PRESIDENT FORD'S ECONOMIC PROPOSALS

689

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-THIRD CONGRESS

SECOND SESSION

(Pursuant to S. Con. Res. 93)

OCTOBER 11, 16, AND 18, 1974

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CONTENTS

WITNESSES AND STATEMENTS

FRIDAY, OCTOBER 11, 1974

	Page
Proximire, Hon. William, vice chairman of the Joint Economic Committee: Opening statement	1
Simon, Hon. William E., Secretary of the Treasury, accompanied by Edgar R. Fiedler, Assistant Secretary for Economic Policy; and Frederic W. Hickman, Assistant Secretary for Tax Policy	3

WEDNESDAY, OCTOBER 16, 1974

Proxmire, Hon. William, vice chairman of the Joint Economic Committee: Opening statement	65
Okun, Arthur M., senior fellow, Brookings Institution	67
Pechman, Joseph A., director of economic studies, Brookings Institution	70

FRIDAY, OCTOBER 18, 1974

Proxmire, Hon. William, vice chairman of the Joint Economic Committee: Opening statement	101
Rees, Hon. Albert, Director, Council on Wage and Price Stability, accompanied by James Blum, Deputy Director	102
Galbraith, John Kenneth, Paul M. Warburg Professor of Economics, Harvard University	115
Nathan, Robert R., Robert Nathan Associates	120

SUBMISSIONS FOR THE RECORD

FRIDAY, OCTOBER 11, 1974

Reuss, Hon. Henry S.:

- Letter to Hon. William E. Simon, Secretary of the Treasury, from Representative Reuss, dated August 16, 1974, regarding the Treasury Department's drift toward a return to fixed exchange rate parities as the basis of the international monetary system — 31
- Letter to Representative Reuss from Hon. William E. Simon, Secretary of the Treasury, dated August 30, 1974, regarding the U.S. position with regard to floating — 38

Simon, Hon. William E., et al.:

- Fact sheet entitled "A Program To Control Inflation in a Healthy and Growing Economy" — 4
- Address of Secretary Simon before the 1974 annual meetings of the Boards of Governors of the International Monetary Fund; International Bank for Reconstruction and Development; International Finance Corporation; and International Development Association — 41

WEDNESDAY, OCTOBER 16, 1974

Pechman, Joseph A.:

- Letter of response to the Washington Post's editorial of October 9, 1974, from Representative Reuss, concerning President Ford's 5-percent surtax proposal — 73
- Prepared statement — 76

FRIDAY, OCTOBER 18, 1974

Nathan, Robert R.:

- Prepared statement — 124
- Chart depicting percentage increase of wholesale price index and consumer price index over same month 1 year earlier, 1964–74 — 125

PRESIDENT FORD'S ECONOMIC PROPOSALS

FRIDAY, OCTOBER 11, 1974

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

The committee met, pursuant to notice, at 9:05 a.m., in room 1202, Dirksen Senate Office Building, Hon. William Proxmire (vice chairman of the Committee) presiding.

Present: Senators Proxmire and Percy; and Representative Reuss.

Also present: John R. Stark, executive director; John R. Karlik, Loughlin F. McHugh, and Courtenay M. Slater, senior economists; Richard F. Kaufman, general counsel; Michael J. Runde, administrative assistant; William A. Cox, Lucy A. Falcone, Robert D. Hamrin, Sarah Jackson, Jerry J. Jasinowski, L. Douglas Lee, Carl V. Sears, George R. Tyler, Peter Stockton, Ralph Schlosstein, and Tom Graves, professional staff members; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig, minority counsel.

Opening Statement of Senator Proxmire

Senator Proxmire. The committee will come to order.

We appreciate your willingness, Secretary Simon, to appear at this early hour and discuss the economic proposals made by the President on Thursday.

I know your schedule today is very crowded. The President's speech contained some proposals which I can support, other proposals which I cannot support. However, my main difficulty with the President's speech is not my objection to any specific proposal, but my disappointment with the package of recommendations taken as a whole. It fails to add up to anything approaching an adequate program to deal with either inflation or unemployment.

I am far from alone in feeling this way. You yourself were quoted as saying that the program was not a blockbuster, which I think is a masterpiece of understatement. The Wall Street Journal, instead of headlining it as biting the bullet, said it was biting the marshmallow, a comment which I understand you considered in a statement that you made before another committee yesterday to be in conflict with opposition of the 5 percent surtax.

Well, I think it is completely consistent to oppose the 5 percent surtax and say the program is not adequate. The 5 percent surtax, in my view, is just not aimed at the kind of problem we have in this inflation period.

Mr. Arthur Burns yesterday called the program a beginning, but implied that it was inadequate to provide the confidence that inflation will be brought under control.

Many Members of Congress indicated that the President's program is inadequate. The press has shown a similar reaction. Wednesday's New York Times editorial concluded, and I quote:

> The individual merits of the President's recommendations do not offset the central weaknesses of his program. While some of his measures are good, and some are questionable, they in no sense add up to a program for an emergency, and if it is an emergency, it is an emergency which confronts the Nation and the world.

Numerous other articles that I have seen have a similar theme.

The Joint Economic Committee, in a recent report, on September 23, contained economic policy steps which needed to be taken quickly.

Now, Mr. Secretary, this was a consensus report, it was not a report by the majority, or part of the majority. All 20 members of the committee joined in it. There were a few differences on some of the issues, but it was a far more comprehensive program than the President set forth, as I am going to indicate.

I am gratified to note that the President embraced a number of our recommendations. A $300 billion spending ceiling, a review of unemployment compensation, a review of Government programs which contribute to inflation, spending, antitrust enforcement.

The trouble is that the President adopted only a fraction of them. We called for price constraint coupled with an easing of monetary policy. Neither the President nor the Chairman of the Federal Reserve gives us any evidence that they have heeded the second part of this recommendation.

We called for revenue-raising tax reforms, coupled with tax relief for low- and middle-income persons. Instead, the President has called for a tax surcharge, which as far as I can see achieves no useful economic purpose.

The President almost entirely ignored the role that the Council on Wage and Price Stability could and should play in influencing private decisions.

This morning the New York Times, in a lead editorial says the following:

> Of all the many weaknesses in President Ford's anti-inflation program, the most glaring is the absence of any direct pressure for moderation on the price-wage front, much less any mechanism for enforcing the restraint. Up to now, wage settlements have contributed relatively little to the climb of living costs. Their management by the White House and Congress last April 30, which was initiated by former President Nixon, did help keep pay increases close to the old guidepost of 5.5 percent a year. The Administration's failure to maintain price stability has left the average wage earner behind this real purchasing power. The deficit that the unions currently seek to raise by immediate pay boosts in the double digit range would become an escalator in future inflation.

Now, we called for a public service jobs program—inadequate, I should say—to provide 500,000 or 650,000 jobs when unemployment reached 6 percent. The President recommended a program of no more than half that size. We called for a commission to comprehensively review all governmental and private impediments to competition. The President has asked only for a review of the regulatory agencies.

The Cranston-Brooke housing bill would provide for financing of 250,000 additional homes. We approved this on the floor of the Senate yesterday. It should be at no cost to the Government. It has been endorsed by the President but he indicated he would only use part of the money, less than half of it to finance only 100,000 homes.

The committee will be hearing further witnesses during the next 2 weeks, not only to evaluate the steps proposed by the President, but also to obtain suggestions for strengthening the program by adding additional and more forceful policies for dealing with both inflation and unemployment.

Mr. Secretary, go right ahead.

STATEMENT OF HON. WILLIAM E. SIMON, SECRETARY OF THE TREASURY, ACCOMPANIED BY EDGAR R. FIEDLER, ASSISTANT SECRETARY FOR ECONOMIC POLICY; AND FREDERIC W. HICKMAN, ASSISTANT SECRETARY FOR TAX POLICY

Secretary SIMON. Thank you, Mr. Chairman. I am pleased to appear before you today to discuss the President's economic program announced on Tuesday.

We believe the President's program is a very broad attack on inflation and related economic problems, comprised of an extensive list of actions to be taken by the executive branch, recommended legislation for the Congress, and proposals for the American people acting individually. None of these actions and recommendations is, of itself, a blockbuster, but many are very important and all are useful. Together they add up to a balanced, comprehensive and integrated package of economic policy.

Thus, I hope the Congress, in considering the legislative proposals in this program, will consider it as a whole, each part in relation to all the others. In particular, I refer to the revenue-raising and revenue-losing parts of the package. They were designed quite intentionally to closely balance out so that the fiscal integrity of our program would be maintained. We would not want to see that integrity seriously compromised.

In making those points, however, I do not mean to imply that we consider the program inviolable in every detail exactly as we have presented it. Quite the contrary, we welcome any and every better idea that can be found and will cooperate with the Congress fully in making improvements.

In that regard, I have been interested in the early public reactions to the program. It is clear that many people have different ideas than we do about the appropriate economic policy. That our proposals were criticized was to be expected, of course, but it is the pattern of this criticism that is worth nothing. Most of the comments taken one of two forms. The first is that our program is not dramatic enough or powerful enough, for example, that instead of "biting the bullet" we are only nibbling at it, or that we are "biting the marshmallow." The other common reaction is that the tax surcharge is unacceptable. What this adds up to is that many think we are not doing enough in this economic program and most of the others think we are doing too much. Not a few hold both views simultaneously.

Again that is not completely surprising, but the point I want to make here is that our program, in the light of these conflicting criticisms, is consistent with the political realities of the present situation. It would be nice if we could lower rather than raise taxes and it would be nice if we could put even more money into programs to cushion the impact of inflation where it has fallen disproportionately. But we cannot do those things and also achieve our primary goal, which is to work down the rate of inflation. I think the President's program strikes a good balance among these competing objectives, and I hope this committee will help us keep that balance.

I do not think it is necessary for me to describe the program to you; all or most of you heard the President on Tuesday and the principal components of the program have been widely reported. Attached to my statement is a copy of the fact sheet for the program, which I hope you will find useful for details of the various programs.

One point I would like to emphasize is the temporary nature of the proposed tax surchage on corporations, and upper income groups. Among those who support it, there are some who think it should be made permanent. I do not think it should, not simply because of my own proclivity for limiting the size and scope of government, but because I believe that attitude is now held rather generally by the American people. We have more government than we need, more government than we want, and certainly more government than we are willing to pay for.

One final thought: I hope the legislation proposed by the President can move forward rapidly. I do not suggest that Congress try to deal with the many complex questions that are involved here in a hasty or ill-considered way, but I most firmly believe that both Houses should act on these measures with an accelerated schedule.

[The "fact sheet" referred to follows:]

[From the Department of the Treasury, Fact Sheet, Oct. 8, 1974]

A Program To Control Inflation in a Healthy and Growing Economy

Although our economic system remains sound and strong, with its basic vitality intact, the economy is experiencing severe difficulties. Inflation is far too high. Too many people are having trouble finding employment. The financial markets are out of kilter. Interest rates are exorbitant. Housing is suffering badly. The productive capacity of the economy is expanding too slowly.

The origins of these problems are complex. Part of the problem grew out of several international shocks:

The disastrous world-wide drop in crop production in 1972, which sent food prices soaring.

Two international devaluations of the dollar, which made the United States a more attractive source for other countries to buy scarce materials.

The tripling of crude oil prices, which exerted a powerful and pervasive effect on our entire price structure.

Here at home, a long period of excessively stimulative policies created inflationary pressures that gradually and inexorably mounted in intensity. With that condition prevailing, the economy could not absorb the outside shocks; rather, those have now been built into the system, deepening and extending our problem.

Twice within the past decade, in 1967 and in 1971–72, we let an opportunity to regain price stability slip through our grasp. Thus inflation has gathered momentum and has become the chronic concern of producers and consumers alike. Indeed, today inflation is the primary cause of our recession fears.

Consumer confidence has been shaken, causing most families to hold back on spending, as clearly indicated by the lack of growth in the physical volume of retail sales for the past year and a half.

An "inflation premium" has been added to "true" interest rates, so that we now have mortgages at 9–10 percent and corporate bonds at 10–12 percent. This has warped our financial markets, including the stock market, which were structured for an economy with a relatively stable price level.

Another development that has created a serious economic imbalance is the fact that our civilian labor force has been expanding rapidly. For the size of our labor force, therefore, we are short on capital equipment. During this same period, the effectiveness of price controls in certain sectors—e.g., steel, paper and other basic materials—created specific bottlenecks that limited the production capacity of the entire economy. As a result, unemployment was higher than it otherwise would have been. Also, the dampening impact of price controls on profits held back new capital expansion programs in some of these vital industries.

Thus, because our problems are complex, it is clear that our program to deal with them must be comprehensive. It is also clear that the solution cannot be achieved quickly. There are no simple, instantaneous cures for our difficulties. Discipline and patience are the watchwords.

We must, therefore, have a strong policy of budgetary and monetary restraint to work down the rate of inflation. At the same time, we must provide the means for a healthy long-run growth in the capacity of the economy, correct the imbalances that have developed in recent years, and see to it that the burdens of this effort are shared on an equitable basis. Some further rise in unemployment appears probable, and we will take steps to deal with it. However, we can and will achieve our goals without a large increase in unemployment. There will be no economic depression in the United States.

Amending the Employment Act of 1946

The Employment Act of 1946 makes it the policy of the Federal Government to "promote maximum employment, production and purchasing power." Although the words "purchasing power" have sometimes been interpreted as meaning price-level stability, it would nevertheless be helpful to clarify the term and make explicit in the Employment Act the goal of stability in the general price level. The American people have a right to receive from their government stronger assurance that policies will be followed to safeguard the purchasing power of their money in addition to policies that will provide abundant job opportunities and a rising level of living.

We, therefore, suggest that the section of the Act referred to above be amended to read as follows: ". . . for all those able, willing, and seeking to work, to promote maximum employment, maximum production, and stability of the general price level."

International Cooperation

There is much that we and other nations can do to restore the health of the international economy. The economic problems of one nation, as well as its policies for dealing with them, affect other nations. Governments thus have the responsibility not only to maintain healthy economies but also to formulate policies in a way that complements, rather than disrupts, the constructive efforts of others.

This is particularly true for major economic powers such as the United States. Our policies to reduce inflation and restore satisfactory growth are intended to contribute to the strengthening of the international economy. We intend, further, to work with others so that:

We can ensure secure and reasonably priced goods, particularly food and fuel, for all nations.

We can minimize national policy conflicts or distortions that direct resources away from their most productive uses.

We can provide early warning of potential shifts in supply and demand so that nations can avoid potential disruptions.

We can try to harmonize national efforts in such areas as conservation, investment and balance of payments management.

A small delegation led by Ambassador Eberle departed today for Canada, Europe and Japan to discuss the policies described herein and to explore how we can better address and resolve common problems in a mutually supportive fashion.

A cornerstone of our international efforts is the multilateral trade negotiation scheduled to begin this fall. Passage of the Trade Reform Act will provide the United States with an opportunity to help improve the international trading order and to ensure that United States interests are well served therein. Without this bill, the United States will be regarded abroad as lacking the tools or the interest to build multilateral solutions to pressing economic problems. With it, the United States can play a leadership role in negotiating guidelines to reduce distortions of trade and investment that force workers or farmers in one nation to pay for the economic policies of another nation. We can also work toward a multilateral system of safeguards that provide for temporary—but only temporary—limits on imports when there is a need for certain industries to adjust smoothly to economic shifts.

Food and Fiber

Food prices are of major concern in our fight against inflation. Because of weather problems and heavy demands from around the world, food prices are anticipated to increase at an annual rate of 10 percent or more over the next 18 months. Only by expanding farm production, improving productivity, and containing foreign demand can we hope to reduce the rate of increase.

Increased production offers our brightest hope for combating inflation, and we are committed to a program of allout food production. There are presently no government restrictions on planting of wheat, feed grains, soybeans and cotton (excluding extra-long-staple cotton). To remove restrictions on rice production, we support pending legislation, but with a noninflationary target price. In addition, new legislation, which we support, has just been introduced to remove restrictions on the production of peanuts and extra-long-staple cotton.

Farmers must be assured of adequate supplies of fertilizers and fuel. The Secretary of Agriculture has been directed to work with the interagency Fertilizer Task Force to establish a reporting system. Fuel will be allocated if necessary. Authority will be sought to allocate fertilizer, if that is needed. We will work with fertilizer companies to initiate voluntary efforts to reduce nonessential uses of fertilizer.

Over the past weekend the Federal Government initiated a voluntary program to monitor grain exports. We can and shall have adequate supplies at home, and through cooperation meet the needs of our trading partners abroad. A committee of the Economic Policy Board will be responsible for determining policy under this program. In addition, in order to better allocate our supplies for export, the President has asked that a provision be added to Public Law 480, under which we ship food to needy countries, to waive certain of the restrictions on shipments under that Act on national interest or humanitarian grounds.

The U.S. Department of Agriculture and the National Commission on Productivity have been directed to help reduce the cost of food by improving efficiency in the agricultural sector. The Department and the Council on Wage and Price Stability will review marketing orders to insure that they do not reduce food supplies. Government regulations will be examined to eliminate those that interfere with productivity in the food processing and distribution industries.

Upward pressure on U.S. food prices will be reduced by helping developing nations to become more self-sufficient. We will share our advanced agricultural technology and aid in the construction of new fertilizer plants. We will support food reserve and emergency food aid programs. We are also taking steps to assure that the burden of the current tight feed grain situation is equitably distributed.

While increased food supplies are the only effective weapon against higher food prices in the long run, it takes time to grow those supplies. We cannot expect to see immediate benefits from the initiatives outlined here. We can, however, be confident that policies to maximize food and fiber production and to restrain food price increases are being pursued vigorously.

Energy

I. GENERAL STATEMENT

Expensive petroleum from insecure foreign sources jeopardizes national security, increases worldwide inflation and places strains on the international financial system. Therefore, in order to reduce United States dependence upon foreign supplies of energy, the President has decided upon the following program to meet the current energy challenge.

The immediate objective is to reduce oil consumption one million barrels per day by the end of 1975 below what it would have otherwise been without affecting industrial output. This energy program calls for both mandatory and voluntary action.

If immediate reductions are not achieved through the energy program presented today, the President will seek more stringent means to insure that United States dependence is reduced.

II. DEVELOP A NEW CONSERVATION POLICY

During the embargo last winter, Americans responded to energy conservation voluntarily. Now, though the crisis is less obvious, Americans must continue to apply voluntary restraint in the use of energy. As part of our continuing effort to conserve energy, the individual American and the American Industry and Government must *think* and *act* conservation, of not only energy but also resources and commodities that are used in our day to day life.

III. SPECIFIC PROGRAM

A. *Submit legislation to require use of coal and nuclear for new electric power generation and conversion for existing plants*

The Administration's policy is to eliminate oil and natural gas fired plants from the Nation's mainland baseloaded electric capacity where it is feasible to convert to coal or nuclear without endangering public health. A meeting of representatives from the utilities, the coal and nuclear industries, state regulatory commissions and the relevant Federal agencies will be called by FEA to establish within 90 days a schedule for phasing out enough oil-fired plants to save 1.0 million barrels per day and to provide a list of actions required to ensure that the schedule is met. Any legislation necessary to accomplish this goal will be submitted afterwards.

Relevant considerations inherent in such a program are as follows:

	MM b/d
Potential for conversion:	
Existing oil and gas plants that are convertible	0.75
Future plants (before 1980) scheduled for oil or gas (30,000 MW)	1.00
Total	1.75
Goal (allowing for cases where conversions will not be attempted)	1.00

Costs:

A. Because future plants are in varying stages of planning and development, total cost of one million barrels per day conversion is not known.

B. However, report from utilities included in "existing plants" category above indicates that 750 thousand b/d conversion costs total $106 million. It should be noted that these costs are considerably lower than what it would cost to continue burning oil at current world prices.

Illustrative comparison of cost of using coal vs. oil (based on 1 million barrels/day):

1. Cost of coal	$6 million (at $25 ton).
2. Cost of residual	$12 million/day (at $12 barrel).
3. Savings	$6.3 million/day or $2.2 billion/year.

There are approximately 500 coal fired units that will not meet state regulations as of June of next year. However, most of these could meet the primary air quality standards (i.e., standards to protect human health). These plants use 185 million tons (⅓ of the nation's total coal consumption) of coal per year. This program would allow these plants to continue to burn coal, thus easing additional pressure on oil supplies.

B. *Defense Production Act*

The Defense Production Act will be used selectively to ensure sufficient supplies of scarce materials needed for energy development projects. This Act was recently invoked to give priority to the delivery of supplies to expedite construction of the Trans-Alaskan pipeline terminal facilities.

C. *Automobile industry must develop program for gasoline savings*

During the past two sessions of Congress, legislation to require fuel saving on new automobiles has been considered. Pursuant to the Energy Supply and Environmental Coordination Act of 1974 a specific study of one aspect of this question is now underway. Unfortunately, the sum total of legislative requirements on automobile manufacturers has often caused confusion, additional cost to the consumer and unworkable deadlines. Therefore, the President is requesting the major automobile manufacturers to submit a five-year schedule of their plans to produce more efficient automobiles. Coals on efficiency for industry to meet will then be established. If necessary, the President will present legislation to the Congress for consideration.

D. *Industry must conduct energy audit and develop savings programs*

During the last six months, it has been demonstrated time and again that individual companies can cut energy usage dramatically. Nationwide, the potential savings for all industries under a strict conservation program can be significant. The President has requested the Secretary of Commerce to develop energy use guidelines which will suggest ways for industry to use energy more efficiently. The Secretary will also report on energy savings in specific industries, and communicate that information to businessmen across the nation. In addition, the Commerce Department will monitor to determine areas of energy misuse within industry, and suggest alternatives to stop such waste.

E. *More rigid compliance with the maximum speed limit of 55 miles per hour; suggest new traffic control measures*

The 55 mile speed limit set by Congress earlier this year has saved at least 250,000 b/d of petroleum. The Administration will emphasize the importance of rigid enforcements of this limit by State and local law enforcement agencies. In addition, the President is directing the Secretary of Transportation to work with State officials to suggest additional traffic control measures for conserving gasoline.

F. *Further conservation within Government*

The effects of energy conservation efforts within government has been dramatic. Most agencies have far exceeded their goals. However, governmental conservation programs will be made stricter, and enforced more vigorously. As a top priority, a review will be made of all governmentally imposed impediments to energy conservation, in so far as they adversely affect the day-to-day programs of both the government and the private industry operations.

Specific actions mandated and underway, or to be taken:

Thermostats lowered to 68 degrees in the winter and raised to 78 degrees in the summer.

Lighting reduced in public buildings.

Speed limits on government vehicles reduced.

Cut backs ordered in the number of trips taken, including miles driven and miles flown.

Car pooling locators to be set up within metropolitan government bases.

Parking spaces to be allocated on a priority basis to car poolers.

Smaller automobiles to be purchased to replace larger cars.

Decorative lighting to be reduced.

Outside lighting to be reduced.

Voluntary Conservation Actions:

G. *Reduce energy consumption in commercial buildings*

The commercial sector of the economy accounts for almost 15% of our total energy use. Studies have shown that commercial energy requirements can be significantly reduced by improved efficiency measures, and by taking positive steps to reduce lighting, heating and air conditioning. A 10% reduction in this sector can save the equivalent of approximately 500,000 barrels of oil per day.

H. *Reduce energy consumption in residences*

Residential consumption of energy accounts for approximately 20% of total energy use. Prudent use of heating and air conditioning, reduced usage of hot water, lighting and appliances, and improved home insulation has the potential for saving the equivalent of well over one million barrels of oil per day. These steps would also, of course significantly reduce energy costs for the consumer.

I. *Reduce gasoline consumption*

About one third of all automobile travel consists of commuting to and from work. If the average number of passengers per commuter auto were to increase by one, a reduction in gasoline usage of well over 500,000 barrels per day could be achieved. The resulting lower consumption would also reduce the commuters out-of-pocket costs for high priced gasoline.

Regarding specific voluntary actions relating to (a), (b) and (c), the Administration will:

Encourage everyone to lower thermostats in the home in the winter and raise them in the summer.

Ask architects to design buildings with energy conservation in mind.
Ask motorists to keep cars tuned and maintain proper tire pressure.
Ask everyone to reduce temperature settings on hot water heaters.
Ask everyone to turn off pilot lights on furnaces in the summer.
Encourage everyone to use cold water for laundry.
Encourage the use of public transportation.
Urge an increase in the use of car pools.
Urge reduction in use of nonessential home appliances.
Urge reduced use of stoves, refrigerators, televisions, electric lights, washing machines.
Encourage home owners to insulate and install storm windows.
Urge turning off outside gas lights.
Urge measures to increase the load factor on airline flights.

J. *Request state and federal regulatory authorities to eliminate rate schedules which encourage excessive energy consumption*

The utility industry, under both state and federal regulations, have often developed rate structures that encourage increased energy consumption. Regulatory authorities should seek to design rate structures that encourage maximum energy conservation, promote use of generation capacity in off-peak periods, and only charge individual categories of users the cost of the power they actually consume.

K. *Natural gas supply act*

Natural gas is an invaluable source of clean, environmentally sound energy. For fifteen years, the Federal Power Commission has controlled and kept low its wellhead price, and thus reduced incentives to the development of new domestic supplies. In 1957, new discoveries of natural gas totalled approximately 22 trillion cubic feet. By 1972 this had fallen to less than three trillion cubic feet. In 1955 the U.S. had a 22.5 year supply of gas reserves, and in 1972 only 10.7 years.

The nation is now importing foreign liquefied gas (LNG) at prices three times controlled domestic price. The nation faces continued and increasing rates of curtailment of gas being supplied to current users, including gas for agricultural production.

The only real solution to the supply problem lies in deregulation of new gas, so as to stimulate production.

Legislation to achieve this result has long been stalled in the Congress. This logjam must be broken, so that domestic gas reserves may be identified and brought into production as quickly as possible.

L. *Naval Petroleum Reserves—permit maximum production from reserve #1 (Elk Hills) and implement full scale exploration and development of production capability of reserve #4 (Alaska)*

At the present time, two Naval Petroleum Reserves, Elk Hills, California (NPR #1), and NPR #4 in Alaska, could, if fully developed, provide significant production capability. Elk Hills is about 50% developed but needs further development to place it in a state of readiness. It is estimated that production capability of 160,000 barrels per day could be achieved within two months, with the long term maximum efficient rate of production at about 267,000 barrels per day. The estimated potential of NPR #1 runs as high as 1.7 billion barrels. The vast tract in Alaska, NPR #4, is largely unexplored but offers a significant potential for development. Recoverable reserves are estimated to be as much as 30 billion barrels.

The statutory authority for the naval petroleum reserves, and oil shale is included in Chapter 641, Title 10, U.S. Code. Key provisions in the authority provide that the reserves shall be used and operated for:

(1) The protection, conservation, maintenance and testing of the reserves.

(2) The production of petroleum, gas, oil shale or products thereof, whenever and to the extent the Secretary of the Navy, with the approval of the President, finds that it is needed for national defense and production is authorized by a joint resolution of Congress.

The President is directing the Secretaries of Defense, Navy and Interior, within the next 90 days, to develop proposals (including any needed legislation) directed toward the exploration and development of NPR #4 as rapidly as possible.

M. *Clean Air Act*

The Clean Air Act Amendments of 1970 represent a landmark in our progress toward environmental protection, and definite progress is being made in cleaning up the Nation's air.

The Act describes very stringent guidelines for compliance by mobile and stationary sources. Many of these goals are achievable as drafted. In some cases, however, more flexibility is needed to achieve the objectives of the Act and to to allow use of coal, the nation's most abundant domestic energy source. The amendments that have been transmitted to the Congress by the Administration would provide this needed flexibility to effectively respond to the nation's energy problems without jeopardizing the Act's health related requirements. Passage of all of these amendments will not diminish continuing efforts for a cleaner environment.

N. *Surface mining*

Coal is the nation's most abundant and available energy resource. The Administration has proposed and long supported surface mining legislation that would allow continued and accelerated development of domestic coal reserves with appropriate protection of environment values.

Severe problems still remain with some of the provisions of the legislation which has passed both houses of the Congress. Its enactment as now drafted could involve not only serious production losses but inflationary cost impacts throughout the entire economy.

Secretary Morton and his staff have been working closely with the committee to resolve the most important of these problems, including surface owner protection provisions, funding absolute prohibitions of mining in certain areas, unnecessarily broad statements of purposes, and provisions of multiple litigation that could delay or halt ongoing production efforts.

O. *Nuclear plant licensing bill*

The 9–10 years now required to bring nuclear power plants on line must be reduced. Towards this end, Congress should pass the Nuclear Plant Licensing Bill which will expedite licensing and construction power costs, and accelerate U.S. energy self-sufficiency.

P. *Windfall profits tax*

Since 1973, the prices that may be charged for domestic crude oil production have been strictly controlled by the Cost of Living Council and the Federal Energy Administration (formerly the Federal Energy Office).

Various measures are available to stimulate production from our existing fields by adjusting these controls. Such adjustments are needed on a priority basis, but they could generate sudden profit increases for companies producing oil.

The Administration has proposed a windfall profits tax that would cushion this shock and reduce such profits, and this requires prompt action by the Congress. Expeditious enactment of this tax measure is necessary to maximize production without undue enrichment of the industry.

Q. *Deepwater Port Facilities Act*

Pending legislation would authorize the Federal Government to grant permits for the construction and operation of offshore oil terminal facilities. Such facilities would allow imported oil to be transported more safely and economically on very large crude carriers, and reduce tanker traffic in the nation's already overcrowded harbors. It would encourage the construction of domestic refineries and thus lessen U.S. dependence on imported products from foreign refineries. An extensive environmental impact statement already prepared indicates that the amount of oil spilled in the nation's harbors and coastal regions will be reduced by these facilities.

R. *Energy Research and Development Administration, ERDA*

The President is urging to complete consideration of legislation to create ERDA before the recess. ERDA's mission will be to develop technologies for efficiently using fossil nuclear and advanced energy sources to meet growing needs and in a manner consistent with sound environmental and safety practices. The agency will have responsibility for policy formulation, strategy development, management, conduct of the energy R&D and for working with industry to assure that promising new technologies can be developed and applied.

S. *Accelerate oil leasing of Federal lands on the Outer Continental Shelf*

Prospects for large, new discoveries of onshore oil and gas deposits in the lower 48 states are small. For this reason, leasing of the Federal OCS must be greatly accelerated with a target of ten million acres annually in 1975. This is an amount 5-times larger than the 2 million acres expected to be leased during 1974; and 1974 in turn is twice the acreage leased during 1973. To sustain this schedule it will be necessary to lease frontier areas off Alaska, California and the Atlantic coast. The accelerated leasing program will comply with all provisions of the National Environmental Policy Act, and every step will be taken to insure that development will be carried out under environmentally sound conditions. The President has directed the Secretary of Interior to meet with coastal state officials to establish the program needed to rapidly develop Outer Continental Shelf resources.

T. *Incentives to secondary and tertiary production*

Under current technology, 65 billion barrels of oil would be left in the ground in known reservoirs. Some existing price controls have a tendency to discourage increased production from existing oil fields, especially declining fields. The President has directed the adjustment of these controls so as to maximize incentives to use secondary and tertiary production methods in such cases.

U. *Coal leasing of Federal lands*

The government intends to complete steps to resume leasing of federal lands in 1975 to develop the vast coal resources underlying these lands. Increased world oil prices have forced the nation to look to alternative supplies of energy. The nation's most plentiful resource is coal, with over 1.5 trillion tons beneath the surface of America; public lands alone contain 200 billion tons. The President has directed Secretary of the Interior Rogers C. B. Morton to complete the requisite environmental impact statements and move to establish a program for leasing coal on Federal lands in 1975 that will insure the availability of this resource when needed for immediate production.

V. *Leasing public lands for oil shale and geothermal development*

Early this year, the government leased 18 tracts in known geothermal areas. Ten of these tracts, located in the Geysers Field of Northern California, can supplement efforts on private lands that have already proven to be of commercial value. The remaining tracts, in the Imperial Valley of California, offer a testing opportunity—tapping hot, mineralized water for commercial use as an energy source.

Early this year, four oil shale tracts were leased in Colorado and Utah which are expected to be of commercial value. Developmental work, already underway, will assess the economic and environmental feasibility of exploiting this vast oil shale resource—estimated as containing 400 billion barrels of oil in the western United States.

The Administration will immediately re-evaluate the government's oil shale and geothermal leasing programs with a view toward encouraging more rapid development of these resources.

W. *Completion of plans to bring Alaskan gas to market*

Exploration and development of natural gas in Alaska is moving very rapidly. By next year, the basic information will be available to determine whether Alaskan gas should be brought to the U.S. via a pipeline across Alaska or a pipeline across Alaska and through Canada. In response to a congressional mandate, environmental and economic analysis for each alternative is under way, and should be completed early next year. With the completion of these studies and plans, the President will determine whether and what legislation is needed to expedite access to this large source of environmentally clean energy.

Increasing the Productive Capacity of the Economy

In the long run, the answer to inflation is an economy with sufficient productive capacity to meet the demands of its people. This growth can be accomplished in three interrelated ways: First, through a better-trained, better-motivated and healthier work force. Second, through a larger and more productive stock of plant and equipment. Third, through an increase in the operational efficiency of workers and their equipment—in short, by working smarter.

Increasing investment.—To accelerate the growth of capital investment, the President is calling for an increase in and a restructuring of the investment tax credit. The credit will be increased from 7 to 10 percent; for utilities the increase is from 4 to 10 percent. The restructuring of the credit will eliminate existing restrictions that now limit the incentive value of the credit and that discriminate unfairly between types of taxpayers and investments that qualify for the credit. (See Tax Proposals.)

Strengthening the capital markets.—The financial markets are the centerpiece of our economic system. Healthy and freely functioning markets to bring together savers and investors are crucial to the expansion of the nation's plant and equipment, which in turn is essential to the creation of new jobs and also to the growth of productivity that permits a rise in our standard of living. Every American has a vital stake in the vitality of our financial markets.

The most important thing that we can do to restore the glow of health to our capital markets is to get control of inflation. A rapidly rising price level is the bitter enemy of savings and investment.

As part of this anti-inflation effort, we will take a step that will also have, of itself, a direct beneficial impact on our financial markets. That step is to move toward a balanced budget, and to end the drain that past deficits have made on our capital markets. This would mean that more of the savings generated by our private economy could be used for new productive investment.

And in this context, we must also take account of the demands of the off-budget agencies of the Federal Government, and Federal credit guarantees (for housing, student loans, etc.) as well.

We must create a better environment in the financial markets for equity capital. In recent years, corporations have been unable to raise adequate new equity capital. They have been adding heavily to their debt, however, and as a result the capital structure of business has been getting out of balance, with too much debt and too little equity. This is especially true for our electric utilities.

As a contribution toward the solution to this problem and also to improve the health of our financial markets and to encourage investment, the President has proposed tax legislation to provide that dividends paid on qualified preferred stock be allowed as a deduction to the paying corporation.

The Administration also supports strongly the Financial Institutions Act of 1973 (see Thrift Institutions), and the securities reform legislation pending in Congress that would authorize the Securities and Exchange Commission to establish a national market system for securities transactions. We are also working with the Congress to revise the treatment of capital gains and losses in such a way as to increase efficiency in the flow of capital.

In addition, we support pending legislation to eliminate the withholding tax on interest and dividend income accruing to foreign holders of U.S. securities. Elimination of this would stimulate a larger flow of funds to capital markets in the United States.

Credit Allocation

An issue that has been widely debated in recent years is whether or not the Federal Government should intervene directly into the financial markets to require banks and other credit institutions to make more loans for socially desirable purposes and less for "unproductive" purposes. In our view, allocation of credit by the Federal Government would be highly undesirable. There is no basis for believing that the Government could in fact allocate credit in a way that was acceptable to the American people.

However, the Federal Advisory Council, a statutory body that advises the Federal Reserve Board, has suggested constructive guidelines for credit extension by the banks on a voluntary basis. The Federal Reserve Board has endorsed these guidelines, and expects compliance by the banks.

Antitrust

The elimination of outmoded government regulation must of course be accompanied by dedicated and vigorous enforcement of the antitrust laws. Violation of these laws is a serious crime. Only through maintenance of vigorous competition can we realize the benefits of less regulation. Our efforts must be strengthened. We will focus particularly on more effective enforcement of the laws against price fixing and bid rigging. These types of activities which increase prices substantially cannot be permitted.

Illegal fee schedules in the professions and in real estate closings must also be eliminated. Such conduct will be prosecuted to the full extent of the law.

To support this intensified enforcement effort, the President has asked for legislative enactments in two areas. First, we must increase the penalties associated with antitrust violations—for corporations the maximum fine should be increased from $50,000 to $1 million while for individuals it should be increased from $50,000 to $100,000. Second, we must strengthen the investigation powers of the Antitrust Division of the Department of Justice. This can be accomplished by speedy passage of the Administration's legislation now pending before the Congress that would amend the Antitrust Civil Process Act, and to provide laws which would give enforcement agencies greater capability to detect bid rigging.

Government Regulation

The Federal Government imposes many hidden and inflationary costs on our economy. Laws and regulations have been put into effect with little concern for the underlying costs. These billions of dollars of increased costs are passed on to American consumers in the form of higher prices. A broad program will be undertaken to attack this problem and to identify opportunities for change. These proposals could save billions of dollars, which could then be devoted to more productive investments. They would also reduce the visibility and impact of government on the American people.

The Council on Wage and Price Stability will act as a continuing watchdog on the inflationary actions of the Executive Departments and agencies to uncover laws and regulations that raise costs and stifle economic flexibility and initiative. We need to eliminate or alter many restrictive practices of the Federal Government in areas such as transportation, labor and agriculture—practices that unnecessarily increase the overall costs of goods and services. Both the Conference on Inflation and the Joint Economic Committee recommendations support this approach. The Council will devote a very substantial part of its effort to this function.

National Commission on Regulatory Reform.—The independent regulatory commissions, through their broad policy determinations and individual case decisions, create a body of regulatory policy separate and apart from that of the rest of the Executive Branch. The President will submit legislation to create a National Commission on Regulatory Reform to examine the policies, practices and procedures of these Agencies and develop appropriate legislative and administrative recommendations. Its membership should include Executive Branch, Congressional, and private sector representation.

Inflation and job impact statement.—The President will require all executive agencies to develop Inflation Impact Statements to assess the inflationary consequences of major legislation or regulations prior to the agency taking action. Such an impact statement would sensitize government decisionmakers to the broader consequences of government activities, and to the tradeoff of costs versus benefits in government programs.

The President recommends that the Congress set a similar requirement for itself. The proposed Commisssion on Regulatory Reform should examine the feasibility of legislation requiring independent regulatory agencies to do a similar preanalysis of their actions.

Speedier adjudication and proceedings.—New approaches are required to eliminate the interminable delays often created before regulatory matters are resolved. The courts and the independent regulatories are urged to develop new approaches to assure prompt resolution of pending matters. The Executive Branch will undertake a similar effort.

States and local governments.—Other governmental units are urged to undertake a similar broad program to bring under control the inflationary influence of government at all levels.

Enactment of pending legislation.—There are several important pieces of legislation now pending before Congress, whose enactment would help to reduce the burdens now imposed on the economy by government activities. These include the Surface Transportation Act, the Financial Institutions Act, Trade Reform, and the creation of a Paper Work Commission to review the administrative "bookkeeping" requirements levied by government on the private sector. Congress is urged to move swiftly to enact these measures.

49-316—75——2

Council on Wage and Price Stability

The Council on Wage and Price Stability will devote primary emphasis to two functions: First, it will act as a watchdog on the actions of the Executive Departments and Agencies of the Government that raise costs and impede competition. It will recommend needed changes in administrative procedures, and changes in legislation where necessary, to correct these practices.

Second, it will monitor wage and price movements in the private sector. In general, the Council will carry out this function by seeking the full, voluntary cooperation of labor, industry, and the public to solve problems of mutual concern. The Council will cooperate fully with the President's new Labor-Management Committee. In addition, the Council has the power to conduct public hearings and intends to use it to explore the justification for price and wage increases, as appropriate.

Among other duties the Council on Wage and Price Stability will work with the Cabinet Committee on Food and the Inter-agency Fertilizer Task Force. Also, in dealing with specific sectors in which price pressures are particularly virulent, efforts will have to be concentrated on food, energy, construction, medical care and primary industrial capacity.

The Council, however, will not be a wage and price control agency. Controls do *not* stop inflation; they did not do so the last time around nor even in World War II when prices increased despite severe rationing.

Indeed, controls can make inflation worse. They often create shortages, hamper increased production, stifle growth and cause unemployment. Ultimately, they can cause the fixer and black marketeer to flourish while decent citizens confront empty shelves and long waiting lines.

National Commission on Productivity

Increased productivity—working smarter to increase the total economic output of our work force and equipment—is a vital component of the drive to increase production. This long-term goal will be pursued by a revitalized National Commission on Productivity. The Commission will also extend and deepen the drive to increase productivity in government—Federal, state and local. It is important that government set a good example of leadership in this effort, and we may be sure that there is no shortage of opportunity for productivity in the operations of government. The rest of its effort will be in the private sector, with primary emphasis on meaningful programs at the plant level. Special attention will be devoted to food, transportation, construction and health-services.

Employment Assistance

Increases in unemployment have raised the Nation's unemployment rate to 5.8 percent in September. During this period of high inflation and unemployment, there is a need for Federal standby authority with minimal inflationary impact, which will help alleviate the impact of unemployment should unemployment rates rise. Such action is necessary to help alleviate unemployment problems in areas most affected and to assure that the impact of inflation does not unduly burden those workers least able to bear the costs.

The National Employment Assistance Act of 1974 would respond to these needs by authorizing, during the next 12-month period two programs which would begin to operate should the national unemployment rate average 6 percent or more for 3 months:

(1) A temporary program of income replacement known as the Special Unemployment Assistance Program for experienced unemployed workers in areas of high unemployment who have exhausted all other unemployment compensation or who are not eligible for such compensation; and

(2) A program of employment projects for these same areas, known as the Community Improvement Program.

While the primary purpose of the two programs is to alleviate the hardships of unemployment upon individuals, it will also alleviate the adverse impact on those local economies hardest hit by unemployment.

The unemployment assistance benefits serve to cushion the effects of protracted unemployment by providing additional income replacement to workers who have either exhausted their regular unemployment compensation benefits or to individuals with a demonstrated labor force attachment not otherwise eligible for unemployment insurance benefits. Not only does this replace lost income, but it provides workers with the time and opportunity to look for work consistent with their skills and experience.

The table below shows funds and services now available under Unemployment Compensation laws and the Comprehensive Employment and Training Act (CETA). It also indicated how much would become available over a twelve month period for current unemployment programs, and for the two new proposed programs, at average national unemployment levels of 6 percent and 6.5 percent. Title II of the National Employment Assistance Act would make a further $1 billion available if national unemployment exceeded 7 percent on average for three months or more.

	5.8 percent	6 percent	6.5 percent
CETA public service jobs:			
Funds	$1,015,000,000	$1,015,000,000	$1,015,000,000
Jobs	170,000	170,000	170,000
CETA other training and employment:			
Funds	$1,700,000,000	$1,700,000,000	$1,700,000,000
Man-years	380,000	380,000	380,000
Unemployment benefits (current law):			
Payments	$7,775,000,000	$8,145,000,000	$9,065,000,000
Beneficiaries	7,900,000	8,200,000	9,200,000
National Employment Assistance Act (annual rate):			
Special unemployment benefits:			
Payments		$2,120,000,000	$2,550,000,000
Beneficiaries		2,730,000	3,310,000
UI exhaustees		(830,000)	(1,050,000)
Previously ineligible		(1,900,000	(2,260,000)
Community improvement projects:			
Funds		$500,000,000	$1,250,000,000
Man-years of employment		83,000	208,000

The initiation of temporary projects by State and local governments is perhaps the least inflationary way of providing jobs for unemployed workers. Jobs provided by these projects help to cushion the loss of income due to unemployment, while enabling State and local governments to provide their citizens with a socially useful product.

Because projects under this program will be generated in and geared to areas with high unemployment in which there exists a substantial amount of available manpower, there should be little or no adverse impact on the regular labor market. There is a limit of $7,000 a year for jobs authorized by this program and therefore the average wages will be considerably less than those earned in the private sector. Most workers will obtain private jobs as the economy grows.

The added cost of Community Improvement Projects may be offset somewhat by reduced demand for food stamps and welfare payments, and by some increase in tax receipts from employees in these projects.

Basic funding provisions of the National Employment Assistance Act. Funds for both the Special Unemployment Assistance Program and the Community Improvement Program become available when the national unemployment rate reaches 6.0 percent on average for three consecutive months. For the Special Unemployment Assistance Program, such funds as are necessary are authorized if unemployment is above this level. For Community Improvement Program, successive increments of funds are authorized if the national unemployment level reaches, for three consecutive months an average of: 6.0 percent—$500 million dollars authorized; 6.5 percent—another $750 million dollars authorized; and 7.0 percent—an additional one billion dollars authorized.

When the national unemployment rate recedes below these respective levels for three consecutive months on average, Federal funds for new projects will cease.

Eighty percent of the available funds for Community Improvement Projects will be distributed by formula among eligible applicants based on (1) the relative number of unemployed residing in areas of substantial unemployment within their jurisdictions, and (2) the severity of unemployment; 20 percent would be expanded at the discretion of the Secretary, principally to finance projects in areas which become eligible after the formula distribution is made.

The local labor market area—and balance of State—unemployment rates determine the communities in which both programs will be operating. Both programs are directed to those areas in which unemployment is highest. Both programs come into effect in a labor market area, with a population of 250,000 or more, when it has an unemployment rate equal to or in excess of 6.5 percent for three months on average. The balance of each State not included in such areas will constitute a single area in which the programs will become effective subject to the same unemployment rate criterion. When the local unemployment level recedes below 6.5 percent on average for three consecutive months no new individuals become eligible and no new projects may be started.

Special Unemployment Assistance Program. This new temporary unemployment assistance program will be separate from but supplemental to the existing Federal-State Unemployment Insurance (UI) System, and is designed to extend coverage to experienced persons in the labor force who have exhausted their UI benefits or are otherwise ineligible for such benefits. The program would be operated through agreements with the States. All experienced members of the workforce will be eligible for benefits as follows:

They must have last worked in a labor market area (or balance of State area) with substantial unemployment.

Benefits will be governed by benefit provisions of each State UI law.

Individuals who had exhausted their benefits under State UI programs will be eligible for a maximum of 13 weeks benefits.

Individuals who were not previously eligible for State UI benefits will be eligible for a maximum of 26 weeks provided that they have attachment to labor force as required by the relevant State UI law.

Benefits for UI ineligibles will generally be the amount that would be payable as computed under State law if all work was performed for covered employees.

No new beneficiaries would be eligible after December 31, 1975.

COMMUNITY IMPROVEMENT PROGRAM

New program is structured so that as the national employment rate rises, more money is available for community improvement projects.

Projects are limited to areas eligible for the Special Unemployment Assistance Program.

Eligible applicants are prime sponsors under the Comprehensive Employment and Training Act, in areas that qualify.

Projects may be with State or local government agencies.

Each Community Improvement project is limited to 6 months duration.

Not more than 10 percent of a sponsor's funds may be used for administrative costs, supplies, material, and equipment.

Individuals eligible for employment on these projects are those who have exhausted their benefits under the Special Unemployment Assistance Program.

Wages paid project employees must be at least the minimum wage under the Fair Labor Standards Act, or the State or local minimum wage, whichever is higher; however, in no case may the wage exceed an annual rate of $7,000. State or local governments may not supplement wages with their own funds.

Prohibitions against political activities and discrimination apply to the program

The Community Improvement Program will provide funding for projects such as conservation maintenance or restoration of natural resources, community, beautification, anti-pollution and environmental quality efforts, economic development and the improvement and expansion of health, education, and recreation services and such other services which contribute to the community.

Interim Housing, Aid

President Ford proposed extending, on a temporary basis, the advantages offered by the Government National Mortgage Association (GNMA or Ginnie Mae) to mortgages which are not Federal Housing Administration (FHA) insured or Veterans Administration (VA) guaranteed—so called "conventional" mortgages. Three billion dollars—an amount sufficient to finance about 100,000 new homes—would be available. The proposed program will be in addition to the over $19 billion of Federal funds that have been made available over the past year for the purchase of mortgages to supplement the buying power of hard-pressed thrift Institutions.

GNMA currently aids in creating a supply of credit for mortgages on new homes insured by FHA or guaranteed by VA—about 20% of the total mortgages—at reasonable interest rates by

Assuring, through commitments in advance, purchase of mortgages at a predetermined price.

Subsidizing market interest rates to lower levels in the event interest rates do not fall after commitments are made.

Guaranteeing, on a "full faith and credit basis," obligations secured by such mortgages.

HOUSING INDUSTRY SITUATION CRITICAL

Over the past 22 months—

Housing starts have dropped from 2.51 million units to 1.13 million units.

Unemployment in the construction industry is 12.4 percent and climbing, with almost a half million construction workers now unemployed.

Many homebuilders are in financial difficulty.

PRESIDENT FORD'S PROPOSAL FOR INTERIM HOUSING AID

By making conventional mortgages on new homes eligible for purchase by GNMA, builders and homebuyers will be assisted where home mortgage credit is scarce or non-existent.

1. *Level of commitments.*—Aggregate amount of commitments and mortgages which GNMA could hold at any time, i.e. have purchased and not resold, could not exceed $7.75 billion. A program of $3 billion of mortgage commitments, or enough to finance about 100,000 new homes, is contemplated. The precise amount would be determined on the basis of market conditions at the time the new authority becomes law, and additional programs would be activated as circumstances require.

2. *Mortgage amounts, discounts, interest rates, and downpayment requirements.*—Subject to Congressional approval the program would provide for a maximum mortgage amount of $45,000. The effective interest rate would be determined on the basis of market conditions at the time the program went into effect and would be somewhat above the rate offered on GNMA tandem programs for FHA/VA mortgages—presently 8¾%. Twenty percent downpayments would be required with an exception for down to 5% downpayments if the additional mortgage amount is covered by a qualified private mortgage insurance contract so as to minimize cost of mortgagor defaults.

3. *GNMA disposition of conventional mortgages.*—Following the precedent of existing law, GNMA could, depending upon market or other factors, sell mortgages to the Federal National Mortgage Association (FNMA) or the Federal Home Loan Mortgage Corporation (FHLMC), sell mortgages or commitments with a provision for pooling by FNMA or FHLMC or other approved issuers and sale by such issuers of GNMA-guaranteed "pass through" securities or bond type securities on the market or to the Federal Financing Bank or sell guaranteed "pass through" securities to the Federal Financing Bank.

4. *Cost and budget implications.*—Any subsidy would be paid out of corporate funds and ultimately from Treasury borrowing. Dollar amount of mortgages purchased would not be excluded from budget authority, but would appear as outlays in any fiscal year only to the extent they are not offset by sales that year. Assuming (i) all mortgages purchased in a given fiscal year were sold in that year, (ii) a face interest rate of 9¼%, (iii) no discount points on GNMA purchase and (iv) an average market rate at time of GNMA sale of 10%, the budget outlays per each billion dollars of mortgages would be about $50 million.

Public Utilities

The problems of our public utilities are extremely serious. More than anything, they are suffering from the effects of inflation—in particular the explosion in oil prices but also from high interest rates. Their inability to raise all the capital they need is forcing them to reduce construction plans, which causes unemployment today and the real threat of brown-outs tomorrow.

The most fundamental part of the solution to these problems is for increases in the cost of electricity, reflecting high prices for fuel, to be paid by the consumers. This means higher rates, as painful as they are.

In the past, the utilities industry has developed rate structures that encourage excessive energy consumption. These promotional rates are often at lower levels than the cost of the energy provided, and thus give a perverse incentive at a time when conservation is our goal. Regulatory authorities should eliminate such rate schedules promptly.

While the Federal Government will not pre-empt the regulatory functions of the States, the States must meet their responsibilities fully.

In addition, the restructuring of the investment tax credit and its increase from 4 percent to 10 percent for the utilities (the same as for businesses generally) will assist these companies in overcoming their financial problems. The new proposal that dividends paid on qualified preferred stock also be allowed as a deduction to the paying corporation will also help the utilities improve their capital structure, and energy conservation measures, mandatory and voluntary, will hold down future financing requirements of utilities.

Thrift Institutions

Our savings institutions are another victim of the twin scourges of high inflation and high interest rates. To correct this situation, we must bring inflation down. However, we must also provide the means for the thrift industry to restructure itself—to give these institutions the ability to compete on an equal basis in the financial markets and to operate effectively under all interest-rate conditions To this end, we urge prompt passage of the Financial Institutions Act of 1973.

The Act will reduce the structural differences between commercial banks and thrift institutions, primarily by permitting the thrift institutions to engage in additional deposit and credit activities. Passage of this Act would provide a broader range of financial services for consumers and a higher rate of return for savers. It would improve income and liquidity in the thrift institutions. The Act also contains provisions that will improve and support the mortgage market.

In addition, we support the proposals now under consideration in both the House and Senate to increase Federal insurance on private deposits. We recommend an increase from $20,000 to $50,000. Such an increase will reinforce public confidence in our financial system.

The Budget

Control of the Federal Budget is a vital component of our antiinflation efforts. Reducing the fiscal 1975 budget is the first step in reducing the powerful momentum of our rapidly climbing Federal budget and thereby gaining the spending control so necessary for 1976 and beyond. And this extended budget control will substantially reduce inflation over the longer term.

This should not suggest that budget control has no short-run benefits. Quite the contrary. A reduction in the deficit for fiscal 1975 would reduce pressures in the financial markets, lower interest rates and provide more credit for housing and other new capital investment. It would mean that monetary policy would not have to bear the full burden of economic policy restraint. And it would reduce inflationary expectations by demonstrating convincingly that the Federal government is putting its own financial house in order.

Our program for fiscal discipline has elements on both sides of the budget. On the revenue side we have proposed a tax surcharge on high-income taxpayers and corporations. The increased revenues from the surcharge will pay for the additional unemployment insurance, the Community Improvement Program, the increased and restructured investment tax credit and the revised tax status of preferred stock dividends.

On the expenditure side, the President has reaffirmed his intention to hold budget outlays for fiscal 1975 to below $300 billion. Cutbacks of over $5 billion will be needed to reach the goal. We are already in the fourth month of the fiscal year; thus reductions of the amount required will be difficult to obtain. There is need for rapid action, and the Congress and Executive together will need to work together quickly and effectively to put expenditures on a long-term track that is consistent with the productive capacity of the American economy and with what the American people are willing to pay for.

The President has asked the Congress to enact a bill setting a spending target for fiscal year 1975 of less than $300 billion. In establishing that target, the bill outlines a plan for developing a set of actions that would result in the necessary spending reductions of FY 1975. These actions would be transmitted to Congress for its consideration when it returns in November. The actions to hold down spending will concentrate on those programs that serve special interests, create inequities, or are less essential at this time when fiscal discipline is so important. Concurrence of the Congress in these proposals before the beginning of calendar year 1975 is essential if the $300 billion target is to be achieved.

The Administration together with the Congress have already begun to take action on this outlay control program in national defense activities. The Congress has passed, and the President has signed, a defense appropriation bill that will reduce defense outlays in FY 1975 by about $2 billion. This is the largest single cut we will be making and is a good start toward the $300 billion goal.

The remainder of the necessary outlay control plan will be carried out in the fullest spirit of cooperation with the Congress. Rapid consideration by the Congress of legislative proposals and budget rescissions and deferrals under the Congressional Budget and Impoundment Control Act of 1974 will be essential if we are to meet our goal. Only through the most careful consultation with the Congress can we succeed. We must achieve a mutual understanding of the best ways to hold down the budget.

We also have to improve the content of the budget. As now stated, the budget—because it does not adequately show the impact of the Government's credit program—does not present to the American people a complete picture of Federal activities and their effect on the economy. The Federally sponsored credit agencies and the many guarantee programs must be brought into the budget more directly.

The table below shows the estimated impact on budget expenditures and receipts of the proposals in this message.

BUDGET IMPACT

[In billions of dollars]

	Fiscal year— 1975	Fiscal year— 1976
New proposals:		
Additional revenues:		
Tax surcharge:		
Corporations	+0.6	+1.5
High-income individuals	−1.0	+1.6
Revenue losses:		
Employment assistance [1]	−.1	−1.3
Housing program	−.1	−.1
Investment tax credit:		
Individuals	−.1	−.5
Corporations	−.7	−2.0
Preferred stock dividends: Net impact	+.6	−.9
Pending tax reform bill:		
Pending tax reform:		
Increased oil taxes	+1.3	+2.2
Closing loopholes [2]	+.1	+.8
Simplification		−.4
Other tax reform	−1.0	−.2
Low-income relief	−.9	−1.6
Recommended addition		−.4
Net impact	−.5	+.4
Budget impact of new and pending proposals	−.1	−.5

[1] For fiscal 1975, this assumes that a 6 percent unemployment rate triggers the program into effect on Mar. 1, 1975 Note, however, that the total expenditures for this program in fiscal 1975 will be $900,000 000; $800,000,000 is already included in earlier budget estimates. For fiscal 1976, this assumes that the unemployment rate falls below 6 percent and thus triggers an end to payments as of Dec. 31, 1975.

[2] Minimum tax on income and limitation on accounting losses.

Note: In addition to the above items, new expenditure deferrals and recissions will be proposed to hold fiscal 1975 expenditures below $300,000,000,000.

Tax Proposals

SURCHARGE

1. *Corporations*

A 5 percent corporate tax surcharge will be imposed effective January 1, 1975, and continuing through December 1975. The surcharge will be computed by multiplying the corporate tax (before credits against tax, but including the additional tax for tax preferences) by 5 percent. For corporations with taxable years ending in 1975 or beginning in 1975 and ending after 1975, the surcharge will be computed on a pro rata basis according to the number of days of the taxable year in 1975.

2. *Individuals*

A 5 percent individual tax surcharge will also be imposed for 1975 on income tax liabilities attributable to income above an upper income threshold.

In general, the proposal is designed to exclude from surcharge families with adjusted gross incomes below $15,000 and single persons with adjusted gross incomes below $7,500. However, because income tax liabilities are based on "taxable income" rather than "adjusted gross income," it is necessary to translate, on some average basis, the $15,000 and $7,500 into comparable "taxable income" figures. That was done as follows:

	Families	Single persons
Adjusted gross income	$15, 000	$7, 500
Standard deduction	−2, 000	−1, 300
Exemptions (assuming 4 for families, 1 for single person)	−3, 000	−750
Total	10, 000	5, 450

Thus, the surcharge will be expressed technically as a surcharge on tax liabilities attributable to that portion of the taxpayer's "taxable income" in excess of the $10,000 or $5,450, as the case may be. Not all taxpayers have the same deductions and exemptions as those assumed above. For example, there will be married taxpayers with more exemptions and deductions than those assumed, who will pay no surcharge even though their adjusted gross incomes are somewhat greater than $15,000. Conversely, some with fewer exemptions may pay surtax even though their adjusted incomes are somewhat less than $15,000.

The computation is straightforward. The taxpayer (1) computes his regular tax, (2) subtracts from that the amount of tax applicable to either his $10,000 or his $5,450 exemption, and (3) then multiplies the balance by 5 percent. For example, a family of four filing a joint return and having $20,000 of taxable income would calculate a regular tax of $4,380 and subtract from that $1,820 (the tax on the first $10,000) to arrive at $2,560 which is subject to the 5 percent surcharge of $128. A single person with $10,000 of taxable income would calculate a regular tax of $2,090 and subtract from that $994.50 (the tax on the first $5,450) to arrive at $1,095.50, which is subject to the 5 percent surcharge of $54.78.

INVESTMENT TAX CREDIT

The proposal to change the investment tax credit has three principal parts: (1) the elimination of existing limitations and restrictions on the credit which tend to discriminate unfairly between the types of taxpayers and investments which qualify for the credit, (2) an increase in the rate of the present credit from 7 percent to 10 percent, and (3) making the credit a reduction in basis for depreciation purposes.

1. *Present law*

An amount equal to 7 percent of the cost of qualifying property (generally, tangible personal property used in a trade or business) may be offset directly against income tax liability, with the following limitations based on the expected useful life of the property:

Useful life:	*Percent of cost of property qualifying for credit*
0 to 3 years	0
3 to 5 years	33⅓
5 to 7 years	66⅔
7 years and over	100

Public utility property qualifies for only a 4 percent credit (The Ways and Means Committee has tentatively decided to remove this limitation).

The maximum credit which may be claimed in a taxable year is limited to $25,000 plus one-half of the excess of tax liability over $25,000.

Excess credits (limited by the above provision) may generally be carried back three taxable years and forward seven taxable years, after which they expire if still unused.

2. *Proposed changes*

Increase the rate from 7 percent to 10 percent. This will increase cash flow for all companies in the immediate future. It will be offset in future years by lesser depreciation deductions.

Eliminate the limitations based on useful life so that all property with a life in excess of three years will qualify for the full credit.

Eliminate the discrimination against public utility property so that it will qualify for the full rate and otherwise be treated the same as other qualifying property.

Replace the present limit on the maximum credit which may be claimed with eventual full refundability for the excess of credits over tax liability. Credits in excess of the present limitations may be carried back three years and then to the succeeding three years to offset tax liability, after which time any remaining excess credits will be refunded directly to the taxpayers. This will

Help growing companies which have present investments which are large in comparison with their current incomes.

Help companies in financial difficulties which get no benefit from credit because they have little or no income tax liability against which to apply it.

Help small businesses, which under present law are more severely affected by the restrictions and limitations.

The three-year rule postpones adverse budget impact until revenues from basis adjustment are sufficient to offset revenue loss from this refundable feature.

Require the taxpayer to reduce the cost of qualifying property for depreciation purposes by the amount of the investment tax credit. This makes the credit neutral with respect to long-lived and short-lived assets and removes the present discrimination against long-lived assets.

Retain the present $50,000 per year limitation on qualifying used property.

DEDUCTION FOR DIVIDENDS PAID ON CERTAIN PREFERRED STOCK

To encourage expansion of corporate equity capital and increase the effectiveness of capital markets, it is proposed that dividends paid on qualified preferred stock be allowed as a deduction to the payor corporation. The provisions of the Internal Revenue Code providing for exclusions for dividends received by corporations would not be applicable to these dividends.

The deduction would only be available for cash dividends paid on preferred stock issued after December 31, 1974, for cash or pre-existing bona fide debt of the issuing corporation. For these purposes, preferred stock would be required to be non-voting, limited and preferred as to dividends and entitled to a liquidating preference. The intention to qualify preferred stock under this new provision of the Internal Revenue Code would be required to be clearly indicated at the time the stock was issued.

THE TAX REFORM BILL

1. *Low-income taxpayer relief*

We support the Tax Reform bill now pending in the Ways and Means Committee. It provides about $1.4 billion of tax relief for individuals with incomes of less than $15,000. In addition, the Tax Reform bill would produce a long-term revenue gain of about $500 to $600 million per year beginning in FY 1976 and we support using those revenues when received also to provide further income tax reductions for lower income families.

The principal individual tax reductions provided in the bill are increases in the minimum standard deduction, the standard deduction and the retirement income credit and a new simplification deduction which for most taxpayers will be larger than the miscellaneous, hard-to-compute deductions which it would replace.

The tax reductions in the bill are made possible primarily by revenues gained from tax reform measures and by increased taxes on oil producers. The tax reform proposals are based on Treasury proposals advanced a year and a half ago. The two main features are: (1) a minimum tax, designed to ensure that all taxpayers pay some reasonable amount of tax on their economic income, and (2) a provision (know as "LAL, i.e., limitation on artifical accounting losses) designed to eliminate tax shelter devices under which tax is avoided through the deduction of artificial losses which are not real losses.

In December 1973, the Treasury proposed a windfall profits tax on oil, which is now incorporated in the Tax Reform bill in modified form. The Committee has also provided for the phase-out over three years of percentage depletion on oil and gas.

The Committee bill raises less revenue from tax reform and oil taxes for calendar years 1974 and 1975 than the Treasury proposed. The Treasury hopes that Congress will restore some of the reform which the Treasury proposed. However, it is most important that tax reform and tax reduction legislation be enacted as promptly as possible and the Administration will support the bill in its present form.

2. *Savings and investment proposals*

Greater productivity in the next several years will be critical in winding down the wage-price spiral. That will require major new investments.

The Tax Reform bill now pending makes an important contribution by (i) bringing the investment credit for utilities up to the credit generally applicable for other industries, (ii) liberalizing the treatment of capital gains and losses, and (iii) eliminating U.S. withholding tax on foreign portfolio investments, thus encouraging investment by foreigners in the United States.

TAX EXEMPTION FOR INTEREST ON SAVINGS ACCOUNTS

Various proposals have been made to exempt interest on savings accounts. We do not support any such proposal for reasons which include the following:

(1) It would initially *decrease* the aggregate amount of saving. A $750 exemption for interest on time and savings deposits would cost about $2 billion, which the government would have to borrow in the private market to make up. That borrowing reduces the amount of savings available for private investment.

(2) It would *not be effective*. It would not substantially increase savings deposits because the tax exemption would not be a major benefit to most taxpayers. For a taxpayer in the 25 percent bracket, exemption would make a 5.25 percent account equivalent to a 7 percent taxable account, which is still considerably below the rates available elsewhere. Only high-bracket taxpayers would get major benefits.

(3) Passbook savings may increase some, but total savings will not increase. The principal effect would be some switching. It doesn't operate as an incentive for new savings because it doesn't reward the *increase* in savings.

(4) It would create new distortions in the credit and investment markets.

Citizen's Action Committee to Fight Inflation

The following Citizens have already agreed to help organize and support a voluntary private sector effort to mobilize all Americans in the fight against inflation:

Mayor Joseph Alioto of San Francisco, chairman, U.S. Conference of Mayors.
Arch Booth, president, Chamber of Commerce of the United States.
Russell W. Freeburg, White House coordinator.
David L. Hale, president, United States Jaycees.
Mrs. Lillie Herndon, president, National Congress of Parents and Teachers.
Robert P. Keim, president, The Advertising Council.
Mrs. Carroll E. Miller, president, General Federation of Women's Clubs.
William J. Meyer, president, Central Sprinkler Co., Landsdale, Pa.
George Myers, president, Consumer Federation of America.
Ralph Nader, private citizen.
Leo Perlis, director of community service, AFL–CIO.
Sylvia Porter, national syndicated columnist.
Governor Calvin Rampton of Utah, chairman, National Governors Conference.
Stanford Smith, president, American Newspaper Publishers Association.
Frank Stanton, chairman, American National Red Cross.
Roger Fellows, 4–H, University of Minnesota.
Vincent T. Wasilewski, president, National Association of Broadcasters.
Roy Wilkins, executive director, National Association for the Advancement of Colored People.
Douglas Woodruff, executive director, American Association of Retired Persons.

Secretary SIMON. As you know, I have a Cabinet meeting at which time I have to report to the President on my trip. I leave for Russia this afternoon, so I brought Ed Fiedler, my Assistant Secretary for Economic Policy, and my Assistant Secretary for Tax Policy, Fred Hickman, with me, and they would be delighted to remain and answer questions, and I can stay until shortly after 10 o'clock, if that is all right with you.

Senator PROXMIRE. That is fine. We appreciate this very much, and it was thoughtful of you to stay until 10 o'clock or a little after, and we certainly want to take the full time period.

Now, as I indicated, I have been very critical of the President's program and so have many others, because it does not seem to zero in on what seems to be the heart of the inflation situation to a big extent. When you look at the Wholesale Price Indexes of yesterday, you can see this really, really large increase in particular areas, some of which have shortages, and some of which do not have shortages.

So, we are actually producing less this year with far higher prices than last year, even though higher prices were supposed to bring forth more production.

Steel is a conspicuous example. We had the leaders of the steel industry in, as you may know, earlier this week, and they pointed out that there is a price increase in steel that according to the latest figures is 45 percent over last year, 45 percent. Just think of that enormous increase, more than twice the greatest increase that we ever had in history in any year. Now we are producing less steel than before, and there does not seem to be much of an answer for that, no justification in terms of costs, more than twice as great an increase as can be justified in terms of costs, and they stipulated to that. They had no showing to disagree with our figures on that.

We have a similar situation in chemicals, with an increase in industrial chemicals of 62 percent in price. We have an immense increase in the price of oil in the last year. Some of that is related to the foreign situation. Some of that is not. It does not seem to be related to cost. The profits, in all these areas, have gone right through the roof, and we are producing less gasoline than we were last year.

Now, my question, Mr. Secretary, is why did the President ignore bringing real pressure to bear in this area, using the power that he has, and only he has, as the President of the United States, to jawbone these prices, to use our procurement powers, to use our stockpile power, and other powers used by Presidents in the past to hold these prices down?

Secretary SIMON. Mr. Chairman, I would like to say several things—one just on a technical point. This producing less gasoline, that is something that occurs every year at this time.

Senator PROXMIRE. I am not talking about this time of year. I was talking about July and August. We authorized this very carefully on a seasonal basis.

Secretary SIMON. When that occurs, it is called turning the screw in the refinery. They stop producing gasoline and start producing heating oil for wintertime consumption. The consumption of gasoline subsided rather dramatically, we believe in response to the higher prices. Inventories of gasoline were higher and gave the refineries an opportunity to stock up on fuels rather than gasoline. But that is just a technical point. I have spoken to a lot of the financial, and indeed regular type, reporters, editorial and otherwise. I think their articles reflect their individual economic ideologies. Just as you have an opinion on certain things that should be done, we believe we have certain things that should be done.

Senator PROXMIRE. Let me just interrupt to say what troubles me is, for instance, the 5 percent surtax which is one you have indicated, one of the most important parts of the President's program. I do not see how that can possibly do anything about these terrific increases I have talked about in the concentrated industrial areas which have administered pricing. It does not seem to be a matter of excessive demand even there, and certainly in the rest of the economy operating so far below capacity, and where you have retail sales, in real terms, below what they were last year, where you have unemployment increasing and people working short hours. I just do not see how that particular prescription really goes to the heart of this problem.

Secretary SIMON. That was not the purpose of that particular prescription. We think, when we talk about capacity utilization in our country, you will find that many of our basic industries are still operating all-out. The demand exceeds their ability to produce.

Senator PROXMIRE. Such as——

Secretary SIMON. Steel, chemicals, paper, cement, all of these industries are——

Senator PROXMIRE. It still does not seem to be doing that.

Secretary SIMON. We talk about a figure of 90 percent, which was the last number I saw on utilization rates. One thing on which I have a difference of opinion with you, Mr. Chairman, only because it is too early, I do not think that we should prejudge the effectiveness of the Council on Wage and Price Stability. They have just come into being. The Director just came on board last week. We are having our first meeting this afternoon, and I believe it can be effective in meeting with industry, labor, management on the subject of reasonable prices and reasonable wages. So let's not prejudge that.

Senator PROXMIRE. Then may I ask what the purpose of surtax is, if it is not to limit demand?

Secretary SIMON. When we look at the surtax, when we look first at the problems, the multidimensional aspects of our inflation problems, we recognize that it was not going to be cured in a short period of time, I think you will agree with that, Mr. Chairman. There are no instant cures to this. It is going to be a battle that is going to take perhaps several years to bring it down to what you and I might describe as an acceptable rate of inflation. It took us years to get into this mess, so it is not going to be cured overnight. We recognize there are those who are going to bear a disproportionate burden of disinflation or anti-inflationary policies that we are putting into effect. We recognize that we need to assist some of these areas: the housing area and the unemployed. The degree of help, I guess we can argue, is an honest difference of opinion. We think we have put enough money into the program to assist it. We also note it was more to increase productive capacity in this country, and to give the incentives, and we felt that the investment tax credit was a proven method of getting additional investment, plus the preferred stock issues which, of course, is smaller.

Now, these are revenue losers. Our goal is to work toward a balanced budget. I think you and I both share this goal. Perhaps, the timetable between you and I would be different.

Senator PROXMIRE. The way I think we differ, Mr. Secretary, is the way in which we achieve that balance. I would make far sharper reductions in spending programs where the President says they are not untouchable. He has not given as much in the way of leadership for reducing military spending, which constitutes about 80 percent of what is controllable. We can act on it or on military foreign aid, or many of these other areas.

Secretary SIMON. Everybody has got their pet peeve about the $305 billion expenditure.

Senator PROXMIRE. I am going to cut everywhere. This is the one area that seems to be a ripe area for reduction.

Secretary SIMON. There is no sacred cow.

The Defense budget is going to be cut, just as everything else will be looked at. We also suggest that the list that is waiting for the Congress upon its return is going to be a political nightmare as far as the sacred cows and the pets of various special interests.

Senator PROXMIRE. You see, there is another dimension that has not been mentioned very much. One thing you can do in cutting Federal spending moderately is to zero in on precisely the areas we have discussed, where there may or may not be shortages, and where prices are going up very fast. Steel is one area, oil is another, chemicals is another. I submit the Federal Government is by far the biggest customer in all of these areas. It buys far more oil than any other customer buys. It buys a good deal of steel in various places, procurements and so forth, expecially in the military area. So here is where moderating Federal spending can have an explicit, direct, favorable effect in easing the pressure on prices that have been the most explosive and the most inflationary.

Secretary SIMON. The Defense Department uses 73 percent of the total energy used in the Federal Government, and the Government's number on overall usage is 3 to 4 percent of overall usage. The Defense Department cut back 28 percent in their consumption of total energy and those cut backs pretty much remain in place.

Our total fuel savings for oil conservation throughout the Government was approximately $360 million last year, which is quite impressive.

Senator PROXMIRE. Well, Bill, there are many areas where we could, I think, make further cuts.

Secretary SIMON. I agree with you, and I think we should do that. You know very well, Mr. Chairman, I am probably as big a hawk as you are as to cutting spending as much as possible. We have gone a third of the way through the fiscal year, just about, and we started working on the budget cuts, and the $5 billion plus budget cut is going to be a tough one to do. And I think you and I recognize that, and I want to do that.

I stand behind you to cut further if you can find things to agree on to cut.

Senator PROXMIRE. Then there is the statement in your presentation before this Committee. You say the Congress has passed and the President has signed a Defense appropriation bill to reduce the Defense outlays this year, 1975, by about $2 billion, a pretty modest reduction. This is the largest single cut we will be making and a good start toward the $300 billion goal.

My point is that we can go further, and we should, and I hope we do. Now, I would like to, in just the remaining minute or 2 I have got before I yield to Senator Percy and Congressman Reuss, I would like to point out there is one area where we can have a very favorable double effect on this puzzling, perplexing problem of recession and inflation at the same time. That is in the housing area. The President said he favored the Cranston-Brooke proposal, but he indicated he would only use $3 billion of the $10 billion they originally proposed in the $7¾ billion that was finally passed.

Now, this seems to be grossly inadequate in view of the fact that you have unutilized resources in this area. You have 12 percent unemployment in the construction trade. We are down a million starts from last year. This is one area where a more vigorous Federal program could really put people to work without an inflationary impact, and we have been told again and again on the floor of the Senate the President is going to veto the bill as it passed the Senate because we provided that the mortgages would be procured by the Federal Government at the cost of the Treasury borrowing rate, plus one-half of a percent for administrative costs, which we feel is very close to eliminating any kind of a subsidy and would mean about an 8½ percent mortgage for the homebuyer, much better than the 9¼ which your representatives and the housing people say that is the way they would handle the program.

Secretary SIMON. Of course that lower rate is a subsidy, Mr. Chairman, as you know.

Senator PROXMIRE. It is not a subsidy. It is not a subsidy if it does not cost the taxpayer anything. It would be the cost of the Treasury, of the money that they borrow, 6-to 12-year funds, which is the area where the mortgages would fall, plus one-half of 1 percent of that adds up to 8¼ percent.

Secretary SIMON. And when these mortgages are packed and resold in the marketplace, the rate would be higher than that. However, that is another argument.

When we talk about housing, we recognize that that has been the hardest hit sector. When interest rates go up, we all recognize the contracyclical effect in housing, the contracyclical role that housing has always played.

We have in the past year put $19 billion into favoring the housing industry. This would be another $3 billion. The only way permanently and really to help is to bring down the rate of inflation which is going to bring down interest rates, and that is when we will see the reflow of money to the thrift institutions, which have been the traditional supplier of funds for housing.

Senator PROXMIRE. Well, you are saying then this program that the President singled out in his message would not help housing significantly.

Secretary SIMON. It is going to help most certainly.

Senator PROXMIRE. We say we ought to do it in an ambitious way, 250,000 housing starts, instead of 100,000.

Secretary SIMON. It really goes to an area that has not been helped before, and that is the conventional mortgage side. This time the conventional mortgage limit was raised to $45,000, so we are helping another area; yes.

Senator PROXMIRE. Senator Percy.

Senator PERCY. Secretary Simon, I would first like to welcome you in your new role as Chairman of the Economic Policy Board and congratulate the President on your appointment. I think it is very important for you to put together economic policy now and try a uniform approach.

Now, some are confused as to whether or not we are in a recession, or not. The President indicated that he does not think we are. And I know the term "definitions" can be confusing.

Arthur Burns said yesterday we were. What does the Secretary of the Treasury say this morning?

Secretary SIMON. Well, you mentioned yourself, Senator Percy, it depends whether we are talking technically or not. What Arthur Burns said yesterday when you tried to pin something down, are we technically in one, or what is the difference? It is a game of semantics.

The National Bureau of Economic Research is the only entity that everyone accepts as the body that will say whether we are officially in a recession or not. The last pronouncement of the National Bureau was a month ago that due to the lack of depth, duration, and diffusion, they cannot call this, classify it a recession.

Now, I have no idea whether that will continue next month or the month after. The one thing we do know is that we are suffering with a stagflation, a very sluggish economy in many areas. And there again, there is a dichotomy because capital spending remains tremendously strong. So this really is a most difficult period for us and that is why we are attempting through this program to attack it on a broad front. And there again, before you came in, Senator Percy, I remarked that there is never going to be agreement that we are doing all the right things. Everybody has got a different opinion, as we heard in the pre-summit meetings and the big summit meetings, on what should be done.

One side wants wage and price controls, the other side is opposed to that. The middle, or slighly right of the middle, wants guidelines.

Senator PERCY. Can I ask one question now before we might all reach agreement and even all of those brought to the summit, but under the two problems, recession and inflation, we are faced with, Arthur Burns said this parallel of inflation is by all bounds the worst of the two and much more severe and much more difficult to control now than the recession, because we do know certain things that can be done to pick the economy up in certain areas.

Secretary SIMON. That is correct, Senator Percy. That is the No. 1 enemy still. That is what we ought to focus on.

Senator PROXMIRE. It most certainly is.

Senator PERCY. It is said that Federal spending does have an influence. We do not want to overplay the influence. It is a psychological influence.

Secretary SIMON. I think it is much more than psychological, and, so do Arthur Burns and Arthur Greenspan, and so do many other private economists. Certainly we differ on the degree, but none of them differ on the assumption, that over the long run, control of Federal spending has a cumulative effect on our inflation problem.

Senator PERCY. Now I have talked last night to George Mahon, the powerful chairman of the House Appropriations Committee. The House intends to pass today the bill to limit Federal spending to $300 billion.

I put out a current resolution the day before yesterday with the support of the chairman of our appropriations committee, the majority and minority leaders, and the chairman of the Budget Committee, and named it at $300 billion, just as the President has asked us.

Now the history of that is that we passed three bills in the Senate to cut it to $295 billion. I voted for every one of those. I believe in it, but now it is 3½ or 4 months along the route. Before we take effect on this it might be 6 months. So that the $295 billion cut that is now reaching for the moon and we may not get it. Is it better than to have a bird in the hand and today pass in the Senate and in the House a $300 billion limitation and have the President then use those 30 days to send us $5 billion of a cut that we can start to work on?

Secretary SIMON. Yes; we believe it is, Senator Percy, and that is exactly what the President has suggested. Not only that, but we are going to have to exercise restraint on additional legislation when we get back, that would again bust the budget.

Senator PERCY. If we set a limit and as the President said, a spending limit of $300 billion, does that in any way detract from his ability to send forth a revision of the 1975 budget that is even less than that if, in this period of some 30 days, OMB, the President, the Chairman of the Economic Policy Board, can find other areas that they can suggest to the Congress that this budget can be cut?

So by passing the $300 billion limit we are not limiting our ability to send even greater cuts if they can find them.

Secretary SIMON. That is correct. That is exactly what we are looking for now. There, again, as you correctly mentioned, Senator Percy, we are a third of the way through the year and it is extremely difficult to look forward more than that.

Senator PERCY. The chairman, the distinguished Senator Proxmire, and I disagreed the morning after the President's address to Congress on the effectiveness of the program that the President has presented. It is a complex problem, very difficult. A lot of unhappy choices had to be made. But I felt on balance it was a significant step forward.

Now we just disagreed with each other on that, and that is the nature of the business here. We can have our different views, but I would like to ask your judgment because of your knowledge of Wall Street. It seems to me that some of the most sophisticated minds in the world are there analyzing and appraising every single day the stock market.

Why, in your judgment, the day after the President announced this program, the next day after that why did we have such an immediate and strong response from the most sophisticated financial minds to the President's program if it were no good?

Secretary SIMON. Senator Percy, if you think that there can be differences of opinion in this great country on economic policy, and what changes should be made, you ought to go up on Wall Street and find out about the differences of opinion on why markets move, and why they are going up, and why they are going down.

The individual has, so I have been reading in the last 2 days, has been the recent strong participant. There has also been great institutional interest as well and the institutional selling has dried up.

I think that they are perceiving this package, recognizing that it takes a long time, the market always anticipates the future. It is not reflecting what is going on today. I think that the American people believe that we have a program. They know what our firm policy is. I think that that has given them a measure of confidence. I think that we can win this. I think we have finally gotten our message across that there are no short-run, quick-fix solutions, that we finally are attacking the causes of inflation and not just going after the results which we have so traditionally done. And if we are firm in our resolve and if we get the legislation that we have requested from Congress which is an integral part of this entire program, we will begin to see some very good results certainly by spring or summer of next year.

I will make that forecast very confidently, Senator Percy.

Senator PERCY. I have proposed productivity councils in every plant in America, in every office, every Government office. They have workers and management together to bring unnecessary costs down to achieve our objectives. I would now be willing to modify that and would modify it to propose that we have WIN councils all over and that we actively engage millions of people in this effort in almost group therapy action acting as catalysts to each other to find new ways to bring unnecessary costs down and lick inflation.

Would you put your stamp of approval behind creating such councils?

Secretary SIMON. Well, yes, we most certainly would. That is part of the voluntary program, because we must enlist the American people in this battle. It is for all of us; it is not a spectator sport.

Senator PERCY. Just a matter of interest to the two of us right now, I told Senator Proxmire I was rather surprised that I had to borrow a pin on that Today program the next morning, and then the President the next afternoon borrowed it back for his press conference. Apparently, productivity is very low on WIN pins. When are we going to have more pins so we can spread them around.

Secretary SIMON. I asked that question the morning after the message and I am told it is going to take 2 to 3 weeks to get them. I think we should have gone to the private sector to have them made.

Senator PERCY. I was aghast when a former competitor of mine Eastmann-Kodak announced worldwide the Instamatic camera and had immediate 1-day delivery every place in the world on a remarkable new product like that.

I thought that was—I know what it felt like to be a competitor of theirs and see the gigantic distribution system. I hope we can get these WIN buttons out pretty fast.

Secretary SIMON. Yes, sir.

Senator PERCY. I wonder if you could comment on interest rates. A Washington bank reduced the interest rate prime rate to 11½ percent this morning. That should stimulate the market a little bit more as we bring the debt cost down.

What do you foresee ahead for interest costs and how can you interpret Chairman Burns' comment about easing the monetary crunch?

Secretary SIMON. I am heartened by last week's figures which were reported in the press yesterday and today on the slight increase in money supply. This was reinforced by Chairman Burns' comments that while he will continue to be moderately restrictive, the money supply will grow at a more normal rate than the rate of 1½ percent that has been extant in the recent past.

49-316—75——3

I am also heartened, but I must wait until I see further weeks develop, that the increase in commercial and industrial loans dropped rather sharply as reported yesterday.

Both of these developments will have an impact on interest rate reductions. We have seen the prime rate go down. I think a bank in St. Louis reduced its rate yesterday. And if these figures, primarily the ones I mentioned, remain and continue as they did, I look for further reductions in interest rates as well.

Senator PERCY. I have one last question. I see Congressman Reuss is not back yet. I fully support the 5-percent corporate surtax. I think we have to pay it on higher incomes as well, personal incomes. We have to pay the cost of some of these extra programs like public service jobs that are being added, and we had better learn that we had better pay it. It is better for everyone in the end to pay those costs than to have inflation continue.

I would like to ask your judgment on the investment tax credit, which I also support at 10 percent; what effect this can have and will have in expanding production and improving the cost reduction, the incentive to buy equipment to bring costs down and therefore prices down, and particularly with respect to utilities being raised from 4 to 10 percent, which I think is long overdue.

What impact do you see that having on the average person, of what benefit it is to the average consumer today to have that kind of an incentive?

Secretary SIMON. That, of course, is exactly the person, who is the ultimate beneficiary of increased productive capacity in this country. As we increase capacity and we are able to supply larger amounts than the demand—which ability in many industries does not exist today—that brings the prices down. I think utilities will probably be the major beneficiary, not only in the investment tax credit going from 4 to 10 percent, but there are two other measures that we recommended that are going to assist many of the public utilities as well as other industries—small business and some of the other industries as well. The first of these is the restructuring of the investment tax credit with a refundable feature for those companies that presently are infinancial difficulties that have no tax liability and for companies that are growing and require more investment than they have income and thus inadequate income tax liability to absorb the credit. And they are going to receive a refund 3 years after the normal corporation would.

Another very positive feature is the preferred stock feature, the deductibility of dividends by corporations, which enlarges their market and will enlarge the preferred stock market that today pretty much is restricted to corporation purchases due to the 85-percent dividends received deduction.

So all of this is going to help. But again, I emphasize that when you look at each component of this package, the 32 pieces of legislation, the administrative actions that were taken, it is a very comprehensive package and when we look ahead 6, 8 months from now and the actions, hopefully, have been taken, then people will begin to perceive exactly the effects that these will have in every area from Government regulation to antitrust to the energy area, everything.

Senator PERCY. Thank you very much.

Senator PROXMIRE. In the absence of Congressman Reuss he asked if the committee will permit him to permit John Karlik, who is the committee's expert in many areas including foreign economic policy, to question the Secretary.

Senator PERCY. I have no objection at all.

Senator PROXMIRE. Mr. Karlik, if you would go ahead.

Mr. KARLIK. Thank you, Mr. Chairman.

Mr. Secretary, Mr. Reuss asked me first to thank you for your answer to his letter of August 16, regarding U.S. policies on floating exchange rates, and our attitude toward the national monetary reform drafted by the Committee of Twenty. He appreciates your response, finds it generally sympathetic to his views, and hopes that when the provisions regarding authorization to float are drafted as amendments to the IMF articles, they will reflect his view and views you have expressed in this letter.

Secretary SIMON. Will you please assure Congressman Reuss that we obviously agree on the whole broad area of floating rates and international monetary reform. We might have some minor disagreements; however, we are fully aware of not only his great expertise in this area but of his great interest as well. And we will work with him as well as other Members of Congress as we develop these policies.

Mr. KARLIK. Thank you. Mr. Chairman, Congressman Reuss requested that his letter of August 16, and Secretary Simon's response be included in the record.

Senator PROXMIRE. Without objection.

[The letters referred to follow:]

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
August 16, 1974.

Hon. WILLIAM E. SIMON,
Secretary, U.S. Treasury Department,
Washington, D.C.

DEAR MR. SECRETARY: On June 14, as you know, the Committee of Twenty established by the International Monetary Fund submitted its final report, accompanied by an Outline of Reform. The Committee on Reform of the International Monetary System and Related Issues, as it was formally known, has—apparently with your assent and that of the Treasury—sustained the drift toward a return to fixed exchange rate parities as the basis of the international monetary system. This trend disturbs me, since it conflicts with the policy recommendations of the Joint Economic Committee, on which I serve, and with what I understood to be the avowed position of this Government.

I.

The First Outline of Reform, presented by the C–20's chairman on September 24, 1973, stated that:

The main features of the international monetary reform should include: an . . . exchange rate regime based on stable but adjustable par values and [with] floating rates recognized as providing a useful technique in particular situations.

This language was endorsed by Secretary Shultz in his speech before the last annual meeting of the IMF Governors in Nairobi. He said:

There is full acceptance of the idea that the center of gravity of the exchange rate system will be a regime of "stable but adjustable par values," with adequately wide margins and with floating "in particular situations."

On November 13 and on December 5, 1973, the Subcommittee on International Economics of the Joint Economic Committee and the Subcommittee on International Finance of the House Committee on Banking and Currency conducted joint hearings to review progress toward international monetary reform. Among the witnesses testifying were Treasury Under Secretary Paul A. Volcker and Federal Reserve Board Chairman Arthur F. Burns. The Joint Subcommittee on International Economics issued on January 9, 1974, a report based on these hearings. The first recommendation of this report stated:

For the foreseeable future, the dollar should continue to float in exchange markets.

The subsequent discussion listed six reasons why a continued dollar float seemed advisable to the Subcommittee members. The second recommendation said:

In the drafting of an agreement to reform the international monetary system, the U.S. monetary authorities should insist that each IMF member retain the option of letting its currency float in exchange markets without the need to obtain any advance authorization from Fund authorities. The American demand that each IMF member have an unequivocal right to float—according to mutually agreed guidelines—should be clearly enunciated when the Committee of Twenty again convenes in Rome in January.

In testimony before the Joint Economic Committee on February 8, 1974, Secretary Shultz observed, "A statement put out by a subcommittee of the Joint Economic Committee just before our own meeting was a very helpful document." I interpreted, perhaps erroneously, this statement to mean that the Secretary was in general agreement with the recommendations of the Subcommittee report and that this position had been forcefully presented at the C–20 meeting in Rome.

A bipartisan majority of the entire Joint Economic Committee endorsed and reiterated the substance of the Subcommittee's earlier recommendations in the full Committee's annual report, published on March 25. It said:

The dollar should continue to float in exchange markets and the trend of this float should not be significantly influenced in either direction by official intervention.

Furthermore, any international monetary reform approved by U.S. authorities should include for each International Monetary Fund (IMF) member, without the need for any type of prior authorization, the option of letting its currency float in exchange markets for as long as that member desires.

I am enclosing with this letter a copy of both the Subcommittee and full Committee reports for your perusal.

Despite the urgings of the Joint Economic Committee, the Treasury, in presenting the U.S. position to the other members of the Committee of Twenty, did not insist upon the option for member countries to float without the need for prior IMF authorization. The language cited above from the First Outline of Reform is repeated verbatim in the final outline presented by the C–20. Under the reformed international monetary system envisioned by the C–20, floating exchange rates will constitute an aberration and a departure from the desired norm. The Committee postulates a return to the Bretton Woods system, the essence of which was established par values for exchange rates.

Other parts of the Outline and accompanying annexes are quite explicit. For example, paragraph 13 says:

Countries may adopt floating rates in particular situations subject to Fund authorization, surveillance, and review. . . . Such authorization will be given in accordance with provisions to be agreed, on condition that the country undertakes to conform with agreed lines for conduct. . . . Authorization to float may be withdrawn if the country fails to conform with the guidelines for conduct, or if the Fund decides that continued authorization to float would be inconsistent with the international interest.

Paragraph 13 appears in Part I of the Outline, which is described as indicating "the general direction in which the Committee believes that the system could evolve in the future." But on the subject of floating rates, the intentions of the Committee and the Fund are not so tentative, since in paragraph 35 under Part II, which details steps to be taken immediately, the following statement appears:

During the present period of widespread floating, countries will be expected in their intervention and other policies to follow guidelines on the lines of Section B of Annex 4 and be subject to surveillance in the Fund as there described.

The substance of Section B under Annex 4 was therefore to be implemented immediately upon the publication of the Outline. Indeed, the guidelines contained in this section were adopted by the Executive Board on June 13, 1974.

Section B, in an apparent reference to paragraph 13 in Part I, presents guidelines for "a country authorized to adopt a floating rate." Given this reference, the Fund authorization procedure, described in paragraph 13, is apparently also in effect. Has the United States been authorized to float?

The need for explicit prior authorization from the Fund is indicated by the preliminary discussion included in Section A of Annex 4, which says in reference to Section B:

An illustrative example is set out below. Under another, more liberal approach, a country might propose to the Fund the adoption of a floating rate for its currency, and provided that the country undertook to conform with agreed guidelines for conduct, the Fund would approve such a proposal.

The procedures laid out in Section B and paragraph 13 are less permissive than this alternative.

I note that under paragraph 41 of Part II on immediate steps, "The Executive Board is asked to prepare draft amendments of the Articles of Agreement" to achieve several purposes. Among these purposes is "to enable the Fund to legalize the position of countries with floating rates." It is suggested that such draft amendments be presented to the Board of Governors, i.e., the member nations, for their approval by February 1975.

II.

The decision of the C–20 to recommend a return to "stable [i.e., fixed] but adjustable par values" ignores current realities in five respects. First, monetary authorities cannot calculate enduring par values. Second, recent history has amply demonstrated the inability of authorities to maintain par values. Third, the ability of monetary authorities to maintain any given par value is steadily diminishing. Fourth, the interventionist philosophy of the Committee of Twenty hampers the ability of exchange markets to grow and smooth exchange rate fluctuations. Fifth, the Report of the C–20 ignores the particular need of countries like the United States to rely upon floating rates.

(1) *Even Theoretically Monetary Authorities Cannot Calculate Durable Par Values*

The economic conditions that determine the abilities of trading nations to compete with one another—including rates of inflation, productivity growth, rates of aggregate economic expansion, technological innovations, and fluctuations in agricultural output—are changing continuously throughout the world and at widely divergent rates. It is folly to believe that any limited group of mortal men, such as the IMF Council proposed in the Outline, can calculate a set of exchange rate parities that will be appropriate and accepted in exchange markets for more than a matter of months, if that long. No model of transactions among IMF members is sufficiently complete, no computer is big enough, and no crystal ball is clear enough to permit the accurate forecasting of exchange rates on more than a very short-term basis. Moreover, fortuitous events are always occurring to upset any smoothly projected rate of change. Even after such random shocks have occurred, the size of their impact frequently cannot be accurately gauged.

Exchange markets must therefore be allowed to adjust to temporary phenomena. Even if subsequently part or all of this adjustment may be reversed, such a reversal, or its extent, is no certainty. To stand in the way of market-directed exchange rate changes is to block the price mechanism from inducing those responses that market participants, who far outnumber monetary authorities and who collectively possess far more extensive knowledge, believe to be necessary.

(2) *The Historical Record Demonstrates the Inability of Monetary Authorities to Set Appropriate Par Values*

The record of central bankers and finance ministers in attempting to establish exchange rates that will be durable is miserable. Nevertheless, without demonstrating any improvement in their performance, the Committee of Twenty would vest the power to set exchange rates once again in the same group of people who have botched the job so badly in the past.

Throughout the late 1960s and early '70s, central bankers and finance ministers, including spokesmen of the Federal Reserve and the U.S. Treasury, insisted that our payments deficits would eventually disappear without the need for exchange rate changes if existing programs to promote exports, curtail American tourism abroad, limit overseas investment, etc., were allowed sufficient time to have their full impact. This line of argument was stoutly maintained even though some of these programs had been initiated in the early 1960s.

After dollar-gold convertibility was suspended in August 1971, officials had two chances to reinstitute a set of exchange rate parities that would be accepted by private traders, investors, and holders of liquid assets. The first attempt came in December 1971 at the Smithsonian Conference. This set of rates lasted until the summer of '72, when British authorities decided to let the pound float. Expectations of an upward revaluation of the German mark and other European currencies strengthened toward the end of 1972, and in early '73, officials finally abandoned the Smithsonian.

But their next step was to attempt to institute a new set of exchange rate parities, and in February the Treasury once again proposed dollar devaluation—the second decrease in the nominal gold value of the dollar in fourteen months. This attempt to return to fixed rates endured for a far shorter period than the Smithsonian arrangement—less than a month. In March 1973, the authorities threw in the sponge and decided to let the external value of most major industrial countries be determined day-to-day by supply and demand in exchange markets. A group of European countries, primarily the members of the EEC, resolved that their currencies would float jointly vis-a-vis the dollar, but even this halfway house has been largely abandoned, since currently the United Kingdom, France, and Italy are each allowing their currencies to float independently.

Both abortive attempts to institute new sets of exchange rate parities for the currencies of the major industrial countries, it should be emphasized, occurred before the producer nations announced major increases in oil prices or any other economic upheaval that could not be anticipated by the officials computing the new parities.

Past attempts by officials to maintain unrealistic parities caused the United States to accumulate tens of billions of dollar liabilities to foreign monetary authorities and produced increases in the money supplies of surplus nations that fueled inflation. But without any argument to the effect that the performance of officials in attempting to establish durable exchange rate parities will be superior in the future to what it was in the past, the Committee of Twenty blandly recommended that the same authorities who fumbled their previous assignment be given even more extensive, like responsibilities in the future.

(3) *Potentially Massive Capital Flows Have Deprived Monetary Authorities of the Ability to Manage Exchange Rates*

The volume of liquid assets capable of being transferred internationally is today so large that no combination of official monetary authorities can prevent exchange rate changes from occurring if holders of liquid assets believe such changes are in keeping with economic realities.

The Bank for International Settlements has estimated that net foreign currency credits extended by banks in eight European countries and by banks in certain "Eurocurrency centers" outside Europe, such as the Bahamas, totaled the equivalent of about $170 billion at the end of March. Short-term investments in the Eurocurrency markets by oil-producing countries, with their huge payments surpluses, may cause the supply of liquid funds susceptible to international transfer to grow further this year. Nor do these totals include the huge volume of domestic currency assets in each of the major industrial countries that can move across international boundaries when strong expectations of impending exchange rate changes arise.

If officials persisted in defending a set of exchange rates among the major industrial countries that holders of liquid assets believed were patently unrealistic, assets worth scores of billions of dollars could move in attempts to avoid exchange rate losses or to realize profits. In comparison with these magnitudes, the reciprocal currency swap network among the central banks of the major industrial countries now provides the potential for loans of a theoretical maximum of nearly $19 billion. Total special drawing rights outstanding and reserve positions in the Fund amount to a similar slightly smaller magnitude. But it is virtually impossible that more than half of the resources in the central bank swap network or a similar porportion of all SDRs and Fund reserve positions could be mobilized to defend any given currency or set of currencies during an exchange crisis.

A billion dollars a day have moved through exchange markets during periods of strong expectations that rates were about to shift, and the volume of internationally liquid mobile capital is growing steadily. Under these circumstances, the apparent conviction held by the Committee of Twenty that monetary authorities can successfully defend exchange rates that are not credible in the market is an exercise in self-delusion. The only effective way to avoid massive international capital flows is to continuously maintain exchange rates that holders of liquid assets find credible. Achievement of this objective requires frequent small shifts in exchange rates, and who can better decide what liquid asset holders find credible than exchange markets themselves?

The C–20's proposed guidelines for countries authorized to adopt *floating* rates say, "A member would not be asked to hold any particular rate against strong market pressure." But why does this statement appear here—under the recommended behavior for floaters? Does it imply that IMF members who have announced fixed parties would be expected to hold to these rates in the face of strong market pressure? I would hope that no country, fixer or floater, would be expected to follow such a policy. Past errors of this type have proved far too costly, in terms of ballooning foreign debt burdens and induced inflation, to be repeated.

(4) *C–20 Interventionism Limits the Ability of Private Markets to Smooth Exchange Rate Fluctuations*

While overlooking the poor record of monetary authorities in attempting to set and maintain credible exchange rates, and while failing to acknowledge the extremely limited ability of the authorities to defend exchange rates in the face of market pressures, the guidelines proposed by the Committee of Twenty would have central banks compete with private exchange dealers in providing the short-term intermediation that commercial interests profitably can and should extend. The impact of the C–20's interventionist philosophy would therefore be to capture the profits that private interests would otherwise earn by buying currencies low and selling them high. Limiting the potential profits of private actors in exchange markets inhibits the growth of these markets and retards the development of expertise that is essential to effective smoothing of exchange rate fluctuations.

The proposed guidelines state:

A member with a floating rate may act, through intervention or otherwise, to moderate movements in the exchange value of its currency from month-to-month and quarter-to-quarter, and *is encouraged to do so*, if necessary, where factors recognized to be temporary are at work. (Emphasis added.)

Public authorities, including monetary authorities, should limit their activities to the provision of services that private interests can or will not. Private banks and other participants in the exchange rate market can and do take uncovered (i.e., speculative) positions in foreign currencies for periods from one month up to and exceeding a year. By helping to make a futures market in foreign exchange, these private speculators facilitate international trade and investment and decrease the range of exchange rate fluctuations. Their inducement for taking these uncovered or speculative positions is the expectations of profit to be gained from these dealings. In buying low and selling high—the only way to make a profit—speculators tend to shave the troughs and peaks off fluctuations in currency values. Of course, all the forward positions taken in exchange markets by private interests do not return profits, as the experiences of the Franklin National and Herstatt Banks have recently demonstrated. But if profitable as a continuing activity, speculation tends to smooth exchange rate fluctuations.

By performing the same functions themselves, monetary authorities limit the potential profits of private èxchange dealers. By reducing profits, the authorities discourage new private interests from entering the exchange market, they inhibit the taking of progressively larger uncovered positions by private dealers, and interfere with the development of additional expertise among private interests. Thus, excessive intervention by monetary authorities hampers the development of large, well-financed, and flexible exchange markets providing ample volumes of forward cover in all major currencies. Monetary authorities should restrict their activities to those jobs which private interests clearly cannot handle and should encourage private participants in exchange markets to expand their services to the maximum possible extent.

The unstated philosophy behind the Committee of Twenty's Outline and intervention guidelines, however, is that the authorities should intervene whenever an excuse for intervention can be offered, not that authorities should stay out until there is evidence that the capabilities of private dealers are being exceeded. The attitude implicit in the C–20 guidelines is one of skepticism and perhaps even mistrust toward the actions of private interests. By adopting this attitude, the Committee tends to perpetuate that very instability that it is avowedly attempting to prevent.

(5) *A Return to Fixed Rates Would Ignore the Particular Need of the United States to Float*

The Outline of Reform prepared by the Committee of Twenty fails to acknowledge any differences among countries that make floating a more appropriate exchange rate policy for some than for others. Instead, the Outline says:

Countries may adopt floating rates in particular situations, subject to Fund authorization, surveillance and review. . . . Such authorization will be given in accordance with provisions to be agreed, on condition that the country undertakes to conform with agreed guidelines for conduct. . . . Authorization to float may be withdrawn if the country fails to conform with the guidelines for conduct, or if the Fund decides that continued authorization to float would be inconsistent with the international interest.

"International interest" is one of those conveniently vague phrases that leaves ample latitude for subsequent interpretation by the IMF. Certainly no one would ask the Fund to act against the international interest. But what about the *national* interests of various IMF members? These various interests differ according to the economic characteristics of individual member states. Is it reasonable to jam the exchange rate behavior of all members into the same mold? I think not.

The industrialized countries differ markedly in the extent to which domestic production is exported and raw materials, intermediate products, and consumer goods are imported. Commercial exports and imports together are equivalent to about 10 percent of the U.S. gross national product. By comparison, the international trade of some other major industrial countries, such as Great Britain, France, and Germany, is equivalent to about 40 percent of their GNP. These other countries, therefore, can use macroeconomic demand management policies, i.e., monetary and fiscal policies, much more easily than the United States to affect their external trade positions. The United States, on the other hand, must rely relatively more on exchange rate changes to alter prices sufficiently to avoid persistent payments surpluses and deficits. The dramatic strengthening of the U.S. trade balance from a $7 billion deficit in 1972 to a $600 million surplus in 1973 reflected, in part, the contribution that appropriate exchange rate policies can make to the maintenance of international payments equilibrium.

Differences among nations in rates of inflation, productivity growth, and economic expansion require more or less continuous adjustment of exchange rates. Small changes effected by the market are preferable to large and, in the past, oft-delayed jumps calculated by authorities. For a country like the United States especially, a nation with a relatively small involvement in international trade compared to its domestic economy, floating probably is the best mechanism for avoiding persistent payments disequilibria. What if the policymakers of this country do choose frequent, small exchange rate changes determined by the market as a preferable means of adjustment to larger, occasional shifts in the par value for the dollar? The Outline of Reform drafted by the Committee of Twenty would not permit the United States the *option* of adopting floating exchange rates as a normal exchange rate regime.

III.

The Bretton Woods Agreements Act, which authorized U.S. membership in the International Monetary Fund and in the International Bank for Reconstruction and Development (World Bank), states that "Unless Congress by law authorizes such action, neither the President nor any person or agency shall on behalf of the United States . . . accept any amendment under Article XVII of the Articles of Agreement of the Fund." Article XVII specifies the procedures for amending the Articles. The Articles have been amended only once, in 1969, when the special drawing rights facility was approved. The scope of the amendments that will presumably be presented to the Congress for consideration sometime in 1975 will be broader and have a more significant impact on the future of the international monetary system than the introduction of special drawing rights. The Congress will weigh the implications of these amendments carefully and not grant rubber stamp approval.

What would the international monetary reform proposed by the Committee of Twenty do? Among other things, it would delegate to the IMF the authority of determining when member states will and will not be allowed to let the external value of their currencies be determined in exchange markets by private supply and demand. The determination of when a country would or would not be permitted to float its currency would be based on "the international interest," without apparent explicit consideration of the national interests of individual IMF members.

Floating has in the last year and a half proved to be a good exchange rate regime. International trade and investment have not been stifled but have both grown at exceptionally healthy rates. If we had attempted to maintain fixed dollar parities in the face of the political and economic upheavals of the past year, the calculations of authorities would have been sent spinning. Instead, exchange markets have adjusted quickly and reasonably easily. Trade and investment have not been interrupted, and the world has gone on quite smoothly.

In discussing the relative advantages and disadvantages of fixed versus flexible exchange rates, it is critical to distinguish between the easy certainty of hindsight and the imperfections of foresight. There is no trick to plotting the fluctuations in the average external value of the dollar over the past year and a half and drawing a trend line somewhere through the midst of these peaks and troughs. Economists advocating a return to fixed parities and monetary authorities propounding their wisdom sometimes plot such a retrospective trend to accompany the argument that if such-and-such a pattern of exchange rates had been maintained, certain unnecessary and costly adjustments resulting from excessive exchange rate fluctuations could have been avoided.

But there is a huge leap from plotting a smooth trend derived from historical data and successfully forecasting future trends. If the monetary authorities are confident in their abilities, let them place in a sealed envelope the level at which they would set dollar exchange rates and the amounts of assets they believe would be necessary to defend these rates. Then let us open this envelope a year or two from now and see if their predictions are borne out. I am extremely skeptical that the authorities performance would be up to snuff. Instead, I believe a return to fixed parities would once again mean large, disruptive exchange rate changes at irregular intervals.

In requesting the power to authorize member states to float their currencies in exchange markets according to their interpretation of "the international interest," the officials of the International Monetary Fund would assume some of the functions of an international central bank. For the United States to submit to this type of authority under the guidelines that have been proposed, I believe, would a major error. The guidelines presume far too much meddling in exchange markets by authorities. Instead, the authorities should stay out of exchange markets except when conditions arise that private interests are clearly unable to manage. The only guideline for central bank intervention in exchange markets that has appealed to me is to permit such institutions to intervene for the purpose of quelling "market disruption," i.e., when some currencies are being offered in large amounts but there are few takers at any price, while other currencies are generally desired but unavailable. Perhaps the IMF or other monetary authorities can propose additional sensible guidelines. But the guidelines proposed by the Committee of Twenty are far too permissive of intervention by authorities.

More importantly, the Outline proposed by the Committee of Twenty is far too stringent in not permitting countries to choose floating exchange rates as their normal regime. Any country which desires to do so should be permitted to float its exchange rate so long as its action does not damage the economic interests of other members. Respecting the interests of other members essentially means not engaging in competitive exchange rate appreciation or depreciation. Guidelines of this type would be perfectly easy to devise. But under no circumstances should the United States deny itself the option of resorting to an exchange rate regime which since March 1973 has proved to be in the best interests of not only this country but also the international economy community as a whole.

A new plan of reform should be drafted that would permit IMF members to opt for either fixed parities under one set of rules or floating rates under another set of guidelines. To approve the plan for reform submitted in June by the Committee of Twenty would constitute an excessive, unnecessary and unreasonable transfer of power to the International Monetary Fund. If a plan such as this is submitted sometime next year to the Congress for approval, I shall argue that it be rejected.

The time has long since passed when the United States should have asserted its national interest in IMF-organized exercises to redraft the Articles of Agreement. The next annual meeting of the Governors will provide an excellent opportunity for the United States to disabuse other members of the notion that we we will subscribe to any international monetary reform that deprives this country of the right to float the dollar in exchange markets as a normal exchange rate regime. This right should be circumscribed only to the extent that floating can be manipulated to damage the economic interests of other countries. So long as an IMF member refrains from causing such injury, there should be no limitation on its right to float.

I urge you, as the United States Governor to the International Monetary Fund, to make an unequivocal statement to this effect in your remarks to the assembled Governors at the forthcoming annual meeting. I would appreciate early confirmation of your intent to make such a statement.

Sincerely,

HENRY S. REUSS, M.C.

THE SECRETARY OF THE TREASURY,
Washington, D.C., August 30, 1974.

Hon. HENRY S. REUSS,
House of Representatives,
Washington, D.C.

DEAR HENRY: I have read with care your recent letter on floating, and I am happy to say that I believe we are in agreement on the basic elements of the U.S. position with regard to floating. As expressed in the negotiations on reform during the past two years, the U.S. position has been that countries should have maximum practical freedom of choice in deciding upon their balance of payments adjustment measures. Specifically, we have argued that countries should be free to float their currencies so long as they adhere to internationally agreed standards that would assure the consistency of their action with the basic requirements of a cooperative order.

While your letter expresses support for this basic position, you express concern that the Treasury has assented in a "drift toward a return to fixed exchange rate parities as the basis of the international monetary system," and that the U.S. representatives in the C–20 "did not insist upon the option for member countries to float without the need for any type of prior authorization."

My own observations do not reveal, however, a drift in thinking among international financial officials toward a return to fixed exchange rate parities. A large number of officials continue to look forward in the hope that some day—which all recognize could not be soon—par values will represent the center of gravity of the exchange rate system, but the experience over the past year and a half with generally floating rates has in fact probably led to a much wider recognition of the contributions which floating rates can make.

I can also report that in the discussions of the C–20 the U.S. representatives did take the position that the International Monetary Fund should not be in a position to prohibit a country from floating so long as that country was willing to follow generally accepted guidelines. The Outline of Reform finally agreed, after lengthy negotiations, to indicate "the general direction in which the Committee believes that the system could evolve in the future," provides "countries will undertake obligations to maintain specified maximum exchange rate margins for their currencies, except when authorized to adopt floating rates." Our position was that a requirement for Fund authorization would be acceptable only on the understanding that there would be an open general license for any nation to float if it were abiding by the agreed guidelines. This position was not agreed by others, but the Outline does provide that "the authorization will be given in accordance with the provisions to be agreed."

The Committee did agree to ask the IMF Executive Board to prepare draft amendments of the Articles of Agreement to enable the Fund to legalize the position of countries with floating rates during the interim period.

In the consideration of proposed amendments over the coming months, the U.S. representatives will continue to take the position that the option to float should be available to any nation undertaking to observe the appropriate guidelines.

I greatly appreciate your support for this position.

Sincerely yours,

WILLIAM E. SIMON.

Mr. KARLIK. There are also two other questions that I would like to put to you.

In September of 1972 Mr. Reuss' subcommittee held some hearings on the use of the central bank swap facility, and at that time received assurances from Under Secretary Volcker and from Chairman Burns that the swap facility would be used only as a short-term financing device.

At that time Secretary Volcker said that, "Drawings would not be made or enlarged to deal with what would be fundamental misalignments in our own payments position. In normal and foreseeable circumstances, repayment could be anticipated from a reversal of market flows."

The question is as follows: With increased concern for the growing payments imbalances due to higher oil prices, has the Treasury contemplated the use of swaps for expanded support of——

Secretary SIMON. Excuse me. I cannot hear you.

Mr. KARLIK. Has the Treasury contemplated the use of swaps for expanded support of other industrialized economies, such as Italy, which are seriously burdened by increased oil import costs?

In other words, is there any thought of altering the basic function of the swap mechanism, which, to date, has been to merely provide short-term balance of payment financing—to change it in such a way as to provide longer term assistance to other countries squeezed by oil import payments?

Secretary SIMON. As you know, the basic responsibility for the swap mechanisms rests in the independent Federal Reserve System. Now we work very closely, recognizing the independence as well as the interdependence of the Federal Reserve and the Treasury Department, and it is not anticipated, although I would question Arthur Burns on this subject more deeply, that the mechanisms be changed or the purpose of these mechanisms be changed at all. They are basically short-term in nature, 3 months' duration, although they can be rolled over.

The Federal Reserve has swap lines with many entities. In the case of Italy that you mentioned I believe the swap line is $3 billion, and I also believe that that has not been used at all.

Mr. KARLIK. Well, I hestitate to disagree with you, but the——

Secretary SIMON. You should not, lots of people do.

Mr. KARLIK. Thank you.

But the impression we have received from both Treasury officials and the Federal Reserve in the past is that all swap transactions are approved by both the Treasury and the Federal Reserve.

Secretary SIMON. Well, we work together very closely and I would have to check on whether the term "approval" is appropriate.

Mr. KARLIK. Well, in any event, we have your assurance——

Secretary SIMON. But we do, I can assure you, consult and counsel the Federal Reserve not only in the area of swaps but in every area regarding domestic and international monetary and financial policy, because they are obviously closely interrelated with economic policy, domestic and international.

Mr. KARLIK. But do we also have your assurance that there will be no change in the use of the swap mechanism?

Secretary SIMON. I can give you my assurance that there has been no change and if there was a change we would certainly, as I said to you before, be consulting, understanding Mr. Reuss' keen interest in this subject.

Mr. KARLIK. Thank you.

Secretary SIMON. But I would also urge you to talk to Arthur Burns on this as well.

Mr. KARLIK. We plan to.

And one final question. The Treasury has been cool to recent proposals that the IMF oil facility be expanded to $5 billion or $10 billion in 1975 and possibly even beyond those amounts. Apparently, the Treasury questions the need for such facilities to supplement the activities of private banks in their recycling of the excess revenues earned by oil producers. The IMF facility raises questions about the appropriateness of the Fund becoming involved in what is essentially the aid business, i.e., making funds available to countries in no position to repay.

Do you see any other way to provide needed resources to financially strapped, primarily underdeveloped economies?

Secretary SIMON. When you say—I also read in the paper that we were cool to this and I would like to send you a copy of my speech at the International Monetary Fund Annual Meeting. We supported the Witteveen oil facility, which was exactly for that purpose; granting loans of funds contributed by the producing nations to aid in recycling.

We also support the idea that the IMF immediately commence a study which will be presented to us at our meeting in December or January to show the need for an additional facility or an enlarged facility, how it would operate, who would contribute. We want to know the entire ramifications of the establishment of this. But in no way have we opposed this.

Quite to the contrary. My statements have been that if it is needed, we will embrace it just as we did the Witteveen special oil facility that was set up some months ago to direct itself to this problem.

Now recycling, as you well know, is not only done by the commercial banks. We are seeing illustrations of recycling being performed in many other ways, through direct government-to-government operations with the producers who recognize their responsibility and recognize the burdens of these high oil prices and what it is doing to certain economies in the world. And they are working to set up their own special facilities in their government.

The Kuwaiti fund has increased from about $700 million to nearly $3.6 billion. This is going to be used not only for the lesser developed Arab nations but other lesser developed countries as well. The Khartoum agreement, Libya, Kuwait, and Saudi Arabia, in direct aid to Egypt has been supplemented with direct aid from Saudi Arabia to Egypt.

There are many funds that are providing this as well as not only the direct investment that countries are making in the United Kingdom and in the United States and other countries, but also direct loans. We have seen Iran with a $1 billion deal with France and there are others pending. So there are many mechanisms going on right at present that are performing the recycling function, and if we need another one in order to have international financial stability, we will accept it and embrace it.

Mr. KARLIK. I appreciate your clarifying the Treasury position on these issues. There still remains a question, whether these facilities will get enough aid, particularly to the developing countries that are hardest hit, soon enough.

Do you feel it will?

Secretary SIMON. Well, yes, I do. The interagency group led by Treasury studied the dimensions of the problems of the lesser developed countries and, well, the most seriously affected, let us call them. The extent of their problem appears to be in the $1 billion to $1½ billion a year area for the next 1½ to 2 years. And we believe that that is a manageable number, yes.

Mr. KARLIK. Thank you, Mr. Chairman. My time has expired. May I suggest that the Secretary's speech before the IMF governors, that he mentioned in his testimony, also be included in the record?

Senator PROXMIRE. Fine. Without objection, that will be done.

[The material referred to follows:]

ADDRESS OF HON. WILLIAM E. SIMON, SECRETARY OF THE TREASURY OF THE UNITED STATES, BEFORE THE 1974 ANNUAL MEETINGS OF THE BOARDS OF GOVERNORS OF THE INTERNATIONAL MONETARY FUND; INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT; INTERNATIONAL FINANCE CORPORATION; AND INTERNATIONAL DEVELOPMENT ASSOCIATION

Mr. Chairman, Mr. Witteveen, Mr. McNamara, Fellow Governors, Distinguished Guests:

Our recent annual meetings have reflected encouraging changes in the international economic scene. Three years ago, our attention was focused on the New Economic Policy introduced by the United States to eliminate a long-standing imbalance in the world economy. Two years ago we launched a major reform of the international trade and payments system. Last year we developed the broad outlines of monetary reform.

This year circumstances are different. We face a world economic situation that is the most difficult since the years immediately after World War II.

Our predecessors in those early postwar years responded well to the great challenges of that period. I am confident we can also respond appropriately to the challenges of our day. But first we must identify the issues correctly.

Let me declare myself now on three of these key issues.

First, I *do not* believe the world is in imminent danger of a drift into cumulative recession—though we must be alert and ready to act quickly should the situation change unexpectedly. I *do* believe the world must concentrate its attention and its efforts on the devastating inflation that confronts us.

Second, I *do not* believe the international financial market is about to collapse. I *do* believe that situations can arise in which individual countries may face serious problems in borrowing to cover oil and other needs. For that reason we must all stand prepared to take cooperative action should the need arise.

Third, I firmly believe that undue restrictions on the production of raw materials and commodities in order to bring about temporary increases in their prices threaten the prosperity of all nations and call into question our ability to maintain and strengthen an equitable and effective world trading order.

THE INFLATION PROBLEM

With respect to the first of these issues, it is clear that most countries are no longer dealing with the familiar trade-off of the past, balancing a little more or less inflation against little more or less growth and employment. We are confronted with the threat of inflationary forces so strong and so persistent that they could jeopardize not only the prosperity but even the stability of our societies. A protracted continuation of inflation at present rates would place destructive strains on the framework of our present institutions—financial, social and political.

Our current inflation developed from a combination of factors: in addition to pressures emanating from cartel pricing practices in oil, we have suffered from misfortune—including bad weather affecting crops around the world; bad timing—in the cyclical convergence of a worldwide boom; and bad policies—reflected in years of excessive government spending and monetary expansion. As financial officials, we cannot be held responsible for the weather, but we must accept responsibility for government policies, and we must recommend policies that take fully into account the circumstances of the world in which we find ourselves.

In today's circumstances, in most countries, there is in my view no alternative to policies of balanced fiscal and monetary restraint. We must steer a course of firm, patient, persistent restraint of both public and private demand, and we must maintain this course for an extended period of time, until inflation rates decrease. We must restore the confidence of our citizens in our economic future and our ability to maintain strong and stable currencies.

Some are concerned that a determined international attack on inflation by fiscal and monetary restraint might push the world into a deep recession, even depression.

I recognize this concern, but I do not believe we should let it distort our judgment.

Of course, we must watch for evidence of excessive slack. The day is long past when the fight against inflation can be waged in any country by tolerating recession. We must remain vigilant to the danger of cumulative recession. But if there is some risk in moving too slowly to relax restraints, there is also a risk—and I believe a much greater risk—in moving too rapidly toward expansive policies. If we fail to persevere in our anti-inflation policies now, with the result that inflation becomes more severe; then in time counter-measures will be required that would be so drastic as to risk sharp downturns and disruptions in economic activity.

There is a tendency to lay much of the blame on the international transmission of inflation. Certainly with present high levels of world trade and investment, developments in any economy, be they adverse or favorable, are quickly carried to other economies. But that does not absolve any nation from responsibility to adapt its financial policies so as to limit inflation and to shield its people from the ultimate damage which inflation inflicts on employment, productivity and social justice in our societies.

RECYCLING AND THE STRENGTH OF CAPITAL MARKETS

In addition to inflation, public concern has centered on methods of recycling oil funds and on whether we need new institutions to manage those flows.

So far, our existing complex of financial mechanisms, private and intergovernmental, has proved adequate to the task of recycling the large volumes of oil monies already moving in the system. Initially, the private financial markets played the major role, adapting in imaginative and constructive ways. More recently, government-to-government channels have increasingly been opened, and they will play a more important role as time goes by. New financing organizations have also been established by OPEC countries. Our international institutions—and specifically the IMF and World Bank—have redirected their efforts to provide additional ways of shifting funds from lenders to borrowers. The IMF responded rapidly in setting up its special oil facility.

In our experience over the period since the sharp increase in oil prices, three points stand out:

First, the amount of new investments abroad being accumulated by the oil-exporting countries is very large—we estimate approximately $33 billion thus far in 1974.

Second, the net capital flow into the United States from all foreign sources, as measured by the U.S. current account deficit, has been small, about $2 billion so far this year. During the same period our oil import bill has been about $12 billion larger than it was in the comparable period last year.

Third, markets in the United States are channeling very large sums of money from foreign lenders to foreign borrowers. Our banks have increased their loans to foreigners by approximately $15 billion since the beginning of the year, while incurring liabilities to foreigners of a slightly larger amount. This is one kind of effective recycling. And while some have expressed concern that excessive oil funds would seek to flow to the United States, and would require special recycling efforts to move them out, the picture thus far has been quite different.

No one can predict for sure what inflows of funds to the U.S. will be in the future. But it is our firm intention to maintain open capital markets, and foreign borrowers will have free access to any funds which come here. The United States Government offers no special subsidies or inducements to attract capital here; neither do we place obstacles to outflows.

Nonetheless, some have expressed concern that the banking structure may not be able to cope with strains from the large financial flows expected in the period ahead. A major factor in these doubts has been the highly publicized difficulties of a small number of European banks and one American bank which have raised fears of widespread financial collapse.

The difficulties of these banks developed in an atmosphere of worldwide inflation and of rapid increases in interest rates. In these circumstances, and in these relatively few instances, serious management defects emerged. These difficulties were in no way the result of irresponsible or disruptive investment shifts by oil-exporting countries. Nor were they the result of any failure in recycling or of any general financial crisis in any country.

The lesson to be learned is this: in a time of rapid change in interest rates and in the amounts and directions of money flows, financial instltutions must monitor their practices carefully. Regulatory and supervisory authorities too must be particularly vigilant. We must watch carefully to guard against mismanagement and speculative excesses, for example, in the forward exchange markets. And we must make certain that procedures for assuring the liquidity of our financial systems are maintained in good working order. Central banks have taken major steps to assure this result.

Although existing financial arrangements have responded reasonably well to the strains of the present situation, and we believe they will continue to do so, we recognize that this situation could change. We should remain alert to the potential need for new departures. We do not believe in an attitude of laissez-faire, come what may. If there is a clear need for additional international lending mechanisms, the United States will support their establishment.

We believe that various alternatives for providing such supplementary mechanisms should be given careful study. Whatever decision is made will have profound consequences for the future course of the world economy. We must carefully assess what our options are and carefully consider the full consequences of alternative courses of action. The range of possible future problems is a wide one, and many problems can be envisaged that will never come to pass. What is urgently needed now is careful preparation and probing analysis.

We must recognize that no recycling mechanism will insure that every country can borrow unlimited amounts. Of course, countries continue to have the responsibility to follow monetary, fiscal and other policies such that their requirements for foreign borrowing are limited.

But we know that facilities for loans on commercial or near-commercial terms are not likely to be sufficient for some developing countries whose economic situation requires that they continue to find funds on concessional terms. Traditional donors have continued to make their contributions of such funds, and oil-exporting countries have made some commitments to provide such assistance. Although the remaining financing problem for these countries is small in comparison with many other international flows, it is of immense importance for those countries affected. The new Development Committee which we are now establishing must give priority attention to the problems confronting these most seriously affected developing countries.

TRADE IN PRIMARY PRODUCTS

For the past two years, world trade in primary commodities has been subject to abnormal uncertainties and strains. Poor crops, unusually high industrial demand for raw materials, transport problems, and limited new investment in extractive industries have all contributed to tremendous changes in commodity prices. Unfortunately, new forms of trade restraint have also begun to appear.

In the past, efforts to build a world trading system were concentrated in opening national markets to imports. Clearly, we need now also to address the other side of the equation, that of supply.

The oil embargo, and the sudden and sharp increase in the price of oil, with their disruptive effects throughout the world economy, have, of course, brought these problems to the forefront of our attention.

The world faces a critical decision on access to many primary products. In the United States we have sought in those areas where we are exporters to show the way by maximum efforts to increase production. Market forces today result in the export of many items from wheat to coal which some believe we should keep at home. But we believe an open market in commodities will provide the best route to the investment and increased production needed by all nations.

We believe that cooperative, market-oriented solutions to materials problems will be most equitable and beneficial to all nations. We intend to work for such cooperative solutions.

PROSPECTS FOR THE FUTURE

In the face of our current difficulties—inflation, recycling, commodity problems—I remain firmly confident that, with commitment, cooperation and coordination, reasonable price stability and financial stability can be restored.

The experience of the past year has demonstrated that although our economies have been disturbed by serious troubles, the international trade and payments system has stood the test.

Flexible exchange rates during this period have served us well. Despite enormous overall uncertainties, and sudden change in the prospects for particular economies, exchange markets have escaped crises that beset them in past years. The exchange rate structure has no longer been an easy mark for the speculator, and governments have not been limited to the dismal choice of either financing speculative flows or trying to hold them down by controls.

Another encouraging fact is that the framework of international cooperation has remained strong. Faced with the prospect of severe balance-of-payments deterioration, deficit countries have on the whole avoided short-sighted efforts to strengthen their current account positions by introducing restrictions and curtailing trade.

In the longer run, we look forward to reinforcing this framework of cooperation through a broad-gauged multilateral negotiation to strengthen the international trading system. In the "Tokyo Round," we hope to reach widespread agreement, both on trade *liberalization* measures—helping all countries to use resources more efficiently through greater opportunities for exchange of goods and services—and on trade *management* measures—helping to solidify practices and procedures to deal with serious trade problems in a spirit of equity and joint endeavor. It is gratifying that more and more governments have recognized the opportunities—and the necessity—for successful, creative negotiations on trade.

We in the U.S. Government recognize our own responsibility to move these negotiations along. Early last year we proposed to our Congress the Trade Reform Act to permit full U.S. participation in the trade negotiations. It is clear that in the intervening months the need for such negotiations has become all the more urgent. We have therefore been working closely with the Congress on this crucial legislation, and we shall continue to work to insure its enactment before the end of this year.

In the whole field of international economic relations, I believe we are beginning to achieve a common understanding of the nature of the problems we face. There is greater public recognition that there lies ahead a long, hard worldwide struggle to bring inflation under control. Inflation is an international problem in our interdependent world, but the cure begins with the policies of national governments. Success will require, on the part of governments, uncommon determination and persistence. There is today increasing awareness that unreasonable short-term exploitation of a strong bargaining position to raise prices and costs, whether domestically or internationally, inevitably intensifies our problems.

Finally I am encouraged that our several years of intensive work to agree on improvements in the international monetary system have now begun to bear fruit. The discussions of the Committee of Twenty led to agreement on many important changes, some of which are to be introduced in an evolutionary manner and others of which we are beginning to implement at this meeting.

For the immediate future, the IMF's new Interim Committee will bring to the Fund structure a needed involvement of world financial leaders on a regular basis, providing for them an important new forum for consideration of the financing of massive oil bills and the better coordination of national policies. The Interim Committee should also increasingly exercise surveillance over nations' policies affecting international payments, thereby gaining the experience from which additional agreed guidelines for responsible behavior may be derived.

Moreover, discussions in the Interim Committee can speed the consideration of needed amendments to the Fund's Articles of Agreement. These amendments, stemming from the work of the Committee of Twenty, will help to modernize the IMF and better equip it to deal with today's problems. For example, the Articles should be amended so as to remove inhibitions on IMF sales of gold in the private markets, so that the Fund, like other official financial institutions, can mobilize its resources when they are needed. In order to facilitate future quota increases, the package of amendments should also include a provision to modify the present requirement that 25 percent of a quota subscription be in gold. Such an amendment will be a prerequisite for the quota increase now under consideration. And the amendment will be necessary in any event for us to achieve the objectives shared by all the participants in the Committee of Twenty of removing gold from a central role in the system and of assuring that the SDR becomes the basis of valuation for all obligations to and from the IMF.

Preparation of an amendment to embody the results of the current quinquennial review of quotas offers us still another opportunity to reassess the Fund's role in helping to meet the payments problems of member nations in light of today's needs and under present conditions of relative flexibility in exchange rates.

The trade pledge agreed by the Committee of Twenty provides an additional framework for cooperative action in today's troubled economic environment. It will mitigate the potential danger in the present situation of self-defeating, competitive trace actions and bilateralism. The United States has notified its adherence to the pledge, and I urge other nations to join promptly in subscribing.

The new Development Committee, still another outgrowth of the work of the Committee of Twenty, will give us an independent forum that will improve our ability to examine comprehensively the broad spectrum of development issues. We look forward to positive results from this new Committee's critical work on the problems of the countries most seriously affected by the increase in commodity prices and on ways to ensure that the private capital markets make a maximum contribution to development.

THE WORLD BANK AND ITS AFFILIATES

International cooperation for development is also being strengthened in other ways, notably through the replenishment of IDA. A U.S. contribution of $1.5 billion to the fourth IDA replenishment has been authorized by Congress, and we are working with our congressional leaders to find a way to complete our ratification at the earliest possible date. A significant new group of countries has become financially able to join those extending development assistance on a major scale. We would welcome an increase in their World Bank capital accompanied by a commensurate participation in IDA.

The United States is proud of its role in the development of the World Bank over the past quarter century. We are confident that the Bank will respond to the challenges of the future as it has so successfully responded in the past.

One of these challenges is to concentrate the Bank's resources to accelerate growth in those developing countries with the greatest need.

A second challenge is to continue the Bank's annual transfer of a portion of its income to IDA. The recent increase in interest rates charged by the Bank is not sufficient to enable the Bank to continue transfers to IDA in needed amounts. We urge that the Bank's Board promptly find a way to increase significantly the average return from new lending.

A third challenge is that the Bank find ways to strengthen its commitment to the principle that project financing makes sense only in a setting of appropriate national economic policies, of effective mobilization and use of domestic resources, and of effective utilization of the private capital and the modern technology that is available internationally on a commercial basis.

I should mention also that we are concerned about the Bank's capital position We should encourage the Bank to seek ways to assist in the mobilization of funds by techniques which do not require the backing of the Bank's callable capital.

Within the Bank Group, we are accustomed to thinking mainly of the IFC in considering private capital financing. While now small, the IFC is, in my view, a key element in the total equation, and should be even more important in the future. But the Bank itself needs to renew its own commitment to stimulation of the private sectors of developing countries.

Finally, let me emphasize that the capable and dedicated leadership and staff of the World Bank have the full confidence and support of the United States as they face the difficult challenges of the current situation.

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CONCLUSION

Ladies and Gentlemen, the most prosperous period in the history of mankind was made possible by an international framework which was a response to the vivid memories of the period of a beggar-thy-neighbor world. Faced with staggering probems, the founders of Bretton Woods were inspired to seek cooperative solutions in the framework of a liberal international economic order. Out of that experience evolved an awareness that our economic and political destinies are inextricably linked.

Today, in the face of another set of problems, we must again shape policies which reflect the great stake each nation has in the growth and prosperity of others. Because I believe that interdependence is a reality—one that all must sooner or later come to recognize—I remain confident that we will work out our problems in a cooperative manner.

The course which the United States will follow is clear. Domestically we will manage our economy firmly and responsibly, resigning ourselves neither to the inequities of continued inflation nor to the wastefulness of recession. We will strengthen our productive base, we will develop our own energy resources, we will expand our agricultural output. We will give the American people grounds for confidence in their future.

Internationally, let there be no doubt as to our course. We will work with those who would work with us. We make no pretense that we can, or should, try to solve these problems alone, but neither will we abdicate our responsibility to contribute to their solution. Together, we can solve our problems. Let me reaffirm our desire, and total commitment, to work with all nations to coordinate our policies to assure the lasting prosperity of all of our peoples.

Senator PROXMIRE. Now Mr. Secretary, one of the things that concerns many of us is that the President's program may well have been an inflationary program, particularly in view of what he came out with the other day after his speech.

Secretary SIMON. What was that?

Senator PROXMIRE. He indicated in his speech that he favored deregulation of natural gas. He indicated the other day that he favors deregulation of oil.

Now as we calculate it, and we have gone over this as carefully as we can, we have checked with other committees that are responsible, I understand that Senator Hart, who is chairman of the Senate Subcommittee on Antitrust, estimates that the deregulation proposal will cost about $10 billion in higher prices for natural gas, $10 billion a year. In addition our best estimates are that deregulation of the oil industry is likely to cost between $5 billion and $10 billion, depending upon what kind of assumptions you make.

If you assume that the domestic price would rise to the world price of oil, if it goes up from $5¼ to $10, then the cost would be over $10 billion to the American consumer. Now these would be highly inflationary consequences which would far overwhelm any deflationary elements that are otherwise in the President's proposal.

What is your answer to that?

Secretary SIMON. Well, many times, you know, when you respond to the press on the specific questions in very technical areas some things are just lifted out. The President favors decontrol of oil. Well, I guess if you had me talk on the subject of energy and oil, that if you wish to do that you could make a headline in the newspapers that would say, "Simon Favors Decontrol of Oil," because I think that in the final analysis that is exactly what we are going to have to do.

But at present——

Senator PROXMIRE. Let me be specific. The law expires at the end of February—March 1, as I understand it. Is it the position of the President that he would ask for at least a temporary renewal, or at that time would he oppose a renewal?

Secretary SIMON. I am going to discuss this with the President. We have favored the extension which was suggested through July of the allocation and the price controls. I have said repeatedly, Mr. Chairman, and I will say once again that at present—but I stress at present—there is no economic justification for removing the lid on control on the old oil.

We have a two-tier system that creates some inefficiencies, as you well know, expecially to the independent component of this industry. We want to increase all of the domestic production we can because our alternative is to pay the cartel-controlled price for the foreign oil.

Now we have exempted, as an incentive, new oil, new oil being defined as anything in excess——

Senator PROXMIRE. Well, Congress exempted that.

Secretary SIMON. No; you exempted the stripper.

Senator PROXMIRE. Yes.

Secretary SIMON. The Cost of Living Council exempted new oil which was defined as anything in excess of 1972 reserves.

Now, as you know, reserves have been declining in wells. It is very expensive to put into effect the secondary and tertiary recovery techniques, and at $5.25 there are many wells that are not producing today that at $8 or $9 would be producing because they would be economic.

Senator PROXMIRE. Let me just get back to whether or not we can get a clear picture of what the administration's position is on deregulation.

As I understand it, what you are telling me is that the President eventually favors deregulation, as I suppose, if you go out far enough in time almost everybody would. We want to see a return to the free enterprise system, but for the foreseeable future, so long as we have this high world oil price, I take it that your disposition or the disposition of the administration, as far as you know, would be to retain control on old oil.

Secretary SIMON. My disposition at this present time is to retain the price of $5.25 for the old oil with a redefinition of secondary, tertiary recovery. I do not know, and I guess nobody knows, when we will be allowed to do what we would like to do, and that is return to a free market. As I say, this has been the administration's position but I have not spoken to President Ford on this specific issue.

Senator PROXMIRE. Well, now that would seem to rule out any administration support for the depletion allowance because the President, as I understand it, also conditioned his support for removing depletion to deregulation of oil, and if we are not going to deregulate the control of oil prices, it would seem that the President's position is to oppose what we thought was a major part of the tax reform measure in the House which was the President supported, to wit, the repeal of the depletion allowance.

Is the President opposed to that?

Secretary SIMON. Let me clarify this. The administration's position in the past year in testifying before Ways and Means has been consistent. We would favor the removal of foreign depletion. We oppose the removal of domestic depletion. And that is still our position, but I add one other thing——

Senator PROXMIRE. Well, foreign depletion is only $40 million. The real loophole, the real revenue loss, is through domestic depletion, right?

Secretary SIMON. Well, I hesitate, but everybody has got their own word on loophole, subsidy, or whatever it is called.

Senator PROXMIRE. Whatever it is the loss in revenue from the depletion allowance is primarily domestic.

Secretary SIMON. There is no doubt about that.

Senator PROXMIRE. And the administration has not changed its position. It is still opposed to repeal of that.

Secretary SIMON. It has been a carrot that the independent producer has used to go out and raise the needed capital to drill the wells. They drill 75 percent of the wells in this country.

Senator PROXMIRE. That leaves us with a still very, very highly inflationary proposal I think the President made in suggesting the deregulation of natural gas.

Secretary SIMON. Well, let me finish on the oil side of the depletion. The President has also said that on balance, as far as the bill is concerned, which includes the phasing out of the depletion allowance, he will sign it. We are realistic enough to know that we and the President are not going to like every single piece of legislation that comes down from the Hill, every single piece in a tax reform legislation, especially. On balance it has got a lot more good in it than bad. We like certain parts in it—you know, you talk about loopholes, Senator. The Treasury there again has been the hawk on this issue and we made two very major recommendations to the Congress in March or April of 1973, one, the minimum income tax revision, which they pretty well embraced, which assures that every taxpayer, regardless of the various discounts, pays some tax. Number two, the limitation on artificial accounting losses which would close one of the major, what you might call subsidies or loopholes, and that has only been very partially accepted.

Senator PROXMIRE. Then the President's position is that he opposes repeal of the domestic depletion allowance, but he will sign a bill which includes that if the rest of the bill is acceptable to him?

Secretary SIMON. As it is pretty much right now, yes, Mr. Chairman.

Senator PROXMIRE. Now let's get to natural gas deregulation. As I say, Senator Hart's estimate is this will increase prices to the consumer by $10 billion, a tremendous inflationary effect.

Secretary SIMON. I just absolutely have great trouble with that figure. Let me just walk through this a second and tell you why. Today we are importing about 38 percent of what we need in the fossil fuel area. If we increase production domestically of natural gas, new natural gas—I am not talking about the old natural gas, just the new wells, the new reserves that are going to be refined, it will seek a market level, there is no doubt about it.

Our alternative is to pay the foreign sources, as insecure as they are, and when they have control of all of the supplies, they also have control, as we have seen this past year, of the pricing of those supplies.

As we bring on the additional natural gas, and coal, and oil which we are doing, we will feel the effects of that for 3 or 4 years. Then the price comes down. Then we have control over our own destinies in the energy area.

I am suggesting that we are paying this inflation price anyway because we are paying it to the Arabs or the other countries that we import this oil from, and we ought to be paying it domestically to get our own supplies, which is ultimately going to bring the price down, Mr. Chairman.

Senator PROXMIRE. Well, ultimately yes, but the fact is that when you deregulate natural gas on the basis of all of our past experience, the price of that natural gas to the consumer is going to triple or quadruple.

Secretary SIMON. The new gas.

Senator PROXMIRE. That is right.

Secretary SIMON. All right, what is our alternative, Mr. Chairman, to pay that price to other countries for import?

Senator PROXMIRE. The alternative is to continue to regulate it, permit whatever increase is necessary to cover costs and to encourage as much exploration and so forth as you can get, but not just take the ceiling off and let it go up so that the average consumer in my State would have his annual gas bill increasing from $250 to $1,000.

Secretary SIMON. Let me tell you, I personally, Mr. Chairman, do not quarrel when we start talking about capping. Let's talk about the control, and let's see what has happened to the FPC recently. They will try to do this and they will raise the price to 45 or 55 cents, and the court rolls the price back, so people say, well, its just not with it. I am not going to drill the wells. They are certainly not going to conserve at 21 cents on the wellhead.

Senator PROXMIRE. I will be more salable on this issue if——

Secretary SIMON. You and I are not very far apart on this. We might have an argument as to what is economic, what is going to give that fellow the incentive to go out and drill the gas wells. We know that some gas comes, and they call it associated gas, along with oil, but we also know there are a lot of formations, offshore as well as onshore, that are pure natural gas formations that people cannot drill because it is not economic at the present.

Senator PROXMIRE. I would be much easier to sell on this if we had not seen what has happened over the last year. We have had these terrific increases in price, as I mentioned, tremendous increase in price on oil, and they do not seem to be able to come forward with much of an increase, if any, on production.

In steel we have this, the biggest increase by far in history, an enormous increase, and they not only have not come forward with any more production, but their plans are very, very limited, about 2- or 3-percent increase a year.

Secretary SIMON. You know, you are looking at too short a time frame, Mr. Chairman, as far as the oil and gas industry is concerned. It takes about 3 years. Drilling is up about 35 percent this year over last year in response to the free prices that are available.

Senator PROXMIRE. I know your time is limited.

Secretary SIMON. Yes; I have to run, if I may.

Senator PROXMIRE. Let me proceed with just a few other issues I would like to cover if I can. Let us look at President Ford's tax program. It is designed to achieve a permanent shift in income from consumers to corporations and individuals to corporations. Individual taxes are raised $2.6 billion while corporate taxes are cut by $700 million in 1975, and at least $2.8 billion in 1976, and thereafter, each year, because that is a permanent reduction for corporations. Because the corporate tax cuts are permanent while the individual and corporate tax hikes are temporary over the next 5 years, from 1975 to 1979, the Ford tax plan will raise individual taxes some $2.6 billion but cut corporate taxes a total of $12 billion.

Secretary SIMON. It is not permanent; but temporary. It is a 1-year surcharge. That is on the revenue side.

Senator PROXMIRE. Yes; I know. That $2.6 billion is 1 year, but what I am saying is discounting that 1 year and no further increase for the individual, that $2.6 billion is nevertheless an increase for the individual that 1 year, and the next year no increase, but he will have paid that $2.6 billion. That is part of the additional tax he pays. There is no reduction, in other words, in the future for the individual. There is a reduction for the corporation in the future. The corporation will not have to pay the surtax after the next year, is that not right?

Secretary SIMON. Neither the individual nor the corporation.

Senator PROXMIRE. That is right, but the corporation will get the benefit of further tax reduction, and corporations have gotten great benefits over the last years in tax reduction, a reduction from about a 43-percent effective tax to a 35-percent.

Secretary SIMON. That is the point. The consumer is the ultimate beneficiary of this because this increases the productive capacity of the various industries that will use the credit.

Senator PROXMIRE. That is the old Herbert Hoover trickle-down theory, is it not?

Secretary SIMON. Well, I do not know if it was Herbert Hoover.

Senator PROXMIRE. Well, with the idea that you help the rich guy at the top, give him the cake, and the people at the bottom get a few crumbs.

Secretary SIMON. Help the rich guy? If you look at the restructuring of the credit, it helps the poor and the disadvantaged businesses more than it does the rich guy because this gives them the refundable feature, enables them during periods of financial difficulty and during periods of growth, as I explained before, to take advantage of this credit when they have never had it before.

Senator PROXMIRE. Well, most of the poor people in this country are not worried about refundable features in corporate taxes.

Secretary SIMON. No, they are worried about getting the goods that we have always gotten in this country at the lowest possible price, and the only thing we can do is produce to meet their demands.

Senator PROXMIRE. Well, I believe strongly in the profit system, but as you pointed out, and pointed out very eloquently, the one area where we have had a remarkable strength in the economy is business investment in plant and equipment. It has been excellent. It has been growing at a great rate.

So it would seem to me that the tax measures to accelerate that even further seem hardly appropriate when the real problem is one of maintaining effective demand in many of these areas.

Secretary SIMON. Well, when you look at the real growth, the real growth in capital spending, I think you will see a good portion of that is the effects of inflation, Mr. Chairman.

Senator PROXMIRE. Part of it, but nevertheless, there has been a real growth over the past 3 or 4 years, I am sure.

Would it not be easier and more effective to promote investment by just easing money and lowering interest rates?

Secretary SIMON. Well, you know——

Senator PROXMIRE. After all, we do not have excessive demand. I think that is the hill we have to climb.

One of the most brilliant columnists we have in this country, George Will, stumbled over that this morning, and it astonished me because he is such a bright fellow, but he still has a notion that somehow we have too much money chasing too few goods, and that just is not the case. How can it be the case when the real retail sales are falling, when overall our productive capacity is so low, there are very few shortage areas. But I think we have to look at this situation and recognize that the big price increases are administered, by and large, by concentrated industry; and then we have the rest of the economy suffering from inadequate demand, increasing unemployment, working short hours.

Secretary SIMON. You see, this is exactly what we are trying to do, Mr. Chairman, is take the monkey, if you will, off the Federal Reserve's back by exerting fiscal pressures that are necessary, so that monetary policy will not bear the burden of the fight against inflation, as most people perceive that it has.

That is going to have the effect of bringing down interest rates, but in the absence of strong fiscal measures and cutbacks by the Government in their spending, a release of the inflationary forces would occur if we just abandoned the moderately restrictive monetary policies. That would just create more inflation and almost immediately even higher interest rates because that is what has happened every single time that we have copped out in our battle against inflation, and I sure hope that we do not cop out this time.

Senator PROXMIRE. Has the Treasury done an analysis of the change in the investment tax credit as to how much it would increase investment and how much it would cost?

Mr. HICKMAN. We have a variety of analyses that indicate increases and we will be glad to supply you what we can in that respect for the record.[1] We have to take that into account always, with other variables.

Senator PROXMIRE. Well, supply us with what you have got because before Congress acts on something that is this costly, I think we certainly ought to have this information.

Mr. HICKMAN. Yes, we surely will do that.

Secretary SIMON. We can show the experience, you know, Mr. Chairman. We have got good experience in gaging the effectiveness of the investment tax credit because it has been taken on and off a couple of times in the last 10, 12 years.

Senator PROXMIRE. Yes, it is very, very hard to measure, still, though, because of lags involved and so many other complications.

[1] The information to be supplied for the record was not available at time of printing the hearings.

Secretary SIMON. Yes, even though George Will takes me to task on my English and other people take Allen Greenspan to task on his, I make things too simple and he makes things too complicated, but this is as George Will complains, judgmental, and I do not say that because I think I am important.

Senator PROXMIRE. To me you are very articulate, and I am delighted that you are as clear and as forthright as you are. One of the big banes of economists is that they do their best, it seems, to confuse us.

But let me just ask questions in just one other area. The President's message proposes to implement the objective of cutting oil imports 1 million barrels per day by the end of 1975.

Now, No. 1, that seems to me to be a very, very limited, modest goal. After all. France, as I understand it—and correct me if I am wrong—has announced that they intend to cut their imports 10 percent now, and this 1 million barrels a day would be less than 10 percent, and not until the end of 1975, which is almost a year and a half away.

Secretary SIMON. I was told, Mr. Chairman——

Senator PROXMIRE. And they are far more dependent on imports than we are.

Secretary SIMON. I was told, Mr. Chairman, France rescinded that policy. I have not been able to find out why. They had a volume entry limit placed on their imports, a dollar volume limit, and we looked at that. We looked at it very carefully, and did an analysis as to which would be the best method to limit our imports. I do not think we should sneeze at 1 million barrels a day. It has got a \$3½ billion to \$4 billion impact as far as balance of payments is concerned. It does represent one sixth of what we are importing, and let me put some of these numbers into perspective.

Assume demand this year was 7¾ million barrels a day. That is imports we would need. We are today consuming about 6½ million barrels a day imported oil. We are suggesting that by the end of 1975 we will have gotten that down 1 million barrels a day.

Now, at the height of the embargo, when it was fully effective, it was about 4.9 to 5 million barrels a day, so we are almost back imposing what we had at that time through the various mandatory and voluntary measures, and some of those measures are pretty stern, like mandatory switching from oil to coal, which could be a significant saver to us over the next couple of years.

Senator PROXMIRE. Let me get into that. I realize you have to leave in just a few seconds.

Secretary SIMON. Yes, sir.

Senator PROXMIRE. Let me get into that by just asking about the position of the President on environmental protection. I was very disturbed by that part of his message. There was a tone there—and I do not want to be unfair to him—there was a tone there of indicating that he was very soft on environmental protection. He is willing to make some real sacrifices in the area of the environment in order to get more fuel produced, in order, perhaps, to ease the inflationary pressure from that sector.

In the case of the proposed shift of all electric utilities from oil to coal fed furnaces by 1980, the provisions of the Clean Air Act would essentially have to be abandoned, because stack scrubbing technology to permit the clean burning of coal has not been sufficiently developed.

Has the administration——

Secretary SIMON. It is being developed quite rapidly now.

Senator PROXMIRE. Does the administration plan to scrap efforts for environmental protection in its campaign to increase energy supplies?

Have you considered the additional cost to health as well as those of cleaning up the environment if we do this?

Secretary SIMON. Absolutely not, Mr. Chairman, and I do not have the verbiage in front of me, but I think the President's statement went on to say switch by 1980 consistent with the health standards and environmental requirements.

So we are not proposing that we are just going to arbitrarily go into every city of the United States and just say to a utility, you must burn coal. No. But we have recommended 12 or 13 changes in the Clear Air Act. That piece of legislation is on the Hill. All but one of them, the tall stack provision, have been agreed to by Russell Train of EPA. So we work very closely in this area, and ours is not a policy that will degrade the environment, nor move us off our resolve in cleaning up the environment.

It has been my personal opinion we have tried to do it a little too quickly, but that is the American way of doing things. We try to solve problems in 5 years that took 50 years to come upon us.

Senator PROXMIRE. All right, sir, you are dismissed. I thank you very much for a fine job.

I will ask the other gentlemen to stay. I have a few more questions for them.

Secretary SIMON. Thank you, sir.

Senator PROXMIRE. Now, either one of you gentlemen can respond to these questions as you see fit.

In the "Fact Sheet," you describe additional public service employment provisions that come into effect if the employment rate exceeded 7 percent for 3 months.

Do you anticipate that unemployment might go that high?

Mr. FIEDLER. We do not, Mr. Chairman. We know there is that possibility, but we do not expect it to go that high.

Senator PROXMIRE. A forecast made available to us by George Perry, a highly respected economist, predicts unemployment averaging 7 percent in the second quarter of 1975. Mr. Perry has an outstanding record for the accuracy of his forecasts, so we cannot treat that possibility lightly, and I see that you do not treat it lightly, and therefore will have a procedure developed in the event you have to act on it.

Mr. FIEDLER. Yes, sir.

Senator PROXMIRE. How confident are you that unemployment will not rise above 7 percent?

Mr. FIEDLER. I do not know how to put any kind of a quantitative answer on this. I think the chances are it is much more a possibility than a probability, and I think it is a low possibility, but it is something that we would have to be prepared for, as you indicated.

Senator PROXMIRE. I would like to ask you a question on taxes. You and others, I should say the Treasury and others have stated that corporate profits should be looked at after the inventory valuation adjustment is taken out.

Mr. FIEDLER. That is correct. We have made that point.

Senator PROXMIRE. All right.

Now, that is after profits, clearly inflated prices are removed. You argue this way on the basis that inventory profits are due mainly to accounting quirks and are reabsorbed in reconstituting inventories.

Mr. FIEDLER. That is basically correct.

Senator PROXMIRE. There are several problems with that. One is the assumption that it seems that you are not going to have any further price increases.

Mr. FIEDLER. No; it means that there is not going to be a further acceleration, I think, does it not?

Senator PROXMIRE. Well, no. Supposing price increases increase at the same rate?

Mr. FIEDLER. Then you would have a continuation of inventory profits at the same level.

Senator PROXMIRE. And on the basis of the trend that we have had in the past, that might very well continue for some time.

Mr. FIEDLER. We expect high price increases, perhaps not at the same level, but still too much inflation for some time ahead.

Senator PROXMIRE. You have a situation as you have in the steel industry where they testified that their prices have increased twice as much as their costs.

Now, you could expect them to continue at a very high level, relatively high level of profits in the future.

Mr. FIEDLER. I think so. I think the profits are needed for the expansion of the industry, which has been lagging for a decade or more.

Senator PROXMIRE. Now, I am informed that the inventory valuation adjustment by the Department of Commerce in the first and second quarters of 1974 included the inventory profits to the domestic oil industry resulting from the $1 a barrel increase in the price of so-called old oil, awarded to the industry last December, and the $6 a barrel increase on new oil dictated by the OPEC oil price policies soon thereafter.

Now, these profits are not reabsorbed in reconstituting the inventory with oil flowing from already existing wells.

Mr. FIEDLER. I am sorry, I do not understand the last part of that.

Senator PROXMIRE. These profits are not reabsorbed in reconstituting the inventory with oil flowing from already existing wells. In other words, their costs are not going up. They have these wells.

Mr. FIEDLER. That is correct.

Senator PROXMIRE. Well, then, why, therefore, should we exclude the component of corporate profits from considerations as far as the oil industry is concerned?

Mr. FIELDER. We should not exclude it from consideration. We should think of it as a different kind of a profit, and everybody who owns oil, because of the action of the cartel, has suddenly had the value of his oil in the ground increased dramatically, three times, as you indicated before, and as you know, that is a one-time event that does not repeat. That oil in the ground has a higher value now.

Senator PROXMIRE. Well, that is another fascinating point to me because we had the Petroleum Institute, API, before this committee last year, and they indicated at that time that there would be a revaluation of their reserves last March, in view of the increase in prices.

Now, that increase in prices would do two things to increase the value of their reserves. Number one, it would increase the dollar value of the reserves that they had before, and number two, it would make other oil which was uneconomical to pump at the lower price economical now, and therefore increase the amount they had, so they would have a terrific increase in their asset value.

But when they reported this year's reserves they based the valuation of their reserves on previous prices on the assumption that the present price was not a stable price and might go down, and I was shocked at that because they indicated they had a decline in their reserves when it should have been a big increase.

Mr. FIEDLER. In their dollar reserves? That surprises me. I do not see why that should happen.

Senator PROXMIRE. They do not estimate it in dollars. They estimate it in barrels.

Mr. FIEDLER. Well, the decline in the reserves—I take it this is domestic reserves?

Senator PROXMIRE. But they had this enormous price increase. They say it should have meant that a lot of the oil that was uneconomic at the lower price would become economic.

Mr. FIEDLER. I do not know how those reserves are calculated and whether they count those reserves until after they have gotten the technology in place to make them come out. I will not try to defend or speak for the API.

Senator PROXMIRE. At any rate, the point is that this industry, the oil industry, has had a really tremendous windfall increase in the value of their assets as well as in their profits.

Mr. FIEDLER. That is correct.

Senator PROXMIRE. Now, businessmen are complaining often in this inflationary period that tax laws do not let them recover the full replacement cost of plant and equipment, but after all, when you buy new equipment, you get with it the improvements in technology and productivity that are taking place. You do not just buy the old equipment. You buy the new equipment which very often has a technological value. When you replace an open hearth furnace with a basic oxygen furnance, you get a tremendous increase in efficiency. So you are buying more than just a replacement item.

Mr. FIEDLER. Absolutely.

Senator PROXMIRE. Then, too, you borrow to buy the old plant. Recoupment of full replacement costs would more than pay off your old debts and yield a reduction in debt proportionate to the new purchase, which is a function not necessarily required by tax equity, and after all, you buy today's new equipment to sell at today's inflated prices and today's profit margins. The law already allows accelerated depreciation in advance of physical obsolescence, so while historical depreciation is too little, replacement cost recoupment, about which we now hear so much, would be excessive.

Would you agree with that?

Mr. FIEDLER. I think I do, yes, sir.

Senator PROXMIRE. Well, that is helpful, I appreciate that.

Mr. FIEDLER. Do you want to take a shot at that?

Mr. HICKMAN. I think you cannot really generalize totally. It all depends. Sometimes you get more productivity and sometimes you get it in sufficient volume to more than compensate for the loss in real value of the dollars that you have recovered, and sometimes you do not. Mr. Fiedler has an overall reaction that probably in the aggregate that might be true. But I do not think it is so easily ascertained.

Mr. FIDLER. I would say, Mr. Chairman, it is not true for some of the pollution type equipment investment. We get benefits from that as a society, but the business itself does not receive those benefits, and therefore in the case of pollution equipment, it might be warranted to reduce the time period over which depreciation is taken.

Mr. HICKMAN. It is also true that again you cannot generalize too broadly because in a good many cases the pollution equipment is in fact a cost that is recaptured in the higher price of the product. Sometimes it is and sometimes it is not. You just have to look and see.

Mr. FIEDLER. Right. It depends on the elasticity—you get into these confusing terms that economists use. The demand for that product as against other products.

Senator PROXMIRE. Now let me ask you about the President's surtax.

That was justified on the gounds that the tax bill in the House Ways and Means Committee sufficiently closed tax loopholes, that revenue should not be raised from that source but should be raised by those middle income Americans who already pay a heavy tax on their wages and salaries over $15,000 a year.

Now, you and I know and the whole country knows of even public officials who have very high incomes who paid little or no taxes recently. The nominee for Vice President of the United States, for example, Nelson Rockefeller, paid no taxes at all in 1970. Five percent of nothing is nothing. You do not get any more taxes from a millionaire or a billionaire if he does not pay any taxes by imposing a 5 percent surtax. So the argument has been made, well, we are taking care of that by plugging those loopholes in the bill in the House. Would you list the loopholes which the House bill closes?

Do you have any information on how much revenue the closed loopholes would bring in next year, for example, the windfall profits tax, the oil depletion allowance, the change in capital gains?

Do you have that kind of material?

Mr. HICKMAN. I have some of that here, Senator.

I would like to make, if I may, just a few general observations about the statement that you made.

It is true that to the extent that loopholes exist, a surtax multiplies the loophole. A surtax is a very progressive kind of a tax because it is a percentage of the basic percentage, and the basic percentage is rising under our progressive system, so that a surtax——

Senator PROXMIRE. It is progressive except to the extent that a taxpayer has a steeply rising income, has a very high income, but he is able to escape from the taxation, and then as you concede, in that event he is not reached.

Mr. HICKMAN. That is absolutely right.

Senator PROXMIRE. So it is regressive in that sense.

Mr. HICKMAN. The loopholes mean more to people in the high brackets than they mean to people in the low brackets, and this puts people into higher brackets, and for people at the top, it increases their brackets more than for the people at the bottom. So it makes it more progressive than it presently is. And to that extent the people at the top would gain even more from any loophole, if you would just look at the loophole, no question about that.

Now, so far as the loopholes——

Senator PROXMIRE. That is interesting, they gain even more from the loophole, so what the surtax does is gives them an additional benefit in that sense.

Mr. HICKMAN. The surtax magnifies all of the progressivity that is in this system, and the progressivity in the system is what makes the loopholes worth more to people at the top than at the bottom. So that so far as loopholes are concerned, the surtax does not help a bit.

Now, the administration 1½ years ago proposed a tax package that had two very basic provisions intended to deal with the loophole problem. Those provisions we have fought for hard in the Ways and Means Committee. We do not yet have a bill. The provisions that we fought for have been very substantially diluted by the committee so far, so that it appears we will have less loophole closing than this administration asked for.

Senator PROXMIRE. I appreciate that, but the fact is also that President Ford when he addressed the Congress the other afternoon, indicated that that was a bill which he was supporting, the bill that was in the Ways and Means Committee that they had acted on.

Mr. FIEDLER. That is correct, Senator, and to repeat what——

Senator PROXMIRE. And this was the basis for calling for a surtax in addition.

Mr. FIEDLER. To repeat what the Secretary said, support of that bill does not mean we approve of every individual item.

Mr. HICKMAN. We are continuing to urge the committee, and when it gets to the Senate, we will urge your body to put back in some of the loophole closings that is at the moment out of the bill.

Senator PROXMIRE. Give us some examples.

Mr. HICKMAN. There were two principal recommendations:

Senator PROXMIRE. Incidentally, one of them that you would not have us put back in, or that you would have them take out if possible, would be the oil depletion allowance. The President wants that removed.

Mr. HICKMAN. We proposed, Senator, a provision for a windfall profits tax on oil in the years 1974 and 1975. It would have collected substantially more money than what the committee's——

Senator PROXMIRE. You know that is a sales tax. It would go directly on the consumer.

Mr. HICKMAN. It would not.

Senator PROXMIRE. I do not know how the incidence could possibly be on the stockholders.

Mr. HICKMAN. At the present time, given the current marketing——

Senator PROXMIRE. Semantics are marvelous. Everybody would be for taxing excess profits.

Mr. HICKMAN. Hear me out if you will.

Senator PROXMIRE. You might as well call it a sales tax.

Mr. HICKMAN. It is a tax on the price of oil production. At the present time in a free market, the price of domestic oil would rise to the foreign price, whatever that is. That is the condition that we are in at the moment. We do now have, so far as the market is concerned, what the economists refer to as market clearing prices. That is the price at which supply and demand are evening out. We have had an artificial constraint on the supply side, but nonetheless, we are buying what oil we need now at what prices we have. And under those circumstances, if you impose a tax on the producers of domestic oil, they are not going to be able to get any more for their oil than they are presently getting. They are locked in.

The ceiling to what they can get is what the OPEC cartel is charging, and so as long as that condition exists, which it is for the immediate present in any event, the incidence of that tax will fall on the producer, not on the consumer. It does not cause the price to go up at all. We did in prior submissions try and go through the analytical details. Again this is a situation where people look at an excise tax, and they say, ah ha, that is an excise tax, and therefore it falls on the consumer. No excise tax falls entirely on the consumer. There are elasticities, and in this particular case the supply curve is straight up, and the tax falls on the supplier.

Senator PROXMIRE. Of course, incidence varies. It goes on the consumer, on the stockholder and so forth, but I just maintain that a great deal of it falls on the consumer.

Nevertheless, the point is, you have great sentiment in this country, great sentiment in the Congress, for repealing the domestic depletion allowance. No question about it. If the administration would support it, I think there would be no question, it would go through very easily.

So you oppose that? Instead of that, you would keep that on, what we regard as a loophole, for some reason that is hard to understand, and then you would impose another excess tax to get at it in some way, excess profits tax.

Mr. HICKMAN. The tax we propose would, as I indicated, take a great deal of the windfall away from oil producers, in the immediate future and in the year 1974, when windfalls were realized. But it would not be permanent.

Senator PROXMIRE. Not necessarily. That may be in the immediate future, you are right. But in the long run, the oil industry would be far better off, perhaps, to hold on to that depletion allowance, because that so-called excess profits tax is pegged to an instant world price situation. And if that changes, and if the price tends to fall in this country, then the excess profits tax, so-called, would evaporate.

Mr. HICKMAN. That is right, and it was designed to do that.

Senator PROXMIRE. You would be left with the depletion allowance, and the oil industry would be in the same cozy position they were in before, paying only 8 percent of their net income in taxes, compared to 35 percent for other corporations.

Mr. FIEDLER. Senator, in the long run, you are right about the incidence of this tax, and would not the reduction of the depletion allowance or the elimination of the depletion allowance also be passed to the consumer? I think it ought to be. That is the only place that anybody can pay taxes, is the final user.

Senator PROXMIRE. Yes and no. It is true for every tax; the incidence is partly shared by the consumer. But in this particular industry, it has gotten so, unless you are in the 60-percent tax—if you are in the 60-percent tax bracket or above, you cannot stay ouf of this. You have got to get into it. I mean, if you are going to be logical about it, how are you going to increase your net income after taxes? So the people that benefit now——

Mr. FIEDLER. I am talking about individual taxes, not corporate taxes.

Senator PROXMIRE. People who benefit from the depletion allowance are people with very large incomes; in the very high income bracket is the rich man's loophole, right?

Mr. FIEDLER. All right.

Mr. HICKMAN. There is an element of benefit in there, and that is what provides the carrot, as there is in the case of tax-free municipal bonds. Where the fellow in the high bracket has less risk, he makes more investment than he otherwise would.

Senator PROXMIRE. Well, now, let us run through without—it is my fault; I have been debating you on these things. Supposing you give us these loopholes; what the provisions in the bill in the House would close, and how much they would bring in.

Mr. HICKMAN. Well, I will start just down my list here. We have probably 60-some items here, and they are not all loophole closers, but I will tell you what some of them are. We have a proposal that cuts down on the deductions for business uses of homes and the tax shelters involved in vacation homes. That would raise about $200 million in 1975. We have changes that deal with exclusions for disability pay for the military, where the thought was that people were being relieved of taxes for what was essentially retirement income, plus some changes in the sick-pay rules which are similar. That would raise about $200 million.

Senator PROXMIRE. These would hit retired military people?

Mr. HICKMAN. Yes. We have limitations on casualty losses. That, I suppose, maybe is not a loophole, depending on how you look at it. But that raises about $150 million. I confess that as to a lot of these items, whether they are loopholes or not depends on the way you look at it. We have got a limitation on the kinds of expenses that people deduct as miscellaneous business expenses, which raises about $800 million.

Senator PROXMIRE. $800 million?

Mr. HICKMAN. Yes; then we have got some relief provisions in here.

Senator PROXMIRE. Relief provisions?

Mr. HICKMAN. Yes. We have a simplification deduction. The purpose was to replace a series of small, hard-to-compute deductions with a single, easy-to-compute deduction, and in that process we realized we would have to, if you will, "buy" those old deductions which people were——

Senator PROXMIRE. That would affect people with pretty modest incomes, would it not? The people with big incomes would itemize everything.

Mr. HICKMAN. Well, this affects all people who itemize, and it says that you cannot have some of the old, itemized deductions that you used to have; but in lieu of that, we will give you this new deduction, and the new deduction—for the people in the middle brackets, where it helps them—the new deduction is not only easier, but it is larger than the sum of the old ones. For the people in the very top brackets, the old deductions tend to be a little bit larger than the deductions we are giving them back; but the difference, in any event, is not major.

Senator PROXMIRE. Well, where you have the really well-to-do people, the people, the really wealthy people—the millionaires and billionaires—they take advantage of the charitable contribution route, which is not affected, I take it, by any recommendation?

Mr. HICKMAN. It was under our proposals. It is one of the items.

Senator PROXMIRE. To what extent? How would you modify it?

Mr. HICKMAN. In our proposal for a minimum taxable income, we proposed that you start with your adjusted gross income and that you add back to it a series of items that represented economic income. Percentage depletion was one, and certain kinds of tax shelter income were others. You then had to pay tax on at least half of that total economic income. Now, that impacted on charitable contributions, because we were dealing with the gross income, and we were saying you had to pay tax on half, and that meant that you could not use charitable deductions to reduce your taxable income below half of this new, expanded base.

Senator PROXMIRE. How do you end up with a minimum tax proposal? That is one that really would, if it is effective and has teeth in it, hit people with very substantial incomes.

Mr. HICKMAN. That is right.

Senator PROXMIRE. How do you end up with—what kind of proposal does the bill have that the President now supports in the House? How much of a bite would that take out of a big income?

Mr. HICKMAN. Well, it would take—I cannot generalize, because it depends. But we can give you examples.

Senator PROXMIRE. It is no good if you can escape it.

Mr. HICKMAN. You cannot escape it.

Senator PROXMIRE. That is what puzzles all of us; how you can have a minimum tax, and then read that the President of the United States, or a nominee for Vice President who has an enormous income and pays almost no taxes, or no taxes at all—how can that be? How come President Nixon, with $250,000 in income, gets away with paying $800 or $900 in taxes with the minimum tax system? He would have to pay, it would seem to me, $20,000 or $30,000.

Mr. HICKMAN. The present minimum tax is no good.

Senator PROXMIRE. That is my point.

Mr. HICKMAN. No question. That is why we gave you another minimum tax proposal. Now, at the time that these figures were in the newspapers, and on the basis of the newspaper figures, we did figure out what President Nixon's approximate liability would be under our proposed minimum tax, and it would have been, if I recollect correctly, about $75,000, as distinguished from the $800 or $900.

Senator PROXMIRE. What is left in the Ways and Means Committees?

Mr. HICKMAN. The Ways and Means Committee has cut back that minimum taxable income proposal to some extent by completely taking out the charitable deductions. You get all the charitable deductions, anyway, regardless of where that puts your taxable income. So that does enable some people who reduced their incomes to nearly zero to get there through the charitable deduction route.

Now, you can argue that back and forth. We thought that regardless of whether there were charitable deductions or not, people ought to pay tax on at least half of what you could reasonably call their economic income. That was our proposal. And the committee cut back on our proposal. Even as cut back, it raises about $800 million a year.

Senator PROXMIRE. How much would it raise if it had not been cut back?

Mr. HICKMAN. I cannot tell you that from this chart.

Senator PROXMIRE. It would be far more than twice, would it not?

Mr. HICKMAN. No, it would not. It was not that large.

Senator PROXMIRE. Surprising. It would be over $1 billion dollars if it were?

Mr. HICKMAN. Perhaps.

The other provision in the twin centerpiece of our tax reform proposals was the proposed limitation on artificial accounting losses, what are generally known as tax shelters. The common ingredient in tax shelters is that through a variety of tax accounting devices, people show losses from activities that are, in fact, not real economic losses, but may come about, for example, through extraordinarily rapid depreciation, or through interest deductions. Or it may come about through the use of the cash method of accounting, where you take expenses now, because you happen to lay out the money now, even though the expense relates to some future period. The proposal would have impacted on three industries, principally, but the principle applied to others. It would have impacted on real estate, where perhaps the largest amount of tax shelters exist; it would have impacted on the oil industry; and it would have impacted on agriculture, where the use of the cash method in a great many cases allows people to show no income, or an actual loss on operations that are in fact profitable.

Our proposal was that, when you had such a loss, as defined in the text of the statutes that we drew up, you could not use it to offset your income from other activities, from being a doctor or lawyer or an assistant secretary, or whatever. It tried to get you back to a point where you were at least matching the expense against the kind of income that produced it. This, I would have to say——

Senator PROXMIRE. Maybe we can put some of these back on the floor of the Senate or the floor of the House. We will certainly try. Now, how much would that tax shelter raise?

Mr. HICKMAN. I cannot give you the number on what it would have raised. It is now down to $67 million in 1975.

Senator PROXMIRE. $67 million? Is that all?

Mr. HICKMAN. But that is not as bad as it seems, because what the committee did, while they deleted the important parts of this—and I will tell you about those—they also phased it in. And I think that we generally believe that where things have a major impact, that there is real justification if people can show hardship, for not having it them all at once, so that this revenue figure does rise in 1978 to $236 million. But it would still have been substantially greater as we had originally proposed it.

Senator PROXMIRE. All right.

Now, let me ask—I am almost through—about the effect of the capital gains proposals that the President made the other day. That had some merit in increasing investment, although he pointed out we have had a colossal increase in buying plants and equipment over the past few years. But what does that do to revenue loss, and is it not true that this would very largely accrue to corporations, and largely people—primarily wealthy people? You have to have wealth, after all.

Mr. HICKMAN. The capital gains provision does not apply to corporations.

Senator PROXMIRE. Well, to wealthy people.

Mr. HICKMAN. Yes, I think that is correct to say, because on the whole, wealthy people are the ones that have capital gains. If taxpayers have substantial capital gains, at least they turn up in our income statistics as wealthy for that year. We do have that problem with people who sometimes turn up in a class of——

Senator PROXMIRE. Well, occasionally. But by and large, this is something that would help them. And furthermore, especially with this surtax, it puts a real premium on unearned income, compared to earned income. People who simply have wealth, and the wealth increases in value, and they dispose of it at the increased value, they speculate, and it goes up; obviously, with a capital gains benefit tax at a lower rate than earned income, the person who does not earn income is put in a privileged position compared to one that does.

Mr. HICKMAN. Well, you can look at it that way. And I know in a sense it is a problem that has to be looked at from several different angles, and you have to take into account what you say. At the same time, the reduction that we proposed—or rather that the committee adopted that we supported—in the capital gains tax deals primarily with assets held for long periods of time. There is a declining scale on which you take the gain into account. I think that in that area, you have to look at inflation. Suppose, for example, in 1930 you bought 80 acres for $1,000 and today it is worth let us say $30,000. If, in 1930 that $1,000 commanded control over a certain amount of wealth, then in order to know what your real economic gain is, you have to know over what larger amount of wealth the $30,000 gives you command today. And so, if you are looking at real income increases, you have to make an adjustment in the $1,000 for the inflation that we have had in this long period of years. Any time you get into what the economists call intertemporal situations when you are dealing with long spans of time—these things become important, and you have to look at what you paid and adjust it for inflation.

You may find, for example, that the wealth that $1,000 commanded back in 1930 may today require $6,000 or $7,000 to command. So, if the land is now worth $30,000, the increment, expressed in today's prices, by which you are better off is not the difference between $30-000 and the $1,000, but it is the difference between $30,000 and what the equivalent of $1,000 would buy today. Now, that problem exists in the capital gains area. It is mitigated at the present time, in a very rough way, by the fact that in the case of long-term capital gains, we take into account only half of the income computed by subtracting the $1,000 from the $30,000. The proposal that we had was addressed in part to the problem of inflation and real income and in part simply to the fact that it would be helpful to market efficiency, and the use of our assets in the best possible way, if people would be encouraged not to sit on particular assets simply because they had a large gain on which they did not want to pay the tax.

Senator PROXMIRE. How much does this cost? How much revenue did we lose?

Mr. HICKMAN. It is our estimate that in the first year or so, that it probably will not lose any revenue at all, because we will get a one-time accumulated unlocking. There will be a great many people who, now that the tax is suddenly substantially reduced, will sell things that they would not otherwise sell, and the increased sales and whatever tax is levied on them will more than make up for—or, at least, roughly make up for—the reduction in the rate.

Looking out a ways in time, the staff of the Joint Committee on Internal Revenue Taxation estimates that this will cost us maybe $800 million a year; and I would have to say, while one never knows, that I do not find that an unreasonable estimate.

Senator PROXMIRE. Well, by and large, overall, it appears that rightly or wrongly, the so-called loopholes will raise—what, a net—well, let us not call them loopholes. Let us say, the changes in the law affecting wealthy people, corporations, and investors would have what effect on their taxes?

Mr. HICKMAN. Well, there is an individual tax reduction in the neighborhood of—if they use the remainder of the revenue they have to develop in the way that the President suggested that they would, which I think they are inclined to do anyway—there would be individual tax reductions in the neighborhood of somewhere around $2½ billion. I can get you the exact——

Senator PROXMIRE. Cash reductions of around $2½ billion?

Mr. HICKMAN. Yes; of which about $2 billion would go to persons in the AGI classes, below $15,000. Now, we have had a lot of talk since this proposal for a surtax came out, to the effect that $15,000 is a pretty low cutoff point, and that there are a lot of people who are not so well off above $15,000. Suddenly, $15,000 has become too low a threshold to define what is upper income. In the $15,000 to $20,000 brackets, for example, there is initial relief under the bill, but the figure is nearly $2 billion for the persons in the brackets below that. That is not as much revenue as we would have liked to have raised from tax reform, but we think that these tax bills, as other bills, are necessarily matters of compromise and differences of opinion. While those bills have not adopted all that we have proposed, they have adopted the basic proposals, in their conceptual outline, for dealing with loopholes. We think that is a step forward, and on balance, it is a bill that we think is better to have than not to have.

Senator PROXMIRE. Mr. Secretary, I am not going to detain you any longer, but I would like to have you get for me for the record—I would like to get an indication of the changes, because there have been a lot of charges and countercharges over the last—well, since 1969—on the changes in the impact of taxes on corporations, on so-called high income individuals, and on low-income groups or non-high-income groups, however you define it. I take it the high-income individuals—that is a category you use—these would be people with $15,000 and above income?

Mr. HICKMAN. Well, I would hesitate to say that that is a high——

Senator PROXMIRE. I am not talking about that. We do not have to talk about that. But that is the way you categorize it, is that right?

Mr. HICKMAN. Yes.

Mr. FIEDLER. We should have called it upper income.

Senator PROXMIRE. Upper income? All right, fine.

Give us those statistics for the record, so that we are in some position to evaluate what changes we have had, and where we might go.

Mr. HICKMAN. Since 1969 is what you want?

Senator PROXMIRE. Since the beginning of 1969; yes.

Mr. HICKMAN. All right; we will supply that for the record.[1]

Senator PROXMIRE. Gentlemen, thank you very much. I do appreciate your staying. You have been most helpful and enlightening to the committee, and in making a good record for us.

Mr. FIEDLER. Thank you, Senator. We are pleased to be here.

Senator PROXMIRE. The committee will stand adjourned, subject to the call of the Chair.

[Whereupon, at 10:55 a.m., the committee adjourned, subject to the call of the Chair.]

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[1] The information to be supplied for the record was not available at the time of printing the hearings.

PRESIDENT FORD'S ECONOMIC PROPOSALS

WEDNESDAY, OCTOBER 16, 1974

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

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

Present: Senator Proxmire and Representative Reuss.

Also present: John R. Stark, executive director; John R. Karlik and Loughlin F. McHugh, senior economists; Richard F. Kaufman, general counsel; Michael J. Runde, administrative assistant; William A. Cox, Robert D. Hamrin, Jerry J. Jasinowski, L. Douglas Lee, Carl V. Sears, and Larry Yuspeh, professional staff members; and George D. Krumbhaar, Jr., minority counsel.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. The committee will come to order.

The purpose of these hearings is to meet the legislative mandate of this Congress which instructed this committee to make a study of our inflationary situation and recommend appropriate policies which can be put into action promptly.

We have been through in the past month or so the most remarkable and highly publicized analysis of our economy and its problems in our history in the so-called summit conference and the many preceding meetings that considered various aspects of our economic problems.

This committee has recently filed an interim report with a series of recommendations and last week President Ford addressed the Congress summarizing what the President of the United States concluded this unprecedented avalanche of economic advice should mean for Government policies and last night he told the people of our country what they as individuals can do to help. The majority leader, Senator Mansfield, came forward on network television yesterday with his recommendations.

All of this public analysis by economists and pronouncements by our leaders show that one way or another our leaders have missed some very crucial points in meeting our present problem.

The No. 1 mistake, in my view, that is likely to lead to the wrong policies that can do further damage to our economy is the fallacious judgment that we are suffering from a general demand inflation, that we have too much money chasing too few goods, that we are spending too much privately and publicly and have to pull in our horns everywhere.

This may have been the situation 2 years ago. It is not the situation today. Real retail sales are down. They don't go down when we face excessive demands. Workers are working the shortest hours in our history, hardly the setting for pressure on resources. Unemployment is growing rapidly with 1,200,000 more people out of work than a year ago. Production is down. Capacity utilization is down. Inventories are up.

In my view, we don't need President Ford's surtax, or his appeal to Americans to stop buying, or Senator Mansfield's restoration of regulation W that would hammer down installment sales. These policies won't have much effect on prices. They will have a serious and adverse effect on unemployment.

On the other hand we do indeed have a serious problem of a potential shortage in food and energy. We have a demonstrable, highly explosive price explosion in certain concentrated industries—with an unprecedented 45 percent increase in the last year in steel—more than twice as great an increase in steel prices than steel cost increases could justify—and a price increase that will give steel a massive 25 percent rate of return on its equity in the second half of this year. We have seen a 43 percent increase in the price of nonferrous metals in the past year alone, of 62 percent in industrial chemicals, and of an obscene 87 percent in petroleum products (which incidentally are supposed to be still under wage and price controls). This price fixing is responsible for more than half of the huge increase in the wholesale price index. This is an inflationary element that has been almost ignored by many economists.

It is not primarily the product of cost or demand but of sheer economic power. We also face the possibility of a wage price spiral not yet full-blown but it could develop and spin inflation on for many months and possibly for years.

And, of course, we confront the dangerous prospect of a gathering recession both domestic and worldwide.

In my view these facts call out for a varied program of using the power of Government to achieve restraint in price increases in concentrated industries and wage increases in big labor unions—not controls, but forthright, loud public jawboning by the President, backed if necessary by congressional action. The situation also calls for a recognition that for the past many months that the real monetary supply corrected for inflation has not been rising—not even a little. It has been declining and declining rather sharply. As Leif Olsen of the First National City Bank of New York wrote in this morning's Wall Street Journal:

> A decline in the real money stock—which represents purchasing power of currency and checkbook money—leads to slower growth of real personal income. Such a decline has preceded every recession in the United States since World War II.

So it's time to change the course of monetary policy, to ease interest rates, to put to work the idle resources in housing and in other areas of the economy. Such easing will not be inflationary. It will help promote an economic recovery.

We are fortunate to have with us this morning two of the country's outstanding economists, Mr. Arthur Okun, who has been Chairman of the Council of Economic Advisors, and is now a top economic expert at Brookings Institution, and has been recognized particularly as an expert in the field of inflation, as well, of course, many other areas. We also have Mr. Joe Pechman of the Brookings Institution. Mr. Pechman, I think, is generally recognized around the country as a leading expert in tax policy and the effect that taxes have on the economy, as well as being a superlative general economist.

Gentlemen, we are delighted to have you here this morning and, Mr. Okun, will you proceed?

STATEMENT OF ARTHUR M. OKUN, SENIOR FELLOW, BROOKINGS INSTITUTION

Mr. OKUN. Thank you, Senator Proxmire.

Basically, all anti-inflationary measures can be divided into two categories—(1) those that hold down demand for goods and services, and (2) those that hold down prices and costs directly. The strategy embodied in the economic program of the President rests primarily on the former type of remedy—demand restraint. I regret that choice of strategy because it would impose on Americans unnecessarily and unacceptably large sacrifices of jobs, production, profits, and investment. On the other hand, if I were somehow obliged to accept that strategy, I would see very little to criticize and much to commend in the program. The proposed policies would allow the economy to go through the wringer of recession in order to squeeze out inflation. It would do that about as mercifully as is realistically possible, given the inescapably high costs of recession. In short, the key defect of the program is one of omission—the inadequate emphasis on the direct actions that can be taken to hold down prices and costs, and that can thereby permit some relaxation of demand restraint.

THE PRESENT ECONOMIC SITUATION

During 1973 and early 1974, our inflation rate shot up from 3 percent to above 10 percent. This surging inflation was unusually centered in food, fuel, and other raw and processed materials. But it basically fitted the classical mode of inflation—too much money chasing too few goods. In retrospect many policy actions should have been taken to prevent this price explosion, including greater fiscal and monetary restraint during 1972 and 1973.

The underlying character of the inflation is changing drastically and the remedies should be altered accordingly. We may face a food shortage and continuing problems on the energy front in 1975. Apart from those areas, however, we are now plagued by a new and different set of shortages—a shortage of jobs for workers and of customers for business. This Nation is in its sixth post-war recession, and no euphemisms or redefinitions should obscure that fact.

Never before in my professional career have so many economic forecasters revised down their projections of real GNP so sharply and so fast as in the past few months. The outlook for economic activity has deteriorated on many fronts. Hopes for relief on food and fuel prices that could have bolstered consumer demands for discretionary items have vanished. Homebuilding has plunged to new depths as a result of a mortgage famine. An inventory correction of significant proportions has become inevitable. Prospects for U.S. exports have sagged in light of the recession in other countries. While economic forecasting is always fraught with uncertainty, the projection of a weak economy at least through the middle of 1975 seems unusually firm and solidly grounded.

Yet the continuing recession offers little prospect of a dramatic relief from rapid inflation. First, the shortfall in the U.S. farm crop threatens to produce bad news in the essential area of food—outweighing what good news the world recession may yield in the form of lower prices for copper, cotton, lumber, rubber, and other internationally traded commodities. Second, the United States is experiencing a major acceleration in wage increases from the rate of about 7 percent that prevailed in the second half of 1973 and early this year to roughly 10 percent in recent months.

Workers' wages have been squeezed by inflation. The real purchasing power of an hour's worth of pay fell by about 3 percent in contrast to its normal increase of nearly 3 percent a year. Given this background, employers and employees alike now recognize a justification for larger wage increases to help workers make ends meet. The step-up in recent months is primarily the result of an unwritten treaty between workers and employers that a job has to pay a living wage. It is certainly not the result of tight labor markets, nor is it largely dus to new union settlements or to formal escalator clauses.

Accelerated wage increases are no cure because the losses suffered by workers are in the pockets of farmers—by acts of nature—and of foreign and domestic oil producers, and not in those of most U.S· employers, whose profits have been rather modest. Consequently, more rapid wage increases will be passed on to the consumer in the form of still more price increases. Workers as a group will be no better off. This process of incomes inflation—the understandable effort to restore the real incomes of working Americans—is bound to be self-defeating. Apart from food, this price-wage-price spiral will be the main inflationary force for 1975.

DEMAND RESTRAINT

A strong dose of demand deflation applied for a long time can ultimately conquer incomes inflation and generate reasonable price stability. However, particularly because of the real wage squeeze that we have inherited, that cure would probably require a weak economy—indeed, a prolonged recession—for several years. In my best judgment, an unaltered maintenance of current economic policy would produce a year from now an unemployment rate over 7 percent and an inflation rate that is close to 8 percent. If I am correct, the administration will certainly alter its present posture as 1975 unfolds. But where will it go? Will it adopt a more temperate program of demand restraint that might promise to end inflation within, say, 6 years at a 6 percent unemployment rate rather than within 3 years of 7 percent? As I see it, that would be a decision to be boiled in water rather than in oil. Or will it opt for indexing and other measures to learn to live with a permanently high inflation rate? As I see it, that would be an unfortunate decision—to scrap the whole institutional structure that rests on a reasonably stable value of the dollar. Or will it embrace a broad program of price and wage controls and replay 1971–72?

In short, I believe that the strategy of demand restraint is unlikely to be successful or sustainable. It is likely to be socially as well as economically intolerable despite the variety of measures recommended by the President to make it less painful. He proposes a significant improvement in our unemployment compensation system, a limited—in my judgment, realistically limited—program of public service jobs, and modest tax cuts for low-income workers. Because demand restraint precludes any increase in the Federal deficit, he needs added revenue to finance these measures. The resulting proposal for a surtax well conceived—it applies to less than one-half of the population, who are better off than the majority of their fellow citizens; and it is very progressive in taxing very high incomes much more than upper middle incomes. The President also proposes to cushion the adverse effects of recession on investment and hence on productive capacity by swapping between the corporate income tax and the investment tax credit. I would urge the Congress to make the corporate income surcharge and the investment credit both expired at the same date—say at the end of 1976—pending further review. Nonetheless, I believe that pair of measures would help a little. In these respects, I believe the President deserves commendation rather than criticism. I also approve the omission of a proposed hike in gasoline excise taxes; deliberately raising prices is no way to combat income inflation.

DIRECT ACTION

My criticism is entirely centered on the administration's lack of emphasis, innovation, and determination to find ways of holding down prices and costs that would not raise unemployment and lower production. The one important recent step to combat inflation directly was the cancellation of the grain deal with the Soviet Union, and it deserves our applause. So does the President's broader pledge to insure an adequate supply of food at home, which will surely require continuing actions to moderate and allocate our agricultural exports so as to serve reliably our reliable customers for food products. The Commission on Regulatory Reform, the proposed statement of the inflation impact of legislation, and the tiny steps taken on antitrust exemptions and penalties also take us in the right direction.

Nonetheless, much more could have been done on these fronts. The Council on Wage and Price Stability seems to have only a minor role in the administration's anti-inflationary scenario. The President has asked us all to eat less, to drive less, and to sign pledges, but has not invoked his moral authority to ask business and labor to moderate price and wage increases.

During the discussions associated with the summit, I set forth a concrete proposal to improve both the inflation and unemployment outlook for 1975. It is a program to hold down nominal wage increases and simultaneously to insure real wage increases. First, a numerical ceiling—say, 7 percent—would be placed on the average pay increase of all sizable employers, with a board consisting mainly of labor representatives empowered to authorize limited exceptions and exemptions. Along with that, a national price target should be adopted for 1975—say, to hold inflation below 5 percent. If the inflation rate exceeded 5 percent, the extra burden of the cost of living would be fully lifted through tax credits that would become retroactively payable to all workers with low and middle incomes. For example, if the actual inflation rate turned out to be 6 percent, a worker with a $10,000 income would get $100 back.

I am convinced that, if the administration accepted such a price target, it would see new vistas on ways to hold down prices. The Treasury would stop trying to sell the decontrol of old oil prices and would start making the two-price system work. The administration would start exploring subsidies for food and techniques to lower excise taxes. It would find ways to encourage mayors and Governors to lower sales taxes. It would rapidly develop a legislative program to eliminate some of the sacred cows whose slaughter would help to hold down prices. It would pay far more attention to the evidence of uncompetitive behavior reflected in such instances as the pricing of 1975 automobile models. If American workers were indemnified against inflation out of Federal revenues, the Government's crusade against inflation would take on some genuine vigor.

The proposal for real wage insurance is manageable and workable; to be sure, it is novel. But we need new initiatives to deal with our unique current problem. The costly remedy of recession and the bureaucratic monstrosity of detailed price controls are not tried and true; they are tried and false. We do not need the wartime brand of price and wage controls that were applied in 1971 and 1972. The Federal Government should not be ruling on price increases for fertilizer, where price incentives are important; rents, where Federal control is realistically unworkable; or popcorn, where the market can take care of itself. As I see it, the most serious problems of price inflation for 1975 and the most important opportunities for restraining prices lie outside the purview of traditional price control programs.

With or without real wage insurance, the Nation should be exploring every possible way of holding down prices and costs in food, energy, profit margins, and wages. The President can and should set forth explicit standards asking business and labor to act in their enlightened self-interest and in the national interest during the year ahead. The Council on Wage and Price Stability should expose violators to the spotlight of public opinion. The administration should be aiding business and labor by holding down food, fuel, and all other costs that they must bear. A comprehensive program of direct efforts to hold down prices and costs would permit some relaxation of the demand restraint that is producing a prolonged recession and would preserve—indeed, enhance—prospects for conquering inflation.

In the absence of such initiatives, I would expect to testify sometime in 1975 on a big and belated antirecession program combined with either a total price-wage freeze or a total indexing program to legislate inflation as a way of life. Those prospects make me sad.

Thank you.

Senator PROXMIRE. Thank you very much, Mr. Okun.

Mr. Pechman.

STATEMENT OF JOSEPH A. PECHMAN, DIRECTOR OF ECONOMIC STUDIES, BROOKINGS INSTITUTION

Mr. PECHMAN. If I may, I think I would summarize at least a——

Senator PROXMIRE. Your full statement will be printed in the record.

Mr. PECHMAN. I thought I would summarize the part of the statement that is in virtual agreement with what Arthur Okun said so eloquently and then go on to the part of the Statement in which I have a different emphasis on that aspect of the President's program.

Basically with respect to the economic effects of the President's program, I agree wholeheartedly with Okun's analysis. We are now in a recession, the recession will be getting worse, and unless the President's program changes fundamentally, we will be suffering from excessive unemployment and intolerable price increases 6 months to a year from now. Nobody can view the future with equanimity.

If Mr. Okun's forecast for next summer of 8-percent inflation with 7-percent unemployment, turns out to be correct, something will have to give. Like him, I am afraid that that something will be tighter constraints on the economy which will require a new bureaucracy and detailed direction of business decisions by the Federal Government. None of us would like to see that.

Like him, I think that the President was unwise in avoiding the problem of how to regulate prices and wages by Government action. A full-blown, comprehensive, mandatory wage and price control system is not needed now. It would be unwise to control prices and wages in the competitive sectors of the economy, but in the noncompetitive sectors of the economy such controls are warranted.

A lot of people argue against such restraint and guidelines, on the ground that they interfere with the freedom of the enterprise economy.

In fact, what we are really saying is that we ought to try to simulate in the currently foreseeable circumstances what competition would ordinarily yield if there were no administered prices.

I believe a majority of the Joint Economic Committee agrees with this point of view. I should think this is the most important economic problem that needs to be faced very soon.

Let me now turn to the President's tax proposals.

As I see it, the President has recommended a balanced program of tax changes that, combined with the Ways and Means Committee bill, would roughly balance out in calendar year 1975. In addition, he recommends cutting the budget below $300 billion.

As Mr. Okun has said, this is a recipe for increasing unemployment. If you constrain demand even more than it is constrained right now, the inevitable result will be to increase unemployment and to reduce GNP more. On that ground alone, the President's program is not satisfactory.

If there are wasteful or undesirable expenditures in the Federal Budget, the Congress should cut them out on efficiency grounds. But the money should not be used to reduce aggregate demand; the funds should be used to raise other worthwhile expenditures or to cut taxes in the low-income classes.

My own view is that, if a real attempt is made to cut the budget below $300 billion, the cuts will be made in social programs that are urgently needed, particularly in the face of the suffering that is taking place now among the low-income population.

Aside from these unfortunate fiscal facts, there are major elements of the administration's tax program that one can question on equity grounds. First, the President relied primarily on the changes in the low-income allowances, and the standard deduction now in the

House bill. Of course, we don't really know what is in the House bill because it hasn't been reported out. But according to the newspaper accounts, the Ways and Means Committee is suggesting that the low-income allowances be increased from $1,300 to $1,400 for single people and $1,500 for married couples and the standard deduction be increased from 15 to 17 percent, with an increase in the maximum from $2,000 to $2,500.

Now, this is all right as far as it goes, but my view is it is quite inadequate if we are talking about low- and middle-income relief.

The Congress made a decision several years ago that the minimum taxable levels, that is, the level at which an individual or a family would first become subject to the individual income tax, should be set no lower than the poverty lines.

In 1972, which was the last time the exemptions were changed, the exemptions were increased to $750 per capita and the low-income allowance was set at $1,300. The low-income allowance, as you know, is an alternative to the standard deduction for low-income people.

I have calculated what the poverty levels would be in 1975 and compared them with the proposals under the Ways and Means Committee bill. I also tried to estimate what it would require, in terms of increases in exemptions and changes in the low-income allowance, to approximate the poverty levels in 1975. I draw your attention to the figures in table 1 which is attached to my prepared statement.

You will see in the first column the projected poverty levels in 1975. This is estimated by taking the official poverty line for 1973, adding a modest 11 percent for 1974 price increases, and then even more modest 7½ percent for 1975. To the extent that prices next year rise more than 7½ percent, you would have to raise the figures in the first column labeled projected poverty level.

The next column shows the minimum taxable levels that would prevail if the Ways and Means Committee bill were adopted without change. The following column, which is labeled difference, shows the difference between the estimated poverty lines and the minimum taxable level. It amounts to $450 to $600 for families of three or less, and then becomes increasingly inadequate as the size of a family increases.

Thus, the Ways and Means Committee bill departs from the policy laid down by the Congress, and adopted by the committee itself a few years ago, that minimum taxable levels should be no lower than the poverty lines.

In the last two columns I show what it would take to correct the exemptions and the low-income allowance for the inflation that has occurred since 1972. Obviously you can't hit the levels exactly for every family size, but on the whole it looks like an increase in the personal exemptions beginning January 1 of 1975 from $750 to $900, and of the low-income allowances from $1,300 to $1,800 would roughly do the trick.

Like the Ways and Means Committee bill, this type of proposal would obviously help people in the higher income levels as well as the people right at the poverty line. In table 2, I show the differences by income levels in the amounts of revenue that would be lost as a result of the two types of adjustments.

The Ways and Means Committee bill which the President has supported would reduce taxes by $1.6 billion, whereas the adjustment necessary to increase the exemptions and the low-income allowance to the poverty lines would cost $8.1 billion. I would argue that, considering the inflation that has occurred since 1972, this kind of low- and middle-income relief is more than justified beginning January 1, 1975.

So I conclude that the low-income relief proposed by the President is inadequate and it should be modified in the direction that I described.

The second reservation I have about the administration's tax proposals is that it embraces the Ways and Means Committee bill as it has been reported in the newspapers lock, stock, and barrel, except for a recent proposal to exempt the first $500 of interest for savings accounts received by single people and $1,000 by married couples.

With respect to the Ways and Means Committee bill, all I can tell you is that, on balance, it will not add to the equity of the tax system. I don't think it will improve the Internal Revenue Code.

The worst feature of that bill is the further preferential treatment that would be accorded to capital gains. This is on top of the already highly preferential treatment they now receive; in the present circumstances this kind of action is unjustified.

I don't want to go into detail on the Ways and Means Committee bill but I would like, if I may, to put in the record, Mr. Chairman, a letter by your colleague, Congressman Reuss, outlining in detail why the Ways and Means Committee bill will make the tax system worse.

Senator PROXMIRE. Without objection, that letter will be printed in the record.

Representative REUSS. I will not object.

Mr. PECHMAN. I know modesty would have prevented the Congressman from asking that it be included in the record so I will do it for him.

[The above referred to letter follows:]

[From the Washington Post, Oct. 14, 1974]

ANSWERS EDITORIAL

In your October 9 editorial you give good marks to President Ford's 5 per cent surtax proposal, and assert that it "is made more acceptable in principle by the President's forthright support of the comprehensive income tax reform bill now in the House Ways and Means Committee."

Before you go overboard, please take a look at the tax position of those modest income people (starting at $10,000 a year taxable income for married couples, $5,450 for single people) who will bear a substantial share of the President's surcharge. Earlier this year, every wage-earner saw his wages subject to social security taxes rise from $10,800 to $13,200. Now his taxes are to be increased again—and why? Because the income tax code has been so eroded by loopholes that there is no longer enough taxable income left in the upper brackets for a surcharge on the genuinely wealthy to raise significant revenues.

Between the President and the Ways and Means Committee, a new union of loopholes is on the way:

1. Last month, the amount which a self-employed doctor, lawyer, accountant, etc., may put aside tax-free for his retirement was tripled from $2,500 to $7,500—a $175 million annual revenue loss.

2. The current Ways and Means "comprehensive income tax reform bill" contains:

a. a capital gain tax rate reduction, with liberalized loss and carryback provisions, to benefit the richest one-fifth of American taxpayers—a $1 billion annual loss. The biggest capital gains loophole of all—failure to tax capital gains realized at death—remains untouched.

b. Increased industrial bond allowances, to permit private industry to finance expansion at public expense—$150 million annual loss.

c. a "tax simplification" allowing a wealthy taxpayer to claim a lump-sum deduction of up to $650 in place of such minor deductions as excessive medical deductions, casualty losses, sick pay exclusion, cost of work clothes, etc., regardless of whether he qualifies for any of them—$400 million annual loss.

3. To avoid putting all its bonanzas in one basket, the Ways and Means Committee has just voted to report out a bill allowing owners of savings accounts to deduct up to $1,000 per couple for interest received—$1.8 billion annual loss. (The Treasury Department opposes this provision, to its credit.)

4. To all this, President Ford wants to add—

a. an investment tax credit of 10 percent for all industries and individuals—regardless of whether the investment is energy-consuming, socially-undesirable, or inflationary—and this at a time when equipment prices are rising at a 21 percent rate—$2.7 billion annual loss.

b. a corporate deduction for preferred stock dividends allowing businesses to write off these payments after December, 1974—$100 million annual loss.

True, there are a few face-saving stabs at plugging loopholes. The oil depletion allowance is to be phased out over three years, the minimum tax will be mildly improved, treatment of foreign income is tightened somewhat, the Limit on Accounting Losses has been accepted by the Committee, although in an eviscerated form. But not only is nothing done about most of the old established loopholes. New ones—$6.3 billion a year worth—are to be created.

In short, one more such administration tax package, one more such "comprehensive income tax reform bill" from the Ways and Means Committee, and the average American taxpayer will join the list of endangered species!

HENRY S. REUSS,
Member of Congress.

Mr. PECHMAN. I will be glad to discuss any of the points raised by the Congressman in that letter. It really does an excellent job of analysis.

Third, I agree with Arthur Okun that the additional investment incentives proposed by the administration would be all right, but the surtax on corporations which is designed to offset the revenue lost from the increased investment credit will not do so. It will last only 1 year, whereas the higher investment credit will go on for an indefinite period. The surtax on corporations should be extended as long as the increased investment credit is in effect. Alternatively, other reforms in the corporate tax field of a permanent nature should be enacted to offset the revenue loss.

I know members of this committee are aware that as a result of the frequent adoption since 1954 of tax incentives to promote investment, either through depreciation allowances or the investment credit, the ratio of corporate tax to the gross national product has declined very sharply. Whereas it used to be the second largest tax in the tax system, the corporate tax is now the third and still going down.

Benjamin Okner and I recently published a book in which we estimated the effective rates of tax for the entire system, Federal, State, and local tax system. We find that without the corporate tax the entire tax system would be regressive; even with the corporate tax most of the tax system is sort of proportional. There is an increase in the tax burden just at the very top as a result of the fact that people at these levels receive the largest proportion of their income in the form of property investments.

So if you continue to erode the corporate tax you continue to erode one of the most progressive elements of our tax system.

I do not agree with those who think that the corporate tax is a sales tax, i.e., that it is passed on to consumers. If I thought it were a sales tax I would oppose the corporate tax because I oppose regressive taxation. I believe that practically all of the corporate tax is borne by people who own capital and therefore it is not a regressive tax.

Finally, let me now turn to the surtax, and here I differ with Arthur Okun.

Admittedly, the surtax would be progressive. It starts at $15,000 for a married couple, and even at those levels its bite is relatively small. However, I wonder whether it is fair. Even though the tax applies to the top, say, 28 or 30 percent of the taxpayers, is it fair at this stage, when we are not fighting a shooting war? I am wondering whether it is fair to impose additional burdens to the extent even of 5 percent on those who already pay taxes and to let those who don't pay their fair share of the tax burden because of the existence of preferential provisions go scot free. It seems to me the time has come to call a halt on further tax increases until the tax system has been cleaned up.

I recognize that this is a matter that has been discussed for many years. Arthur Okun and others might argue for the use of this kind of progressive change in the interest of promoting speed and efficiency in fiscal decisions. My answer is that I have been around here for almost a quarter of a century talking about tax reform. Many of you people on the committee have also been around for a long time. The same tax reform promises have been made every time taxes have been raised in the interest of increased revenue: Tax reform is for tomorrow, tax rate increases we must have today.

There is no urgency for the revenues that would be raised by the surtax right now in any case. The Joint Economic Committee should urge the tax writing committees that a real program of tax reform be enacted when the revenues are needed. If the revenues are needed in 1976, there is more than enough time to make effective reforms.

For example, I wish we had a little more time to prepare calculations on the Brookings tax file comparing the surtax and various tax reforms. I hoped to show the committee the difference between the way a surtax would apply to the various income levels and some of the tax reforms that are well known to the members of the committee.

We made some preliminary calculations, which is a part of my prepared statement, showing added constructive realization of capital gains transferred by gift or at death as income and modifying the minimum tax to eliminate the deduction for taxes paid to reduce exemption from $30,000 to $5,000 and raise the tax rate to one-half the ordinary rates. These two reforms are reforms that have been talked about for many years. I don't think that they would require a great deal of effort on the part of the two tax-writing committees if they were of a mind to go this route.

My calculations suggest that, whereas 40 percent of the revenues from surtax comes from incomes with taxation of $50,000, I would say 75 percent of the revenue from the tax reform would come from these same income levels.[1]

[1] See table 3 of Mr. Pechman's prepared statement.

As you know, I have never been in favor of punitive taxation. I don't think that high tax rates are desirable in our type of economy. I support tax reform not only on the ground of vertical equity but also on the ground of horizontal equity. If we were able to get constructive realization and an effective minimum tax or other reforms, that would broaden the tax base so property incomes would not receive preferential treatment. I would then support reducing the top bracket rate very substantially. Under these circumstances, we could afford a reduction of the top bracket rate from 70 percent to say 50 percent. The resulting tax system would be somewhat more progressive than the present one and would also be better, far better on horizontal equity grounds.

I conclude that the administration program will not improve our chances to combat the inflation currently in prospect. It will aggrevate the recession and thus increase unemployment and reduce corporate profits and increase rather than reduce the inequity in the Federal tax system. I think the Congress should also pay attention to Arthur Okun's ingenious suggestion for introducing a tax credit for any inflation that exceeds national goals, as a method of moderating wage increases.

Finally, I strongly urge that the Congress should turn its attention to real tax reform which, of course, is already long overdue.

Thank you very much.

[The prepared statement of Mr. Pechman follows:]

PREPARED STATEMENT OF JOSEPH A. PECHMAN [1]

POLICIES TO COMBAT STAGFLATION

Tight monetary and fiscal policies have taken their toll in the economy. Assuming Congress does not alter the policies proposed by the President, the real gross national product will decline during the next six months and perhaps even longer. At the same time, inflation will continue at a high rate. The administration's fiscal program will not have a significant effect on inflation, and will aggravate the recession. The proposed tax measures, particularly the surtax on individuals, should not be enacted without substantial modifications.

Economic Conditions

All categories of demand, except for fixed business investment, are either declining or are growing slowly. Residential construction is in a slump that will not end until long-term interest rates ease; retail sales are not keeping pace with rising prices; inventory investment is falling; net exports are declining as a result of the increases in the cost of oil imports; federal and state-local expenditures are rising, but at a slow pace. Business investment is the only component of the gross national product that is not declining in real terms, and even this component is likely to fall as aggregate demand continues to fall.

These developments indicate that conditions are much more serious than a temporary oil induced recession. Unemployment increased slowly so far this year, because businesses expected the decline in output to be brief and moderate. Now that there is widespread recognition that the recession will be protracted, layoffs will increase as business attempts to cut costs. Estimates of unemployment for mid-1975 are in the neighborhood of 7 percent of the labor force.

Corporate profits have been rising despite declining demand. This is partly a reflection of the attempt to increase profit margins following the termination of price controls. However, much of the increase in profits is due to the large profits made on inventories that will have to be replaced at higher prices. In real terms,

[1] The views expressed in this statement are those of the author and do not necessarily reflect the views of the officers, staff, or trustees of the Brookings Institution. I am indebted to Barry Eichengreen who did the programming for the calculations referred to in this statement.

corporate profits are still low by comparison with historical trends. Unless the business situation improves, corporate profits will begin to decline soon, even in money terms. Thus, business as well as labor has been hurt by the recession.

Although the economy has been in a recession, prices have risen at double-digit rates throughout 1974. This was due primarily to the diffusion of the increased cost of oil through the price structure and to continued bad luck in agriculture, but some of it could have been avoided if price and wage controls had not been abandoned in the spring. Some easing of the inflation may occur as world commodity prices decline in response to weakened world-wide demand. But this will not be enough to reduce the rate of price increases to satisfactory levels in this country, because the cessation of controls has generated a price-wage spiral that will continue to raise costs and prices even in the face of declining demand.

It should be emphasized that labor cannot be blamed for initiating this spiral. Wage settlements did not reach the 10-percent range until the prices of the products they produce began rising at double-digit rates after price controls expired earlier this year. Now that it is in process, the spiral will not be broken in a reasonable length of time without direct government action. The right policy would be to compensate labor for moderating its wage demands by reducing taxes and to reinstate controls over prices in noncompetitive sectors of the economy. Although labor officially opposes price and wage controls, I believe that it will respond to a genuine effort by the government to establish such a social contract.

However, the administration continues to be adamant in its opposition to government intervention in price and wage decisions. Instead, it is relying on continued restraint of demand to moderate price and wage increases. Inflation must be stopped, but it will not be stopped fast enough by present policies. In my judgment, these policies wo ld work only after great damage has been done to the workers and business enterprises of this country.

The Tax Proposals

The administration has proposed a fiscal package of tax changes that would roughly balance in 1975 and a cut in expenditures of $5 billion or more during this fiscal year. The economic effect of this package would be to aggravate the recession, with only a minor impact on prices. Congress should cut expenditures only if it finds them to be inefficient, wasteful, or undersirable on social grounds. If any cuts are made from presently projected levels, these cuts should be used to finance other expenditures or to add to the tax reductions. This is a time to loosen the fiscal restraints, not to tighten them.

Aside from the unfortunate fiscal effects, major elements of the administration's tax program are questionable on equity grounds. First, primary reliance for low income tax relief is placed on the increase in the low-income allowance proposed by the House Ways and Means Committee from $1,300 to $1,400 for single persons and $1,500 for married couples. In addition, the standard deduction would be raised from 15 to 17 percent, with an increase in the maximum from $2,000 to $2,500. When the present personal exemptions and the low-income allowance were established in 1972, Congress intended to remove from the tax rolls individuals and families with incomes below the poverty levels. Since prices have risen sharply, the levels of income at which taxes begin to apply are now substantially below the poverty lines and will fall even farther behind next year as prices continue to increase. It would be necessary to increase the per capita exemption from $750 to $900 and the low-income allowance from $1,300 to $1,800 to approximate the presently-projected poverty lines for 1975. As Tables 1 and 2 indicate, the Ways and Means Committee proposal is wholly inadequate on the basis of this criterion: the minimum taxable levels would be 10 to 20 percent below the 1975 poverty lines (Table 1) and the amount of tax relief would be about one-fifth of the amount needed to correct for the erosion of the per capita exemption and the low-income allowance due to the inflation (Table 2).

Second, the administration seems to be embracing all the revisions now in the Ways and Means Committee bill, except for the recent decision to exempt the first $1,000 of interest per couple ($500 for single persons) on savings accounts. There are a number of desirable revisions in this bill, but on balance it will make the tax system less, rather than more, equitable. Perhaps the worst feature is the tax reduction for capital gains from the sale of assets held more than one year, a provision that would increase the preferential treatment accorded to capital gains which accrue mainly to high-income taxpayers.

Third, the administration is proposing to increase the investment credit from 7 to 10 percent in the interest of increasing investment incentives. There would be no lack of investment incentive if demand were not being restrained by fiscal and monetary measures. (The ratio of investment to GNP has remained close to peak levels in 1973 and 1974.) Nevertheless, it would be appropriate to tilt the tax system in favor of more investment, provided the cost is not borne by the general taxpayer but by business, so as to maintain the progressivity of the tax system. The 5 percent surtax on corporations would not have this effect, because it would apply only to a single year—1975—while the increase in the investment credit would be permanent. Thus, over the long run, the role of the corporate tax would be further eroded and the progressivity of the federal tax system would be reduced if the administration's proposal were adopted. The investment credit should not be increased unless the cost is financed by permanent reforms of the corporate tax or by a permanent increase in the corporate tax rate.

Fourth, the 5 percent surtax on individuals with incomes above $7,500 and families with incomes above $15,000 should be rejected for two reasons: As noted earlier, in the economic conditions now foreseen for 1975, the revenue from the surtax is not necessary. With unemployment rising and profits falling, there is no reason to pay lip-service to the balanced budget philosophy. Higher taxes would further reduce demand, without doing anything very much about the price-wage spiral. Moreover, if additional revenues are needed for the long run, a surtax on those who already pay taxes would be paid by the wrong people. It is true that the surtax itself would be a progressive tax change, but there are numerous tax reforms that could raise as much or more revenue from people who now avoid paying their fair share of the tax burden. For example, about 60 percent more revenue could be raised by taking capital gains transferred by gift or at death under present capital gains rates and revising the minimum tax (to eliminate the deduction for taxes paid, to reduce the exemption from $30,000 to $5,000, and to raise the tax rate to one-half the ordinary rates). Yet, 39 percent of the revenues from the surtax would come from taxpayers with incomes above $50,000, while 69 percent of the revenue from the capital gains and minimum tax reform would come from these income levels (Table 3). Many other urgently needed tax reforms would have similar distributional effects.

I conclude that the administration's programs will not improve our chances to combat the inflation currently in prospect; that it will aggravate the recession and thus increase unemployment and reduce corporate profits and business incentives; and that it will increase, rather than reduce, the inequities in the federal tax system. The first order of business for the Congress should be to restore the President's authority to intervene in price and wage decisions. It should then turn its attention to real tax reform, which is already long overdue.

TABLE 1.—MINIMUM TAXABLE LEVELS UNDER THE WAYS AND MEANS COMMITTEE BILL AND ALTERNATIVE TO APPROXIMATE ESTIMATED POVERTY LEVELS IN 1975

Family size	Projected poverty level [1]	Ways and Means Committee bill [2]: Income level	Ways and Means Committee bill [2]: Difference	Alternative to approximate poverty levels [3]: Income level	Alternative to approximate poverty levels [3]: Difference
1	[4] $2,747	$2,150	−$597	$2,700	−$47
2	[4] 3,540	3,000	−540	3,600	+60
3	4,206	3,750	−456	4,500	+294
4	5,384	4,500	−884	5,400	+16
5	6,350	5,250	−1,100	6,350	0
6	7,134	6,000	−1,134	7,200	+66

[1] Projected from the official poverty line for 1973, assuming increases of 11 percent for 1973–74 and 7.5 percent for 1974–75.

[2] $750 per capita exemption; low income allowance of $1,400 for single persons and $1,500 for married couples; standard deduction of 17 percent, with a maximum of $2,500.

[3] $900 per capita exemption; low income allowance of $1,800.

[4] Assumes members of the family are under 65 years of age.

TABLE 2.—TAX REDUCTION UNDER THE WAYS AND MEANS COMMITTEE PROPOSAL FOR LOW INCOME RELIEF AND PROPOSAL TO RAISE THE MINIMUM TAXABLE LEVELS TO APPROXIMATE ESTIMATED POVERTY LEVELS, BY ADJUSTED GROSS INCOME CLASSES, 1975

	Ways and Means Committee bill [1]		Alternative to approximate poverty levels [2]	
Adjusted gross income classes	Tax reduction (billions of dollars)	Percent distribution	Tax reduction (billions of dollars)	Percent distribution
Under $5,000	−167	10	−881	11
$5,000 to $10,000	−366	23	−2, 290	28
$10,000 to $15,000	−201	13	−1, 427	18
$15,000 to $20,000	−541	34	−1, 276	16
$20,000 to $25,000	−193	12	−889	11
$25,000 to $50,000	−125	8	−1, 058	13
$50,000 and over	−5	(3)	−315	4
All classes	−1, 598	100	−8, 136	100

[1] $750 per capita exemption; low-income allowance of $1,400 for single persons and $1,500 for married couples; standard deduction of 17 percent, with a maxiumum of $2,000.
[2] $900 per capita exemption; low-income allowance of $1,800.
[3] Less than one-half of 1 percent.

Sources: Based on Brookings 1970 Tax File projected to 1975. Figures are rounded and will not necessarily add to totals.

TABLE 3.—INDIVIDUAL INCOME TAX INCREASES UNDER THE 5-PERCENT SURTAX AND ALTERNATIVE TAX REFORMS, BY ADJUSTED GROSS INCOME CLASSES, 1975

	5-percent surtax [1]		Alternative reforms [2]	
Adjusted gross income classes	Tax increases (millions of dollars)	Percent distribution	Tax increases (millions of dollars)	Percent distribution
Under $5,000			$122	2
$5,000 to $10,000	$35	1	6	(3)
$10,000 to $15,000	137	4	10	(3)
$15,000 to $20,000	305	9	27	(3)
$20,000 to $25,000	486	14	24	(3)
$25,000 to $50,000	1, 187	33	1, 598	28
$50,000 and over	1, 402	39	3, 915	69
All classes	3, 552	100	5, 702	100

[1] Applies to amount of tax paid on incomes taxed at rates applying to taxable incomes of more than $5,450 for single persons and $10,000 for married couples.
[2] Tax capital gains transferred at gift or death at present capital gains rates; and revise minimum tax by eliminating the deduction for taxes paid, reducing the exemption from $30,000 to $5,000, and raising the tax rates to one-half the ordinary rates.
[3] Less than one-quarter of 1 percent.

Sources: Based on Brookings 1970 Tax File projected to 1975. Figures are rounded and will not necessarily add to totals.

Senator PROXMIRE. Well, I want to thank both of you gentlemen very, very much. These are, I think, two superlative presentations. I told Mr. Okun before the beginning I cheated a little bit, I got your statement last night and I had a speech last night, and used excerpts from both of your statements in the speech because I thought they were thoughtful and useful.

I especially like the way that you, Mr. Okun, separate the alternatives we have in economic policies on what we are going to do about inflation. You say, No. 1, we can put the country through a recession, even a depression, for months or years, and eventually squeeze out inflationary pressures and achieve a greater degree of price stability, but it is at enormous cost.

The second alternative is somewhere holding down prices, and it is not as attractive, as you point out, as it seems because that also has a terrific price, and we are somewhat aware of that because of what we have gone through in the last couple of years.

You point out there are ways we can hold down prices and you suggest, as Mr. Pechman said, a most ingenious way of doing it.

I also like Mr. Pechman's conclusion. I am going to read it again because he didn't give it directly, and it is very short. He says:

> I conclude that the administration's programs will not improve our chances to combat the inflation currently in prospect; that it will aggravate the recession and thus increase unemployment and reduce corporate profits and business incentives; and that it will increase, rather than reduce, the inequities in the Federal tax system. The first order of business for the Congress should be to restore the President's authority to intervene in price and wage decisions. It should then turn its attention to real tax reform, which is already long overdue.

Now it seems that, Mr. Pechman, you have given us your view on the President's program very clearly and simply there. I think you have been somewhat in more general terms, Mr. Okun.

Could you tell us whether you would agree with the conclusion that the President's economic package will have a very limited impact on the economy? Some parts of it are good but in general overall it will not retard inflation very much, if any, and that it could aggravate recession?

Mr. OKUN. That is a fair statement. Certainly, if my expectations are correct, we will be looking at unemployment rates and inflation rates in the 7 to 8 percent range a year from now. That suggests that the President's program would be accepting a deep and prolonged ecession and not producing very much progress against inflation. I don't consider that an acceptable degree of progress against inflation at the cost that it imposes.

Senator PROXMIRE. Now, you made the statement that, never before in your professional career have you seen so many economic forecasters revise their estimates so sharply and so fast as in the past few months.

What is your own estimate?

Let me give you a couple of your colleague's estimates. DRI estimates real GNP will drop in the first and second half of 1974 by a tenth of a percent. The second half of 1974 to the first half of 1975 it will rise by a small margin; 1.1 annual rate. Wharton thinks we are going to have a drop between the first and second half of 1974 of 0.7, and a drop in the second half to the first half of 1975 of 0.4.

Mr. Perry is the most pessimistic of all. He thinks we are going to have a falloff this half compared with the first half of 1.8 gross national product and the second half it will deepen, that is between the first half and second half of 1975 it will deepen with a falloff of 2.6 percent.

Which do you think is the most realistic?

Mr. OKUN. I haven't been producing forecasts of my own. I have studied the Perry forecast and it seems quite realistic and not excessively pessimistic. There are as many chances that the outcome may be on the down side of that forecast as on the up side. My impression is that other forecasters are joining Perry. Every week I get a new model from some of my friends who are revising down considerably. I am not sure whether the DRI model that you are citing is the latest version Mr. Eckstein has produced.

Senator PROXMIRE. He has revised his downward from this, too.

Mr. OKUN. That is my impression. I am not certain.

Senator PROXMIRE. At any rate, Mr. Perry, I understand, concludes that unemployment could reach 7 percent this year. Do you agree with that as a fairly realistic estimate?

Mr. OKUN. Yes sir, in 1975. If anything, he is a little conservative on his estimate of unemployment; in my judgment it could exceed 7 percent. I think I can explain why unemployment rose as slowly as it did during much of this year. The initial reaction of the business community, as well as of the Government and many academic economists, to the bad news of the first quarter was that the economy was going through what was called an energy spasm which was going to pass away. They expected a renewed expansion in the second half of this year.

Given the fact, that business had a good year in 1973, that markets had been strong and profits good—particularly the ones swollen by inventory gains—businessmen went ahead and kept hiring even though they didn't really need the workers currently. Everyone is now revising down and that is accompanied by significant retrenchment of business. I think we saw the first installment in the September unemployment rate. I am not expecting the unemployment rate to keep moving up at that clip. The September increase seems a little extreme. I wouldn't be surprised if, in October, the rate leveled off. But, looking ahead over 6 months, I expect a very sharp rise in the trend of unemployment.

Senator PROXMIRE. Do you think the President's proposals will change these forecasts, in your view?

Mr. OKUN. I see nothing in the program to strengthen the economy. I read the program as saying we have to accept the recession as part of the price to get rid of the inflation. I find that an intolerably high price and I think it is a very inefficient way of getting rid of the inflation.

I share the administration's assessment of the importance of getting rid of the inflation. I don't think we should pump up the economy from a point where it has a double-digit inflation rate. That would be a decision to live with the high inflation rate for a long, long time to come and I would oppose that as much as I would oppose using this particular cure for inflation.

Senator PROXMIRE. But what you do propose, instead of relying so exclusively on letting the economy sag, you would move in with more forceful action by the President to hold down major price increases that are inflationary and then adopt other policies that would stimulate the economy, monetary policies, fiscal policies?

Mr. OKUN. To the extent that we hold down——

Mr. PECHMAN. Isn't it true that, if in fact the President does get a net reduction in the budget deficit, his program would actually increase unemployment above what it would otherwise be?

Mr. OKUN. Yes. If you view the program as involving a $5 billion net cut in budgetary expenditures and what is essentially a balanced tax program for next year, that the net effect of that has to be restrictive.

Senator PROXMIRE. And you would agree with that?

Mr. PECHMAN. Indeed.

Senator PROXMIRE. You think the prescription the President proposed is going to aggravate the recession, increase unemployment, without having a significant effect on moderating price increase?

Mr. PECHMAN. Yes; he has opted for a program of demand restraint which, if you kept it on for a long time, might reduce the inflation to reasonable levels. But as Art Okun just pointed out, a program which would yield us a combined total of rates of inflation plus unemployment of 15 percent next summer is utterly unacceptable. Something will have to give, and like many, I am worried that we will get mandatory controls over the entire economy which should not be necessary.

Senator PROXMIRE. Is it possible you gentlemen are being too gloomy? You have several shafts of light here that may indicate that you may be too pessimistic. One is that we had a drop in the wholesale prices in September. It is true that that drop is peculiarly constructed. It consisted of a very sharp drop in farm prices, and an increase in industrial prices. Overall, nevertheless, it was a drop in industrial prices moderated from their enormous increases in past months. I shouldn't say many, some administration spokesmen indicate they now see daylight at the end of the tunnel. This is the beginning of a constructive situation.

This morning in the Wall Street Journal, Leif Olsen indicated he felt that inflation could moderate to a 6-percent level by next year with most of the inflation problems behind us, that the real problem is a recession problem and not an inflation problem.

You gentlemen seem to feel we have both, that we are facing—and I get from your remarks so far you don't see any significant easing in the inflation situation?

Mr. OKUN. Well, there are certainly lots of uncertainties around anybody's inflation forecasts. I can think of lots of rays of sunshine, as you put it, that could break through, but I don't see them yet. If the oil cartel fell apart the day after tomorrow, that would produce a big decline in petroleum prices and would dramatically improve our price situation. If it turns out that weak labor markets have a much more dramatic effect in holding down wages than recent past history would suggest, we could get better news on labor costs. I don't see any evidence that any of these things are happening. In allowing for the inflation rate to come down from 12 percent to 8 percent we are counting on a slowdown in energy price rises and on some relief from the flexibly priced commodities that enter into world trade, such as lumber, cotton, and the like.

The adverse food situation really put the nail in the coffin of the demand restraint program, in my judgment. It is conceivable that, if we had had that bumper crop this year, we would get very good news on food prices next year. We would have less wage pressure, more discretionary income for consumers and, therefore, a less dismal outlook on real GNP and the prospect of a more rapid deceleration of inflation.

Miracles can happen but I don't think Federal policy should count on favorable miracles. We ought to take the steps that are necessary to make a favorable outlook probable rather than conceivable. If all the good news happens, then we would get the inflation rate down to 3 percent by the end of next year without a recession and compliment ourselves on the remarkable turnaround. I would take the good news on top of a realistic proposal rather than set a proposal which requires miracles to bail it out.

Mr. PECHMAN. My reason for pessimism is that you have to rely on good luck just to get down to 7 percent unemployment for the next year because wages——

Senator PROXMIRE. You say you have to rely on good luck to get down to 7-percent inflation or 7-percent unemployment?

Mr. PECHMAN. Get down to 7-percent inflation. I base this estimate on the fact that wages, compensation per manhour, or average hourly earnings, seem to be rising at an annual rate of 10 percent a year or more.

Now, even assuming a generous estimate for productivity of 2.5 to 3 percent a year, prices must increase 7 percent a year avoid cutting into profit margins. Any number of the things Mr. Okun mentioned could happen to make matters worse. Commodity prices might increase rather than come down a little bit. The food situation might not improve. And who knows what oil prices are going to do. Even if the OPEC countries reduce the price of oil $1 per barrel, if the administration relaxes price controls on old oil next February, oil prices to the consumer in the United States would rise. There would be at least a one-shot increase next spring in consumer prices due to oil.

The way to reduce the inflationary pressure is to get labor to accept somewhat more moderate wage increases. The way to do that is for the administration and the Congress to agree on what our colleagues George Perry and Charles Shultz have called a social contract to to substitute tax reductions for wage increases. Our preference would be a reduction in the payroll tax, of say 2 percent, in return for a 2 percent increase in wages. I think labor would go along if there seemed to be a will in the administration and the Congress to do something like that.

Senator PROXMIRE. Congressman Reuss.

Representative REUSS. You are saying, reduce the present 5.85 percent payroll tax?

Mr. PECHMAN. That is right.

Representative REUSS. To 3.85 percent?

Mr. PECHMAN. Yes, sir.

Representative REUSS. What would be the revenue loss?

Mr. PECHMAN. It is about $6 to $7 billion for each point reduction.

Senator PROXMIRE. A point; that would be a total of $14 billion?

Mr. PECHMAN. I am assuming you are talking about the employee tax?

Representative REUSS. Yes; so it would be $14 billion?

Mr. PECHMAN. Something like that.

Representative REUSS. Mr. Okun, you describe the President's program of public service jobs as limited, and "in my judgment, realistically limited." The President's program which, I must say, I found disappointing, which is why I am raising this with you, was limited in numbers to 80,000 jobs, as against an unemployed group of at least 5.3 million. It was limited in scope so it cut out public service jobs in public safety, and health, and education, and daycare, and many other things, and made it just beautification or a parks program, and it is also limited in when it takes effect—it wouldn't take effect now, for instance, it would only take effect after unemployment got above 6 percent, and then would cut off again when unemployment got down below 6 percent.

Do you really think those limitations are realistic?

Mr. OKUN. I think one could do somewhat more and I must say I read the details of the program after drafting my statement. Maybe the Administrations' proposals are more limited than realism requires. But I am very skeptical that one can, say, multiply the program by a factor of five or ten. I think that only a limited number of people really need a $7,000 a year job or, even on broader eligibility qualifications, can fit into that kind of job on the payroll of States and localities. According to the evidence I have seen, the last program was pretty good in terms of efficiency, but that was true precisely because it had fairly modest objectives and never got very large. The estimate is that for any calendar year its maximum job creation was 140,000 jobs. The Urban Institute has study a which estimates that about 40 percent of those were jobs that the cities and States would have created out of their own funds anyway.

I want to stress that there really is no such thing as a painless recession which can take care of people who suffer by putting them on payrolls in some creative job—it is bound to be a low paid job, fairly low quality and temporary job—and still have the anti-inflationary effects that are supposed to develop as a result of people pushing hard for jobs.

It seems to me that public employment is an aspirin. If I have a headache, I want to take aspirin. Perhaps the President proposed one aspirin. We could take two, and in principle have more relief from the headache. But let's not use aspirin as though it were a cure for a brain tumor. I think the situation that I am envisioning for next year is in the brain tumor category and not the simple headache category.

Representative REUSS. Anyway, taking the 80,000 jobs as it is, let's go on to your professed satisfaction with the surtax on individuals making $15,000 per couple. You say that is well conceived, and you believe that that and the other tax measures will help a little, and you say that the President deserves commendation rather than criticism.

Isn't it a fact that—leaving equity aside, which shouldn't be, but leaving it aside—at least the lowest third-income people who pay that surtax are people who spend almost all of their income, and isn't the removal from their pockets of the 5 percent surtax going to markedly decrease the effective demand for a good many commodities which are not in short supply at all, clothing, consumer-durables, furniture, many other things?

Mr. OKUN. Yes; again this gets back to the fundamentals. Is recession the only cure for inflation? If it is, then when less is spent, that does us a little bit of good in reducing inflation.

Representative REUSS. Since neither the two witnesses nor the two of us here on the committee feel that that is the solution, let me ask another question.

If, in coming forth with a program which says we are going to impose a tax surcharge on people making $15,000 a year, $7,500 a year if you are single, the effect is to fracture jobs—which it certainly will be as we just said—what in the world have we accomplished by fracturing jobs in private industry and then making them in beautification public service jobs. That is inadvertent socialism, it seems to me.

Mr. OKUN. Yes.

Representative REUSS. Nobody should be for inadvertence.

Mr. OKUN. Yes, the demand restraint program is a program of reducing employment in private industry and reducing opportunities for career building through promotion. It hurts workers in every conceivable direction.

Representative REUSS. Would you say Alan Greenspan was a secret socialist? How do you account for this kind of program?

Mr. OKUN. Well, I have talked to the people in the administration at some length and offered them my dire view of the situation. I think some people are unduly impressed by the record of 1957–58, which looked terrible at the time but which in retrospect did pave the way toward 7 years of price stability in this economy. That one sharp, short recession really hurt a lot. But it did take the inflation out of the system. The inflation that prevailed at that point in time was a about a 4 percent inflation rate that had lasted about a year or a year and a half. It is not surprising that we could eliminate it with one short, sharp recession. The inflation today is much more deeply built into the system and would be much more costly to eliminate.

Apart from 1957–58, you have to go back to 1920–21 to find another instance in which old time religion cured an inflation. We got out of other inflations in very different ways—during Korea, with no recession whatever, or, in the case of the late 1940's, because supply caught up with demand.

Some of the people who recommend this demand restraint strategy may hope that, if the Government really sounds tough enough and savage enough, then it can convince business and labor that they don't dare raise prices or wages. Perhaps they see some symbolic significance in budget cutting and in not giving a nickel of net tax reduction in conveying the message that Uncle Sam is battening down the hatches or is ready to administer the tough medicine. In effect, they want to say, the sooner you guys recognize the facts of life, the sooner we can get out of this recession. I wish I believed that would work. Part of the problem is that there is no way that any individual, group of workers, or any individual businessman can rescue himself from the present sitution of soaring costs of living and soaring cost of inputs except by raising prices and wages. We are all caught on a treadmill individually.

This is exactly the kind of situation requiring collective action. We have to get people to lay down their guns when they can't afford to engage in unilateral disarmament. I really do believe that there is a strong ideological determination on the part of the sensible economists in the administration to do everything possible to avoid any kind of direct intervention with prices and wages.

I also regard that intervention as costly but I don't think that it is a cost that compares with the realistic prospect of 3 years of 7 percent unemployment as a cure for the inflation. Comparing those costs, Government intervention in the price-wage process looks much less costly to me.

Representative REUSS. I want to thank you both for the notable contributions you have made.

Mr. OKUN. If I may say so, I agree fully with everything you said in the letter. It seems to me that it is a strong piece of evidence on how unlikely it is that Congress would produce a good tax reform in a reasonable period. This is the bill that was formulated by the Ways and Means Committee, a congressional arm consisting of a majority of Democrats. It caved in and adopted the interest giveaway; it reviewed capital gains and made the law worse. Given that situation, I could not really expect the President to count on tax reform as any solution to the near term problem.

Representative REUSS. I will ask both of you gentlemen to give a short answer to this question. Then my time up up.

Could one at least dream that, in the election on November 5, the tax reform public, joined this time by the middle class who sees the prospect of endless surtaxes on them, would elect to the Congress great numbers of new tax reform-minded Congressmen. Couldn't it then be that Congress, which has done some reforming of campaign expenditures and House jurisdictions, could embark upon the greatest reform of all, reforming the Ways and Means Committee. And couldn't thus the 20 years of destruction of an adequate tax system be brought to an end, and a splendid budget-balancing, loophole-plugging, inflation-destroying tax bill emerge, and, under open rule, be debated by these new philosopher kings, and passed?

Mr. OKUN. I look forward with great hope for that day.

Mr. PECHMAN. Well, obviously the election of a more progressive Congress will enhance the prospect of a tax reform.

I want to add to what Arthur Okun said. Part of the reason why we don't have effective tax reform is that we have had successive administrations that didn't take tax reform to heart. If a President, of whatever party, took the leadership in proposing meaningful tax reform, I think the Ways and Means Committee and the Finance Committee would go along.

The problem is that these committees, which include the most conservative members of the Congress, will not act unless they are pushed. One way to push them, of course, is to elect a more progressive Congress, I agree with you in that respect. The other way is to have the President exercise the leadership that we expect of him.

In this particular instance, just endorsing a Ways and Means Committee tax reform bill that is reform only in name and not in substance is the wrong thing to do. I would hope that the Treasury Department would look at these things more carefully and come up with a much more effective reform bill next year.

Representative REUSS. Thank you, Mr. Chairman.

Senator PROXMIRE. Mr. Okun, last night the President said we should fight inflation by shopping more wisely, turning down the thermostat, trying not to get sick and so forth, cleaning your plate. What value do you see in efforts like the President made last night to develop such a great citizen mobilization to "Whip Inflation Now." The President also said last night the Nation would be out of the economic trenches by Christmas.

How would you respond?

Mr. OKUN. I thought he said we would not be out of them by Christmas. Perhaps I am less negative about the possibilities for voluntarism in this society than others. I don't see any harm in asking people to enlist in doing constructive things.

Senator PROXMIRE. I don't see either. I don't see any harm in it. I think it is very helpful. I think the country will respond if there is some reason behind it. I think the country responded very well to President Nixon when he was at his low level of popularity and yet the country responded to the energy crisis with a substantial savings of oil, and in addition to the fact that, of course, we had long lines and so forth. But there was also a substantial citizen response.

I am just wondering if this is the right advice. Supposing we do go on a kick in which people reduce their spending, what will this do to the economy; will it be good or bad?

Mr. OKUN. On food and energy, the two areas of genuine pressures of demand on supply, cutting demand will have a significant anti-inflationary effect. I interpret the careful shopping and the rest as trying to buy where the prices are lowest, not deferring from buying entirely.

At this point, consumer spending is so weak that its weakness is a substantial threat to the health of plant and equipment spending, which is the only strong area of our economy.

Senator PROXMIRE. We have had a drop in real retail sales of 5.4 percent, now below what it was a year ago, and it seems to me this is about the best evidence you don't have a demand inflation, general demand. You are right in food and energy. Maybe there are a couple of other areas, but——

Mr. OKUN. We have had by far the largest decline in real consumer purchases in this recession than in any previous post-war recession. I don't understand why anyone would want the consumer to tighten his belt generally. I agree with you fully—if he winds up saving more, the economy will be pushed even harder through that recession wringer and that is the wrong kind of cooperation.

As I indicated in my statement, I wish the President would try one other area of voluntarism—on prices and wages. He should enunciate a reasonable and equitable explicit set of guides for business and labor on price and wage decisions next year and explain to the leaders of business and labor what he wants them to do, how that will help the country, and how it will get rid of this wage-price spiral. Let's try voluntarism on that; we have nothing to lose.

Senator PROXMIRE. The Wall Street Journal reports this morning in an article by Leif Olsen, the President said the country would be out of the economic trenches by Christmas. The Post says we will not be. [Laughter.]

This committee in 1970 made a study of subsidies and we found that the Federal Government was responsible for something like $63 billion a year in subsidies. Now subsidies can be classified in all kinds of ways and $38 billion of this were so-called tax expenditures or tax loopholes or tax subsidies; we have updated that and it has been released today. At any rate, it will be released this week. I think today, showing that the subsidy expenditure is now $95 billion of which $60 billion is tax subsidies.

Now, if we enact the Ford program, as he asked Congress to do last Tuesday, a week ago yesterday, subsidy would exceed $100 billion of which $65 billion would be tax subsidies. My question is whether looking at this broader picture, not the immediate picture but the trend that we have of trying to solve our economic problems by increasing the investment tax credit by a long-term capital gain concession to get people to save more or exempting interest on savings from taxes, whether this kind of proposal doesn't create a situation which our whole tax system is being progressively undermined and which the inequities are becoming very serious indeed and might have an overall adverse effect.

Would you put this in perspective?

Mr. PECHMAN. I couldn't agree with you more. The enactment of an increase in investment credit would have a positive effect on business investment. In other words, we would get more business investment than we otherwise——

Senator PROXMIRE. Let's stop there a minute. What is the purpose of the additional business investment. If there has been one strong area of the economy in the last 2 or 3 years its been business investment in plant and equipment; it continues strong and we want to encourge that. But I just wonder if it is wise to have about a 40-percent increase in that incentive which 7 to 10 percent would constitute now, when, as Mr. Okun has just pointed out, we may have a weakness in the demand component, so that we may be possibly overbuilding and where you have underutilization of capacity generally, although you do have a few areas where capacity is operating at about 90 percent of capacity. There is not one single area hat I could find in the Commerce Committee's release of last night, not one industry that is operating at the preferred rate, at the 100 percent rate. Most of them are well below it.

Mr. PECHMAN. This is, of course, an area in which Mr. Okun is one of the Nation's experts. A partial answer is that we did get into supply shortages when we were approaching full employment in 1972 and 1973. I think, that, in light of the inadequacies of investment in a considerable number of areas over the past several years, it would be in the national interest to increase the ratio of investment to GNP somewhat.

The point I was going to make was that this kind of subsidy device will accomplish very little as compared to a policy that would avoid recession and maintain a stable growth aggregate demand. The basic incentive for business always is the incentive of being able to sell its product. If adequate levels of demand are maintained, there will be adequate incentive to produce. So while the investment credit itself would have a positive effect, I think, that that positive effect is now being more than offset by the other policies of the administration.

In regard to your general point about subsidies, you are quite right. The tax subsidies in particular, have not, on the whole, promoted national objectives. I don't think they promote economic growth anymore than a more even tax system would and, of course, they really distort the equity of the tax system.

Senator PROXMIRE. One of our complaints here is, we do take a look at it regularly the way we do appropriations; we provide for a direct subsidy, we have to look at it every year or every year we have to appropriate the money for it and sometimes we reduce it and sometimes we eliminate and sometimes increase. With a tax situation you may take a look at it. There is always vested pressure to keep it in. It is extremely hard to resist and very hard to overcome.

Mr. PECHMAN. I am delighted——

Senator PROXMIRE. It seems to me we have to be extraordinarily careful about increasing these concessions as the President has asked us to do.

Mr. PECHMAN. I am delighted the Joint Economic Committee has taken the leadership in this area. Nobody else is doing it and you are certainly doing an effective job in keeping this problem before the public.

I do think that your public education on this score has borne fruit. After all, the legislation that created the new congressional budget process requires the Congressional Budget Committee to consider and to publish tax expenditures annually and to evaluate them just as much as they would evaluate positive expenditures. So this is an area where we certainly need more work and I am delighted the Joint Economic Committee——

Senator PROXMIRE. Mr. Okun, I would like to ask you about your very ingenious proposal for a tax rebate to insure workers real income. I hate to be in a position of being critical. It is so easy to bat down any constructive suggestion, but I think there are some very serious problems involved here. For one thing, it could cost an enormous amount if we have continued inflation at a high level, for example, say, 9 or 10 percent inflation. Then with a 7 percent ceiling on wages, you would have to have a perfectly enormous rebate, wouldn't you, for the wage earner?

Mr. OKUN. Yes sir.

Senator PROXMIRE. Wouldn't that tend to be inflationary? In other words, the higher the inflation rate the more rebate, the more the worker would have to spend, and you might get into a situation that wouldn't be true right now, because, as we have discussed, there is not the same kind of demand inflation but it might get into a very aggravated situation where you are encouraging inflation.

Mr. OKUN. Well, in the first place——

Senator PROXMIRE. I don't see any discipline here, don't see any reason why there would be reluctance to and willingness to slow down wages under your proposal.

Mr. OKUN. Well, in the first place, if the present consensus of economic forecasters is right and we are in for 10 percent wage increases for next year, pulling that down to 7 percent will translate to about a three-point reduction in the inflation rate. What history tells us is that any change in wages pushes prices very rapidly and almost equally. So we obviously do improve the inflation outlook by curbing wages. Any such compact combining a wage ceiling and a price target should be made only after a careful assessment by the Government of what it thinks it can do. The discipline lies in putting a tremendous amount of pressure on the Secretary of the Treasury to preserve his revenues.

You will create the greatest crusader against inflation in history if the Secretary of the Treasury has to recognize that an extra point of inflation costs $5 billion worth of Federal revenues. For example, all the nonsense about decontrolling old oil would stop immediately. I can't imagine a more unconstructive proposal at the present time, raising both the inflation rate and the unemployment rate for next year by adding $10 billion to the consumer cost of oil. That kind of thing would stop overnight.

The Department of Agriculture's efforts to peddle exports over the last 2 years would never have taken place if the economic advisers to the President had been on the spot to defend an explicit inflation target. I can't imagine a better form of discipline than having the Government on the line with an inflation target and on the line to indemnify the workers out of tax revenue——

Senator PROXMIRE. Don't we need a far more comprehensive analysis of what wage increases are than we have at the present time? It seems to me there are all kinds of levels. Some wages like Government agencies have been increased relatively little, 5.5 percent, other wages such as members of Congress and probably members who work at Brookings and others not at all. But the notion that we have got a 10 percent increase may not be accurate. To the extent that it isn't it would mean the people who get an increase may be up to 7 percent which they haven't had in some cases, and then that they would enjoy a 3 percent tax credit, 3 percent of their total wages, which would be a classical tax credit to wipe out the taxes of some people and eliminate 30, 40, or 50 percent of the taxes for others.

We should study this very carefully to see what the revenue impact would be and the extent to which this might be practical. I like the notion of a new, fresh idea very much, and, as you say, you would have an inflation fighter in the Secretary of the Treasury but I am afraid you would really have a Secretary of the Treasury go all out to do everything he could to persuade the President to veto it.

Mr. OKUN. I did want to add, Senator, that there are cases one could imagine in which the Government couldn't meet its target because of factors outside of its control. For example, if one year it became clear by September or October that the inflation rate was exceeding the target, at that point, it would have an immense impact on the formulation of the next budget—to hold down expenditures and possibly in some instances to require the administration to come in with a tax proposal to finance the credit. It would be clear that, whatever form the tax proposal took, it would have to exempt the people who were being protected by the pledge. It might be a surcharge on the corporate income or on very high incomes. It might even be the event that would finally get us tax reform of a constructive nature.

In a way, the complaint that the labor unions have made again and again is that, in a weak labor market, wage controls are all too easy to administer. The reason is that the employers administer them for the Government. Once Uncle Sam says, as he did in 1972, that 5.5 percent should be the ceiling, employers are perfectly happy to abide by that since it takes them off the hook. Nobody else is giving bigger wage increases and all the pressure on morale and the possibility of dissatisfaction by workers is eliminated because the Government has assumed the responsibility of holding down wages.

There is no similar mechanism on the price side. It seems to me labor just has to realize that it can't look for equity in a wage-price control program. It has to look for some kind of guarantee other than that of having Uncle Sam trying to manage rents and dividends and the like. Those things don't work. My proposal realistically accepts the principle that the Government will not run an effective price controls program across the board. We don't really need it across the board. What we do need is to have the Government determined to do everything it can to hold down prices by being committed to a target and by having money on the table that will be paid in the event of failure.

Senator PROXMIRE. That would be somewhat concerned—that could be moved in the direction you and I both are very concerned about—and that is price controls, that would be one answer, and it would be an answer that I wouldn't like and neither would you, on the basis of what you have told us this morning.

Mr. OKUN. I have no doubt it would mean greater Government concern about some of the bigger administered price increases we have seen in recent months, like automobiles, and that would be for the good. I think there are areas where the Government should be taking much more of an interest in the nature of business decisions. I know you share my concern about the rather paradoxical nature of a very weak demand situation for automobiles producing a king-sized price increase.

Senator PROXMIRE. Let me ask each of you gentlemen to comment briefly on what specific way you see to strengthen the Council on Wage and Price Stability. First, subpena powers, industry-by-industry guidelines and a 45-day delay, a price rollback authority, controls in selected industries such as health and construction. Take them one-by-one. Subpena powers. Do you think the Council on Wages and Price Stability should have subpena power?

Mr. OKUN. I think there is a general issue involved. If one wants to show that voluntarism will work, there may be a case for doing none of these things and really trying to make the thing work on a completely voluntary basis. I can't imagine an industry or union refusing to give information that is requested by the Council on a voluntary basis. If they do refuse, that would produce a much stronger case for subpena powers.

The same approach holds for any of these other procedures. I think that for most of the things on which the Council on Wage and Price Stability will be operating, there is a reasonable presumption that they should try to do it in a completely voluntary way. Maybe I am unduly influenced by what I view as the success of the guideposts in the Kennedy era and the early Johnson era. That system operated without any authority and clout at all, but it worked with the firm dedication of the President behind it, and with people who really wanted to make it work.

Mr. PECHMAN. I am somewhat less pessimistic about the chances of complete voluntarism working in this situation. While I agree with Arthur's objectives in trying to avoid a program that smacks of mandatory controls, I do think that relying purely on the voluntary action of business and labor may not be enough. Consequently, while I haven't examined every one of the suggestions you read off, I should think that the Council on Wage and Price Stability ought to be given legal authority to obtain the data it needs to exercise its advisory powers, to delay price increases in cases where there are flagrant increases in prices that don't seem to be justified, and also to set particular guideposts or guidelines that could be modified where there are good reasons to modify them.

Senator PROXMIRE. Would you favor price rollback authority, the so-called "shotgun in the closet"?

Mr. PECHMAN. I think I would. I think that, in the situation which we are talking about, I would favor that.

Senator PROXMIRE. How about controls? Remember, the administration asked for controls in health and construction.

Mr. PECHMAN. Yes, sir.

Senator PROXMIRE. Would you provide for those controls?

Mr. PECHMAN. No question that those controls should be restored. Those are two areas that have misbehaved in the past, they are already misbehaving again and I think these controls should be restored.

Senator PROXMIRE. Let me run down with Mr. Okun. Subpena powers you are somewhat reluctant about. How about industry-by-industry guidelines?

Mr. OKUN. If we decide to depart from pure voluntarism, the whole list that you mentioned makes a good deal of sense.

Senator PROXMIRE. It would be one package and you would say if we have to go that way, all right, but you would be reluctant, you would want some more evidence that the voluntary way wasn't working?

Of course we had guidelines in the Kennedy-Johnson era, when you were on the Council. We had a situation in which the President suggested a 3-percent increase in wages, price stability, wasn't that generally the——

Mr. OKUN. The general guideline, yes.

Frankly, in sharp contrast to the voluntary initiatives in every other dimension, I don't see the administration launching an effort to make voluntarism work in this particular area. Consequently I would advise anyone in the Congress that the way to have the Council taken seriously is to stiffen its authority, to make clear that the Congress puts a great deal of weight on price- and wage-monitoring. The Council on Wage and Price Stability was created upon the proposal of the President—I think it was his first request of the Congress after assuming the Presidency—and the package of strengthening the statutory authority of this body is well conceived unless you can be convinced that the administration has really launched a sufficiently determined effort to make this thing work on a voluntary basis, in which case you might decide to give it a try I haven't seen that evidence.

Mr. PECHMAN. I think you and I would agree that, if Arthur Okun were Chairman of the Eccnomic Advisors today, there would be a better chance for voluntarism to work than under the present circumstances.

Senator PROXMIRE. Well, let me ask you this. The staff has indicated to me that there is some question as to who is making economic policy today, whether the Council of Economic Advisors is actually advising the President. Does Mr. Greenspan advise the President and, if so, if he is the only one who does, is there any input from Mr. Seevers and Mr. Fellner. Mr. Seevers is an expert in the food area and Mr. Fellner in the manpower area. Can you enlighten us on that? We have some oversight, with respect to the Council of Economic Advisors. We have a legitimate interest in it, we should know about it.

Mr. OKUN. I really don't think either of us would be privy to the kind of information that would throw much light on it. I infer from the cancellation of the Soviet grain deal that somebody else was watching. I am sure that proposal did not come out of the U.S. Department of Agriculture. Maybe Mr. Seevers is the unsung hero of that particular event. I don't know. It is conceivable.

One should never try to infer the role that the Council is playing from the frequency and visibility of its public statements. If anything, maybe they are inversely related. Perhaps the fact that the Council is on the podium less often now means that it is giving more time to its internal influence and its analytical influence, which I take to be its chief function and chief constructive role. So in this case, I view silence by Council members as good news.

Mr. PECHMAN. I would agree.

Senator PROXMIRE. I think you are too modest. I think when you were on the Council and you were Chairman of the Council, that the Council played a very helpful public education role getting people throughout the country and Members of Congress who are important in determining ultimate economic policy, more aware of what our problems were, what our options are, what we can do, what the consequences are of various policies. I would hope that the Council wouldn't become so anonymous and so invisible that we lose that kind of professional advice. After all, these are the only professional economists that have a direct influence on policy. The other people are good people, sincere people, and they are experienced in law or experienced in some other area, but they don't have the professional training, and if the economists are going to be anonymous I think we, are unlikely to follow sound and desirable economic policies.

Let me ask Mr. Okun, you indicate the need to slaughter some of the sacred cows, that is agencies in which the Government imposed constraints to hold some prices higher than their market level. Given that we might be able to abolish all 40 or 50 such obstacles that I have listed by various experts, which ones would you begin with?

Mr. OKUN. I see some merit in the package approach. We tried during my years on the Council to make politically feasible the abolition of one, two, or three of them and always found that these quiet efforts to slaughter them one by one were so quiet that they never reached the attention of the people who would benefit, but they sure could never be quiet enough to escape the notice of the people who would be harmed by their removal. Each attempt got murdered by the interest group most directly affected. The only hope is in an aproach a little like tax reform; it is the comprehensive approach that one should be taking.

Now, if the political feasibilities have changed, then there are some individual ones that could be removed. Retail price strikes me as one particularly noxious form of Government exemption to the antitrust law, that, I believe, at last count in 19 States, results in the consumer not being able to get the benefits of price competition on a number of items including drugs, small appliances, and the like. I know back in 1968 we estimated its impact as about 0.3 percent on the Consumer Price Index. That is not the difference between price stability and inflation, but it is a step in the right direction, it does not raise unemployment, and it will strengthen the economy.

In addition, some of our regulations on shipping certainly would be high on my priority list.

Senator PROXMIRE. Do you think this would have a negative or positive effect on employment if we abolished these various agencies? It is true that in the long run, the economy will operate more productively and efficiently if we can eliminate some of these restrictions. But for example, the import restrictions are designed to protect American jobs; some of the regulatory restrictions are designed for that purpose, too. If we have a wholesale elimination at a time of rising unemployment, could that have an adverse effect?

Mr. OKUN. In most instances, these measures supply protection out of the consumer's budget. The consumers would be spending for something else otherwise; and probably, in my judgment, would create a more efficient market and a larger number of jobs. To be sure, there are places where we have created whole industries that depend on these protections, and you have to phase the protections out gradually, rather than to eliminate something overnight that has become an important element in making an industry operate. There you have to look for a more prolonged movement toward efficiency which eases the blow on the people affected.

On the whole, the real trade-off I see is that the more prospect we have of getting rid of the inflation by direct action, the less we will have to rely on this savage fiscal and monetary restraint.

Senator PROXMIRE. I agree with you. I agree with you wholeheartedly we should act in this area, but again, I want to do it in a way I can persuade my colleagues and be sensitive to the unemployment problem.

In your statement, you state that the current economic policies could lead to 7 percent unemployment or more by this time next year. But you apparently are not ready to embrace the public service employment program.

First, what are your reservations about the public service jobs, and and how would you proceed to deal with huge increases in the unemployment?

Mr. OKUN. If someone could convince me that that would be a major aid, I would become more enthusiastic about it. I am not opposed to them. Again, I view this as aspirin, an aspirin worth taking. I have never seen anything that suggested that you could move a great deal faster in creating public service jobs which are $7,000-a-year, short-term, basically unskilled jobs, without having the national disgrace of a mass leaf-raking project. It seems to me that the enthusiasts for the program have not proved its feasibility in creating large numbers of jobs. We had a limited program. It was successful to the extent of perhaps subtracting a tenth from the unemployment rate, and that is worth subtracting. But what worries me is the illusion that we could take a recession of any size and just cushion the blow by what Congressman Reuss called the inadvertent socialism of destroying private jobs which may average $10,000 to $12,000 a year and replacing them with $7,000 public jobs that really don't meet most of the needs of the States and the cities. It meets some of their needs, but the possibilities for aid from that direction are limited.

Senator PROXMIRE. Before I call on Mr. Pechman, let me say that this was debated on the floor when Senator Humphrey put in an amendment to provide immediately for a big expansion of public service jobs. And Senator Pastore disputed it, saying it is hard for him to understand how we can justify impounding funds for sewers which we need so desperately in this country, and holding up that money on the ground of fighting the inflation, while at the same time turning around and creating public service jobs. You need the sewers; they are matters of health and matters of making it possible to have a sound housing program, and there are many reasons to justify it. It is the kind of work that doesn't require a high skill, you can put unemployed people to work on it, why not proceed with those programs rather than moving into a public service jobs program, as you say, maybe leaf raking or something that isn't nearly as constructive.

Mr. PECHMAN. That is exactly the point. I don't think either of us is against a long-term public employment program or some kind of guaranteed employment which would have a training component to it and improve job skills as well as provide job opportunities. In the current situation, an additional 1.2 percentage points of unemployment, which is what the forecast is, from 5.8 percent to 7 percent, would involve over a million additional unemployed workers. That number should not be traded for a public-service employment program that might involve an additional 100,000 jobs for very low-wage workers. I don't blame representatives of trade unions for being angry with the administration's efforts to cool down inflation. After all, it is the skilled worker, the middle-class worker who will suffer in addition to the low-paid worker.

Senator PROXMIRE. The best example of this is in housing. Housing has been crucified by high interest rates. You have a dropoff of a million housing starts, 2 man-years in each housing start, here you have lost a tremendous amount of employment by a monetary policy and other policies that have massacred the housing industry that is in the private sector with all of the disciplines in the private sector and all of the advantages of being revenue producing and so forth.

Mr. PECHMAN. I don't think you could persuade the carpenters and plumbers and bricklayers who are not employed right now.

Senator PROXMIRE. They have 12-percent unemployment in the construction trade, 12.4. Obviously we have to cut back on oil consumption. I don't see anything in the President's package to accomplish this. It seems to me to be a pretty weak way. On the other hand, I agree with you, Doctor, we shouldn't have a gasoline tax, that is one way to do it. I don't think it would do the job, for one thing. I don't think that the demand is that elastic. How would you go about reducing oil consumption, what option do we have?

Mr. OKUN. My colleague, George Perry, whom I keep invoking, had a very simple proposal over coffee the other day. If we want to cut back imports a million barrels, then, let's put on an import quota at that level, and find out what happens to our market. It is not absolutely clear that the voluntary efforts won't work. Maybe they will.

Senator PROXMIRE. You still have wage-price controls until next February.

Mr. OKUN. I hope strongly that they are extended. This would be a serious blow to our hope for curbing inflation in general if they are not extended.

If lines form at the gas stations, maybe the simplest thing to do is to live with them again. We all survived last spring. If we want to cut the quantity, let's cut the quantity directly. I don't see any harm in the proposal, if you have an import quota, of making the sales through sealed bids. Maybe the members of the cartel will all stick together and all bid $10.68½, but maybe one or two of them will decide they really want that business and try to undercut the others a little. That is not a tremendous benefit but it won't hurt, and there is no loss in allocating the quota through the sealed-bid process.

One other thing keeps intriguing me. I wonder whether there may be opportunities to do some things on the supply side, even in the short run, to add to the availability of domestic supplies. I have seen half a dozen serious economic studies dealing with the long-run supply of energy and they all come out with the one conclusion that energy is plentiful. With normal market means, if there is competition and if there isn't too much speculation, we will have adequate energy supplies in a decade. If that is the case, then I think we could afford to increase oil production above what is currently considered to be the maximum efficient rate of petroleum extraction. If that costs some oil in 1990, that cost is less serious.

The evidence is that the adjustment is a matter of time. The oil-producing countries quadrupled the world price when the world was adapted to a particular price structure. It takes a long time to adapt. But over time we will learn that we have lots of energy sources, and that the price today is far above any long-run true economic price. That argument leads me to think that we should scrape the bottom of every petroleum barrel in trying to get as much production as possible next year, if necessary through somewhat heroic means. We might use some Government explicit procurement contracts for oil that is producible but only at very high prices.

Senator PROXMIRE. I think we can do a lot in that respect. I know the President called for deregulation of natural gas, which I think would be highly inflationary. Our best estimate is it would result in an $11 billion increase in natural gas expenditures by consumers and $181 billion increase in the value of the reserves of the natural gas companies. It is an astonishing windfall to them, and one that seems to me is not justified in view of the fact that the most recent evidence we have is that in one big field alone—off the Louisiana and Texas coast—there is something like 2.7 trillion cubic feet of natural gas in proven reserves and another 2 trillion in probable reserves, and that 4.7 is almost three times the shortage projected for this winter. They are keeping it fallow, they are not releasing it because the President indicates he would like to deregulate and, therefore, they are going to wait until the price goes up.

Mr. OKUN. I would underline the fact that the worst possible situation one could have is holding down the price and spreading the rumor that the price is going to go up. There will never be any production that way. I suspect that, over time, natural gas prices will have to rise. We will probably need something like a two-tier system that recognizes that a lot of gas has been identified, explored, and made available for use in a world in which the price was low. That supply must have been profitable at that price and should flow at the old price. However, to encourage exploration where it is more costly, we will probably have to offer a considerably higher price for natural gas. At the present time natural gas is a bargain fuel but I see nothing to justify hitting the consumer with an $11 billion in added inflationary burden during the next year or two. Maybe over 8 or 10 years, we will have to move up to those competitive prices for natural gas.

Senator PROXMIRE. The Brookings study recently on this by a man from Rutgers and his associate says the policy key is for the Government to do its best to make sure that producers recognize that the increase in natural gas prices will be limited each year and if they simply withhold their production they are not going to get a windfall. Mr. Pechman, I would like to ask you if you would, for the record, elaborate on the text of your prepared statement, where you criticize the President's proposal for the surtax and support of the the House bill. For the record if you could give the details for us, how that House tax bill would make the tax system less equitable.

We would like to know specifically where that House bill reduces equity and price and windfall for——

Mr. PECHMAN. The most important provision, as I indicated in my prepared statement, is the provision to increase the exclusion for long-term capital gains by 1 percentage point per year for every year the asset was held. Today long-term capital gains are reduced by 50 percent before putting them into income subject to taxes. This provision would increase the exclusion from 50 percent to a maximum of 70 or 75 percent.

The alleged purpose of this is to correct for inflation. This is a subject that has received widespread attention in the professional literature. The conclusion of the experts is that over a long period of time, the the deferral privilege on capital gains tends to offset the inflation. Even if you wanted to correct for inflation, which I don't think is necessary, you would have to take into account the effect of the deferred privilege against the inflation adjustment.

Second, I just don't see any reason to increase the limit for issuances of tax free industrial development bonds by local governments. This simply increases a loophole that now exists. The Congress almost closed it in the 1969 act, but left it open for small projects. It has been used rather widely in recent years and I think that loophole should be closed rather than widened.

Third, as we mentioned earlier, I just cannot see how one can justify an exclusion for interest on savings accounts. This would not increase the supply of savings measurably, it might in the short run increase the flow of funds to the savings and loan associations. The extent to which that would occur would depend on competiton from commercial banks. If you want to help the savings and loan associations, it seems to me that there is a more efficient way of doing it than by losing up to $2 billion a year permanently through tax exemption.

Senator PROXMIRE. Well, the gross inequity of that, who has $20,000 sitting around in cash?

Mr. PECHMAN. You are exactly right.

Senator PROXMIRE. You have to be very wealthy to have that kind of money and $20,000 is what it would take at 5 percent to give you a $1,000 in return.

Mr. PECHMAN. I am sure that if you ran it off on the tax file, you would find it to be a very inequitable provision from the standpoint of its distributional effects on the distribution of the tax burden.

Now, there are also a number of things that the Ways and Means Committee has done to simplify the itemized deductions. At the same time, they have introduced a $650 standard deduction for itemized taxpayers. Simplification of the itemized deduction is desirable. However, I think that if we do raise revenues through simplification, we should reduce the standard deduction and not introduce additional standard deductions for itemizers and lose more revenue.

So these are the major provisions.

I also think that the provisions to close the real estate tax shelters are quite inadequate and that much more could be done along those lines.

Finally, let me remind you that the Ways and Means Committee bill does ultimately eliminate percentage depletion by 1979.

Senator PROXMIRE. Eliminate what?

Mr. PECHMAN. Eliminate percentage depletion on oil. I see no evidence that there is any reason to keep percentage depletion even with respect to 1974 income. If the Congress goes home at the end of this year without acting on percentage depletion, the increased profits of oil companies in 1974 will not be subject to increased taxation. I think that this is not appropriate tax policy.

Senator PROXMIRE. Well, the time is late. You have been very patient.

Mr. Okun, I understand you have a 12 o'clock lunch. You are late for it now. I do have one question you might want to answer for the record. In what ways would you say economics has failed us in the last 18 months? What can we do to improve the profession in the situation? Do you want to take a crack at it now?

Mr. OKUN. Yes, I think I can. I have had some occasion to think about this. What we macroeconomists have learned in the last 18 months or so is that we can't afford to be quite so macro in our view of the economy. This was the first time that individual sectors like food and fuel played such an enormous role in the overall performance in the economy. Those of us who try to take a broad view of the economy were not paying enough attention to the individual sectors. The tail did wag the dog and in the future, we are going to have to watch that tail much more carefully. We will have to be much more concerned about the balance of capacity among sectors and about supply problems arising from outside the country. The broad overview for the U.S. economy can no longer be 98 percent domestic and only 2 percent international. We have to watch developments outside our borders a lot more carefully. In addition to trying to understand overall patterns of consumption, investment, fiscal and monetary policy, I know I have to understand the workings of these critical sectors like food, fuel, and primary-material processing. I hope economists can do a better job in the years ahead.

Senator PROXMIRE. Thank you, gentlemen. The committee will stand in recess and we will reconvene Friday, October 18.

[Whereupon, at 12:15 p.m., the committee recessed, to reconvene at 10 a.m., Friday, October 18, 1974.]

PRESIDENT FORD'S ECONOMIC PROPOSALS

FRIDAY, OCTOBER 18, 1974

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

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

Present: Senator Proxmire.

Also present: John R. Stark, executive director; Richard F. Kaufman, general counsel; William A. Cox, Lucy A. Falcone, Robert D. Hamrin, Jerry J. Jasinowski, L. Douglas Lee, Carl V. Sears, and Larry Yuspeh, professional staff members; Michael J. Runde, administrative assistant; and George D. Krumbhaar, Jr., minority counsel.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. The committee will come to order.

We are very fortunate this morning to have an opportunity to get probably the most intensive review and consideration of what we can do about wages and prices directly that this committee or perhaps any committee in Congress is likely to have. I say that because we have before us Albert Rees, the Executive Director of the Council on Wage and Price Stability, and two of the most eminent experts in this area that we have in the country. For that reason I think this morning can be especially helpful and useful.

I think everybody, Mr. Rees, who has considered our inflationary problem has recognized there is no way we can meet this combination of recession and inflation by simply following monetary and fiscal policy. We just can't do that because obviously if we tighten up the economy and try to reduce economic activity that has a very serious effect on the recession which is developing so rapidly. If we follow a more expansive policy to try to provide for employment that will have an inflationary effect. We have to follow some discriminatory policy that gets at the heart of our problem.

Yesterday I asked Mr. Arthur Okun, of the Brookings Institution, if he had any regrets about what has happened to the economic profession in the last year or so on the basis of their performance, if he would do anything a little different. He said yes, he thought he would put more emphasis on microeconomic policy, more on recognizing the differences that affect our economy, energy and food and so forth. I think that anybody who takes a look at the wholesale price index and sees the explosion in steel and nonferrous metals, in chemicals as well as oil, recognizes this is an inflation in some limited areas

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that has had a profound affect on the general price levels and not generally across the board, particularly if we recognize the level of capacity of utilization, the hours of work, the increasing unemployment, the general drop in retail sales over the year. All suggest if we are going to cope with this kind of inflation we need to put emphasis on exactly where you office is called upon to act in the wage-price area.

Many of us are disappointed that President Ford didn't put much more emphasis than he did on trying to hammer down unjustified price increases and being prepared for the possibility of a wage-price push.

For that reason a great deal of attention is going to be focused on your office, and as a member of the Banking Committee as well as a member of this committee, I will be expecting that perhaps after the election the President may call for further authority and power for your office, and we would be interested for all these reasons in getting your views on the kind of problems that confront us and what we can do about them.

Mr. Rees, go right ahead.

STATEMENT OF HON. ALBERT REES, DIRECTOR, COUNCIL ON WAGE AND PRICE STABILITY, ACCOMPANIED BY JAMES BLUM, DEPUTY DIRECTOR

Mr. REES. Thank you very much.

I have a very brief opening statement.

I am very happy to appear before the Joint Economic Committee today and to provide whatever information I can about our plans for the Council on Wage and Price Stability and the part it can play in helping to restrain inflation.

The Council has had some staff since about September 30. For the first week it was just my secretary and myself. We now have six, including the Deputy Director, Mr. James Blum, who is with me today. We are moving steadily but carefully toward our full complement of about 40 staff members.

Of the seven functions set forth for us in Public Law 93–387, we plan to give particular emphasis to two: first, monitoring wage and price movements in the private sector of the economy; and second, studying those policies and practices of the Government itself that have the effect of raising costs and prices, and making recommendations for their correction. We choose this emphasis not because the other five functions are unimportant—they most certainly are not—but because in those areas we share responsibility with other Federal agencies.

In the process of wage-price monitoring we expect to get the full voluntary cooperation of labor and industry in providing the information we need to do our job. Where it seems appropriate, we will make vigorous use of our authority to hold public hearings, and to make recommendations based on the findings of those hearings.

On the price side, the President has directed us to give first priority to studying the processing and distribution of food to discover areas where productivity can be raised and costs and prices can be lowered.

The rise in food prices in the past year has caused hardship for many consumers, especially the poor and the elderly. Within the food area, we are especially concerned at the moment with the price of sugar and of products that use sugar, such as soft drinks, candy, and breakfast cereals.

Other areas of special concern to us include the rising cost of medical care, including hospital bills, physicians' fees, and prescription drugs. A narrower but very timely area of concern is the high price and short supply of antifreeze, and we are looking into that matter right now.

On the wage side, the current negotiations of greatest interest are those affecting the pay of airline pilots and of coal miners. We would like to do anything we can to help see that the settlements reached in those areas do not have a serious inflationary impact.

In the area of government operations, the President has asked the Congress to create a National Commission on Regulatory Reform to reexamine the independent regulatory agencies. This means that the primary concern of the Council on Wage and Price Stability will be with the departments and other agencies of the executive branch, with emphasis on actions which have an inflationary impact greater than their social and economic benefits.

Mr. Chairman, thank you for your attention. Mr. Blum and I would be most happy to answer any questions as fully and frankly as we can.

Senator PROXMIRE. Thank you very much, Mr. Rees.

As I am sure you are very much aware, what you can do, of course, depends upon the authority that Congress has given you and the mandate that the President has given you, and I am very concerned about both.

For one thing, you asked the Congress—I don't say "you" because you weren't responsible for this, but the administration asked the Congress for authority, for example, to control the price of health services and construction, and you refer to health services in your opening statement here, indicating that you are concerned about the rising cost of medical care, including hospital bills, physicians' fees and prescription drugs. You go on to say you would like to do all you possibly can to see that wage settlements don't have an inflationary impact, and you are studying the processing and distribution of food.

What can you do? You say you are going to hold hearings, you say you are going to make recommendations based on those hearings. Can you give us any more specific notion of what you can do?

Of course, the President, I think, can have very great effect in jawboning, but what can your particular agency do?

Mr. REES. Well, obviously, the President isn't going to get personally involved in all these specific situations that are of concern to us. While he may occasionally, as he did with the price of automobiles, I think the great majority are cases where the action initially will be taken by our agency. In some cases what we may be trying to do is to divert resources into areas where there have been particularly sharp price movements.

The antifreeze situation is apparently one of those cases. Antifreeze, as you probably know, is about 95 percent ethylene glycol. That has two principal end uses, the other is the manufacture of polyethylene fibers. It would be helpful if the producers took it out of polyethylene fiber and put it into antifreeze. I have been talking with some companies to see whether that is possible. I don't know the answer.

It is that sort of thing, discussion of actions that could be taken voluntarily in the private sector, that could have the effect of relieving price increases in particular commodities.

Senator PROXMIRE. You think if you can persuade private industry to make that kind of transfer of resources into antifreeze that the price of antifreeze will not go up so much; is that right?

Mr. REES. There are two price increases of concern. The price increase by the major distributors, the chain stores and so forth. Over and above that we hear of people paying prices in emergency situations that are very much higher than even the sharply increased price being charged by the major distributors. Certainly, adequate supplies would prevent the second kind of increase. They would probably not prevent——

Senator PROXMIRE. I am glad you are specific and bringing up something like antifreeze, because we are not talking in vague terms and generalities.

But at the same time it is almost humorous to suggest the main direction of the principal anti-inflationary agency of this Federal Government is mainly concerned with antifreeze.

You know, we are concerned with steel and oil and food. You did mention food. But antifreeze seems to be about the only place where you can give us a specific example of any kind of action that would ameliorate the threatening inflation.

Mr. REES. I happened to think of that one first because I have been personally involved with it. I think there are other specific examples. Let me give you one affecting sugar.

Senator PROXMIRE. What can you do about that?

Mr. REES. Well, we have not yet started to do anything except that I have engaged the services of a very able consultant, Ms. Mary Hamilton, a former member of the Price Commission, and she is going to begin immediately an investigation into the sugar situation. Sugar prices, as you may know, have quadrupled within the last 2 years. This is one of the areas where we are getting many complaints from consumers, some directly, some through members of Congress.

I believe there it would be useful if the manufacturers of softdrinks and chewing gum were to create a price differential between the softdrink that contains sugar and the diet drinks, and my rather unsystematic sampling suggests that the stores I visit are selling at the same price, even though the increase of the price of sugar is undoubtedly one of the major causes of this increase in the price of softdrinks.

It would probably be good for the American consumer if he consumed less sugar. It is a rather different situation than say an increase in the price of milk, where you don't want to advise people to drink less milk.

So again I think it is quite possible we might get some voluntary action on the part of chewing gum manufacturers that would cut down the price of sugar. I haven't had discussions with these people but I plan to do so.

Senator PROXMIRE. You didn't indicate where your agency would work and give us a more substantial amount of relief in the price area.

You cited sugar and antifreeze, and you properly point out that sugar is something we probably should consume a lot less of, better for our teeth and our general health. But nevertheless, the housewife does buy sugar. It is a very important element in the cost of living.

But how about in these other areas, meat, bread, vegetables, and so forth? What are you doing there?

Mr. REES. We have not yet begun to do anything. I think one of the areas where we may be able to help on the cost of food generally is in encouraging actions that would reduce waste in food transportation. Now, a lot of that falls within the purview of the Interstate Commerce Commission, and will therefore fall within the scope of activities of the proposed Commission on Independent Regulatory Agencies if Congress creates such a commission.

But I think in the meanwhile, until such a commission is formed, that we can be doing some preliminary work to see if we can help eliminate waste in the transport of food. I might say not all of that activity requires legislation.

The National Commission on Productivity, an agency that has been in business a little bit longer than we have, has already succeeded in doing some very useful things, for example, in creating unit trains of fruits and vegetables from the west to the east coast which have sharply reduced the cost of transporting fruits and vegetables.

So I would say transportation is one of our major concerns in the cost of food.

There are some restrictions in certain trade union contracts on productivity on the part of meat-cutters in retail stores. That is a situation I have some familiarity with because I used to be the Chairman of the Tripartite Food, Wage, and Salary Committee under the old Cost of Living Council. That is one thing I can explore. I can't promise that anything can be done in that matter because that is embodied in collective bargaining agreements, and unless those agreements come up for renewal it is not too easy to get that modified. I would like to look into it.

Senator PROXMIRE. Let me be blunt about this. I think you can make some progress and contribute usefully in getting industry to getting their prices down. But there is a great suspicion about this administration, as the previous administration, that they are very soft in cracking down on price increases that are a rip-off for the consumer. We had the top people in steel come in before this committee and testify last week. They weren't able to make any defense for this 45-percent increase in steel. Their cost increases were about 21 percent. There wasn't any question in my view that that was a far too big increase.

We not only have this in steel, but many, many areas. We have in the automobile industry big price increases at a time when they are operating far below capacity where if they obviously were in any kind of a competitive situation there would be a strong tendency to cut prices rather than increase them sharply.

I am just wondering, you are going to move in and focus on price increases not related to cost that take advantage of the price leadership of one kind or another, monopoly price increase practices.

The antitrust route which the President referred to is a long 10, 15, 20 year route, if you will win it ever. It seems right now we need prompt relief and your agency is in a position to hold hearings, focus attention, call for the President to come into the act, too, and in general have a far greater impact on holding down unjustified price increases.

Mr. REES. I certainly don't mean to neglect the basic industries. I think the price of steel is of great concern and enters into a tremendous other number of commodities. These things are very complicated. I followed those hearings before your committee with the steel industry with considerable interest, and there are arguments on both sides. I am not prepared at this momemt to express a judgment on whether those price increases were justified or how much of them were justified.

Senator PROXMIRE. To take a look at the best evidence is what happens to their profits. The profits were too low a few years ago, but they went up sharply in the last half of this year. There is no question about it. There wasn't any argument in the Bethlehem and Inland Steel that there will be around 25 percent return on equity. That is awfully hard to justify, especially in an inflationary period when the President is calling for cutbacks. Steel isn't necessarily by itself. I am sure in the chemical area and in the oil area where we have some wage and price controls we are not using the authority we have in my judgment effectively. There is an even bigger increase in profits.

The profit picture is so uneven. Overall they aren't up a great deal but there are extraordinary increases. So it would seem to me that a discriminating and sensitive action on the part of your agency would be very helpful, calling attention to these big increases that aren't justified and prodding the President to do something which only the President can.

Mr. REES. I would like to make two comments, and state my agreement with something you stated in the course of the steel hearings.

In the last few months since the end of controls under the old Economic Stabilization Act many industries have taken the occasion to widen their profit margins and in some cases to restore profits from what they regarded perhaps correctly as unsatisfactory levels during the control period.

I agree with your statement that perhaps that process now is completed and there is not the need any longer for further widening of profit margins. I would hope some of these industries would agree with that.

Senator PROXMIRE. In order to do that it seems to me that we need the sharp eye and the loud mouth of your agency to call attention to these increases, because as these increases occurred in the past 4 or 5 months they slipped by with—I think to the surprise of the industry itself, nobody criticizing them. That steel increase was twice as great as any increase in the history of our country, 10 times as great as the increase in 1962 when President Kennedy was outraged and called for a rollback and succeeded in getting it. But this time there wasn't any agency in government calling attention to it, the press ignored it. The price just went up and was accepted.

Mr. REES. Mr. Chairman, I believe steel prices are likely to come down. By that I do not mean posted prices. I mean prices paid by the buyer. The prices of steel include a great many extras, based on the size of the shipment and so on.

Over a long period of years the price actually paid by buyers has been below posted prices when markets are soft.

One of the procedures that my agency intends to use is to collect prices from buyers rather than from sellers. It has been my experience in doing research in the field of price statistics that price data furnished by buyers are by and large very much more accurate.

The U.S. Government itself is a large buyer of many of these commodities and we could get some very accurate price statistics on actual transactions, for instance, from the General Services Administration or the Department of Defense.

But we will be looking at that and I think it is important to look at the transaction prices and not the announced prices. The ticket price on a new car is just the basis on which you begin bargaining. In reporting consumer prices, the Bureau of Labor Statistics does look at the actual transactions price.

In my opinion, in a commodity like steel, information on posted prices is virtually worthless.

Senator PROXMIRE. Now, one of the mistakes that we make is adopting policies to deal with historical developments, what's happened in the past, a year ago or 2 years ago or sometimes 20 years ago and not being sensitive enough to what is likely to happen in the future. Mr. Okun warned us one of the possibilities, although it hasn't developed, although in recent months it might happen, is that we might be pushed into a wage price spiral. They could be in the future on a catch-up basis and recent settlements have been in the 10 percent area, and this will be general throughout the economy, and unless we do something about it we will be in very, very serious trouble.

What can your agency do with respect to this? I know there is sensitivity on the part of the agency with respect to the AFL-CIO. Of course, they have an understandable stake in this and understandable argument for some kind of a catchup. If we have a catchup and permit it to move ahead for 10 years with a 10-percent wage increase how are we going to deal with this? Are you prepared to hold hearings and follow up those hearings with recommendations that the increases be moderated to be made less inflationary?

Mr. REES. We might do that on occasion.

Mr. Okun is correct, there have been some wage settlements in the 10 percent area, but the averages are lower than that. In the second quarter of 1974, and that includes 2 months after the expiration of controls and almost all the settlements in that quarter were made after the expiration of controls, in that period, which is the latest that has been reported by the Bureau of Labor Statistics, the average increase in major labor settlements for the first year of the contract was 9 percent, and over the life of the contract it was 7½ percent. Those figures do not include the effects of cost-of-living escalator clauses. So they may be somewhat low on that ground.

But what they suggest is that even in contracts negotiated as recently as the second quarter of 1974, the wage increases by and large have been less than the increase in the cost of living. I believe that so far we have been very fortunate in having quite responsible wage settlements in our major collective bargains. I contrast that situation with the very difficult situation in the United Kingdom where with about a 15 percent rate of inflation most people are predicting wage increases in the neighborhood of 20 percent, so you would have an accelerating wage-price spiral rather than a contracting one.

Senator PROXMIRE. On the assumption your analysis is right how are you prepared to deal with it if the wage situation does become inflationary; what will you do?

Mr. REES. We have a President's Labor-Management Advisory Committee composed of eight leaders of major trade unions and eight chief executive officers of corporations under the chairmanship of Mr. Dunlop. I plan to work very closely with him, and in doing so I have been in contact with him almost daily on collective bargaining situations.

The exact way in which we will coordinate our future activities with those of that committee have not really been worked out in full yet. I do not rule out holding public hearings about a wage settlement. I would prefer, where possible, to try to be involved in some of these situations before the settlement is made rather than after it has been signed, sealed and delivered.

Senator PROXMIRE. It is my understanding that the settlements, construction settlements on the west coast have been in the neighborhood of 18 percent in wage increases. This is exactly the kind of situation which could establish a pattern first in construction and then expressed elsewhere. It is the kind of situation, it would seem to me, an ounce of prevention would be very helpful and you would be the one agency I could think of in the Government who could be very helpful in that regard. What would you do about that particular increase?

Mr. REES. I was a public member of the Construction Industry Stabilization Committee for 2 years and I know most of the general presidents of the construction unions and most of the leaders of the contractors associations.

I agree with you, some of those west coast settlements do create rather serious problems. They were reached in the spring. What effects they have had on other settlements have probably already been felt, but many construction agreements will expire next spring.

I would hope that Mr. Dunlop between now and next spring could reestablish some sort of voluntary machinery in the construction industry that would take the place of the increase.

There is one industry where that has occurred, retail foods. After the controls expired last spring a voluntary industry committee was set up in the retail food industry representing the three big unions involved, the meat cutters, the retail clerks, and the teamsters, and almost all of the major food chains. There is a neutral chairman, Mr. Wayne Horvitz, who has succeeded in making real progress, particularly in the Washington-Baltimore area. I think this is a pattern that might be very useful in construction, and I would like to see Mr. Dunlop have an opportunity to try out something along those lines.

Senator PROXMIRE. As you know, the interim report of the Joint Economic Committee recommended that the agency promulgate voluntary wage-price guidelines. Do you have any plans to establish these? On this committee are Republicans and Democrats. It is a bipartisan committee. We have made bipartisan recommendations.

Mr. REES. I have read that report very carefully and with great interest, and I have great respect for the judgment of this committee.

Senator PROXMIRE. We have 12 Democrats and 8 Republicans on the committee.

Mr. REES. I have very serious questions about whether the announcement of a wage-price guideline at this particular time would be useful. I have asked a number of people who have suggested this to me to suggest back what number they would suggest, what would be a reasonable wage-price guideline at the present time. I have great difficulty with the suggestions I get back. Some of the numbers are so low they would be totally unacceptable to the labor movement, and I would have no hope of being able to persuade people to abide by them. Others are so high they would act as a floor rather than as a ceiling and the people would feel they were entitled to a wage increase larger than the one——

Senator PROXMIRE. How about industry-by-industry guideline?

Mr. REES. I know of only one instance in all the income policies that have been used in this country and Western Europe where anyone has attempted to do an industry-by-industry guideline, and that was the Netherlands, and my impression is that in the Netherlands that was not successful. It is awfully, awfully hard to tell workers in one industry they are entitled to 5 percent while telling workers in other industries they are entitled to 8 percent. Under the pay board we had a 5.5-percent standard under some circumstances and 7 percent under other circumstances and this created pay differentials in the same craft in the same city where they have never existed before.

Senator PROXMIRE. Let's move over to the other area. You have done a pretty good job, it seems to me, this morning in refuting the notion that we have at the moment at least a general wage push problem; therefore, how about concentrating on a price guideline?

Mr. REES. I have never seen anything called a price guideline. Generally, it turns out to be a rate of return on capital or profit margin guideline. It is conceivable that one might want to do that under some circumstances, but I am not prepared to say we will do it in the near future.

I do think, though, that one of the ways of attacking the possible inflationary effect of a wage settlement is to look at the extent to which the wage increase might be absorbed rather than passed through.

Senator PROXMIRE. I am getting the impression, Mr. Rees, that you are an extraordinarily gifted and informed fellow and particularly adept to saying you are not going to do anything. I don't want to be unfair, but I don't see what you are going to do. There are good reasons for not doing anything, but the overwhelming need, obviously, is action, and I think we ought to find something that we can justify acting on.

As I say, this was not a recommendation of one or two Senators or one or two Congressmen. It was a bipartisan recommendation. We did have guidelines in the Kennedy-Johnson era and they worked. We have quite a different situation now. The guidelines would have to be quite different. But I am wondering if it is not within the capability of mankind to find a way of devising guidelines that would be helpful. Without guidelines it seems to me you will have colossal increases, where they go up 60 percent in 1 year, which is true of chemicals, 45 percent in steel.

Some kind of guidelines would put some perspective on this, perhaps permitting exceptions where they are justified.

Mr. REES. Mr. Chairman, you yourself pointed out this morning we are in a situation where circumstances differ enormously. Some industries are running flat out and pressing against capacity constraints.

Senator PROXMIRE. Name the ones that are running flat out. The ones that are supposed to be running flat out are producing less than last year. This year you can't argue that petroleum is running flat out. Production as we all know is down this year in real terms, across the board. It is hard to find, when you look at the capacity figures that the Department of Commerce released 3 days ago, I went through those and couldn't find any operating at their preferred rate of capacity. They were all below it. There wasn't any 100 percent.

Mr. REES. I thought steel was running very close to capacity. At any rate, that is not what I intended to say.

Senator PROXMIRE. Well, the evidence we got in the hearings, some companies are.

Mr. REES. I stand corrected, Mr. Chairman.

The point I wanted to make was there are very great differences in the circumstances of different industries at the present time. That is why I prefer to look at this on an industry-by-industry basis. That is why I am looking at your committee report. I am balking at the word "guidelines" because I am not particularly fond of announcing a single number. I would rather tailor our recommendations to the situation we find when we decide to look into the problems of a particular industry.

Senator PROXMIRE. The latest report out this morning, the Federal Reserve Board indicates industry generally is operating at only 79 percent capacity, which is well below last year and well below what they have usually been in periods of economic growth and progress.

Let me ask you, in our Joint Economic Committee report we recommended a number of things the Council on Wage and Price should do.

No. 1, recommend appropriate noninflationary behavior for prices, wages and executive compensation on a specific industry-by-industry basis; do you support this recommendation?

Mr. REES. Yes, except that I don't think we will have the capacity to make such recommendations for every industry, and I am not at all sure that I will want to get into the very tricky area of executive compensation.

Senator PROXMIRE. That is a pretty important area. The Gallagher report comes out and tells us what it is, relative modest resources in the areas where they make the report.

It is helpful because it seems to me there is a tendency on the part of people not to pay so much attention on the part of what their leaders say as what we do, and when you find bureaucrats riding around driving limousines and flying all over the world and telling everybody just to conserve on the use of gas and energy it is less true. I think that is true for corporate executives, too. Some of those increases in the past have been very great, and I think we should have vigorous publicity on them.

Mr. REES. I am not opposed to that.

Senator PROXMIRE. Why not include this as a noninflationary behavior? You are not saying you put these people in jail, but a mild recommendation as to what you think would be a reasonable executive compensation increase.

Mr. REES. Maybe we should look into it further. I would be happy to consider it.

Senator PROXMIRE. No. 2, send formal public notice to both Congress and the President whenever the national effort to restore price stability is threatened by either private or public failure to comply with the Council's guidelines or to supply essential information. Do you support this recommendation?

Mr. REES. Yes, I do.

Senator PROXMIRE. Do you intend to do that?

Mr. REES. Yes.

Senator PROXMIRE. Do you have the capability?

Mr. REES. Not yet, but we are developing it.

Senator PROXMIRE. Do you need further legislation or appropriation from Congress?

Mr. REES. I am not willing to advocate that until we have staffed up to the level that is already authorized and seen what we can do with the resources that have been put at our disposal so far.

Senator PROXMIRE. The committee also suggested that it may be necessary, we didn't say, to strengthen the Council's effectiveness in creating subpena power; do you want that?

Mr. REES. I would like to see what I can do without subpena power.

Senator PROXMIRE. How long will it take you to find out?

Mr. REES. I should think several months.

Senator PROXMIRE. Why would it hurt to have that subpena power available? We have had a reluctance on the part of industry very often to come forward with the information that is critical if we are going to make any wise judgments on policy in this area. We ought to know costs, a number of other things, you ought to know that even if the public doesn't have to know all these things.

Mr. REES. Mr. Chairman, I am in the process of trying to administer an act passed in the Congress by an overwhelming vote as recently as August. It seems to me it would be unfair for me to call for changes in that legislation before I have made a good faith effort to administer it as Congress asked.

Senator PROXMIRE. I don't argue with that.

How about authorizing power to delay wage or price increases for 30 to 60 days?

Mr. REES. Again, I am not prepared to ask for that at the present time. If I find we can't do the job we want to do with the powers we have got I will consider asking the President to come back and ask for authority, but not at the present time.

Senator PROXMIRE. How about rollback authority where wage and price increases pose a major threat to price stability?

Mr. REES. I will have to give you exactly the same answer, sir.

Senator PROXMIRE. Why is it unfair to say that all you appear to wish to do is to report on economic conditions? The Bureau of Labor Statistics, the Commerce Department, and other Government and nongovernment agencies do this now. I can't see any specific actions that you would take other than this recommendation with respect to moving resources into antifreeze and be somewhat helpful in the sugar area. I can't see any really overall action that your agency would take that would help us win the inflation fight.

Mr. REES. Well, I think there is a great deal of difference between routine statistical reporting of the kind done by the Bureau of Labor Statistics, and I have great admiration for that Bureau and have worked closely with them in the past, and the kind of information you can develop by making particular inquiries where there is great concern at a particular period of time. There is a lot of information companies are willing to supply on a one-time basis which they are not anxious to supply year in year out as to the Bureau of Labor Statistics or some other Government agency.

I am aware of the reporting burden on industry. They have a tremendous number of forms to fill out. That was one of the reasons why the controls program was so unpopular and such an effective job was done in persuading the Congress not to extend it. I would like to minimize the routine burden on industry while at the same time trying to get from them on a less regular basis the kind of information that is needed to judge the reasonableness of particular price increases and particular collective bargaining agreements.

Senator PROXMIRE. All right. I understand that answer, but let's be specific now. Under your statutory authority you are directed to monitor the economy as a whole, including wages, costs, productivity, prices, sales, profits, and so forth. You are directed and I quote: "Evaluate the reasonable price of price increases which may have a material effect on inflation." For the purposes of carrying out that authority you are given various information-gathering powers, to obtain information from any person or company necessary or appropriate to do that. Would you describe the efforts of the Council being made now to secure information on costs, on prices, on sales and profits in various industries?

Mr. REES. As I indicated in my opening statement, as of the moment we have a staff of six. Mr. Blum and I are the only professional economists on that staff. We have not yet hired any statisticians or accountants or financial analysts or attorneys.

Senator PROXMIRE. Really, that is pretty ridiculous; isn't it? When you think of that, you have two professionals, four other people assisting you, and we have an economy that is by far the most varied, complex economy in the world. We have one of the most difficult inflationary situations we have ever faced and we have exactly two professionals working on it. What can you do, even if you wanted to do, even if you had Galbraith and Nathan, I don't know what these two fellows could do without some people who are capable of backing them up and going after this data in a detailed, thorough way.

Mr. REES. Mr. Chairman, I am afraid you are very unsympathetic with my situation.

Senator PROXMIRE. I didn't get that.

Mr. REES. I said I am afraid you are very unsympathetic with my situation.

I was appointed on the 28th day of September, which happened to be a Saturday. I reported for work at 9 o'clock on the following Monday morning, the 30th of September. I was ushered into the New

Executive Office Building, given one secretary and told, go start yourself a new agency of the Federal Government. It takes a little time.

Senator PROXMIRE. Well, again, I am not criticizing you. What I am saying is I asked if you needed more resources and more appropriation, and you say it will be several months before you get around to determining that.

Mr. REES. I hope to be fully staffed by the beginning of the year.

Senator PROXMIRE. What does that mean, fully staffed?

Mr. REES. Forty people.

Senator PROXMIRE. Forty people.

Mr. REES. I am looking at people very carefully. If you have a small staff you want to make sure you get the best possible people available.

Senator PROXMIRE. Would 40 people be enough to obtain information on cost, prices, sales, profits, even in the top industries, ignoring all the others?

Mr. REES. It would not be enough to do a systematic investigation of every industry in this economy, no, sir.

Senator PROXMIRE. It would not be enough to do an investigation of any industry of any size, really thorough, getting down and verifying the costs and following up on them and being in a position to really evaluate the justification of price and wage increases?

Mr. REES. I suppose there would not be enough for the thoroughness of an investigation for a scholarly treatise.

Senator PROXMIRE. Do you have sufficient authority for monitoring the economy under present law? You have the authority. I don't think you have the resources, but you do, but how about the authority?

Mr. REES. That depends entirely on what type of cooperation we can secure from industry and labor unions and other Government agencies. I would like to believe I will get the cooperation I need until it is proved otherwise and should it be proved otherwise, I will ask the President if he will be willing to request further authority.

Senator PROXMIRE. Have you encountered any difficulty in getting information you need from industry so far?

Mr. REES. No, sir, I have not. Every time I have made a request for information, that has been forthcoming promptly. There have not been many requests because we are so new.

Senator PROXMIRE. Will you keep us informed on that problem as it goes along?

Mr. REES. I would be most happy to, sir.

Senator PROXMIRE. We would be very grateful for it.

As you know, the FTC recently instituted its line-of-business information program, which requires over 300 of our largest companies to report the profits they make on their major products, in addition to figures on sales, costs, and capital expenditures. It seems this information would be valuable to the Council in carrying out its price stabilization functions. However, the Council cannot obtain information of this sort from other agencies because it cannot be disclosed. Furthermore, language attached to the FTC appropriation would bar the FTC from making information available to any other Federal agency or even to its own antitrust enforcement division.

Do you feel that your agency should be allowed access to line-of-business information, in order to facilitate carrying out its legislative responsibilities and to avoid duplication in requests for information from business?

Mr. REES. I have not yet had a chance to discuss that issue. We do have some meetings with members of that staff scheduled for next week, and after that I will be in a position to have a more informed opinion.

Senator PROXMIRE. You understand how helpless we feel. You have a situation with conglomerate firms that stretch across many industries. How can anybody really understand what the profits are in General Motors if they don't break out their profits, because the other things they do overwhelm trucking. They are an enormous unit in trucking but they don't give us that line of business because they don't tell us their trucking profits, and so forth.

The same thing can be true in many appliance areas, General Electric, for instance, a very important company in that area, but their other operations dwarf their appliance industry, so we don't know their profits in this area.

We are trying to get it but so far we are barred by law and the administration hasn't been very helpful—in fact, they have supported opposition in breaking out this information. It would seem if we can't get it at least you ought to have it so you are in a position to evaluate price increases in industries which are dominated by conglomerate corporate operations.

Mr. REES. I understand the nature of the problem and I certainly can see where it would be valuable under certain circumstances to have information from a conglomerate on one of its many lines of activity. If we can't get access to information furnished to the Federal Trade Commission because of provisions of a particular law, maybe we can get the same information furnished directly to us on a voluntary basis where we have a particular reason to request it. I don't think it would be useful for us to get that, again, on a routine basis, because I do believe that given the size of the agency that has been established that the only way we can make any contribution to the fight on inflation is to be selective in our targets.

Senator PROXMIRE. My point, of course, was that I would take a lot less time and resources on your part to be able for you to use the very limited resources you have available if you could use the FTC. The law doesn't permit them to disclose it to you, that is all. We hope you would look into that and consider the possibility of you recommending to the President that your agency have access to that.

Mr. RESS. I will look into it, sir.

Senator PROXMIRE. Mr. Rees, I want to thank you very much. Obviously, you are a man who knows a great deal about this area. We all know you are a highly competent economist, but I am very, very disturbed at the limited impact. I am reminded of Fred Allen's classic example of ineffectiveness, a butterfly's hiccup. It seems to me that is the effect of your agency at the present time; but I am hopeful it will have far more effect in the future and you are most gracious to come before us.

Our next witnesses are Mr. Galbraith of Harvard and Mr. Robert Nathan.

Mr. Galbraith, we are very fortunate to have both you gentlemen here this morning.

Mr. Galbraith is certainly one of the most eminent economists in this or any other country, probably the most eloquent because of his writing, former head of the American Economic Association and particularly expert in the area of wage and price controls and what will work and what will not work.

Robert Nathan, of course, we all respect and admire as an eminent economic expert who has been at the top level of economic policy-making longer, although he is certainly anything but an elder statesman, he is not that old, but he has been on top of things for 40 years in Washington, since the beginning of the New Deal, and in a marvelous position to give us the benefit of a vast amount of experience.

Mr. Galbraith, you go ahead, sir.

STATEMENT OF JOHN KENNETH GALBRAITH, PAUL M. WARBURG PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. GALBRAITH. Mr. Chairman, thank you very much.

I have a brief statement which follows in three parts. I would like first to mention a few of the lessons which follow from the recent Summit Conferences and the reaction to the problem of inflation generally. Then I would like to make some observations on President Ford's economic program. Third, and finally, I would like to offer some affirmative suggestions.

Any detached review of the recent discussion on inflation would suggest, it seems to me, some major errors against which all who are serious about this subject should be warned. They are:

(1) The tendency of men of conservative mood to believe, and I may add for the President to agree, that what hasn't worked in the past will somehow work in the future. The past 2 years have involved a heavy reliance on monetary policy, a lesser reliance on fiscal policy, to prevent inflation. Obviously, these haven't worked. Inflation has got worse. Nonetheless, by all outward evidence, the President's advisers have been inspired to an even greater belief in the remedies that they have proposed in the past. One is astonished at the faith of these devout and excellent men. Having got us into this mess, they now prescribe the same medicine for getting us out of it. This is a kind of economic homeopathy unparalleled in public experience.

(2) I am uneasy, though less so, about my liberal friends. Some have shown a tendency in the recent discussions to review all of the available measures that can be taken against inflation, to find them all uncomfortable or inconvenient, and in consequence to recommend against all. There is no way of ending inflation that is not inconvenient or uncomfortable. It is only that inflation is worse.

(3) A related problem is the tendency to look at inflation, conclude that the real problem is the danger of recession and to prescribe for that. That the present inflation could give way to recession is possible—anything is possible. But inflation is the problem we have. And its effects, both domestically and internationally, are painful. So it is the problem with which we must deal. One of the reasons

economists—some economists—go on to recession and depression is that, until recently, reputations have been made fighting these. Also, scholars react to what, in our social memory, seems the ultimate economic disaster. They neglect the suffering that is presently forcing down the real incomes of many helpless people. Finally, there is the fact that all remedies for inflation are unpleasant, all remedies for depression or recession extremely agreeable. To ease the money supply, lower interest rates, reduce taxes, increase spending, have no controls. the things you do in recession, are perfectly lovely. So there is a tendency to diagnose the illness which allows one to prescribe the pleasant medicine.

(4) In speaking of the danger of recession, we must also remember that much of the present stagnation is the result of the particular way in which we have been fighting inflation. Overwhelming reliance in the last 2 years has been on monetary policy. That has a deeply selective effect on the industries that must borrow money, most notably on housing and other construction. It doesn't hurt GM or Exxon. And any anti-inflation program that relies exclusively on monetary and fiscal policy operates, we now know, only if the depressant effect on the economy is very great. It is effective only after unemployment is very severe.

(5) We need also, it is obvious from recent discussion, to beware of the man who thoughtfully examines his own needs or those of his industry and concludes that they are, for that reason, a cure for inflation. This was a tendency of pandemic proportions among businessmen attending the recent so-called Summit Meetings. Had a major manufacturer of contraceptives been present, he would have argued eloquently for birth control as the ultimate instrument against inflation.

(6) Let me emphasize again one point. There is no pleasant way of fighting inflation. That is because every single method of dealing with inflation has some adverse effect on the real income of some group. The test is not to avoid pain. That is one measure of efficacy. The test is to see that the pain is distributed equitably, and particularly to those best able to bear it.

With these perhaps unnecessary injunctions in mind, let me turn now to President Ford's program.

Much of the program, alas, was rhetorical. Much else was less than operational. In the realm of rhetoric we must include the proposals to increase competition, enforce the antitrust laws, improve productivity and increase international trade. These steps were well calculated to warm the hearts of economists; they are to my profession as cats or or telephone poles are to little dogs. Alas, they have nothing to do with inflation. Even economists in their more normal moments do not dissent. There is no theoretical model which shows inflation to be less serious in a competitive than in a regulated industry. It can occur in both. And those who took the position that competition was the cure for inflation—and this includes the President—were singularly reluctant to urge the dismemberment of General Motors, General Electric, General Foods or ITT—or even for that matter the trade unions.

It should be obvious, in any case, that inflation is a problem here and now. A change in the competitive structure of the American economy, as I was pleased to hear you suggest a few moments ago, is something that only could be accomplished over decades.

The President's proposals on energy supply and conservation and food supply and conservation were more relevant but not more operational. What he urges is good only as it is made specific and then effectively implemented. There is a strong case for putting a stiff tax on high-horsepower cars. And on air conditioners. And on new electric heating, a very inefficient way of heating houses. The technical possibilities in food production are overwhelmingly related to fertilizer supply. I am intrigued by the idea of a national Fertilizer Authority charged with bringing into use at the earliest possible date the supplies of fertilizer that will not be forthcoming from the private sector. The President should also have turned attention to luxury-food consumption. A heavy tax on restaurant meals above a certain price would do something to prevent nutritionally wasteful use of food and the bidding of food away from the poor. Any income tax deduction for food for entertainment purposes should now be suspended for an indefinite period. The case for energetic development of mass transportation and for arresting any further, and I may say, deadly decline in the railroads is obvious. I would not think it wise entirely to rule out the idea of rationing gasoline, although anyone experienced with this problem, as Bob Nathan and I are, will come to such a suggestion with some caution.

The proposals for public service employment and for extended and enhanced unemployment compensation are right in principle, if niggardly in design. I would also be afraid that, given the general tendency of the administration, the public service employment would be unenthusiastically administered. The proposals for increasing the investment tax credit and for making preferred dividends deductible should be promptly rejected. Let all beware of the tendency for inflation control to come out on the side of more freeloading for the affluent. Investment credits are not necessary at a time when businesses are besieging the banks unsuccessfully for investment funds. The deduction for preferred stock opens up for corporations another loophole at a time when we should be closing loopholes. I shall have a word on the surtax in a moment.

The President's proposals on housing are outside my range of competence. I have generally the feeling that the housing industry will be most aided by anti-inflation measures which by being successful reduce the present reliance on tight money. Only if this is done will there be real and general relief.

This point emphasizes my last observation on the President's program—and the most serious one. That is the neglect of the central problem of inflation; namely, the control which powerful industries now have over their prices and their ability to use this power to offset increasing wage costs and something more. From this comes the wage-price spiral. Its importance is conceded by the existence of the Council on Wage and Price Stability. What is not conceded is the need for doing anything that is tough and real. Economists similarly concede the condition and react from the cure. In the recent meetings there was something close to a consensus among the economists that the wage-price spiral could not be halted by monetary and fiscal means alone. This, it was agreed, would require more unemployment than was socially or compassionately acceptable. But controls have never been popular with economists. To advocate them is to accept and, indeed, proclaim the decline of the market. It concedes the obsolescence of much economic knowledge. Economists, no less than others, protect their vested interest. So, while admitting the power of the wage-price spiral, they too avoid the natural corollary which is to control it. I would also urge us to beware of new and undefined references to a new social contract. That is an evasion of reality.

There can be no effective economic policy, as the President will himself discover, that combines reasonable price stability and reasonably high employment, that does face up honestly to the problem of the market power of the great corporations, the associated problem of cost-push wage settlements and, it must be added, that deals equitably with profits and executive salaries. The failure to deal with this was not a defect of the President's program; it comes close to reducing its prospect to zero.

I did note with some pleasure, Mr. Chairman, that Mr. Rees said he would come back after his program failed for subpena powers, et cetera. This is very encouraging news, because he will be back. You can depend on that.

The program I would urge comes more or less from the foregoing and can be quickly summarized. We should tackle the present inflation and not the ensuing recession. And we should deal with it on all fronts. Policy must be eclectic, not selective. Five things seem to me especially important:

(1) While it is the most unpredictable, unfair and socially damaging instrument of control, there must continue to be, no doubt, a relatively tight hold on monetary policy. In saying this, we must recognize that its excessive use is the instrument most likely to produce a sudden downturn in the economy—the depression which is so much a part of our present anxiety. For people who are seeking housing accommodation, and I chose this word carefully, its discriminatory effect is appalling. In suggesting continued monetary restraint, I would emphasize that once inflation is under control, this should be the first measure to be relaxed.

(2) Fiscal policy is eminently a more equitable and more predictable instrument for limiting demand-pull inflation than monetary policy. It has the difficulty that, as expenditures are inelastic downward, taxes are inelastic upward. But if we are to use fiscal policy, it is taxes we must employ. They can be increased; their effect is reasonably prompt. To use taxation is to hasten the day when monetary policy can be effectively and substantially and permanently eased. For this reason I would support President Ford's proposal for a 5-percent surtax on taxable incomes above a certain level. The President is right in his argument that the incidence in the $15,000 to $20,000 range is not very painful. On balance, however, I would urge starting higher than he does—at $20,000 for joint returns, $10,000 for individuals. This avoids unsettling any union wage settlements and the associated, and needed, wage restraint. I would also urge that above $20,000 the surtax be 10 percent and at above, say, $40,000 it should be moved up to 20 percent. These are the brackets that have had major tax relief in recent years. Since part of taxation in these brackets comes out of savings, the increases must be stiff if they are to have an appreciable anti-inflationary effect. Loopholes should also be closed but closing

loopholes, and here again is a point I would emphasize, is not a substitute for the surtax. The case for closing loopholes is not for fighting inflation, for the primary effect is on saving, not spending; it is for returning equity to the tax system.

Let me repeat: All who are feeling indignant about the tax increase should be reminded that this is the only way of giving any early relief to the homebuilder, the homebuyer and the construction worker. These people are really suffering. The surtax is also the natural compensation for affirmative assistance to those who are now out of work or whom an anti-inflation program may cause to be unemployed. I am not, parenthetically, persuaded that a vigorous anti-inflation program necessarily causes unemployment. This is asserted by economists, including those who insist most strongly on evidence, without any visible proof. In 1926, France brought a severe inflation to an end without unemployment. The period of unemployment following the great German inflation of the early 1920's was very brief. In 1948, the Germans ended a period of extreme though suppressed inflation with a big expansion in employment.

(3) The heart of any program for the control of inflation is a system of price and wage controls. This is not a substitute for a general balance between aggregate demand and aggregate supply in the economy; it is the indispensable supplement to such balance in the area where market power can defeat monetary and fiscal policy and increasingly does. Wage controls need apply only to union contracts. I would apply price controls only to firms employing more than, say, 1,000 people. No one should take seriously the argument that this action interferes with the free movement of market prices. The free movement of market prices disappeared when the corporations—oligopolies—gained control of prices. Nor is the administrative task here intolerable. Only a few thousand firms are involved. It is not so difficult—as I had the experience of doing some 25 years ago in regard to World War II—it is not so difficult to fix publicly prices that are already fixed. Equity requires that executive salaries be also subject to control—and on occasion, as in the case of Harold Geneen, to reduction to actual worth, though not to zero. In any upcoming wage and price control, there must be an opportunity for wages to catch up. In controlling inflation something must give—be squeezed. Profits, which for the larger firms have been increasing rapidly, are the obvious case.

Needless to say, this time we must be serious about controls. It would be tragic if they were put into effect again in the frivolous fashion they were used in the Nixon administration. They must be for as long as we have corporations with great market power and strong unions, which is to say permanently. They must be in the hands of people who are dedicated to making them work and understand that they can't please everyone who wants an increase in his prices and profits. The effort in these past years under the Nixon administration was anything but encouraging. But in World War II and the Korean war price control under far more difficult circumstances was made to work—and it did its job. It has often been said that those who administered the controls in those years had the advantage of deep and abiding patriotism. I think this helped, but I was in charge of controls in World War II and I did not encounter any person who was willing to give up profits out of patriotism. Balancing these, all Americans came to the conclusion they should have both. It takes organization; strong enforcement is required. But what was done before can be done again.

(4) I have already indicated the need for a full-scale attack on bottlenecks—both to enlarge them and to conserve use. We must recapture in this country the ability not only to talk about things, but to do them.

(5) The counterpart of a tough tax increase on those who can pay is an especially strong effort to ease the position of those who are the victims of inflation. This gets back to public service employment and I would hope, Mr. Chairman, that the whole idea of income support is not dead.

One final thought: In all the recent discussions there was much talk of the need for patience. It was not made clear how Congress goes about legislating patience or whether it is a virtue that can be asked of people on fixed incomes or pensions who are increasingly unable to eat. There is no proof that prompt, effective action against inflation is a cause of unemployment. Certainly, there is no proof that such action is more damaging or likely to cause unemployment than greater gradualism. And gradualism is too hard to distinguish from inaction.

Thank you very much.

Senator PROXMIRE. Thank you very much, Mr. Galbraith.

Mr. Nathan, go ahead, sir.

Mr. NATHAN. Let me summarize briefly. I have a prepared statement and chart which I have submitted for the record.

Senator PROXMIRE. Without objection, that will be printed in full in the record at the end of your oral statement.

STATEMENT OF ROBERT R. NATHAN, ROBERT NATHAN ASSOCIATES

Mr. NATHAN. I would like to refer to the chart[1] on some occasions during this presentation.

First, I believe, Mr. Chairman, that you touched on what I regard as the most critical thing; I think it is appropriate for us to pay very serious attention to what is taking place, especially that 11½ percent increase in the GNP deflator in the third quarter. We had a decline in the gross national product in the third quarter, a drop in general activity, but very serious was the pace of increasing prices reflected in the figures.

We have had recently the release of the Wholesale Price Index for September, showing a 19.7-percent increase over the same month a year ago. The Consumer Price Index will be out by Monday or Tuesday at the latest, and I think it is almost certain that that index will be at least 12 percent above September of 1973. Later this year, given what has been happening, it is almost certain that increases will be sizable.

We have a problem which doesn't lend itself to patience. I think Ken Galbraith is absolutely right when he says perhaps the most

[1] See chart, p. 125.

prevalent feeling that came out of that summit meeting was the urging to the President to be patient and just wait. I couldn't help but think of those who told him if we just took our time things would be better. You know the old slogan, "steady as she goes," is what we have heard for many years. I think it ought to be changed to "steady as she goes—down the drain." I think the threat to our national economy was well expressed by the President but that is as far as it went.

From President Ford we have heard deep concern about the economy, but on the other hand, his program is totally inconsistent and unrelated to that view.

The big question is where we are and how we got here. Let me turn to this chart, and I hope everybody has this in front of them. Here we see in the last 20 months the rate of inflation in this country in terms of consumer prices having more than tripled. What I did here was to chart what I call a pace of inflation, not the consumer price index. This chart shows the percentage increase in wholesale prices and consumer prices over the same identical month a year ago. So when it gets to 10 percent that means they are 10 percent higher than a similar month a year ago.

In January 1973, consumer prices were running less than 4 percent higher than what they were in January 1972. January 1973, by the way, was the date when controls were crippled. I think that is a mild word to use. Even Herb Stein says all hell broke loose when they took controls off or weakened them in January 1973.

Increases in consumer prices were at 3 to 3.5 percent, certainly less than 4 percent, all during phase II. We have now gone to roughly 12 percent and that is a 3 to 3½ time increase in the rate of inflation since the end of phase II.

It seems to me, Mr. Chairman, all one has to do is look at this chart and see what's happened to inflation and to realize today wholesale prices are running for the last 3 months, 20 percent above a year ago and retail prices around 12 percent, to realize that any expectation that we can sit by and wait for 3 months, 6 months, 9 months or longer to do something about this situation is just an abdication of responsibility.

What we have observed up to now, Mr. Chairman, is a one-front war against inflation, and that one-front war is the resort to recession to fight inflation. That is basically what has been done up to now.

I listened to Professor Rees this morning and I think we all owe him a tremendous debt of gratitude for having taken on this assignment because he is outstandingly able and an understanding person. I can't help but agree with Mr. Galbraith that he will have to come back for more power. But I can't see that he will be able to do anything about this severe, contageous, self-generating spiral in which we have gotten ourselves involved in such a very, very serious degree in the last year and a half.

In terms of the President's program, I listened to it very carefully and then read it and also listened to and read the statement the President made in Kansas City this week. I think if we were to grade the President we would have to give him an "A" on what I believe is his sincere concern about inflation, and a "B" or "B—" on equity, especially on improvements in unemployment compensation and community type jobs. When it comes to inflation I think we have to give him a grade of "F." I just don't see anything in this program that is going to deal with this very serious critical problem that has national ramifications throughout every sector of the country, and which has worldwide consequences. We are continuing to try to fight the inflation by a planned recession, and I use that word advisedly because we have been following a tight monetary policy now in an effort to reduce aggregate demand with the expectation that soft demand will bring an end to inflation. This has brought a sharp drop in GNP. We have only had three occasions in the last 25 years when real GNP was lower than in the preceding year. This is the third such year. It is practically 100 percent certain now that 1974 will show a real decline in GNP. That has brought our unemployment to 5.8 percent. It is likely to go to 7 percent by the middle of next year. It would already be well above 5.8 percent if all of those out of work were actively seeking jobs, but aren't because they feel they can't find jobs.

But the sad part of it is there is no direct hard attack on inflation per se and the reliance on recession approach is just not going to do any good. What I sensed out of the Summit was a number of people looking at the President and saying, Mr. President, just wait, stability will come around the corner and I couldn't help but feel we are back to Herbert Hoover. I see no prospect it will work out that way at all. In my judgment we are engaged in a kind of dog-eat-dog situation on costs and prices, with no restraint anymore.

Now, the real question is what do we come up with as a solution? We cannot rely on the marketplace. Let me just take 1 minute to indicate what I regard as strange. Many of the ultraconservative or conservative economists have been saying if we will slow production down, the economy will take care of itself and we will have an end to inflation. I hear those same people saying even if we just talk about controls, business raises its prices in anticipation of controls. For the life of me I can't see how you reconcile those two views. If you have a little softness, and we do have softness now, inflation should at least slow a bit and it isn't. If the market place functions effectively, business can't raise prices in anticipation of controls. If it doesn't function effectively controls are needed to break the spiral. Few are ever satisfied with the level of earned profits. That is all right. That is the way the economy functions. If industry achieves big profits by raising prices, this leads us to ask what we will do about it. I don't see any alternative if we are going to break this inflation in a reasonable period of time to the introduction of direct controls.

There are two or three points about controls that I want to summarize:

First of all, there are those who say if you put on controls you will go back to an irresponsible monetary and fiscal expansion program. I don't buy this "either/or" approach. There is nothing at all that says when you introduce controls then you take a very expansive route. Once President Nixon did put on controls in the fall of 1971, that was when the whites of the 1972 ballots were becoming visible, the administration pursued a very marked expansion in activity which rate probably was unsustainable. Fundamentally there is no reason we shouldn't have some modest restraints in the fiscal and monetary area along with direct controls. Maybe we will have to live with 5 or even 6 percent unemployment for a time, but I don't believe that alone will bring a break in this price spiral. That is why I think we have to go to direct controls.

The most interesting claim that emerges is that controls won't work. This chart shows what was happening in phase II. During phase II consumer prices were very stable. If anything, they slowed down just a little bit. Wholesale prices did rise increasingly starting in the middle of phase II and that is contributable to the Russian wheat deal and what happened in food prices. If we had handled that deal more intelligently we would have been in much better shape.

Also, in phase II we were beginning to get the inflationary consequences of the devaluation. Devaluation of a currency is almost by definition inflationary. Even so, phase II did very well. It was eliminated prematurely.

Mr. Chairman, phase III and phase IV were about as near to frauds imposed on the American people as anything I have seen. We were kidding ourselves. We were trying to run a difficult control situation by words alone. There was almost no enforcement. The benefits were tremendous with those who moved ahead with higher prices and the deterrents were practically insignificant.

For effective controls, we need a reasonable number of good people, capable people, reasonable organization. They will have to be fair and firm. Controls don't have to be absolutely across the board, including everything. Whether Mr. Galbraith's 1,000 employee firm is the right break in size, or whether one might vary controls in those industries in which you have had certain levels of increases in prices, whatever the criteria. There is no doubt that direct intervention is going to be needed to break this spiral. Even if we started out with subpena power and power to rollback and delay wage and prices that would at least be moving in the right direction. Without direct action, 6 months from now we will be suffering the same kind of problems we have today, or worse. We ought not to accept this excuse that controls won't work when they were made not to work by those who largely didn't really believe in them.

One final point, in fighting inflation there are a lot of things that should be done. We should seek to provide credit at attractive terms in essential areas. We should work together to improve productivity. We obviously need conservation and I would hope the President would come up with far tougher measures than we have now. We need more vigorous competition, but that is for effectiveness 10 or 20 years hence. So the big issue is whether or not this country is serious about the efforts to bring inflation under control and if we are we are not on a path to achieve it and we will be back again and again and the next time it will be the second decimal of the double digit we are concerned about. If we stay on this path we will have an increasing ability to deal with other crucial problems like oil and the like. So I feel very strongly we have to move toward controls. We have to first of all break this spiral.

Senator PROXMIRE. Thank you very much.

[The prepared statement and chart of Mr. Nathan follow:]

Prepared Statement of Robert R. Nathan

President Ford's expressed concern about the serious and damaging inflation which threatens every aspect of our economic life, regrettably, is not matched by an equally serious program of action. The President's prescription fails to relate in degree to his diagnosis.

We have a feverish inflation worsening every month, a deepening planned recession arising out of brinksmanship that frightens the whole free world. The mild medication offered to date will not cure either inflation or recession, let alone this strange combination of diseases.

There is no evidence of any significant change from the Nixon reliance on recessions as the major weapon against inflation. Unfortunately, President Ford is still receiving too much of his advice from those who gave us worsening inflation and two recessions in less than five years, accompanied by the tired old refrain "steady as she goes." That line more accurately should read "steady as she goes down the drain." Patience is the principal behavior they still suggest to the President.

The solution to inflation does not lie in the polarized choice either of a planned serious recession or of all-out pursuit of full employment. The advocates of exclusive reliance on restrictive monetary and fiscal policies seek to smear anyone who disagrees with them with charges that dissenters merely want to build up deficits and increase inflation.

I know of no economist who today recommends pushing the pedal of economic exapnsion to the floor in an effort to restore full employment quickly and before major progress is made in overcoming inflation.

That does not warrant our sitting idly by while the planned recession gets deeper and the inflation worsens. The year 1974 is certain to be the third year of decline in output in the last quarter of a century and 1975 will be the fourth if we persist with present policies.

There is no basis for confidence that six percent, or even seven percent unemployment will significantly cut the rate of inflation. Maybe a deep depression will break the back of the inflation but that is a cost we need not and should not pay. It is a dead end "back again to Hoover" approach.

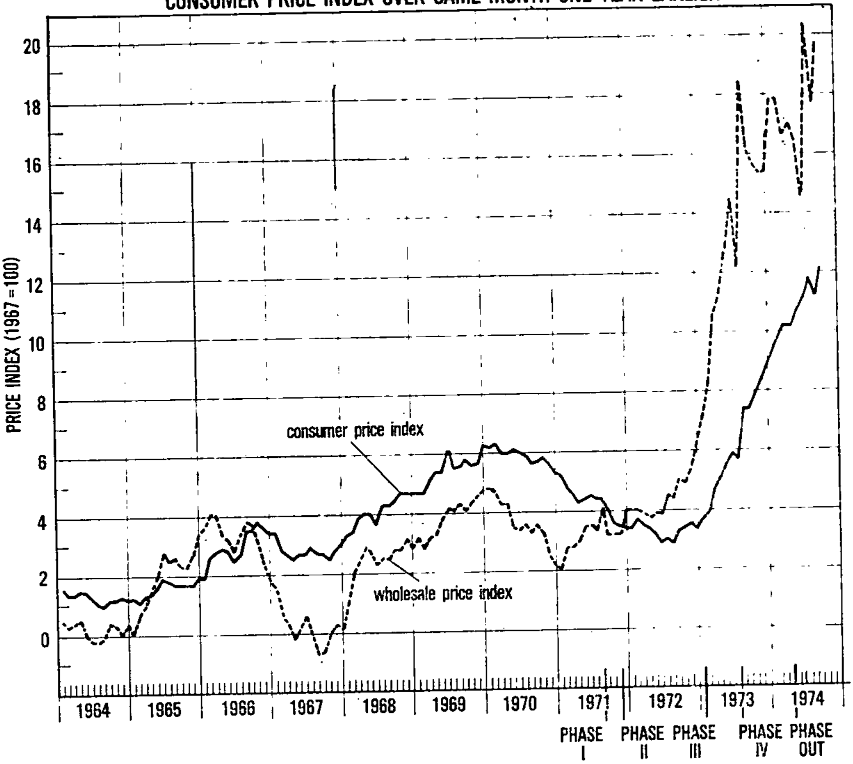
Of course, the country needs some degree of overall economic restraint so that excess aggregate demand does not emerge. Perhaps we will have to resign ourselves for a limited time to perhaps five to nearly six percent of unemployment, a costly measure in the war against inflation. But there is little point in paying the harsh price of a recession if we do not reap the benefits of substantially less inflation. Excess demand is not the cause for the runaway inflation and continuing the one-front losing war on inflation makes no sense.

Reasonably early and perceptible progress toward price stability is going to require direct government intervention. Regretably, the President not only has refused to use his moral persuasion and high official position to fight the spiral head on, but he repeatedly and affirmatively commits himself against direct controls and intervention. The call for voluntary restraint and for local community action committees to reduce price and wage increases is like using a tea kettle to stop a forest fire. There are self-generating elements in the inflation spiral which cannot easily be slowed or halted. A recession is not going to break this spiral. Tough measures are needed, and they are long overdue.

We need direct controls along with appropriate monetary and fiscal restraints to get down to tenable levels of inflation. Twenty months ago consumer prices were rising at an annual rate of less than 4 percent a year. Twenty months from now we will be celebrating our 200th anniversary; we must set a target of subduing inflation as fast in these coming 20 months as inflation overwhelmed us in the last 20 months.

Volunteerism and rhetoric will not do the job. It will require direct action, and the American people are not only ready for sacrifices and discipline but they want to respond to tough measures, provided they are fair and equitable. We need direct controls and we need selective actions to assure credit wherever needed to overcome shortages, to stimulate improved productivity, to achieve substantial conservation in food and fuel usage and to really strengthen competitive forces.

PERCENTAGE INCREASE OF WHOLESALE PRICE INDEX AND CONSUMER PRICE INDEX OVER SAME MONTH ONE YEAR EARLIER



Senator PROXMIRE. You were both here when the distinguished Director of the Council on Wage and Price Stability, a man that we all respect, testified—do either one of you feel that this Council on Wage and Price Stability provides effective service, recognizing as Mr. Galbraith has pointed out it will not work, it will fail, but will it do any good, accomplish anything. Do you see any value in this or as an economy move should we simply abolish it?

Mr. GALBRAITH. Well, the cost is small so I would not react strongly to Mr. Rees' 6 employees, or even to the 40. And I share your appreciation of Mr. Rees' ability and I also share his appreciation of the ability of my colleague, John Dunlop, whose operations I have watched with a combination of wonder and admiration over some 30 years.

If free market competition were easy to achieve we wouldn't be here talking about inflation today.

I don't want to suggest what doubts these excellent theoretical free-market economists or Mr. Rees harbor deep in their souls, but I hope that you wouldn't ask them to guarantee that their suppressive, contractivist, and mildly direct efforts will bring the rate of inflation down measurably in 6 months.

Senator PROXMIRE. Do you think it will have any effect at all?

Mr. GALBRAITH. No.

Mr. NATHAN. I can't see how it can have any significant effect. What we hear here is that there will be hearings and exposure, but based on what the President has said, Congress is put in an almost impossible position. The President talks so strongly and repeatedly about being against any kind of intervention that I don't think Mr. Rees' efforts will make any difference. If you find somebody in your house stealing jewelry or something else and you say get out of here or I will shoot you, and you go on to say that you don't have a gun, he is not going to pay attention to you. I don't see how this Council is going to have any effect. The powers to subpena, delay, rollback are needed. Without these as a minimum it will not work.

I don't think this country is in a position to wait 6 to 9 months, to see whether this kind of extreme volunteerism is going to work and then try another voluntary step and then a little bit more. We have a big fire burning and the blanket approach of monetary and fiscal restrictions and rhetoric are not going to achieve much. We will be in worse trouble rather than enjoy any abatement of inflation.

Senator PROXMIRE. Both of you gentlemen, of course, as I said in my introduction, and I meant it, I didn't overstate it a bit, you are certainly two of the most respected economists in the country, but you are a minority in asking for wage-price controls. If you are right I think you recognize there is no way in the next few months we can persuade the Congress, even if we wanted to, to put in wage-price controls. You have labor opposition, management opposition, and a Congress just voted against them and the administration would have to turn around.

On the other hand you have a very strong sentiment in Congress to provide for considerably stronger action short of controls, including a hold up of wage prices, the possibility of rollbacks and so forth.

Do you see any wisdom in proceeding along that path or do you think if you don't get the kind of controls you have called for, rather comprehensive controls, that anything short of that will not be helpful?

Mr. NATHAN. I have no hesitation in saying I would strongly urge Congress to take the initiative on those proposals in the Joint Economic Committee report; legislate the subpena power whether they ask for it or not, give them the power to delay wage and price increases and I would rather see 60 to 90 days rather than 30 to 60. I think we have been dealing with an all or nothing approach for too long, monetary restriction or total controls. A look at what has been happening raises doubts as to how long we can wait. I think we are going to have to come around to controls. I think we are just delaying at a very great cost, but in the meanwhile I would move right ahead with all of these other measures.

Senator PROXMIRE. Mr. Galbraith.

Mr. GALBRAITH. I would agree with that, but I'm somewhat less less pessimistic than you are. I would sense that the instinct of people generally is that the old religion, which comes down to heavy reliance on the Federal Reserve, isn't working. Therefore, given the adverse reaction to inflation, there is a tendency to move on to alternatives. I don't think this is limited to a relatively small number of people. I have a sense this is becoming a fairly general attitude.

Senator PROXMIRE. Well, you have some very important support in the Congress, the majority leader who has come down very clearly on the side of wage-price controls.

Mr. GALBRAITH. I was speaking on this matter last night in New York to a moderately conservative group and I was struck by how generally favorable the reaction was to Senator Mansfield's speech. At the summit meeting Mr. Goldfinger, of AFL-CIO, said they were opposed to controls unless they treat everybody alike. I wouldn't be in favor of controls that didn't treat people alike either. So, I would be somewhat more optimistic than my colleagues about the possibility of people coming to a plausible solution especially when there is no alternative.

Let us take part of the cake if we can't have all. We can always go on to strengthen legislation if it proves inadequate.

Senator PROXMIRE. Let's take a look to see if we can really determine what the prospects are as far as prices are concerned. You do have a very strong argument in your favor about the GNP deflator. You say this is the biggest increase we have had, much bigger than the last quarter, this one is very troublesome and a very high level of overall inflation.

At the same time I think you could interpret this chart in the precisely opposite way. You could argue that when controls were put into effect in August of 1971 inflation was at a rate of about four percent. After 2½ years of controls, inflation was at a rate of about 12 percent.

No. 2, you could argue there is always a big bubble, there is always a big increase wherever you take off controls, there is always a tendency for industries which have a power to catch up to do exactly that.

Then there is one other factor which makes it even harder to analyze these figures, and that is the fact that the majority leader speaks out for controls, people who could oppose controls still say we are lucky to end up with them, persuades some labor unions and especially corporations to increase their wages and prices now when they can and get ahead of the prospects of further controls. When you put all of these elements together I wonder if you have a case of an economic situation now which would suggest that if we simply don't put controls into effect that maybe the weakening of demand, which is very demonstrable, the fact that overall inventories are high, and that there is not a lot of muscle behind further price increases now in most areas, except for food, I wonder if you have much of a case now that there is a prospect for a continued double digit inflation.

Mr. GALBRAITH. First I will go back to the history. The President and his economists have averted repeatedly to the history, have said controls didn't work in World War II, didn't work in the Korean war. That is wrong. They worked. The record should be made completely clear.

Senator PROXMIRE. I wholeheartedly agree, if we hadn't had controls in World War II we would have had enormous inflation.

Mr. GALBRAITH. Controls became substantially effective in the summer of 1943. From the summer of 1943 to the summer of 1946 somewhere around half the gross national product was diverted to war purposes, millions recruited and taken away from their jobs.

There was very high taxation, but covering, I recall, only about 40 percent of expenditures. Controls held the wholesale price index stable from the summer of 1943 to the summer of 1946. There was a bulge taken off—approaching 25 percent. Many of us felt if that was kept another 6 months that would have been avoided.

Senator PROXMIRE. Consider, Mr. Galbraith, consider the difference in World War II and that period we had 2 percent unemployment, a tremendous pressure on resources of all kinds, a great increase in personal income; so you are right, those controls undoubtedly did the job. We had to have them. Today we don't have that at all.

Mr. GALBRAITH. In the Korean war we had good organization and good enforcement organization. In the autumn of 1950 there was a very sharp increase in prices, then in 5 months the controls broke the increase and they were stable for the rest of the war. There should be absolutely no question in anyone's mind that when one is determined to make these work, they can be made to work.

Senator PROXMIRE. Those are both wartime economic situations with strained resources and shortages in many, many areas, and in general an overall excess of demand; we don't have that now, do we?

Mr. GALBRAITH. That is absolutely right; we don't. One does have to have people who believe in the policy. I have said many times that putting controls, as in these last years, under people who have a devout religious faith in the free market is like putting the New York vice squad under Xaviera Hollander. Bob Nathan has already mentioned the ineffectiveness of having enforcement through IRS agents who know, and rightly so, that their careers depend not on price controls, but on what they do about taxes.

So, I don't think this is a record that proves controls are ineffective. Nor is the comparison with Britain and other European countries valid. In the United States, as I said earlier, we have a much more reasonable trade union movement. It is capable of thinking in terms of the overall goals of stability. It practices a restraint, as compared to the British unions, which is of a totally different order. That other countries, whose prices also are extensively made beyond their borders, have more difficulty than we do is to be expected. They prove nothing as to our ability to make a success of it.

Mr. NATHAN. Can I come back to the point you raised, Mr. Chairman, two or three times?

One, I know there have been a lot of people who said when you put on controls it suppresses inflation and when you take them off, it explodes. Controls were weakened at a critical time in January 1973. It was the worst possible timing. Various elements were at work intensifying the rate of inflation. The effects of the dollar devaluation still had inflationary consequences and which had not worked their way through by the end of 1972.

Senator PROXMIRE. You had a second devaluation about that time, didn't you?

Mr. NATHAN. Yes; a second one after that, which just threw gasoline on the fire.

But then you had also in 1972 a situation which should have made the administration cautious in January 1973, and that was the Russian grain deal where we gave the Russians the opportunity of buying grain at a reasonable price and at very low interest rates; and we never talked about volume. I said to somebody the other day it is like the neighbor who comes in and says can I have some sugar and you expect him to take a cup or a half a cup and he looks in your cabinet and sees 25 pounds and he walks out with 25 pounds.

Given the price rises in agricultural products in the fall of 1972, it was absurd to weaken controls in January of 1973. We did have, of course, a bad corn crop this year, but on the other hand not every instance has been unfavorable.

Senator PROXMIRE. Even on the assumption that was a bad time, I wonder if the fall of 1974 is similar to the beginning of 1973. We now have a much higher level of unemployment, much more slack in the economy generally. We have reduced most of our shortages; we do have and we continue to have wage-price controls, very badly administered, but we have them there. But I wonder if the argument makes sense to extend controls to every firm that employs a thousand people, which may be two-thirds of our manufacturing capacity, and covers most of the service area, too.

Mr. NATHAN. What we should have is a very substantial slowdown in inflation, but it gets worse and worse because what we have now is a spiral that keeps going round and round. Everybody says well, today the recession hasn't worked its way through the price structure, so let's wait. The result is more inflation because of the self-generating spiral. It is true that aggregate demand is not excessive. We ought, within a short period of time with controls, to be able to break this inflation; but not without controls.

Senator PROXMIRE. We have 1.2 million more people out of work than a year ago. We have, as you pointed out, a housing industry in a depression, and the policies that you suggest, Mr. Galbraith, both the continuation of tight money and the support of the President's increased taxes, it seems to me, can do nothing but aggravate that situation. It is true that if you put controls into effect you might adopt policies that might begin to move the economy up to provide more jobs, somewhat more easily with less inflation, but if you follow a policy of what seems to be depressing the economy somewhat, aren't you going to move in the direction that will mean 7 percent unemployment by the end of next year?

Mr. GALBRAITH. Let me answer in two steps. First, we have a wide measure of agreement, that a substantial slack in economy no longer brings down prices; the area of administered prices and strongly negotiated wages continues to maintain the upward spiral. Parenthetically it does so with an increasing squeeze on the competitive sector of the economy, notably in agriculture. This problem can only be dealt with by direct controls.

My suggestions as regarding monetary and fiscal problems, I think, are motivated in the main out of caution. I would like very much to easy monetary policy because of the particular effect that that has on people who borrow money, particularly on the housing industry. I am reluctant to talk about that until there is some compensatory action on the fiscal side. This is why I would propose increasing taxes in the upper brackets. I am led to do that out of unwillingness to act on the basis purely of prediction.

Senator PROXMIRE. But you want to follow a restrictive fiscal policy, a restrictive monetary policy. What can you offer to people who are losing their jobs?

Mr. GALBRAITH. I am anxious to get away from action by general policy, Mr. Chairman. There should be liberality in the policies that we then use to make sure those who are unemployed don't carry the burden of arresting the inflationary spiral. For this reason I would avoid a very strong endorsement of public service employment, and extended and enhanced unemployment compensation.

Senator PROXMIRE. That seems to be so contradictory, public service jobs may be all right, but lots of weaknesses. Under the proposals you would qualify it if your unemployment compensation ran out, this would mean teenagers and others who haven't had jobs wouldn't qualify. It seems to me this is an artificial action that is likely to mean we are destroying jobs by a stringent policy in housing, impounding funds for sewer construction. On the other hand, we come along with public service jobs, if not leaf raking, aren't permanent and would permit only a limited proportion of your unemployed to qualify.

Mr. GALBRAITH. Let me stress one point. The objection is to the diverse effects. It works, but the man who has to borrow money, generally speaking has less than the man who lends money. This is why I share with most of my liberal friends a strong antipathy for this particular form of inflation control. In contrast, fiscal restraint—higher taxes on those that can afford to pay them—it works equitably across the economy. In easing monetary policy I would urge, to be safe, compensating action in fiscal policy, and this gains force if one is also arguing for much stronger support to the people who are now unemployed.

Senator PROXMIRE. But look at the overpowering argument for the really imaginative program of providing housing. We are way, way short of our goals. We have congestion in housing. One of the economic failures in this country is in shelter, housing.

No. 2, an increase in unemployment in the housing industry, 12.4 percent unemployment. You have the other homebuilding resources available. Here is one area where you can stimulate the economy without an inflationary effect because the resources are there, ready to move, and as a matter of fact having a somewhat anti-inflationary effect inasmuch as you would provide the shelter that is short now that would tend to hold down rent increases and housing increases. Why rely on public service employment which may be rather nice in some respects but far less satisfactory and efficient in providing resources——

Mr. GALBRAITH. You have in mind mortgage and other support.

Senator PROXMIRE. And I am being very careful about any kind of tightening in monetary policy because the conventional area is overwhelmingly influenced. An increase of 1 percent in the mortgage rate knocks out a couple million families from their prospects of being able to buy a home.

Mr. GALBRAITH. My reluctance is in easing monetary restraints as long as inflation is as bad as it is now unless something is put in its place. I would substitute final restraint which does not have these discriminatory effects on housing.

Senator PROXMIRE. You feel this is a compensating inflation, but also to some extent is related to excessive demand? I can't see that excessive demand, with retail sales down, capacity so low, hours of work down, I don't see the evidence.

Mr. GALBRAITH. On the other hand you don't have food prices shoved up this way unless there is some excess of demand in relation to supply in that sector.

Senator PROXMIRE. But food is the one sector it would seem to me to be much less elastic. By and large people eat what they need. I would think as compared with automobiles, compared with housing, clothing and so forth, where people can economize, food is one area where it wouldn't be susceptible to changes in price.

Mr. GALBRAITH. In my now-distant experience as an agricultural economist, I would slightly disagree. There is some elasticity related to food in regard to nutritional substitutes, particularly in regard to meat consumption; how we use feed grains.

Senator PROXMIRE. Well, you suggested some ingenious ways, but I would think they are politically hard to put into effect. The notion of restaurant meals above a certain price; I can't imagine people with incomes of $15,000 and above—because they pay a surtax—of eating less food, or even less choice cuts. I don't see monetary effects having much effect on appetites.

Mr. NATHAN. I think the problem here is one of magnitude. The question is how much curtailment of aggregate demand does one accept as part of the fight against inflation. I would say, if we could have 5.5 percent, or even 6 percent unemployment, with a big drop in inflation, maybe we should pay that price. But I don't think there is a ghost of a chance that a mild recession will significantly slow the inflation. That is why I am for controls.

Senator PROXMIRE. I don't think we have been able to establish a connection between increased employment or a slowed-down economy and eased inflation. Prices went up more sharply in 1969–70 when unemployment increased. For one thing you have a slowdown in productivity as you have less activity and the unit cost of labor increases, and of course the labor people are fighting for higher wages and that pushes up prices.

Mr. NATHAN. This is why any tendency now on the part of the administration to sit back and say the inflation will subside if we wait is unrealistic. The steel industry may say it has the profit margins it wants, but it will want more, and that is natural. Productivity has declined and it is not going to increase unless the economy recovers. If unemployment increases productivity will drop further.

Don't forget that the wage-settlement figures you were hearing today were exclusive of the escalated clause. I think we are in for a price wage spiral and I don't blame labor. I think labor took a beating.

With these and a number of other inflationary elements prevalent I think we will have more inflation. Dairy prices next spring and summer will just take our ears because we will have a drop in the dairy herd size due to increased feed grain prices.

Senator PROXMIRE. No doubt we will have a big increase.

Mr. NATHAN. Some say that if we take a lot of softening factors into account we can expect that prices will be down 6 months from now or even 3 months from now.

For the second summit meeting in New York David Groves and Otto Eckstein were asked to project the impact of varied budget cuts on the rate of inflation. They showed a considerable rate of price increase in 1977 even with very large budget reductions. Herb Stein said why not test the results beyond 1977, which was in sharp contrast to Stein's repeated forecasts and promises of slower inflation within months, when he was chairman of the Council. I don't think we will get rid of inflation without controls.

Senator PROXMIRE. Gentlemen, I want to thank both of you very, very much. I think this morning's hearings have made a most helpful record. Mr. Rees' testimony was helpful. I do think, and I don't want to be unfair to Mr. Rees, for whom I have great admiration, but I think this morning's hearing made it clear we need far more effective control on wages and prices than we have. Whether we have to go to the controls you gentlemen advocate may be debatable. You certainly need far more forceful action.

Thank you very much.

The committee will stand adjourned until the call of the Chair.

[Whereupon, at 12:10 p.m., the committee adjourned, subject to the call of the Chair.]

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