to providing that stimulation.

Representative CONABLE. How big a deficit would we have to have, or how much further expansion in the expansionary fiscal policy do we have to have, to achieve a four percent unemployment rate in this year? Have you any idea what that might be?

Mr. SHULTZ. In my opinion, that is a tricky kind of question, because it seems to me that you can go so far in the stimulation of the economy by Government, and then somehow you must reach a point of diminishing returns. It is very important, I think, to show that over a longer period the situation is under control, so that people have some confidence that the economy has the stability to it, that the outlook is that prices will come under control and stay under control. This is going to have its impact on what the economy is really made up of, namely all the private decisions that go into the sum total of our economic activity.

I think that we have gone about as far as we ought to go right now.

Representative CONABLE. Is the implication of what you are saying, then, that if we were to try to press to achieve a 4 percent unemployment rate in this year, we would almost inevitably at least lay the groundwork for substantial price instability?

Mr. SHULTZ. I think the question has to do with what you try to do by fiscal policy, what you try to do by your projections of the long run outlook, what you try to do in the composition of the budget, particularly in the manpower policy area to get directly at unemployment problems.

All of these things are added together. We have estimated that an increase in the GNP of about $100 million a year is as fairly in the ball park as any other estimate. We feel that is consistent with a fall in unemployment to the neighborhood of about 5 percent by the end of the calendar year. I think it is a very tricky proposition to estimate how much unemployment would decline. It could go further than that, it could go less than that. A lot of it depends on what happens to people's attitudes toward entering the labor market, particularly young people and women. A strong rise in economic activity tends to draw people into the labor market. It seems to me difficult to specify with any confidence that if you spent $20 billion more, say, you would automatically get the kind of economic behavior you seek. You might not at all.

Representative CONABLE. We have been talking about an expansive budget. I understand you have already answered some questions about monetary policy. I wonder if you could tell us, sir, what general growth in the money supply in fiscal 1973 you foresee as being consistent with the aims of the new budget, assuming, which is not true, that you had control of the money supply as well? What do you feel it ought to be to be consistent with the budget?

Mr. SHULTZ. I don't want to seem to be ducking your questions, but, as the chairman said, you will have Arthur Burns as a witness, and I don't want to infringe on the prerogatives of the Federal Reserve. I would make the general observation, though, that this committee at one time—I have forgotten just when, but it was several years ago—put forward a general proposition that the rate of increase in the money supply, as I recall, ought to be in the range of 4 to 6 percent, as a general proposition.

If it is going to move outside those boundaries there ought to be some special reason brought forward for that. That has always appealed to me as a pretty good general proposition, and I would support it.

Representative CONABLE. How much of the President's proposed budget for fiscal 1973 requires additional legislation by the Congress? What major programs are included in this package? You have talked about revenue sharing and I assume welfare reform. What other major programs are included in the 1973 budget?

Mr. SHULTZ. We have a list here of items proposed for later transmittal under proposed legislation. Some of it is new, such as the revenue sharing area, and others are reauthorizations of programs that are fundamentally familiar. I can submit this list for the record, if you would like, or I can read down it, if you would like.

Chairman PROXMIRE. We will be happy to have the entire list for the record. Why don't you pick out a few of the ones you would like to highlight. The entire list will be printed in the record at this point.

(The list follows:)

1973 BUDGET—ITEMS PROPOSED FOR LATER TRANSMITTAL UNDER PROPOSED LEGISLATION

[In thousands of dollars]

	1972		1973	
	BA	Out	BA	Ou
Executive Office of the President: Council on International Economic Policy	1,130	980	1,341	1,316
Funds appropriated to the President:[1] International financial institutions	380,000	10,000	910,000	103,000
Department of Agriculture:				
Federal Crop Insurance Corporation:				
Administrative and operating expenses			−1,000	−1,053
FCIC fund				1,452
Farmers Home Administration:				
Direct loan account		−20,158		3,977
Agricultural credit insurance fund	−163,094	20,158	−136,503	−593,816
Total, Agriculture	−163,094		−137,503	−589,440
Department of Commerce:				
Maritime Administration: Operating-differential subsidies	15,000	15,000		
Department of Defense:				
All-volunteer armed force			400,000	390,000
Military retirement systems reform			296,000	290,000
Total, Defense			696,000	680,000
Department of Health, Education, and Welfare:				
Food and Drug Administration:				
Food, drug, and product safety			38,845	29,743
Health Services and Mental-Health Administration:				
Health services planning and development	57,000	9,000	60,000	36,000
Office of Education:				
Education revenue sharing			223,911	110,000
Emergency school assistance	500,000	80,665	1,000,000	381,000
Higher education	259,500		−288,000	−28,500
National Foundation for Higher Education	3 000	1,000	100,000	30,000
National Institute of Education	3,000	2,500	125,000	50,000
Social and Rehabilitation Service:				
Grants to States for public assistance			−859,220	−859,220
Social and rehabilitation services			10,000	2,348
Social Security Administration:				
Payments to social security trust funds			175,000	175,000
Social security trust funds: Benefit increases, and tax base and rate changes	200,000	15,000	1,303,000	4,020,000
Welfare Reform			450,000	350,000
Total, HEW	1,022,500	108,165	2,338,536	4,296,371
Department of Housing and Urban Development: Urban community development revenue sharing			490,000	490,000
Department of the Interior:				
Bureau of Land Management: Management of land and resources			20,000	10,000
Bureau of Indian Affairs:				
Resources management			4,000	4,000
Revolving fund for loans	5,000	1,000	5,000	1,000
Territorial Affairs: Trust territory of the Pacific Islands	1,000		1,000	1,000
Geological Survey: Surveys, investigations, and research			5,000	4,000
Bureau of Mines: Conservation and development of mineral resources			7,000	7,000
Total, Interior	6,000	1,000	42,000	27,000
Department of State:				
International Boundary and Water Commission: Construction	12,881	503		4,345
Department of Transportation:				
Federal Railroad Administration: Federal grants to the National Railroad Passenger Corporation	170,000	105,000		65,000
Department of the Treasury: General revenue sharing	2,500,000	2,250,000	5,300,000	5,000,000

Footnote at end of table.

1973 BUDGET—ITEMS PROPOSED FOR LATER TRANSMITTAL UNDER PROPOSED LEGISLATION—Continued

[In thousands of dollars]

	1972		1973	
	BA	Out	BA	Out
Environmental Protection Agency: Operations, research, and facilities			35,000	22,000
Veterans' Administration:				
Compensation and pensions	25,000	25,000	151,700	151,700
Readjustment benefits	54,100	143,100	15,300	167,300
Medical care			15,945	15,945
Medical administration and miscellaneous operating expenses			155	155
General operating expenses			−1,000	−1,000
Grants for construction of State extended care facilities			2,700	
Total, VA	79,100	168,100	332,800	334,100
Other Independent Agencies:				
Federal payment to the District of Columbia	1,000	1,000	22,000	12,000
Federal contribution to the Washington Metropolitan Area Transit Authority			8,481	8,481
Payment to the John F. Kennedy Center for the Performing Arts	1,500	1,500	1,500	1,500
Water Resources Council			1,000	800
Total, other independent	2,500	2,500	32,981	22,781
Total, items proposed for later transmittal under proposed legislation	4,026,017	2,661,248	10,041,155	10,456,473

[1] The budget proposes for "Expansion of defense production," legislation which provides for the termination of interest payments and the cancellation of remaining borrowing authority. The proposal is not included in the above list, since it does not affect budget authority or net budget outlays. For further details, see page 107 of the Appendix to the Budget.

Mr. SHULTZ. One that this committee has been interested in typically, and that I mentioned in my statement, is the continued effort to get an all-volunteer force. Here we support essentially the proposals Senator Allott put forward in the last session.

Emergency school assistance is a program that the Congress has had before it for about a year and a half, I think, or maybe a little longer. It would amount to about $1 billion of budget authority, although it would have smaller outlays, of course, until the new program gets started. We think that is an extremely important piece of legislation to get going on. There are a number of things in the field of education. There is the National Foundation for Higher Education and the National Institute for Education, some of which you have acted on to a degree but not conclusively.

H.R. 1, of course, is pending. It passed the House but has not come out of the Senate Finance Committee as yet. That has quite an impact, not only on the welfare reform as such, but in the adult categories of public assistance. As you know, there are major changes there.

There are proposals for urban special revenue sharing, rural special revenue sharing, and manpower reform. Manpower was called to your attention yesterday. They are all in the budget for various amounts. Of course, the biggest revenue sharing amount is general revenue sharing, which we hope will be effective as of January 1, this year, and which would continue at a $5 billion rate next year.

Representative CONABLE. My time is up, Mr. Chairman.

Mr. SHULTZ. I might say, Mr. Chairman, we have gotten this list up and gotten it into the hands of the Appropriations Committees, and hope that they will help push it before the authorizing committees.

We are pushing on the Departments to get their legislation up so that the whole budget process can go forward on as speedy a basis as possible. The way that we have been operating in the past few years, as I have experienced, anyway, is one in which the budget doesn't get acted upon until over half of the fiscal year has gone, and in which one piece of the budget may be acted upon, say, in May or June, and then the Defense budget in December. This makes it very difficult to know just what the budget will amount to and what its economic impact is going to be.

I might say one of the reasons why you see a stepup in outlays in the second half of this fiscal year as compared with the first half, taking the Defense case, is we didn't get those appropriations in Defense until December 17. You can't spend the money you don't have. Once you have it, then you can move forward on your program. If we can have this whole process go forward on a more timely basis, then from the standpoint of economic policy and the needs of this committee, you will be able to see, as we will, more clearly just what the budget is finally going to amount to.

Chairman PROXMIRE. Mr. Shultz, you know, as a real commentary on the time, or on the softness of this committee, that you come before the committee with the biggest deficit in the history of our country by far, except for three World War II years. Not a single member of the committee takes the hide off you or even touches very much on that issue.

Mr. SHULTZ. Mr. Reuss characterized the deficit as small, if you will recall.

Chairman PROXMIRE. If you had come before this committee 30, 20, or 10 years ago, we would have had at least one member of the committee, Republican or Democratic, probably Republican who would have raised unshirted hell about it. Now we seem to accept this $38 billion projected deficit. Perhaps it is an indication of a greater degree of understanding, economic understanding, and appreciation.

At any rate, I would like to pursue that line by asking you this: You made a very good statement before the Appropriations Committee and you repeated it here this morning, that you felt that in the future any new program requiring new expenditures should either require new taxes, specified, or an old program that would be reduced or eliminated.

Is that roughly what you said?

Mr. SHULTZ. Roughly speaking, that is right.

Chairman PROXMIRE. This morning you said you do not favor an increase in taxes, at least at the present. That must mean that if you are going to have a new program you favor cutting out old programs. This committee has just finished a study, a 6-month study, of Federal subsidies. We found that there was almost no work that had been done in this area either by your office or by any private group or any preceding administration of subsidies. There is not a single monograph in the English language on it. Germany has rich literature on it but we have nothing.

Under these circumstances, in view of the tightness affecting new programs in the future, shouldn't there be an effort on the part of the Office of Management and Budget to get at the kind of old programs that can be reduced?

Do you have anybody over there who is looking at this, who can tell us where we can cut back old programs?

Mr. SHULTZ. I think, Mr. Chairman, on the question of the subsidy programs, I personally welcome the work that the committee has done on that. I think it is very constructive and helpful. If I am not mistaken, the Office of Management and Budget at least tried to be quite cooperative with your staff.

Chairman PROXMIRE. That is correct.

Mr. SHULTZ. We supplied a fair amount of information, and we continue to work on it as part of our regular work on the budget. I think it is a very worthwhile effort and is something that we need to keep after. In our process of budget review each year——

Chairman PROXMIRE. Are you doing any zero base work?

Mr. SHULTZ (continuing). Is an extensive examination program by program, with an effort on our part to evaluate the departmental proposals, and to cut them down or out when they are not good and to encourage them on when we feel they are. There are extensive rearrangements proposed. I think special revenue sharing is a very promising approach to improving the effectiveness of the spending of the Federal dollar.

Chairman PROXMIRE. Can you give me any specific programs where you were considering elimination or sharp reductions?

Mr. SHULTZ (continuing). Is an extensive examination program in detail, and we have made a number of savings in it.

Chairman PROXMIRE. Let me try this by getting into the one area where there is a very big increase which is highly controversial. On page 79 of the budget it shows Department of Defense obligations increasing from $73.6 billion in fiscal year 1971 to $81.8 billion in fiscal year 1973. If we subtract the cost of the Vietnam war from these figures, $12.6 billion in 1971 and almost $5 billion in 1973, the total increase in non-Vietnam obligations in 2 years is an astronomical $16 billion. This amounts to an amazing 25 percent increase. This tells me that the President's theme of returning to a peacetime economy is just not true. How do you justify these huge increases?

Mr. SHULTZ. I think one of the principal reasons for the large increase is the very sharp increase in rates of pay in the Armed Forces.

Chairman PROXMIRE. We have had a sharp decrease in personnel, too.

Mr. SHULTZ. This, of course, is something that the President proposed, advocated, and which has taken place. We think it is a very healthy thing, that the kind of tax imposed on young people by drafting them into an Armed Force, at very low pay, well below the opportunity costs of their alternatives, was wrong. Yet, now we have a situation in which the proportion of the defense budget going to personnel costs has risen from——

Chairman PROXMIRE. It has gone up to about 54 percent, I believe.

Mr. SHULTZ. It is up to 57 percent of the Department of Defense budget, Mr. Chairman. In 1964 it was 43 percent. So there has been a very large increase. As you know, that has taken place just in the last couple of years. In fact, I think within a calendar year there will probably be four pay rate increases in defense for members of the Armed Forces. I think that is appropriate. Beyond that is the effort to improve our fleet; the effort to work effectively in the research, development, test, and evaluation areas; the effort to improve the strategic posture of our defense establishment.

All of this represents things that the President feels are necessary to have a proper defense posture.

Chairman PROXMIRE. This committee has pointed out in the past several years that the Pentagon budget just is not adequately reviewed by the Office of Management and Budget. When OMB was created we were assured that the situation would be changed, that there would be a new emphasis to scrutinize defense spending requests.

This year's budget document indicates to me that our worst fears are being realized. I received reports that the Defense Division of OMB has been downgraded, that it does not have the authority or the inclination to challenge the Pentagon. If not, how else can you explain the huge increases planned this year and the fact that every major weapons system talked about in recent years, the B–1, the ABM, the high shipbuilding program, the aircraft carrier has been approved at the White House level?

Mr. SHULTZ. You may want to challange specific programs in the appropriations process——

Chairman PROXMIRE. I intend to.

Mr. SHULTZ. You are welcome to do that. But the President's judgment, as reflected in his budget, is that these programs are necessary. Just because something goes up, doesn't mean it hasn't been scrutinized.

Chairman PROXMIRE. Everything goes up. It seems to me in the Defense Department as in other areas you have to make a choice of alternatives. When everything goes up, it indicates to me at least it is not getting the critical scrutiny it should get.

Mr. SHULTZ. It gets a very critical scrutiny. The work of our National Security Programs Division is, I think, of very high caliber.

Chairman PROXMIRE. Let me get into that. James Schlesinger, I understand, was brought into Budget Bureau for the express purpose of heading up Pentagon spending requests. That is what his role was as explained to us. Now he is made Chairman of the Atomic Energy Commission. Has anyone of equal stature replaced him? Has there been any other turnover in the Defense Division of OMB?

Mr. SHULTZ. The head of the National Security Program Divisions is the same, Ellis Veatch. He is an old hand and extraordinarily able person. I might say while we hated to lose Mr. Schlesinger, we are glad to see our alumni move on, and I think he has done an outstanding job as Chairman of the AEC. The replacement for Mr. Schlesinger as Assistant Director of OMB, in charge of our work on defense, international, and intelligence activities, is Mr. Kenneth Dam.

He, in my judgment, is a brilliant person who came to us from the law school at the University of Chicago. He has a brilliant record. He was first in his law school class. He was a Supreme Court clerk. He comes from the top intellectual echelon and is an extremely effective person. He is very, very good.

Chairman PROXMIRE. How many professionals in OMB review the Pentagon budget?

Mr. SHULTZ. We have those numbers.

Mr. WEINBERGER. I don't have the exact number but it is well in the high thirties or low forties.

Mr. SHULTZ. Why don't we give you a table on that.

Chairman PROXMIRE. You say it is in the high thirties.

Mr. SHULTZ. Don't go on that, Mr. Chairman. We can give you the breakdown.

Chairman PROXMIRE. Mr. Weinberger should know.

Mr. SHULTZ. We don't have instant information on everything under the sun at our fingertips. We can get you an accurate table showing the number of professionals, the number of secretaries. If you want it broken down by grade level, you can have it. We will give you all the information.

Chairman PROXMIRE. Mr. Shultz, I can't believe that you, Mr. Weinberger and Mr. Cohn, three of the ablest and most intelligent men in Government do not know how many professionals are working in your department on the Defense budget and cannot tell me the additional point of what proportion this represents of your total professionals in the Office of Management and Budget.

Mr. SHULTZ. Mr. Chairman, of course, we can tell you approximately. But knowing your penchant for absolute accuracy of statistics I wouldn't want to make an approximation.

Chairman PROXMIRE. I am asking for an approximation.

Mr. SHULTZ. I want to go back and get an actual count. Well, I have a number here.

Chairman PROXMIRE. What is it?

Mr. SHULTZ. It is a number derived from the sampling process——

Chairman PROXMIRE. From the sampling process? Are you kidding? I am asking whether there are 34, 39, or 41. What kind of a sample do you take? Do you have George Gallup come in and survey the people and ask how many are professionals working on the Defense budget?

Mr. SHULTZ. Well, the number we have here is 47 professional and clerical.

Chairman PROXMIRE. What does that represent as a proportion of your total professionals?

Mr. SHULTZ. It is about the same. The National Security Program Division is about the same as it was last year.

Chairman PROXMIRE. How much is that?

Mr. SHULTZ. We will get that for you, Mr. Chairman.

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

PERSONNEL ANALYSIS, PERCENT OF STAFF EXAMINING DEFENSE AND RELATED PROGRAMS

	Fiscal year 1970	Fiscal year 1971	Fiscal years 1972, Feb. 8, 1972
Total professional staff	367	432	423
(a) Engaged in nonexamining activities	178	261	248
(b) Engaged in examining activities	189	171	175
(c) Engaged in examining defense activities	51	52	53
(d) Percent of staff examining defense	26.9	30.4	30.3

Chairman PROXMIRE. I just want to know how many professionals you have.

Mr. SHULTZ. Mr. Chairman, we don't have available in complete detail a breakdown of who works where in the OMB, but we can have that by this afternoon very readily. We just don't have the table here and I don't like to throw out numbers at random.

Chairman PROXMIRE. Would you say you probably have 200 professionals or 300?

Mr. SHULTZ. We have probably on the order of 380 professionals.

Chairman PROXMIRE. And this Defense Department contingent would represent about 15 percent?

Mr. SHULTZ. This includes all of what we call the management side of the OMB as well as the budget side. Of course, we have six divisions, of which the National Security Program Division is one. That is the principal one that works on the Defense budget.

Chairman PROXMIRE. The Defense budget is about 35 percent, much less than it used to be as a proportion of our total spending. But still if you have 15 percent of your professionals working on the Defense budget, it represents 35 percent of the spending, and is at least as complex and as challenging as others.

Mr. SHULTZ. I don't think it is proper to take the proportions—to the extent proportions mean anything at all—of the total of professionals, but rather, the proportion of professionals working on the budget.

Chairman PROXMIRE. It is a much larger than half of the controllable budget.

Mr. SHULTZ. It is an important controllable element in the budget.

Chairman PROXMIRE. You have only about 15 percent of your professionals working there.

Mr. Bentsen.

Senator BENTSEN. Thank you, Mr. Chairman.

I might make an observation, Mr. Shultz. You commented earlier that it would be better if Congress did not continue to try to tell the President how to run his job. I think that is a pleasant thought. But I think it has just about as much chance as your getting the President to quit telling the Congress how to run its job.

I would like to further state for the record that Congressman Reuss did not refer to this budget deficit as a small deficit. I think the record will reflect that.

You were commenting earlier about the National Commission on Productivity. This was brought into being in June of 1970. I share your concern with the problem of increase in productivity. I am wondering just how much has been accomplished since that time. It is my understanding that up until almost the end of last year you only had a staff director and a secretary there. I read in the President's Economic Report those things to which the Commission was supposed to have given primary attention, productivity bargaining between labor and management, manpower adjustment policies, education, research and development, and Government productivity.

I would like to get some feel for how many pieces of legislation you have been able to get together on in that Commission in the way of specific recommendations to the Congress that might implement the resolution of this problem.

Mr. SHULTZ. I don't think that the output of the Commission was directed toward getting up legislation as a method of improving productivity, except insofar as the area of research and development, including the Federal budget for research and development, was identified as a particularly important area. Rather, the thought was that the main efforts will take place in the private sector, and that we should study this problem in its various respects and see the degree to which we could get things going in the private sector that would be helpful in this regard.

I don't think that the Commission, of which I am chairman, has been regarded as an agency designed to try to figure out what legislation was appropriate for stimulating productivity, but rather, to take the subject in more general terms and see what we could do to understand it better, to promote better understanding around the country, and to work in particular areas that seemed to be worthwhile.

Senator BENTSEN. Apart from legislation, you refer to generalization. Would you not be dealing with it with some specificity, with concrete recommendations to labor and management?

Mr. SHULTZ. We have put out a statement, I believe last September, which was agreed on by all members of the Commission, and which reviewed the areas that I outlined here and that you read off a moment ago, and rendered some judgments about them.

It was fairly general in most cases, but we tried to give the general drift of the thinking of this very disparate group. We are trying to be helpful in the steel industry. We have developed a group that is working on productivity in the construction industry. That is part of the whole set of developments that the administration encouraged in the construction industry.

I think the efforts reflected in the budget on research and development have had their origins, to a degree, in the discussions of the Productivity Commission with the President. I wouldn't say that the decision to ask for reinstitution of the investment tax credit last year is something that the Productivity Commission recommended particularly; however, there was a fair amount of discussion of that tax credit and the obvious relationship of more modern plant and equipment to the productivity problem.

That has helped to create a climate in the way of discussion in the administration that I think probably contributed something to making that recommendation. So I think that the answer is that the Commission has worked in a variety of ways, not necessarily limited to legislation.

Senator BENTSEN. Mr. Shultz, I want to commend you for not including in your statement any reference to the increased number of women and young people in the labor force today. Sometimes it seems to be used as the primary reason by many for the increase in unemployment. But there are many other factors involved in addition to that. I think we ought to study all these changes that have taken place in our economic structure in trying to work toward a well defined full employment goal.

But I would like, if you would, for you to state your definition of full employment and when you think we might achieve it.

Mr. SHULTZ. The definition we have used in calculating full employment receipts and full employment outlays is a rough four percent unemployment level. I think the statements you refer to, about the rise in the proportion in the labor force and in the unemployed of young people and women are useful for the professional analyses of the unemployment problem.

What they suggest to me, anyway, is not so much that we should lower our sights in terms of objectives, but that we have to be constantly alert to how we are going to go about getting to genuinely full employment. I define full employment as the situation in which anybody who wants a job and is willing to work realistically within that person's skill level can find a job, whether that is a young person, a woman or a man. It is hard to pin a percentage on that. Certainly, as we work at this, it would be lower than 4 percent.

Senator BENTSEN. You talk about ongoing budgets and long-range planning and, of course, trying to tie in this full employment figure as part of that.

Would you care to make a projection as to when you think we might be at this 4-percent figure?

Mr. SHULTZ. I think it is something that we will have to work at. I don't think we will get there by the end of this year. As I said, I don't think we should necessarily settle that 4 percent has some special magic to it. The problem is one that we need to work at in a great variety of ways, many of which don't occur to people very often. For example, the efforts now going forward to improve the occupational health and safety conditions in American working life will ultimately make a great contribution to our ability to have full employment without inflation.

The efforts that we have been making in this administration and before to open up employment opportunities on a more equal basis, aside from conditions of race, color, creed, and sex, will help to achieve full employment. So will the formal things that we outlined in our special analysis of the manpower programs, such as special training and work arrangements.

I think we have to have a many-sided approach to the problem. When we will achieve the millennium, I would hesitate to say.

Senator BENTSEN. Thank you, Mr. Chairman.

Chairman PROXMIRE. Congressman Moorhead.

Representative MOORHEAD. Thank you, Mr. Chairman.

Mr. Shultz, I would now like to talk with you about the reliability of the proposed deficit for 1973 of $25 billion. I am not at all being critical, but I am trying to examine it. Last year you predicted a deficit for the current year of $11 billion and it turns out to be $38 billion, with the greatest variation being on the anticipated receipts. They were $20 billion below what was anticipated.

Last year you anticipated receipts of $217 billion and for 1973 you anticipate $220 billion.

Is there not a chance that what ever mistake was made last year it will be made again this year, and that receipts will fall far short of the anticipated?

Mr. SHULTZ. It is partly a question of whether or not the prediction about gross national product turns out to be about right, too high or too low. That will affect the revenue. At the same time, the short fall as compared with our estimate of revenues was a little over $20 billion and is made up of two components: One, a little over $12 billion due to the short fall in GNP compared with our estimates, but then a little over $7 billion is attributable to tax changes. A postponement of the social security tax increase took place early in the year, and then the tax changes were made towards the end of the year. These together add to a little over $7 billion. So that is a result of deliberate policy on your part and the President's part as contrasted with a change in revenues due to a misestimation. I don't anticipate that you will have the tax changes again, although who knows?

Representative MOORHEAD. On receipts, the main figure that you look to is the projected gross national product; is that correct?

Mr. SHULTZ. That is correct. however, in order to make a revenue calculation you have to break that down and estimate what you think corporate profits are going to be, what you think personal income is going to be, and so on. Depending upon composition, of the national income you can get a range of actual revenues.

Representative MOORHEAD. Do you end up with the same projection of those items as does the Council of Economic Advisers?

Mr. SHULTZ. This was discussed among the Council, the OMB and the Treasury and represents our pooled best judgment. But the Council, of course, as is always the case, takes the lead in developing an economic forecast.

Representative MOORHEAD. In making this projection, do you make an estimate as to the rate of unemployment that will exist in the fiscal year 1973?

Mr. SHULTZ. The $100 billion rise in GNP compares the calendar year 1972 with the calendar year 1971. Associated with that is an estimate that unemployment will fall to somewhere in the neighborhood of 5 percent. In fiscal year 1973, we must develop an estimate of the amount of unemployment compensation that will be paid through the fiscal year. We try to estimate the relationship between what the total unemployment level will be and what the insured unemployment level will be, which, of course, is much less.

We are estimating somewhere in the neighborhood of a little less than 3.5 percent insured unemployment. I think perhaps it will be less than that, myself.

Representative MOORHEAD. What is the estimate for all over unemployed as opposed to insured?

Mr. SHULTZ. We would expect that unemployment would continue on down in the first half of 1973, in other words the last half of the fiscal year, and fall below 5 percent.

Representative MOORHEAD. Fall below 5 percent in the last half of fiscal 1973?

Mr. SHULTZ. I have always been quite reluctant to try to make an estimate that unemployment will fall to 5.1 percent or 4.9 percent, or something like that, because these numbers are so hard to estimate. They are so dependent upon what happens to the influx into the labor market. I think it is presuming a kind of accuracy that you just can't have to try to pin things down that much. As a matter of fact—and I will speak for myself but I have also observed the record of many others—economists, as well as businessmen and others have much to be humble about in their ability to project the gross national product. So rather than try to appear exact, we have made a forecast of about $100 million. We decided among ourselves that we would have an estimated gross national product that would either end in zero or five, so we wouldn't presume to have 1147 or 1143, something like that. I think that suggests the range of error which is inherent in all this.

Representative MOORHEAD. On insured workers you do produce and calculate in the budget a figure.

Mr. SHULTZ. We have to make to make an estimate of the amount of outlays for unemployment insurance, and the estimate is not necessarily right on the button. It is our best estimate. We have to put a number in the budget, and we have.

Representative MOORHEAD. Than you, Mr. Chairman.

Chairman PROXMIRE. Senator Percy.

Senator PERCY. Mr. Chairman, I can't resist the temptation to comment on your question of why the big increase in defense costs. It is really my feeling that the expenditures that this country has made on Vietnam over the past decade have been made at the expense of our real national security and our own defense establishment. For many years the Presidents have been telling the Chiefs of Staff that when the Vietnam war emergency is over we will get the mony for these things that we need. We have let the ships get rusty, housing run down, and we have also let a great many things slide by to pour money into Vietnam. But we are not going to have a piece divided and can't expect it. We won't have it because we have these accumulated expenses, and because we have to say that these are things that cannot be deferred any longer.

I think once again it is an indication that the Vietnam war, with $140 billion spent out there, has really endangered out security here as well as endangered our fiscal integrity.

I would like to ask a question on productivity. I don't have a preoccupation with the subject, but I do think it is a long range answer to many of our problems. There is a public resistance to the term productivity. Many people feel that it really is going to mean fewer jobs; that actually if you increase productivity you get the same amount of work out with fewer people.

Would you comment, Mr. Shultz, on your feeling as to the long range job creating potential that increased productivity has in the American economy?

Mr. SHULTZ. It doesn't seem to me from the record that there is any inconsistency whatever between improving productivity and expanding employment. We have had a long record in this country of steady gains in productivity and we have also had a long record of steady gains in employment. It is important to recognize that there are occasions when technological change or other kinds of change affect a work group and do cause layoffs. Therefore, I think the efforts that have been made to improve the system of unemployment insurance, improve our manpower program, are an important part and parcel of the effort, by constructing a situation where we can make transitions and helping people who might be displaced by the productivity gains to rearrange their lives and get on to productive work.

It seems to me also that if we are to regain our competitive edge in the world markets we are going to have to reduce our costs and improved productivity is the key to doing this. If we don't do it, it isn't that we will have more jobs but we will have less jobs because we won't be able to sell our products abroad. So I think this is the case where improved productivity and lower costs will definitely help our employment picture.

Senator PERCY. The effort to establish productivity councils, I am happy to report, is receiving a good response in business and labor circles. I hope you will lend your very valuable support toward the possibility of a productivity council in the Midwest where labor unions have now pledged to work on this and management is attuned to it. I think we should have an example out in the field of how we can get together and work on the same side of the table, and do what the Japanese have been doing for 25 years. They have differences between labor and management but they resolve them when they have a common enemy which is someone trying to take markets away from them. That is what I think we have to do, to get on the same side of the table.

I am all for the ceiling on Federal expenditures. I am a cosponsor of that bill. I think we have to discipline ourselves. I am worried about one thing. When we approach that ceiling, who is it that decides what programs will be cut out or what falls by the wayside? In the present legislation discussed it is the President who will make that decision.

Realistically, if it does not appear that Congress will give up that full prerogative and leave it entirely to the executive branch, would your office be prepared to work with some of us who feel we ought to have another piece of legislation ready if that cannot go through? Can there be a procedure figured out whereby we would share the ultimate responsibility with the executive branch? Could the Appropriations Committees of the Senate and House and the House Ways and Means Committee and the Bureau of Management and Budget jointly decide what programs have to be cut down if we have imposed upon us an absolute ceiling on expenditures which I think is crucial and essential?

Mr. SHULTZ. Of course, we welcome a chance to work with the various committees of the Congress in trying to develop a workable scheme. If an approach is going to be workable, it does have to have decisiveness built into it somewhere and sometime. If the ceiling actually is operative; that is, lower than the sum total of all the parts, there has to be a process which actually results in reducing outlays. It has to have finality to it. On the whole I think you come back to the fact that somebody has to bear that responsibility. We have thought about it a good deal, and we arrive at the conclusion that this is a responsibility the President has to bear. If there are other arrangements, we would certainly welcome the chance to talk about them. We have thought about it a good deal, and that is where we come out.

Senator PERCY. If we are going to be realistic about getting it through this year, I think we ought to have some legislation along that line and I would be happy to work with you on that.

In the Joint Economic Committee Report of 1970 a suggestion was made:

> Another reform of vital significance is the adoption by the Congress of zero-base budgeting. The current procedure is for the Appropriations Committee to examine only the proposed spending increments in the particular program over the previous year's total. What has already been spent is accepted without examination. Congress should require agencies to justify their entire budget request every several years on a staggered basis just as if they were new programs. This would not only sharpen program control in the executive branch, but give the Congress a basis for deciding where particular cuts in existing programs might have to be made to accommodate new initiatives.

Would it be a step in the direction that you are suggesting if we realined our appropriations processes in the Congress?

Mr. SHULTZ. I would encourage that development, yes. I am trying to be consistent with my comment to Mr. Reuss, of not telling the Congress how to do its business.

Senator PERCY. This is a suggestion from Congress. Does this look as though it is a practical basis for proceeding?

Mr. SHULTZ. Sure.

Senator PERCY. We are all concerned about the objective.

Mr. SHULTZ. We try in our own internal processes not simply to look at the incremental changes, but to look at the program as a whole and see whether or not lump sum changes can be made. In some ways, I think the movement to special revenue sharing is an effort to gather a group of programs together and allow differentiated treatment to occur in different parts of the country and in different cities, depending upon the differential needs they have.

Senator PERCY. Just to correct the record, I guess what I was quoting was not the full committee report. It was the minority—that is, Republican—views. But there are, I think, many members of the majority who would concur.

Chairman PROXMIRE. I certainly concur.

Senator PERCY. I would like to follow up on a comment made by our chairman and quote from the 1971 Joint Economic Committee Report, something I said at the time.

It was another way of putting what you said. I stated:

> Congress is ill equipped now to set overall priorities due to the way the legislative process is set up. Each bill and appropriation is handled separately with no real attention given as to how each piece of legislation fits into an overall framework of needs and resources available—

Then we commented—

> Finally, a program budget should be drawn up to show not only direct budget outlays but also revenues foregone by the Treasury as a result of special provisions of the Internal Revenue Code. A recent estimate by Assistant Secretary of the Treasury Weidenbaum concluded that selected special tax provisions will cost the Federal Government more than $45 billion in fiscal year 1971.

Following up on the chairman's questions, is it possible to continue to put forward to us the cost of these special programs and subsidies so that we can continually look at them to see whether or not, in the light of existing conditions, budget deficits, the need for revenue, those subsidies can be justified?

Mr. SHULTZ. But I believe the Treasury has been requested and has agreed to provide that information to the Congress.

Senator PERCY. I understand it is a separate report that is not put in the budget.

Mr. SHULTZ. I believe Treasury will be making that report.

Chairman PROXMIRE. Treasury will do that as far as tax expenditures are concerned, I believe. The other subsidies, the cash subsidies, the credit subsidies, and so forth, we have not covered.

Mr. SHULTZ. The Federal credit programs are covered in Special Analysis E of the Budget.

Chairman PROXMIRE. Do they provide the full cost?

Mr. SHULTZ. Of the credit programs, yes.

Chairman PROXMIRE. I certainly favor enthusiastically and firmly giving the President the authority to decide where the cuts have to be made when we set the ceiling. I don't think there is any other way to do that. I would like to work with Senator Percy to see if there is an alternative. My instinct is as you have indicated that you come down to the President. I see nothing wrong with that. The President would make the cuts, presumably, within the area where Congress has gone over his budget, very probably. He would have to disagree with some of us here who disagree with his priorities, if we come down to giving him the final determination. If we have a ceiling, we have to make some sacrifices and that sacrifice Congress has to make.

You have indicated very strongly that if Members of Congress propose new programs, then they ought to indicate what old programs ought to be cut out. You have proposed, and by you I mean the President, a space shuttle, an expensive, new program costing well over $5 billion and including contingencies costing over $6 billion. According to an Air Force study if the shuttle will be worth anything we have to expend something like $140 billion in a 13-year period in order to justify a shuttle. What old programs or what marginal programs, or what other programs, are you cutting back to make room for the shuttle in this full employment budget?

Mr. SHULTZ. The President's budget portrays not just the costs of the shuttle but all the other costs, all the other budget decisions. So it is a complete layout of the President's priorities.

Chairman PROXMIRE. What I am asking is whether you apply the same test to yourself of stopping or cutting old programs if we propose new ones. You are saying Congress ought to do this. But when the President or the Space Agency comes in with this, you make a vague reference to the whole budget. What other program you would cut out? If so, what other program did you cut out?

Mr. SHULTZ. We regard it as a discipline, the full employment budget, and that was our guide as to how much outlay we could see in this budget. Within that framework, we cut, fit, increased some things, did not increase others, and so on, and have come out with a budget level of about $246 billion.

Chairman PROXMIRE. I understand that. What I am getting at is the specific program that you would look at if you have a marginal appraisal of some kind of your programs. You say if we are going to come in with a new program like the space shuttle, or if the President should come up with another one, is there a specific program that you cut back? Or do you just say we will have to adjust to this and we don't know where it comes out?

Mr. SHULTZ. We have made our adjustments and the $246 billion includes all the various things that the President has proposed.

As far as the space program is concerned, the outlays in NASA have come down quite dramatically over the past 4 or 5 years.

Chairman PROXMIRE. I understand that.

Mr. SHULTZ. We see now a stable period ahead for NASA, and we are trying to work with them on this basis.

Chairman PROXMIRE. They would have been cut down a lot more without this space shuttle.

Congress, of course, is always in debate and has a difference of opinion on this. I believe that Congress will reduce President Nixon's budget as they reduced President Johnson's, President Kennedy's, and President Eisenhower's budgets consistently over the past 25 years. We have made that decision to cut in various areas. But I am asking if this is a new principle, that when you come up with a new program that you have to come up with a specific old program where you reduce or a specific area out of which you take it.

Mr. SHULTZ. I don't know that it is an especially new principle. It is by way of saying that if you accept the $246 billion ceiling and you are going to raise some things beyond the President's budget, then you will have to find something to cut, to stay within the ceiling. But more than that, as we project the revenues that the tax system will generate at full employment 5 years from now—and we all know that it is a difficult process—and project just the programs we have and the President's proposals out 5 years, we see that we will have very little room for maneuver. That would suggest real care in choosing among various program needs. We are saying that is the fact now so we have to have a put and take process here.

Chairman PROXMIRE. I was just trying to reach out to see if we could determine whether or not the Office of Management and Budget is determining a priorities system, where you have marginal programs, places where you think if you have to make a cut that is where it will come. Apparently, you don't operate that way.

Mr. SHULTZ. We have engaged in a lengthy detailed budget process with the President, in which he has made all sorts of choices that are reflected in the budget detail. That does state his priority. If you seek to change them and stay within the numbers, then you have to take away as well as put in. I think the Congress has cut some aspects of his budget in the past. It has added substantially in other areas. And, of course, new authorizing legislation comes along; on the whole, that tends to be the thing that breaks the budget more than the appropriations process, as such.

Chairman PROXMIRE. Let me get into another area. In the past few weeks we have been hearing a great deal about the composition of unemployment. Senator Bentsen referred to it. A general impression is left with me that there is an effort by this administration to show that unemployment is not as serious as the overall facts would lead one to believe. Does the Executive Office have under study the nature of the unemployment, its meaningfulness, the methods by which the figures are compiled, and what resources could be put forth to improve the statistics?

Mr. SHULTZ. Let me comment first on your characterization of the analyses that have been presented, not only by the administration but by many private economists studying the whole unemployment and unemployment-inflation problem. It isn't an effort to downplay in any way the importance of unemployment, but, rather, to understand it better, so one can see more clearly how to deal with it. If its composition changes drastically, it is clear, it seems to me, that you may want to bring forward new methods for dealing with the problem. As far as the statistics are concerned, yes, the Office of Management and Budget has a Statistical Policy Division and we work with all the various statistical agencies in studying statistical programs in an effort to improve them.

We have worked with the Bureau of Labor Statistics. Among other things, they have brought forward, with our support, this proposal that Senator Bentsen referred to for more frequent gathering of information on unemployment in order to get around these blips.

Chairman PROXMIRE. I am talking about something else, a new study I just learned about, going on at the present time by an executive agency, about the nature of unemployment, its meaningfulness, the methods by which statistics are compiled, and what effort should be put into improving the statistics. Are you familiar with that? I understand that there is such a study and I understand that the Office of Management and Budget is not included as one of the agencies studying it. The agencies include Defense, Agriculture, Commerce, Labor, Health, Education, and Welfare and the Council of Economic Advisers, and it is headed by the Secretary of the Treasury.

Mr. SHULTZ. I think that is a group that is studying this problem. We are involved in all these things, but not in that particular group.

Chairman PROXMIRE. I think OMB should be on that. For one thing, you are right in the heart of the budget process which has a great effect on unemployment, and, another thing, you are in a particularly strong position to evaluate, appraise and recommend changes in statistics.

Mr. SHULTZ. Well, if we have anything to say, we don't have any difficulty getting through.

Chairman PROXMIRE. Do you consider payment of unemployment compensation a disincentive to employment?

Mr. SHULTZ. To a degree, but I don't consider that a major problem. That is, the theory of unemployment compensation is, in part, to provide income when a person becomes unemployed, and also to provide a little bit of a cushion to that a person has a little time to seek a job that meets his or her objectives and qualifications, and isn't just forced to take whatever immediately comes along. If the point you are getting at is the so-called malingering problem, I don't think that is the major problem in the unemployment compensation system.

There are problems, no doubt about it, but it isn't a major matter.

Chairman PROXMIRE. I have had a chance to talk to many employers about this. They tell me in Madison, Milwaukee, and so forth, it is not a problem; that when people receive unemployment compensation they still want work. It is a rare exception who will sit on unemployment compensation as a way of avoiding work.

I want to get at a point differently than Congressman Reuss did earlier. It may seem similar to you, but I would like to ask you this: It appears that the President wants to make his huge deficit look better by insisting that the budget is in balance at full employment. If you look at the outlays that are on paper being shifted back in fiscal year 1972 or forward in fiscal year 1973, and the paper sale of Government assets and the huge paper increases in oil receipts, and the exclusion of excess unemployment compensation from outlays, don't you really end up with a much larger deficit, a deficit on a full employment basis, fracturing the principle the President said was so important?

Mr. SHULTZ. You can move these numbers around and make some changes in the overall balance. We have stated that the fiscal 1973 budget is roughly in balance at full employment. The actual numbers show a $700 million surplus. But we did not say there was a $700 million surplus in our text. We described this as roughly in balance, realizing that there is room for variation in what you estimate the receipts level is and what the budget outlay picture is. There are many people—I think Nancy Teeters of the Brookings Institution, also—who have studied the full employment outlay picture and would feel that actually the full employment outlays are considerably lower than we have estimated. There is a range of error. I think the best characterization is that it is roughly in balance.

Chairman PROXMIRE. If you add asset transactions you will find that outlays as published, before you add the asset transactions, in 1972 are $236.6 billion. After you add them they are $239.7 billion. slightly higher. On the other hand, in 1973 they are $246.3 billion before you add them, and then you come in with the paper shuffling and it comes to $257 billion, something that is not published. Asset sales are much higher, 4.6 compared to 3.5; stockpile is much higher, three times as high; oil royalties are about four or five times as high; advanced payments are a plus instead of a minus figure; and miscellaneous is 1.3.

I wonder if you are concerned as a professional economist how exclusively the budget document has become a political statement and not a true presentation of economic facts.

Mr. SHULTZ. The question of where you take asset sales or where you take royalty payments, or so on, has a certain arbitrary nature. Actually, we were rather disappointed recently in the inability to proceed with certain oil leases because of a court suit. So we have had to move some of those offsetting receipts, or subtractions from expenditures, into fiscal year 1973.

As I have said, we are not seeking to rest on a point estimate here, but, rather, what we have is a rough balance within a reasonable range. I think some people would say we have a fairly good size surplus. We don't think so, but anyway it is kind of a rough thing.

I don't think there is anything that people have dug up that is hidden in any way. Everything is in the budget.

Chairman PROXMIRE. It just seems to be an extraordinary change in these asset transactions, a change which is very dramatic as compared with last year.

Mr. WEINBERGER. On the asset sales, Mr. Chairman, we have hopes that we are going to get some of the enabling legislation from the Congress that will permit us to make the asset sales. It has been up now for a year and a half, and we are hopeful that it will go through. The The oil royalties are not cash in the bank. We have a decision by the Supreme Court that enables us to take, in fiscal 1973, a substantial additional amount that was tied up in a law suit in Louisianna.

Chairman PROXMIRE. That is an enormous change in estimate, $700 million to $3.2 billion.

Mr. WEINBERGER. Well, there is $1.3 billion involved in this decision that I am speaking about.

Chairman PROXMIRE. It goes far beyond that.

Mr. WEINBERGER. No, I don't think there is any additional assumption that is unwarranted in either event. But this one decision did allow the Federal Government to take that amount because that portion of the royalties is now determined to be not in dispute.

Chairman PROXMIRE. If you subtract that entire amount, the full $1.4 billion you are more than 100 percent higher than 1972 in 1973.

Mr. WEINBERGER. This, again, involved some of the royalties sales that, as Mr. Shultz said, we were not able to make in 1972 because various law suits from environmental groups have tied them up. We are now resigned to the fact that they will have to be deducted in fiscal 1973.

Chairman PROXMIRE. And you estimate tripling your sales from the stockpile?

Mr. WEINBERGER. We hope that we will get the enabling legislation from the Congress that will permit us to do that, yes.

Chairman PROXMIRE. And you estimated advance payments will be plus $1 billion instead of a minus $1 billion?

Mr. WEINBERGER. Advance payments? That is the public assistance for the States. That was the amount urgently requested by the States so that they could get it in this fical year. There is no economic difference, as Mr. Shultz pointed out. That comes 1 month or 4 weeks ahead of the time when it might otherwise come. But it is a payment which was urgently requested by the States. If revenue sharing had been enacted, I don't think they would have requested it.

Chairman PROXMIRE. Those are good explanations of each individual amount, but the fact is there is a consistent and dramatic increase all along the line, and suggests that this juggling alone keeps you in line with a full employment balance.

Mr. WEINBERGER. I don't see how anyone can characterize a budget that does show a large deficit as being prettied up.

Chairman PROXMIRE. I am talking about the full employment.

Mr. WEINBERGER. Well, full employment outlays are within the full employment revenue.

Chairman PROXMIRE. You adjust it so it is.

Let me get into something else. Among the few dramatic new priorities in the fiscal year 1972 budget is the pork barrel priority. Here is how it looks: Total outlays for the Corps of Engineers increases from $1.3 billion to $1.8 billion in fiscal 1973. Total outlays for the Bureau of Reclamation increases from $316 million in 1971 to $550 million in 1973, a $189 million increase. Taken together this amounts to an increase, an astronomical increase, of 42 percent in outlays in 2 years. Almost every economist who has testified before this committee in my experience believes these programs are generally of questionable economic merit. More and more environmentalists are also questioning them. What is your justification for this enormous increase in pork barrel?

Mr. SHULTZ. The water resources outlays are partly the result of new program starts but much more importantly the results of the pace of work on projects that have been approved and are ongoing, and which are in process. We have deliberately gone through the list of projects, and where projects could be speeded up and work done on them at a faster pace, we have proceeded to fund those efforts on the theory that here is this work, it is going to be done, and when the economy has some slack in it, it is both good for the economy to speed up the work and good for the work, itself, in that you have resources available and can use them.

Conversely, when we get up toward full employment, this is a good area to ratchet back down again. It is just an effort to use the flow of Federal spending on projects that are there, that have been approved, and are going on, to vary that flow as a sort of countercyclical device.

Chairman PROXMIRE. That is interesting because 1971, of course, was a bad year, comparatively. It wasn't a good year as we anticipate 1972 will be. It was certainly a year of slow economic growth, a year of consistantly high unemployment; 1972 is expected to be a big year, according to the President. There is a difference, however; 1971 was not a presidential election year and 1972 is a presidential election year. Do you think the explanation might be political instead of economic?

Mr. SHULTZ. This goes back some time. We have been trying to move up the pace of this spending since I came into the OMB. All the economic textbooks that I have read will tell you this is the sort of thing you ought to do or try to do.

Chairman PROXMIRE. As a matter of priority, the economists and environmentalists question these very seriously. Public employment has great logic and appeal, it seems to me, and the desperate plight in the cities and the unemployment in the cities.

Mr. SHULTZ. We share your concern about the plight of the States and cities and malaise it has created. The President has a program for that called revenue sharing. So we say let the Congress get busy and pass that program.

Chairman PROXMIRE. Let me ask you about what the administration has done about the one phase of inflation over which it should have the greatest degree of control. That is Federal policies that affect prices. On January 25 I sent you a letter, Mr. Weinberger, requesting a detailed explanation of why the Regulations and Purchasing Review Board, which you chair, which was established by the President to correct Federal activities that cause inflation, has done practically nothing.

I received your reply of February 7, and while appreciating your response find myself unsatisfied with the explanation. The tone of your letter is that all the responsibilities of the Board have passed to other groups. Does this mean that the Board is no longer a viable entity and should be abolished?

Mr. WEINBERGER. No, Senator. I am sorry you didn't have the opportunity to read the letter more carefully because it didn't make that point.

It did point out that there have been other groups created since the Regulations and Purchasing Review Board was created, and it points to some of the things they have done and some of the changes in the assignments as a result.

But it also points out in considerable detail several of the things the Board has done. That report was attached to the letter to you.

Chairman PROXMIRE. I have the copy of the letter here. I have read it carefully. Tell us what specifically by way of actions it has taken since August 1971.

Mr. WEINBERGER. I suggest you might want to look at the progress report.

Chairman PROXMIRE. I will be happy to put the letters and report into the record.

Mr. WEINBERGER. All right.

(The letters and report follow:)

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., January 25, 1972.

Hon. CASPAR WEINBERGER,
Deputy Director, Office of Management and Budget,
Executive Office Building, Washington, D.C.

DEAR MR. WEINBERGER: In June, 1970 when the President created the Regulations and Purchasing Review Board he stated that "all government actions will be reviewed to determine where Federal purchasing and regulations drive up costs and prices." This is in my judgment a laudable objective given the fact that the Federal Government is the largest purchaser of goods and services in the world.

This Administration's major economic emphasis has been on fighting inflation. The main thrust of the President's New Economic Program was to halt the inflationary spiral. In his State of the Union message the President emphasized that "we can look with confidence to 1972 as the year when the back of inflation will finally be broken."

The Board which you chair should be a powerful tool available to the Executive branch for achieving this goal. As Chairman of the Joint Economic Committee, I am concerned that the Board has not been even slightly effective in the past. As far as my staff can determine, the Board has issued only one progress report, more than a year ago, and it has not even met since August, 1971. Dr. Hendrik Houthakker, who served on the Board during his tenure at the Council of Economic Advisers, last week told the Committee, "I have to concede that the Board has not lived up to its promise at all."

In view of this disturbing situation, would you please answer the following questions for the Committee:

1. In its first progress report issued more than a year ago, the Board stated that it had identified 80 potential problem areas where Federal government practices might contribute to inflation. Please provide the Committee with a list of those 80 areas, and the action taken by the Regulations and Purchasing Review Board with respect to each area.

2. The Board's activities during the past year have received little public attention. Could you please prepare a progress report for 1971? In light of the New Economic Program announced by the President in August, what initiatives has the Board taken to ensure that government purchasing complies with the wage-price program?

3. Which areas are on the Board's agenda for study in 1972?

4. Professor Hendrik Houthakker also said that the Board had reviewed the Jones Act during 1971. What were the results of that review, and what recommendations were made to you? Would you please supply the Committee with the Board report on the Jones Act. I am specifically interested in knowing the annual cost of the Jones Act to the taxpayer.

5. The Committee has undertaken a study of Federal subsidy programs, the cost of which was $63 billion in Fiscal Year 1970. Has the Regulations and Purchasing Review Board studied the possible inflationary impact of government special benefit and subsidy programs? If not, will this be on the Board's agenda in 1972?

6. Would you provide the Committee with an explanation of why the Regulations and Purchasing Review Board has not made any significant effort to fulfill its objectives?

Thank you for your cooperation. I would appreciate a reply to the above questions at your earliest convenience.

Sincerely,

WILLIAM PROXMIRE, *Chairman.*

EXECUTIVE OFFICE OF THE PRESIDENT,
OFFICE OF MANAGEMENT AND BUDGET,
Washington, D.C., February 7, 1972.

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

DEAR MR. CHAIRMAN: This is in response to your letter of January 25, 1972, inquiring into the activities of the Regulations and Purchasing Review Board.

You mention in your letter that you supported the President's objective in creating the Board in 1970. Also, I am aware that you supported the legislation that created the Commission on Government Procurement in November 1969. As you recall, the Commission was established to *comprehensively* review procurement policies, practices, and organization, including "the practices of awarding Defense contracts on the basis of price negotiations rather than competitive bids." The Commission is scheduled to complete its report to the Congress December 31, 1972.

The Regulations and Purchasing Review Board was not intended nor has it acted to parallel the work of the Commission. Rather it has been supportive of its efforts. The Board was intended and has acted to selectively review policies which appeared to affect inflation. This it has done during the last 18 months. The Board's activities are described in the most recent annual progress report which is attached.

The Board's activities have been greatly and appropriately affected by major changes in economic policy and organizational structures such as—

the creation of the Council on International Economic Policy,
the suspension and subsequent reinstatement of the Davis-Bacon Act,
the creation of the Construction Industry Stabilization Committee,
the Wage-Price-Rent Freeze,
the change to wage-price-rent controls, and
the suspension of convertability of the dollar into gold and the subsequent agreement to devalue the dollar.

The Board's agenda changed in a number of ways. The Board has assisted the new organizations and the Commission on Government Procurement. The Board passed its analysis and recommendations onto new organizations which were subsequently designed to handle those issues. New issues have been raised and some unresolved issues remain.

The attached report is intended to answer the questions you asked except for your inquiry as to whether your committee's recent report on subsidies will be reviewed by the Regulations and Purchasing Review Board. I am pleased to say that an initial review of your report has already been made. Also, I understand that the staff of the Office of Management and Budget assisted your staff people in the development of your estimates. Because subsidies are given for many purposes, however, it would be inappropriate to review them solely from the point of view of their effect on price levels. Rather, we plan to review any new data or insights into Federal subsidies, such as your studies, in our planning and budgeting sessions during the year, in preparation for the FY 1974 budget.

Sincerely,

CASPAR W. WEINBERGER,
Deputy Director.

Attachments.

REGULATIONS AND PURCHASING REVIEW BOARD—PROGRESS REPORT

Background and purpose

The President established the Regulations and Purchasing Review Board on June 17, 1970, to review particular Government actions" . . . to determine where Federal purchasing and regulations drive up costs and prices." At the same time, the President established the National Commission on Productivity to study ways to increase growth of productivity and thereby increase economic growth and reduce cost-push inflation. He also instructed the Council of Economic Advisers" . . . to prepare economic inflation alerts."

Also, during mid-1970, the congressionally mandated Commission on Government Procurement completed the organizational phase and began their assigned task to review comprehensively Federal procurement practices, procedures, and organization, including the procurement of military goods and services.

These actions were preceded by significant changes in monetary and fiscal policy which were aimed at dampening inflationary pressures stemming from excessive demand in the economy. However, the cost-push element of inflation continued to be a serious problem in 1970. This was the major factor which lead the President to stress productivity improvement, to alert the Nation to prospective inflation in selected areas, and to initiate a continuing review of Federal policies which adversely affect price levels.

Organization

The President asked Caspar W. Weinberger, Deputy Director of the Office of Management and Budget, to serve as Chairman of the Board. The other members are Peter G. Peterson, Secretary of Commerce (Maurice H. Stans was the Commerce Secretary until January 1972) ; Herbert Stein, Chairman of the Council of Economic Advisers (Paul W. McCracken was the Council Chairman until December 1971) ; Rod Kreger, Acting Administrator of General Services (Robert L. Kunzig was Administrator until January 1972) ; and Richard W. McLaren, Assistant Attorney General for Antitrust. (Peter M. Flanigan, Assistant to the President, was a member until January 31, 1972, when he became Executive Director of the Council on International Economic Policy.) Jack W. Carlson serves as Executive Director of the Board in addition to his other duties at the Office of Management and Budget. Other agency heads have been invited to participate when issues arise which affect them.

To insure in depth evaluation of the issues coming before the Board, a Working Committee was established consisting of representatives from major agencies (see attached roster). This Committee was then divided into subcommittees which are responsible for analyzing particular problem areas, identifying alternative solutions and estimating the costs and benefits associated with each. This information is then transmitted to the Board for policy action.

Activities of the board

Initially, the Board identified many potential problem areas in Federal regulations and purchasing which were adversely affecting costs and prices. Several of these areas were then selected for more intensive analysis and consideration by the Board. However, it was not long before a number of events occurred that directly affected the Board's activities.

Important Events Since the Board Was Created.—In view of the inflationary pressures which continued in 1971, the President first acted to restrain excessive wage and price increases in the construction industry under the authority granted him by the Economic Stablization Act of 1970. Subsequently, overall restraints on wages, prices, and rents were initiated in the face of the continuation of unacceptably high inflation.

Specifically, on March 29, 1971, the President, working with labor and industry leaders, developed a cooperative program designed to restrain cost increases in the construction industry. A twelve-member tripartite Construction Industry Stabilitation Committee was established to review and pass upon the acceptability of all economic adjustments in all collective bargaining agreements negotiated in the construction industry. At the same time a Cabinet-level Interagency Committee on Construction was also established to develop procedures designed to mitigate the excessive price increases observed in industry.

On August 15 the President ordered an immediate 90-day freeze on prices, rents, wages, and salaries and created a Cabinet-level Cost of Living Council to administer the freeze and to advise on further stabilization policies and actions. Prior to the end of the 90-day freeze, the President announced the outline and the goal of a program of controls. The interim goal of the control program and other policies was to achieve a slowing down of price increases to the range of 2 to 3 percent by the end of 1972. Guidelines and standards aimed at this goal were subsequently developed by several new policy-setting organizations: the Pay Board, the Price Commission, and four other committees and a board. The Cost of Living Council continued to act as the coordinating and monitoring organization.

Also, on August 15, 1971, the President suspended the convertability of the dollar into gold and other reserve assets. On December 18, as a result of the Smithsonian Agreement among the finance ministers of the industrialized countries, the President agreed to propose to the Congress the devaluation of the dollar in terms of gold while other countries revalued their currencies upward in terms of the dollar in order to correct a chronic maladjustment of international currencies which was causing a serious balance of payments problem for the United States.

Since mid-1970, the Commission on Government Procurement has initiated its substantive review of all procurement policies and procedures. The Commission has subsequently recognized the effort needed to review comprehensively Government procurement and has requested and received an extention of the date that the Commission is to report to Congress. The legislation creating the Commission stated:

"The Commission on Government Procurement is directed to study and investigate the present statutes affecting government procurement; the procurement policies, rules, regulations, procedures, and practices followed by the departments, bureaus, agencies, boards, commissions, offices, independent establishments, and instrumentalities of the executive branch of the Federal Government; and the organizations by which procurement is accomplished to determine to what extent these facilitate the policy declared in the bill."

The legislation goes on to say the following:

". . . it is the policy of Congress to promote economy, efficiency, and effectiveness in the procurement of goods, services, and facilities by and for the executive branch of the Government."

The Commission is now planning to submit their report to the Congress by December 31, 1972.

The Board was never intended as a parallel organization to the Commission. The Commission was intended to be comprehensive and study the fundamental problems. The Board was intended to be selective and study immediate problems—and primarily those that impact on inflation. In particular, the Commission was intended as the vehicle to study the fundamental problems involved with procurement of unique government products such as Weapon Systems.

In January 1971, the President established the Council on International Economic Policy. The Council was created in response to the general recognition by many agencies and organizations, including the Regulations and Purchasing Review Board, that better coordination and staffing was required in this vital area.

These events have required adjustments in the work program of the Regulations and Purchasing Review Board. The Board has redirected its efforts in three ways: First, the Board moved to assist other organizations in their tasks and has initiated actions which would reinforce their policies. Second, the Board has made recommendations and then stepped aside as other institutions took on the responsibility of implementing the new policies. Third, the Board continued to work in those areas unaffected by these events.

Economic Stabilization Program.—In support of the President's wage-price freeze, the Regulations and Purchasing Review Board released the following statement on August 18, 1972:

"The United States Government is the largest purchaser of goods and services in the world. That Government purchasing power should be used to the full extent the law permits to support the President's Economic Stabilization Program. In placing Government contracts for goods and services, officials should consider, as a decisive factor, whether contractors are in compliance with the Economic Stabilization Program in all of their transactions.

"Each Federal agency should establish procedures for notifying contractors and subcontractors and insuring compliance. The major Federal agencies, . . . will notify the Chairman of the Regulations and Purchasing Review Board . . . as to the steps they are taking to comply with the guidelines."

On December 28, 1971, the Board issued a similar statement covering wage, price, and rent controls. Subsequently, all Federal agencies notified contractors and grant recipients that they must certify their compliance with the program. Compliance was described as follows:

"The pay standard calls for increases in wage rates of no more than 5½% unless specific exceptions have been granted by the Pay Board. The price standard has the objective of holding economy-wide price increases to 2½% after adjusting for cost increases and productivity gains and considering allowable profit margins. Average productivity gains are estimated to be 3% or higher for the economy during the next 12 months." This action, through the procurement process of the Federal Government, has had and will likely continue to have a major impact on insuring compliance with the Economic Stabilization Program.

There were several particular issues the Board acted upon which became a part of larger efforts in the fight to contain inflation and improve the U.S. balance of payments position. Among these issues are the Davis-Bacon and Buy America Acts which were under study by the Board.

Davis-Bacon Act.—During the latter part of 1970 and early 1971, the Board reviewed the Davis-Bacon Act under which wage standards for federally funded, assisted, or insured construction are set. There was concern that the procedures followed under this Act and related acts may be contributing to inordinately high negotiated wage increases and substantially increased costs in the construction industry. The Board considered the nature of the problem and alternative ways to overcome the potentially inflationary characteristics of the Act.

Early in 1971, the President first suspended and then reinstated the Act after establishing a cost restraint program under the newly created Construction Industry Stabilization Committee. This program has been a very positive force in reducing wage increases from a pre-program level of 19% to an 11% rate of escalation just six months later.

Buy American Programs.—The Board reviewed regulations that require Federal agencies to give domestic suppliers preference over foreign suppliers. There are several types of policies which were considered. The Buy American act and an Executive order require Federal agencies to give a 6% price preference to domestic over foreign suppliers when procuring goods for use in the United States. Under separate authority the Defense Department several years ago adopted a higher preference (50%) as a measure to improve the Nation's balance of payments by reducing foreign source procurement. Under separate administrative regulations, Federal agencies are required to apply a 50% preference in favor of domestic suppliers when procuring for overseas use. These regulations were intended to restrain U.S. Government foreign purchases at the cost of higher budget expenditures and higher prices.

The Board evaluated several possible changes in the current policies and shared their evaluation with the Council on International Economic Policy when it was established and operating. At that time, it was obvious to the Board that any changes in Buy National policies should be made subject to negotiated changes in similar policies of our major trading partners. Subsequently, the President agreed to devalue the dollar in relation to gold, which is likely to have a much greater positive effect on the U.S. balance of payments. Subsequently, responsibility for policy review of the Buy American programs has shifted to the new Council on International Economic Policy which will be responsible for initiating next steps.

The Board has considered a number of other issues which have resulted in improved policies and procedures and is still considering many others.

Government Procurement of Floor Space.—From the start of its deliberations the Board was concerned with improving policies and procedures affecting the Government's provision of buildings and structures. Improvements for the Federal Government would undoubtedly have a desirable effect on all commercial construction. The Board has considered several areas such as the choice of lease vs. purchase, more efficient production techniques, and performance contracting.

Leasing Policies.—The Board considered the advantages and disadvantages of leasing as opposed to the predominant policy of Federal construction and ownership. It also considered the existing restrictions on property leasing, such as lease terms limited to 5 years or less, and the desirability of removing some of them.

Areas of improvement were identified and some of these have already been incorporated in a bill before the Congress which will allow more flexibility in the leasing and lease-purchase of Government buildings. Leasing was found to be less costly than Government construction and ownership in several projects which might have inadequately considered leasing before the analysis occurred.

Systems Approach and Performance Contracting.—The Board considered ways to lower the cost of providing government floor space thereby mitigating cost-inflation pressures by planning and constructing buildings on a "systems approach." The building would be planned to include modular pieces that could be constructed in a factory environment with less costly on-site costs, which are often associated with weather, and transported to the site. This approach was an analog to the Housing and Urban Development Systems Breakthrough program.

The General Services Administration took the lead in developing this approach. The progress today has been significant. Three proposed buildings in the fiscal year 1973 budget are identified to use this approach. The experience from these projects will be evaluated and used in all subsequent federally sponsored building projects. On paper the projects offer the prospects of lowering costs by 10–20% and of reducing cost-push pressures. Moreover, the techniques developed can be exploited by the private sector in its own building which will also contribute to cost savings and less pressures on prices. Finally, these experimental projects are designed to initiate performance contracting for Federal floor space. The intent is to contract for a building that will serve the needs of an agency but will allow even more flexibility for innovation and cost reduction.

Regulations vs. Expenditures vs. Taxes.—Early in its deliberations, the Board was faced with the prospect that regulatory approaches to resolving public problems could be substituted for credit, budgetary, or tax approaches. These alternative approaches were apparent when the Federal Government received requests to assist railroads in their efforts to reorganize and become commercially viable. The Congress and the executive branch received suggestions, ranging from credit assistance and subsidies to special tax advantages. As a partial substitute some carriers pointed to the need for rate adjustments and abandonment procedures. Responsibility for these competing alternative approaches is lodged in different branches and departments of Government.

It was quite apparent that the existing processes in the executive branch did not fully meet this responsibility. Therefore, the Board recommended the establishment of new procedures to coordinate Federal agency positions before regulatory bodies. An OMB Circular is being developed which will assign primary responsibility to particular agencies for coordinating executive branch agency positions before regulatory bodies. On major issues, the affected Federal agencies will meet to determine if an executive branch position is desirable and, if desirable, what it should be.

This process was initially developed and used in support of railroad rate adjustments which were necessary to keep the railroads running in the Eastern part of the U.S. in 1970 and 1971. The alternative of massive subsidies or additional tax relief was considered to be a less desirable alternative at the time. However, some credit assistance was also made available.

Timing and Magnitude of Rate Increases.—When major tradeoffs in budget, credit, tax and regulatory approaches are not the major issue, the Board has appealed to regulatory bodies to re-evaluate and/or change the timing on rate increases which appeared to be inflationary and above the immediate need for cost coverages.

For example, the Board appealed to the Tennessee Valley Authority to reassess, and consider postponing, electricity rate increases in 1970 which appeared excessive, inflationary, and premature. Despite the Board's request, the independent Authority put the new rate into effect.

For another example, the Board reviewed and subsequently protested as highly inflationary and unjustified a proposed freight rate increase of 11% to 58% for transporting modular and mobile homes. It petitioned the Interstate Commerce Commission to investigate the proposed rate increase carefully and to hold public hearings before any significant rate increase was granted. The proposed rate increase was subsequently withdrawn and rates were actually reduced below their existing level.

Subsequently, the Board, with the Department of Housing and Urban Development and the General Services Administration, has cooperated with truck and rail carriers to monitor price movements of modular and mobile homes so as to encourage technological change while still permitting adequate coverage of costs.

Government as a Consumer of Services from Regulated Industries.—After more than a year of deliberation by the Board, it was apparent that the Federal Government could benefit by beefing up its down efforts before regulatory bodies. The Federal Government pays about $15 billion annually for services whose rates are set by regulated industries. Like any other consumer, the Government has an interest in fair and equitable rates.

The General Services Administration has by law the responsibility to represent the Federal Government as a consumer of utility services before regulatory commissions. The Board has asked GSA to develop a multi-year plan to improve this function. Clearly, modest improvement in staffing and organizational structure and location can mean more competent and complete representation before regulatory bodies. The Federal Government should be able to reduce its future utility bills by approximately 5% or as much as $750 million below what these bills would have been without this improvement.

Administrative Practices That Restrict Imports.—The Board has reviewed several administrative policies that impose quantitative restrictions on the flow of imported products into the United States. They were reviewed with regard for the inflationary consequences and to consider alternative policies that would be less inflationary.

Some agency heads have authority to establish regulations as to product characteristics, source, processing and other factors which have the practical effect of restricting imports and thereby causing higher prices than would otherwise have prevailed.

For example, the Board reviewed the size requirements for green and pink tomatoes grown domestically and in Mexico during the "winter season" to assess the inflationary implications. Over $150 million are paid by American consumers for tomatoes during the winter's six months, and they account for about one percent of the typical household's total food budget. A small change in requirements could significantly reduce consumer food prices and, perhaps, increase the quality of tomatoes reaching the consumer.

In this and other cases, the Board has reviewed the inflationary consequences of alternative ways of managing import restrictions programs with the appropriate Department heads assigned program responsibility. This is not a simple exercise, however, because each program has many policy objectives in addition to price stability.

The Jones Act.—The Board has reviewed the economic effect of the Jones Act and evaluated possible modifications. The Jones Act, Section 27 of the Merchant Marine Act of 1920, is a "cabotage" (coastal trade) law which precludes the use of foreign-built, foreign-owned, foreign-flag, and/or foreign manned ships from trading in the coastwise, intercoastal, or offshore, (e.g., Alaska, Hawaii, and

Puerto Rico) domestic trade of the United States. In addition, a ship is precluded from domestic trade if it has ever been registered under a foreign flag, regardless of whether it was built in the U.S. and owned by a U.S. citizen or manned by U.S. seamen. Only minor and short-term exceptions have been made to the law, such as the one-year suspension to allow transport of lumber in foreign-built ships to Puerto Rico during 1962.

The Board has analyzed the benefits of changes in the Jones Act as well as the losses to be suffered by current beneficiaries. Defense implications weighed heavily in the deliberations. The Board has not finalized its work in this area because the Defense implications have not yet been totally assessed. Also, the Federal maritime program which was passed by the Congress in 1970 needs to be fully evaluated before recommendations for changes in the Jones Act can be formulated.

Red Tape in Federal Grant Administration.—The Board considered the problem of excessive requirements and inadequate prescreening criteria for some Federal project grants. This problem has led to needless waste of effort, which in turn has raised costs. For example, a Federal agency solicited applications from 97 cities for a contract where only two complete grants and four partial ones were made. The total cost of preparation of these applications exceeded the value of the grants themselves.

The Board requested the Office of Management and Budget to find ways of simplifying the application methods. At the present time, the Office of Management and Budget is working with an interagency group to accomplish this task.

Attachments.

REGULATIONS AND PURCHASING REVIEW BOARD—WORKING COMMITTEE MEMBERS

Jack W. Carlson, Chairman, Assistant to the Deputy Director, Office of Management and Budget.

Edwin U. C. Bohlen, Assistant to the Under Secretary, Department of the Interior (David P. Stang was a member until November 15, 1971).

Walker B. Comegys, Deputy Assistant Attorney General. Antitrust Division, Department of Justice (Bruce B. Wilson will replace Mr. Comegys February 3, 1972).

E. William Dinkelacker, Economic Counselor, General Services Administration.

Edgar R. Fiedler, Assistant Secretary for Economic Policy, Treasury Department (Murray L. Weidenbaum was a member until Sept. 1971).

Julius L. Katz, Acting Assistant Secretary for Economic Affairs, Department of State (Phillip H. Trezise was a member until Nov. 27, 1971).

Clifford J. Miller, Deputy Comptroller for Plans and Systems, Department of Defense.

Charles J. Orlebeke, Deputy Under Secretary, Department of Housing and Urban Development.

Don A. Paarlberg, Director, Agricultural Economics, Department of Agriculture.

Harold C. Passer, Assistant Secretary for Economic Affairs, Department of Commerce.

Laurence H. Silberman, Under Secretary, Department of Labor.

Ezra Solomon, Member, Council of Economic Advisers (Hendrik S. Houthakker was a member until June 1971).

(George Crawford, Staff Assistant to the President, was a member until January 31, 1972).

Chairman: Hon. Caspar W. Weinberger, Deputy Director, Office of Management and Budget.

Members:

Hon. Rod Kreger, Acting Administrator of General Services.

Hon. Richard M. McLaren, Assistant Attorney General, Department of Justice (Resignation effective February 3, 1972).

Hon. Peter C. Peterson, Secretary of Commerce.

Hon. Herbert Stein, Chairman, Council of Economic Advisers.

(Robert L. Kunzig was a member until Jan. 14, 1972).

(Walker B. Comegys will become an acting member February 3, 1972).

(Maurice H. Stans was a member until Jan. 31, 1972).

(Paul W. McCracken was a member until Dec. 31, 1971).

(Peter M. Flanigan, Assistant to the President, was a member until Jan. 31, 1972, when he became Executive Director of the Council on International Economic Policy).

Executive Director: Jack W. Carlson, Office of Management and Budget.

Chairman PROXMIRE. Would you like to briefly summarize for us about this? What specific action has it taken since August 1971 to get at various Federal programs that are inflationary? I identified 80 problem areas, a list of 80 problem areas, in my letter to you.

Mr. WEINBERGER. The Board, beginning immediately after the President's program was announced in August, put out the statement and directive following rather intensive consultation with several of the large purchasing agencies of the Government. The directive stated as a policy that all Government purchasing was to be in accordance with the economic stabilization program and that in placing Government contracts for goods and services, all purchasing officials should consider as a decisive factor whether contractors were in compliance with the economic stabilization program in all of their transactions.

We secured the cooperation of GSA, Defense and various other agencies which are the major purchasers in their field. In December, after the phase II program had taken effect, we required the same kind of compliance, that the contractors show the same kind of compliance, before Federal agencies would be able to enter into contracts with them. Compliance was described as stated in the letter; that is, full compliance with the various goals and guidelines.

Chairman PROXMIRE. What specific actions did you contemplate? What was done?

Mr. WEINBERGER. That was a very specific action. The Government of course, is the largest purchaser of goods and services in the world, as you know, so this action by the Board led to the compliance of the purchasing contracts of the largest purchaser in the world with the phase II goals and guidelines.

Chairman PROXMIRE. Has this been the case? Have you followed up to determine that it has been the case?

Mr. WEINBERGER. The followup that we have been able to make since the December action is not very substantial because barely a month and a half has passed. We have had full compliance with the purchasing agencies, and there is a requirement that will make it, in effect, self-enforcing because it requires the affidavit and the certification by the contractors with the Government that they are in compliance, thus laying the groundwork for any kind of legal actions that may be necessary to insure that.

Chairman PROXMIRE. How about the import quota program?

Mr. WEINBERGER. Well, the import quota programs are some of the matters that we have had under general study. We have also had a lot of other items under general study. The Davis-Bacon Act has been under general study. As you know, in 1971 the President suspended that act.

Chairman PROXMIRE. It is the one specific area, it seems to me, where some action has been taken and it has been effective. But I don't know of any other.

Would you, for the record, provide answers to the 80 specific problems areas to which I referred in my letter? Not now but for the record.

Mr. WEINBERGER. We will supply additional information based on the report the Board has filed of our activities. As we indicated in that report, the membership of the Board is made up of people who all have other major assignments within the Government. But we will try to supply the information, if there is additional information required, in addition to what we have already supplied.

Chairman PROXMIRE. That means that you will, that you won't, that you may, or that you will supply in part? Which answer?

Mr. WEINBERGER. Senator, the 80 problem areas that you listed are areas of your own definition. We have a board that has been constituted by the President to do specific tasks, some of which were taken over by other groups that have been formed.

Chairman PROXMIRE. Let me interrupt to say that those are the 80 problem areas that your board identified. They were your definitions, not mine. We picked that up and asked you to give us specific responses on those 80 areas that you identified.

Mr. WEINBERGER. What is it that you want?

Chairman PROXMIRE. I want to know what actions have been taken. The initial action of the Board was to screen all Federal programs, to identify policies that may contribute to inflation. This exercise resulted in the identification of about 80 potential problem areas requiring further analysis.

That is from your report of last year. You never identified those 80 areas. We want them identified and to learn what has been done.

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

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

FEBRUARY 10, 1972.

Hon. CASPAR WEINBERGER,
Deputy Director, Office of Management and Budget,
Executive Office Building, Washington, D.C.

DEAR MR. WEINBERGER: In testimony before the Joint Economic Committee on February 8th, you agreed to provide additional information on the Regulations and Purchasing Review Board. We would appreciate having the list of 80 problem areas identified by the Board and a statement of what action has been taken in each case. As requested in my January 25th letter, we would also like a copy of the Board's report on the Jones Act.

I want to thank you again for your responsive testimony and cooperation.

Sincerely,

WILLIAM PROXMIRE, *Chairman.*

EXECUTIVE OFFICE OF THE PRESIDENT,
OFFICE OF MANAGEMENT AND BUDGET,
Washington, D.C., March 2, 1972.

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

DEAR MR. CHAIRMAN: As you requested during my testimony before the Joint Economic Committee, February 8, 1972, I have enclosed an insert for the transcript concerning the problem areas considered by the Regulations and Purchasing Review Board. Also, I have enclosed the most recent progress report of the board.[1]

In a letter which you subsequently sent me, you requested a copy of the Regulations and Purchasing Review Board's study of the Jones Act. Unfortunately, the study is not yet complete. The national security aspects of the problem are incomplete.

Sincerely,

CASPAR W. WEINBERGER,
Deputy Director.

Enclosures: 2.

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[1] EDITOR'S NOTE.—The progress report referred to is the same as the one beginning on p. 103.

Most of the areas considered by the Regulations and Purchasing Review Board are identified in the list below. The list contains all of the major problem areas the Board and its Working Committee have considered. More than one issue arose in some of these problem areas. The disposition of the issues in each problem area is described. This reflects the actions of the Board as well as other participants in the executive branch.

Problem Areas	*What Has Been Done*
Evaluation of lease vs. purchase of real property.	Change in both evaluation procedures and policy (OMB draft Circular under review. Proposed legislation pending in the Congress—S. 1736).
Improved use of Federal property.	Require agencies to pay annual rent for use of Government-owned office space. Proposed legislation (S. 1736) now pending in Congress.
Federal property hoarding.	Primarily the activity of Defense Department, General Services Administration, and the Property Review Board. As indicated in the Environmental Message, some Federal property is being converted to park use.
Davis-Bacon Act.	Davis-Bacon was suspended in 1971 and then reinstated after the President established the Construction Industry Stabilization Committee.
Systems Approach for Federal Building Construction.	Evaluation completed and application approved.
Application of Systems Approach.	Three projects selected for initial application and design beginning in FY 1972.
Performance contracting.	Evaluated and included as part of the Systems Approach.
Federal Government representation before regulatory and rate-making bodies concerning rate changes affecting the Government as a consumer.	Capacity has been increased for Government representation activity.
Federal Government appearance and posture before regulatory bodies concerning regulatory policy as a substitute for expenditure or tax policies.	New procedures are under consideration.
Renegotiation Act.	Being considered by the Procurement Commission.
Government supply priorities.	Under review.
Miller Act.	Reviewed and no action recommended at this time.
General deregulation of surface transportation.	Legislation is before Congress.
Electricity rate changes by TVA.	Requested TVA delay increasing rates, without success.
Motor carrier rates for modular and mobile homes.	Requested ICC investigate proposed rate increases; the proposed increases were withdrawn.
Railroad rates for modular and mobile homes.	Requested reduction in rates. Rates were reduced.
Import restrictions on winter tomatoes.	No restrictions exist today.
Import restrictions on meat.	Allowable imports may be allowed to increase, resulting in reduced prices.
Import restrictions on sugar.	Congress extended the existing policies to 1974.
Buy American Act.	Reviewed; recommendations identified; to be assigned to the new Council on International Economic Policy.
Buy American Act exceptions.	Reviewed; some changes identified; to be assigned to the new Council on International Economic Policy.

Problem Areas	*What Has Been Done*
Preference for domestic supplies for overseas use.	Reviewed; recommendations identified; to be assigned to the Council on International Economic Policy.
Jones Act.	Evaluation incomplete primarily because of uncompleted consideration of national security needs.
Excessive red tape in Federal grant administration.	Improvements being considered and some implemented by the Federal Assistance Review program.
Slowdown in cost-push inflation from Federal purchases of goods and services.	Required all Federal contractors to certify that they are in compliance with the Economic Stabilization Program.
Federal policies affecting the setting of prices, rents, and fees.	Monitor Federal compliance with Circulars Nos. A–25 and A–45; provide progress reports to the Cost of Living Council.
Federal purchasing to assist in compliance with the Economic Stabilization Program.	All Federal contracts now require certification that contractors are in compliance with the Wage-Price Controls (see Federal Register, Vol. 37, No. 40, Tuesday, Feb. 29, 1972).

Chairman PROXMIRE. Again, gentlemen, I apologize. I don't mean to be rude in any way if I press too hard. I am sure I don't have to apologize because you men are very capable, Mr. Shultz, Mr. Weinberger, and Mr. Cohn. I want to thank you for excellent testimony and very responsive replies.

The committee will stand in recess until tomorrow morning at 10 o'clock when we will hear from the Chairman of the Federal Reserve Board.

(Whereupon, at 12:40 p.m., the committee recessed, to reconvene the following day at 10 a.m., Wednesday, February 9, 1972.)

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

RESPONSE OF HON. GEORGE P. SHULTZ TO ADDITIONAL WRITTEN QUESTIONS POSED BY CHAIRMAN PROXMIRE

Question 1. Budget outlays as published are estimated at $236.6 billion in 1972 and $246.3 in 1973, an increase of roughly $10 billion. However, the national income accounts budget shows an increase of $18 billion over the same period.

Which is the more meaningful concept to use when we want to examine the economic impact of Federal outlays? Could you give us the major factors leading to this difference?

Answer. Economists generally content that the NIA concept provides a better measure of the Government's impact on the economy than does the unified budget. However, the case is far from clear. Federal financial transactions (excluded from the NIA) do have an economic impact, even thought the impact may be more indirect than for many other types of Federal spending. Also, the NIA practice of recording defense purchases on a deliveries basis often distorts the short-run economic impact of changes in defense spending. Since the adoption of the unified budget, the evident superiority of the NIA over the budget has diminished appreciably; its principal advantage now is that the Federal sector is meshed with other components of the national income and products accounts, while the unified budget is not. As a practical matter, neither is a perfect measure of the Government's economic impact; they are largely complementary indicators.

The major differences between the budget and NIA Federal sector are discussed in Special Analysis A of the budget. One set of differences is caused by items included in the NIA as receipts and in the budget as negative outlays, or vice versa. Such netting and grossing transactions affect the total level of receipts and outlays but not the surplus or deficit. In 1973, these are expected to total $5.2 billion, an increase of $0.5 billion from 1972. The other major adjustment on the receipt side is a set of timing adjustments. The budget records receipts at the time the cash is received, while most NIA receipts are recorded when earned (accrued) even though they may not actually be received by Treasury unil after a substantial lapse of time.

On the outlay side the budget includes net loans and financial transactions which the NIA excludes; these financial transactions are expected to total $2.9 billion in 1972 and $1.3 billion in 1973, so the change is $1.6 billion. The budget also normally records payments when checks are issued; the NIA records delivery of purchases rather than payments for purchases. In 1972, defense payments are expected to exceed deliveries by $0.7 billion, while deliveries will exceed payments by $3.0 billion in 1973. Also in 1973, the Federal Government will receive a non-recurring $1.0 billion increase in receipts from Outer Continental Shelf oil and gas lease sales, which is counted in the budget as a negative outlay but which the NIA does not count at all. There are a number of other relatively minor differences between the two concepts.

Question 2. Perhaps the Federal activities in the credit and loan markets will be the source of Federal Government stimulation of the economy. Either directly or indirectly these credit activities will supply an amount equaling $31 billion of increase this fiscal year, almost double the increase in FY 1971. And the increase in FY 1973 will be even greater. Would you please give us your analysis of such activities on total spending, on credit markets, on interest rates?

Answer. Four of the five parts of this question appear to duplicate questions raised by Senator Bentsen. A response to these has been separately supplied for the record, and a copy is attached.[1]

The fifth part of your question asks about credit program accounting differences between 1971 and 1973. The only such change has been the exclusion of the Export-Import Bank from budget totals effective August 17, 1972, as authorized by statute.

For purposes of the credit analysis, Export-Import Bank net lending was included with Government-sponsored credit agencies, which are excluded from the budget. Inclusion of Ex-Im Bank direct loans with budget agencies in the credit analysis would have added $1,327 million to divert lending in 1972 and $1,187 million in 1973. The identical amounts would be deducted from lending by Government-sponsored agencies in tables E–5 and E–6 (but total credit assistance in table E–6 would remain the same).

If Ex-Im were still in the budget, the budget deficit and other means of financing would be increased by $1,220 million in 1972 and by $1,054 million in 1973 (see means of financing table C–2 in Special Analysis C). These amounts include the net lending of Ex-Im Bank plus other Ex-Im transactions such as interest income and expenses and operating costs. Borrowing from the public would be unchanged since Ex-Im Bank borrowing is already included in that figure.

TABLE C-2.—MEANS OF FINANCING THE FEDERAL BUDGET DEFICIT

[In millions of dollars]

Description	1971 actual	1972 estimate	1973 estimate
Budget deficit	23,033	38,783	25,472
Means of financing the deficit:			
Borrowing from the public	19,448	39,500	27,500
Other:			
Decrease or increase (—) in cash and monetary assets	(1)		
Increase or decrease (—) in liabilities for:			
Checks outstanding, etc.[2]	2,164	88	−5
Deposit fund balances	940	−125	−1,501
Seigniorage on coins	378	540	532
Other	[3] 104	[4] −1,220	[4] −1,054
Subtotal, means of financing other than borrowing from the public	3,585	−717	−2,028
Total, means of financing	23,033	38,783	25,472

1 Less than $500,000.
2 Includes military payment certificates, accrued interest (less unamortized discount) payable on public debt, and, as offsetting assets, certain collections in transit.
3 This consists of the collections resulting from the redemption of securities owned by Government-administered funds which had been issued by the Federal National Mortgage Association, now privately owned, at the time when it was Government-owned and therefore included within the budget totals.
4 This consists of the net disbursements of the Export-Import Bank (a wholly Government-owned corporation) beginning Aug. 17, 1971, when it was removed by statute from the budget totals.

1 See p. 69 for the response to Senator Bentsen's question.

Question 3. We can calculate from the various submitted reports the half-year figures for Federal purchases of goods and services (NIA basis). Such calculations suggest that Federal purchases in FY 1973 will be no higher than the rate of spending in the first half of this calendar year. Prices will, however, average higher in fiscal 1973. Doesn't this mean that the Federal Government will be exerting a downward pressure on total GNP in fiscal 1973? Grant-in-Aid to State and localities are "budgeted" to rise $10 billion to an annual rate of about $41 billion in the current half year. The total for all of FY 1973 is almost a billion dollars lower. Does the big jump apparently budgeted for this half year rest on assumed passage of H.R. 1 and general revenue sharing bills? If so and Congress does not pass these measures before June 30, where does that leave the full-employment budget deficit predicted by the Administration for this fiscal year? If Congress approves some such welfare and general revenue sharing bills after June 30, where is the full-employment budget balance for the next fiscal year?

Answer. Federal purchases declined from fiscal year 1969 to 1970 and from fiscal year 1970 to 1971. In contrast, Federal purchases are expected to rise by $7½ billion in fiscal year 1972 and $4 billion in fiscal year 1973. As you suggest, on a half-year basis, the greatest expansion shows up in the last half of fiscal year 1972, when purchases are projected to increase at an annual rate of over 16%. This increase will add great stimulus to the economy; maintaining Federal purchases at this high level should provide continuing short-run stimulus in fiscal year 1973.

Grants-in-aid are expected to rise by $10 billion in the last half of fiscal year 1972. This sizeable increase is due in large part to (1) revenue sharing, assumed to be effective retroactive to January 1, 1972, and (2) an advance of public assistance payments to the States. These two items account for about $7 billion of the $10 billion increase in the last half of fiscal year 1972. Fiscal year 1972 grants-in-aid are not affected by the passage of H.R. 1. If Congress does not pass revenue sharing effective in fiscal year 1972, and if the rest of the budget remains as proposed by the President, the full-employment deficit would be about $2¼ billion less than the current estimate of $8.1 billion.

Passage of the President's $5 billion revenue sharing proposal, effective in fiscal year 1973, would not alter the current fiscal year 1973 budget estimates since revenue sharing outlays have already been included. Likewise, passage of welfare reform as proposed by the President would not alter our fiscal year 1973 budget estimates.

Question 4. In a separate letter to Mr. Weinberger on February 10, I requested a list of 80 problem areas identified by the Regulations and Purchasing Review Board and a statement of what action has been taken in each case. I also requested a copy of the Board's report on the Jones Act. This is to confirm that this information is expected for the record.

Answer. Mr. Weinberger sent the requested information to the Committee on March 2, 1972.

Question 5. On page 9 of the President's Budget Message there is a table showing the distribution effect of the Federal income tax reduction over the period 1969–1972. Please provide the income class impact of the 1971 Revenue Act, to include all income and not just wage income.

Answer. The use of wage income is a simplifying assumption that in no way detracts from the basic point that income taxes have been cut between 1969 and 1972. In order to produce a similar table for other income, the Treasury would have to be provided with specific assumption about the amount and type of non-wage income. Inclusion of such assumption in the table on page 9 would have unnecessarily complicated the table and would not alter the point that was being made.

Question 6. Please provide the income class impact of individual income taxes when corrected for social security tax increases for the period 1969–1972.

Answer.

INCOME AND SOCIAL SECURITY TAXES OF A MARRIED COUPLE WITH 2 CHILDREN, 1 WAGE EARNER (CALENDAR YEARS)

Wage income	Taxes paid		Change between 1969 and 1972	
	1969	1972	Amount	Percentage
$5,000:				
Income taxes	290	98	−192	−66
Social Security taxes	240	260	+20	+8
Total	530	358	172	−32
$7,500:				
Income taxes	756	484	−272	−36
Social security taxes	360	390	+30	+8
Total	1,116	874	−242	−22
$10,000:				
Income taxes	1,225	905	−320	−26
Social security taxes	374	520	+146	+39
Total	1,599	1,425	−174	−11
$15,000:				
Income taxes	2,268	1,820	−448	−20
Social security taxes	374	530	+156	+42
Total	2,642	2,350	−292	− 1

Question 7. Table 16 of the budget contains five-year projections of major new and expanded programs in the 1973 budget. The total of the items identified is approximately $29 [31] billion in FY 1976. This total is less than half of the $54 [64] billion increase projected elsewhere in the budget. Please identify the other new or expanded programs and their cost through FY 1976.

Answer. Table 16 presents the estimated future costs of legislative proposals for all proposed new and expanded programs within the meaning of section 221(a) of the Legislative Reorganization Act of 1970 (P.L. 91–510). The discussion of the long-range outlook in Part 2 of the budget (pages 47–51) deals with *increases* in existing and currently proposed programs between 1973 and 1976 and between 1973 and 1977.

The total increase in outlays *over the recommended 1973 levels*, attributable to the effects of all proposed legislation that would substantively expand the scope of Federal activities, is expected to be about $19 billion by 1976, as indicated in the table on page 49 of the budget. This $19 billion is the difference between the total of 1976 outlays in that table ($31 billion) and the total of 1973 outlays in that table, adjusted for items for which no costs are expected to be incurred until after 1973.

In addition, outlays for existing Federal programs are expected to increase between 1973 and 1976 as a result of such factors as population growth (including growth in the number of eligible beneficiaries for programs such as social security and civil service retirement), price increases (such as increased costs of health care under Medicare and Medicaid), increases in rates of pay for Government employees, and increases in construction activity and costs under public works and environmental programs. The "built-in" growth in outlays for all existing Federal programs is estimated to amount to about $45 billion between 1973 and 1976. This $45 billion, plus the estimated $19 billion growth attributable to proposed legislation, will result in an estimated total growth in Federal outlays of $64 billion, as shown in the table on page 49 of the budget. Although outlays for a few Federal programs can be expected to remain level or decline between 1973 and 1976, for all practical purposes all existing Federal programs can be expected to share in the $45 billion overall "built-in" outlay increase.

THE 1972 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 9, 1972

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

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

Present: Senators Proxmire, Javits, and Pearson; and Representatives Patman, Reuss, Conable, and Blackburn.

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

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The committee will come to order.

It is a great pleasure to have as our witness this morning the distinguished chairman of the Federal Reserve Board, Mr. Arthur Burns.

A year ago when you appeared before this committee during our 1971 annual hearings, Mr. Burns, a chief subject of discussion was what we regarded then as the administration's overly optimistic gross national product forecast. If I recall correctly you took strong exception both to the probable accuracy of the forecast and to the notion that a strong economic recovery could be initiated through monetary policy alone. I will only say that time has borne you out. The famous $1,065 billion GNP forecast was, of course, far wide of the mark.

More important, there has since been a recognition by the administration that modern economic management requires more than one policy tool. First, we have had the dramatic reversal on incomes policy, from the position of complete "hands off" to the adoption of the first comprehensive price and wage control system this country has ever experienced in peacetime.

Even more recently, we have had a new recognition by the administration that old-fashioned stimulative fiscal policy still has its basic role to play in promoting full employment.

This new emphasis has been quite apparent in the testimony this week by both Mr. Stein and Mr. Shultz. While I support a program of fiscal stimulus to get us out of the present unemployment crisis, I find the recent pattern of tax and expenditure decisions unsatisfactory.

76-150—72—pt. 1——9

The tax relief was investment-oriented and I approve a long-range effect. After all, I voted for those changes. But in the short run I don't see them providing a great deal of stimulus, at least not during the next 6 months or next year.

The proposed expenditure increases I think are too defense-oriented. I am convinced we could get more bang for the buck through expanded public service employment and putting resources to work on pressing social needs.

Despite this difference with the administration policy, I want to go on record as applauding the recognition of fiscal policy and incomes policies exist and have an essential role to play in economic management.

The danger now may be that with attention focused on the rediscovery of fiscal policy and the new experiment with incomes policy, we are letting monetary policy slip too far into the background. Excavating ourselves from the current recession requires balance and coordination among monetary, fiscal and incomes policy. We had only limited discussion of monetary policy during the first 2 days of our hearing. You can be sure we will try to make up for that today. Of course, we will also seek your views on fiscal policy and inflation policy.

We expect, on the basis of responses, a number of members of the committee to attend. They usually arrive a little late. I read your excellent statement. If you wish to summarize any part of it, the entire text will be printed in full in the record.

STATEMENT OF HON. ARTHUR F. BURNS, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. BURNS. Thank you, Mr. Chairman.

I am glad to appear before this committee once again to report the views of the Board of Governors of the Federal Reserve System on the state of our national economy.

The early months of the past year presented an extraordinary challenge to our national policies. Although a recovery had commenced in economic activity, it proceeded at a rather sluggish pace. Although the number of men and women at work was again rising, the advance was no faster than that of the labor force; hence unemployment continued at a 6 percent rate. Although gains in productivity were resuming, they had yet to display the vigorous improvement characteristic of earlier cyclical recoveries. And, despite much idleness of men and equipment, wages and prices continued to rise at a virtually undiminished pace.

Moreover, the competitive position of the United States in international trade was deteriorating further, confidence in the exchange value of the dollar was weakening, and a massive shift out of dollars and into foreign currencies was getting under way.

In mid-August of last year, the President took bold and comprehensive steps to deal with these accumulated economic ills; for it had become reasonably clear by then that the performance of the economy was eluding our national goals.

The new economic policy had four major objectives: first, to slow sharply and at once the rate of inflation and thereby break the inflationary psychology gripping the nation; to set in motion forces that would stimulate more rapid expansion in aggregate demand and a decline in unemployment; third, to promote increased efficiency in our factories, mines, and other workshops; fourth, to set the stage for a reinvigoration of export trade, restoration of confidence in the exchange value of the dollar, and progress toward a sustainable equilibrium in the balance of payments.

The major new initiatives announced by the President included a 90-day freeze on virtually all prices and wages, to be followed by a more flexible price and wage policy; some selective reductions in taxes, including restoration of the investment tax credit; a temporary surcharge of 10 percent on imports; and suspension of convertibility of dollars into gold or other reserve assets. The Congress in its turn moved with exemplary speed to enact the basic tax measures recommended by the President, and to strengthen the legislative basis for the new wage-price policy.

The Nation responded with a sense of exhilaration to the new economic policy; for it meant that we as a people could and would deal energetically with our major economic problems— inflation, unemployment, inadequate growth in output and productivity, and imbalance in international payments. A new confidence in our nation's economic future was felt all around.

But, as so often happens in human affairs, the first blush of enthusiasm gave way to a more cautious appraisal of the problems yet confronting the economy. Doubts gradually began to be expressed about the effectiveness of the control program that supplanted the freeze, about the strength of the economic recovery, or about the durability of the Smithsonian currency agreement negotiated last December.

These are understandable concerns and it would be foolhardy to dismiss them. Surely, we must recognize that uncertainty is inherent in all economic life, that the deep-seated economic problems we have been struggling with have not yet been solved, that more— perhaps much more—remains to be done to restore the conditions for lasting prosperity. Indeed, we must try to see to it that the momentum generated by the new economic policy of last August is sustained in the months to come.

But if all this is worth keeping in mind, it is all the more important to recognize the solid evidence of improvement that has occurred since last August in the economic and financial scene.

The brief freeze on wages and prices turned out to be an outstanding success. True, deferred increases went into effect when the freeze ended, causing an upsurge in average wage rates and to a lesser extent in prices. Nevertheless, both wages and prices have advanced at markedly lower rates since August 1971 than they did earlier in 1971. Moreover, demands for very large increases in wages seem less pervasive now than at any time in recent years, due in large part to the controls now in existence.

Financial markets have reacted constructively to this slackening pace of inflation. Interest rates have declined, as the inflation premium in the cost of credit has been whittled away. Yields on high-grade corporate and State and local government bonds have fallen about 75 basis points since last summer despite continued heavy demands on the capital markets. The rate of interest charged by some banks on prime business loans has dropped to the level prevailing in the early 1960's. Interest rates on mortgages have been moving down. And stock prices have risen significantly since August, reflecting the greater confidence with which individuals and businesses view the future.

This increased confidence has been evident also in markets for goods and for labor. Consumers stepped up their buying of new cars and other durable goods last fall, and they were willing to go into debt to do so. This was a major factor in the qickening pace of economic activity in the fourth quarter. The demand for capital equipment, which had been conspicuously weak, is now appreciably stronger than last summer. And of late business firms have been adding substantially to their work forces; by the fourth quarter of 1971, civilian employment had risen more than a million from its level 6 months earlier, and a further significant increase occurred this January.

Gains have also been made in restoring confidence internationally. The readjustment of currency values negotiated in December by the Group of Ten countries was an event of far-reaching significance. While concern about international trade and finances has by no means ended, the uncertainties that had been troubling businessmen and the exchange markets have been greatly reduced. Confidence in continuing growth of the world economy and of international trade is now much stronger than it was last fall.

All these signs indicate that our people can look to the future with more confident expectations. The state of confidence, however, is always apt to be delicately poised in the early stages of economic recovery. It is therefore vitally important, now that the Federal Government has become such a large factor in our Nation's economy, that its operations and policies be conducted in ways that sustain the more confident public mood released by the new economic policy. If that is accomplished, the prospects will be very favorable for a quickening tempo of economic expansion in the year and years ahead.

Several major areas of private demand offer promise of additional stimulus to economic activity during 1972. Business inventory policies have been conservative throughout 1970 and 1971. As sales pick up, there will be a need to keep larger inventories on hand. Fixed capital expenditures by business firms should also move up. Over the past 2 years these outlays declined in real terms, so that a backlog of postponed projects has in all probability accumulated. Recent surveys already indicate a substantial rise in planned capital expenditures during 1972—an anticipation supported by a marked rise in manufacturers' new capital appropriations and the recent strengthening in new orders for capital equipment and in construction contract awards.

A more rapid pace of consumer spending may well be an additional source of stimulus in 1972. The rate of personal saving has been abnormally high for an extended period, and consumers have accumulated large amounts of liquid assets that could be drawn down. The tax reductions resulting from recent legislation will provide additional support to consumer buying power this year.

As buying of goods or services goes up in one sector, its strength will be transmitted to other sectors, and the economic expansion will gather momentum. This is a familiar process in business cycle history, and it seems likely that we are even now experiencing such a development.

The Federal budget for fiscal 1972 that has just been presented to the Congress seems broadly consistent with the objective of more rapid economic expansion, for it embodies a good deal of further stimulation through both higher expenditures and tax reductions. I recognize that the budget deficit reflects preponderantly the shortfall in the performance of the economy. Yet, as I contemplate the future, the sheer size of the projected fiscal 1972 deficit—close to $40 billion—gives me some pause.

To maintain the public confidence that is so vital to the achievement of faster economic expansion, I consider it crucial to make tangible progress toward a more balanced fiscal position in the 1973 budget and beyond. Whether or not the projected revenues are realized will depend principally on the strength of economic recovery.

On the other hand, the projections of further increases in expenditures are largely within the control of the Congress. I would urge, in keeping with the President's recommendation, that the Congress impose a rigid ceiling on fiscal 1973 expenditures—a ceiling to be treated as inviolate except in the event of grave national emergency. This necessary discipline, which I have urged on other occasions, would go far to reassure the public that the Federal budgetary process is not out of control.

Let me turn now to the role that monetary policy needs to play in furthering national objectives this year. Clearly, our monetary affairs—no less than our fiscal affairs—must be kept in order, so that public confidence in our monetary management is maintained. An unduly expansive monetary policy would be most unfortunate, particularly in view of the large Federal budgetary deficits now projected. We need always to be mindful of the fact that increases in money and credit achieved today will still be with us tomorrow, when economic conditions may no longer be the same as they are today.

At this stage of the business cycle it is essential to pursue a monetary policy that will facilitate good economic recovery. Supplies of money and credit must be sufficient to finance the growth in consumer spending and in investment plans that now appears in process. Let me assure this committee that the Federal Reserve does not intend to let the present recovery falter for want of money or credit. And let me add, just as firmly, that the Federal Reserve will not release the forces of a renewed inflationary spiral.

We are now in a favorable position to provide the monetary support needed for a quickening pace of production and employment. While expansion in the supply of money and credit was relatively brisk during 1971, we successfully avoided an unduly rapid growth of liquidity.

No single measure of money or credit represents adequately the impact of monetary policy on the economy. Let me nevertheless cite a few salient facts. Growth of the narrowly defined money supply—that is, currency and private demand deposits—amounted to 6.2 percent during 1971, compared with 5.4 percent in 1970. If the money supply is defined more broadly, so as to include also consumer-type time and savings deposits at commercial banks, the rate of growth was 11.1 percent during 1971, compared with 8.1 percent in the previous year.

These 1971 growth rates of money balances are at the upper end of the range witnessed over the postwar period. That is what should happen at a time of sluggish economic growth, as this committee has pointed out.

The substantial increase of the money supply, as variously measured, was accompanied by abundant and readily available supplies of credit. Inflows of deposits at the nonbank thrift institutions were unusually large, and they permitted a record increase in the volume of mortgage borrowing. Residential construction was greatly stimulated, and new housing starts rose to unprecedented levels by the fourth quarter. Business firms were able to fund short-term debt and to rebuild their liquidity position. State and local governments, too, finding a ready market for their securities, were able to expand fairly rapidly their outlays on public goods and services.

Interest rates fluctuated over a fairly wide range last year as financial markets were buffeted by international as well as domestic disturbances. In the spring and early summer, inflationary expectations worsened, and interest rates moved up despite the ready availability of funds. But they declined again after the announcement of the new economic policy in August. By the end of 1971, interest rates on virtually all types of debt instruments had fallen below the levels prevailing at the beginning of the year.

Looking at 1971 as a whole, the growth in money and credit was, I believe, consistent with the needs of an expanding economy. There were, nonetheless, sizable variations in monetary growth rates—particularly in the narrowly defined money stock, which rose rapidly in the first half of the year and slowly thereafter.

These variations reflected the public's changing demand for cash balances, which is related not only to the need to finance current expenditures but also to the desire to hold money for precautionary reasons. Given the changing state of confidence during 1971, there is reason to believe that precautionary demands for cash intensified during the spring and then subsided following the August announcement of the new economic policy.

To some degree, however, the variations in monetary growth resulted from shifts of emphasis in monetary policy. Early in 1971, the Federal Reserve sought to promote a rate of monetary growth sufficient to make up for the shortfall in late 1970. With precautionary demands for funds burgeoning unexpectedly at that time, key monetary aggregates expanded at a faster pace than expected or than would have been desirable for any length of time.

Monetary policy, therefore, moved gradually during the spring and summer to restrain excessive monetary growth. Once again, the change sought was magnified during August by outflows of dollars to foreign money centers, and later—over a longer stretch—by an unforeseen upsurge of domestic confidence and consequently smaller precautionary demands for ready cash.

In recent months, the Federal reserve has sought to encourage a faster rate of monetary expansion than occurred in the late summer and fall of last year. Open market operations have been conducted with more emphasis on increasing the reserve base of the banking system. In the 5 months from September through January, total bank reserves rose at an annual rate of over 8 percent. Thus far, much of this increase has supported an accelerated growth in time deposits. But, in due course, the narrowly defined money stock, on which so much emphasis is nowadays placed by some single-minded observers, will also respond; preliminary calculations indicate that this aggregate rose more rapidly in January than in the immediately preceding months.

The additions to bank reserves have helped to move interest rates down in recent months, especially short-term rates. With the passage of time, this effect should become diffused as the additional funds—the reserves and the deposits they support—are employed to finance consumer loans, or mortgage loans, or for other purposes. It would not be surprising, therefore, to see short-term interest rates rise somewhat as economic expansion carries the economy to higher levels of resource utilization.

On past occasions, a rise in short-term interest rates has more frequently than not induced a similar increase in long-term rates. At the present time, however, the differential between short-term and long-term rates is unusually wide. If further progress is made in dampening inflationary expectations, there need not be any rise in the cost of long-term funds. In fact, my hope is that further downward adjustments in long-term interest rates will occur in the months ahead, and that credit will remain in abundant supply for housing, for State and local construction, and for our Nation's business firms.

Before closing, let me turn briefly to other financial and economic issues. I have already referred to the significance of the Smithsonian agreement of December 18. I have little patience with the view that this agreement will prove to be fragile. The nations participating in the negotiations last fall realized that much was at stake. They still do. All of us are compelled by our own economic interests to continue in the same spirit of cooperation that led to the agreement.

There is, however, much unfinished business at hand. Legislation is needed to permit a change in the official dollar price of gold, as called for by the Smithsonian agreement. This legislation will soon be considered by the Congress, and I strongly recommend swift approval.

Over the longer run, we and our trading partners must fashion a new and stronger international economic order. The issues are many and complex.

A searching reevaluation will be needed of the roles played by gold, reserve currencies, and special drawing rights in settling international accounts. Sufficient flexibility in exchange rates will be essential to prevent large and persistent balance-of-payments problems. The circumstances under which the dollar may again be convertible into international reserve assets will have to be reviewed carefully. And determined new efforts will be required to reduce impediments to the international flow of goods, services, and capital.

Progress in these areas will not be rapid. But it is essential to the health of every national economy, including ours, that we get on with the job.

In the domestic sphere, the most urgent need is to realize the promise of our present wage and price policy. The return to a free-market economy will be speeded if the Pay Board and the Price Commission find ways to deal more successfully with outsized requests for wage and price increases. It is of great importance that the Pay Board resist pressures to reach compromises in specific cases that threaten to undermine its overall objective. The Price Commission is less subject to this hazard, since its decisions do not involved direct conflict between labor and management. Its efforts to hold down prices must be pursued with the utmost vigor, and yet leave sufficient scope for confident and constructive business behavior. For more rapid economic expansion is no less important at this juncture of our Nation's history than bringing the rate of inflation down to 2½ percent by the end of this year.

The jobs of both of these bodies will be lightened if improvements in productivity accelerate. Our performance in this critical area has deteriorated in recent years relative to that of other industrial countries and of our own past. Resumption of rapid productivity growth is fundamental to our longer term prospects. With higher productivity gains, we could have significant wage increases, larger profit margins, and numerous individual price declines within a framework of a stable level of average prices; our ability to compete with foreign producers would be greatly enhanced; and our national aspirations for cleaner air and water, for halting the process of urban decay, for better housing, and a host of other things would be more readily achieved.

Elevating the growth rate of productivity will require a many-sided effort, with full participation by the public and private sectors. A larger commitment of resources to technical research and to new and improved capital equipment will be needed. Labor and management will also need to get together in joint ventures to increase productivity within the individual firm and plant. This can best be done by assuring workers that they will individually share in the benefits of improvements in output per manhour. Productivity councils at the community and plant level could help to achieve this objective, and—thanks to the initiative of the Congress—the National Commission on Productivity will shortly be initiating a program to establish such councils.

A serious national effort to increase economic efficiency should also include the most careful consideration of the steps needed to reduce abuses of private economic power, whether of business or labor. That, I think, is an objective toward which the great majority of the American people quietly aspire. Once our labor and product markets become more competitive, there will be little or no need in the future for direct wage and price controls such as we have recently instituted. This, too, would strengthen the foundation of confidence on which our economy rests.

Thank you.

Chairman PROXMIRE. Thank you, Mr. Burns. As I told you before, I think this is the most revealing statement you have given us. You said aren't you always frank and I think you always are. You are always very revealing and helpful. But I think this is one of the best. Perhaps I am reading something into this that I shouldn't. But what I am reading into it is that you are telling us that we are not going to have the kind of expansion and stimulus in the monetary policy in 1972 that we had in 1971, that it will be less.

I don't want to be unfair but to indicate why I think that is the case. In your statement you say:

Growth of the narrowly defined money supply, that is, currency and private demand deposits, amounted to 6.2 percent during 1971 compared with 5.4 percent in 1970.

And then you say,

These 1971 growth rates of money balances are at the upper end of the range witnessed over the postwar period. That is what should happen at times of sluggish economic growth as this committee has pointed out.

I would take it that that means that in view of the rest of your analysis, which indicates that the economy is expanding better now, we have more fiscal stimulus in this period at the present time—you use the term

Very favorable for quickening economic expansion—under these circumstances it would see that a rate of 5.5 to 6 percent, which was appropriate for a sluggish economy would be inappropriately great for an economy which is moving ahead more rapidly.

Is that correct?

Mr. BURNS. Senator, you are very gracious and very kind in praising my statement. I wish I could let the matter rest at this point, but I am just about to say something that may make you change your mind. I did not state, and I surely did not intend to convey the impression, that monetary policy this year will be less expansive than during the preceding year.

You have commented on certain pages. Let me comment on another page, which I think is crucial, of my statement.

We are now in a favorable position to provide the monetary support needed for a quickening pace of production and employment. While expansion in the supply of money and credit was relatively brisk during 1971, we successfully avoided an unduly rapid growth of liquidity.

I think we are in that position—and we certainly intend—to support economic recovery fully. As I state on the same page, the Federal Reserve does not intend to let the present recovery falter for want of money or credit.

What does this imply in terms of numbers? That is a question that I cannot answer at this time. A central banker who attempted to answer a question like that would not be worth his salt,

Chairman PROXMIRE. I understand that and I certainly respect it. After all, though, you did say that 5.5 to 6 percent is at the upper end of the range witnessed and that is what should happen in times of sluggish economic growth. I can't reconcile that with the notion that it might be higher it might be more stimulative or even as stimulative in a period of economic expansion. Am I wrong?

Mr. BURNS. We entered a period of economic expansion last year. I anticipate a very good economic recovery this year. But we have large unused resources, and all of us have to keep this in mind. We also have the benefit of an incomes policy which we expect and hope will be at least moderately successful.

Chairman PROXMIRE. I want to pursue that, but let me follow up again on what you say in your statement. You say, "It would not be surprising to see short-term interest rates rise somewhat"—rise, go up. And you indicate that this would not be inconsistent with stable long-term rates. Long-term rates might not rise. This is another discouraging element here, it seems to me, in terms of getting any expansion on the money side of our economic policy. If short-term interest rates rise, that does have somewhat of a restraining influence, somewhat.

If long-term rates stay at what historically on the basis of recent years is a very, very high level—not as high as it was 2 or 3 years ago but much higher than most of the 1950's and most of the 1960's—again, it seems to me this is a restraining factor, so that I would interpret this assertion that your statement, and I quote: "to see short-term interest rates go up would not be surprising" as another indication that you anticipate some restraint, or at least not the same kind of expansionary push we have had in the last 6 or 8 months in monetary policy.

Mr. BURNS. Senator, I don't know of any period of business expansion, with any vigor at all, when you did not have some rise in short-term interest rates. That is fact No. 1.

No. 2, the effect of short-term interest rates on movements of the real economy is of minimal significance. That is my judgment, and I think that is the view of economists generally.

No. 3, long-term interest rates are of fundamental importance. But, as you point out, I do not anticipate a rise in long-term interest rates if we keep our inflation under control. I even indicate that further downward adjustments in long-term interest rates may occur.

Chairman PROXMIRE. Do you think they may occur while short-term rates are rising?

Mr. BURNS. Yes, I do.

Chairman PROXMIRE. Is that unlikely? Isn't that rare?

Mr. BURNS. It is extremely rare. But we have very unusual conditions, Senator. We have had an extraordinary demand on the part of business firms for long-term money, going through the bond market. That is a most unusual development, and I think it reflects, to a large degree, the unhappy experience of some of our business firms in 1966 and again in 1969 when it was so difficult to obtain credit from commercial banks.

Also, our long-term interest rates are heavily influenced at the present time by inflationary prospects. As inflationary expectations weaken, the inflationary premium that has gotten built into our long-term rates will continue to wither away.

Chairman PROXMIRE. Shouldn't we take advantage of our wage and price controls, which should help greatly to dampen that inflationary anticipation, to provide for a greater degree of monetary and fiscal stimulation than we could otherwise?

You see, what I miss in your statement, Mr. Burns, with great respect, is any sense of urgency about the unemployment problem which some of us feel is the most urgent problem that faces us. With 6 percent unemployment that has held on and held on for month after month after month, with very little indication that it is going to improve, though there is some optimism about it in the administration, it seems to me that you do not give us a confidence that we can expect the kind of stimulation from the monetary policy which would seem to me to be the framework that wage and price controls would permit.

Mr. BURNS. Senator, I have very deep concern about the unemployment problem. If I didn't convey it in my statement, then my facility for lucid exposition is inadequate.

Chairman PROXMIRE. That certainly isn't true.

Mr. BURNS. As far as the rate of monetary expansion is concerned, we have a rather high rate of monetary expansion now. What the future will bring, I can't say. But I have indicated flatly to this committee that the economy will be supported and supported fully by the monetary authorities.

Chairman PROXMIRE. You see, what concerns me, Mr. Burns, and I recognize the great complexity, the great burdens of your position. There is so much pressure on your office that to push you to support with everything you can the integrity of the dollar internationally.

You have been working so hard on that. You have referred to the Smithsonian agreement in which you have confidence.

Inflation is right at the heart of this. It just seems to me that there may be more pressures brought to bear on the Federal Reserve Board in this area, although again and again you and others on the Board have disavowed the notion that the international situation should take precedence over the domestic health of our economy, especially our economic growth being the number one priority.

I am afraid that this doesn't come through as clearly as I would like to see it this morning.

Mr. BURNS. Let me reaffirm Senator, that the health of our national economy is our primary consideration. In furthering the strength of our economy and the prosperity of our people, we at the Federal Reserve think that we are making a major contribution to international confidence as well.

Chairman PROXMIRE. My time is up.

Mr. Conable.

Representative CONABLE. Thank you, Mr. Chairman.

Mr. Burns, I consider this a very lucid statement and I thank you for it.

May I ask you, sir—and I know there is great concern on this committee about interest rates generally and usually that concern is expressed in terms of interest rates being too high, and the hope that they will go down—a couple of days ago Robert Roosa, speaking before the American Bankers Association, charged that you and the administration have torpedoed the Smithsonian agreement by pursuing an interest rate policy which discouraged any reflux of dollars back into the country. It was anticipated, of course, following the Smithsonian agreement, that there would be short-term extensive reflow of money that had fled the country during a period of diminishing confidence prior to that successful achievement of that agreement.

I am sure you would want to comment on Mr. Roosa's charge.

Mr. BURNS. I haven't read Mr. Roosa's address. All I know of it is the account I saw yesterday in The Washington Post. Mr. Roosa, if he is being reported correctly, I think is very sadly mistaken.

Before I comment on the report of Mr. Roosa's statement, rather than the statement itself, which I repeat I haven't read or seen, let me say that we at the Federal Reserve serve a very useful function, really. We receive criticism from all quarters. Many of the inhibitions and frustrations of life are conveniently visited on the Fed. That is one of our functions.

While Mr. Roosa is very much concerned, apparently, about Federal Reserve policy being too easy, there are others who are very much concerned that Federal Reserve policy may be less expansive than it should be, given the Nation's economic condition.

I hear constantly from the monetarist school, which is very articulate. That school includes a fair number of economists. Also, a good many of the brokerage firms these days seem to be a part of the monetarist school, and—curiously enough—this school has invaded the investment banking field. But so much for that.

What about the Smithsonian agreement and what is it that Mr. Roosa may be overlooking if, to repeat once again, his statement is being interpreted or reported correctly?

The present situation cannot be compared with what followed other currency devaluations because this time there is no convertibility into gold or other reserve assets.

This is a point that apparently Mr. Roosa has overlooked.

Second, this country is still suffering from a high level of unemployment. The kind of prescription that Mr. Roosa apparently is suggesting has not been used, to the best of my knowledge, when a country suffered from substantial unemployment, except when you go back rather far in history. And we certainly are not going to have a repetition of the catastrophe of 1931, when the Federal Reserve authorities, in the midst of that Depression, raised the discount rate from 1½ to 3½ percent, and thereby intensified the very difficulties this country was suffering from—difficulties that were spreading internationally and causing havoc abroad as well as at home.

To go on, we now have the Smithsonian agreement. The nature of that agreement was very well understood by every central banker and by every finance minister. Since no convertibility was provided for, and since the expectation was that a deficit in the U.S. balance of payments would continue for a time, the other countries, in effect, in accepting that agreement, indicated that they would accumulate dollars, if necessary, until a new permanent reform was worked out.

I was there, participating at every stage, and let me repeat, other countries clearly understood that they may well need to accumulate additional dollars.

Let me say one thing more. Other countries had no good alternative. If they didn't want to accumulate dollars, if they wanted to make sure they didn't, we could have had another kind of currency realinement—a currency realinement under which the appreciation of foreign currencies in terms of U.S. dollars would have been a good deal larger than the Smithsonian agreement called for. Other countries did not want that. To get the appreciation that we did get, we had to wrangle and struggle and compromise.

If the Smithsonian agreement blew up, what would happen? The consequence would be that we would again have floating exchange rates. The consequence would be that the world would again move toward restrictive and protectionist policies. The consequence would be that trade would be restricted, as it was during the difficult months from August to December.

Then what would other countries do? They would plead for a new currency realinement. They would plead for a new stablization policy. What would be the outcome of such an effort at stabilization? It would be to appreciate again, and perhaps appreciate substantially, the price of foreign currencies in terms of U.S. dollars. Other countries do not want that. Other central bankers understand that.

I find it difficult to believe that Mr. Roosa doesn't understand it. Therefore, I must read his statement to make sure.

Let me just add a few words about the common expectation on which you commented, that there would be a large reflow of dollars from foreign countries to the United States.

That was a common expectation. It was an expectation held abroad; it was an expectation held here. But that expectation, and I say this with complete honesty, was based on a piece of mistaken analysis. It never should have been held. That expectation, that false analysis, is now used by men who ought to be better informed as a yardstick of actual market experience. That I think is most unfortunate.

Let me elucidate what I mean. Interest rates are lower in this country than they are abroad. In such circumstances, why would you expect dollars to be returning home when they can earn a higher rate of interest abroad?

Second, the price of foreign currencies just before the Smithsonian agreement and just after the Smithsonian agreement settled at a level generally below the new parities, or, as they are now called, the new central rates.

Well, under those circumstances, those who held dollars could well afford to sit back and see what would happen, particularly in view of the widening of the margins. People could afford to see if the price of foreign currencies would not rise in terms of dollars. So the outlook for gain through a movement in the foreign exchange market was very good for holders of dollars.

And still another factor to bear in mind is that our corporations now are in a relatively liquid position. There is no great pressure to bring funds home.

And, finally, there has been some return flow.

But the return flow is being masked by the continuing deficit in our balance of payments. Those who say there has been no return flow are simply looking at the holdings of dollars by foreign central banks. Even on that basis there has been some return flow.

I have talked too much, but this is a subject that is not too well understood and perhaps this lengthy statement will serve some purpose.

Representative CONABLE. Thank you. My time is up.

Mr. BURNS. I must apologize for taking your time.

Chairman PROXMIRE. Mr. Patman.

Representative PATMAN. Mr. Burns, I know you are very sincere, you are a very sincere man. But when you were paying such great tributes to the Federal Reserve System I couldn't help but think back in Mr. Herbert Hoover's book in which he made the statement that he found the Federal Reserve to be a very weak reed to lean upon in time of trouble. I know you must have had your good times and your bad times.

I consider the best times for the people under the Federal Reserve System were from 1939 to 1953. Then the people were properly and adequately served by the Federal Reserve System.

Mr. Burns, when I was chairman of this committee in 1970, I asked the General Accounting Office to make an investigation of the Government securities market. That is one of the areas that is covered by the Federal Reserve System that is subject to auditing. As we have discovered in recent years to our sorrow, the main functions of the

Federal Reserve System are not subject to audit and the Federal Reserve System refuses to permit the General Accounting Office to audit its books.

The study that was made is of the largest securities market in the world. It embraced $738 billion of transactions in 1970, and it is in that area now. Every dealer, and there are 20 dealers—they fluctuate from about 15 to 20 or 22—these dealers are all selected by the Federal Reserve and they have a very valuable, lucrative franchise or privilege. They have a privilege of buying and selling all of the U.S. Government bonds to the open market. They have what is the equivalent of two toll gates at every securities dealer. One toll gate is where the bonds come into the open market system and they get a cut on that, they get a profit which they are entitled to as long as it is reasonable, and they have another toll gate on the other side, we will say, where the bonds are sold by the Federal Reserve Open Market Committee and they get a commission on that, when they go out.

So they do this tremendous business. The study that was made by the General Accounting Office and reported to me in October of last year, after nearly a year and a half of study, showed chaotic financial reporting procedures. Many correspondents, when this went out over the country, said that it was a scandalous situation, and they described why they thought it was scandalous. Many people said some things even worse than that.

The GAO study showed that the financial reports were meaningless in terms of providing accurate and reliable information to the public and the Congress.

The Government securities dealers were able to reap windfall profits averaging from 31 percent in the previous 5 years, and ranging up to 90 percent in 1970, far in excess of the profits earned on comparable transactions in the money market.

Mr. Chairman, I will ask that the report be distributed to members of the committee and to members of the press who are interested. We have it available here.

Closed, even secret relations, are maintained between the select group of 20 dealers and the Federal Reserve trading desk that results in giving dealers inside information on the Federal securities market which is totally unregulated.

In submitting this report to you last fall, Mr. Burns, I called on the Federal Reserve Board to consider eliminating these toll gate Federal security dealers and establishing a joint Treasury-Federal Reserve trading desk which would deal directly with the buyers of securities.

What has been done by the Federal Reserve about this issue, Mr. Burns?

Mr. Burns. Mr. Patman, before I answer your question, I would like to have the privilege of making a very brief comment on the statement that preceded.

Representative Patman. That is fine. I would just like to add to it. Does this report convince you it would be in the best interest of the Nation to have a full audit of the Federal Reserve activities?

Mr. Burns. I still would like to make a brief comment but now I have two questions by you. Perhaps I should have answered your question. My comment will be brief.

The GAO report did not find, if I read it correctly, that the reporting system was chaotic. The GAO did point out numerous defects in the reporting system. These were defects, most of them, that we were well aware of. We did not consider them significant, Mr. Patman. The statistics that we have on the securities dealers we have gathered for one purpose; that is, to make sure that the dealers who traded in government securities, with whom the desk dealt, were in a strong financial position. That is all that matters to us. We want to deal with responsible people, and we needed financial statements for that purpose. The financial statements that were being gathered were adequate, we felt, for that purpose.

Next you commented on the huge windfall profits, on a profit rate of 90 percent made by these dealers in 1970. Without subscribing to that figure—I neither want to assent to it nor question it—let me say this: It is perfectly obvious that securities dealers made large windfall profits in 1970. They must have. Anyone who held a portfolio of debt securities made huge profits in 1970. He made huge profits in 1970 because interest rates were coming down. This, I think, is the policy that you approve, Mr. Patman.

The only way to have prevented windfall profits for those who held debt securities would have been to have rising interest rates, and I doubt that any one of us would want that.

A third comment. You spoke of inside information. I deny that completely. If there is any evidence on that, I wish that it would be brought to me because that would then be ended and ended promptly. I am just as intolerant as anyone in this room, or anyone in this country, of improper procedures.

Now let me turn to your question about the Federal Reserve itself, doing the trading in securities. We have no intention to do that at the present time. We have no intention to do that because a very efficient securities market exists and we have no reason to think that we would save the taxpayer money. On the contrary, if we tried to do it ourselves we couldn't do it as well.

The interest that you have shown in these statistics is important to me and to the Federal Reserve. While I have felt, and my colleagues on the Federal Reserve have felt, that the statistics that we have gathered were adequate for our purpose, you may have other purposes in mind and we have therefore, taken important steps to improve these statistics.

I have some of the details before me, but perhaps it would be best if I sent you a letter describing the steps being taken to improve these statistics.

As for your second question, about my views on a GAO audit, you know my views, Mr. Patman. They have not changed. I have no objection whatever—no one of us on the Federal Reserve has or ever has had—to a financial audit.

Representative PATMAN. Do you mean you are in favor of the audit by the General Accounting Office of all other agencies except the Federal Reserve?

Mr. BURNS. If legislation were written specifying that the GAO audit would be confined simply to the kind of work that auditors do—in other words, go over our figures, go over our assets, check the completeness of the figures, check the accuracy of the figures, check the integrity of our accounts in every detail—I don't have the slightest objection to that. But I would have objection to having the GAO begin commenting and advising on monetary policy.

Representative PATMAN. There is no thought of that.

Mr. BURNS. Well, that thought has occurred to some people, Mr. Patman. It is because that thought has occurred to some people that the Federal Reserve has objected to it.

Representative PATMAN. May I say that the limitations imposed by the Secretary of Defense and the Defense Department, in all procurement activities of the Government, on the limitations imposed upon GAO by the Atomic Energy Commission would be satisfactory with me.

There are too many things that are documented by GAO about the Federal securities market. If you will read it closely, you will find the charge of scandalous situations is justified. There are too many things going on that are wrong, that you cannot say are not wrong. Regarding those 20 dealers, you state they are well qualified because they are well equipped in business, finance, and in monetary worth. But you are giving them a subsidized interest rate right now.

You permit them to borrow money from the Federal Reserve, from the open market, I assume, at a rate of about 3 percent on Federal securities, and probably other securities. That is bound to be a subsidized rate. They make a lot of money just on that alone. I don't see why you should keep on subsidizing them after giving them one of the most lucrative of franchises, second only to the franchise that the Federal Reserve System holds itself.

Mr. BURNS. Mr. Patman, on the one hand, if I interpret you correctly, you feel that we are withholding information and that all kinds of secret dealings are going on. On the other hand, you apparently are very well informed on the rate of interest that the dealers have to pay. That is an item, surely, of public information.

As for that rate of interest, there is a way of avoiding it, Mr. Patman. That is by lowering the discount rate and lowering it sharply. That is a judgment that the Federal Reserve authorities, whether rightly or wrongly, have not been prepared to make at this point.

Representative PATMAN. There is another way, Mr. Burns, and that is from 1939 to 1953 the Federal Reserve fixed the rate on Federal securities with the Treasury. During World War II and the Korean war, the rate was considered the wholesale rate for money. People could buy Treasury bonds or securities, bills or anything else, and they could always get their money back if they wanted it. It was only 2½ percent but they felt very happy with the fact that they could get it back any time they wanted it, without any discount or charge of any kind. That worked mighty good.

Mr. Chairman, I will have insufficient time, but I would like the privilege of inserting in my remarks statements of interest rates during that time and since that time, and also the report that was made by the General Accounting Office in the record at this point.

Chairman PROXMIRE. Without objection.

Representative PATMAN. I will release the information about the interest rate statement that I am putting into the record to the members of this committee and also to any members of the press who desire it.

(The information to be furnished follows:)

THE ABILITY OF THE FEDERAL RESERVE TO PEG INTEREST RATES AT REASONABLE LEVELS

Until the Eisenhower Administration, the Federal Reserve maintained yields on long-term government obligations at or near 2.5%. This was true during all kinds of economic conditions—during depression, during war, and during the post-war expansion.

Nothing illustrates the ability of the Federal Reserve and the Treasury to work together to maintain low interest rates better than the period 1939 through 1952. The following tables show the yields on long-term Government bonds from 1939 to 1952, and how these yields increased from 1953 on.

Yields on Long-Term Government Bonds, by years, 1939 to 1952
(Percent per annum)

Year:	Yield	Year—Continued	Yield
1939	2.36	1946	2.19
1940	2.21	1947	2.25
1941	1.95	1948	2.44
1942	2.46	1949	2.31
1943	2.47	1950	2.32
1944	2.48	1951	2.57
1945	2.37	1952	2.68

Yields on Long-Term Government Bonds, by years, 1953 to present
(Percent per annum)

Year:	Yield	Year—Continued	Yield
1953	2.94	1963	4.00
1954	2.56	1964	4.15
1955	2.84	1965	4.12
1956	3.08	1966	4.65
1957	3.47	1967	4.85
1958	3.43	1968	5.26
1959	4.08	1969	6.12
1960	4.02	1970	6.58
1961	3.90	1971	5.74
1962	3.95		

EXCESS INTEREST RATES ON FEDERAL DEBT, 1951–73

[Dollar amounts in billions]

Fiscal year	Total Federal debt	Total interest paid	Computed annual interest rate	Computed interes cost at 1951 rate
1951	$255.3	$5.7	2.23	$5.7
1952	259.2	5.9	2.27	5.8
1953	266.1	6.6	2.48	5.9
1954	270.4	6.4	2.36	6.0
1955	274.4	6.4	2.33	6.1
1956	272.8	6.8	2.49	6.1
1957	272.4	7.3	2.67	6.1
1958	279.8	7.8	2.78	6.2
1959	287.8	7.8	2.71	6.4
1960	290.9	9.5	3.26	6.5
1961	292.9	9.3	3.17	6.5
1962	303.3	9.5	3.13	6.8
1963	310.8	10.3	3.31	6.9
1964	316.8	11.0	3.47	7.1
1965	323.2	11.8	3.65	7.2
1966	329.5	12.6	3.82	7.3
1967	341.3	14.2	4.16	7.6
1968	369.8	15.6	4.21	8.2
1969	367.1	17.7	4.82	8.2
1970	382.6	20.0	5.22	8.6
1971	409.5	21.6	5.27	9.1
1972[1]	455.8	22.1	4.84	10.2
1973[1]	493.2	23.4	4.74	11.0
Total		269.3		165.5

[1] Estimated.

Note: Excessive interest on national debt—$103,800,000,000.
Source: Budget of the United States for fiscal year 1973.

EXCESSIVE INTEREST CHARGES ON THE PUBLIC AND PRIVATE DEBT, 1953 THROUGH 1971

[Dollars in billions]

	Net public and private debt	Interest paid	Interest costs figured at 1952 average	Excess interest paid
Year:				
1953	$581.6	$21.7	$20.5	$1.2
1954	605.9	23.5	21.4	2.1
1955	664.9	25.8	23.5	2.3
1956	698.3	29.5	24.7	4.8
1957	728.3	33.6	25.8	7.8
1958	769.1	35.5	27.2	8.3
1959	831.4	40.3	29.4	10.9
1960	872.4	44.2	30.9	13.3
1961	929.8	46.8	32.9	13.9
1962	997.1	52.5	35.3	17.2
1963	1,071.7	58.7	37.9	20.8
1964	1,153.7	65.2	39.8	25.4
1965	1,245.6	72.4	44.1	28.3
1966	1,341.4	81.9	47.2	34.7
1967	1,442.7	89.9	50.8	39.1
1968	1,584.5	104.9	55.8	49.1
1969	1,722.7	120.6	60.6	60.0
1970	1,839.7	135.6	64.8	70.8
1971	[1] 1,950.0	[1] 156.0	68.8	87.2
Total				497.2

[1] Estimated.

THE POWER OF THE FEDERAL RESERVE TO HOLD DOWN INTEREST RATES

There is no question of the power, the ability, and the responsibility of the Federal Reserve and the Treasury Department to work together to manage this debt in a manner which will protect the American people and which will reduce the tremendous interest burden borne by the taxpayers. The Federal Reserve can peg this interest rate at any point it so desires. This is an absolute fact that cannot be contraverted by anyone.

This has been admitted time and time again. Back in March of 1947 at a hearing before the Housing Banking and Currency Committee, Mike Monroney—then a U.S. Representative and later a U.S. Senator—questioned Marriner Eccles, the Chairman of the Federal Reserve Board, on this issue:

"Mr. ECCLES: Now, the fact that the interest is where it is, of course, is not just an accident. The interest is where it is because that is where the Federal Reserve System put it in conjunction with the Treasury—I mean with the approval of the Treasury. The rates during the twenties and during the last war, had there been an open market committee—which there was not, in the Federal Reserve System—they could have financed the last war and financed the Government during the twenties at prevailing rates."

"Mr. MONRONEY: Do you mean to say that with your present open-market committee, and the operation of the Federal Reserve, as it now stands, that, regardless of what the national income is, or other economic factors, that you can guarantee to us that our interest rate will remain around 2.06 percent."

"Mr. ECCLES: We certainly can. We can guarantee that the interest rate, so far as the public debt is concerned, is where the open market committee of the Federal Reserve desires to put it."

REPORT TO THE VICE CHAIRMAN
OF THE JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

Improvements Needed In The Federal Reserve Reporting System For Recognized Dealers In Government Securities B-169905

BY THE COMPTROLLER GENERAL
OF THE UNITED STATES

OCT. 6,1971

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-169905

Dear Mr. Vice Chairman:

This is our report on the improvements needed in the Federal Reserve reporting system for recognized dealers in Government securities. Our review was made pursuant to your request of May 1970.

As agreed, we discussed our report with officials of the Federal Reserve Bank of New York. Although they agreed with our findings, they felt that formal comments should come from the Informal Treasury-Federal Reserve Steering Committee which has overall responsibility for the reporting system.

We plan to make no further distribution of this report unless copies are specifically requested, and then we shall make distribution only after your agreement has been obtained or public announcement has been made by you concerning the contents of the report.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

The Honorable Wright Patman
Vice Chairman, Joint Economic
Committee
Congress of the United States

50TH ANNIVERSARY 1921 - 1971

Contents

GLOSSARY

Accrual accounting	recording of financial transactions in the accounts as they actually take place (that is, as goods and services are purchased or used and as revenues are earned) even though the cash involved in such transactions is paid or received at other dates
Borrowings	funds borrowed to maintain positions
Cash accounting	recording of financial transactions only at the time that cash is received or paid for goods and services
Commitment basis	recording of securities transactions in the accounts on the date agreement to purchase or sell is made
Delivered basis	recording of securities transactions in the accounts on the actual date the securities are delivered
Margin requirements	difference between market value and the maximum loan value of securities
Market value	estimated selling or purchase price of security based on bid and ask quote of dealer
Position	the total value of the securities that a dealer holds for resale
Recognized dealers	Government security dealers who--the Federal Reserve Bank of New York considers--have established a satisfactory financial credit standing and can handle a large volume of trading and accordingly are permitted to deal directly with the trading desk

Repurchase agreement	arrangement for borrowing money whereby securities are "sold" by the dealer with a commitment to buy identical securities back at a specific price
Settlement basis	recording securities transactions on the date agreed upon for delivery of the securities
System open market account	the Government securities held by the Federal Reserve System
Trading desk	the personnel who buy and sell securities for the Federal Reserve Bank of New York
Transactions	purchase or sale of securities

COMPTROLLER GENERAL'S REPORT TO THE VICE CHAIRMAN OF THE JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

IMPROVEMENTS NEEDED IN THE FEDERAL RESERVE REPORTING SYSTEM FOR RECOGNIZED DEALERS IN GOVERNMENT SECURITIES
B-169905

D I G E S T

WHY THE REVIEW WAS MADE

The Federal Reserve Bank of New York operates a voluntary reporting system to accumulate statistical and financial data on the activities of private dealers in Government securities.

Participating dealers report statistical data daily and financial data annually. In 1970 the total transactions reported were $738 billion, or more than three times the value of transactions on the New York Stock Exchange.

At the request of the then Chairman of the Joint Economic Committee, the General Accounting Office (GAO) reviewed the reporting system to determine whether

--good accounting practices were being followed in preparing the reports and

--the reporting system afforded the Committee and the public with an accurate picture of the operations and profits of the dealers as a group.

GAO examined into the procedures and methods of report preparation employed by six of the 20 dealers in Government securities recognized by the Federal Reserve System.

FINDINGS AND CONCLUSIONS

The daily statistical information furnished by the dealers was reasonably reliable. This information is published regularly for the use of Government officials, financial analysts, and the public. (See p. 18.) GAO does not believe, however, that financial data which is reported annually can be relied upon because

--sound accounting methods were not followed consistently,

--numerous errors were made, and

--different accounting bases were used by the dealers in preparing the reports.

The Federal Reserve Bank of New York made reviews of the reported data; however, these reviews were not effective in ensuring that the information was reliable. (See pp. 9 to 17.)

As a result of errors and inconsistencies, the annual financial data is not published and little use is made of it. (See p. 24.)

RECOMMENDATIONS OR SUGGESTIONS

The reporting system functioning as it does on a voluntary basis is a commendatory achievement. Substantial improvement in the accuracy of the annual financial reports, however, could be made by correcting some of the problems which GAO found. (See pp. 26 to 28.)

AGENCY ACTIONS AND UNRESOLVED ISSUES

Officials of the Federal Reserve Bank of New York told GAO that, although they agreed with GAO's findings and conclusions, the Informal Treasury-Federal Reserve Steering Committee which has overall responsibility for the reporting system would have to decide what corrective action would be taken. (See p. 28.)

MATTERS FOR CONSIDERATION BY THE VICE CHAIRMAN, JOINT ECONOMIC COMMITTEE

This report outlines some measures that the Federal Reserve System could take to correct the inadequacies in the reporting systems. GAO is including these measures for such action as the Vice Chairman may deem appropriate.

CHAPTER 1

INTRODUCTION

In May 1970 the Chairman of the Joint Economic Committee requested that the Comptroller General look into the reporting system established by the Federal Reserve System for dealers in Government securities and advise him as to whether the reporting system was likely to afford the public and the Joint Economic Committee an accurate picture of the operations and profits of these dealers as a group and whether the accounting practices used in reporting were in accord with good accounting standards. A copy of the Chairman's request is included as appendix I.

BACKGROUND

The Federal Reserve System, among its other functions, is responsible under the Federal Reserve Act for maintaining a flow of credit and money that will foster orderly economic growth and a stable dollar. This function is, in part, accomplished through the public sale and purchase of Government securities (U.S. Government and Federal agency securities).

To carry out this function, the Federal Open Market Committee of the Federal Reserve System has the responsibility of determining the policy to be followed in the purchase and sale of Government securities. The objective of the Federal Open Market Committee is to protect the monetary machinery from undue stress and to influence the economy by affecting the cost and availability of credit.

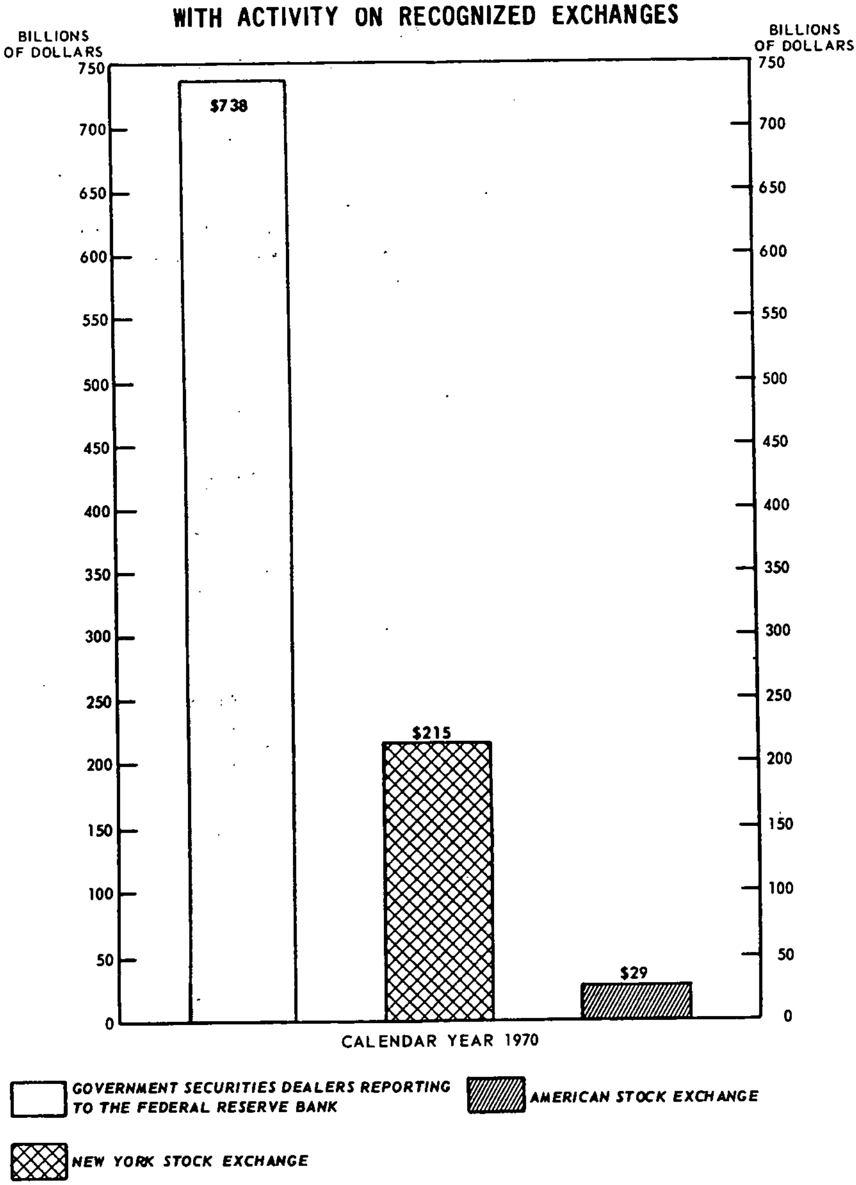
The Federal Open Market Committee has delegated the responsibility for executing its policy for all Reserve banks to the Federal Reserve Bank of New York (Federal Reserve Bank). Each year the Federal Open Market Committee appoints a senior officer of the Federal Reserve Bank to manage the system open market account. The manager maintains a trading desk at the Federal Reserve Bank to handle all purchases and sales of Government securities.

Marketable Government securities are traded daily in an over-the-counter market by dealers in Government securities. Certain dealers, called recognized dealers, are permitted by the manager of the system open market account to trade directly with the trading desk and are expected to respond to the trading desk's needs for buying and selling these securities. This procedure is designed to ensure that dealers admitted to trading have the resources and ability to undertake large volumes of trading.

The number of recognized dealers varies from year to year. As of March 31, 1971, there were 20 recognized dealers, of which 11 were nonbank business enterprises and nine were banks. They form a security market which is the largest in the country in terms of dollar volume and which is heavily vested with the public interest. The market is not regulated by either the Government or a private association.

The volume of purchases and sales by recognized dealers in Government securities increased steadily from $573 billion in 1966 to $738 billion in 1970. A comparison of the 1970 volume of Government securities traded with purchases and sales of the New York Stock Exchange and the American Stock Exchange is shown in the following chart.

TRANSACTIONS REPORTED BY GOVERNMENT SECURITIES DEALERS COMPARED WITH ACTIVITY ON RECOGNIZED EXCHANGES



Because statistical and financial information about the dealer market was scarce, a formal reporting system was established in 1960. The reporting program was aimed at providing current information on the functioning of the market in Government securities to the public, to students of the market, and to market participants, including the Federal Reserve System and the Treasury Department. Reports include, in addition to annual reporting of balance sheet and income data, daily statistics covering securities positions and borrowings and volumes of transactions. No legal or regulatory requirements exist to enforce reporting; the dealers have reported voluntarily.

NATURE OF GAO REVIEW

Our work was done at the Federal Reserve Bank and at business offices of six dealers in Government securities located in New York. The dealers included in our review were selected with a view toward obtaining representation from each of the three types of dealers which are categorized as specialist, bank, and multioperation.

In the case of financial reporting, we reviewed the requirements imposed on dealers by the Federal Reserve Bank instructions. At each dealer's office we obtained reports submitted to the Federal Reserve Bank for the year ended December 31, 1969. We determined whether the figures on these reports were taken from the dealers' books of account or financial statements or whether the amounts in the accounts or statements had to be revised to satisfy Federal Reserve Bank instructions.

In those instances in which revised figures had been reported to the Federal Reserve Bank, we identified the procedures and methods used to make the changes. We reviewed some of these adjustments, calculations, and other transactions to determine whether sound accounting principles and practices were followed and whether the results were reasonably accurate.

For the daily reports, we reviewed the detailed procedures followed by the six dealers to accumulate, record, and report information required by the Federal Reserve Bank. We selected a few transactions and traced them through the dealers' systems to determine whether the transactions had been handled in accordance with dealer procedures, sound trade practices, and Federal Reserve Bank instructions. We observed the preparation of daily reports for one day at each dealer's office and traced the information through the Federal Reserve Bank processes into its computer file.

Our work was done principally through discussions with the Federal Reserve Bank and dealer officials; onsite observations of operations; and reviews of a limited number of transactions, accounting records, and other data. The cooperation and courtesies extended to us by the Federal Reserve Bank and dealers were excellent.

Our review did not cover the activities of the System Open Market Account.

The confidential nature of the data relative to operations of individual dealers was maintained in accordance with rule 23 of the Joint Economic Committee which places limitations on the disclosure of data obtained from individual dealers.

CHAPTER 2

FINANCIAL REPORTS

We found that the financial reports submitted by the dealers had not been prepared in accordance with sound accounting methods. Further, the dealers used different bases in preparing the reports and made substantial errors in compiling the information in the reports. Consequently we have little confidence that these reports provide accurate information on the operations and profits of the dealers as a group. A list of the deficiencies in the reports we examined is included as appendix II.

The deficiencies in the reports we examined occurred primarily because the dealers did not use sufficient care in preparation of the reports and because the Federal Reserve Bank reviews failed to detect them. The inconsistencies in the data contained in reports prepared by the participating dealers are attributable to the wide latitude in reporting practices permitted under the Federal Reserve Bank instructions.

Before describing some of the major deficiencies affecting the reliability of the reports, it is important to mention the factors that complicate dealer reporting. The Federal Reserve Bank instructions provide for submission of reports on a calendar-year basis, whereas seven out of 20 dealers operate their accounting systems on a fiscal-year basis. Their closing of accounts can be at different dates during the calendar year. Thus their normal year-end adjustments are not made for the period covered by the Federal Reserve Bank reports.

Also 14 are engaged in activities other than trading in Government securities and their accounting systems and normal financial statements relate to the entire operations. As a result of both these factors, many adjustments had to be made to the information in their formal accounts to prepare the Federal Reserve Bank reports. It is in this conversion process that most of the problems existed.

76-150 O - 72 - pt. 1 - 11

INCOME

We found two major problems which affected income--namely, all trading gains or losses were not reported in the right reporting period, and dealers used different methods to calculate unrealized gains or losses.

All gains and losses not reported in the right reporting period

The dealers included in our review used three methods of recording security transactions (1) the commitment basis, recording transactions on the date that the purchase or sale is made, (2) the settlement basis, recording transactions on the agreed-upon date for delivery, and (3) the delivered basis, reporting transactions on the actual date that the securities are delivered. For 1969 the Federal Reserve Bank required dealers to report on a commitment basis in their income statements all unrealized gains or losses on positions as of December 31.

Included in our review were three dealers who were on other than a commitment basis and who did not make the necessary adjustments for reporting. Thus one dealer reported unrealized gains and losses on $649 million of securities but did not report in that reporting period unrealized gains and losses on an additional $330 million of securities that should have been included in his computation if it were made on a commitment basis.

The second dealer, with a position of $313 million, omitted from his computation about $44 million of securities; the third omitted $6 million from his calculation on $54 million of position. In addition, these same dealers did not compute the realized gains or losses on securities which were purchased and sold prior to January 1 but which were not settled until after December 31.

Although the dealers knew that they were required to report on the commitment basis, they did not do so because they said that too much effort was required. The dealers did not provide us with data on what the cost of reporting on the commitment basis would be and we did not make our own study of such costs; however, we believe, with proper planning, the report could be prepared on the commitment basis without an unreasonable amount of effort.

Early in our study, we advised the Federal Reserve Bank of our findings regarding the use of other than the commitment basis of reporting. On their own initiative, bank officials revised the instructions to permit dealers to compute profits on their own accounting bases. We doubt the merits of this revision because it could have a material effect on the reported gains or losses. This would occur when there are large variances in opening and closing positions on a commitment basis which would not be reflected by the dealer's accounting basis.

Further, in the case of interdealer trading, there could be significant transactions lost to the reporting system. For example, if a dealer reporting on the commitment basis sold securities on December 31 to another dealer reporting on the settlement method, these securities would not be reported in the positions of either dealer.

Different methods used to calculate unrealized gains and losses

The Federal Reserve Bank also instructs the dealers to compute their unrealized gains or losses on year-end positions at market value and allows the dealers to choose their own methods of determining market values.

The dealers whose records we reviewed used four methods of determining market values for their positions. Three dealers used their own judgment of prices. One used published composite prices; one used last sale; and one dealer used a combination of his own judgment and price quotes of another dealer. Thus the same class of securities held by each dealer may be valued at different prices for computing unrealized gains or losses.

When we advised the Federal Reserve Bank of this problem, they again issued new instructions requesting dealers to use the Federal Reserve Bank composite closing quotations. This, however, did not fully resolve the problem because closing quotations only include securities issued by the Treasury and do not include securities issued by other Government agencies. Agency securities can represent significant sums. For example, one dealer's position included $121 million in Government agency securities.

EXPENSES

The major problems in reporting expenses were the numerous errors made by dealers in allocating them and the different methods of accounting for them.

Questionable allocations

The Federal Reserve Bank instructs dealers to allocate expenses between their Government operation and other operations. The five dealers who had to make allocations attempted to comply with instructions; however, they did not follow sound accounting practices or were not careful in making distributions.

In pooling their expenses for allocation, some dealers did not follow the accepted practice that there must be some relationship between the expenses and the operation to which they are allocated. For example, one dealer overstated his reported expenses by about $900,000 because his pool included commissions and dividends not related to Government operations and interest on partnership capital, which is not an expense but a form of profit distribution. Another dealer did not reduce his reported expenses by $84,000 because he did not allocate to other operations the cost of services performed for those other operations by his Government operations.

Also Government securities are used to borrow funds for all of the dealers' operations. In allocating the related interest expense, two dealers charged their Government operations with the total interest on borrowings made with Government securities without regard to how much was relatable to non-Government operations. Since interest on borrowed funds is the dealers' largest expense, this could have a material impact on reported net income. To illustrate the impact that this allocation can have when done properly, one dealer who did allocate such interest costs, instead of reporting all of it under Government operations, showed only $8.1 million out of a total of $10.3 million as relatable to Government operations.

In addition, dealers used various bases for making allocations. One dealer arbitrarily allocated administrative expenses on the basis of the number of people employed in Government operations to the total number employed and did not establish that this ratio was commensurate with the benefits obtained by the Government activities. Another dealer merely had his staff estimate the amount of expenses to be allocated to Government operations without any supportable basis except judgment.

Different methods of accounting used in reporting

The Federal Reserve Bank instructions are silent as to whether reports should be prepared on an accrual or cash basis; this is one of the reasons for the lack of uniformity in reporting. Three dealers prepared their statements on an accrual basis and three dealers submitted their statements on a combination of accrual and cash basis. For example, one dealer reported interest earned, prepaid insurance, and interest on borrowed funds on an accrual basis but reported general and administrative expenses on a cash basis. We did not make a study to determine the difference in profit and loss that would result from the use of the accrual basis for general and administrative expenses; however, in view of the size of such expenses, we believe the difference could be substantial.

Other

The following paragraphs illustrate other questionable methods employed by dealers in the preparation of financial reports.

Some dealers' Government securities positions were financed with funds borrowed from their other operations. The Federal Reserve Bank requires these dealers to apportion a part of these funds as interest free because they represent allocated capital. Interest is includable on the remaining portion as part of reportable expenses.

One dealer has been using an estimated amount of $7.5 million since 1965 to represent his allocated and therefore interest-free capital and has been reporting the interest on the remainder as expense. We were told that this $7.5 million estimate was based on a comparison of the relationship between capital and total Government positions of several other New York City dealers. We believe that more exact methods of determining allocated capital should have been employed.

Another dealer made no allocation in 1969 and reported interest expense on the total borrowings. He reported interest-free borrowings in 1965 of $5 million. Assuming the same apportionment for 1969, the reported interest costs for borrowed funds would have been reduced by about $429,000.

The dealers told us that they could not make a realistic apportionment unless the Federal Reserve Bank gave them more guidance. These same dealers, in computing interest on funds borrowed to finance Treasury bill positions, used par value of the securities as a base rather than the amount borrowed. In addition, one of these dealers used the wrong interest rate to make the calculations. As a result, the interest expense reported by one dealer was $175,000 too high whereas the other reported a figure that should have been $9,000 higher.

Also, the Federal Reserve Bank instructs dealers to report profits both before and after income taxes and specifically states that income taxes are not to be included as an expense. We found that three dealers reported correctly. One of the remaining three dealers included the New York City income tax as an expense, and two dealers ignored the city tax altogether in preparing their reports.

NET WORTH ALLOCATION

The Federal Reserve Bank requires nonbank dealers to estimate net worth allocable to Government activities for use in its profit studies on return on capital. The methods used for allocation did not appear to provide reasonable results because the Federal Reserve Bank has not given dealers suitable guidance.

A Federal Reserve Bank study in 1967 indicated that it was aware that dealers were having problems and were using various methods to allocate net worth. The report also discusses various concepts of net worth allocation and the difficulties encountered in applying them. It was silent, however, as to which method would be preferable or what guidelines should be followed.

The dealers are apparently still having problems in complying with this requirement and are still using various methods in preparing the reports. In some instances the results appeared questionable. The following examples illustrate some of these conditions.

In determining the amount of net worth used for his position in Government securities, one dealer included $4 million of Government securities held for his own investment purposes plus $2 million of Government securities deposited with clearing corporations for handling other than Government transactions. The $6 million should have been treated as applying to his other operations since these funds were not used in maintaining his position.

Another dealer using a ratio of positions to all company assets reported a net worth allocation to Government operations of $2.4 million. This dealer did not retain the details of his calculations. We used the method he described in his report to the Federal Reserve Bank to compute an allocation of $1.9 million as applicable to Government operations, or $500,000 less than reported. Although the dealer agreed with our computation, he was unable to determine what caused the difference.

In allocating net worth, a third dealer used a ratio of Government securities to his total position. This method appears inequitable because considerably less of the company's own capital is needed to maintain Government securities positions since

--large positions of Government securities need less borrowings owing to their margin requirements which range from less than 1 to less than 6 percent, whereas 25 percent margin is necessary on corporate bonds and 65 percent for stocks and

--the low amount of positions kept by the dealer's underwriting activities (which handles other than Government issues) required substantial resources to operate.

Under such circumstances, a disproportionate amount of net worth can be allocated to the Government securities operation.

REVIEW OF FINANCIAL STATEMENTS

The Federal Reserve Bank reviews of dealer reports were not effective in ensuring that the reported financial data was reasonably reliable because the group responsible for such reviews did not

--visit dealers to examine the supporting data and review report preparation practices,

--have staff with professional accounting expertise, and

--have the authority required to obtain dealer cooperation.

Among its other duties, the Market Statistics Division of the Federal Reserve Bank is responsible for processing, reviewing, and distributing dealer reports. Its reviews consisted essentially of checks for mathematical accuracy, completeness, and consistency with other reports. They told us that they also made certain analyses of the financial data but did not rely too heavily on them because they felt that the information was unreliable. These reviews were done at the Federal Reserve Bank. According to the Market

Statistics Division, visits were not made to the dealers' offices to examine into the reports in more depth because it did not have the authority to do so.

Another problem in making such reviews was that the Market Statistics Division did not have any professional accounting expertise on its staff. The Market Statistics Division had about 32 individuals on its staff comprising 11 professional and junior economists, 16 statistical clerks, and five typists and messengers. About eight of these staff members were assigned to processing, reviewing, and distributing the financial reports.

The Market Statistics Division had no authority to correct errors found in dealer reports or to enforce improvements in dealers' reporting practices.

If the staff of the Market Statistics Division obtained professional accounting expertise and were permitted to review dealers' accounting procedures at the site, they could more effectively identify errors and inconsistencies in the dealers' reports. They could also encourage dealers to make changes and improvements in the data reported.

CHAPTER 3

DAILY STATISTICAL REPORTS

The Federal Reserve Bank requires the dealers to submit daily the following statistical information.

Type of report	Description
Positions	The amount of securities held for trading valued at par by type of security
Borrowings	The amount borrowed to maintain positions by source and type of security
Volume	The amount of sales and purchases at par value by source and type of security

We found a marked contrast in the procedures and controls covering the processing and reporting of transaction data when compared with those used for reporting financial information. The transaction reports usually came directly from the dealers' day-to-day operating systems. The need to have up-to-date and accurate data for trading operations undoubtedly had an influence on the reliability of those systems.

Although we found that two dealers had reported certain repurchase agreements incorrectly, the Federal Reserve Bank told us that in two instances the incorrect data had not materially affected the data as a whole and in another the Federal Reserve Bank had issued corrected instructions for future reporting. On the basis of our observations, it seems that the dealers have adequate internal control procedures for processing daily transactions. Accordingly we believe that the information furnished to the Federal Reserve Bank in the aggregate is reasonably reliable.

The following paragraphs illustrate the errors found.

The Federal Reserve Bank and the dealers regard repurchase agreements as loans secured with collateral. The then-current instructions required that repurchase agreements be reported as borrowings at the actual amount borrowed. We found that two dealers were valuing their outstanding repurchase agreements at par value of the securities pledged as collateral instead of at the amount of funds borrowed. As a result, these dealers were overstating from 3 to 4 percent the amount borrowed in the daily transaction report. Although this practice was contrary to instructions, Federal Reserve Bank officials said that they were aware that some dealers were doing this but they believed that the aggregate borrowing statistics were only slightly affected by it.

We found also that one of the dealers discussed in the preceding paragraph had, in accordance with a 1966 instruction, reported a certain type of repurchase agreement as a sale. Although the total amount was substantial, about $148.6 million, the transactions occurred rather infrequently. After discussing this situation with Federal Reserve Bank officials, they rescinded the 1966 instruction and advised the dealer to follow then-current instructions.

CHAPTER 4

OTHER OBSERVATIONS

During our review, we noticed conditions which we consider important to the subject of the review and which may be of interest to the Committee. These conditions deal with problems in analyzing net income, improved disclosure of matters that would significantly affect the reports, and the lack of use made of the financial reports.

PROBLEMS IN ANALYZING NET INCOME

Except for information relating to net profit and net worth, data permitting analysis of the profitability of market operations in Government securities was limited. This situation stemmed essentially from the Federal Reserve Bank's inability to obtain information on certain sources of income and factors affecting profits.

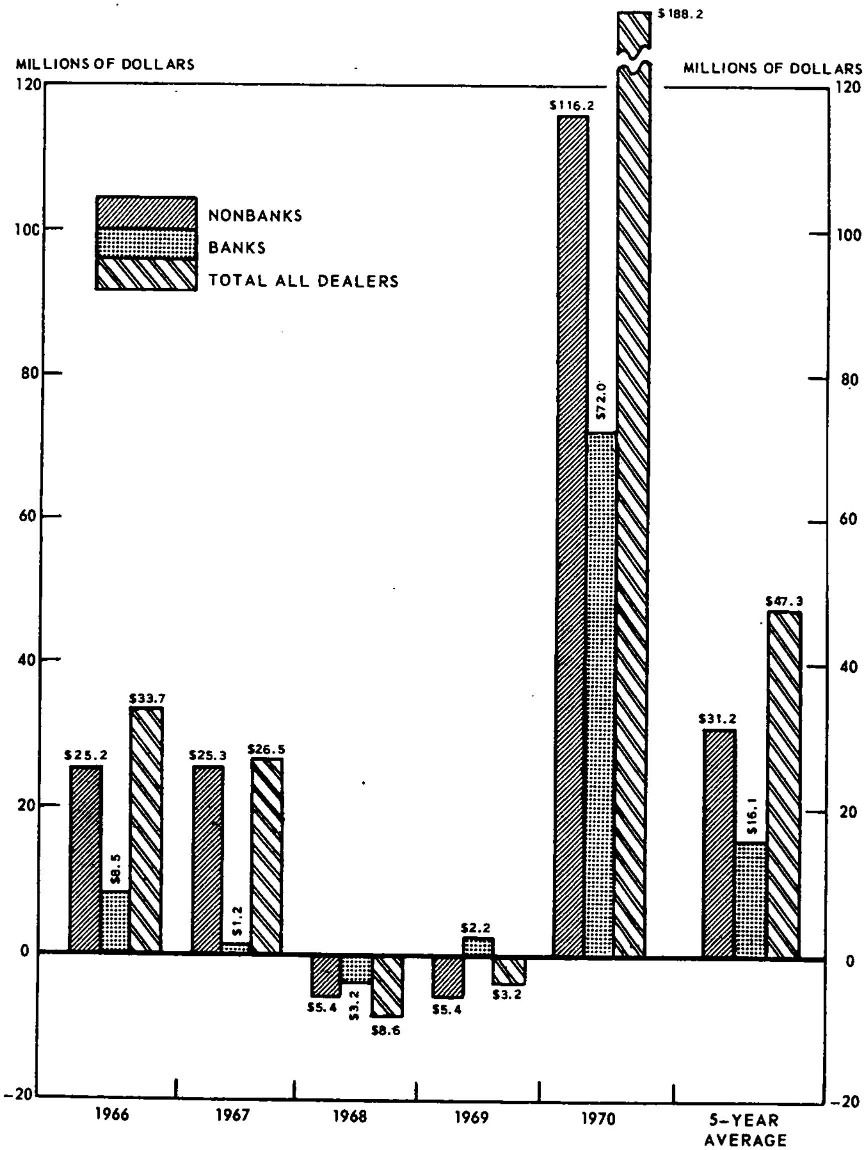
For the period 1966 through 1970, the aggregate of earnings reported by all dealers, before taxes, ranged from a loss of $8.6 million in 1968 to a net profit of $188.2 million in 1970. The chart on the following page shows the reported profits for each year and the 5-year average.

In discussing the difference in the 1969 and 1970 figures, a Federal Reserve Bank official told us:

The sharp swing in dealer earnings between 1969 and 1970 stemmed from the turnaround in interest rates. In 1969 interest rates were rising and they reached record levels. Dealers maintained relatively small positions and had to finance them at negative yields. In 1970 interest rates declined and dealers increased their positions in anticipation of further reductions. Also the drop in short-term money market rates outpaced declining yields on long-term securities and allowed dealers to finance their positions at favorable rates. The trend toward higher prices enabled the dealers to earn substantial trading profits.

A more detailed analysis of these factors was not possible because the net income information obtained by the

DEALERS IN GOVERNMENT SECURITIES REPORTING TO THE FEDERAL RESERVE BANK OF NEW YORK DEALER PROFITS (BEFORE TAXES)



Federal Reserve Bank did not provide, in all cases, for dealers to segregate trading profits from interest earned on Treasury bills. Such information is furnished only if the dealer normally makes such a breakdown. Although bills constitute the largest volume of securities sold, three of the six dealers that we visited did not separate interest earned from trading profits but lumped these factors together. Thus the extent of trading profits in the aggregate was undeterminable.

An analyst of the Federal Reserve Bank stated that another important factor influencing profits was the interest paid on funds borrowed by the dealers to finance their positions. We noted that in 1970 the Federal Reserve Bank entered into about $34 billion worth of repurchase agreements with nonbank dealers. The Federal Reserve Bank enters into these transactions in performing its function of maintaining a flow of credit and money. The interest rate paid by the dealers on these borrowings is almost always less than if they obtained the funds from other sources.

For example, during July 1970, the Federal Reserve rate was as much as 2 percent less than the New York City bank loan rates for dealers. Thus these transactions enable dealers to finance their securities at lower costs. Financial data that would readily allow assessment of these transactions on nonbank profits is unavailable.

The rate of return reported on net worth by the nonbank dealers for the 5-year period is shown below.

Rate of Return on
Net Worth Allocated to
Government Securities Operations

Year	Net income (millions)	Net worth (millions)	Percentage of return
1966	$ 25	$ 76	33
1967	25	97	26
1968	–5	101	–5
1969	–5	104	–5
1970	116	129	90
5-year average	31	102	31

We obtained profit and net worth data on the profitability of other industries and operations. The First National City Bank of New York monthly economic letter of July 1971 showed composite rates of return on net worth, after taxes, for more than 3,700 leading corporations. These included manufacturing, transportation, and financial institutions (commercial banks, investment trusts, etc.). To put the economic letter figures on the same basis as those of the dealers, we adjusted the profits, after taxes, to arrive at profits, before taxes, by assuming a tax rate of 50 percent. The economic letter figures as adjusted are shown below.

	Percent of return on net worth	
	1969	1970
Manufacturing	25	20
Transportation	8	2
Financial	12	13
Composite	21	18

We also obtained from the New York Stock Exchange reported statistics covering the financial results of member firms. This information showed that more than 300 firms made a return on net worth, before taxes, of 16 percent in 1969 and 19 percent in 1970.

A General Accounting Office profit study showed that, for 74 large defense contractors in 1969, the average return on net worth, before taxes, was 17.4 percent on work for the Department of Defense, 24.8 percent on work for other defense agencies and 20.4 percent on commercial work.[1]

These figures are shown not for the purpose of assessing the reasonableness of earnings by the dealers but merely to provide some information on how they compare with other business enterprises in the economy.

[1]Defense Industry Profit Study, B-159896, March 17, 1971.

NEED FOR REFINING FINANCIAL REPORTS

In addition to the incomplete disclosure of income data, we observed:

1. Federal Reserve Bank instructions did not require assertions to the effect that financial statements were or were not prepared on a basis consistent with that of the preceding year. In our opinion, such an assertion should be required to disclose any accounting procedural changes that would produce results differing materially from past years.

2. Some dealers adjusted their security positions each month to market values and record the unrealized gains or losses in the income accounts. Under these circumstances, the more acceptable method of financial data presentation requires that disclosure be made of the amount of unrealized profit which accumulated over the year and is still in the position values at year-end. Such disclosure is not specifically required by the Federal Reserve Bank.

USE MADE OF REPORTS

The expressed doubts about the reliability of the financial reports have limited their usefulness. We understand that the daily reports were meaningful to officials of the Federal Reserve Bank.

Financial reports

We found practically no use made of the financial reports and therefore discussed this matter with officials of the Federal Reserve Bank, the Federal Reserve Board, and the Treasury Department. Some of their comments follow.

An official of the trading desk, Federal Reserve Bank, told us that the financial reports were not necessary to its operation. Such information, however, could be useful to observe broad trends in the market if it were not for the problems in allocating income, expense, and net worth.

A Federal Reserve Board staff member stated that the reports were used for (1) identifying changes in dealer operations, (2) evaluating dealer profits, and (3) determining those dealers that may have financial difficulties. He added that the reports would be more useful if the allocation methods for expenses and net worth were improved.

Treasury officials were concerned with whether there were enough dealers to handle the volume of trading and were also interested in such other matters as dealer profits. They believed that the reports were necessary but that they could be more useful if improved.

We also found that the financial data, in the aggregate, was not regularly distributed to the Congress or to the public. An official of the Federal Reserve Bank told us that this was not done because the reports were considered unreliable and therefore meaningless.

Daily reports

Each day the trading desk at the Federal Reserve Bank receives position data for each dealer and aggregate data on positions, dealer borrowings, and volume of transactions to assist it in its open market operations. In addition, selected data in the aggregate is sent daily to all the Federal Reserve Bank presidents, to the Federal Reserve Board, and to the Treasury Department.

Only aggregate statistics are released to the public through weekly press releases and the monthly Federal Reserve Bulletin. The volume of transactions is publicly released weekly and position and borrowings after a 4-week time lag.

Federal Reserve Bank officials who operate the trading desk have told us that the data is useful for several purposes. The data is used to determine the amount of securities available for purchase from dealers and to determine the amount of money borrowed and the source of borrowings.

76-150 O - 72 - pt. 1 - 12

CHAPTER 5

SUGGESTED CORRECTIVE MEASURES

Considering the highly sensitive nature of the Government security market operation and how little was known about it in 1960, we believe that the progress made toward developing and operating a financial and transaction reporting system merits commendation. The fact that this progress was made without regulations and achieved through the Federal Reserve Bank and dealer cooperation also warrants recognition.

Even so, we believe that our findings show a need for the Federal Reserve Bank and dealers to improve the reliability and usefulness of the financial data accumulated under the reporting system. This will require special effort by them if improvement is to be achieved. In the remainder of this chapter, we are suggesting some corrective measures that we believe could be taken by the Federal Reserve System to achieve appropriate improvements.

STRENGTHENING CONTROLS OVER PREPARATION OF REPORTS

In chapter 2 we pointed out major problems that were encountered: (1) all income was not being reported for the accounting period because some dealers were not on a commitment basis and (2) some dealers reported some accounts on an accrual basis but reported others on a cash basis. It is generally recognized that the accrual method of accounting more accurately shows the financial position of a concern and more precisely measures the results of operations for specific periods. Accordingly we believe that the financial reports should be prepared on an accrual basis if a significant difference might result.

Another problem discussed in chapter 2 was the reasonableness of expenses allocated to the Government securities operation. The inequities found were mostly attributable to mistakes made by the dealers and the need for more specific guidance by the Federal Reserve Bank. We believe that the following steps could be taken by the Federal

Reserve System to build a greater degree of assurance into the reporting system.

--Develop criteria for the dealers to follow in allocating expenses with special emphasis on the suitability of the basis used to allocate costs and the relationship of expenses to Government securities operations.

--Require dealers to retain the working papers supporting such items as adjustments, allocations, and calculations in preparing reports so that questions involving the data submitted can be properly resolved.

--Establish methods for increasing awareness on the part of top management officials of the dealers that complete and accurate data is to be provided.

--Establish and require dealers to use uniform quotations to determine market value of Government agency securities.

Chapter 2 also covers the question of obtaining realistic allocations of net worth which has been a continuing problem. Essentially there is a lack of guidance in this area. We believe that problems in such allocations could be overcome through the development of specific criteria on the method to be used in allocating net worth.

IMPROVING REVIEW FUNCTION

To strengthen the Federal Reserve Bank review function we believe that

--the Market Statistics Division should obtain professional accounting expertise,

--the review procedures of the Market Statistics Division should be modified to provide for examinations of financial data and supporting workpapers at the dealers' offices, and

--the authority of the Market Statistics Division could be broadened to provide for visits to dealers' offices and enable it to make changes necessary to improve the accuracy and usefulness of financial reports.

REFINE FINANCIAL REPORTS

In chapter 4, we show the advantages that can be gained by refining the financial reports particularly with respect to more complete disclosure of income data. The following steps could be taken to provide for better reporting.

--Require dealers to segregate Treasury bill trading profits from interest earned in the net income analysis.

--Require dealers to indicate whether reports were prepared on a basis consistent with that of the prior year. If changes in accounting procedures were made, the dealer should describe the nature of the change and the effect on the data.

--Require dealers to disclose the unrealized gains and losses for all Government securities using cost as a base. The balance sheet should show the amount of unrealized gain or loss included in reported positions.

DISTRIBUTION OF AGGREGATE REPORT DATA

To ensure distribution of financial data to the Congress and the public, we believe that consideration should be given to inclusion of the dealers' aggregate data in the annual report of the Federal Reserve Board. To accomplish this, we suggest that the Federal Reserve Bank establish reporting dates to coordinate with the date of the annual report.

AGENCY COMMENTS

We discussed the report with officials of the Federal Reserve Bank who gave us their informal comments. Although they agreed with our findings and conclusions, they told us that the Informal Treasury-Federal Reserve Steering Committee, which has overall responsibility for the reporting system, would have to decide on what corrective action would be taken.

APPENDIXES

APPENDIX I

Congress of the United States
JOINT ECONOMIC COMMITTEE
(CREATED PURSUANT TO SEC. 5(a) OF PUBLIC LAW 304, 79TH CONGRESS)
WASHINGTON, D.C. 20510

May 1970

The Honorable Elmer B. Staats
Comptroller General of the United States
Washington, D. C.

Dear Mr. Staats:

Eleven years ago, at my request, the staff of the Joint Economic Committee developed a set of reporting forms and accounting standards to use in obtaining information on the operations of the dealers who make a market in Government securities. At that time there were seventeen such dealers. The results were published by the Committee in 1960 in a pioneering staff study of this market. Subsequently a system of regular reporting on this market was developed by the Federal Reserve System in cooperation with the dealers. This system now produces a regular flow of data about transaction in the market and on revenues, expenses, and profits of dealers, both bank and nonbank.

Now that this system has been operating for several years, it would seem appropriate to review the basic accounting standards that are employed to make sure that these are in accord with the best practices. This would insure that we could have confidence in the data, particularly as to the profits of the dealers. With this aim in view, I am attaching a set of the forms and instructions used by the Federal Reserve Bank of New York in operating this system of reporting and I request that your accounting experts go over this system and advise me as to whether or not: (1) the accounting practices are in accord with the best accounting standard; and (2) such a system is likely to afford the public and our Committee an accurate picture of the operations and profits of these dealers as a group.

Mr. James W. Knowles, Director of Research for the Joint Economic Committee, has been involved with this system from the beginning in 1959, and is available to work with you in any way needed in the course of your review.

Sincerely,

Wright Patman

Wright Patman, Chairman

APPENDIX II

LIST OF FINANCIAL REPORT DEFICIENCIES

BY TYPE AND PRIMARY CAUSE

Statements of Financial Condition

		Primary cause
1.	Adjustment of securities positions from the dealer's basis of accounting to the commitment basis was made incorrectly. (2)[1]	D[2]
2.	Various methods were employed for determining the market value of securities positions. (6)	F
3.	Net worth allocated to Government securities activities was not adequately supported. (1)	D
4.	Securities borrowed and the offsetting liability were not reported. (1)	F
5.	Liability for outstanding repurchase agreements reflected par value of the securities instead of actual money borrowed. (1)	D
6.	Securities purchased but not yet received understated due to a footing error. (1)	D
7.	Accrued interest receivable and accrued interest payable were inaccurate. (2)	D
8.	Nonreportable securities were included in financial statements. (2)	D
9.	Securities sold but not yet delivered were improperly stated. (2)	D
10.	Securities positions were overstated. (2)	D
11.	Repurchase agreements were improperly classified as to maturity and type of security. (2)	D

[1] See page 34.

[2] See page 35.

	Primary cause
12. All contingent liabilities were not reported. (1)	D
13. Required explanations of data were not submitted. (2)	D
14. Positions in agency securities were erroneously classified as "other securities." (1)	D
15. The reported increase in net worth was not accurate. (1)	D
16. Related asset and liability accounts were offset even though the Federal Reserve Bank instructed otherwise. (1)	D
Net Income Analysis	
17. Trading profits were not reported on the commitment basis, as required by Federal Reserve Bank instructions. (3)	D
18. Unrealized gains or losses not reported in the right reporting period. (1)	D
19. Unrealized gains on Government securities including Treasury bills were not properly classified. (1)	D
20. Unrealized loss was erroneously reported as unrealized gain. (1)	D
21. Income was not reported on a calendar-year basis as required by the Federal Reserve Bank. (1)	D
22. Certain interest income was offset against interest expense. (3)	D
23. Expenses on certain transactions were offset against interest income instead of being reported separately as required. (1)	D

APPENDIX II

	Primary cause
24. Required explanations of data were not submitted. (2)	D
25. Income on Treasury bills was overstated. (1)	D
26. All income items were not reported. (1)	D
27. Cost of borrowed funds was overstated because interest was on the par value of Treasury bills instead of the discounted value. (2)	D
28. Unrealistic interest rate used for calculating the cost of own bank funds used. (1)	D
29. Miscellaneous income items were incorrectly classified. (2)	D
30. Miscellaneous interest expense was inaccurately reported. (3)	D
31. Expenses included certain items not applicable to Government securities activities. (2)	D
32. No schedule supporting expense allocations was submitted. (1)	D
33. Interest-free dealer department capital estimate was unrealistic or not estimated. (2)	D
34. Local income taxes were treated inconsistently. (6)	F
35. Interest expense was overallocated as a result of including costs incurred in financing other than Government securities activities. (2)	D
36. Data submitted was not fully on an accrual basis. (3)	F

NOTE: Figures in parentheses ( ) indicate the number of dealer errors.

TABULATION OF DEFICIENCIES

	Number of deficiencies Type	Instances
D = caused primarily by erroneous dealer procedures.	32	51
F = caused primarily by weaknesses in Federal Reserve Bank instructions, guidelines, etc.	4	16
	36	67

Representative PATMAN. There is one thing, Mr. Chairman. I want to submit to Mr. Burns questions that I would like him to answer. I will submit them to you, Mr. Chairman, to be transmitted to Mr. Burns, when he looks over his transcript.

Chairman PROXMIRE. He will be happy to do that. He has always accommodated us in that respect.

Representative PATMAN. He certainly is accommodating in that respect. I would also like for him to state the amount of business that the dealers do in borrowing money at this subsidized rate at 3 percent, when other people have to pay at least 5 percent. It may have been reduced a quarter or so since that time.

With that information I will forgo asking other questions at this time.

(The information to be furnished follows:)

RESPONSE OF HON. ARTHUR F. BURNS TO ADDITIONAL WRITTEN QUESTIONS POSED BY REPRESENTATIVE PATMAN

Question 1. Does this monopoly power help to explain the failure of the economy to act as the economists tell us it is supposed to act; that is, when economic activity tapers off and unemployment rises, prices and wages are supposed to fall?

Does this mean that we must as public officials face up to the fundamental problem of concentration and lack of competition in our economy and try to reinstate competition or we will be stuck with controls for a long time to come?

How should we go about deconcentrating our economy—should we break up large corporations which have acquired too much economic power, should we limit shares of markets in various industries—what do you recommend?

Specifically, in the banking field, do you think there is adequate competition within commercial banking and among other financial institutions such as life insurance companies?

Answer. The failure of wages and prices to respond more flexibly to slack in labor and products markets in the past few years can be traced to several factors. Concentration of economic power in the hands of both trade unions and businesses has been partly responsible. Because of their economic power in national or regional markets, some businesses are able to charge higher prices than they could if competition were stronger. Many trade unions, because of their strength at the bargaining table, are able to obtain excessive wage increases even in periods of high unemployment. The latter problem was most evident in 1970 and the first half of 1971, when union wage increases actually accelerated, even in the face of growing unemployment.

A variety of government programs aimed at alleviating the effects of economic dislocation on affected groups and individuals have also added to pressures on costs and prices, even though the overall goals of many of these programs have been worthy. The minimum wage, unemployment insurance, public assistance programs, price supports for farm products, and import quotas are some examples.

Improving the competitive nature of our markets will require special efforts to reduce the capacity of some trade unions and firms to set wage rates and prices irrespective of market conditions. Vigorous enforcement of the anti-trust laws should suffice to restrain firms from exercising their power in setting commodity prices. It may be that new legislation is needed to deal with the abuses of economic power by trade unions. The whole range of public programs of the sort mentioned above should be reviewed to determine their effects on wage-price behavior.

In the banking and financial field, competition generally appears to be adequate. Financial markets are highly competitive, and changes in the balance of supply and demand in financial markets are reflected in prompt adjustments in interest rates on most classes of financial assets and in all regions of the country.

Question 2. Mr. Burns in your statement you mention certain tax concessions proposed by the Administration to help revitalize the economy. The facts of the matter are that accelerated depreciation of plant and equipment and enactment of the 7 percent investment tax credit came at a time when manufacturing capacity was and still is operating at less than three-fourths of full potential. As a result, these measures haven't yet done much of anything to improve the economic picture.

By the same token, higher Government outlays for unemployment compensation, Social Security and other welfare costs, while vital to the people receiving these payments, haven't done much to stimulate the economy.

Why should we expect any real improvement this year from the same approach?

Answer. The incentives to business investment provided by accelerated depreciation and the investment tax credit could hardly be expected to affect plant and equipment outlays materially as yet—since enabling legislation was just passed in December. However, recent surveys of anticipated plant and equipment expenditures do suggest a significant upturn in 1972—even more than had been expected late last fall. The latest Commerce-SEC survey of spending plans now shows an anticipated increase of almost 11 percent in capital outlays during 1972. This evidence is supported by rising new orders for capital equipment. Given the continued strengthening of confidence that has been taking place recently, the additional fiscal stimulus expected in the months to come should act to invigorate economy activity.

In the longer run, however, concerted efforts must be made to stimulate the quality and quantity of investment as a basis for elevating the productivity growth which is fundamental to a well-functioning economy. There is a need for investment incentives and technical research directed toward this end.

Question 3. In your statement, Mr. Burns, you express the hope that although short-term rates may start going up due to increased credit demands, long-term rates will come down "and credit will remain in abundant supply for housing, for state and local construction and for our nation's business firms."

Isn't this expectation contrary to what usually happens?

Doesn't increased credit demand affect long-term interest rates first and longest?

How often in the recent past have short-term rates gone up while long-term rates have gone down?

Answer. Normally, short- and long-term rates tend to rise and fall together. although the timing and amplitude of movement seldom correspond exactly. With respect to amplitude, for example, short-term rates generally fluctuate much more widely than long-term rates. Whether short- or long-term interest rates change first in response to variations in total credit demands depends in large part on the structure of those demands, the state of market expectations, and the stance of monetary and fiscal policy. In the period of economic expansion from 1961 to around mid-1965, short-term rates drifted up, while some long-term rates actually declined, reflecting the subsidence of earlier inflationary expectations and generally moderate long-term credit demands.

In the coming year, economic recovery is likely to be accompanied by an increase in short-term credit demands, as the rate of inventory accumulation increases. There could be some diminution in longer-term market demands, however, since yield spreads of long- over short-term rates are unusually wide now. This should induce some shift in borrowing from long- to short-term markets. Moreover, corporations have issued an extremely large amount of bonds over the past two years in order to help improve their liquidity and achieve a sounder debt structure. It seems likely that this source of pressure on bond markets may abate.

As the public becomes convinced that inflation will be contained, attitudes should shift and lenders should become willing to accept lower interest rates over the long-term because they will have less fear of an erosion in the real value of their investment.

Question 4. Mr. Burns, up until 1953 interest rates on long-term Government bonds never exceeded 2.5% because of the coordinated efforts of the Federal Reserve and the Treasury to hold down interest rates on Federal securities. This, in turn, held down all other money market rates.

In 1953 this policy was abandoned. As a result, American consumers and taxpayers have paid $497 billion in excess interest on the public and private debt since then. The total amount of interest paid on the public and private debt exceeds the entire public debt.

If this excess interest had not been paid, there would have been far less inflation and the real purchasing power and productivity of American workers would have been sustained at significantly higher levels.

You agree with this, don't you?

Answer. Attempts to employ the tools of monetary policy to peg interest rates at artificial levels have proved both fruitless and counterproductive. In the final analysis, real rates of interest are not determined by monetary and credit policies but by the productivity of capital and the volume of savings. Efforts to peg interest rates at levels below those that bring investment and savings into equilibrium at stable average prices inevitably lead to excessively rapid increases in the money supply and hence to inflation. Rates of interest are then also driven up, as an inflationary premium becomes built into the interest rate structure.

Abandonment in 1951 of the policy of pegging interest rates on Treasury securities was essential to the achievement of our national economic stabilization objectives. Had we not done so, price inflation would have run riot, with ruinous effects on productivity and on incentives to save and invest.

Question 5. During the 1930's and 1940's the Federal Reserve and the Treasury worked closely in the sale and purchase of Federal securities in order to hold down interest rates on these obligations. This tandem arrangement resulted in rates of less than 2.5% on long-term Federal bonds during all of this time.

Would you advocate a return on a permanent basis to this policy so that interest rates on Federal securities could be maintained at reasonable rates—so that all market interest rates, influenced as they are by the Federal share of the market, would be held at more reasonable levels?

Answer. For reasons given in my answer to the previous question. I would not.

Question 6. In your statement, Mr. Burns, you assert: ". . . More—perhaps much more—remains to be done to restore the conditions for lasting prosperity."

What more needs to be done that is not now being done and who should do it?

Answer. First and foremost, we must bring to a successful conclusion our present struggle to gain control over the forces of inflation. The information becoming available recently suggests that the new economic program in effect since August has resulted in a noticeable slowdown in the rise of both wages and prices. We must make sure these benefits are not lost. As economic activity picks up this year and next, it will be vital to keep our fiscal and monetary houses inorder to prevent the reemergence of fresh inflationary forces. Only in this way can we continue to increase the confidence of consumers and businessmen in the viability of our economic policy. It is for this reason that I have argued strongly that the Congress should adopt a rigid ceiling on the level of Federal expenditures.

Lasting prosperity will not be achieved unless we can demonstrate that high levels of employment and rapid economic growth are attainable within the framework of stable average prices—without resort to direct wage-price controls. To accomplish this, we will need the help of all sectors of our economy, public and private. As I stated in my testimony, efforts to raise productivity deserve high priority, as do measures to increase competition in both our product and labor markets. Also, there are still many things to be done to bring our unemployed and underemployed citizens into the mainstream of economic life—such as improving job training programs, reducing discrimination, providing more job opportunities for teenagers, and improving our employment placement services. Such steps would improve the quality of our labor force and reduce welfare and unemployment compensation payments.

On the international front, there are a number of steps needed to achieve greater stability in international financial markets and to restore equilibrium in our balance of payments. Over the longer run, procedures for changing par values of national currencies will need to be developed that are flexible enough to prevent the buildup of large and persistent imbalances in trade and payments among countries. A searching re-evaluation is also needed of the roles to be played by gold, reserve currencies, and special drawing rights in settling international accounts. Various proposals for modifying the operations of the International Monetary Fund require study and discussion. The circumstances under which the dollar may again be convertible into international reserve assets will have to be reviewed carefully. And determined new efforts will be required to reduce impediments to the international flow of goods, services and capital.

Question 7a. Could you comment on the possible relationship between the volume of U.S. funds exported for overseas investment and the problem of domestic unemployment? Also, could you comment on the significance for monetary policy of bank borrowings of Euro-dollars from their overseas branches?

Answer. There is no direct or necessary relation between U.S. overseas investment and domestic employment. It is true that some American companies manufacture products at their foreign plants for shipment to the United States, or for sale in foreign markets in competition with U.S. products. But it is likely that foreign producers would have taken some advantage of these opportunities if U.S. companies had not done so. And there are many cases where the foreign output of a U.S. business firm contributes directly to domestic production in the United States.

Bank borrowing from their overseas branches (and the subsequent repayments) does not affect the ability of the monetary authorities to control the total supply of credit for domestic purposes. If banks as a group increase the loanable funds at their disposal by borrowing from overseas branches, open-market policies can be employed by the Federal Reserve to offset the effects on aggregate bank credit. Not all banks, of course, have equal access to the Euro-dollar market. But in 1969, the banks that borrowed most from the Euro-dollar market were larger banks that were under intense liquidity pressure because of a decline in the volume of large-denomination negotiable certificates of deposit.

Question 7b. My second question relates to what adjustments in policy have been made to cope with the fact that orthodox monetary policies are not currently effective. In your statement, you said "open market operations have been conducted with more emphasis on increasing the reserve base of the banking system." How does this differ—or does it differ—from previous responses?

Answer. Placing more emphasis in open market operations on increasing the reserve base of the banking system represents a difference in degree—not a fundamental shift in approach—from previous methods of implementing monetary policy.

Various indicators of money market conditions have often been used as guides for day-to-day open market operations in the expectation that this would result in the desired change in monetary and credit aggregates and bank reserves. Such an approach has sometimes led to excessively wide swings in growth rates of the aggregates because market demands for funds have either been more or less buoyant than anticipated. By putting more emphasis on achieving a desired growth of bank reserves, while assigning a lesser role to achieving money market conditions, better control may be gained over growth rates of the money supply and bank credit.

Monetary policy cannot ignore conditions in the money market. Pressures in the money market convey information about the state of credit demands and about needs for liquidity. And open market operations are still used to avoid undue fluctuations in short-term interest rates, which could create destabilizing effects on credit markets and the economy generally.

Question 8. I would like to ask you to comment on the point I made about the high rates of interest on small loans and installment purchases. These rates are at least 18 percent and some are 24 and 36 percent. The customer who pays $10 a month on a $100 balance will pay $1.80—or almost one-fifth—$2.40, which is approximately one-fourth, or $3.60, which is more than one-third of the payment in finance charges. These charges bear no relation to the cost of credit to the merchandiser. They are not competitive and do not respond to market forces. They are like regressive taxation in that the highest cost of credit is borne by the people who can least afford it.

Answer. I can well understand your concern over the high rates of interest on some consumer loans. The level of these rates, however, reflect primarily the high cost involved in processing new loans and in servicing and collecting outstanding loans. Since these costs are relatively fixed, and do not vary directly with the size of the loan, the cost per dollar of loans is quite high when the dollar size of the loan is small, as is often the case in consumer loans.

When adequate consideration is given to these elements of cost, it is clear why interest rates on some consumer loans are high relative to other interest rates. Moreover, because administrative costs account for such a large proportion of their total costs, consumer loan rates tend to be more inflexible than are rates on most other types of loans.

Question 9a. I would like to refer to the GAO study of Federal Reserve open market transactions. As I stated, the volume of transactions in 1970 is $738 billion. I think it is important to determine, Mr. Burns, how much of this amount represents transactions which are necessary to effectuate the objectives of monetary policy and how much represents transactions which are necessary as a function of managing the $70 billion Federal Reserve portfolio of Government securities.

I have commented before on the destabilizing effect of managing this huge portfolio and many economists agree that because of the relatively short maturities of the securities in the portfolio and the fact that they must be replaced as they mature, it is necessary for the manager of the open market account to be in the market very frequently and for reasons which have nothing to do with the objectives of monetary policy. Since all transactions in the market affect the market, this kind of transaction by the Federal Reserve must necessarily hamper operations which are related to the conduct of monetary policy. I would like you to comment on this issue, Mr. Burns, and also to provide information as to the average maturity of securities currently in the portfolio.

Answer. All of the open market transaction of the Federal Reserve—outright purchases and sales as well as repurchase agreement—are carried out to effectuate the objectives of monetary policy. The volume of transactions is very large because the System has to undertake a sizable amount of short-run purchases or sales in response to variations in technical factors affecting reserves, such as float and changes of currency in circulation.

Market transactions are not required to replace short-term securities in the System's portfolio. Securities that mature are replaced either by bidding in Treasury auctions or by exchanging them for new issues during Treasury refundings.

The average maturity of Treasury securities currently in the System's portfolio is 2 years and 1 month, as compared with an average maturity of 3 years and 4 months for all marketable Treasury debt outstanding.

Question 9b. In view of your objections to my proposal to cancel all but about $9 billion of the securities in the Federal Reserve portfolio, I would like to ask you, Mr. Burns, if you would object to having the approximately $60 billion of superfluous securities—those which it is not contemplated that the System could ever dispose of in the market without precipitating utter ruin on the economy and which it therefore must be prepared to hold in perpetuity—with non-negotiable non-interest bearing obligations of the U.S. Government.

Answer. What would be accomplished by replacing part of the Reserve Banks' portfolio of marketable Treasury securities with non-marketable, non-interest-bearing obligations? Interest on Treasury debt would be reduced, but Federal Reserve payments to the Treasury would be reduced by exactly the same amount. So there would be no saving to the Government or to the taxpayers.

However, there would be a change in the collateral that the Reserve Banks are required to maintain behind Federal Reserve notes. Since a strong economy depends on confidence in our currency, and Federal Reserve notes make up the great bulk of our circulating currency, the collateral behind those notes should not be changed without good reason. Particularly at this time, achievement of a vigorous recovery depends on building confidence—confidence in the currency, confidence in our ability to bring inflation under control, confidence on the part of businessmen that markets will exist for their goods, and confidence on the part of consumers that their jobs are secure and that they will be able to meet the payments if they buy a new car. A change in present arrangements for providing collateral for Federal Reserve notes would weaken confidence in the currency. It would raise needless questions, and much damage to the economy could ensue.

Question 9c. Specifically, under what circumstances and for what reasons would you consider a reduction in reserve ratios justified?

Answer. Reserve requirements have been changed infrequently, since day-to-day adjustments in reserves can be accomplished by the System through open-market operations and by member banks through borrowing at the discount window. When monetary policy calls for additions to reserves, the choice of whether to do so by open market operations or by reducing reserve requirements may be affected by the fact that the two methods distribute reserves in different ways. When reserves are supplied through open market operations, the initial recipients usually are money-market banks; other banks' reserves rise later, as the funds work their way through the banking system. Reductions in reserve requirements. on the other hand, may be structured to release reserves uniformly to all member banks or to particular classes of banks.

In the past twenty years or so, reserve requirements have been reduced in periods of recession in order to supply reserves needed to stimulate recovery; and to do so in a way that would distribute the reserves simultaneously to all parts of the economy. Conceivably, other occasions may arise when reserves should be supplied in this fashion rather than through open market operations. For example, actions taken to reduce float (and thus reduce reserves) have been under continuing study. If such actions were taken, offsetting actions by the System to supply reserves would be required in order to avoid a tightening of monetary policy. Considerations of equity and monetary policy would suggest exploring the possibility of reducing reserve requirements so as to distribute reserves in a way that generally matched the pattern of reserve losses due to the reduction of float.

Question 10. I have the impression, based on your testimony, that you would not oppose a full GAO audit of all Federal Reserve System financial activities, so long as no comment was made about monetary policy. Is this an accurate statement of your position? If not, why not? Am I correct in assuming you would not require imposition of any restrictions, other than those already applying to GAO in its audit of other Federal agencies, regarding GAO audit of the Federal Reserve System? If not, would you state what areas you would withhold from GAO examination and why?

Answer. The point I attempted to make in my testimony is that a GAO audit has a much broader purpose than verification of accounts. A GAO audit of our books to check their accuracy and integrity would be unobjectionable, although it would duplicate work that is now performed with competence by others. But in auditing most Government agencies. GAO interprets the statutes that established such agencies, assesses the intent of Congress in authorizing programs, and considers whether the programs authorized continue to serve their intended purpose.

As Chairman of the Board of Governors, I stand ready at all times to supply to Congress information it needs to assess the manner in which the System is carrying out its assigned responsibilities. I feel that questions of policy—particularly in the sensitive area of monetary policy—should be discussed directly with the Committees of Congress charged with oversight of the System, as I have done frequently. Review by GAO of System operations would be expensive, since it would duplicate auditing and examination processes in existence. It would raise questions of maintenance of the confidential relationships that the System must maintain, not only as a central bank but also as a bank supervisor. And to use GAO as the conduit for assessment of policy matters by Congress would retard, rather than facilitate, the review of System operations that Congressional committees are now performing directly.

Response of Hon. Arthur F. Burns to Oral Question Posed by Representative Patman Regarding Repurchase Agreements

The essential purpose of repurchase agreements (RP's), exercised by the Federal Reserve with dealers in government securities, is not to assure ready financing of dealer security positions, but rather to make temporary additions to bank reserves, as needed, to support desired growth in the nation's supply of money and bank credit. Without such adjustments, bank reserves would frequently undergo sizable short-run variations, because of random or seasonal fluctuations in such things as check float, currency held by the public, and changes in the Treasury's cash balance at Federal Reserve banks. To keep the banking system from being buffeted by temporary and often unanticipated shortfalls in the general availability of bank funds, it is helpful for the Federal Reserve to have at hand a flexible open market instrument to provide temporary reserve injections. RP's with dealers provide such an instrument.

When it initiates repurchase agreements, the Federal Reserve buys securities from dealers, who in turn agree to buy them back at a later date, usually one to three days hence. The dealers, agree to pay a specified rate of interest for the period the RP's are outstanding. While the RP's, as a result, do help dealers to finance their inventories, this is a peripheral effect. The main reason for RP's is to quickly—and temporarily—inject funds into the banking system.

Since the purpose of System RP's is thus to facilitate needed short-run adjustments in the bank reserve base, RP's are offered only when it suits the policy requirements of the System to do so. For this reason, dealers cannot depend on the Federal Reserve as a predictable and regular source of financing. To cover most of their needs, dealers turn to other sources—chiefly collateral loans and RP's from commercial banks, RP's from large nonfinancial corporations, and RP's from other types of institutional lenders. In fact, Federal Reserve RP's are a relatively unimportant source of dealer financing, a point illustrated by the attached table summarizing dealer borrowing in 1971. Although dealer borrowing from all sources in 1971 amounted to almost $3.8 billion on a daily average basis, the table shows that dealer RP's with the System amounted to only $252 million on the same basis, or less than 7 percent of the total.

At times when policy objectives do indicate the desirability of supplying bank reserves through Federal Reserve RP's with dealers, the System must make sure that the RP's are accepted. To achieve this result, the System must set an RP rate at least as attractive as the rates dealers are paying for alternative sources of funds. If this rate is too high, dealers naturally will borrow from others rather than the System, and the desired volume of reserve injection sought through RP arrangements will not occur.

As a general practice, the System's RP's with dealers have been made at the Federal Reserve discount rate. However, the effective rate at which dealers can borrow from sources other than the Federal Reserve is generally close to, or a little above, the prevailing rate on Federal funds. During periods of general monetary restraint the Federal funds rate has typically been above the Federal Reserve discount rate, so System RP's made at the discount rate have provided dealers with some subsidy. With monetary policy recently quite stimulative, however, the Federal funds rate has dropped well below the Federal Reserve discount rate (currently 4½ percent). In these circumstances, when the System has sought to provide reserves through RP's with dealers, it has had to drop the RP rate commensurately with the funds rate.

The lowest rate on System RP's in recent years was 3¼ percent (not 3 percent, as indicated by Mr. Patman). The 3¼-percent rate was offered on four different occasions in February of this year. These transactions involved a relatively large daily average volume of $845 million 1–4 day RP's. Over the same period, however, dealers were also borrowing an additional daily average volume of $3.8 billion from other sources, at rates centering generally around the same 3¼-percent level.

As Mr. Patman suggests, rates on bank loans to some types of borrowers were closer to 5 percent at the same time dealers were paying 3¼ percent on System RP's. However, these higher bank rates were typically on loans of longer maturity and less liquidity, involving higher administrative costs and greater risk, and thus were not comparable with the System RP's. As noted, on collateral loans and RP's from banks and others that were comparable to the System RP's, dealers were also paying close to 3¼ percent.

SYSTEM RP'S AS A SHARE OF TOTAL—NONBANK DEALER FINANCING IN 1971

[Daily average figures in millions of dollars]

Month	Total nonbank dealer borrowing	System repurchase agreements	System financing as percent of total borrowing (col. 2 ÷ col. 1)
January	4,442	126	2.8
February	4,019	256	6.4
March	3,207	328	10.2
April	3,931	218	5.5
May	2,292	273	11.9
June	2,275	46	2.0
July	2,541	284	11.2
August	2,526	160	6.3
September	3,419	312	9.1
October	3,657	203	5.5
November	4,834	346	7.1
December	4,189	180	4.2
Yearly average	3,761	252	6.7

Chairman PROXMIRE. Mr. Blackburn has yielded to Senator Javits who has to be on the floor to handle critical legislation.

Senator JAVITS. I thank Mr. Blackburn very much.

If Mr. Burns will cooperate with me, I have three questions.

I would like to thank Congressman Conable and Congressman Blackburn.

First, I wish to express our appreciation in your being here. I have enormous respect for you.

In your statement you strongly recommend swift approval of the dollar devaluation legislation which is shortly being sent to the Hill by the administration. What in your view would be the effect of the attempts to amend the administration bill with the kinds of measures that are apparently being speculated about in the press, to wit, gold ownership by Americans, trade quotas, other trade legislation?

In other words, do you believe that Congress should act swiftly to pass a clean bill for the President, and if we don't do it, what are the consequences?

Mr. BURNS. I very much hope, because of the uncertainties that are now stirring in financial markets, that the Congress will pass a simple, clean bill on the gold price, raising the official price from $35 per ounce to $38 per ounce, and I very much hope that this action will be taken speedily. This will help to restore confidence.

If the Congress deliberates over a protracted period, if a variety of amendments is added, I think the effect on world trade and the effect on our own economy will be very unsettling. This is a result that I devoutly hope that you and other leaders of the Congress will do everything you can to avoid.

Senator JAVITS. Do you see any danger if we fail to act promptly and cleanly, as you say, of the dollar markets deteriorating so as to face us with perhaps another crisis and another devaluation?

Mr. BURNS. Let me put it this way, Senator Javits: In view of the uncertainties and confusion that already exist, there is always a danger of unsettling markets further. This risk should simply not be taken by the Congress in dealing with this legislation.

Any views that Members of the Congress may have on ownership of gold by Americans, any views that Members of the Congress may have on desirable trade legislation, I think should be handled separately.

Senator JAVITS. Now my second question, Mr. Burns, is on the matter of productivity. I can't tell you the respect in which I hold you as being the one Member in high office outside of Congress who has really understood this. I thank you for your fine statement about us. I might tell you that without the cooperation of Senator Proxmire and Congressman Patman and their colleagues it would never have gotten into the Economic Stabilization Act. It is the same with the Appropriations Committee that put up $10 million for it at our initiative.

You say that the Commission will shortly be initiating a program to establish productivity councils at the community and plant level.

Will you give us any further enlightenment on that subject? That is in your statement.

Mr. BURNS. Only that I have checked with the Director of the Commission. He has assured me on the point.

Let me give you this word of advice, Senator. You have been interested in this for a great many years, and I too have. You have been in this city for many years, and I have been in and out of this city for some years. There is such a thing as bureaucratic delay in this Government, but there is a way to avoid it: Have the Commission report to the Congress at frequent intervals on progress. I think that is very important to do.

Senator JAVITS. I thank you. I shall certainly do everything I can to bring that about. I am sure I will have the cooperation of my colleagues who are so interested, too.

My last question, Mr. Burns, is this: We have a bill pending here which is getting a lot of attention from organized labor, which is very disturbing to many of us interested in the international economic policy of the country and the peace of the world. It is called the Burke-Hartke bill. It has various provisions relating to literally changing the whole economic thrust of American private enterprise everywhere in the world.

To what extent—and I would like to submit this to you in writing—would you, as Chairman of the Board, feel free to comment on the substantive parts of that bill? I am not going to ask you to tell us whether we ought not to pass the bill. But there are various questions—repealing the foreign tax credit, widening import quotas, creating a foreign trade and investment commission to regulate imports and so on.

Could we ask you to give your opinion as to what that will mean in your judgment to the international economic policy of our country?

Mr. BURNS. I will be very glad to respond. I want to thank you for giving me the opportunity to respond.

Senator JAVITS. Thank you very much. Don't you think it is better to get that in writing? It will really take quite an answer, I imagine, to cover all those points. Would you agree to that, Mr. Burns?

Mr. BURNS. I agree with you so much of the time, Senator and this time, too.

Senator JAVITS. Thank you, Mr. Chairman. I will submit that question to the Chair for submission to Mr. Burns and ask unanimous consent that the reply may be made a part of the record. I again thank my colleagues very much.

Chairman PROXMIRE. Without objection, that will be done.

(The information to be furnished follows:)

FEBRUARY 14, 1972.

DEAR ARTHUR: I am sorry that my duties on the Senate floor in connection with the EEOC bill did not allow me to hear all of your fine testimony before the Joint Economic Committee on Wednesday, February 9, 1972. Your written statement was excellent and gave the dollar devaluation bill an important push forward, and I do hope it will pass the Congress swiftly and cleanly. As you may know, I issued a press release shortly after your testimony indicating that I would not push any amendment to the bill which would allow U.S. private citizens to hold gold, even though I had earlier cosponsored such a measure that had been introduced by Senator Hatfield.

You may recall that during the hearing, I did ask for your written evaluation of the Hartke-Burke bill. Since this time, this evaluation has become even more important to me since I will soon appear on "The Advocates" arguing the position against Hartke-Burke. In addition, your reply will be placed in the record of the Committee hearings. The formal questions that I would like to ask on behalf of the Joint Economic Committee are:

Could you give the Committee your views on the various provisions of the Hartke-Burke bill: 1) repealing the foreign tax crdit, and making payment of foreign taxes by multinational corporations merely deductible; imposing stricter depreciation rules for foreign investment; imposing taxes upon income received by U.S. companies for transfers of technology. 2) creation of a Foreign Trade and Investment Commission, with strong powers to regulate imports. 3) widening the scope of import quotas to cover more goods. 4) tightening of anti-dumping and counter-vailing duty laws. 5) relaxing the criteria for escape clause assistance. 6) enabling the President to regulate capital transfers, including transfers of technology, if he determined that the effect of the transaction would be to decrease domestic employment. 7) repeal of sections 806 and 807 of the Tariff Schedule that permit U.S. corporations to reimport goods that have been assembled in low-wage countries, paying duty only on the value added. 8) more visible labeling on the origin of foreign made goods, or porducts with componants made overseas.

With warm regards,

Sincerely,

JACOB K. JAVITS.

CHAIRMAN OF THE BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, D.C., March 16, 1972.

Hon. JACOB K. JAVITS,
U.S. Senate,
Washington, D.C.

DEAR JACK: I am writing in reply to your letter of February 14, 1972, in which you requested my views on the Hartke-Burke (S.2592/H.R. 10914). Let me comment briefly in this letter on each of the eight features of the bill you have listed. I am also sending along an analysis preparated by our staff which goes into the issues in more detail.

As I have already said in testifying before the Joint Economic Committee on February 9, 1972. I regard the bill as a most unfortunate legislative action which could only injure this country and the international economy. My reasons for this view will be apparent in the following comments on its provisions as you summarized them.

(1) "Repealing the foreign tax credit, and making payment of foreign taxes by multinational corporations merely deductible; imposing stricter depreciation rules for foreign investment; imposing taxes upon income received by U.S. companies for transfer of technology."

If these provision were enacted they would impose on the foreign earnings of U.S. companies a tax burden significantly greater than on their domestic earnings, and generally much greater than is borne by their local competitors abroad. In many cases it would probably make the investiment in foreign affiliates uneconomic, and it would apply not only to new or recent investments, but to the whole range of existing investments—income from which is an important support for our balance of payments.

I believe that what we should seek for these investments is a position of tax neutrality, that is, neither our tax laws nor those of other countries should create subsidies or extra costs that would induce U.S. corporations to invest abroad, or prevent them from doing so. To the extent there are such elements in our present tax structure I would support actions to eliminate them. However, in my view the provisions of this legislation would impose an unfair tax burden on the foreign affiliates of U.S. companies.

(2) "Creation of a Foreign Trade and Investment Commission, with strong powers to regulate imports."

I believe the Commission as proposed would introduce an arbitrary and potentially divisive element into the administration of foreign trade policy, since it would include representatives of partisan interests. We now have a Council on International Economic Policy, and expert staffs at the Tariff Commission and at several other agencies that perform fact-finding functions and carry out policy in their areas of responsibility. I doubt that the proposed Commission would further the broad public interest of the United States in the foreign trade and investment field.

(3) "Widening the scope of import quotas to cover more goods."

There is no question in my mind that the imposition of quotas as conceived in this bill would be an enormous setback for U.S. and world trade. It would not only cut back U.S. imports by perhaps one quarter of their 1971 value, but it would also create severe rigidities and inequities in the whole trade picture and plunge us into bitter controversies with other countries. It would involve us in clear violation of our obligations under the General Agreement on Tariffs and Trade.

I recognize that at times import competition falls especially heavily on certain sectors of American industry and labor, and we should be prepared to assist the people involved to reestablish themselves in viable occupations. But we will only weaken our economy in the long run if we try to do this by fencing off certain sectors from competition—either foreign or domestic. The interests of American consumers would be damaged by rising prices and more limited choice. Moreover, it is certain that other countries would retaliate by shutting us out of their markets. The shrinkage of world trade that would occur if this legislation were implemented would set back efforts in many countries to overcome recessionary tendencies.

It is especially inappropriate to be considering a measure that would shrink our foreign trade at the very time that we have succeeded in reaching multilateral agreement on a realignment ofexchange rates that will allow us to move from trade deficits to trade surpluses in the period ahead.

(4) "Tightening of anti-dumping and countervailing duty laws."

It may be that improvements could be made in the administration of these laws, but it is not clear why this cannot be done within the present legislative and administrative framework.

(5) "Relaxing the criteria for escape clause assistance."

I believe the proposals to relax the criteria for escape clause assistance would go too far toward protecting firms from competition, since a finding of injury from imports could be made even though an increase in imports was not a major or primary factor causing, or even threatening to cause, serious injury. Under present law an increase in imports would have to be a "major" factor causing injury, and the increase in imports must be related to a trade-agreement concession.

(6) "Enabling the President to regulate capital transfers, including transfers of technology, if he determined that the effect of the transaction would be to decrease domestic employment."

There has been a very lively debate on the effects of direct foreign investment on the U.S. balance of payments, and we already impose certain restrictions on these investments because of the large balance of payments deficits we have had for many years. In my judgment, it is not desirable to continue such controls as a long-term measure, though they may be necessary to deal with short-run difficulties. As to proposals to limit the dissemination of technology, I would consider this to be unwise and, as history shows, very unlikely to be effective. At the same time, I believe that when U.S. technology is used abroad there should be an adequate payment to the United States to compensate for the development costs. There is now a large return to the United States as fees and royalties on such technology.

Apart from questions of the correct policy to follow, the specific criterion for imposing restrictions suggested in the legislation—the net effect on employment in the United States—would probably be impossible to administer.

(7) "Repeal of section 806 and 807 of the Tariff Schedule that permit U.S. corporations to reimport goods that have been assembled in low-wage countries, poying duty only on the value added."

This is a rather technical matter, which has been studied by the Tariff Commission, and I would defer to the judgment of others more knowledgeable in this area.

(8) "More visible labeling on the origin of foreign made goods, or products with components made overseas."

This question also is rather technical, and I would have no strong views.

I hope that you will find these comments helpful.

Sincerely yours,

ARTHUR F. BURNS.

Attachment.

COMMENTS ON THE HARTKE-BURKE BILL (H.R. 10914/S. 2592)

The following comments regarding the principal provisions of the Hartke-Burke Bill are concerned with both the specific sections of the bill and the overall thrust of the legislation. The stated intent of the Bill is "to promote and maintain a fully employed, innovative, and diversified production base in the United States." In general, the bill would achieve this objective by rigidly limiting imports into the United States and restricting the transfer of capital and technology to foreign locations by U.S. business. There are a number of problem areas covered by the Bill where action might well be taken, but these areas are overshadowed by those elements of the Bill that would shrink both the exports and imports of the United States, and impose handicaps on the foreign affiliates of U.S. firms that woud make it difficult for them to survive against their foreign competitors. Moreover, the specific provisions of this Bill would be extremely difficult, if not impossible, to administer.

An appreciation of the potential effects of the Bill is best gained by reviewing its principal features. The following comments cover (1) sections affecting U.S. trade, (2) sections affecting U.S. foreign investments and the use of technology abroad, and (3) other provisions.

(1) SECTIONS OF THE BILL AFFECTING U.S. TRADE

The discussion under this heading covers Titles III, IV and V of the Bill, which provide for quotas on imports changes in the application of the antidumping and countervailing duty provisions of present law, and the operation of "escape" clause provisions of the Trade Adjustment Act of 1962.

Title III—Quantitative restraints on imports

Section 301 of Title III of the Hartke-Burke Bill would establish across-the-board quantitative restrictions on U.S. imports. In the first year—1972—the *quantity* of imports *in each category* of goods *from each country* would be limited to the 1965–1969 annual average imports in that category from that country. In succeeding years, the new Foreign Trade and Investment Commission (1) *must* increase *or decrease* quotas from 1972 levels so as to maintain the ratio between imports from each country of each category and domestic production which existed during the period 1965–1969, (2) may further decrease quotas if it determines that imports are inhibiting the production of any manufactured product, and (3) must make any increase or decrease in quotas the same percentage for all countries. Exemptions to the across-the-board rules are provided where (1) voluntary government-to-government agreements limiting imports are entered into under Section 302 of the Bill, (2) quantitative controls have been imposed under some other law or existing government-to-government agreement, (3) failure to import the goods would cause long-term disruption of U.S. markets or (4) the domestic industry has repeatedly failed to make adequate technological advances to remain competitive. The Commission may group 5- and 7-digit TSUSA (Tariff Schedules of the U.S., Annotated) categories for purposes of establishing the "categories of goods" to which quotas will be applied.

Section 302 of Title III authorizes the President to enter into bilateral or multilateral agreements with foreign governments to regulate imports. If a country refuses to be party to a voluntary agreement which the United States has signed with other supplying countries, the Commission may establish an involuntary quota for that country (which, presumably, could be at a lower level than would be the case under the voluntary agreement).

Discussion

Any quantification of the rollback in imports that would result from Title III is extremely difficult since it is unclear precisely how particular provisions of this Title would be interpreted in practice. A very crude estimate, however, indicates that if total imports in 1971 had been limited to the 1965–69 average level, after allowance for price increases since the base-period and assuming no exemptions, the rollback in imports would have been roughly $12 billion. This would be a reduction of about 26 percent from the actual 1971 level of $45.6 billion. Since the Hartke-Burke formula is to be applied to quantity data but only value data for aggregate imports are readily available, a rough adjustment to the value data for price rises since the 1965–69 period had to be made in arriving at this rough estimate. Thus, impots in the base-period were inflated to current 1971 dollars through the use of unit value indexes.

This crude estimate of import rollback based on *1971* data may have to be adjusted *upward* by the amount of increase in imports from 1971 to 1972 in order to estimate the rollback for *1972*—the earliest year in which the Bill would be effective. It would also have to be raised by some unknown amount to take account of the fact that the actual rollback, when finely disaggregated by commodity and by country, may be greater than the estimate based on aggregate data. This would occur whenever imports of specific commodities from particular countries have declined since the base period and the country for any reason does not raise its exports to take advantage of the quota that might now be available. The effect of disaggregation is impossible to quantify at this time since the level of disaggregation under the Bill is left completely to the new Commission's discretion.

The estimate of import rollback may have to be adjusted *downward* by some unknown amount to take account of exemptions to the across-the-board formula. It is unclear from the Bill which specific import items might be exempt, but if the exemption provisions are liberally applied, and if automotive imports from Canada are given a special exemption, the downward adjustments to the original $12 billion estimated rollback may well exceed the upward adjustments mentioned above.

Because of the very large magnitudes of trade involved under Title III, an immediate effect of implementation of the Hartke-Burke Bill's provisions would undoubtedly be massive retaliation by foreigners against U.S. exports. Implementation would be a clear violation of the provisions of GATT (General Agreement on Tariffs and Trade). The losses in terms of U.S. production and jobs in export-related industries need to be offset against gains in production and jobs which might result from substituting domestically-produced goods for imports.

Title III of the Hartke-Burke Bill would result in an inefficient allocation of U.S. and world resources. It would protect U.S. industries against foreign competition, thus preventing market forces from reallocating domestic resources from less efficient to more efficient industries.

Consumers would be adversely affected in several ways. By severely reducing imports, Title III would increase inflationary pressures in the U.S. market. Consumers and producers would have to substitute higher-priced domestically-produced goods for lower-priced imports. In addition, the rigid formula of the Hartke-Burke Bill would no longer permit the United States to shift among alternative foreign suppliers in search of the cheapest possible source of supply. Also, consumers would no longer be able to obtain new products, or greater variety and better quality, by purchasing imported times. It is not likely that U.S. producers would be able to begin production of many of the goods which can no longer be imported within a short period of time, and meanwhlie supply shortages might result. Moreover, any domestic shortages of goods resulting from other causes would be intensified, since as domestic production falls off for any reason imports must also be cut back by a proportionate amount to maintain the 1965–1969 import/production ratio.

The constraction in world trade that would result from this legislation would be very serious at a time when most industrial countries are operating below their potential. Moreover, Title III would introduce a great deal of uncertainty into world markets. The quota amounts must be varied such year, depending on whether U.S. production rises or falls, so that foreign producers could never be certain what they might expect from one year to the next.

The administrative problems that would have to be faced by the Foreign Trade and Investment Commission would be immense. Existing data needed in administering Title III are wholly inadequate. Import and production data are seldom comparable or available in sufficient detail. Forecasts of a year's production of each category of goods would have to be made by October 1 in order to determine the following year's quota; such forecasting would necessarily be difficult and involve many hazardous assumptions. Quantity data for many product classes are unavailable even at the most disaggregated level. In addition, the Commission is given inadequate guidelines for administering Title III. For example, the exemption to be granted where "failure to import the goods would cause long-term disruption of U.S. markets" would require highly subjective judgments on the part of the Commissioners. Also, the provision that quotas can be reduced below the base level if imports are "inhibiting the production of *any* manufactured product" in the United States could involve unpredictable restrictions at the discretion of the Commission. Moreover, the Commission would be completely free to define as it sees fit the "categories" of goods to which the Bill's formulae are to be applied. If these categories were defined too narrowly, the controls would be rigid and very restrictive; if too broadly, large and unpredictable shifts in imports within categories could result.

Foreign governments would also be faced with difficult administrative problems. They would have to determine how to allocate quota amounts among individual foreign producers—a potentially very sensitive political and economic issue.

Title IV—Antidumping and Countervailing Duty Acts

The Hartke-Burke Bill would change the existing Antidumping and Countervailing Duty Law procedures by transferring the existing fact-finding functions of the Tariff Commission and the Treasury Department to the proposed new three-person Foreign Trade and Investment Commission. Also, the entire investigative process would be required to be completed within four months. The only time requirement now is that the Tariff Commission makes its findings within three months under the Antidumping procedure. There is no stipulated time limit for Treasury's decisions. The major provisions of the Antidumping Act and the Countervailing Duty Law would be unchanged.

Discussion

It is highly questionable whether the accelerated implementation of these Acts would be achieved by the proposed legislation. The new Commission would have tremendous responsibilities—not only under this provision but under other provisions of the Bill—and the only possible way these could be met is by building up an extremely large staff. This would take time and a considerable shifting and addition to the people presently employed in this line of work at the Tariff Commission or the Treasury Department.

It would certainly be most desirable if the time for antidumping investigations could be shortened but it seems that this could be best achieved by building up the staffs at the existing agencies rather than establishing a new investigative staff. In fact this is being done. The Antidumping Section of the Treasury Department has expanded from 5 people in 1969 to over 60 currently, and this has cut the average investigation time from an average time of 2 years in 1968 to 1 year. Treasury hopes to further reduce this time to 6 months by the end of this year. The number of Antidumping hearings held by the Tariff Commission has increased very sharply in the last few years. From 1965 to 1970 the average number of cases was 5. In 1971 there were 17 cases. So far this year hearings have been scheduled for 10 cases. The quality of the Antidumping decisions is also believed to have improved greatly with the additional staff, and there is much greater certainty about their accuracy than previously.

Title V—Amendments to "Escape" Clause Provisions of the Trade Expansion Act of 1962

This provision would transfer the administration of the "escape" clause provision of the Trade Expansion Act of 1962 from the President and the Tariff Commission to the proposed Foreign Trade and Investment Commission. It would relax the standards for "escape" clause action by requiring the imposition of quotas if imports are actually or potentially "contributing substantially" to the difficulties of domestic industries rather than being the "major" factor. Under the present law the increase in imports would have to be found to result from a trade-agreement concession before "escape" clause action can be taken. This criterion would be eliminated under the proposed new law. The President now has the discretion to decide whether any "escape" clause action should be taken and, if so, whether it should be by raising duties, imposing quotas, or other measures.

Discussion

The principal effect of the proposed change would be to limit the power of the President to make decisions on matters that involve many conflicting interests that would be directly and indirectly affected. For example, if mandatory quotas were set by the new Commission, our commitments under GATT would allow foreign countries to retaliate if we did not reduce duties on other imports as compensation to them. This would impinge on other U.S. producers, and would raise a major foreign policy issue. Because of the broad effects of these actions it would appear that the President should have the responsibility for invoking the "escape" clause rather than such a Commission.

If the sweeping quantitative limits on imports called for in other sections of the Bill were also enacted, there would be no possibility of providing compensation to other countries. Therefore, equivalent retaliation against U.S. exports would be assured whenever relief is provided against import competition.

Under the terms of this Title, industries in the United States which are for any reason in economic difficulties could apply for relief by the imposition of quotas, under very loose criteria. Thus, in contrast to a forward-looking adjustment assistance program which would try to promote a transition from noncompetitive industries and occupations to more fruitful ones, or to offer facilities for modernizing or otherwise improving the efficiency of the affected industry, this Bill would tend to reinforce the immobility of labor and capital.

(2) SECTIONS OF THE BILL AFFECTING U.S. FOREIGN INVESTMENTS AND THE USE OF U.S. TECHNOLOGY ABROAD

The discussion under this heading covers Title I, which contains the provisions changing the taxation of controlled foreign corporations, and Title VI, which provides for controls on investment abroad and the use of U.S. patents abroad.

Title I—Taxation of Earnings and Profits of Controlled Foreign Corporations

In broad outline, this Title would subject all the income of controlled foreign corporations to U.S. income taxes (there would no longer be deferral of U.S. taxes on the undistributed profits of the controlled foreign affiliates of U.S.

firms) and it would eliminate the present provisions for crediting foreign taxes paid against U.S. taxes—which is intended to avoid double taxation of foreign earnings. Such taxes would still be deductible. Other sections of this Title prescribe tighter rules for calculating depreciation of foreign assets, impose a tax on gains on certain transfers of patents, and impose higher taxes on U.S. citizens working abroad.

Discussion

Taxation is a field where knowledge of intricate legislation and regulations is required in order to judge the full effect of changes. Rather than attempt such a detailed evaluation, attention here is on the broader issues raised. This Title of the Bill (and also Title VI) seems to reflect a conviction that U.S. welfare is likely to be harmed when U.S. companies operate controlled subsidiaries abroad, or employ their patents abroad. There is at present a very lively national debate on that subject, which cannot be resolved here and may never be resolved. While this matter is an open question, however, it would seem to be appropriate for the tax system of the United States to be neutral—to operate so as to neither encourage or penalize investment abroad by taxing income from such investments differently from income from U.S. sources, or more severely than the income of foreign competitors is taxed.

Under the existing tax regime there seems to be on the whole a more favorable treatment of the earnings of foreign affiliates of U.S. firms than of domestic earnings. This comes about mainly when such an affiliate has earnings in a country where the effective tax rate is lower than in the United States, and when such earnings are not subject to U.S. tax until paid to the U.S. parent company. A proposal to eliminate such deferral of U.S. taxes was rejected by Congress in 1962. There are many difficulties connected with the removal of deferral—such as the conflict with foreign tax jurisdictions, the fact that U.S. affiliates abroad would be taxed higher in some cases than their local competitors, and the complications arising from higher indirect taxes abroad—but this seems to be an area where careful studies should be made. and steps taken if necessary. to be sure that tax advantages promoting investment abroad are removed. The relevant provisions of the Hartke-Burke Bill probably would need much modification and refinement before they would be serviceable for this purpose.

It should be noted that deferral of U.S. taxes on foreign affiliate undistributed profits under the present rules is of little benefit to the U.S. investor when the foreign rate of corporate income tax is close to the U.S. rate. That is in fact the case in most industrialized countries, so that the overall effect of the removal of deferral—taken alone—would not be very great. However, since it would make the most difference when foreign tax rates are low, and low rates are found most often in less-developed countries, the removal of deferral could bear most heavily on investments in some of these countries. This would not support overall U.S. objectives abroad.

Whereas removal of the deferral privilege would probably not bear drastically on foreign investments, elimination of the effective protection against double taxation through the use of the tax credit for foreign taxes paid could be extremely costly—especially if coupled with the removal of deferral. The combined burden of foreign direct and indirect taxes and of U.S. taxes on the entire earnings of the foreign affiliates (even when foreign taxes paid are allowed as a deduction) would render many of them uneconomic from the companies' point of view. Moreover, this would apply not only to new investment but to the entire body of such investments now in existence. Even if it were accepted that these investments may sometimes have adverse effects on the U.S. economy or some sectors of it, the stream of income from them already constitutes a major plus item in the U.S. balance of payments. Punitive taxation would not eliminate the basic economic factors that might make it necessary to produce abroad in the first place, and it would have to be expected that in due course if the U.S. affiliates were curtailed these same operations would be taking place under foreign ownership—leading to the same adverse results now alleged, but without the compensation of an income stream coming to the United States.

The other elements of this Title relating to foreign taxes also tend to inhibit foreign investments by U.S. firms, but they seem to be less fundamental than those discussed above.

There are many issues of tax equity and tax administration that are not covered in this note, but that should be aired before drastic changes are enacted into law. On balance, the proposals in Title I cover tax problems that need study and action, but this Bill goes far beyond tax neutrality and would be a sharp and punitive reversal of the tax regime under which such investments have been made up to now.

Title VI—Foreign Investment and Technology Export Controls

This very brief title authorizes the President to prohibit any U.S. investment abroad that in the judgment of the President would result in a net decrease in employment in the United States, and to prohibit the use of a U.S. patent to manufacture the patented product abroad when such a prohibition would contribute to increased employment in the United States, in the judgment of the President.

Discussion

These controls, to be substituted for the present regulations imposed under the Trading with the Enemy Act, are extraordinarily sweeping and clearly impossible to administer. They reflect, as does Title I on taxation, a judgment that the U.S. economy would be more prosperous if U.S. industry and technology could be isolated from the rest of the world.

By being brief, this Title completely lacks specificity. It does not say what is meant by "capital", nor does it give a clue as to how the impact of these particular activities on employment are to be distinguished from all the other relevant variables. At the extreme, it could be ruled that *any* transfer of capital or patents should be prohibited on the grounds that the direct employment effect was likely to be adverse and the possible indirect positive effects could not be identified and quantified.

Taking this Title together with the tax provisions of Title I, U.S. investment abroad would be severely curtailed, and the two-way flow of technology between the United States and foreign countries would be stifled. This would be done in a completely arbitrary way, without regard to the equities of the investors affected or the broader impact of such limitations on the international economic position of the United States. Many foreign competitors are beginning to export capital and technology to important markets in order to confront U.S. companies most effectively in such areas. Restraints on the ability of U.S. companies to meet this competition in foreign markets as well as in the United States will not in the long run create jobs in the United States.

On more narrow considerations—if there were a judgment that the U.S. Government should impose new restrictions on U.S. investments abroad, the provisions of this Bill do not provide an operable framework or terms of reference. Under the present regime the control is quantified in terms of an allowable, definable flow of investment capital; in this Bill there is no possibility of establishing a quantifiable rule to be applied to each proposed investment or to the aggregate of all investments abroad by U.S. companies. At the extreme, each proposed foreign investment, or transfer of technology, might require approval by the Government.

(3) OTHER PROVISIONS

There are two other major sections of the Bill on which we might comment.

Title II—Establishing a United States Foreign Trade and Investment Commission

The purpose here is to establish a three-man independent Commission to regulate U.S. trade (and presumably also investment). The new agency would replace the Tariff Commission and certain parts of the Treasury, Commerce, and Labor Departments. The new Commission would have much more power to regulate imports than any existing agency. One of the Commissioners would represent labor interests, a second would represent industrial interests, and a third would represent public interests.

A significant aspect of the proposed new Commission is that it would include partisan interests. capable of making decisions that would determine national policy. The Tariff Commission is considered a neutral body whose principal function is to make objective investigations of the Tariff Acts. In administering the tariff and trade laws the President, or the Executive Agencies, and the Congress then use these studies to determine the appropriate U.S. policy in that area. The Tariff Commissioners are all expected to be representative of public interests and this, in itself, assures the objectivity of that agency's studies. The creation of the new Commission with the extensive powers proposed by the Hartke-Burke Bill would seriously erode the decision-making powers of the President and the Executive Branch of the Government.

Title VII—Other Foreign Trade Provisions

This section of the Hartke-Burke Bill contains amendments to existing law and requires the collection and publication of much new material on foreign trade. It also contains requests for expanded reports by the Export-Import Bank and AID on the effects of their operations on U.S. trade and employment, and the requirement that the Bureau of Labor Statistics collect data on workers employed abroad by the U.S. Government or U.S. corporations—matters on which we have no comments.

There are two other provisions in this section requiring comment. The first is section 703 which removes items 806.30 and 807.00 from the U.S. Tariff Schedules. These items provide for duty-free entry of U.S. materials contained in imported articles. The stated purpose of this part of the Hartke-Burke Bill is to remove the incentive for U.S. companies to move assembly operations to Mexico, Taiwan, Hong Kong and other places to utilize cheap labor.

The Tariff Commission made an investigation of these tariff items in 1970 and concluded that only a small number of the estimated 121,000 jobs in 1969 in these foreign assembly plants would be returned to the United States if these tariff items were repealed. It also estimated that about 37,000 people in the United States are involved in the production of the materials exported and in further processing of the resultant imports.

Another provision in this section deals with the requirement that finished goods containing foreign components be clearly marked as to the specific foreign country of origin and that the advertising of such goods should also make this identification. There are two problems associated with these requirements. There would be an additional burden on domestic producers and retailers to maintain records in the detail needed to comply. Also, these more stringent foreign marking requirements may be in conflict with certain provisions of GATT or our treaties of Friendship, Commerce and Navigation with many countries.

Chairman PROXMIRE. Congressman Reuss.

Representative REUSS. Welcome, Mr. Burns. You have done a splendid job. I think you have given Senator Javits good advice on the follow-through on the December 18 Smithsonian agreement. I am delighted to be told just now by my Chairman, Mr. Patman, that he expects the bill to validate the agreement up today, and that he will hold prompt hearings this month, as soon as we get back from the recess. I am confident that the good sense you have just enunciated will prevail. It better, I might add, or we will be in trouble.

I have several questions. One is on your overall monetary policy. In a marvelous effort to accommodate the penny-pinching Proxmire and the profligate Patman, you have said that your monetary motto this year will be: "Enough but not too much." Is that about right?

Mr. BURNS. That is a good summary.

Representative REUSS. You, like me, are disturbed about the current close to $40 billion deficit. My own position is that I have no objection to deficits, as such, but I am concerned about the composition as well as the size of the deficit. When a deficit like this year's $40 billion appears to be caused in considerable part by excessive loss of revenues due to loopholes and tax preferences on the revenue side, and by feckless non-job-producing expenditures, like large subsidies to corporate farmers for not growing crops on the expenditure side, then I wonder as to its efficiency in doing the job of reducing unemployment. I don't ask you, as a Republican, to comment on what I regard as the vulgarization of Lord Keynes that is inherent in this kind of a deficit. But take it for what it is, $39 billion or $40 billion, do you really think it is the job of the Federal Reserve to validate, by cranking out new money, whatever deficit an administration may cook up, good, bad or outrageous?

I am a little worried, you see, because you said in your statement here that we are now in a favorable position to provide the monetary support needed.

Wouldn't you feel a lot better if this deficit that confronts you had been somewhat smaller in amount and a lot more precisely aimed at the problem of reducing unemployment, without all the leakage in it?

Mr. BURNS. That is a difficult question, Congressman Reuss. Yes, I would feel happier if the deficit were smaller. I think that is true of my colleagues, and I think that is probably true of most Members of the Congress and people around the country.

At the same time, I don't feel that I can justly criticize a deficit that arises in very large part because of a shortfall in revenue, which in turn is attributable to the failure of our economy to perform at levels close to full employment.

Representative REUSS. Part is. But part of the shortfall in revenues is surely due to the loopholes and preferences in the tax system.

Mr. BURNS. This is a large subject. We have had tax reductions recommended by the Administration and enacted by the Congress, and the budget reflects those. That is the will of the two branches of the Government.

Representative REUSS. Yes, but weren't they both wrong?

Mr. BURNS. I don't think the restoration of the investment tax credit was wrong. I might quarrel with some of the other measures, but I think when the economy is not performing satisfactorily, tax reduction has a role to play.

I would add that perhaps too much emphasis is being placed nowadays on old-fashioned remedies such as an easy monetary policy or an expansionist fiscal policy. These remedies are not working as well as they did in the past. Times are different.

Representative REUSS. Isn't that difference largely due to the structural nature of our present five-plus million unemployed? Easy money and easy fiscality has less of a chance to operate and, therefore, other measures, such as the Jobs Now program are needed, wouldn't you agree?

Mr. BURNS. I think that is part of the problem. But I think also that something has happened to the American people, something has happened to the system of responses of both consumers and business people. They are not reacting to classical remedies the way they did because they are living in a disturbed world and they are themselves disturbed and are to a large degree, confused. These have been very troubled times and they have left their mark on the psychology of people, on the thinking of people, and that inevitably spills over into the economic realm. We have had a very long and most unhappy war which has divided this country and confused the people. Not very long ago we had riots in the streets and we had riots in the colleges, and now we have busing of school children. We also have all kinds of tax changes, Congressman Reuss. I wish we would stop talking about tax changes for a little while. I don't imply criticism of you at all, but this is confusing people.

Now we have youngsters who are going to vote and now women are also marching in the streets, and now we have badly unbalanced budgets. If only life would quiet down for a while, if only both the administration and the Congress would become just a little less active in pushing new reforms for a while, if only some of my academic colleagues would keep quiet for a while, then I think this country might absorb a little better all these tumultuous changes around us and we might find that old-fashioned economic policies are working better. Of late, they have not worked too well.

Representative REUSS. You aren't suggesting that, by my talking about the need for plugging tax loopholes, I am consciously aiding and abetting the enemy?

Mr. BURNS. Let me say this, Congressman Reuss: If it weren't for you I doubt that the Smithsonian agreement would have been achieved when it was, and if it weren't for you much of what is so fine about America would not be here.

Representative REUSS. I had better hastily yield back the balance of my time.

Chairman PROXMIRE. Congressman Blackburn.

Representative BLACKBURN. Thank you, Mr. Chairman.

I, too, want to welcome Mr. Burns. I know he wouldn't want to suggest that the gentleman from Wisconsin has been acting unconsciously.

Chairman PROXMIRE. It sounds like we have two more candidates for the presidency this morning.

Representative BLACKBURN. Mr. Burns, I, too, find your statements always most persuasive. I want to give my "amen" to your comments that perhaps we in the Congress are contributing to some of the instability in our country through some of the statements that we make on occasion.

I think we would do well to sort of leave the country alone in some respects, in both the political field as well as the academic field, and let some of these problems sort of thrash themselves out.

You have answered most of the questions that I had been considering. Could you very briefly comment on your instinctive reaction to the Burke-Hartke bill? Then I have another question I would like to ask after that.

Mr. BURNS. I can be brief. I regard it as a most unfortunate bill, one that could only injure this country and the international economy.

Representative BLACKBURN. That is frankly the opinion that I thought you were going to express. I do know we will have the Export Control Act coming up for an extension. There have been some indications that attempts may be made to draft parts of that bill onto the Export Control Act extension. As I interpret your response, you would favor a resistance of any such additions to the Export Control Act.

Mr. BURNS. I don't know the Export Control Act, as such. Therefore, I would not want to comment on it at this moment. But I am going to reply to a series of questions in this area that Senator Javits will forward to me.

Representative BLACKBURN. Thank you. In your statement you make the statement, "A serious national effort to increase economic efficiency should also include the most careful consideration of the steps needed to reduce abuses of private economic power, whether of business or labor."

Could you elaborate on this statement for us? What steps do you think would be most appropriate in reducing abuses of private economic power?

Mr. BURNS. This is a subject that I hope the Congress will study very intensively in order to prepare the country for what I hope will be Phase III, a phase when we can do away with direct controls and when we may have a more competitive economy than we have now. I think that our antitrust laws should be reexamined, and they probably should be enforced better than they are being enforced. I also feel that our trade unions now have excessive power and that this is causing grave economic difficulties for our Nation; and that the time is ripe for a reexamination of the special immunities that our trade unions have accumulated over the past 30 or 40 years.

Representative BLACKBURN. Would you be thinking in terms of something similar to the antitrust laws to apply to trade unions? Would that be an approach that you would suggest?

Mr. BURNS. I would not suggest that approach, partly because I don't understand the problem well enough; partly because to the degree that I have looked into it I have become skeptical of that way of dealing with the trade union problem.

Representative BLACKBURN. Would you suggest legislative actions to make the trade union leadership more responsive to the membership, to make it a more democratic functioning institution than they are today? Naturally, it is a broad question because it is an area to which I think Congress has to give thought, and we frankly need advice and suggestions.

Mr. BURNS. Let me say one thing. I most reluctantly have come to the conclusion that compulsory arbitration of labor disputes in industries that vitally involve the public interest is necessary.

This does mean some interference with collective bargaining. I am certain in my own mind that the Congress will have to do this. It is a question of time. I rather hope that the Congress will deal with this soon rather than later.

Representative BLACKBURN. I share your reluctance because to me I fear that compulsory arbitration will ultimately lead to complete control of the economy. If you can force a man to accept a certain wage, then inevitably you are going to be telling what management will be paid, what the prices will be that are charged for the goods. That is the basis of my reluctance to move forward to compulsory arbitration.

Thank you, Mr. Burns. I have enjoyed your testimony.

Chairman PROXMIRE. Mr. Burns, you and Mr. Shultz and Mr. Stein all point to the buoyance of fixed capital investment. I am wondering how you arrive at that interpretation. The official Commerce-SEC projection for 1972 suggest an expansion of 9 percent, but almost all of that is in the first half of the year. As a matter of fact, the differential in the last half over the second quarter is only about 1½ percent, which could be accounted for and probably would be, or more than accounted for, by an increase in prices.

Why do you place such reliance over the year on increases in capital fixed investment?

Mr. BURNS. I attach much more importance to the annual figure than to the distribution by quarters. But the Department of Commerce-SEC survey is not alone in indicating a recovery in business capital expenditures. There was a sharp rise in manufacturers' appropriations for capital investment in the third quarter of last year, after 2 years of stagnation. There is no fourth quarter figure for that series as yet. The orders for capital goods have been rising fairly briskly in the last few months. Construction contracts for industrial plant, commercial buildings, have been going up. There has been a very notable increase in the formation of new business firms. This has been a fairly reliable indicator along with the others that I have mentioned, of the future level of business capital expenditures. That is the basis for my judgment.

Chairman PROXMIRE. On the other side you have the fact that we are operating so far below capacity, still at 75 percent or less of capacity.

Mr. BURNS. That is true.

Chairman PROXMIRE. Historically, there have been very few instances of a sharp increase in capital investment when you are operating at that level of capacity, isn't that correct?

Mr. BURNS. That I have to quarrel with. On the contrary, history indicates that once confidence returns, even with a low rate of utilization, new projects immediately get underway on a large scale, and capital investment rebounds.

Chairman PROXMIRE. My recollection of two or three studies I have seen would not indicate that. Your generalized reassurance does not impress me.

Let me move on. One of the difficulties that we encounter with Mr. Stein and Mr. Shultz, and I don't see anything to rebut it in your testimony, is that we seem to be getting a very sharp expansion, a very great stimulus in the first half of the year. The deficit is greater in the first half of the year and some of the indicators are more promising in the first half, and then in the last half we lose it. There are political implications, of course. If the stimulus comes now it could carry, to some extent, through to the election. That makes it somewhat suspect.

Do you feel uneasy about the distribution of the stimulus that we have particularly from the budget deficit which is so great in the first half and so much less in the second half? It is much less in the second half and on a full employment basis it is in balance or in surplus in the second half.

Mr. BURNS. Senator, I think the time to apply economic stimulus is at an early stage of a recovery; and once the economy gathers momentum, the stimulus should taper off. I am absolutely certain of this as a good economic principle for policy purposes. Whether the interval should be 3 months, 6 months, or 9 months is a question of judgment on which neither I nor any other economists in the world can speak with any authority.

Chairman PROXMIRE. What troubles me is we have had great fiscal stimulus in the past 6 months and we have had preceding that the monetary stimulants, which should be effective. We are still operating at a low rate of capacity, at a very high percentage of unemployment. We haven't seemed to move.

Mr. BURNS. There is one other thing you should keep in mind. I don't know if it is brought out clearly in the budget document. But withholding rates have been increased rather sharply. In fact, there is now a good deal of overwithholding in the country. So the fiscal stimulus is really smaller over the coming months than raw budgetary statistics may suggest. That stimulus is being transferred, because of the overwithholding, to early 1973.

Chairman PROXMIRE. I know about that, of course. You are the first economist who has mentioned that as a significant factor in the fiscal stimulus equation. It is interesting that you mention it. I would like to know what the quantity of it is.

Mr. BURNS. The budget documents, I believe, allow for $2 billion, and the judgment of members of my staff is that the figure will be significantly larger. However, members of my staff have not been able to come up with anything like a firm estimate.

Chairman PROXMIRE. Let me quickly move into a couple of other areas. I don't want to get back into a subject you have already discussed, but I am reluctant about compulsory arbitration because I don't think it works very well. I think we have to take strikes.

One of the great points made by Prof. Sumner Slichter was that with all the pain for the strikers, the management and society, strikes are the price you have to pay in the free society and if you pay it there are some meaningful benefits. That is why I was so concerned about this longshoreman settlement.

You realize that the settlement is for a 32-percent wage increase in less than 2 years. This makes a shambles out of the wage-price guidelines. Furthermore, it exempts that settlement from the Pay Board. So that will go into effect if the Arbitration Board doesn't upset it, and I doubt very much under the circumstances that they are going to do that. So I do think this is a very tough, painful kind of action to take. Only three of us voted against it in the Senate yesterday, so I am in a small minority.

I would say that we may be moving toward compulsory arbitration, but I don't think that means we are moving toward an inflation. I agree with Mr. Blackburn in much of his feeling.

Let me ask you about housing. The Council of Economic Advisers forecast for this year assumes a further strong rise in residential construction spending, about 15 percent. Do you think it is realistic to expect the housing starts to increase further, or will they stay at their present unusually high level? They are so sensitive to monetary policy, as you know.

Mr. BURNS. Yes. I do not recall the Council's precise analysis of the housing problem. May I ask you a question before I try to comment, Senator, because I want to be sure that my comment really gets to your central thought?

Did the Council refer to an increase in expenditures on residential construction or to an increase in housing starts?

Chairman PROXMIRE. Spending.

Mr. BURNS. You see, with a constant level of housing starts, because of the upward trend that we have had in housing starts in recent months, you could very well have and you should have an increase in housing expenditures.

My own guess would be—I can't give you numbers—that housing starts would not rise this year but would remain at the very high level that we have had. In view of the upward trend in housing starts in the second half of 1971, we should have an increase in expenditures.

Chairman PROXMIRE. Let me read you a short paragraph:

The total number of private housing starts in 1972 is expected to be 2.2 million units. Within this total single-family units are expected to be much stronger than starts of multifamily units. This shift from multifamily to single-family units will strengthen total residential outlays in 1972 which are expected to exceed 1971 by 15 percent or more.

Mr. BURNS. I don't know enough to quarrel with that. Qualitatively, the Council's statement seems reasonable to me.

Chairman PROXMIRE. You are well aware of our continued concern with the terrific impact of monetary policy on housing. Of course, at a time like this, when the monetary policy is relatively easy, and interest rates have started to come down some in housing, there is less pressure there. But we are still waiting for a real report from the Federal Reserve on Housing.

You promised that report. We got an analysis of the staff, a very competent analysis, with some factual data which is useful, but no recommendation from the Federal Reserve Board as such as to how we can provide some degree of insulation for housing from the devastating effect of monetary policy when it is in restraint. When can we expect something on that?

Mr. BURNS. Very soon, Senator Proxmire, and I hope this report will make you happy. I think it is a good report, if I may say so.

Chairman PROXMIRE. When you say soon, how soon?

Mr. BURNS. Within a month.

Chairman PROXMIRE. Within a month? Very good. Thank you very much. My time is up.

Congressman Conable.

Representative CONABLE. Mr. Burns, you have quite a reputation as an economic philosopher because of your experience, your position, and the overview that you have of the economy. There is an apparent new modesty among economists. I am interested in the extent to which they seem to be thundering around in a herd right now as far as growthmanship is concerned. Last year there was considerably more disagreement about how much we were going to grow. It is quite apparent to me that economic analysis is in some transition in this country. We probably are reflecting the change in the mix of production and services. Our service side is growing very fast and that changes the old rules, to a degree.

There is quite obviously a very complex short-term movement of money across the national boundaries that complicates the rules of economics.

The mix of the labor market is very much more complicated than it used to be with considerably less homogeneity as a result of the infusion of new people from the underprivileged, from youth, from housewives, into the economy.

This committee has an economics statistics subcommittee which has been comparatively dormant lately. I am not sure that we can make a significant contribution, but I wonder. I would like to know if there is a good deal of economic work going on in the review of our economic statistical processes that can bring a greater degree of certainty to the economic prognostication than we have obviously had in the past few years, that could bring some return of confidence to the community of professional economists that serve this country.

Would you like to comment on this general condition that we seem to be in, this statistical uncertainty that I have described? It may be more apparent than real; I don't know. Would you also like to comment on the possible contribution this committee can make in trying to add to the certainty in this field?

Mr. BURNS. I appreciate your asking me the question. Let me say first that the new humility that you find among economists is most welcome. It is a very healthy sign. How long it will last I couldn't say. But when members of my profession move in a certain direction, they stay in that direction for quite a while. They change slowly. Therefore, I would expect humility to be a part of my profession for a good many years in the future, and I think as a result we will be more helpful to the Congress than we have been.

As for statistical information, our statistical services have improved. But they have not improved sufficiently. The President appointed a statistical commission and its report has been issued. I have not had an opportunity to read it but I, of course, did read the contribution that the Federal Reserve staff made to that study.

If you would like, I would be very pleased to send you the thinking of the Federal Reserve staff on the improvements that are needed in our statistical services.

Chairman PROXMIRE. How long a report is that?

Mr. BURNS. The report by the Statistical Commission?

Chairman PROXMIRE. Yes.

Mr. BURNS. How long is it in terms of pages?

Chairman PROXMIRE. Yes.

Mr. BURNS. It is voluminous.

Chairman PROXMIRE. The reason I interrupt is because if there is a summary we would like to have it printed in the record. I think it would be most helpful. I think Congressman Conable is on a most significant issue. This subcommittee should be much more aggressive than it has been. There was a time in the recent past when we were more aggressive.

Mr. BURNS. I haven't read that report, as I indicated. I would be surprised if it did not have a summary.

Chairman PROXMIRE. If so, the summary will be printed at this point in the record.

Mr. BURNS. I will be glad to supply the summary, if there is one, and also the report of my staff.

(The information to be furnished follows:)

FEDERAL STATISTICS—REPORT OF THE PRESIDENT'S COMMISSION

VOLUME 1, 1971. COMPILATION OF RECOMMENDATIONS

This *Report* reflects a broad review of the production and use of statistics in the federal government. It covers not only the activities of statistical agencies but all statistical activities of the federal government. The *Report* presents guidelines for developing a correspondingly broad view in government of the scope of statistical activities and, consequently, of the opportunities for improving government statistics. This breadth is necessary if answers are to be found to the searching questions raised by President Nixon in his letter to Chairman Wallis stating the Commission assignment.

We have found solutions for some problems and partial solutions for others. We have found no solutions for some problems. Among the latter, the most important is the widespread inability of many users of statistics to define problems so that statisticians can produce the facts that would be useful. The convulsive nature of political events rules out orderly specification of statistical requirements and ensures tardy adjustment to kaleidoscopic changes in these requirements. We call attention to the implications of this inherent problem for statistical programs.

Our major recommendations are listed below, with references to the points in the text where they are discussed.

1. *The scope of coordinating activities should be broadened.*

Two kinds of broadening are equally important. First, the traditional concentration of coordination on the collection of data from respondents should be expanded to coordination of *all* data-generating programs. These include controlled field studies, operating programs, purchases from the private sector, and scientific experimentation, as well as surveys. Second, and even more important, the traditional concentration of coordination on development and dissemination of quantitative data should be augmented by coordination of the application of statistical methods in all federal programs. (See Volume I, Chapters 4 and 5.)

To match this broadened scope of action, reliance should be placed on what we have chosen to call statistical audits, as well as on the review and approval of forms. We believe that these audits should be carried out by the Statistical Policy Division of the Office of Management and Budget, backed up by an independent advisory group under the auspices of the National Academy of Sciences and the National Research Council.

2. *More systematic efforts should be made to eliminate obsolete statistical programs.*

The filling of statistical gaps is nearly automatic and causes us relatively little concern, but the elimination of unproductive programs is important and, at the same time, one of the most difficult problems facing government. The failure of most federal agencies to prune outdated programs is well-known. Given the plethora of new demands for information, this failure lies at the heart of rapid increases in expenditures on statistical programs in the 1960's. We recommend that special attention be given to screening existing and proposed programs, and we offer a set of considerations designed to aid in this screening. (See Volume I, Chapter 5.)

3. *Public confidence in data-gathering should be increased.*

Opportunities for misunderstanding about the purposes for which data are gathered and the uses that will be made of them should be eliminated. These opportunities exist mostly in gathering and handling of program and regulatory data, rather than in the operations of general purpose statistics-producing agencies.

To strengthen legal safeguards, we recommend that the meaning of the terms "confidence" and "confidential" be standardized throughout government and that a promise to hold data in confidence be made only when there is adequate legal authority to uphold such a promise.

To guarantee public confidence in the statistical system, we recommend establishment of an independent advisory board. In addition to helping citizens with their problems, the board could carry on a program of studies to help find new ways to ensure that data are adequately protected and properly handled. (See Volume I, Chapters 6 and 7.)

4. *Means of increasing the comparability of economic statistics through greater integration in collection processes should be explored.*

The happenstances of history and the working of the budget process have led to the use of economic statistics gathered independently by separate agencies. Inconsistencies are "papered-over" when the independent statistics are brought together. This process may lead decision-makers to react to reported changes in the economy that have not occurred. (See Volume I, Chapters 2 and 5.)

AUGUST 11, 1971.

AREAS OF NEEDED IMPROVEMENT IN ECONOMIC DATA

(Prepared by Federal Reserve Staff)

The following is a statement of areas where improvements in data have been indicated by Federal Reserve policy, analytic, and reporting needs. Practically all of the listed deficiencies and needs for improvement have been noted before by producers and users of the various statistical series. In some cases, there have been fairly extensive and detailed reports on data improvement needs—e.g., the Stigler report in the price area and the report of the Subcommittee on Construction Statistics. For several of the areas listed, programs for improvement are already under discussion or underway either within the producing agency or at an interagency level.

Some previous Federal Reserve statements on needed improvements in data have tended to concentrate on a few areas of high-priority, relatively feasible improvements in statistical compilations produced by other agencies. The present list is more comprehensive in scope than these earlier statements including needed improvements in the banking area and covering more than highest priority needs. Nevertheless, it is far from exhaustive; in several areas, there is implied a considerable amount of detail that has not been spelled out.

The deficiencies noted or implied are of various kinds and relate to a great variety of problems—basic availability of information; sampling; seasonal adjustment; timing of availability; frequency of collection and reporting; format of availability; quality of reporting; quality of processing; relevance and consistency of definition; relevance and consistency of coverage; organization of the responsibility for the data preparation, etc. In general, the present list has been confined to statements of need, with little focus on the feasibility of improvement or on how or at what cost or by whom the improvements might be brought about.

NONOFFICIAL DATA

Employment, unemployment and labor force

1. As an important aid to current economic analysis, work should be carried forward on reasons for the differences in trend and cyclical response between the series of nonfarm employment derived from payroll data and the series derived from the household sample. More explicit measurements should be developed of the number and characteristics of dual job holders as well as of other noncomparable categories in each series. Further efforts are also necessary to clarify reasons for differences in movements between insured unemployment and total unemployment. Efforts might be made, for example, to identify the unemployment compensation status of all persons classified as unemployed in the household sample survey.

2. Considerable additional survey work is needed on labor force participation, relating particularly to cyclical variations in participation rates. Greater efforts should be made to measure the numbers and determine the personal characteristics of the individuals who "drop out" when jobs are scarce, or who postpone their entry for shorter or longer periods as an indication of the adequacy of the current definitions of labor force employment and unemployment in reflecting the full impact of changes in labor demand.

3. Seasonal adjustment of labor force data remains a serious problem, particularly acute when traditional relative seasonal factors are used for series such as unemployment, whose base changes by large magnitudes. Tests should be made with alternative seasonal adjustment techniques, including the use of additive seasonals as well as procedures which take into consideration changes in the labor force reflecting demographic and other significant exogenous factors. Substantial improvements also are necessary in the seasonal adjustment of initial claims and the insured unemployment total. One of the few economic series available weekly, the current seasonally adjusted series on claims, is too erratic for dependable use as an analytic tool.

4. Additional efforts should be directed toward the development of comprehensive series on employment and hours of work for production workers and all

employees, for each major industry sector of the economy, comparable with and additive to a total for the non-farm economy. The problem of data inadequacy is particularly severe in the service sector. In addition, the classifications in services need improvement: current groups lump together vastly different types of services, from highly complex, sophisticated activities to services of the most simple, unskilled types.

5. Further support should be given to the development and improvement of a regular series on job vacancies, by area and occupation, which can be aggregated to national totals.

Wages, productivity and labor costs

1. A regular quarterly series is needed on earnings, productivity and labor costs for broad industrial sectors of the economy comparable with the private nonfarm total. Ideally, these data should be consistent with GNP and national wage and salary and supplements statistics. Such data would permit a more accurate analysis of the interrelationships among output, labor input, and wages and other labor costs. This will require the development of a comprehensive set of series on employment, hours of work and hourly and weekly earnings for major industry sectors and for the nonfarm total, for production workers and for salaried workers, comparable with the national income wage and salary data.

2. Analysis of the effectiveness of policies designed to counter inflationary pressures requires a considerably improved body of data on wage rate changes and earnings on a regular basis. Among the most useful would be data for union and nonunion establishments outside of manufacturing; data by occupation and skill and by size of firm, and data by geographic region. More detail on straight time hourly earnings for three digit industries is needed for the analysis of the cost of contract settlements in key industries such as autos, steel, coal, etc. Data on major contract settlements currently available quarterly provide few industrial breaks—manufacturing, non-manufacturing and construction. Efforts should be made to provide estimates of the cost of settlements in each major industrial sector.

Industrial production

As part of our continuing improvement of the index of industrial production, the Federal Reserve Board has completed a revision that not only embodies the most recent *Censuses and Annual Surveys of Manufactures*, but also has improved market classifications, and reduced reliance on manhours data which have been supplemented with data from a Federal Reserve System monthly survey of kilowatts consumed by individual industries.

Further improvements in the compilation of the production index would be facilitated as follows:

1. Investment in equipment is a major area where improvement in both compilation and comparison with other data sources is needed. In order to strengthen the monthly production index and to make a weekly index of production possible, weekly data are needed for manhours or payrolls in the nonelectric machinery and aircraft industries. Weekly data might help to reduce conflicts in opinion over the current state of investment in equipment.

2. Further classification of equipment developments would ensue if there were a firmer basis for comparing establishment data such as those in the index of production with company data for orders, shipments, inventories, and exports as well as with company surveys of intentions, etc.

3. Greater resources should be devoted to the *Annual Survey of Manufactures* and *Manufacturers' Shipments, Inventories and Orders* to speed up both current reports and benchmark adjustment and to improve coverage and classification. The monthly series for both new and unfilled orders have never been adjusted to comprehensive levels. This might be accomplished in part by the use of the *Annual Survey of Manufactures.*

4. If the advance tabulations provided to us by the Census Bureau could be speeded up four or five data, the release date of the industrial production index could be moved up from the 15th to around the 10th. For example, we receive January's data between March 8 and 10. Because our estimate for February is not made until we receive the Census tabulation for January, earlier reporting by Census would allow us to publish sooner.

5. Major improvements should be sought in market classification standards for Federal Statistics with much wider use of market groupings for inventories, shipments, prices, etc. This would facilitate comparisons with the new constant

dollar gross value of industrial production series which are designed for comparison with flows such as foreign trade and consumer spending.

6. Comparisons among statistics originating in different agencies would be facilitated by a uniform classification of electricity and gas series. They are represented in U.S. and foreign industrial production indexes. The consumer portions are classified as goods in the international statistics on national accounts. The Office of Business Economics classifies them as services in the U.S. accounts. The Bureau of Labor Statistics classifies them as services in the consumer price index but they are included as goods in the wholesale price index.

Industrial capacity

In addition to the industrial production index, the Federal Reserve Board publishes a capacity utilization index for manufacturing and for two subdivisions of manufacturing. This index, which relies heavily on the McGraw-Hill capacity survey, has some potentially serious defects. This survey is on a company, rather than an establishment or business line basis, rendering unclear the meaning of the results in the cases of large companies engaged in numerous business lines. The Annual Survey of Manufactures should be used to collect more reliable figures on capacity utilization to supplement the McGraw-Hill results. The Federal Reserve Board is currently undertaking a revision of the capacity utilization index with the following goals:

1. Reduction of the index's dependence on the McGraw-Hill survey.
2. Incorporation of capacity information published by certain industry groups and also fuller use of the results of the OBE Capital Stock Study than is made in the present index; and
3. Making the index more of a true measure of industrial capacity by extending its coverage beyond manufacturing.

Prices

The Bureau of Labor Statistics is currently engaged in pursuing improvements in at least some of the areas of deficiency. We fully support these efforts.

1. There are important gaps in coverage of available price data. Thus, we do not have (wholesale) prices currently reported for a substantial proportion of the product classes of manufactured goods, with a very serious underreporting in the machinery and equipment area. Prices for communication and transportation need considerable work as do prices paid by Governmental units. Filling these gaps is essential both for improvement of the various price indexes for the GNP (deflator and fixed weight), and for the measurement of real GNP, as well as for construction of a new comprehensive and multipurpose price index system as proposed by the BLS. Better price data would enormously improve the usefulness of the input-output structure for analyzing the dynamics of price change over time. Available data on prices of exports are highly deficient, and are noted separately under "Merchandise Trade."

2. Apart from increased coverage, it is essential to improve the quality of data in key areas, both because of the intrinsic importance of these areas and in order to improve the key overall price measures. Improved data are badly needed for producers' equipment and capital goods; military goods; and construction costs. In some of these areas, the problem of specification change associated with changes in the nature and quality of the product poses difficult problems, both of conceptual treatment and of adequate data for adjustment, e.g., in the machinery field. We urge allocation of substantial resources to these problems.

3. One important aspect of the quality of data for a number of important commodities relates to the difference between actual transactions prices and list prices as now included in the wholesale price index. These differences can make for significant distortion in interpretation of price movements in key periods. Some experimental work has been done in this area, but much remains to be done We realize that collection of actual transactions prices can be a very expensive enterprise, but experimental work should be intensified in key industries where substantial discounting is known to occur.

4. A long-discussed need is for special consumer price indexes for groups other than wage earner and clerical workers to whom the present CPI is geared. Especially important here are consumer price indexes for low-income groups and/or the aged. Such indexes would require price weights appropriate to the group; specifications for the goods they purchase; and quite possibly some changes in the present store or seller sample.

5. Another highly desirable innovation, on which BLS has already expended some effort, is the development of a "true" cost-of-living index, i.e., an index that "measures the changing cost of a constant level of satisfactions." Such an index would, of course, be an approximation that, among other features, would take into account substitution of one commodity for another as relative prices change. In addition, the cost of the services of houses and other assets would be measured instead of the initial price of long-lasting goods. These are only some aspects of such an index, but we strongly believe that an intensive experimental effort is well warranted. Present discussion and effort at BLS seems to center on such an index for foods. We support this endeavor fully.

National income and product accounts

The quality of these accounts is heavily dependent on the nature and quality of the data upon which they are based. We make numerous suggestions in this document for improvement of the underlying data—including Federal fiscal statistics, State and local expenditures and corporate profits—although we rarely refer to them as being important components of the income and product accounts. We add here only a few suggestions:

1. Effort should be intensified to obtain estimates of productivity change for government product.

2. Efforts should also be intensified to improve output measures for other sectors which, among other advantages, would provide a basis for improved industry productivity estimates.

3. The whole area of consumer expenditures for services is deficient in terms of current reporting. While better employment estimates in the service category, as proposed elsewhere in this document, would help, we feel that in some categories these should be supplemented by other types of specific data including more detail than is now available.

4. On the income side, the data on nonfarm proprietors should be greatly strengthened.

Federal fiscal statistics

1. For the purpose of economic analysis, Federal data as classified in the National Income Accounts are by far the most useful. In their present form, however, these data cannot be derived directly from the basic source-data in the Treasury Monthly Statement, and only the technicians in the Office of Business Economics can interpret the source-data because of the many adjustments and reclassifications that are required. Hence, it is urgent that the Treasury Monthly Statement be reorganized with the aim of introducing National Income Accounts classifications. This reorganization, however, should not preclude continuation of reporting on a cash basis, which is essential for such important policy purposes as estimating Treasury cash balances and borrowing. An alternative approach would be for the OBE to make a greater effort to use the Monthly Treasury Statement data more directly in the derivation of their Federal account.

2. There is also a scarcity of data on Federal financial activity, especially since the National Income Accounts do not attempt a full sources and uses statement; that is, they do not explain the financing of surplus and deficit. Accrued assets and liabilities must be so accounted for as to maintain a clear relationship to cash transactions.

3. Of considerable help in the formulation of policy would be a Quarterly Budget Report which would update estimates of important spending categories and also of receipts.

State and local expenditures

With the exception of the construction expenditure series gathered by the Construction Division, Bureau of the Census (for which an important shortcoming is noted elsewhere), there are no regularly collected quarterly data on State and local expenditures. The need for such data is urgent, perhaps through a quarterly survey of a representative sample of governments. The reports should separate current and capital spending and include a further breakdown by functional categories. Without current data, it is difficult to assess the impact that the greatly increased use of the capital markets is having on current as well as on capital outlays of these governments, and the impact of monetary policy in this key area cannot be measured adequately. (Note: State and local revenue data are available on a quarterly basis, but spending data are currently gathered and reported only on a yearly basis with a six month lag.)

Retail sales

1. Large revisions in the successive estimates of retail sales for a given month are a major problem. Census continues to make available, but has officially disavowed on grounds of statistical inadequacy, the so-called "advance" estimate of retail sales, released on the 10th of the month following that to which it pertains. A most urgent need to which a very high priority should be assigned is the development of a high quality index of retail sales available at about the same time as the present unofficial "advance" index.

2. It would also be extremely useful to have more detailed information on retail sales by commodity type than can be adequately obtained from the present classification of retail sales by major store types. This detail need not be available on a monthly basis. Particularly important would be some commodity breakdowns of the heterogeneous general merchandise category. We consider the absence of this sort of information a serious shortcoming in our present array of statistics and one which is necessary, among other purposes, for the improvement of such a widely used measure as the GNP classification of consumer expenditures.

Income distribution

It is our understanding that later this year OBE will resume publication of the size distribution of income for families and individuals before and after Federal income taxes. We hope that this information will be available for all post-World War II years and that it will be maintained on an annual basis. It would also be highly useful if the series also included separate estimates of State income taxes and possibly of sales and property taxes.

Residential construction

1. Direct measurement of progress on construction projects is needed separately for single-family and for multi-family units. If monthly surveys prove not to be feasible, an alternative program would involve the development of badly needed new and improved progress patterns as a basis for estimating residential construction outlays from starts.

2. An official comprehensive series on subsidized starts, separate from nonsubsidized starts by type of structure and by region, is now essential for productive analysis of the movement of total starts. Our own compilation, while extremely useful, involves a number of ad hoc adjustments to data secured from HUD, the Farmers' Home Administration and the Census Bureau. Further improvements in underlying series and reconciliation of conceptual problems by the agencies directly concerned are still pending and are required.

3. The available series on additions and alterations—an important component of residential construction outlays—is subject to considerable revisions with a long lag. A monthly series or a letast earlier availability of the underlying quarterly series would help.

4. Sales of used homes are a key variable in new home demand, yet no comprehensive series comparable to that for new home sales is available. The series from the National Association of Real Estate Boards is publishable only in terms of per cent change from a year earlier. We should now distinguish between the subsidized and the nonsubsidized sector, at least quarterly; so should the new home sales series.

5. With respect to mobile homes, a major component of available low-priced shelter in recent years, we need a monthly series on dealer inventories. Currently only shipments to dealers are reported by the Mobile Home Manufacturers Association. A dealer inventory series would, among other things, yield data on actual sales to final users as a residual. Price indexes for mobile homes, separately for both wholesale and retail, are essential for use in BLS price indexes and elsewhere. Finally, it would be most helpful to have estimates of expenditures for mobile homes broken out separately in the GNP accounts.

6. Annual censuses covering both the components of change and the significant characteristics of the stock and use of available housing, nationally and also by region and for important SMSA's, are currently under renegotiation, though funds may limit the sample. The data are needed to benchmark other monthly series. Data on the components of change in the stock are particularly crucial because demolitions and other removals from the housing stock are an important variable in projecting housing demand, apart from demographic and financial factors.

7. Decennial periods are much too long for most purposes, even with provision for annual sample "censuses," and quinquennial censuses of housing and population would help keep our knowledge up-to-date.

8. The problem of adequate price deflators or cost indexes (monthly and quarterly) is an old one whose importance has, if anything, increased in recent years. With few exceptions, available indexes are based on labor and materials cost only, with no allowance for a profit component and utilizing weights long since outdated.

Nonresidential construction

1. Comprehensive quinquennial censuses are essential to provide inventory and use benchmark data for private (and public) nonresidential structures and also to provide data comparable with those for residential properties. Even though private (and public) structures account for an important part of new capital formation, loan collateral, rental income and property taxes, no coverage along these lines has been attempted.

2. Data on vacancy rates or capacity utilization rates for offices, stores and other nonresidential income properties (quarterly) are either fragmentary or nonexistent.

3. Also most helpful would be separate detail showing breakdown of outlays for commercial structures between offices and stores, respectively (monthly). This would require augmentation of the monthly sample to permit showing the commercial sub-groups separately.

4. Continued efforts are needed to improve the preliminary monthly census construction outlay figures both for the total and the component detail. All too often revisions between preliminary and final figures tend to be significant and with a considerable reporting lag. This is a problem of which the Census Bureau if acutely aware; it is especially disconcerting in the case of the series on State and local construction outlays, the major component by far in the public sector.

Inventories

1. The long lag between the availability of book value data and the month to which they pertain should be shortened, in view of the key nature of these data for overall economic analysis.

2. Both current inventory analysis and model-building are handicapped by the fact that OBE publishes no GNP inventory detail below the level of farm, durable nonfarm, and nondurable nonfarm, and by the poor comparability of the categories in the census manufacturing inventory series with OBE's GNP final demand classifications. We therefore propose (in a detailed memorandum not included in this summary) substantial changes in both the Census market classification for orders, shipments, and book value of inventories and in the OBE classification for GNP inventories. We believe that calculation of the constant-dollar value of inventories and of inventory change on a GNP basis along the lines of our proposed classification would provide a better basis than we now have for determining the effects on inventories of changes in sales and orders for various types of spending and also for better evaluation of the inventory effects of actual and prospective strikes in key industries.

Farm expenditures for production and family living

A new benchmark survey of farm production and living expenditures is very much needed to improve the various farm cost and input estimate that are fundamental components of the farm income accounts, GNP series, and input-output statistics. The last benchmark survey was made in 1955, and the composition of farm expenditures found at that time is now obsolete. Either a comprehensive survey should be scheduled at ten-year intervals, or smaller sample surveys should be conducted more frequently in order to keep these series reasonably up-to-date.

FINANCIAL STATISTICS

Monetary and Banking Statistics

Monetary aggregates

Accurate and timely measures of various concepts of the money stock are essential to effective conduct of Federal Reserve operations. Considerable effort has recently been devoted to improvement in the statistical and definitional bases of these measures. This is a continuing program as there are still some gaps and deficiencies in the component statistics from which the major monetary aggregates are built up and, also, detailed information in addition to what is now available is needed to permit more flexibility and greater depth in analysis of monetary conditions.

Further improvement is needed in the statistical basis of the adjustments required to derive conceptually appropriate measures from the compilations reported by banks. This includes provisions of information not now available on the composition of cash items in process of collection and Federal Reserve float, and definitional and reporting improvement for the various interbank items.

There are serious deficiencies in the nonmember bank components of the monetary aggregates. Frequent sample reporting of nonmember bank demand and time deposits, on a daily average basis, would contribute significant improvement to the current measures.

In addition, some further detail is needed on the distribution of demand deposits, currency, and the major types of time deposits by principal holder groups, with selected detail within these groups both foreign and domestic, financial and nonfinancial. Information is also lacking on deposit turnover by major ownership groups. In order to be able to relate banking statistics on the money stock to the money balances reported by holders, the estimates of money-stock ownership measured from holder records should be improved through separate reporting of the various components usually contained in "cash" accounts, which may cover, in addition to currency and domestic demand deposit, CD's and other time deposits and a variety of domestic and foreign short-term loans, securities, and other instruments.

Improvement in the member bank credit proxy and provision of an all-bank credit proxy require additional current reporting from a sample of non-weekly reporting banks on borrowings, other liabilities, capital, and cash assets. In general, improved information is needed on the sources of bank "borrowings."

Bank credit

There are several gaps in the information currently available on bank credit. For example, more current detailed information on a breakdown of loans and investments is needed at a sample of non-weekly reporting banks. More information on extensions and repayments of business loans would permit closer analysis of changes in bank loans. Separate identification of construction loans on a regular basis is not available. Some further detail on loans and investments at weekly reporting banks would facilitate analysis. Benchmark surveys of business and agricultural loans are overdue. Definitional and reporting improvements are needed for interbank loans and Federal Funds transactions. Some experimentation is needed on developing daily average measures for bank credit and its major components. Usefulness of the loan commitment data would be enhanced by improved information on the nature, terms, and take-downs of the reported commitments.

Terms on deposits and loans

Improved analysis of the impact of monetary policy requires more information than is now available on interest rates and other terms and conditions for bank deposits and loans, viewed in relation to various characteristics of the deposit and credit instruments and of the bank customers. Among the other terms and conditions on which such information is needed are compensating balances, service charges, customer services and relations, correspondent relations, etc.

Bank affiliate relations

With the recent institutional changes in bank financing patterns involving the relations between banks, subsidiaries, holding companies and other affiliates, and foreign branches, there has developed a need for additional information both from banks and from affiliated institutions on loans, deposits and other sources of funds reflecting the changing patterns and relations. This should include regular reporting of holding company and affiliate full balance sheets, identifying claim relationship with the banks. The changing patterns also require changes in the definition and scope of many existing series and the identification of the bank holding company component of these series.

Bank trust departments

For purposes of analysis of trust departments' role in financial markets, improvement is needed in some of the asset definitions and categories and in the reported valuation used in the present bank trust department reports. Identification of broad classes of their pension funds (e.g., for State and local retirement systems) would be helpful.

Banking market and structure information needs

In carrying out its responsibilities in the areas of bank mergers and bank holding companies, the Board has need for a considerable amount of information, much of which is not now available, focused on specific market areas. The needed information relates both to banking and, particularly in light of the 1970 amendments to the Bank Holding Company Act, to a number of nonbanking industries. Data are needed both to establish the boundaries of the relevant markets, and, within delineated markets, to indicate market shares and activity by the various participants in those specific markets.

For market delineation, development of data on commuting patterns for towns of less than 20,000 inhabitants should be completed. For market share analysis, annual information is needed by office—for commercial banks, mutual savings banks, savings and loan associations—(a) on amount and number of deposits by size class and by type of deposit, and (b) on loans by a variety of loan types and a variety of size classes, with accompanying information (c) on interest rates and other terms and (d) on customer characteristics for the indicated deposit and loan data cells. Similarly, for companies in industries that the Board has determined to be closely related to banking, certain data are needed by establishment, e.g., appropriate measures of business volume in the "related" products or services, as well as selected income and expense items for these firms' entire range of operations.

OTHER FINANCIAL STATISTICS

Nonbank financial institutions

Improved information is needed for savings banks (and commercial banks, also) on deposit flow experience over reinvestment periods. Maturity and size distribution of the accounts of the depositary institutions is needed for analysis of the sensitivity of these institutions to changes in financial conditions. The present reports on rates offered on accounts should be made available more promptly.

More information is needed on the structure of total cash flows for mutual savings banks and on projected cash flows for the mutuals and the savings and loan associations. Information on new and outstanding commitments and on scheduled takedowns of commitments for major types of investments, now available for life insurance companies, are also needed for other financial institutions.

There is very little information now available on the quality of existing portfolio of these institutions.

Information now available to the SEC on brokers and dealers who are members of the NASD should be made available to other agencies.

The reporting system on private noninsured pension funds has many deficiencies and improvements are needed in the quality and type of the information provided.

Mortgage market

The recommendations with respect to housing and construction finance made by the Subcommittee on Construction Statistics of the Cabinet Committee on Construction in its 1970 report on "Statistics on Construction: A Program for Improvement" are concurred in here but are not repeated. The following paragraphs list some mortgage data needs not covered in that report.

New or improved annual benchmarks are needed for new and outstanding mortgage commitments, by type of property and by type of loan, and for construction loans and permanent mortage loans, made or held by all major types of mortgage investors, including "individuals and others." Also needed is reporting of mortgages held by location of property, by State, and inside-outside SMSA.

Quinquennial Census-type surveys of financing practices, by major type of property—residential and nonresidential, are needed to document sources, uses, borrowers, and methods of financing, and to highlight the important changes taking place.

Improved and expanded coverage of the current HUD monthly sample series on mortgage commitments and gross flows is needed to provide data for mortgage investment trusts, GNMA-guaranteed mortgage-backed securities, State and local government credit programs, and mortgage companies and to improve consistency with available benchmarks. These changes would permit more comprehensive and accurate coverage of mortgage developments that are particularly sensitive to major shifts in general financial conditions.

A monthly series is needed on mortgage investment trusts, providing balance sheet and sources and uses of funds information, in order to improve analysis of the impact of changing financial market developments on this growing type of mortgage financing and of its impact on the securities and mortgage markets.

In order to provide the basis for analyzing what local barriers, if any, exist to the ready flow of mortgage credit at market costs, a monthly compilation is needed of usury ceilings applicable to mortgage investment in each State, indicating which types of lenders, borrowers, and types and sizes of loans are covered.

A monthly series is needed on rate and non-rate terms on construction loans, for selected types of private real estate, to help in analyzing real estate development costs and the relative attractiveness of this type of credit.

Monthly series are needed on the amounts, terms, and collateral of the borrowing of mortgage lenders—mortgage companies, savings banks, and life insurance companies—from commercial banks in order to help analyze the impact of general credit conditions on mortgage warehousing and on the process of originating, holding, and placing mortgages.

With the development of different kinds of channeling of funds into the mortgage market (e.g., the various GNMA guarantee programs), it has become necessary to improve the current statistics on mortgage holdings through standardization of reporting with respect to funds flowing through these new channels.

Business finance

The area of business finance is, in general, one of serious statistical deficiencies. Interagency programs are underway attempting to deal with several of the problems but there will still be considerable room for improvement. In the corporate area, there is a need to improve coordination and consistency among the various reports and sources of data as well as to improve the coverage and quality of particular series. In the area of small business and unincorporated business, there are little recent data available on financial position, needs, and practices.

For corporate profits, better information is needed on the relationship between series based on stockholder reports and those based on tax returns. There is little information on current profits outside of manufacturing and large public utilities.

For corporate balance sheet structure, there is no current information for some major industries; the long-range intent to expand the Quarterly Financial Report to groups other than manufacturing should be implemented as rapidly as possible. There are also needed statements of sources and uses of funds for several industries on a consistent basis.

The growth of conglomerate corporate structure has blurred the meaning of industry finances and there is a need to develop methods for cross-classifying industrial activities with financings by consolidated corporations. The line-of-business survey proposed by FTC is one step toward this, but additional developments in data and in statistical presentation may be required.

Present data on corporate liquidity are incomplete in coverage of liquidity instruments; proposals are being developed that could improve the coverage. Improvement is also needed in the quality of the data.

More frequent information is needed on the structure of bank loans to business. The most recent benchmarks by size and industry of borrower, size of banks, and loan characteristics date back to 1955 and 1957.

The presently available series on number and liabilities of business failures is grossly deficient in coverage, definitions, and statistical procedures. The present indicators of quality of business credit are too aggregative for analytic use; micro-data are needed on individual loan transactions and borrower financial position.

Corporate securities

The series on corporate gross security issues are in serious need of an extensive program of improvement with respect to consistency of definition, timing of availability, reliability of estimate, method of collection and compilation, coverage of private placements and of non-underwritten securities. The corresponding net change series suffer from all these deficiencies and in addition from problems of definition and coverage with respect to inadequate measures of exchanges, conversions, repurchases, and retirements, especially where mergers are involved. For example, there is inadequate reporting of issues of stock due to shareholder exercise of warrants; the industrial breakdown is faulty, particularly with respect to retirements.

Improvements are also needed on the estimates of net purchases by holder group, particularly by foreign holders and by bank trust departments. More emphasis should be put on direct reporting of purchases and sales rather than estimating through changes in reported book values, particularly in periods of high and changing interest rates.

With respect to estimates of corporate bonds outstanding, a new survey is needed of amounts outstanding, their forms, their term to maturity, and their coupon rates.

For stock market transactions, there is a need for volume data for over-the-counter transactions and some back data on OTC stock price indices.

State and local government securities

Some improvement is needed in the timing definition and in the coverage of short-term municipal issues; in particular, many forms of short-term municipal debt such as notes privately placed or negotiated directly with banks are not now covered. A new or greatly improved yield series for new muncipal issues is needed. Data on outstanding municipal debt is inadequate with respect to the timing basis used and the lag in availability. The data on purchases and holdings of these securities are in need of considerable improvement, e.g., for nonlife insurance companies. In the case of commercial bank purchases, more current data is needed on a breakdown between purchases for own account and purchases for trading account.

Federal Government and agency securities

A needed improvement in the sampling procedures of the Treasury monthly survey of ownership of government securities is now under consideration. Some addditional data may be needed on the sources and maturity of dealer financing arrangements in the Treasury market.

With the growing number and types of issues of Government agencies and Government-sponsored agencies, it is important that information on the holdings of all such issues be included in the monthly survey. There is also need for further information, with respect to agency issues, on trading volume, prices, yields, and dealer activity.

Commercial paper market

Commercial paper has become increasingly important as an instrument for business borrowing, for saving and liquidity, for money market adjustments, etc. The information available in this area has not yet caught up with the changed role of the instrument. Improvement is needed in the quality of the series and in the availability of information on the types of paper, types and industries of issuers, types of holders, rates, related lines of credit, dealer activity, and financing relationship to banks and bank affiliates, etc.

Similar improvements are needed in data on bankers' acceptances.

Consumer credit

In order to improve the quality and coverage of the consumer credit statistics, figures on consumer debt holdings (and gross extensions and repayments) for practically all creditor groups and types of consumer credit must be improved in varying degree in coverage, quality of reporting, timing, detail by type, frequency, sample design, and/or benchmarking. The most serious deficiencies occur with respect to credit held in retail trade, savings and loan associations, mutual savings banks, and credit unions. In addition, data on consumer credit extended to farmers are lacking. Information on interest rates and other loan terms, lending standards, and the quality of consumer credit are also deficient for most creditor groups.

The series on amounts outstanding and on gross flows are unfavorably affected by the uncertain and inconsistent manner in which finance and insurance charges enter the figures as reported. Similarly, the usefulness of the gross flow figures is affected by the lack of identification of the amounts of refinancing and prepayments in the series.

Better information is also needed on the amount of installment credit used for non-consumer purposes on gross flows of non-installment consumer credit, and on the use of leasing (which to some extent is a substitute for installment purchase).

With the growing use and importance of credit cards as both a credit instrument and a payments instrument, fuller information is needed on a variety of aspects of their use—types of purchases, credit limits, profitability and losses, incidence of fraud, etc.

Agricultural finance

In order to complete the "uses of funds" statement for the agricultural sector and to analyze farm capital, savings, and credit flows, there is needed a new annual series on withdrawals of funds from the agricultural sector through migration, retirements, and sales of farm property by nonfarm heirs. This gap in the available statistics represents a major portion (perhaps 40 percent) of the total uses of funds of the sector.

Analysis of the changing pattern of the sources of agricultural credit when financial institutions are affected by changes in credit market conditions requires improvements in the estimates of outstanding farm debt held by individuals and nonfinancial institutions; these could be provided through more extensive annual collecton of data on real estate credit provided by sellers of farms, including sales financed by unrecorded land contracts, and on non-real estate credit provided by national farm supply corporations and other dealers.

Similarly, more frequent reporting of gross flows and terms of farm loans made by banks and of the characteristics and qualifications of the borrowers are needed for studies both of the impact of changes in monetary conditions on the supply of bank credit to agriculture and of the impact of agricultural conditions on the demand for agricultural credit from bands.

Flow-of-funds accounts, saving, and sector balance sheets

The flow of funds accounts are an attempt to dray up comprehensive and consistent descriptions of the balance sheets and capital transactions of all major groups in the economy and at the same time to summarise for each major credit market the debt-asset positions, sources of funds supplied, and borrowing that withdrew funds from the market. The accounts are built up from a wide range of the available financial and nonfinancial series. Given the interrelations being measured in the accounts, errors, inconsistencies, and gaps in the data tend to be highlighted, sometimes dramatically, in the accounts, which can thus serve as an effective way of focusing on the needs for improvement in many series. Conversely, a very large proportion of the improvements listed above as needed for specific series would also take care of statistical problems in the accounts. In general, there is thus no need to list the specific data improvement needs of the flow of funds accounts; they have in the main been listed already. There are, however, one or two areas of data deficiency affecting the flow of funds estimates that have not been cited under the previous headings and some of these will be mentioned here.

State and local governments are in total a rapidly growing part of the economy and carry sizeable holdings of financial assets in various forms apart from employee retirement funds. Information is needed directly from the major units on a more current, frequent, and specific basis than the annual Census survey.

Land, existing real estate, and mineral rights.—Available evidence suggests that transactions in land, existing real estate, and mineral rights impinge significantly on credit markets for their financing. Apparently trading on the order of many billion dollars annually is going on and circulating in credit markets. No reporting system at present generates information on the size or nature of these transactions or on the participants. Some kind of program to produce even rough estimates would be highly desirable. The information would also assist in the improvement of sector balance sheets.

Sector balance sheets.—Work is underway on constructing full sector balance sheets utilizing a variety of sources. The nonfinancial assets are derived mainly from work done in the Office of Business Economics. Anything that contributes to that work will improve the statistical base of the sector balance sheets. The financial components require many of the improvements indicated throughout this report. One additional source of data on balance sheet for the household sector that should be extensively developed for this purpose is the estate tax returns.

Saving.—No explicit suggestions have been made for improvements in saving statistics. While it is important that estimates of saving be improved, such estimates are derived either as the difference between the relevant income and expenditures or as the difference between the relevant increase in assets and increase in liabilities. Improvements in saving figures would be covered in improvements listed for the specific series going into the saving estimates.

INTERNATIONAL TRADE AND FINANCE

Merchandise trade

1. *Price data for exports and imports.*—The BLS has been making some progress in deriving better information on the transactions prices of selected commodities, but a great deal of work remains to be done. This information is essential for much of our work in attempting to identify the factors underlying the U.S. competitive situation in world markets. Unit value indexes have severe drawbacks for this purpose, nor are other existing price indexes appropriate for this purpose.

2. *Export orders.*—This monthly series now prepared by the Industry Division of the Census Bureau is potentially a significant indicator of trends in exports, but as now compiled there are indications that it is inconsistent with other data. We understand that resources have not been available to carry out the necessary investigation of discrepancies and effect the necessary corrections.

3. *Import data.*—From time to time suggestions are made that import data should be collected on a CIF basis, rather than the present FOB basis. In our view, the present FOB data are indispensable for many purposes, and should not be replaced. However, CIF data would be useful for many purposes. We would support the collection of such data, *in addition to* the FOB data, provided the use of resources for this purpose does not conflict with other high priority data needs.

Direct investments

The Office of Business Economics has been producing an increasing body of data on the multinational operations of U.S. corporations, but there are still data gaps, as well as need for quicker collection, tabulation and publication. We consider this a very high priority need now, and one which will become increasingly urgent. We would vigorously support the program of the OBE for broadening and speeding the data now being collected on these investments.

Banking data

Data on international assets and liabilities of U.S. banks are compiled by the Treasury Department. It would be helpful in analyzing these data to have more detail on the types of assets and liabilities reported—especially in view of the newly-instituted measures of overall balance which depend on greater identification of liquid types of assets. In addition, more effort is required to speed up the collection of advance data on a weekly basis.

Foreign assets of nonbanks

The increasing size and variability of the "errors and omissions" residual item in the balance of payments accounts indicates that there are large capital flows not being captured by the present reporting system. There is reason to believe that at least part of these flows originate with nonfinancial businesses. Although the Treasury and the Federal Reserve Banks have continued their efforts to improve the coverage of the reporting system, a considerably greater effort seems to be needed.

Mr. BURNS. I think there is a very strong need for improvement in our statistical services. I have quarreled over many years with the National Income Unit of the Department of Commerce. This Unit has acquired all kinds of skills in making interpolations and extrapolations, in conjuring figures out of the air when hard data are not available. To a surprisingly large degree, our estimates of the gross national product and its components and the related income accounts are not based on hard data. I think we need to make a very substantial investment in hard data, so that there would be no need to practice this priestly art of interpolating, extrapolating, and conjecturing.

Representative CONABLE. Do the Fed's estimates agree with the roughly $100 billion growth in GNP for the coming year?

Mr. BURNS. Yes.

But take the estimates of the gross national product and related figures. They keep being revised, and revised very significantly. If

I recall correctly, we suddenly discovered that the annual rate of the gross national product in the third quarter of 1971 was lower by some $7.5 billion than we thought it was. I have no quarrel with our statisticians when they revise figures. They should, whenever they have better data. But they also ought to organize themselves for the purpose of providing data so that revisions of such magnitude would become unnecessary in the future. I very much hope that your committee will do what it can to improve, or to contribute to the improvement of, our statistical services.

Representative CONABLE. I note in your statement the expectation that the hope expressed that inventory accumulation will begin and that that will provide a fillip for the economy, and yet it occurs to me that we have had a rapid development in the computerization of inventories in this country, and the old historic relationship of inventory to sales is probably no longer justified in the light of the improved inventory management that is possible with computers.

I am wondering if, for instance, in this field we are not perhaps putting too much hope that inventory accumulation is inevitable when we are looking at only the historic pattern and not at the changes in techniques of inventory management? We have been talking about inventories being low in this country for 2 years now, and yet businessmen continue to keep their inventories low. Do you have any comment on that, sir?

Mr. BURNS. Just two brief comments. First, the improvement in our inventory controls through better management, through the computer, has been a continuous process for the past 15 years or more. I think this is a factor that careful economic statisticians do try to allow for but they don't know quite how to do it adequately. It is a very hard thing to do.

As for inventory policy, the opinion that I gather from my conversations with businessmen across the country is that they have been conservative in their inventory policy, just as they have been conservative in their capital expenditure policy. Of course, they have been conservative in large part because their profits have sunk to a dangerously low level.

They have economized in this direction just as they have economized in almost every direction. This is the very first recession that we have had when overhead labor has lost its privileged status. In earlier recessions those who were engaged in scientific work, accounting, supervisory responsibilities, kept their jobs. But now the so-called nonproduction workers have been let go in very large numbers. Top executives have been let go, sometimes because they were inefficient and sometimes because the firm was just forced to get along with fewer top executives.

So I do think that conservative inventory policies have been practiced, but with a resurgence of the economy, businessmen will have to do a significant amount of adding to their stocks simply to be able to take care of their customers.

Chairman PROXMIRE. Congressman Patman.

Representative PATMAN. Mr. Burns, I wanted to ask you about the Interest and Dividends Committee that you are chairman of. That is the one that is the equivalent of or comparable to the price and wage control, I believe.

Of course, we were disappointed because you did not put interest rates under control. Our committee in the House passed an amendment to the effect that would require it. In the conference it was stated that the President had a right not to impose interest rate controls if after filing a statement fully disclosing why, in his judgment it was unnecessary. What I base this upon is the fact that the people of the Nation are paying at the rate of about $150 billion a year interest.

At least $15 billion of that has been estimated to be usurious and exorbitant because it goes to interest rates ranging up to 36 percent. A person lending money at 36 percent in 2 years 8 months gets back the equivalent of his entire capital lent.

That is pretty high for an interest rate, 2 years 8 months pay-out. In the oil business of drilling wells, you would have to strike a gusher to get a 2 year 8 month pay-out. So that is pretty high interest.

Furthermore, most of the merchants generally that I know are good persons, and do not take advantage of their customers, the public.

But it is possible for a merchant who has his prices of products fixed by the Price Commission to have no fixation of interest rates charged by him. In other words, if merchants wanted to they could require installment debt for the payment of any goods purchased. In that way, they would soon collect back any amount they wanted to on the installment debt side.

I wonder why you could not afford to see that interest rates should be under control when you are controlling the very people that are selling the goods in the country and not controlling interest rates.

It occurs to me, as the law says, that if you fix the price on one you should fix the price on the other, like interest rates. I wonder if you are willing to give reconsideration to that and include not only the 36-percent rate, which is over the Nation today—that is certainly a rate against conscience—and there are two below that that are not much better, 24 percent and 18 percent. Don't you think you ought to give reconsideration to that judgment, Mr. Burns?

Mr. Burns. May I point out, Congressman Patman, first of all, that the Economic Stabilization Act empowers the President to establish interest rate controls if in his judgment that is required. This is not a responsibility given to the Federal Reserve under the law.

Let me point out, secondly, that the President did establish a Committee on Interest and Dividends, and this committee is now doing what it can through a voluntary program to nudge interest rates down wherever that seems indicated or desirable.

Let me point out, third, that the market for money and capital is probably the most competitive market that we have in this country, by far the most competitive. The prime rate on business loans, when I moved into the Fed early in 1970, was 8.5 percent and now the prime rate is 4.5 percent in some banks and 4¾ percent in most banks.

We have had a dramatic decline in interest rates in this country on short term loans, and we have had an appreciable, although I think insufficient, decline of interest rates on long term loans.

Let me point out that the 36-percent interest rate that you refer to on consumer installment loans is by no means universal. I have just made a quick survey of a dozen banks and the average interest rate that is charged by these banks on 36 month automobile paper is a little under 10 percent.

Let me point out next that the Committee on Interest and Dividends is engaged in a very extensive survillance program that I think will be very helpful to you and the Congress generally, as well as to us on the Federal Reserve Board. Vast new collections of interest rate data are in the process of being generated. For example, the Federal Reserve Board and the FDIC have started collecting interest rates on a monthly basis from a sample of 375 commercial banks, and we will have data on eight specific types of loans, monthly. They will cover the interest rate on small loans to business; the interest rate on two types of farm production loans; and the interest rate on five types of consumer loans. We are extending our collection of statistics on interest rates on mortgages so that they will be available on a commitment basis as well as on a closing basis.

Also, we are starting a new bimonthly survey of interest rates charged by finance companies on loans made for the purchase of new and used cars, the purchase of mobile homes, and other consumer goods, as well as personal cash loans.

These data will be helpful in following developments.

Also, we in this committee have been meeting with bankers and mortgage lenders. We intend to have meetings with representatives of different types of lending institutions to call these facts to their attention.

I also want to bring to your attention a policy statement that we issued which is helping to nudge interest rates down, particularly in the case of the more sticky type of loans; namely, mortgage loans and consumer loans.

As far as open-market interest rates are concerned, they are the most competitive, I think, of any market that we have. I doubt if you would want to improve on it.

Representative PATMAN. We would like to see the reports, Mr. Burns.

Mr. BURNS. Yes. These reports, once they begin coming in and once they are processed will be sent to you and they will be made available to the public on a regular basis.

Chairman PROXMIRE. We would like to have them sent to the committee, if you would.

Mr. BURNS. We will make sure that that is done.

Representative PATMAN. About the prime rate, I am convinced that is a meaningless rate. That is up to each bank. Each bank keeps its own prime rate. It is a split second deal to change it if they want to. They are not compelled to let a person have money at a rate that has been advertised as the prime rate because they could change that rate instantly. They have been known to do that. So there is no enforcement machinery there. There is nobody to enforce a prime rate.

Mr. BURNS. There is enforcement machinery. There is no better enforcement machinery than is provided by a competitive market.

Representative PATMAN. I know that is what is said.

Mr. BURNS. It is worth repeating, Congressman.

Representative PATMAN. The prime rate, in effect, is just no rate because a bank can change it in a split second if they want to, and there is nothing to keep them from doing it.

Mr. BURNS. If you take the average interest rate on business loans as shown by the Federal Reserve quarterly survey of business loans made by commercial banks, you will find a very sharp drop, not very much smaller than that of the prime rate itself.

Representative PATMAN. I want to close with this: There is no real evidence that the consumers are benefitting by any reduction in interest rates. Recently one of the largest banks reduced interest rates one-fourth of 1 percent on housing loans, from 8 percent to 7¾. But at the same time they reduced the interest rates on savings accounts one-half of 1 percent, which was a meaningful figure. The bank was not making many housing loans, but they had a lot of money in the savings accounts. They reduced that 100 percent compared to the amount they reduced the interest on housing loans.

On consumer loans generally, like this 36 percent, 24 percent and 18 percent, I don't like for that to be passed off by the Federal Reserve by a wave of the hand, saying it doesn't amount to much, that interest rates are coming down. There is something very realistic going on in this country, Mr. Burns, and I must invite your attention to it. Lots of time was taken and lots of money was spent by people interested in maintaining the very highest interest rates. They got up a uniform credit code and they agreed to it and submitted it to all 50 States.

They are urging its adoption. This code contains those rates, 36, 24 and 18. So it is not just a dream of someone. It is something that is going on in all 50 States today. It means that the administration is fixing the prices of what the merchants are allowed to charge for their merchandise, but you as a member of the Interest and Dividend Committee are saying nothing about what they can charge in addition to that on the consumer credit code in the way of 36 percent, 24 percent or 18 percent. It occurs to me if you fix one you should certainly consider fixing the other. All I ask you to do, in conclusion, is to give reconsideration to the subject, if you will.

Mr. BURNS. Congressman Patman, this is a subject that I live with. In fact, I stay up nights now and then, or maybe more than now and then, dreaming, studying and worrying about this subject. I promise you I shall continue to do so.

Representative PATMAN. Thank you, sir.

Chairman PROXMIRE. Congressman Reuss.

Representative REUSS. On January 14, 1972, I wrote Chairman Burns asking him whether, as a supplement to his testimony today, we might have his comment on the extent to which the Federal Reserve in 1971 followed both the general monetary guidelines of the committee and the views on monetary guidelines contained in my supplementary views in last year's report.

Mr. Burns has, by letter of February 7, replied in very interesting detail to that letter. Accordingly, I would ask that my letter of January 14, second, my additional views in the 1971 report of the Joint

Economic Committee at pages 76 to 78, and, third, Mr. Burns' reply of February 7, be incorporated in the record at this point.

Chairman PROXMIRE. Without objection, it is so ordered.

(The information follows:)

JANUARY 14, 1972.

Dr. ARTHUR F. BURNS,
Chairman, Federal Reserve System, Federal Reserve Building, Washington, D.C.

DEAR DR. BURNS: You will shortly be appearing before the Joint Economic Committee in its annual hearing on the Economic Report. At that time, I shall appreciate the judgment of yourself and your colleagues on the suggested guidelines for monetary policy which were contained in my additional views in the 1971 Report of the Joint Economic Committee, pp. 76–78.

Particularly, I shall be interested whether the Federal Reserve approves of the suggested guidelines, and has in mind any improvements on them; and whether the Federal Reserve System during 1971 in fact followed the suggested guidelines, or deviated therefrom. Perhaps it would be most helpful to have this as a supplement to your testimony.

Sincerely,

HENRY S. REUSS,
Member of Congress.

Enclosure:

[From the 1971 Joint Economic Report, pp. 76–78]

SUPPLEMENTAL VIEWS OF REPRESENTATIVE REUSS ON MONETARY POLICY

In my supplementary views on the 1968 Joint Economic Committee report (pp. 44–46), I pointed out how widely the Federal Reserve System was disregarding the admonition of the Joint Economic Committee in its 1967 report to stay within a normal rate of growth of the money supply, narrowly defined (the formulation in recent reports of the Joint Economic Committee, including this 1971 report, sets a desirable rate of growth in the money supply narrowly defined, at 2–6 percent). I also said: "Perhaps the Joint Economic Committee's 'advice' has been too tersely stated, with insufficient regard for other factors than the money supply, narrowly defined."

I then proposed a more comprehensive set of guidelines—a general principle, and seven qualifications. During the hearings of the Joint Economic Committee on July 23, 1970, I had an opportunity to question Chairman Burns of the Federal Reserve System on these proposed guidelines. (Hearings, pp. 596–600). Dr. Burns thereafter supplemented his testimony by additional materal, which is included in the printed hearings.

As a result, I am prepared to suggest guidelines which emerge from my questions and Dr. Burns' reaction to them. It seems to me that until improvements come along, these guidelines would be sensible advice for the Joint Economic Committee to give the Fed, rather than the present simplistic "Keep the money supply, narrowly defined, in the range of 2–6 percent growth per year."

The suggested guidelines follow:

The Federal Reserve System, through open-market operations, reserve requirements, and discount policy, shall endeavor to accommodate a growing full-employment gross national product by expanding the money supply (narrowly defined to include commercial bank demand deposits and currency outside banks) by 2–6 percent yearly, with the following qualifications:

1. The target figure should be adjusted up or down from the above band from time to time to reflect the extent to which time deposits in commercial banks, and in savings and loan institutions, mutual savings banks, and credit unions, substitute for the narrowly defined money supply.

2. The target figure should be on the higher side of the band in periods of less than full use of resources, on the lower side in periods of full use of resources. This qualification is subject to the further qualification that the lag between monetary actions and their effects on output and prices, and information about the recent behavior of prices, economic activity, and the course of fiscal policy, must be carefully considered. If the recent past has been dominated by excess demand and substantial inflation, an attempt to reach full use of resources in the short-run through accelerated monetary growth could sacrifice the prospects for non-inflationary growth over the longer run. Under such circumstances, if the economy were operating somewhat below its potential, but moving upwards, a rate of money stock growth that was too high might risk overstimulating the economy. On the other hand, when the economy is relatively free from inflationary pressures, and fiscal policy is restrictive, a relatively expansionary monetary policy may be needed to maintain full resource use.

3. The target figure should be on the higher side of the band, or even higher than the band, when reesources are underemployed, and simultaneously businesses are making exceptionally heavy demands on credit, not for current business expenditures, but for additional liquidity in anticipation of future needs, or to replenish unexpected liquidity losses. It must be recognized, however, that additions to money holdings to satisfy present liquidity preference would prove to be a source of funds to finance inflationary demands later on, should the preference for liquidity decline.

4. In general, cost-push inflation should be attacked by a moderate rate of growth in the money stock, a sound fiscal policy, and a wage-price-incomes policy. An effort to offset, through monetary restraint, all of the upward push that rising costs exert on prices may unduly restrict aggregate demand, and increase greatly the risk of substantial under-employed resources. On the other hand, expanding the growth rate of the money stock by the amount of inflation attributable to the pressure of costs on prices would provide the potential for an unending round of price and wage increases.

5. The target figure should generally be sought over a three-month period. But a longer period than three months may occasionally be needed to average out the targeted rate of growth in the money supply, depending on the current and immediately prospective state of the economy and of financial markets, the size of Treasury borrowings, the management of the Treasury balance, and the source of short-run variations in private money demands.

6. The proper use of monetary policy to avoid domestic inflation, as outlined above, is equally necessary from the balance of payments standpoint—the effect of price inflation on the country's international transactions in goods and services, and the vital role of the dollar as an international reserve currency.

From the point of view of international capital flows, balance of payments considerations should affect monetary policy only through varying the maturity of the Federal Reserve System's portfolio so as to achieve to the extent possible appropriate interest differentials as between long-term and short-term securities. It should be noted that differentials between short- and long-term yields in any one country are less directly relevant than are differentials between levels of both short- and long-term yields in one country and those in another. For a country experiencing persistent balance of payments difficulties, adverse differentials in long-term yields may assume considerable importance, though their effects may be offset by devices such as the Interest Equalization Tax. With respect to short-term interest rates, large changes and yield differentials may also be undesirable, because they may induce large flows of short-term investment funds. On the other hand, adverse yield relationships and adverse flows of funds may at times be unavoidable, and if they appear likely to be self-limiting, they need not be a cause of special concern.

7. The consequences of monetary policy for the home-building industry should be taken into account by including Federal National Mortgage Association and Federal Home Loan Bank Board securities in the Federal Reserve System's portfolio in meaningful amounts, and by lengthening its portfolio whenever home-building finance is unduly retarded by overall monetary stringency.

I hope that the Joint Economic Committee will carefully scrutinize monetary policy over the period ahead, with particular reference to the above-proposed guidelines. I am afraid that the Administration will not get the expensive monetary policy on which it is apparently depending in order to achieve its targets, assuming that the Federal Reserve System follows the above guidelines. It is up to the Administration, in my judgment, either to tell the Federal Reserve System and the Joint Economic Committee wherein it believes the above guidelines are too restrictive, or to propose additional fiscal and other policies which will achieve its goals with a monetary policy operating according to the above guidelines.

HENRY S. REUSS.

CHAIRMAN OF THE BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, D.C., February 7, 1972.

HON. HENRY S. REUSS,
House of Representatives, U.S. Congress, Washington, D.C.

DEAR CONGRESSMAN REUSS: In your letter of January 14, you asked for my judgment regarding your new, suggested guidelines for the conduct of monetary policy as well as for suggestions that might improve the guidelines. You also inquired whether the Federal Reserve System followed or deviated from the suggested guidelines during 1971.

I concur in your view that a broad set of guidelines is greatly preferable to a simple rule such as "Keep the money supply, narrowly defined, in the range of 2–6 per cent growth per year." I would only add that financial conditions are not adequately represented by a single variable such as the narrowly-defined money supply (M_1), even when subject to various caveats and qualifications. Monetary policy must take into account the behavior of other monetary aggregates, the liquidity position of key sectors, interest rate movements and relationships, and overall credit conditions, since all these have a significant bearing on domestic spending and economic activity and also on developments in the balance of payments.

Your first qualification—varying the growth in M_1 to take into account of inflows of interest-bearing deposits at banks and nonbank financial institutions—recognizes the importance of broader measures of money supply. I believe that the behavior of M_1 has to be gauged against a still broader spectrum of liquid assets, including short-dated market instruments as well as deposits. Moreover, quite apart from changing preferences for various liquid assets, changes in the demand for money relative to income can occur in response to such factors as the extent of precautionary attitudes, interest rate expectations, and changing cash management practices. Changing attitudes toward cash may need to be accommodated by monetary policy if overall credit conditions are not to be affected in ways that are adverse to economic activity.

I am entirely in accord with the main thrust of your second and third qualifications. They provide needed discretion and flexibility for monetary policy to take account of the degree of resource utilization, lags in the impact of policy actions, the stage of the business cycle, fiscal policy, and liquidity preferences of the public.

I agree in general with your fourth qualification which indicates that a wage-price-income policy should be included, along with a moderate rate of growth in the money stock and a sound fiscal policy, in attacking cost-push inflation. As you know, I have been a strong proponent of incomes policies in specific circumstances; but I regard them as temporary measures, useful mainly in speeding the transition from a period of excess demand to general price stability. I would hope that progress can be made in improving the structure of our labor and product markets so that competition can do its job more effectively. Thus, I would prefer to regard an incomes policy as a special, temporary supplement to monetary and fiscal policies when sustained cost increases are occurring in a period of persisting inflationary expectations and high unemployment.

As for your fifth qualification, I would think that any target rate of growth of M_1 should be evaluated over a period of at least six months. Experience has repeatedly demonstrated how volatile the public's demand for money can be. It also appears that Federal Reserve action to stimulate or dampen growth of the money supply influences actual growth with an appreciable but variable lag. Deviations from some desired long-run M_1 growth can and do occur for months without significantly affecting future levels of economic activity. How long that interval may be is a question to which economic knowledge does not yet provide unequivocal answers. But some evidence that we have examined definitely suggests a period longer than three months. Thus, I would expand the period in your fifth qualification from three months to six months.

I have some difficulty with your sixth qualification. The first sentence of the second paragraph suggests that when the Federal Reserve System seeks to affect international capital flows, it should vary the maturity of its portfolio to influence interest differentials between long-term and short-term securities. Yet the rest of that paragraph—taken from my suggestions in response to your questions in the July 1970 hearings of the Joint Economic Committee—suggests that such differentials are less important than differentials between short-term yields in one country and those in another or between long-term yields in the two countries. Thus, I am not persuaded that varying the maturity of the System's portifolio would materially affect international capital flows. Moreover, it would not seem necessary to limit the effect of monetary policy on international capital flows to changes in the maturity structure of the System portfolio. In recent years, for example, the System has made use of reserve requirements on Euro-dollar borrowings of banks to affect international capital flows.

Your final qualification suggests that the consequences of monetary policy for the homebuilding industry should be taken into account by purchasing issues of Federal housing agencies and by lengthening the System's portfolio at times of monetary stringency. As you know, since September 1971, the Federal Open Market Committee has been purchasing agency issues outright, including those of the housing agencies. But it should be borne in mind that such purchases are likely to have only marginal significance for the housing market. Similarly, a general lengthening of the System's portfolio would probably have no more than a marginal impact on long-term rates.

Other measures are needed to reduce cyclical fluctuations in housing. Possible approaches are explored in the Board's staff study of the mortgage market, which has previously been forwarded to the Congress.

Let me turn now to the relation between Federal Reserve policy in 1971 and the suggested guidelines. Over the year the narrowly-defined money supply expanded at a 6.2 percent annual rate, which is at the upper end of the guidelines. But during the year the rate of growth in M_1 (taken in seasonally-adjusted form) fluctuated widely, growing in the first half at a 10 percent annual rate and in the second half at a 2.4 percent rate.

The reasons for the disparate growth rates are very largely those covered by your proposed guidelines. During the first half, rapid growth of M_1 reflected the special circumstance of the catch-up first quarter rise in economic activity.

following the auto strike of late 1970 when M_1 grew at a relatively slow pace. Growth remained rapid in the second quarter partly because of an increased preference for liquidity by the public in the face of mounting balance of payments problems, gathering doubts about the nation's ability to control inflation and persisting unemployment.

By the second half of the year the new economic policy announced in mid-August had restored a measure of public confidence, and there was an abatement in demands for liquidity. Moreover, with inflationary expectations reduced, the public began to move surplus cash balances into market instruments in order to capture high yields while they were available. Furthermore, Federal Reserve policy recognized that the very rapid growth rates in the early months of the year could not long persist without harmful inflationary consequences. Reserves began to be supplied less generously in the spring, and short-term interest rates began to rise; but because of lags in response by the public, most of the effect on M_1 growth did not show up until later in the year.

I hope these comments are useful to you.

Sincerely yours,

ARTHUR F. BURNS.

Representative REUSS. I was glad to see in your presentation this morning on international money that you suggested that we and our trading partners must fashion a new and stronger international economic order, and that you explicitly listed after that that there would have to be a reevaluation of the roles played by the reserve currencies, mainly the dollar, and also the question of dollar convertibility.

Like yourself, I am very hopeful that Congress will smoothly and speedily ratify the Smithsonian Agreement. If we can then embark on the broader questions of international monetary reform, there is no reason for recurring crises.

It would, of course, be perfectly possible for people abroad in general to follow the Smithsonian Agreement and yet disorder recur. Specifically, if there is not a measurable reflux to this country of dollars held abroad this year, in 1972, I think it is anybody's guess as to whether disorder will take place. If there is no great reflux of dollars, I would anticipate a basic deficit in our balance of payments on a large order, like $5 billion, simply because I agree with you that one can't expect instant improvement as a result of the Smithsonian Agreement.

Nobody should expect instant improvement. If that is so, if we do have that kind of continuing large-scale deficit, I would feel that we are somewhat exposed to deterioration.

Specifically, I would think it might be tempting to various countries which are accumulating large amounts of dollars to go back and institute two-price systems, and have capital controls and maybe even more controls, and to think about surcharges.

On our part we might again be stung into retaliation by reimposing the 10-percent surcharge. I see some possibilities of this.

Accordingly, wouldn't it be well that a frontal attack on these very difficult, longer term monetary problems that you have mentioned—flexibility, a new form of reserve currency, convertibility—should start at once, and be prosecuted with due dispatch this year?

Mr. BURNS. I agree entirely.

Representative REUSS. Thank you very much.

Chairman PROXMIRE. Mr. Burns, I just have a couple of questions, but one of them is very fundamental. I will ask the one that is not first.

Mr. Solomon, an extraordinarily able economist, who is a member of the Council of Economic Advisers, as you know, predicted that in 1972 the performance of the American economy would be the best of any industrial economy in the free world. He didn't spell out precisely what he meant by that, but I presume he had optimism about our productivity increase and optimism about our inflation performances, optimism about our economic growth. When Mr. Moore appeared, Commissioner of Labor Statistics, I asked him at some length about productivity prospects. I asked him for his personal comment. He said that according to the National Bureau of Economic Research there is a tendency in the middle stages of economic recovery for productivity to tail off. The main increase is in the beginning. He said by definition the present economic recovery began 14 months ago. Therefore, he would conclude that on that basis, at least, our prospects for a much better productivity performance in the coming year is not very good. We had a 3.4 percent improvement in productivity in 1971. It may be less than that in 1972.

On the basis of this historical experience and on the basis of the fact that we are just beginning a Federal leadership in a productivity effort which is pretty low key now, what do you really expect from the economy in the coming year?

Mr. BURNS. Let me say first that Mr. Moore's broad generalization about the progress of productivity during the course of a business cycle expansion is certainly accurate. In the early stages of an expansion, the rate of productivity is very rapid. Then it diminishes. And if the expansion lasts several years, it tapers off, rising, and even now and then declines. That is the historical experience that Mr. Moore referred to. This has been reported very fully in the National Bureau's studies.

Now, how do we relate the current situation to that historical experience? I haven't talked to Mr. Moore about this recently, and in fact I haven't talked to him at all about it. I certainly assume that your summary of his views is fully accurate. I rarely if ever find you inaccurate, sir. But I should then say that I would interpret the current expansion differently for this reason: Yes, the recovery started in November 1970, but we have had an extraordinarily sluggish recovery. Momentum is finally beginning to develop in the economy. Therefore, the kind of experience that we typically had in the early stages of business cycle recoveries in the past is likely to come now, in my judgment.

Chairman PROXMIRE. Do you think that productivity improvement might be 4 or 4.5 percent, possibly?

Mr. BURNS. It could well be that this year, yes.

Chairman PROXMIRE. This is the reason that Mr. Moore, frankly, was in kind of a box, because I argued that if we only had a 6 percent economic growth in 1972, if the labor force increases at a 2.6 rate, which it should in view of demographic figures and population estimates, and so forth, and if you have a four percent or 4.5 percent increase in productivity, there is no improvement in unemployment with a 6 percent growth. You have to have more than that. You would still have 6 percent unemployment at the end of 1972. We want productivity improvement, but, of course, we are going to have to have more growth than even the optimists seem to think we are likely to get. Some people say 5, or 5.5 or 6 percent seems to be a more reasonable figure that the optimistic people think we can achieve. But it is not enough. How do you follow that kind of evaluation?

Mr. BURNS. Senator, I am not a prophet. We talked a little about humility on the part of economists. Perhaps they haven't learned humility sufficiently. They are still making predictions in terms of precise numbers as if they knew what they were talking about. I haven't been blessed that way. What I know is that once an economy develops momentum, it can go very, very rapidly, and unemployment can disappear for all practical purposes within 9 or 12 months.

Chairman PROXMIRE. Than you are telling us you would anticipate that we could very well have growth that would exceed 6 percent, real growth?

Mr. BURNS. I am saying that if that happened I would not be at all surprised.

Chairman PROXMIRE. We have to get it if we are going to reduce unemployment. Do you follow the arithmetic on that?

Mr. BURNS. Well, I am not good at arithmetic. Members of my staff who have worked on projections far more than I have, and far more skillfully than I could, see a decline of unemployment this year, and I expect that to happen.

Chairman PROXMIRE. Now let me ask you the fundamental question. It is an issue on which I must say I find myself in sharp disagreement with a man whom I respect very highly—Mr. Burns. Recently the President appointed a man named John E. Sheehan as a governor of the Federal Reserve Board. The appointment came before our committee, the Banking Committee, and I opposed it. I was the only member who did. I opposed it on the Floor and I was the only Senator who opposed it. The great force behind this appointment was that Arthur Burns had recommended the appointment. John Sheehan is not a man who is a trained economist. He has had no economic background in banking or in monetary policy, particularly. The Federal Reserve Board, it is true, started in 1913, as a board that was thought to require the common sense of businessmen, bankers, farmers, and other sound and solid citizens who were intelligent. But I think we have gotten such an enormously complicated economy that that view no longer prevails.

In the last 15 or 20 years the Board has changed, I think, with great improvement. I think it is the best Federal Reserve Board we have ever had, by far. I think the leadership is the best and I think the membership is the best. From a qualifications standpoint it has been professionalized.

Five of the seven members are economists. Mr. Robertson who serves on it has been on it for many years and has learned over the years. Mr.

Sheehan will be the other noneconomist member. I raise this point, and I made the kind of a fight I did on the floor knowing I would lose, because I understand that Mr. Maisel's term has expired and he may be replaced, and there is a lot of talk that he may be replaced by someone who is not an economist.

In view of the very, very serious nature and complicated problems that beset the Federal Reserve, I cannot understand how we can justify selecting people however fine they may be—and Mr. Sheehan is a very fine man, an intelligent man with a good, solid business background—that anybody, it seems to me, but a professional economist could serve on this very vital, independent economic agency.

How do you justify the selection of a man with no economic background to that position?

Mr. BURNS. The Federal Reserve Act calls for occupation diversity. There is a question in my mind whether, having seven economists on the Board would satisfy that requirement of law.

Second, if the law were not a constraining factor—and let me grant quickly that the law can be interpreted in a different way than I interpret it—I still, if this were a matter solely of my own doing, would not want a Federal Reserve Board consisting of seven economists.

I say this because if you had professional economists on the Federal Reserve Board, that and that alone, there would be a certain danger that in the course of our deliberations we would become excessively involved in technical and peripheral issues.

Before Mr. Sheehan joined the Board, having had during my stay with the Board Mr. Robertson, an attorney, and Mr. Sherrill, a former Government official and banker, I found that their presence kept our discussions from degenerating into involved harangues on technical or peripheral issues.

But there is also a positive fact that I would mention. I think that a business man with a good education, with wide managerial experience, with familiarity with economic and financial issues, can bring a certain common sense and intelligence to bear on the questions that concern the Board, and that this can be very helpful.

I have lived with economists, but I have also learned a great deal from businessmen and financial leaders and labor leaders. I think having a man of Mr. Sheehan's background can be, and I am sure will be, enormously helpful to the Federal Reserve.

Finally, let me say that we have a responsibility at the Federal Reserve Board not only for monetary and credit policy, but we have regulatory responsibilities and we also serve as fiscal agents for the Government. This involves us in all kinds of difficult managerial problems. Beyond that we have a vast system of banks and branches to supervise. Having a trained, disciplined, outstanding business manager, a man with that background, can be, and I am sure will be, helpful to the system.

Governor Sheehan learns very, very quickly. He is a man of a studious nature and scholarly temperament. I think you will be pleased with him as you watch his work with the Federal Reserve Board in the years to come.

Chairman PROXMIRE. I have the same reaction to that response as I would if somebody suggested a nonlawyer to the Supreme Court. Maybe there was a time when we should have had a nonlawyer on the

Supreme Court, and maybe a philosopher, a poet, somebody with greater imagination than many lawyers have, somebody who could escape from the legalisms of the law. That might be a useful addition. But on reflection a non-lawyer would be lost on the Supreme Court.

But when I envision the kind of debates and discussions you must have in your very crucial decisions that you make, it would seem to me that a man like John Sheehan or any number I might know would be at a complete loss. He didn't know what a Philips curve was when he came up. It is not that this is something you can't learn sometime. But this is something that it seems to me a man who serves on the Federal Reserve Board should have had years of discussion, analysis, debate, and consideration on before he moves on to a board where he is going to get, in effect, on-the-job training.

As far as having a competent business manager, it seems to me that is what the staff is for, that the staff would do that. What you need, it seems to me, are people who can make the very great decisions that were made so badly, as you pointed out this morning, by the Federal Reserve often in the past, that have been made, it seems to me, with far greater sophistication, understanding and success in recent years.

We are going to lose some of that if we depart from the very useful professionalization that I think President Eisenhower, President Kennedy, President Johnson, and President Nixon have helped us accomplish in recent years.

Mr. Burns. Senator, I respect your view. I would be the last to deny that the case you make is an imposing one. But I do not agree. As for the Philips curve, let me say—and I don't do it in a mood of flippancy—that if a Ricardo Marx or John Maynard Keynes came and joined the Federal Reserve Board, he also wouldn't know what a Philips curve was. But they would learn very quickly and Governor Sheehan will, too.

Chairman Proxmire. To compare Governor Sheehan with Ricardo is something else.

You come before this committee and you do so extraordinarily well. I think the best way I can describe your performance this morning, Mr. Burns, is to say that I really feel as if you are Stokowski playing us as if we were your orchestra. I feel like I am the guy in the last row who bangs a cymbal about three or four times during a 15-minute opus.

You have done a fine job. Thank you very much.

The committee stands in recess until next Tuesday at 10 o'clock in the morning.

(Whereupon, at 12:35 p.m., the committee recessed, to reconvene at 10 a.m., Tuesday, February 15, 1972.)

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

Response of Hon. Arthur F. Burns to Additional Written Questions Posed by Chairman Proxmire

Question 1. The Administration's estimate for the forthcoming budget deficits are $38.8 billion in FY 1972 and $25.5 billion in FY 1973. There are serious questions about the accuracy of these estimates—particularly the FY 1973 estimates.

Would you give the Committee your estimates for the FY 1972 and FY 1973 deficits?

Answer. We have no basis for making better estimates of Federal expenditures and receipts than the Office of Management and Budget. However, the Administration's expenditure for fiscal 1972 assumes Congressional approval of various items, including retroactive imposition of the proposed revenue sharing program which would cost about $2.3 billion in this fiscal year. There is some possibility, therefore, that actual expenditures may fall short of projected levels. Also, the Administration's receipts estimate for fiscal 1972 assumes that individuals will adjust declared exemptions for withholding purposes promptly in response to the new withholdings schedule, and could prove on this ground to be conservative. Certainly, I hope that the deficit will be less than $38.8 billion this fiscal year.

The Federal deficits projected for fiscal year 1972 reflects, to a large extent, the sluggish pace of the economic expansion. Nonetheless, the rapid growth of Federal expenditures in recent years is a matter of great concern to me, as I know it is to your Committee. In the seven year period from 1965 to 1972, Federal outlays have about doubled. Congress can restore control over spending totals by imposing a rigid ceiling on outlays in fiscal 1973, as the Administration has proposed. Such an action by the Congress would help greatly to restore public confidence.

Question 2. In the past few years we have witnessed a sharp increase in the borrowing and lending activities of government-sponsored enterprises. In 1971 the debt of these enterprises increased $1.3 billion. The estimated increase in 1972 is $8.6 billion and 1973, $9.2 billion. The Administration has proposed legislation establishing additional lending agencies such as a District of Columbia Development Bank.

Would you describe the effect this relatively "uncontrollable" lending has on the Fed's management of monetary policy?

Answer. The activities of government-sponsored credit agencies have not as yet posed serious problems for monetary policy. While borrowing by these agencies may put some pressure on money and securities markets, their lending activities increase the availability of credit to home buyers, farmers, and others. Lending by these agencies actually may be helpful to monetary policy by reducing the disproportionate effect of monetary policy on sectors such as housing.

Conceivably, however, borrowing by government-sponsored agencies could become a problem for monetary policy if the scale of their activities grew so rapidly that financing operations became much larger or more frequent.

Question 3. Let me quote what Mr. Shultz said in testimony before this Committee about monetary developments in 1971. "I think the slow growth of the money supply, particularly in the last three months of the year is something to worry about—it was so erratic during the year 1971 that it sort of almost went outside the bounds of historical experience."

Would you agree with this characterization of the 1971 experience?

Answer. Variations in the growth rate of the money supply were quite large last year. The narrowly defined money supply (M_1) grew at an annual rate of about 10 per cent in the first half of the year and 2-½ per cent in the second half. Growth in the fourth quarter was at about a 1 per cent annual rate.

The slow growth in the latter months of the year does not appear particularly worrisome. The behavior of M_1 is merely one measure of the impact of monetary policy on economic activity, and in any event that impact is best judged in terms of a trend in the growth of M_1 over a sustained period. Over the year 1971 as a whole, M_1 grew at about a 6 per cent rate—or at the upper end of postwar experience, as should be the case in a period of sluggish economic activity.

It would have been worrisome if the exceptionally rapid growth rates of the first half of the year had persisted into the second half. But the slower growth of the second half served to nullify the potential inflationary impact of the large rise in the first half. The limited growth in the fourth quarter might, in turn, prove worrisome if it were long sustained under current economic conditions. However, preliminary figures indicate that growth in M_1 in the first two months of 1972 has picked up considerably.

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