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THE 1974 ECONOMIC REPORT OF THE PRESIDENT

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-THIRD CONGRESS

SECOND SESSION

PART 1

FEBRUARY 7, 8, 15, AND 18, 1974

Printed for the use of the Joint Economic Committee

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

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THE 1974 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 7, 1974

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

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman of the committee) presiding.

Present: Representatives Patman, Reuss, Widnall, Brown, and Blackburn; and Senators Proxmire and Humphrey.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; Richard F. Kaufman, general counsel; Michael J. Runde, admininstrative assistant; William A. Cox, Lucy A. Falcone, Sarah Jackson, Jerry J. Jasinowski, John R. Karlik, L. Douglas Lee, Courtenay M. Slater, and Larry Yuspeh, professional staff members; Leslie J. Bander, minority economist; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig, minority counsel.

OPENING STATEMENT OF CHAIRMAN PATMAN

Chairman PATMAN. The committee will please come to order. This morning, the Joint Economic Committee begins its annual hearings on the Economic Report of the President. It is the duty of this committee to evaluate all of the recommendations put forth by the President and to advise the Congress thereon.

The economic outlook for 1974 is a distressing one. Unemployment is going up. Interest rates are at exorbitant levels. Housing is in a state of depression. The energy shortage is causing great disruption, and food prices continue their sharp increases. I don't recall any time since the depression of the 1930's that the American people were so troubled by the state of the economy.

Mr. Stein, in the past years, your statements have always tried to take as optimistic view of the circumstances as possible. This year, you have estimated that our economy will suffer no growth and probably be in a recession in the first half, and that there will be some recovery in the second. Even so, the best you can see is a 1-percent growth rate for the year, which is not good at all.

Your projections of price increase is 7 percent—about as bad as last year's inflation. That is a dismal prospect for the American people. Also, you expect unemployment to go up to something over 5½ percent.

As you know, many analysts feel that conditions will be worse than you predict. Unemployment could easily reach 6 percent or more. Moreover, I don't see any reason for optimism about any decline in interest rates, so we may not have the recovery in housing that you hoped for.

I would feel better if the President's economic message offered us some specific remedies for our present sickness. But all I can detect is the promise that somehow the President will take care of inflation, unemployment, and the energy crisis.

When it gets down to specifics, we find that Mr. Nixon's only program for dealing with unemployment is to propose some minor improvements in the unemployment compensation program. I don't see any responsible effort to provide work for the unemployed or to otherwise ease the burdens of those families whose wage earner is thrown out of work.

The program for dealing with the energy crisis seems to rely heavily on letting rising prices reduce demand. This amounts to an economic bloodletting for the lower and middle income families. Naturally, it will result in excess profits for the energy industry.

Neither is there any adequate proposal for dealing with the serious inflation that we are suffering. It looks to me as if the administration intends to play it by ear with the same disastrous consequences that have brought us to the present state of affairs.

It is shocking to realize that a family purchasing a $20,000 home now has to pay about $40,000 in interest over the course of the mortgage. Thus, the final cost is three times the original cost of the house, or, in other words, it can be said he has to pay for three $20,000 homes in order to get a title to one $20,000 home.

Mr. Stein, you are welcome, sir, and your counsel. Of course, we know you, but would you make known the gentlemen who accompany you, please?

Mr. STEIN. Thank you, Mr. Chairman, for those warm words of welcome. I will introduce Mr. Gary Seevers, who is a member of the Council of Economic Advisers and Mr. Fellner, who is a member of the CEA; Mr. John Davis, who is my special assistant. I believe this is the first time any of them have had the pleasure of appearing before this committee when this committee was in full session.

Chairman PATMAN. Would you like to present a statement?

Mr. STEIN. Yes, I would like to present a statement and have my colleagues answer the questions.

Chairman PATMAN. I think we will have a number of questions for you.

STATEMENT OF HON. HERBERT STEIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, ACCOMPANIED BY WILLIAM J. FELLNER, MEMBER; GARY L. SEEVERS, MEMBER; AND JOHN DAVIS, SPECIAL ASSISTANT

Mr. STEIN. We are pleased to appear before you today to present our views on the state of the economy and on appropriate policy for achievement of the Nation's economic objectives. It is less than a week since the President submitted his economic report and we submitted our annual report. We shall not try to summarize those documents this morning, but shall touch on the points that seem to us of most importance. We shall, of course, be glad to try to answer questions about aspects of the reports or of the economy that we may not cover in our statement.

As 1973 ended and 1974 began, the expansion of the economy which had proceeded rapidly from the middle of 1971, was slowing down. Real total output rose at an annual rate of only 1.3 percent in the fourth quarter of 1973. Industrial production declined by one-half of 1 percent in December. Nonagricultural employment was approximately unchanged from October to January. With the labor force continuing to rise rapidly the unemployment rate rose from 4.6 percent in October to 5.2 percent in January.

This weakness of the economy has undoubtedly continued since the latest figures became available and will probably continue for some months more. The low level of housing starts in recent months portends a further decline of construction activity. The excessive inventories of large automobiles to be worked off will hold back automobile production. Consumers will be paying still larger amounts of oil and energy products, partly to foreign countries, and this will cut into their purchases of other products.

Although the figures have not yet been compiled, it seems probable that industrial production declined in January by more than it did in December. Real output in this quarter will almost certainly rise less than in the fourth quarter of 1973 and may show an absolute decline. The unemployment rate will probably rise further from the January figure of 5.2 percent. Profits are probably declining, both absolutely and relative to the GNP.

We expected a slowdown before the energy crisis hit. In fact, the rate of increase of production had already slowed in the second and third quarters of 1973, but this was apparently because we were running into capacity limits. Employment kept rising strongly. However, we thought then that by early 1974 we would cross over into a position where limitation of demand would hold production to something like its normal growth path, or possibly less for a brief period.

The oil shortage has changed that picture. It has affected the economy in three principal ways:

(1) Difficulties and uncertainties of gasoline supply are cutting consumers' expenditures for some products in ways that are not immediately offset by increases in other expenditures. Automobiles are the leading case. People who give up buying a big new car and can't get a little car, are unlikely immediately to spend the same amount of money on something else, especially if they would have borrowed to buy the new car. In addition, there is a shifting of the pattern of consumer expenditures, causing unemployment in some industries and regions.

(2) A larger part of consumer expenditures is going directly or indirectly for a foreign product, oil, and does not constitute a demand for U.S. products.

(3) Some industries are limited in their ability to produce because of a shortage of oil or gas. This does not seem to be a major factor except in the industries very close to the processing or distribution of oil.

Just how much of the current slowdown should be attributed to the energy situation is hard to tell, but we think it is quite substantial. For example, the decline in the industrial production index in December was more than fully accounted for by reduction in motor vehicles, petroleum products and electric power. And while nonagricultural employment was constant from October to January there was a decline of 90,000 in employment in the transportation equipment industry and a decline of 120,000 in retail trade, heavily influenced by gasoline stations and automobile dealerships.

We believe that this present period in which the economy is rising little and possibly declining will be of limited duration, probably not extending beyond midyear, and will be followed by a fairly strong expansion. There are several reasons for this belief:

(1) Automobile sales should increase as producers raise their capacity to manufacture small cars. This is happening now but will be more substantial, we think, when the new models are introduced. Moreover, automobile sales will be stimulated when consumers are better assured of their ability to purchase gasoline.

(2) Housing starts should reach bottom soon and begin to rise. We expect mortgage money to be more readily available at lower rates, partly as a result of action recently taken by the Federal Government. Clarification of the fuel oil and gasoline situation will also help housing.

(3) The drag on other consumer expenditures exerted by rising outlays for energy-related products will come to an end—not that these outlays will fall but that they will stop rising.

(4) The Federal budget will cushion the slowdown, by continuing strong growth of Federal expenditures while revenue gains slacken. In fact, unemployment compensation expenditures will rise because of higher unemployment.

(5) We expect continuation of a rate of monetary expansion which will be conducive to accelerating the growth of real output in the second half of 1974, but not so fast as to prevent a decline in the inflation rate.

(6) We look for a steady rise of business investment during 1974.

(7) We believe that while the rest of the world is also going through an economic slowdown in 1974, the individual and cooperative actions of the developed countries will be effective in preventing a worldwide recession in which we drag each other down.

Recognizing the uncertainties of the outlook, we consider it important to be prepared for the possibility that the economy may not run along the path we have described. One of the best ways to be better prepared would be to strengthen the unemployment compensation system. This would help those who are the first victims of a protracted slowdown. It would also help to support the economy against the depressing effect of their loss of income.

Last April the President proposed an improvement of the unemployment compensation system which would have raised the maximum weekly benefits to at least two-thirds of the average State wage, as well as extending coverage to farmworkers. We hope that the members of the Joint Economic Committee, who are so conscious of the need, will urge their colleagues in the Congress to act on this recommendation.

The President will soon submit recommendations for increasing the benefits available in areas of exceptionally high unemployment. At present, as a result of legislation proposed by President Nixon in 1969, the duration of unemployment benefits is extended for the Nation as a whole when the national insured unemployment rate is at or above 4.5 percent for 3 consecutive months.

The duration in a State is extended when a 13-week moving average of the State's own insured unemployment rate equals 4.0 percent or more and exceeds 120 percent of the average of the comparable period in each of the 2 preceding years.

These provisions of law can be helpful if the employment situation deteriorates substantially. However, the President believes that it is desirable to go beyond this. He will soon submit a proposal for further expansion of unemployment benefits in areas of severe unemployment. We hope this will have prompt and favorable action by Congress.

The President has directed that other measures be prepared to support the economy if it seems clearly to be departing from the desired path. We at the CEA are engaged with the Office of Management and Budget and the Treasury in building up a list of reserve measures. Our attention focuses primarily on budget expenditures which could be accelerated without adding to the level of the budget in future years, which promises to be large enough in any case. However, our considerations are not confined to budget expenditures.

We wish to emphasize our view that moves to stimulate the economy should be taken only with great caution and based on strong evidence that they are necessary. We are now in the ninth year of an inflation which has been irregularly escalating. To stop that accelerating process and begin t owork down the rate of inflation is essential. We will never achieve that goal if we turn to pumping up the economy whenever it falters a little. This is not to argue for indifference or for squeezing down the economy. But it is an argument for steadfastness in pursuing greater price stability even at some cost.

A reduction of the rate of inflation can be achieved in 1974 and we expect it to be achieved. Food and energy price increases have been contributing well over half of the increase in consumer prices in recent months. This situation will probably continue in the next few months. But thereafter the rate of inflation in these two explosive sectors will subside. We have had a massive rise of food and energy prices relative to other prices in the last 2 years. This rise reflects some durable changes in supply and demand conditions, and some changes that are probably more transitory. These prices are not going to go on rising endlessly at the rate of the recent past.

Prices will reach the levels reflecting underlying conditions, and from that point on will not be likely to rise faster than other prices. We will then be back to the more general determinations of the rate of inflation, such as the overall expansion of demand, the growth of the labor force and productivity and the behavior of wage rates. These factors do not, in our opinion, point to so rapid an inflation as we have been experiencing.

Our belief that we will enter, after about midyear, a period of less rapid inflation rests on the belief that as we pass out of the period when energy and food prices are increasing sharply we will not accelerate more general inflationary forces. We must avoid a revival of the overheated economy. And that is why we must be cautious about moving to stimulate the economy now, because of the danger that the effect would occur mainly after midyear when an upturn of the economy is already the most probable forecast.

The United States now faces the inflation problem in stark terms. Three years ago people could say that there is a ready remedy in the medicine chest if you would but use it. The remedy was income policy, or in stronger form price and wage controls. We have now used the medicine, and have learned what others have learned before us, that it gives temporary relief only, followed by many headaches.

The administration is now in the process of phasing down mandatory controls. It is asking for continuing authority to impose mandatory controls on prices and wages in only a limited area—energy and health having been identified. We believe the phasing down of controls is a responsible and courageous course of action. It is a courageous course because it involves the risk of being blamed for all future inflation by those who will maintain that the controls system could have stopped the inflation.

But we know that the controls will not stop the inflation; they only offer us more and more shortages and inefficiencies. Those who know this have a responsibility to say so, and not to exploit the popular illusions, however widespread they may be.

The administration intends to continue the fight against inflation vigorously by all promising means. In addition to anti-inflation fiscal and monetary policy we shall rely upon a number of other activities the need for which has been demonstrated by experience under the Economic Stabilization Act. These include reviewing the programs of Government agencies which may have an adverse effect on supplies, working with labor and management to improve the structure of collective bargaining, identifying potential capacity bottlenecks, and holding hearings on inflationary problems and on price and wage behavior in various sectors of the economy. The Cost of Living Council would be continued with an adequate staff to perform such functions.

The United States is now at a critical point of economic policy. The key issue is not how we shall get through 1974. It is how we shall get through the next generation. The question is whether we shall restore and strengthen the free market, free price system which has provided the American people the highest standard of living in history or whether we are going to be enmeshed in more and more controls, each one designed to remedy the problems created by the last one. The question arises most acutely with reference to the termination of price and wage controls. It is also encountered at every turn in dealing with the energy problem.

However, it is not only in these dramatic arenas of general price and wage control and energy policy that the struggle for the free economy goes on. It goes on in agricultural policy, where substantial progress has been made recently. It goes on in international financial policy, where flexible exchange rates have demonstrated how constructive reliance on market forces can be. It goes on in foreign trade policy, where we have asked Congress for authority to negotiate further steps to free up world markets. It goes on in transportation policy, where the administration has made proposals to free the Nation's railroads of some of the regulations which stand in the way of efficiency, and will make other proposals to improve transportation.

There is no need to list other examples. The basic point is that the existence of a free market requires constant vigilance. The political forces tending to smother it are strong. But the American people have a great stake in the survival and health of this system. We hope that your committee, which understands the economy so well, and has the confidence of the Congress, will give its support to this essential cause.

Thank you, Mr. Chairman.

Chairman PATMAN. Thank you, Mr. Stein. We certainly welcome you. We will proceed as we have in the past. Each member who is recognized will be entitled to 10 minutes. I hope the time is well kept because we want to expedite consideration of this report.

I will take the first time and ask the questions that are most important to me.

First, I would like to start with the budget. The debt is up to about $508 billion now. That is much more than it was a few years ago.

I notice in the column, held by the public, you show the amount that is held as $359 billion. Who holds the remainder of that debt?

Mr. STEIN. Most of the remainder is held by trust accounts, chiefly the social security trust account. If you are looking at the table that I am looking at, there are two main holders, there are these trust accounts, mainly social security, but including unemployment compensation, the veterans life insurance trust fund, and the Federal Reserve banks.

Chairman PATMAN. Did you list Federal Reserve banks as holders?

Mr. STEIN. I don't know what table you are looking at.

Chairman PATMAN. Page 57 of the budget.

Mr. STEIN. Well, we don't do the budget.

Chairman PATMAN. That was the part that I noticed was not listed and I just wondered why it was not listed?

Mr. STEIN. It isn't on page 57.

Chairman PATMAN. It is in the abbreviated copy.

Mr. STEIN. I don't have the Budget in Brief. If you would look at our report on page 333, we show the estimated ownership of public debt securities. We show a total in December of $469.9 billion, $129.6 billion held by the Federal Government accounts——

Chairman PATMAN. That is held by accounts of the Federal Government?

Mr. STEIN. Yes, and $78.5 billion held by Federal Reserve banks.

Chairman PATMAN. What do you hold in the portfolio of the Federal Reserve banks?

Mr. STEIN. $78.5 billion.

Chairman PATMAN. $78.5 billion?

Mr. STEIN. Yes.

Chairman PATMAN. Well, Mr. Stein, who do you consider owns that portfolio of bonds?

Mr. STEIN. Well, it is a little hard to say, but the beneficiary is the Federal Government. Practically all the interest paid on that debt is returned to the Federal Government.

Chairman PATMAN. But isn't it paid by people who shouldn't have to pay it because the bonds have been paid for once with U.S. Government money?

Mr. STEIN. Well, it is a wash transaction.

Chairman PATMAN. Beg pardon?

Mr. STEIN. It is a circular transaction. The Federal Government pays it to the Federal Reserve banks and they pay it back to the Government except for the small amount which it costs to operate the Federal Reserve System.

Chairman PATMAN. Small amount—$495 million?

Mr. STEIN. $495 million.

Chairman PATMAN. That is almost $500 million.

Mr. STEIN. There are a lot of numbers under that.

Chairman PATMAN. I am talking about the operating cost of the Federal Reserve.

Mr. STEIN. You and I will agree the Federal Reserve performs a Government function and that is how it gets paid for it.

Chairman PATMAN. Well, anyway, tax money paid by the people was used to pay interest on these bonds amounting to $4 billion.

Mr. STEIN. We know that interest is returned to the Federal Government.

Chairman PATMAN. I know, but it shouldn't have been paid. It was not payable because the bonds had been paid.

Mr. STEIN. It is important that the Federal Reserve should have a portfolio of securities with which it can operate on the market. That is one of the ways in which it carries out its function for the management of the supply of money.

Chairman PATMAN. In 1959 the Federal Reserve sent a bill to the House and Senate which was referred to the Banking Committees. The Senate passed the bill and then came to the House and the House didn't pass it. At that time the testimony was that the Federal Reserve portfolio was about $24 billion and the Federal Reserve Board sent a message up to the committee, known as a staff report, but actually speaking for the Federal Reserve Board, in which they stated that the amount of the portfolio was larger than it should be, that they would never need as much as $10 billion to perform the functions that they would formally perform under the law; therefore they wanted permission to let the remainder be—in other words, give it to the member banks of the Federal Reserve System. I well remember the statement they made to the effect that the commercial banks needed the earnings, whereas the Federal Reserve did not need the earnings.

Do you remember that?

Mr. STEIN. No, I don't.

Chairman PATMAN. Well, it was just that way. They committed themselves to never using more than $10 billion and they wanted to give the rest of the portfolio to the member banks. I just wonder how you can afford to continue an operation that calls on the people to pay their bonds twice?

Now, these bonds were paid for once and now, then, if they are not canceled, they will be paid for again and with interest at $4 billion a year?

Mr. STEIN. They were not paid for.

Chairman PATMAN. Well, William McChesney Martin was a pretty well-informed man, wasn't he?

Mr. STEIN. Yes.

Chairman PATMAN. He testified they were paid for once.

Mr. STEIN. Not by taxpayers.

Chairman PATMAN. Our money is good legal tender. If you use it to pay a debt and the person to whom you owe the debt refuses it, you are considered to have paid the debt. Can you improve on that?

Mr. STEIN. It is good currency. We control the behavior of the banking system by controlling their reserve and we trust that function to the Federal Reserve System. They consist of liabilities of the Federal Reserve System and the way in which the Federal Reserve System generates these reserves as are needed by an expanding economy is by purchasing Government securities. There are many other ways in which this accounting could be handled—that is, there is a certain amount of to and fro with interest, but the system does not constitute a burden. There is a certain amount of interest which is paid by the Federal Government.

Chairman PATMAN. Whenever the Open Market Committee buys these bonds through the dealers in New York, they pay what is equivalent to Federal Reserve notes for these bonds. Now, these notes go out all over the world and all over the United States. If you would cancel the bonds, it would be all right. If you don't you have got both the bonds outstanding that the interest must be paid on, and the money that has been paid out for the bonds, so it is double inflation, isn't it, Mr. Stein?

Mr. STEIN. No.

Chairman PATMAN. If they are both out there, it is double inflation.

Mr. STEIN. They are not. We distinguish between the debt held by the Federal Reserve Bank and that held by the public because we don't consider the debt held by the Federal Reserve Bank to be out there.

Chairman PATMAN. I don't see it in your report.

Mr. STEIN. On page 333 it says: "Estimated Ownership of Public Debt Securities," and we distinguish "Held by Government Accounts and Held by Federal Reserve Banks" and "Held by Private Investors."

Chairman PATMAN. It is really not held by the Federal Reserve banks, is it?

Mr. STEIN. Yes, sir.

Chairman PATMAN. It is held by the Federal Reserve Open Market Committee for the 12 Federal Reserve banks.

Mr. STEIN. No, it is owned by the Federal Reserve's 12 banks.

Chairman PATMAN. They didn't pay a dime for them. How do you figure they own them?

Mr. STEIN. They have got them.

Chairman PATMAN. I know they have them. They have a squatter's rights.

Mr. STEIN. They own them, but their ownership has certain peculiar consequences and significance.

Chairman PATMAN. Well, Mr. Burns said they own them.

Mr. STEIN. Well, if that makes him happy, that is all right. He knows that he has to pay something like 90 percent of the interest on them over to the Federal Government.

Chairman PATMAN. He said that in answer to my question about a year-and-a-half ago. It was the most disturbing statement I ever heard a member of the Federal Reserve Board make, but he made it. I said:

> Well, now, Mr. Burns, you mean you use the Government money to buy U.S. Government bonds and deal in the future? You not only pay the money out, but you don't cancel the bonds and you continue to collect interest from the taxpayers on those bonds? You mean to say since you didn't pay a penny of that money, the Federal Reserve didn't, that you own the bonds?

And he reiterated that they did. That is the most alarming statement that I ever heard in my life.

I have always heard professors in teaching economics or credit say that when the obligor and obligee became the same person, the debt is considered to be paid.

Mr. STEIN. All right. I consider the Federal Reserve being a branch of the Federal Government. I am not more concerned about their owning the debt than I am about the Veterans Life Insurance Trusts owning the debt.

Chairman PATMAN. All right.

Congressman Blackburn.

Representative BLACKBURN. I wish to welcome you and your colleagues to the committee. One thing that always makes me amazed is that some of our members who understand very well the working of the Federal Reserve System do not understand the working of the clock, because his 10 minutes has been up for some time.

Would you say the Federal Reserve has been with us in good times and bad?

Mr. STEIN. Yes, they have been with us since 1913.

Representative BLACKBURN. During the 60 years of the establishment of our Federal Reserve System, our country had an economic growth unmatched by any other country?

Mr. STEIN. I am sure that is true.

Representative BLACKBURN. If we are having economic difficulties right now, do you attribute it to a monetary system that has served us as well in times of great economic prosperity, the same system that may be facing problems today?

Mr. STEIN. I think the system is well designed for the system of a modern economy, and every modern economy has such a system and the particular bookkeeping system may vary from country to country, but generally we have a central bank which controls the supply of the money.

Representative BLACKBURN. You council does not control decisions of the Federal Reserve Board?

Mr. STEIN. No, we do not.

Representative BLACKBURN. You might say it is irrelevant to cross-examine you about the operations of the Federal Reserve System, wouldn't you think?

Mr. STEIN. We have a great interest in their operations. We talk with them and they talk with us. We think as I am sure they would agree that they have a responsibility under the same act as we do but, of course, they are the expert and responsible people in this field.

Representative BLACKBURN. Mr. Stein, at the present time, one of the matters receiving most of the public's attention is the truckers' strike which has resulted in violence and death. It is aggravating an already unhappy economic situation. As I understand the complaint of the independent truckers, they are caught and squeezed between the regulations of different Government agencies, that is the ICC which fixes their rates; the increasing costs of their supplies, that is fuel; and the decreased speeds at which they can operate so that they cover less mileage at the same rate with an ever-increasing cost.

In your opinion, is the present plight of the truckers an illustration of the problems that you see generated by too much Government involvement in what should be basic economic decisions?

Mr. STEIN. Yes, it is. I don't want to enter into this particular problem which is in the process of discussion. I think it illustrates the difficulty of making economic adjustments in a period of rapid change when every decision has to be made by one or another Government agency.

Representative BLACKBURN. Now, your truckers' problem is another manifestation of the overall energy problem that we are facing in this country. In your projections, you take into account a decrease in automobile production; uncertainty in housing starts because I think we recognize that suburbia, which has been the big growth area for new homes, is not going to be as attractive if people feel there is doubt about their ability to get back and forth from work.

Are you taking into account the energy problems or that the embargo will be lifted?

Mr. STEIN. We assume it will end by the end of the year. We hope it will end before that. What is significant is not so much whether the embargo ends, but the supply of oil that is produced in the Persian Gulf States and the prices at which they sell it. We expect some clarification. We think the economy and people are suffering from excessive uncertainty about the supplies of gasoline and heating oil and other products which we believe will be relieved or should be relieved regardless of what happened to the embargo.

Representative BLACKBURN. So what you are saying in effect is that the problem may be aggravated somewhat because of the public's uncertainty about the solution of the energy problem?

Mr. STEIN. I think that is right, yes.

Representative BLACKBURN. And to the degree that the public could be assured of reliable sources of energy which we now have on hand, as well as projections of sources of energy from Venezuela perhaps, and perhaps extended domestic production available, the amount of energy that is available next year, and which is projected to be available, will be sufficient to meet the needs of our country?

Mr. STEIN. Yes, I think that is right. They won't be as ample as in the past, but I think they will be adequate. I think what we are suffering from is uncertainty which tends to exaggerate in people's minds the risks to which they are exposed and somewhat overstates the danger of their being unable to get gasoline or unable to get fuel oil.

Representative BLACKBURN. So the long lines we see when people are buying 50 cents of gasoline is just aggravating the problem. If they waited until they needed the gasoline, the lines wouldn't be so long?

Mr. STEIN. Right.

Representative BLACKBURN. You are projecting unemployment will run close to 6 percent by the end of the year?

Mr. STEIN. We say it would average a little over 5½ percent for the year.

Representative BLACKBURN. How much of that do you think will be due to the energy crisis? Do you have any thoughts as to which sectors of the economy might be able to expand to absorb some of that unemployment? The Chase Manhattan Bank has projected that plant and capital equipment expansion will be able to absorb some of the unemployment.

Mr. STEIN. In the absence of the energy crisis, or before it, we were estimating an unemployment rate for the year at about one-half of 1 percent less than we estimate now in view of the energy crisis. We think that the energy problem is obviously very heavily concentrated in the automotive sector and things related to it and probably is contributing to the sharpness in the slowdown in housing starts.

We believe as the year passes that we will find consumers shifting to buying other things. There are already some observations that consumers are not driving so much on Sunday afternoons, they are buying more color television. There will be some other substitution in durable goods. We believe plant and equipment will be strong. We believe the automobile situation will reach its bottom early in the year.

Representative BLACKBURN. The unemployment problem will be more crucial this quarter and it will diminish during the year?

Mr. STEIN. The rise in unemployment will begin early in the year and later decline.

Representative BLACKBURN. My time is up.

Chairman PATMAN. Senator Proxmire.

Senator PROXMIRE. I want to thank you for a hardhitting and gloomy forecast. This is the gloomiest statement we have ever had before us by any Council of Economic Advisers since the agency was established. I want to commend you for spelling it out in a candid fashion.

It is appropriate and it is to your credit. We have a tendency to paint the kind of picture we want to and for administration spokesmen to testify that the situation is rosier than is warranted.

The first part of your statement is refreshing because it shows we have a problem. It is refreshing that the administration speaks that way. However, from that point on, it is hard to see the logic of the rest of your statement because I don't see any effective prescriptions.

You indicate that the President may ask for increased unemployment compensation later. You indicate that there may be other measures which are very vague and not at all specific, and then you rely pretty much on nature to take its course and you say the economy is sick now, but it is going to get well somehow soon.

Automobile sales are low, but they are going to come up. You don't say why. Consumer expenditures are going to rise and you expect under those circumstances the situation might get better.

There doesn't seem to be any policy to consciously improve this sad situation where people are increasingly unemployed and our resources aren't used well and prices continue to rise so sharply.

Mr. STEIN. Yes?

Senator PROXMIRE. How about it, give us some specifics?

Mr. STEIN. I am glad that 1 percent of the report pleased you.

Senator PROXMIRE. It is not 1 percent, it is about 35 percent of the words.

Mr. STEIN. Although it may be the gloomiest report, we are certainly not foreseeing the gloomiest year. I think it is in fact, as you suggested, the most candid report. We describe the difficulties of 1974. We are describing an economy which is going through some travails which is by no means in a grim, bleak, or dour state.

As for prescriptions, we have a policy which is consistent with this outcome that we predict. We say, one could pump up the economy more rapidly if one wanted to do that, but that would not be appropriate to the situation that we face. We believe that the package of policies which we have proposed brings about the best reconciliation that we can see.

Senator PROXMIRE. What in that pack of policies will help unemployment?

Mr. STEIN. It is the budget policy which I have described; in fact, I just read them in our testimony. It is a budget policy which includes an increase of $30 billion in expenditures, from fiscal 1974 to 1975, in which we will run a significant deficit in calendar 1974 because of the slowdown in economy, but it seeks to avoid an all-out pumping up of the economy when inflation is running at a very high rate.

It is a policy which we understand from consultations with the Federal Reserve involves a fairly steady expansion of the money supply. It is a policy which includes some new steps to stimulate housing.

It includes a proposal of strengthening the unemployment compensation system for the benefit of those people who are injured in this process, and it includes management of the energy problem in a way which will keep a large sector of the economy from being closed down by lack of supply.

I think one of the great dangers, of course, is that it is always possible to ask for more in the way of policy and we overdo this.

Senator PROXMIRE. Let me interrupt. I am not asking necessarily for more. I am curious as to what the specifics are. Let me take one of the situations you have indicated. Take housing. What have you done? Last year you began with a moratorium beginning in January on all Government-assisted housing.

Since then you have come forward with one program for 20,000 units. Then another program of 100,000 additional housing units. We had a goal of 600,000 publicly assisted housing units and we have had a year in which we have had a fall in all housing, particularly for low-income groups.

That seems to be seriously inadequate. Especially when you have high unemployment in the construction trades.

Mr. STEIN. We don't think it is inadequate. We have to avoid pumping up the economy too rapidly. That is an aspect of this question. If you ignore that, then the whole thing is obvious. If you have only one side of the problem, then there is no limit.

Senator PROXMIRE. No; it is not a matter of pumping up the economy too rapidly. It is a matter of recognizing priorities. You have a large increase in military spending, a $7 billion increase. You do this at the end of the war. The war is over.

This is the first time we have had an increase in military spending after a war is over, particularly a war that was this long and involved at its height $30 billion in spending. That we don't have now and we are spending money in an area which does not provide as many jobs on the basis of dollars spent.

The Bureau of Labor Statistics—BLS—found from a study last year that $1 billion spent in the military sector employs fewer people than $1 billion spent in almost any other way. We can get more mileage out of a budget which is designed to provide that employment via some other means than national defense.

Mr. STEIN. Maybe we have a different view. I don't think we spend money for national defense to put people to work. We spend it to defend the country. I think we need it.

The increase in expenditures that the President has proposed is very small in view of the increase in pay and the cost of military service and we have had, as you know, in real terms, a decline in military spending since the Korean or the Vietnam war ended.

Senator PROXMIRE. Both of them. We haven't had a decline, $30 billion of expenditures were involved in the war. That part of the expenditure is almost entirely gone, not all of it.

Mr. STEIN. It is the real terms which defend the country, not nominal.

Senator PROXMIRE. In real terms we are not spending less if you leave the Vietnam war out?

Mr. STEIN. That is right, we are spending more than we were in real terms. I don't think you ought to look upon me as a defender or explainer of the national security problem.

The Department of Defense can do that. I can just tell you as an interested citizen of this country, I don't think we are spending too much on defense. I think we need more.

Senator PROXMIRE. Let me come to another part. In your statement you say:

> The Administration is now in the process of phasing down mandatory controls. It is asking for continuing authorty to impose mandatory controls on prices and wages in only a limited area—energy and health having been identified.
>
> We believe the phasing down of controls is a responsible and courageous course of action. It is a courageous course because it involves the risk of being blamed for all future inflation by those who will maintain that the controls system could have stopped the inflation. But we know that the controls will not stop the inflation; they only offer us more and more shortages and inefficiencies.
>
> Those who know this have a responsibility to say so, and not to exploit the popular illusions, however widespread they may be.
>
> The Administration intends to continue the fight against inflation vigorously by all promising means. In addition to anti-inflationary fiscal and monetary policy we shall rely upon a number of other activities the need for which has been demonstrated by experience under the Economic Stabilization Act.

Now we can't have it both ways. You have a budget that provides some stimulation, but it is not an anti-inflationary budget for the very simple reason that you and Mr. Fellner seem to agree that when we get unemployment at 5 percent or lower we begin to have a fiscal effect, which is inflationary, and if you calculate your full-employment budget on that kind of a basis, it means that this is certainly a budget which is not going to be anti-inflationary.

I realize this is a dilemma. To be honest about it, you can't call this an anti-inflation budget. Mr. Fellner, would you respond to that? You are a distinguished scholar in this area. I thought you thought when you get unemployment at 5 percent, below that we begin to have inflationary problems.

Mr. FELLNER. Given the present composition of the labor force, if we use monetary and fiscal policy for reducing the unemployment rate to less than 5 percent, we get into a tight inflationary position.

It depends upon the labor force as to sex and age. I would not be very much in favor of formulating a precise numerical goal for the long run.

Senator PROXMIRE. If you have a budget which is in deficit at 5 percent, can that budget be called anti-inflationary in your view?

Mr. FELLNER. It also depends on the change of the deficit from one year to the next. Our forecasts imply that we will have higher than 5 percent unemployment rate during 1974 and we will have a deficit that I would consider as one of the factors that might dampen this slowdown, that is to say, make the slowdown less dramatic then it otherwise would be.

We would have a deficit for the fiscal year 1975 of $9 billion according to these forecasts which are, of course, subject to revision as the year goes on.

You can't predict that with numerical precision. It is a deficit on that and the monetary policy that Mr. Burns, I thought, conceded can't rate will be rising beyond 5 percent. It will work in the right direction.

Senator PROXMIRE. My time is just about up. Let me conclude. My problem is this, I think the first part of your statement is an honest one, but I don't think you are effectively fighting the recession and I don't think you are effectively fighting the inflation.

It is hard to do it. It is extremely difficult to design a program to do both. If we are honest, we recognize that the fiscal policy doesn't do that and the monetary policy that Mr. Burns, I thought, conceded can't go both ways at once, it can't fight inflation and depression.

The controls are gone. Once the administration says no, that's the ball game. Congress can't administer controls. This review problem, looking at the economy and bottlenecks and holding hearings on inflationary problems make nice publicity and make nice college seminars, but it doesn't help the person whose wages are worth 7 percent less this year than they were last year.

Chairman PATMAN. Congressman Reuss.

Representative REUSS. I want to respond to the criticism of those who forced price-wage controls on you—Congress. In your statement you said:

> Three years ago people could say that there is a ready remedy in the medicine chest if we would but use it. The remedy was "incomes policy," or in stronger form "Price and Wage Controls." We have now used the medicine, and have learned what others have learned before us, that it gives temporary relief only, followed by many headaches.

You have now used the medicine and said it doesn't work. The big bottle of pills we gave you clearly said on the label "Take one daily," which you did from August 15, 1971, until January 1973, and it worked liked a charm.

Your inflationary eruptions cleared up nicely and then, under something called phase III, you threw away the bottle of pills, let inflation rage, and then, remorseful in June, under "Freeze Two" found the bottle and ate 100 pills all in 1 day.

You know, next time we do this, please follow instructions. We will do much better.

Let me commend you for including in your annual report a very comprehensive chapter, chapter V, on distribution of income. There you sum it up on page 140, when you talk about income shares of the American people and you point out—I am reading from page 140:

> Quite remarkably, relative income shares measured in this way have hardly varied in the 25 years between 1947 and 1972. Thus in a relative sense the rich were not getting richer and the poor were not getting poorer.
>
> The general impression is that no significant trend has developed in the relative inequality of income among families * * *.

I have prepared a chart on this which demonstrates that you are quite right. The rich are just about as rich and the bottom three-fifths of the American families, those who today are included in the income group making $13,000 or less, they have done about the same.

However, I was interested in those census figures that you use and so I have made a breakdown of what happened between 1947 and 1972. This is quite instructive. It shows that the bottom three-fifths of American families, those today in the $13,000 a year income bracket and below, made steady progress in improving their share of family income right up to 1968. Conversely, the top one-fifth of American families experienced a decline in their share of income which, since it was up in the 40 percents, was pretty high anyway. Then, in 1968, the rich, who had been steadily getting a little less rich, suddenly started to improve their share of national income again, while the share of low- and moderate-income families declined—by coincidence, when Mr. Nixon came in.

You find what I think is an alarming trend—the rich are getting richer, and not just poor, but middle-income Americans, the three-fifths of the American families making below $13,000 a year are, relatively speaking, getting poorer. This trend coincides with Mr. Nixon's economic policies whereby rising inflation, with special emphasis on food, fuel and interest rates, hits the moderate-income family much harder than it hits the top fifth. In addition, the only tax increases have been in payroll taxes on the average family—a worker making $13,000 a year pays more than $200 more in taxes with the same income than he did a little over a year ago as a result of those increases in social security taxes.

It is suggested that the process is getting worse. No wonder there is alienation and bad feeling and heartbreak in America.

I suggest that the problem is not just confined to the poor, but to three-fifths and perhaps two-thirds of the Nation.

I go into all this because your apparent failure to perceive the problem may account for the fact that nowhere in your economic program is anything being done about it.

Inflation—you removed controls entirely.

Unemployment—I don't see a word about public service employment, which I want to discuss with Mr. Fellner.

Tax distribution—I don't find anything about plugging loopholes and giving a tax break to the lowest three-fifths of the Nation.

Shouldn't you go back to your drawing boards and see if you didn't too facilely look at the beginning and end of your income distribution table—1947 and 1972—without recognizing that for one brief shining moment of 5 or 6 years in the middle there was a trend toward an income distribution Camelot?

Mr. STEIN. You stagger me. The whole variation in the share of income received by the top fifth of families during the past 20 years, for anyone who is taking pictures, is in the range of 42.2 percent to 40.4 percent.

Representative REUSS. That is more than $10 billion a year at current aggregate income levels, isn't it?

Mr. STEIN. That is about 10 percent per capita.

Representative REUSS. Are you suggesting it should be taken from the middle-income group and given to the top? That is egalitarian.

Mr. STEIN. In all statistics of the real world, you have made these by this scale look enormous when they are not. These figures are shown in our table. We shown different years and we show that there is a variation.

We think the outstanding fact about these numbers is how little they have changed. We look at the numbers for the highest fifth, 1947, 43.3; 1950, 42.7; 1960, 43.3, 1966, 40.5. I don't remember whether that was still Camelot or whether it was over and the share of income was 41.4 in 1972.

Now, the essential things that the numbers show is that there has been very little change except the one significant thing is that for the top 5 percent who are the really wealthy people in this country, there has been a declining trend; 1947, 17.5; 1950, 17.3; 1960, 15.9; and 1970, 15.6——

Representative REUSS. Haven't the top 5 percent improved their share of the family income since Mr. Nixon took office in 1968? The answer has to be yes.

Mr. FELLNER. We should know something about the statistical significance of these variations; I frankly don't. This variation which you have needs to be explored from that point of view. I have the impression it lacks statistical significance and will supply an answer for the record.

[The following information was subsequently supplied for the record:]

In response to Representative Reuss' question we examined the statistical significance of the variations. From 1953 through 1972 the share of income received by the top fifth of families fluctuated about a trend line which was declining at merely a very slight rate. The lowest share observed for the period was 40.4 percent, the highest 41.4 percent. The corresponding deviations from the trend are sufficiently small that they are not considered "statistically significant" because they occur too frequently as a result of random variations. This same point is valid for the share of income received by the top five percent of families.

[EDITOR'S NOTE.—For a different view on this subject, see additional information of Edward C. Budd, pp. 140–151.]

Representative REUSS. Let us explore it. With the aim of helping the press and public, we present the two charts plus the basic information from the Bureau of Census——

Representative BROWN. May I see them?

Representative REUSS. Yes, it will lead to further questioning. The basic data is from the Bureau of Census; the Council's figures are based on that.

I commend this study to the press and public. This, I think, is the answer to the deeply felt problem of the average, lower middle-class family. This proves that the feeling of being left out is not just an illusion.

My time is up, but let me, if I may, say this: I gave Mr. Fellner a series of questions on the international aspects of the economic report and I ask unanimous consent that he be permitted to answer those for the record.

Chairman PATMAN. You wish it to be inserted?

Representative REUSS. Yes.

Chairman PATMAN. So ordered.

[The following information was subsequently supplied for the record:]

RESPONSE OF HON. WILLIAM J. FELLNER TO ADDITIONAL WRITTEN QUESTIONS POSED BY REPRESENTATIVE REUSS

Question 1. In the event that the oil embargo continues throughout 1974, contrary to the President's prediction, and oil producers do not roll back their prices, how will the industrialized world pay for petroleum imports? Under these circumstances, how will the U.S. balance of payments fit into a sustainable global payments pattern?

Answer. The payments pattern that would develop on the assumptions described in the question is much less predictable than some of the current speculations about it may suggest. Typical speculations of this sort start from some not particularly dependable country estimate of the 1974 current account outcome that would have emerged aside from the recent steep increase of oil prices; and then an oil-price adjustment is made in estimating the value of the imports of individual countries and a small allowance is made for additional exports to the oil producing countries. For example, one such estimate puts the joint current-account deficit of the OECD countries at about $35 billion for 1974, a figure which results from assumptions concerning the deficits of individual countries. However, it is generally recognized that the analysis cannot stop at this point because the so resulting size of the current account deficits of the various countries could establish themselves only if precisely the required offsetting items developed in each country's overall payments balance. Either capital inflows or reserve movements would have to be of the required magnitude, for each country.

Since therefore this kind of reasoning stops somewhere half-way, the question arises what the other half of the way will look like and to this it is possible to take two kinds of attitude. Some experts are more inclined to think in terms of an overall plan which would postulate some desirable distribution of the current account deficits among the countries and would then imply the desirability of policy measures by which this distribution would be achieved. It is not clear to me how comprehensive such a list of policy measures would be but it would presumably include the planning of borrowing operations, and of reserve movements, and also of exchange rate adjustments. To me this lofty conception seems not only impractical but also undesirable, because "acceptable" current account outcomes depend on a good many circumstances which at this stage are unpredictable and about which a wait and see attitude seems justified.

For example, the expectation is widespread that a disproportionately large part of the Arab investment will tend to find its way to the U.S., probably via the Eurodollar market. This may be true but one should take into account also the effect of such a lopsidedness on international yield differentials which may produce a less uneven distribution of these capital flows. The market tendencies with which the OECD countries will become faced are as yet unpredictable in a good many respects. What does seem predictable is that the U.K. and Italy will be facing continued serious difficulties which have originated in political developments in these countries.

I believe that the practical and desirable procedure is to observe the pressures that will be developing on exchange rates and then—if interventions in currency markets should be contemplated—to cooperate in reaching decisions on interventions that are mutually acceptable to the various countries, that is, do not lead to actions at cross purposes. I believe there is a good chance that agreement on mutually acceptable interventions will be achieved in cases in which reasonable objectives can be achieved by such interventions—for example by the reduction of the large official dollar holdings of some countries or by borrowing operations by some or by American interventions in the currency markets. Only in retrospect and by implication could the result of such behavior be said to reflect an acceptable distribution of the current-account deficits.

Question 2. What will be the impact of higher oil prices, if maintained, on the economies of the United States and of other industrial acountries.

Answer. The high oil prices will have an adverse effect on the terms of trade of the importing countries; differently expressed they will impose a burden on the population of each country dependent on oil imports. Just how great this burden will be is hard to estimate numerically because it depends on how much oil will be imported at the high prices. For the U.S. the burden would exceed $10 billion a year if our imports were unaffected by say a $6.00 a barrel increase in the price of crude but may well not exceed that figure, or even fall short of it, on reasonable estimates of oil prices and of demand elasticities. (However, such a figure leaves out of account the non-measurable part of the terms-of-trade burden as a result of the shifting away of buyers from what their preferred "market basket" would be at the initial prices of energy products).

These terms-of-trade effects of the higher oil prices do not exhaust their unfavorable impact on the U.S. economy or on any other importing country. While it is generally believed that in the U.S. and in Europe the direct output-limiting consequences of the reduced oil consumption will be small in 1974, the public has been turning away from the purchase of some commodities (in the U.S. large cars serve as the most prominent illustration) and the substitution for these goods of other commodity purchases by the public is not expected to take place quite promptly. Nor can this problem of adjustment be made smoother by expansionary monetary or fiscal policies unless excess capacities become spread fairly widely over the economy, since if this is not the case the result of expansionary policies would simply be to worsen the inflation problem by driving up the prices of goods to which the public is gradually turning but which are not yet available in sufficient quantities. Hence most western countries expect smaller growth rates for 1974 than those expected prior to the development of the energy problem.

Question 3. Is the Administration considering the sharing of U.S. energy resources, that is, domestically produced oil and coal or oil that would otherwise be imported into the United States, without industrialized partners in the event that depressions caused by high oil prices or petroleum scarcities imminently threaten either the Japanese or European economies?

Answer. Secretary Kissinger said at the Energy Conference held in Washington on February 11–13 that in the event of the establishment of a broad international cooperative framework we would be willing to share our energy resources in times of emergency.

Question 4. Presuming that the prices of petroleum imports will remain about where they are throughout 1974, what is your prediction for the outcome of the U.S. trade balance for this year? I ask because we are getting a variety of estimates from different sources. The OECD, according to newspaper reports, has recently predicted a shift in the U.S. trade balance from a surplus of $5 million to a deficit of $1.5 billion. The London *Economist* predicted a deterioration in the U.S. trade position of almost exactly the same amount. On the other hand, Walter Levy, a respected petroleum analyst, foresees a potential worsening in the U.S. trade position of twice this amount, or even possibly more. Where do you come out?

Answer. Referring back to the answer to question 1, it should first of all be pointed out that any figure of the kind to which question 4 relates emerges somewhere half-way along an adequate line of reasoning. Such a figure is obviously intended to represent a trade deficit expressing a pre-oil trade-balance expectation with subsequent adjustment for the direct effect of the higher oil prices on the value of American imports and with a further adjustment for a relatively small amount of additional American exports to the oil producing countries. I believe that neither $1.5 billion nor a lesser amount nor twice this amount would be an unreasonable estimate of the trade deficit emerging at such a half-way point but this is not what really matters. What matters is the balance of payments outcome after the countries have decided how far to allow prompt exchange rate adjustments to take place under the influence of market forces (including those exerted by capital movements), and at what point interventions in the currency markets *might* be regarded as mutually acceptable. The final outcome will be significantly influenced by the behavior of countries in these respects.

As for the American position, as it will be gradually evolving, I suggest that it will be advisable to make our position concerning currency sales or purchases by official agencies, borrowing operations, etc., dependent upon our greater or smaller need for the potential *inflation-dampening* effect of a trade deficit on the one hand and the *demand-stimulating* effect of the *avoidance* of a large deficit on the other. Yet in this context it will be necessary also to see whether the capital inflows accompanying a large deficit become rather promptly associated with additional investment expenditures in the U.S. become an inflation-dampening factor but would have a growth stimulating rather than reducing effect. It may be necessary also to pay attention to the danger of protectionist pressures in the event of the growth of the deficit to a very large size.

Question 5. The private market price of gold is now approximately three times the official value. What do you think should be done, if anything, about the official monetary value of gold?

Answer. Since the time when this question was formulated there has occurred a further increase in the price of gold. I am inclined to the view that the behavior of the gold market is influenced by the expectation of speculators that central banks will agree on valuing gold at some very high price in their settlements among themselves. I think the U.S. should strongly oppose this development which could gradually lead to purchase as well a sales operations of central banks in the gold market.

I would *not* suggest changing the price of monetary gold in terms of dollars.

Question 6. What role do you believe the IMF should play in financing the balance-of-payments deficits of member states resulting from oil imports at prices equivalent to about 3 times the early 1973 level.

Answer. The main oil-induced problem that may require special policies involving the institutional framework of the IMF and/or of the World Bank is that connected with the difficulties to which the high oil prices expose a substantial number of underdeveloped countries. The oil-producing countries may be willing to use part of the revenues for alleviating the situation of these countries but at any rate a problem will develop here that will not become resolved either by market forces or mutually compatible intervention policies of the major countries. Most other problems discussed above can presumably be resolved by exchange-rate movements and capital flows under the influence of market forces, and by mutually compatible interventions, though of course the countries in question operate in the framework of the IMF and have access to Fund facilities too.

Question 7. Do you feel any limitation should be put on a further upward float in the exchange value of the dollar? If so, what type of curb?

Answer. I favor allowing exchange rates to respond to market forces, especially when these express themselves consistently in one or the other direction, but it would be quite unrealistic and probably also undesirable to exclude the possibility of the kind of official intervention that takes place when the American net reserve position changes from a large to a smaller negative magnitude or in general when official agencies engage in borrowing operations. On my views about how these may affect the U.S. see my answer to question 4.

Question 8. If the recent removal of capital export limitations—of which I heartily approve—proves to have no significantly adverse impact on the U.S. balance of payments, can we look forward this year to a Presidential announcement permitting American citizens to own gold? In these days of rapid inflation, small investors should enjoy the freedom to invest in whatever assets they feel will best protect their future purchasing power.

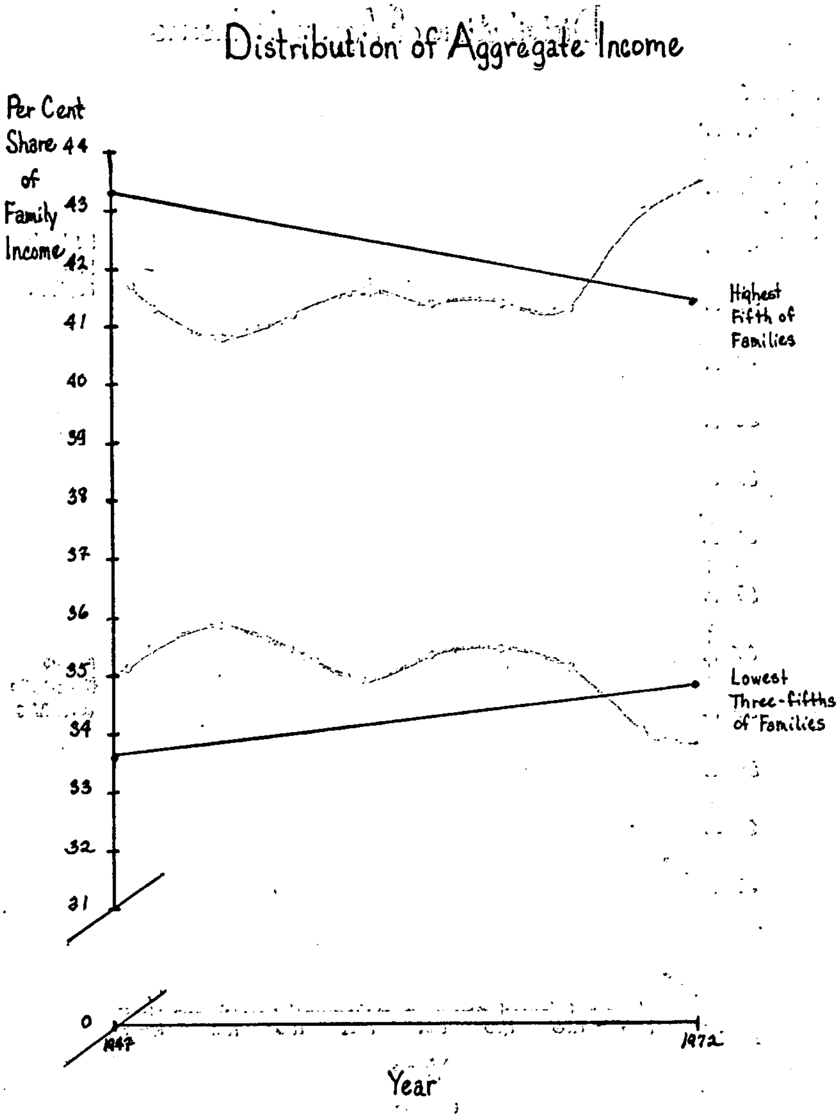
Answer. As I interpret it, the American position looks to lifting the prohibition on the ownership of gold by American citizens at a time when the change will have no disruptive effects.

Mr. STEIN. May we have permission to submit an answering statement and a chart starting with zero?

Chairman PATMAN. Without objection, it is so ordered.

Representative REUSS. I ask that my charts be made part of the record at this point, and that Mr. Stein's statement and chart immediately follow.

[The charts of Representative Reuss follow:]



Distribution of Aggregate Income
Per Cent Share of Family Income
44
43
42
41
40
39
38
37
36
35
34
33
32
31
0
1947
1972
Year
Highest Fifth of Families
Lowest Three-fifths of Families

CHART 1

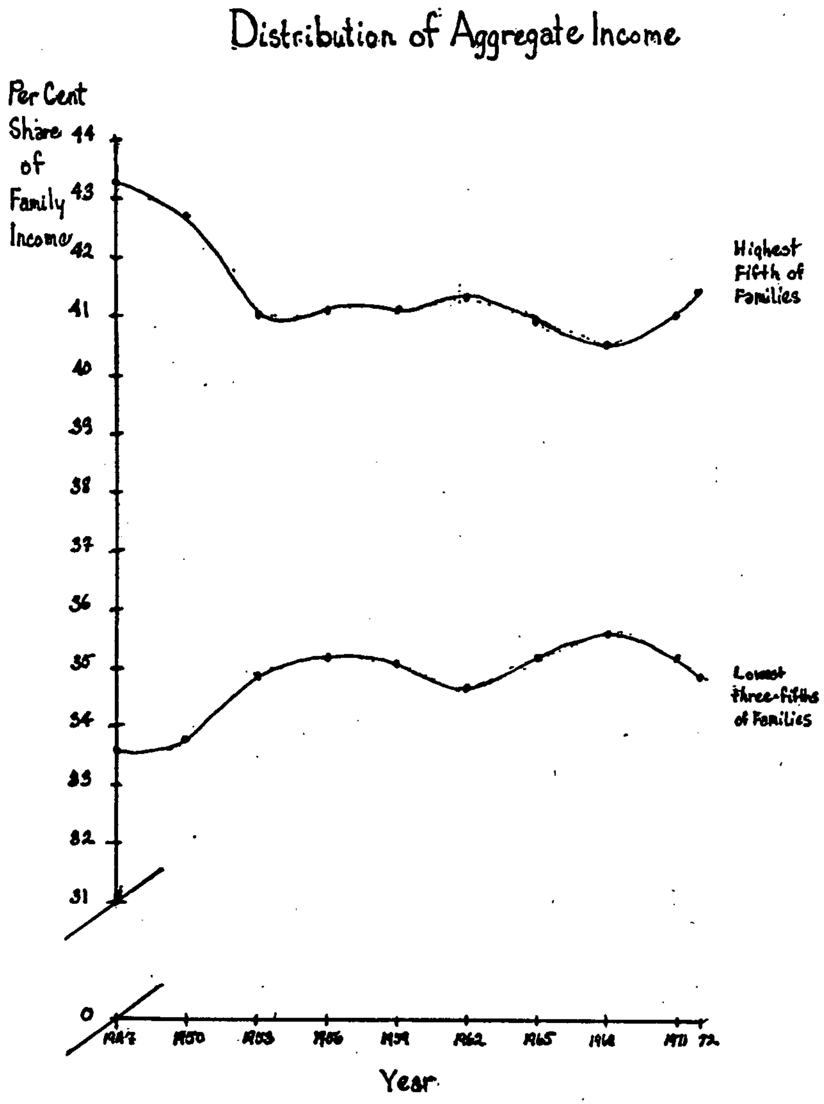
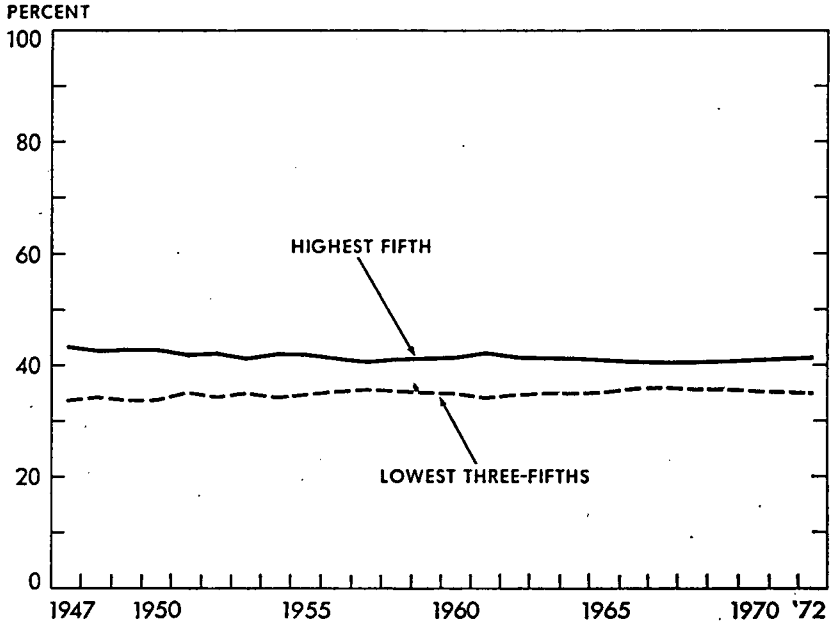


CHART 2

[The following statement and chart were subsequently supplied for the record by Mr. Stein:]

We have prepared a chart in which the share of income received by the top fifth and the bottom three fifths of families are graphed from 1947 to 1972. The vertical axis in our chart ranges from 0 percent to 100 percent. Although there are small year-to-year fluctuations, the basic characteristics of income shares that is shown in the chart is a remarkable stability in the post-World War II period, including the most recent decade.

Proportion of Aggregate Income Received by Highest Fifth and Lowest Three-Fifths of Families and Unrelated Individuals



NOTE: DATA FOR 1959–72 WERE CALCULATED USING UNGROUPED DATA WHILE DATA FOR 1947–58 WERE CALCULATED USING GROUPED DATA.
SOURCE: DEPARTMENT OF COMMERCE, BUREAU OF THE CENSUS.

Representative BROWN. I ask that charts be put in to show after tax income. I think that would be helpful to clarify the picture.

We are in the process in the Congress of doing what we do so well, and that is put off decisions about major problems, and one of them that we have been dragging for the last couple of months is energy legislation.

One of the things that we did yesterday was a complete conference on the Energy Emergency Act which would roll back prices on fuel oil, on crude oil that is produced domestically.

Of course, we couldn't do anything about the price of foreign crude oil, and we do have some differentiation between companies as to the source of the oil which they sell in the American market, some companies selling a good portion of foreign produced crude oil in order to fill up the gap between what we produce domestically and what we need or consume in this country.

I had the impression that that is the kind of thing brought by the same wonderful folks who brought in beef and food price controls that created somewhat of a problem in that field and who still fail to recognize that freezing the price of natural gas, increases consumption and discourages production.

I suggest we might put a codicil on the Emergency Energy Act to repeal the law of supply and demand. Can you advise me what the effect of the impact would be if we roll back prices of natural gas to $5.25?

It isn't a total rollback. The Congress rolls the prices back to $5.25 and then gives the President the authority to raise those prices, should the demand be such that the supply can't keep up with it at these lower prices. Thus, it lets the Congress do things and lets the President have the responsibility for doing all the bad things, but then that is politics.

Can you give me some analysis of what may happen to oil if we are successful in getting prices rolled back to $5.25 for a barrel of oil?

Mr. STEIN. It would have a number of consequences. It would have an immediate discouraging effect on the crude oil production in the United States because crude oil in the ground at $5.25 is a good investment.

You have a good possibility that you will be able to sell it later for more, so there is no point in pumping it out and selling it for $5.25, nor is there any point in going into more specific fields and using more expensive methods to get more supplies, so you will get less domestic supply.

Representative BROWN. What you are saying is, there are a number of oilfields where if the price went up to $7 or $8, you could get the oil out because you could use more expensive methods of extracting it; but while the price is $5, that oil will not come out?

Mr. STEIN. That is right.

Representative BROWN. The second effect, which everybody overlooks, is that holding down the price of U.S. crude oil tends to raise the price of imported crude oil. It tends to increase the world prices for crude oil.

Mr. STEIN. Holding down the price of domestic crude holds down the composite price, increases the demand, increases the profitability of getting foreign oil at whatever price in order to sell it and mix it with the lower cost domestic crude.

The lower the price if this goes on, the price of product in the American market would reach the same price it would have reached if we had not controlled the domestic crude, but all that domestic price will go to the foreign producing countries and not to the U.S. producers.

Representative BROWN. I can envision two companies selling gasoline on corners opposite each other where one company must provide its gasoline from a basic foreign crude oil source, which it is buying now, I think, at around $12, and another company will be supplying gasoline at a domestic oil price of $5.25 a barrel, so obviously there is going to be a discrepancy between the price of regular gasoline. Thus, any consumer in his right mind will go to the cheaper price, and the result will be that that company will run out of gasoline and there will be a necessity for rationing.

Mr. STEIN. That is right.

Representative BROWN. In terms of production, it seems to me that somebody who can find oil abroad and sell it at $12 a barrel and maybe create gasoline at 75 cents to $1 and $1.25 a gallon, which is what the price is in Europe, would sell in the European market. We are benefiting the gas price in Europe because you are discouraging people to look for oil in the United States.

Mr. STEIN. We are frustrating every opportunity to get more of a supply. We are encouraging people to put billions of dollars into energy. They have to have some confidence that this price is not just a political flag.

Representative BROWN. Why do they feel that way? The farmers knew better. As soon as we fixed the price of beef, the farmers wanted to cooperate?

Mr. STEIN. They did what was natural. They won't sell something today for $40 if they can sell it next week for $60.

Representative BROWN. What about natural gas? We fixed the price on natural gas many years ago, so that the consumers would be benefited and we got a lot of low-price natural gas?

Mr. STEIN. No, we got a very low-priced natural gas. We bit off our nose to spite our face. We could have a much larger supply of natural gas at this moment. People outside the gas-producing States would be much better supplied with natural gas if the price had been deregulated years ago.

Representative BROWN. Well, let us look at it from the other side. Isn't one of the reasons that this country gets into the housing market—that is, gets into the national level of trying to build, or stimulate funds in, housing—is to break the price or cost of housing for the average citizen? Isn't one of our objectives to increase the supply by putting more money into the housing market? Isn't that the way we operate to some extent?

Mr. STEIN. That is the nominal objective. But there are many studies which raise questions about whether that is the effect in the end because we just push the money around. We establish some subsidized program which absorbs money out of the mortgage market which subsidizes these particular houses, but that keeps some other houses from being built.

Representative BROWN. I get the suspicion you are speaking to some extent for a free market and you are against Government controlling of prices?

Mr. STEIN. You didn't hear my flag-waving speech at the beginning. I think you came in a little late. I made that speech at the beginning.

Representative BROWN. I am sorry. Could you summarize it?

Mr. STEIN. My basic point is that we have an efficient mechanism for solving economic problems in this country, and that is a free market——

Representative BROWN. Isn't that just an admission that the Government doesn't know how to do it?

Mr. STEIN. I don't feel anything personal about that.

Representative BROWN. Pardon.

Mr. STEIN. Nothing personal.

Representative BROWN. All of us are involved. Some are not so much for it as against it.

Mr. STEIN. That is going a little too far. Government has appropriate functions, one of which is to manage the supply of money; another is to manage its own budget, and others which could be listed. It does not do well in managing the details of the economy, deciding whether the gasoline should go to New York or Newark or Detroit, and deciding what the price of gasoline should be in producing oil and distributing it. Those are matters of infinite complexity and detail which are handled by a very flexible and adaptable and decentralized system and cannot be handled by a Federal administrator, especially if he has to spend 90 percent of his time before congressional committees.

Representative BROWN. Are you talking about Mr. Simon?

Mr. STEIN. Just in general.

Chairman PATMAN. Senator Humphrey.

Senator HUMPHREY. Welcome, Mr. Stein.

Mr. STEIN. Thank you. It is good to see you back.

Senator HUMPHREY. Thank you. I think you and I have a big dinner coming up.

Mr. STEIN. I am looking forward to it.

Senator HUMPHREY. I have a big appetite, I think the dinner is on you.

Mr. STEIN. It may be the last supper.

Senator HUMPHREY. Your implication there worries me, Mr. Stein, and I have a number of questions. I don't know whether we will be able to get to all of them.

I have been intrigued and interested, and I would say entertained by the discussion of a recession. First of all, I was relieved when the President served an edict and said there would be none. That sort of made me feel good for 2 or 3 minutes and then you came along with this report and both upset the President and myself. It has a bipartisan quality of equal treatment.

There has been lots of talk and humor among administration spokesmen about what constitutes a recession. At the budget meeting Secretary Shultz said, "There will be no recession as we regard it." I have a high regard for him.

On Tuesday night you were recorded as saying:

> You will never get me to say we are in recession. A recession is a state of mind. A recession is a slowdown when the other party is in power.

That is pretty good, by the way. It is a good line. I am going to use that somewhere along the line.

Now while that humor is sort of good to have once in a while, particularly in these difficult times, I don't think that the current outlook for the economy is a humorous matter. It is very, very serious and it is not funny for an auto worker getting laid off or for a trucker and farmer not getting fuel or for shoppers in the supermarket and, quite frankly, to see price rises take place in areas on commodities that seriously affect so many people who are working families.

One of the things about general statistics is that people are not "generals," people are individuals. People in this income bracket of from zero to, say, $15,000, or even up to $20,000 market are finding that many of the things that they need have gone up not 10 percent, not 16 percent, not these general governmental averages, but they have gone up a lot more than that.

Having said that, I would like you to give us a serious statement about the condition of the economy, about how bad you think it would have to be for you to acknowledge that a state of recession exists. What do you mean by "recession"? Let us quit goofing off about it. This is going to get down to a very serious matter that we are going to be talking about.

Mr. STEIN. I am glad you asked me that and I am surprised you took so long to get to that question.

Senator HUMPHREY. Well, I was just reading back some of your more entertaining language.

Mr. STEIN. We have a kind of official body for determining what is a recession, that is the National Bureau of Economic Research. One might quarrel with them as I have done. It is not wise to do that if you don't want to be labeled as having a recession.

The term "recession" during the past two decades has come to be defined as an extended, substantial and widespread decline in aggregate economic activity, but less severe than earlier depressions.

It must have a certain durability, a certain depth and a certain diffusion. We do have a certain number of periods in postwar years which have been identified as recessions by the National Bureau. They have characteristics which can be seen. There was in all cases—there have been five of them—the unemployment rate increased by more than 2.3 percent. Nothing has been declared a recession which didn't have an increase of 2.3 percentage points in the unemployment rate. Nothing has been declared a recession in the postwar period in which the unemployment rate did not rise at least to 6.1 percent. Usually it was over 7 percent. Nothing has been declared a recession which didn't have a 9- or 10-month period of decline in the generally measured indexes of the economy. I am saying that I think these five periods we have had were recessions, although the most recent one in 1969–70 might not have been called a recession if it hadn't been for two things, one was an automobile strike in late 1970 and the other was that I made a sarcastic remark to someone in the National Bureau.

When I say we will not have a recession, I am saying that we will not have an episode of the magnitude of any of the things that have so far been declared a recession.

Senator HUMPHREY. The definition that you referred to had a time frame in it, didn't it, where the economic indicators existed for a slip of a period, for two quarters?

Mr. STEIN. That is not in the Bureau's definition. The two quarters is a shorthand which has been used. It is one of many possible measures. Nobody sanctified that.

Senator HUMPHREY. We have two quarters of substantial economic decline with rising unemployment and rising inflation and a slowing down of the economic growth. Do you classify that as a recession or what do you call it?

Mr. STEIN. What do you mean by "substantial" and how big was the rise in unemployment?

Senator HUMPHREY. Let us say we have continued rising unemployment.

Mr. STEIN. Again, I can't separate that from the quantity. If it goes 5.2, 5.25, and 5.35 percent—that could go for quite a while and not be a recession. You could have two quarters of a decline in which you have 0.001 percent in the first and second quarter. Nobody in his right mind would call it a recession. You have to look at the magnitude and duration and how broadly diffused the thing is.

Senator HUMPHREY. Let us say you had 6 percent unemployment plus another percentage increase or two with inflation. I am going to give you a series of questions because I want this more specific. If we are going to use these terms, we ought to use them with some preciseness.

The words "recession" and "depression" ought to have meaning so that when we talk about this and discuss this we are not doing it with any frivolity, we are talking about things that are measurable.

Mr. STEIN. I would be glad to answer the questions.

Senator HUMPHREY. One of the things that disturbed me in the report is that some of the problems we face today are hardly even discussed in this report and there were very few pages devoted to agriculture, and I am prepared to discuss this food policy with you or whoever you wish at some length. There were no real policy recommendations and there was no significant mention of the energy problem, and I have just been reminded by my staff that the same situation prevailed in last year's report.

This makes one believe that the work of the Council is done in almost complete absence of long-range planning, even though you have talked of late about the necessity of some planning. What is the administration going to do to correct this lack of long-range planning? Are you going to make any serious investigation of the need for a long-range planning agency? I developed a program called national growth and development policy.

The food situation is a national disgrace. We are so far behind in our informational system on food that the American people are being taken for a ride. We paid farmers $500 million in payments that the facts did not merit because of poor calculations on the price of wheat. We had no regard when we opened up 60 million acres of new land as to the availability of fertilizer, storage, transportation or credit. We run around doing things as if every one of these departments of Government was a separate, autonomous member of the United Nations voting its own individual vote—just plain no coordination.

I don't hold you accountable. I want to say it is a first order to tell the American people when you open up an additional 20 million acres of land that you are going to get production when you don't even have the fertilizer to put on the land knowing that the land is marginal land in the first place, and it is the worst kind of economics to drain down your reserves without any regard of what is going to be the effect upon the market price and this group in this room ought to know today we have the lowest food reserves in 47 years.

I think today you ought to know that the world faces the shortest food supply that we have had in the 20th century and I think you ought to know that the Department of Agriculture and the Council of Economic Advisers seem to have very little collaboration on economic policies that relate to agriculture according to these reports. What are we going to do about getting planning so when the Secretary of Agriculture comes up with some plan and tells everybody it is going to be jolly, we'll have lots of wheat and 22 bushels per acre even if it rains and you haven't talked to God or seen the banker and you don't know where the fertilizer is? What is the Council of Economic Advisers going to do about it when it prepares a report because agriculture is one of our biggest businesses and it is almost ignored in these reports?

Mr. STEIN. I am really surprised, we have a chapter 4 entitled "Energy and Agriculture."

Senator HUMPHREY. Yes; I know.

Mr. STEIN. It has a fundamental discussion of the long-range problems of agriculture in the United States and I believe one of the most reasonable and unemotional discussions of the energy problem you will find anywhere.

Senator HUMPHREY. I know what the problem is, what are you going to do about it? I just came out of the hospital. I know what my problem is, what is the cure? Where are we going?

Mr. STEIN. Most people don't know what the answer is in either of these two fields. I responded that we didn't ignore these. In chapter 1 and in chapter 4 a great deal of attention is paid to energy. I think that your comment is unreasonable.

Senator HUMPHREY. Let me say why I think you ignored it. The ramifications of the rise in price on crude oil upon the developing countries in the world is unbelievable in terms of what it can mean in terms of its solvency. Also it will have the impact of upsetting most of the monetary reforms that the countries thought they had arrived at in Nairobi.

The implications of the increase in the price of crude oil upon the price of fertilizer availability at home and abroad. These should be brought out in these reports in some greater detail. We are not an island unto ourselves in the United States. Today we have an energy crisis. Next year I will predict it will be the food crisis because they are tied together like Siamese twins. That is going to affect the American economy, our exports, our prices, our jobs—all the way across the board.

What disturbs me about the Economic Report of the President is the lack of the kind of long-term look, the broad picture and the interrelationship domestically and internationally of these events.

My time is up.

Chairman PATMAN. Thank you, Senator Humphrey.

Congressman Widnall.

Representative WIDNALL. Thank you, Mr. Chairman. My apologies for not being here earlier, but I had an important meeting with the energy czar, Mr. Simon, and the Governor of our State, due to the very serious fuel oil problems we have. Could you summarize briefly the windfall tax proposal by the administration with regard to oil?

Mr. STEIN. Yes; I am not sure that I can give you all the numbers that are involved in the tax schedule, but what the proposal is is that there should be a progressive tax on the revenue realized by domestic producers of oil from prices above the prices in effect or authorized by the Cost of Living Council on December 1, 1973, and the system goes something like this:

Assuming that that price was, I don't remember, say $4.50, on the revenue of the first 50 cents there would be no tax, on the next 50 cents there would be a tax of say 10 percent and at some later point the taxes get into the 70 or 85 percent area.

The tax is proposed to be in effect for 5 years and these base numbers would be raised by 10 percent a month, so that as we go through time a gradual increase of prices can be allowed without attracting liability to such a high rate of tax.

The idea behind this is that price increases beyond some point do not, in the short run, have very major supply inducing effects, although they may have other beneficial effects in getting a better allocation of this supply and we can, therefore, afford to take back some of the revenue that would be raised from these higher prices.

Well, that is the general theory of it, I probably missed something, but——

Representative WIDNALL. Could you also describe the basic tax changes contemplated by the administration regarding the oil industry and the effect which those changes might have on the incentive to explore for new oil and other energy resources?

Mr. STEIN. Well, I think there are four, Congressman Widnall, in addition to this one. There is the withdrawal of percentage depletion on foreign—a lot of this has to do with foreign oil development or production by U.S. companies.

There is withdrawal of percentage depletion from foreign development, from foreign production. There is the change in the treatment of credit for foreign taxes paid by the oil and gas industry.

At the present time, these taxes paid in one country by an oil company are permitted to be offset against taxes due on earnings in U.S. taxes on earnings in other foreign countries.

There is a great misconception. People think these foreign taxes are allowed to be offset against taxes due on U.S. business. That isn't the case.

The case is the taxes paid in one country, say Saudi Arabia, can be offset by business done in Switzerland, which has a low tax rate. That has been done.

The maximum tax that would be allowed to be credited would be tax that would be due at the U.S. rate of 48 percent and the rest of the tax would be considered a business expense just like a royalty.

Then there is a change in the U.S. tax provision which was proposed last April, which would provide an investment credit instead of the deductibility of drilling expenses and oil expenses.

These are the main things; there may be something else.

Representative WIDNALL. Repeating the last part of the question, this would affect the incentive to explore for new oil and other energy resources?

Mr. STEIN. I don't think any of these things will reduce the incentive to explore in the United States. There will be some effect of reducing the incentive to explore outside the United States, although I would think not very major.

Representative WIDNALL. What is the present overall agricultural outlook?

Mr. STEIN. Well, I would like Mr. Seevers to speak about that.

Mr. SEEVERS. The outlook is contingent on where we stand now and we stand in a situation where stockpiles and inventories of farm and food commodities are very tight. Prices are high.

We think there will be substantial rises in food prices the first half of this year. We do have a policy on agriculture and that policy is to expand production and I think the Government is doing all that it can to minimize the extent to which Government inhibits this expansion and production.

We have released practically all acres for production in 1974 for crops and I think with normal weather, we don't have to have super weather, but with normal weather and given our perspective of what the fertilizer outlook is, we should have record crops this year.

As those begin to come in, we can expect agricultural prices to at least stabilize and probably decline somewhat in the second half of the year and I think in the process of doing that, that would cause food prices to stabilize or at least rise at a much lower rate than in the first half of 1974 and I would also say at a much lower rate than they did in the second half of 1973.

Representative WIDNALL. I have seen numerous analyses which suggest that stocks in the United States of basic agricultural products will reach postwar lows during 1974 and the price consequences of this will be severe.

What is the world production outlook on basic agricultural products in 1974?

Mr. SEEVERS. Let me comment on that. The price consequences will not be severe. We are already in the position where the consequenses have been severe. Wheat and soybean prices are more than double what they were a year ago.

I think the high prices worldwide are going to be an excellent incentive for producers all over the world to try to expand production this coming year and we have signs that that is occurring.

However, the outlook is mixed because the interrelationship between the energy shortage and the fertilizer supply should not greatly interfere with our own production.

It could have significant impacts elsewhere in the world. India is having real difficulty getting adequate supplies of fertilizer both from its own plants and from other countries from which she imports, such as Japan.

India may have difficult food problems in the second half of 1974. There may be repercussions on us. The impact of the energy problem on economic growth in developing countries will slow down their growth somewhat, maybe significantly in some cases and that will reduce their demands so those may be offsetting.

Representative WIDNALL. Will we have to give consideration to export controls on certain of our basic agricultural products, bearing in mind the undesirability of those controls in general?

Mr. SEEVERS. One should never rule out a policy alternative. That is one of the worse alternatives. The chances are very, very good that we will have excellent crops and we will not face the kind of situation you characterize could occur, skyrocketing prices.

Our outlook is that the prices of the basic commodities will reach their peak in the first half and will fall in the second half.

Representative WIDNALL. How long before we will see the end of beef shortages and price fluctuations which are in a sense a hangover from the freezing and unfreezing of the prices last year?

Mr. SEEVERS. That is a good question. That depends on whether there is further intervention or uncertainties for the beef sector that cause uncertainty to prevail and discourages sufficient, and a reasonable, orderly expansions in production.

The hangover effect is a very important one. I agree with you. There were a whole series of events that distorted beef production and beef planning. Now we have had the truckers' strike. Hopefully, that is reaching a resolution.

That is another case where the beef sector in particular is getting disrupted by some more or less outside factor. This really gets back to our discussion of free markets.

I think it is important for the Government to avoid intervention, particularly in this sector and if that occurred, I think we will probably by the second half of the year be getting into the period when we can have more orderly supplies and more normal conditions in the beef sector.

Representative WIDNALL. Thank you, Mr. Chairman; my time is up.

Chairman PATMAN. Mr. Stein, I wanted to ask you some questions about the executive branch of the Government as compared to the legislative and judiciary.

I asked the Library of Congress to ascertain for me the number of people employed in the executive branch last year, the average number, and I got the figure 2,726,000. And also the legislative which is including the GAO and the GPO, 33,000. The judicial branch is 9,000.

Of course in the executive branch there is only one person elected by the people. In the legislative branch, 535 out of the 33,000 are elected. In the judiciary, none.

It occurs to me the Council of Economic Advisers could well consider calling on the President frequently about getting things done that are upsetting our economy quite badly.

Take for instance housing which has been almost completely stopped. Senator Proxmire referred to it as a basket case. We are really in a depression in the housing area. Why couldn't the Council of Economic Advisers consult about these things with the President?

The President is in charge. According to the Constitution, he is the executive officer. He executes the law for all of those offices; not a few, but all of them. I don't see why the Council of Economic Advisers don't more frequently call on him and advise him for his own good.

For instance when you have to pay for three houses to get one, that is pretty bad. Take, for instance, such injustices as excessive interest rates—exorbitant and usurious rates—nobody seems to take the side of the people.

Don't you think it is the obligation of the President to take the side of the people to prevent these abuses?

Mr. STEIN. Of course it is and he does. We consult with the President on the housing. He made decisions about the housing questions, including the ones that have been made most recently about adding 100,000 to the subsidized housing—perhaps the decisions are not the ones you would urge him to make.

He considered these. We consulted with him and the Secretary of HUD and other people did. He has to balance the obvious desirability of having more housing with other matters with which he is greatly concerned, and having a higher rate of housing construction with the desirability of not setting off another overheated boom.

There is always this shortsightedness, the failure to see there is also something besides this slowdown which could lead us to other levels of inflation which would lead us to European and Japanese levels. He can't say yes to everything if he is going to be responsible.

Chairman PATMAN. There is something going wrong here. We have 435 representatives of the people who represent, of course, 435 congressional districts and they remember that in the House everyone has been elected by the people.

No one other than someone who has been elected by the people can serve. In the Senate, they have some exceptions. If a Senator should pass away, the Governor can appoint someone until the next general election.

Generally, the representatives of the people are directly from the people. They should be kept advised by the executive branch. The executive branch is the only one that has the employees who have the power and duty to get information that is needed for elected representatives of the people to do their jobs.

The Executive is the only one that can pass on these 2,726,000 employees. He can direct them and, as he said, he could fire every one of them if he wanted to. Yet here in the legislative branch, they are not helping us. We have to get the information as best we can.

It occurs to me that there is some imbalance there that should be reevaluated. I have some questions, Mr. Stein, that I would like to submit for the record and if you gentlemen would comment on them, it will be appreciated very much and without objection, I will send them over to you. I also have some economic statistics to include in the record about the total Federal debt, interest rates, price increases, and Federal employment.

Without objection, the material will be placed in the record at this point.

[The following information was subsequently supplied for the record:]

ECONOMIC STATISTICS

TOTAL FEDERAL DEBT

	Billions
1970	$382.6
1971	409.5
1972	437.3
1973	468.4
1974	486.4
1975	508.0

INTEREST RATES

[In percent]

	3- to 5-yr. Government bonds	3-mo. Treasury bills	FHA mortgage rate	Conventional home mortgage rate
1971	5.85	4.07	7.53	7.74
1973: I	6.58	5.64	7.56	7.69
II	6.76	6.61	7.72	7.74
III	7.47	8.39	8.04	7.99
IV	6.86	7.46	9.00	8.39

PRICE INCREASES

	December 1972–December 1973 (percent)
WPI—Farm products, processed foods and feeds	26.7
WPI—Consumer foods	22.5

Wharton School forecasts that farm prices will increase almost 19 percent in 1974.

DRI forecasts farm price increases of about 12 percent in 1974.

FEDERAL EMPLOYMENT

The following statistical information indicates the number of employees in the three branches of government as of March 1973, the latest information available:

Executive branch	2,726,000
Legislative branch (including GAO and GPO)	33,000
Judicial branch	9,000

These figures clearly show the imbalance among the three branches of government as far as personnel are concerned. While equality in the number of personnel may not be necessary in order for the Legislative Branch to properly oversee the operations of the Executive Branch, these figures certainly indicate that the ability of the Legislative Branch to carry out its complex functions may be severely limited by lack of adequate personnel.

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

Question 1. The Council supports giving the Federal Reserve power to extend reserve requirements to non-member banks and savings institutions.

This disturbs me a great deal. Isn't this but the opening wedge to ending our dual banking system?

As near as I can see, the only excuse offered for this move is that the Fed would be better able to control the money supply. Dr. Burns stresses the recent revision of the money supply, and blames the need for large revisions on poor reporting by nonmembers. The assumption seems to be that by giving the Fed more control of nonmembers, they would improve the accuracy of their figures. I take that with a great grain of salt, at least insofar as controlling monetary developments.

The Fed has almost complete control of the monetary base (member bank reserves and currency in circulation). What more do they need?

In my view, the Fed is not giving enough attention to interest rates, with the end of getting them back to earth once more.

Moreover, it is not paying enough attention to seeing that high priority needs are filled first. Why shouldn't the Fed be including mortgages in open market operations?

Answer. Uniform reserve requirements on all types of transaction accounts would not jeopardize the dual banking system. Aside from the extension of reserve requirements to net demand deposits and NOW accounts at all financial institutions, the supervisory structure of the dual banking system would be left intact. Further, banks with deposits below $2 million according to the Federal Reserve Proposal would be exempted and the discount window at the Federal Reserve would be open to nonmember institutions.

The uniform reserve requirement, if enacted by Congress, would result in better management of money and credit for the following reasons. The major difference in reserve requirements between member and nonmember institutions is the form in which the required reserves are held. Nonmember institutions are allowed to count liquid earning assets as part of their required reserves, while member banks must hold reserves either in cash or in deposits with the Federal Reserve System. Consequently, deposits at nonmember institutions require a smaller percentage of reserves than those at member banks; the potential for credit expansion increases when funds are transferred from member banks to nonmember banks. Such shifts of funds between member and nonmember institutions frequently tend to be volatile and unpredictable and this complicates monetary management.

In the past, the use of changes in legal reserve requirements as a tool of monetary management has been restricted because raising reserve requirements for member banks affects the competitive balance between member and nonmember banks, especially when the required reserves of nonmember banks may include earning assets. Uniform reserve requirements would provide a more equitable system of reserve requirements among competing financial institutions, and also make changes in legal reserve requirements a more effective tool of monetary control.

Why shouldn't the Federal Reserve include mortgages in open market operations? Monetary policy is an aggregate stabilization measure. As such it would be highly inappropriate for open market operations to favor a specific segment of financial markets whether they be mortgages, state and local government securities, or whatever. This does not mean, however, that high priority needs such as housing are neglected. Several federally sponsored housing agencies including Federal Home Loan Banks (FHLB), Federal National Mortage Association (FNMA), Federal Home Loan Mortgage Corporation (FHLMC) and Government National Mortgage Association (GNMA) have increased the liquidity of mortgage markets. These agencies all channel funds from the open market to mortgage markets, spreading the impact of monetary restraint more evenly throughout financial markets. In 1973, for example, massive support from these agencies considerably eased the condition of the mortgage market.

Question 2. In your discussion of monetary policy you seem to imply policy action was about right in 1972 and 1973 ("Monetary policy in 1973 applied somewhat more restraint than the year before, since it was aiming for a gradual return to a sustainable rate of growth in demand and output." Page 83, Economic Report of the President).

Am I interpreting you correctly?

Doesn't it bother you at all that during almost all of 1973 interest rates were close to the highest on record?

What do you expect interest rates to be in 1974?

Answer. The *Annual Report* stated that "monetary policy in 1973 applied somewhat more restraint than the year before, since it was aiming for a gradual return to a sustainable rate of growth in demand and output." We were simply pointing out that the rate of monetary expansion in 1973 decelerated as shown in Table 18 on page 82. In the fact of rapidly expanding demand and output accompanied by inflationary pressures, the slower growth of monetary aggregates in 1973 helped to moderate the rate of aggregate economic activity.

The high interest rates in 1973 were also consistent with the objective of attaining orderly economic growth. The appropriate level of interest rates depends upon particular economic circumstances. In a period of little inflation and small demand for credit in relation to the volume of savings, low levels of interest rates are appropriate and financial markets operate so as to produce this result. During periods of substantial inflation and a large demand for credit, as in 1973, higher levels of interest rates are appropriate and financial markets operate to produce such results.

The Federal Reserve through its effect on the volume of money and credit can influence interest rates, but only for short periods. Excessive expansion in money and credit, though reducing interest rates for a while, eventually lifts the volume of expenditures sufficiently to cause correspondingly higher inflation, credit demand and interest rates. Monetary restraint, though raising interest rates temporarily, eventually produces a corresponding decline in spending, inflation, credit demand and lower interest rates.

We expect aggregate economic activities to slow during the first half of 1973 and to recover during the second half of the year. As the growth of demand and output subsides, credit demand will moderate putting downward pressure on interest rates. Short-term interest rates have been generally declining since last September, and we expect the same trend throughout 1974. On the other hand, long-term interest rates are not likely to decline greatly. With the rate of corporate profits reduced and large requirements for new capacities, corporations have been borrowing heavily in the bond market. These large scale financing activities will continue for the remainder of the year. In addition, inflation expectation is an important determinant of long-term rates. During periods of substantial inflation, lenders try to protect the value of their principal by demanding inflation premiums. Borrowers, anticipating repayments in cheaper currency, are willing to pay the premium. Countervailing the upward pressures on long-term yields are the declining short-term rates. As short-term rates decline, investors attempt to reshuffle their portfolios in favor of longer-term securities, generating downward pressure on bond rates. The downward pressure, however, is unlikely to be large enough to offset the forces producing upward pressures.

Question 3. Your Economic Report makes it very clear that you expect the economy to slow down further and unemployment to rise. Yet the Report makes few specific recommendations for what to do about this situation. You do say that policy should be flexible and that, if necessary, further steps to fight recession will be taken.

When will you determine if further steps are necessary? What economic signals will you be watching? How high will unemployment have to rise before you decide that additional policies are necessary?

If you do decide that additional policies are necessary, what specific policies will you recommend?

Answer. We think that second quarter developments will be especially important because during the next quarter we expect to see signs of an upturn in housing and automobiles, which have accounted for most of the slowdown we have observed thus far. Aside from these the signals we will be watching are the broad array of statistics we always watch in making our assessments of current developments and the near-term outlook. Although we pay close attention to unemployment developments we do not have an unemployment trigger as such to institute new policies. The Administration has under consideration several measures which would be instituted if economic prospects show a significant deterioration.

Chairman PATMAN. Congressman Blackburn.

Representative BLACKBURN. I was just reviewing some unemployment statistics for the previous years when we are talking about recessions and depressions and good times and bad times.

I remember in 1961, which was the first year of Camelot, we had 6.7 percent unemployment. In 1962, it averaged 5.5 percent and in 1963, it was 5.7 percent.

Now, Mr. Stein, I don't believe either you or I are of such tender years that we weren't around at that time. Do you recall any of the personalities who have been deploring our present economic state, when the unemployment is running about 5.2 percent, describe those years as recession years or perhaps even worse?

Mr. STEIN. No; I am quite sure they didn't except for a few months after they came in, which could still be described as Mr. Eisenhower's recession. When it became their own, it was no longer a recession.

You will find some quite exuberant language written at the time when unemployment was where it is now about how this is the best of all worlds.

Representative BLACKBURN. I think it is fair to say just as beauty could be described as being in the eyes of the beholder, the economic status seems to have some partisan flavor depending upon who is looking at it?

Mr. STEIN. I believe so.

Representative BLACKBURN. Mr. Seevers, in discussing the question of farm policies and food supplies and the need for fertilizers, isn't it true that different crops require different fertilizers, and some crops require very little fertilizer?

Mr. SEEVERS. That is true, it varies quite a bit from one crop to another.

Representative BLACKBURN. And soybeans which have enjoyed a phenomenal growth in world demand, which is reflected by the rate, is one of the crops that does not require nitrogen fertilizer.

Mr. SEEVERS. That is right, they generate their own nitrogen fertilizer.

Representative BLACKBURN. So it isn't totally accurate to say, without some central planning to insure fertilizer, that these crops are not going to grow. It depends on which crops are going to be planted.

Most of our farmers have good judgment about what they can grow with or without fertilizer. That is one option available to farmers.

Mr. SEEVERS. There will be probably as much fertilizer applied this year as there was last year; of course there will be more acres in total to be fertilized.

At higher prices, farmers will be considerably more careful in applying it. There has been some tendency to err on the safe side and apply somewhat more than what is necessary.

By using it somewhat more carefully and putting it in the right place on the right crops, I don't think it will be a serious constraint. I am not saying it is a problem, but it is not something that will greatly hold food production this year.

Representative BLACKBURN. Actually when you talk about the overall world of food supply, there are many factors over which this country has absolutely no control which are contributing to increased demand for foodstuffs.

Mr. SEEVERS. Yes; economic growth abroad is something we don't have control over. That is increasing demand. That is a good thing that is favorable to this country. The weather is another thing we haven't been able to control so far.

Representative BLACKBURN. One of our spokesmen asked if you talked with God. Do you attempt to perform such a function?

Mr. SEEVERS. We have given that up.

Representative BLACKBURN. There was some discussion about the military budget; isn't it true that the military budget is the lowest percentage of the gross national product since before World War II?

Mr. STEIN. Lowest since before the Korean war.

Representative BLACKBURN. That is right. We had some lean years before that and that helped to bring about the war. Those who said "Let us cut the military budget" are ignoring the old adage: The best defense is a military that you don't need. If you cut it, you encourage someone to challenge it. We need a larger military budget than the President proposed. The figures spent for the military during the Vietnam war compared to the present time has failed to take into account the very greatly increased rate of pay for our military personnel. Isn't it true most of our defense budget is going to personnel, and not to procurement of hardware or basic research and development?

Mr. STEIN. Yes; I think something like 60 percent or more is going for pay. The pay has increased enormously. Everybody regards that as a good thing where we have gotten to the basis where we pay people instead of drafting them into the Armed Forces but it has been an expensive proposition.

Representative BLACKBURN. It is unfair to condemn the military when the people, who make the condemnation, voted to increase the military pay to avoid the need for a draft. You can't have it both ways. If you eliminate the draft and increase the pay to encourage men to join—I don't want to get in trouble with the feminist groups—it is grossly unfair to condemn the military because the budget has gone up.

Mr. STEIN. Yes; 55 percent of the defense outlays are for manpower.

Representative BLACKBURN. I am particularly interested in Mr. Fellner's figures about unemployment. I expressed the feeling 1½ years ago that our national goal of 4 percent unemployment was unrealistic in light of our performing of economic provisions for people who are not employed; that we really don't have enough incentive in the form of economic deprivation to really get the unemployment realistically below 5 percent. Do you care to comment on that?

Mr. FELLNER. Congressman Blackburn, I believe that these general unemployment figures as we compute them do not serve as a dependable guide of a goal toward which we may safely strive by monetary and fiscal expansionary policies.

This is so because the composition of the labor force has been changing very rapidly. What 15 years ago or 20 years ago was 4 percent in terms of the general unemployment rates, is now something else.

It is something else largely because the representation of women and of teenagers has grown very substantially and their habits in terms of labor force behavior are different.

There are always more entrants and reentrants among women than adult men because their lives shape up in such a way that this is happening in the course of their lives and, of course, teenagers are, by their very nature new entrants. There are also many reentrants among them. The representation of the age groups 20 to 24 has also increased significantly, and for different reasons they too have a high unemployment rate. That is because they have not yet settled down in a steady job and job changes come more frequently among them.

This has a significant effect on the meaning of the unemployment rate. The question arises should one try to specify a specific unemployment rate that corresponds to what used to be about 4 percent in the mid-1950's?

One can do that, but I think there can be some danger of doing that for any longer period because of changes in the future and because sex and age are not the only specific circumstances that need to be taken into account in judging this problem.

Consequently, all I suggested, and I had similar ideas about it already a year or two ago, is that one should not at present try to get by this kind of expansionary policy below about 5 percent or not much below 5-percent unemployment or one will generate these very large inflationary pressures and generate inflation which subsequently will call for policies of more rigorous restraint than smoother policies would require.

I still do have that conviction. I think the administration was wise in not trying to formulate a specific number which now should guide the country for the next 10 years. I think the present policy is to take it for granted that after the shortages into which we ran in the early part of 1973, a slowdown had to come if we wanted to avoid constantly accelerating or exploding inflation.

The administration was wise in not trying to formulate a numerical goal but merely to take it for granted after what happened that a slowdown was necessary, that we have to bring inflation down to some reasonable level.

Our behavior should be very much less inflationary than it has been in the past and our policy assumes we can do that by the end of the year at the cost of what we describe as a flat output trend in the first part of the year, but an output trend that we hope will pick up considerably in the second half.

It is this trend which we describe by an inflation rate of 7 percent year over year in terms of the GNP deflator. That rate should become much lower toward the end of the year if everything develops as we hope it will and policies will be reasonable and nothing will happen to force the administration to add additional fuel.

The unemployment rate will be higher than it should be in the long run, but it should diminish and go to a lower level after the adjustment.

Representative BLACKBURN. Thank you.

Representative BROWN. I want to know whether it would be possible for the Council of Economic Advisers to relate the income efforts that have gone into our economy at the Federal level to the 1946 setting of the 4-percent standard of full employment so we could bring that up to date and get some kind of pictures of what comparisons are between current 4-percent unemployment—do you understand that.

Mr. FELLNER. There is some discussion of that in the report. I can do that. Yes.

Senator PROXMIRE. [presiding]. Mr. Stein, the tenor of your statement is that things will be rather bleak in the first half of the year and then things will be better. You think automobile sales will pick up as automobile dealers convert to smaller cars, and you think the housing starts will pick up.

I would like to challenge you on that. Isn't it a fact that economic slowdowns have continued for 6 months, that as the cycle continued for a while and the momentum increased, the psychology was, as more and more people lose their jobs, as overtime diminishes and people's income drops, they are less likely to buy automobiles; isn't that the case?

Mr. STEIN. There have been some slowdowns which did not go on for a very long time. We had the late 1966 and early 1967 slowdown which was very brief. It caused some concern at the beginning of the year.

In 1962, we were all concerned about whether the economy was leveling out. We were concerned about whether we were going to fall into something more serious. It isn't true that everything starts slowly and builds up.

Senator PROXMIRE. Not always. But usually they go longer?

Mr. STEIN. There is the danger of cumulative process. The circumstances connected with the energy thing are rather special. We are concerned about the possibility that we keep saying to ourselves and to others that we must be alert. If we should think that there was strong reason to doubt the revival, we would have to take other measures.

Senator PROXMIRE. The energy crisis comes on top of the expectations, before the embargo took place, that there would be something of a slowdown in economic activity perhaps in the first half or at least in the first quarter of 1974; isn't that correct?

Mr. STEIN. Yes, sir, that is correct.

Senator PROXMIRE. A comprehensive study of economic forecasting by the Bureau of Economic Research a few years ago indicated forecasts are pretty good for the first 6 months, but after that they don't do well at all. It looks as if your forecast of an unfortunate situation in the first 6 months may be correct, we might have less. But like weather forecasting the farther out you go, the less reliable the prediction.

Mr. STEIN. That is true, but it could be true in either direction. We are sure it will be wrong, we just don't know in which direction.

Senator PROXMIRE. But at any rate you come down on the side that it will be a little better. It is always nice to be a little cheerful. It is nice to have one item of cheerfulness in this gloomy forecast. You gave some reasons why you think that inflation may moderate. We get the feeling that energy and food prices can't go higher. I submit that they can indeed go higher. Just like recession feeds on itself, inflation is likely to do the same.

There is a special element that is overlooked. By far the most important element is what happens to wage costs. We have had a remarkably stable performance on the wage front in the last year or so, but there is every indication or expectation that wage rates are likely to be higher in settlements this year than last year for good reason, because the average worker lost ground last year. Then there is every indication that productivity is likely to slow down as it did in the fourth quarter. You put those two things together and it means that wage costs will be pushing on prices and when you recognize that controls are gone, so there will be no holddown on prices and also controls on wages, of course, are gone. Then a wage-price spiral seems most likely.

It seems to me that there might very well be in the second half of the year considerable cost push pressure on prices which could aggravate the inflation in the last half. Why isn't that a likely development?

Mr. STEIN. Certainly, there is that danger. Our estimates do assume some drifting up of the rate of wage increase and the magnitude of that is very important for the behavior after the middle of this year, that we can look at the situation as one in which there are some special circumstances superimposed on an underlying trend of inflation which is in itself very high and in danger of accelerating. We think we will get rid of the transitory things.

We are concerned with the longrun trend which is in danger of accelerating. We want to be very cautious about taking overexpansive measures at this time.

Senator PROXMIRE. That is one of the elements which would tend to make me question your estimate that business investments will continue to rise because as you get a slowdown in the economy in the first half, that would tend to discourage business investment.

Mr. STEIN. There are dangers on all sides of this situation. We don't think this is going to happen. That is partly because we don't think the cumulative process will develop to a point at which the business investment plans come unstuck. They don't usually come unstuck so quickly. There are still a lot of shortages of capacity out in the economy. There is certainly great incentive to expand investment in all the energy-related industries.

We observe very closely what seems to be happening to new orders for plants and equipment, for business equipment and so far it has stood up quite well and we think that it will stand up quite well.

We don't see the initial signs that we usually get at the beginning of a substantial downturn.

Aside from the automobile area, we don't have very heavy inventories and that is usually the major precursor of widespread decline.

Senator PROXMIRE. On page 28 of the Economic Report of the President, you predict or forecast the likelihood of a 7-percent inflation. If we have a 7 percent inflation and it could get worse, and I want to tie this in into your discussion, Mr. Stein; isn't it true for a great majority of American workers, they will be in an income recession, their real income will be less in 1974 than it was in 1973 for this reason: Unless they get a 10 percent increase in compensation, they will lose ground and here is why: With a 7-percent inflation and say a $10,000 income and a $1,000 increase, with a 7-percent inflation, they lose $700 of that $1,000 increase to inflation.

Also, they will pay a marginal tax because of course the tax on the $11,000 is higher, they will pay a marginal tax to the Federal Government and State government and the social security tax will approach 30 percent. That is another $300.

What is left is no gain for those who would get a highly inflationary wage increase. For the rest, those who get 6, 7, 8 or 9 percent, they are worse off, so in terms of income the great majority of American workers will suffer a recession in 1974 if your forecast of 7-percent inflation turns out to be true.

Mr. STEIN. I don't think that is true, Senator Proxmire, because we foresee an increase in the real output in the United States that will be distributed among the people, and the thing just adds up in the end; that is, you are assuming the 10 percent.

If you have assumed 10.5, the outcome would have been quite different. I think there is this to say that in a period in which the price of an imported product like oil rises very rapidly, and we will be paying another 10 or perhaps more billion dollars a year to the rest of the world for oil, this has to come out of the incomes of the American people somehow. How it will be distributed, we don't know. Also in a period in which food prices are rising very rapidly, there will be a transfer from the urban people to rural people somehow.

Senator PROXMIRE. You are confirming what I am saying. There will be a transfer. Maybe some people in our economy will be much better off, it may be that some domestic oil companies may be better off, maybe not.

Mr. STEIN. Not necessarily.

Senator PROXMIRE. The great majority of working people will be worse off in 1974 than they were in 1973.

Mr. STEIN. See, part of what is the problem here is that this increase, this 7 percent increase in prices from year to year reflects what is happening in the second half of 1973. Our estimate of the behavior of consumer prices between the end of 1973 and 1974 is significantly less than that. This number is not in the report. We have said our estimate in the consumer price increase from the fourth quarter of 1973 to 1974 is a little under 6 percent. It will be higher in the first half of the year.

I think this is true that nonfarm people will find their real incomes squeezed.

Senator PROXMIRE. On doing something about this, there doesn't seem to be a very wide area of options for us to really crack down on the inflation. We have had some 25 or some 26 witnesses appear before the Senate Banking Committee in these last days on this issue of wage price controls. Not a single one favored continuation of comprehensive controls. Labor has been against its consistently. There seems very little chance that we will have comprehensive controls.

Based on the estimation by Mr. Burns and also Dunlop and Shultz representing the administration, the administration seems to feel we should have no kind of even temporary mandatory wage controls in most sectors of the economy. Mr. Burns provides a partial limitation.

He would provide in pace-setting industries, including steel and automobiles, that they would not be allowed to raise their price without prior notice, or wages without prior notice; that 30 to 45 days would be allowed for hearings, and then the pressure of public opinion and perhaps action by Congress or by the Executive might then be taken to hold down and prevent the price increase.

What is wrong with Mr. Burns' proposal in view of the fact that we seem to be moving out of any kind of effective wage controls so swiftly at the same time that we are likely to suffer more inflation?

Mr. STEIN. It is largely irrelevant to the kind of inflation we are concerned about. What we see is mainly a food and fuel situation. The fuel prices will be under control, at least the authority will remain under the Mandatory Allocation Act and the food prices we have just never controlled. Nobody proposes——

Senator PROXMIRE. Let me interrupt to say at that point, this was the feeling a lot of people had when you moved from phase II to phase III. There was a comprehensive across-the-board increase. Won't we get into similar trouble everywhere when we move out of wage-price controls with a bang between now and April 30 without anything except the studies and talk, but no opportunity to hold down an examination and get the congressional action to work?

Mr. STEIN. We hope not to go out with a bang on April 30. We are going out step by step between now and then. We do hope that the Cost of Living Council should have the residual authority to call people in, to subpena them in if necessary, to call people in, hold public hearings on wages and prices, but the basic point is that we think in general the system is counterproductive. We have used it in ways that have increased our problems rather than reduced them, and while we don't want to go out with a bang as I believe was said yesterday, the question of whether some other things should be kept in after April 30 is an open question, although I don't myself see any case for that.

We propose a certain degree of moral persuasion after the mandatory expires.

Senator PROXMIRE. I have a couple of more questions to ask you on that. I realize the hour is late. I won't detain you very long. I will ask you a couple of questions related to defense spending.

Secretary Schlesinger was invited to appear. He will be able to answer in detail and on some of the specialized areas we hope. But this has such a terrific economic impact. It is one of the few sectors of the budget that is largely controllable. Let us see if there is anything we can do in this sector with respect to inflation.

In 1968, we spent $76 billion on the defense budget and that was at the height of the Vietnam war. By 1973 we increased that by a little in money terms to $77.6 billion and decreased it rather sharply in real terms, maybe 15 percent or so in real terms.

In 1974, it went up to $83.7 billion.

In 1975, it goes up to $91 billion. Now, if we would make the assumptions on inflation that you have indicated, it means a significant increase in real terms in the amount that we are spending in the military.

I would like to ask you this: In the past, the administration has successfully managed the transition from wartime to peacetime; in view of the high level of defense spending and the increases asked for, do you still say the economy is not characterized by a high level of defense spending?

Mr. STEIN. Yes, as pointed out in another question, we have the lowest proportion of gross national product going to defense than we have had since about 1949. This is a continuation of a trend which was interrupted during the Vietnam war, but we are now down lower than we have been in any of these years.

Senator PROXMIRE. No. 1, isn't that deceptive inasmuch as the whole economy has grown enormously, and No. 2, since the Korean war, we have been on a close to a war level. When you reduce your expenditure from one of the most expensive and longest wars in our history by 15 percent, how can you say we are operating in a peacetime economy?

Mr. STEIN. I can. We will be in a semantic production. If you devote 6 percent of your gross national product to national defense it is not on a wartime footing.

Senator PROXMIRE. If anti-inflationary measures were called for, one of the steps the administration might take is to decrease defense spending. You indicated earlier that wasn't the case in view of the fact you indicated that was an option.

Mr. STEIN. If it was not, this increase was made in a calculation of what seemed to be the minimum requirements of the Defense Establishment. It wasn't support for the idea of putting more here. I would think if we should——

Senator PROXMIRE. Was it made without any regard for the economic consequences of increased military spending?

Mr. STEIN. No, it was made to be confined within the limits of this budget which we think is a stabilizing budget. Of course, if we weren't limited by budgetary constraints, I think there would be a desire for more, but it does seem to me, and here I speak just personally, that if we found the need to increase spending and if there were useful things on the defense side that could be done or be done more quickly, I would sleep better if it were done.

Senator PROXMIRE. Who among the members of the Council, among the staff, is assigned responsibility for analyzing economic consequences for defense spending?

Mr. STEIN. We have been over this track many times in the past. We don't have anybody devoted to this purpose at this time.

Senator PROXMIRE. Don't you think you should?

Mr. STEIN. We kept finding there was nothing in that box, so it didn't seem desirable to keep somebody constantly looking into it.

Senator PROXMIRE. Have you undertaken any analysis of defense spending during the past year?

Mr. STEIN. We did.

Senator PROXMIRE. Will you provide us some copies of those studies?

Mr. STEIN. Yes, we did it in our own terms.

Senator PROXMIRE. In your judgment if the economy continues to deteriorate would the administration consider supplementary request for a decrease in the defense budget? Is the defense budget considered a fiscal tool available for those purposes?

Mr. STEIN. It is not high on the list. I would doubt that we would send in a supplemental request. We might consider whether there are some things within present authority that could be speeded up, but it isn't a major element in our thinking.

Senator PROXMIRE. I had one more question, I wish I had the article here because it expressed the situation so clearly, but unfortunately I don't. I would like to ask you this: We did request a couple of years ago a study to be made by the Council of Economic Advisers on whether or not the economy had changed so that we had to tolerate a certain level of unemployment and that it would be extraordinarily difficult and very costly to get that level of unemployment down, also whether or not the economy had changed to a point where we had to expect the level of inflation that was higher than we had historically, and certainly in the recent past, and also if the tradeoff between the two had changed in such a way that we would have to settle for something different than we have in the past. It seems to me that is about the most profound and important matter of economic policy that we can study.

Now, with my understanding that work was done on this by Mr. Solomon before he left the Council and that it was also carried on by a staff member of the Federal Reserve Board after Mr. Solomon left, we were never furnished with a report on it, to my knowledge, and, if we were, the staff hasn't told me about it.

Mr. STEIN. It was supplied. Mr. Stark asked me for it and we sent it to him. It was never published.

Senator PROXMIRE. Why not?

Mr. STEIN. We didn't think it was an adequate answer to this particular question. We would have no objection if you wanted to put it in the record. It is a question which has baffled economists for a long time, and which has been the subject of some very sophisticated work.

I think this was a very good review of the state of knowledge at the time. We didn't feel that it really answered the question. But it is not embarrassing to us in any way as far as policy is concerned.

Senator PROXMIRE. Is it now feasible to have some study of that kind made and completed? I realize there is no final answer to this, but we would certainly like to have better answers than we have, and I can't think of an agency that is more competent to make the study and in whose responsibility it would fall more clearly than the Council.

Mr. STEIN. We could make another attack on the problem if you will understand that it may not be possible to arrive at a definitive answer. There are more questions than answers in this world and I think you have our views about this. Obviously you can't operate without having some views about this, but we have expressed some views.

Senator PROXMIRE. It is imperative. Up until recently our inflation record was better than other countries. Our unemployment record was substantially worse. Now we are doing poorly on both counts. It am not saying it in a partisan way. It may be endemic in the economy. We ought to be able to find out.

Mr. STEIN. All right, we will be happy—I will not say we will be happy, we will try to do a study for you on this subject. Our view as expressed in the report is after 8 or 9 years of regularly, accelerating inflation. It is very difficult and still important to get the inflation rate down. We do not believe we are committed to this rate of inflation. We think it can be gotten down. To get it down is going to take us quite awhile. It will have to be gotten down essentially by avoiding situations of persistent, excessive demand.

On the other hand with respect to the unemployment rate or the definition of what is full employment, Mr. Fellner has just spoken about this and expressed our views that this unemployment rate is a variable, that the rate which has the same meaning as 4 percent had in 1956 is considerably higher now. But I agree with you that is one of the fundamental questions. I would say there are two. That is one.

The other is the free market question which we addressed in our testimony.

Senator PROXMIRE. Mr. Fellner, I hesitate to detain you longer at this late time. You have done more work than any other scholar in this country in this area. It is eminent work. I disagree with what you say, but I highly respect your ability and your work.

Mr. FELLNER. Thank you, Senator Proxmire. I also believe you could have no definitive results on the tradeoff. I am somewhat suspicious of the tradeoff as it is usually formulated because I see that about 10 years ago we had reasonably full employment with very little price increase and a few years later, when full employment came back, inflation was higher. Then we got inflation down to 3 percent which was higher than the full employment inflation rate had been.

Now again we got full employment and somewhere around 8 or 9 percent inflation and we are determined to moderate that as well as we can, but, again, at the unemployment rate to which a few years ago a very much lower inflation rate corresponded. This so-called tradeoff appears to be a very unstable tradeoff. It is not what one means by tradeoff unless we avoid those situations which give rise to these explosive developments, unless we really watch out not to get in those excess demand situations.

Senator PROXMIRE. Thank you very much. If you would like to expand that answer for the record, you will be very welcome.

Mr. STEIN. Yes.

Senator PROXMIRE. Will you supply your calculations of potential GNP on a quarterly basis from 1969 to 1985 and put the budget numbers in the record?

Mr. STEIN. We have provided this on half-year or calendar year bases. Maybe Mrs. Slater could tell you.

Senator PROXMIRE. We want your potential GNP for the next few years.

Mr. STEIN. There is a lot of information about potential. Tell me if you think you need more.

Senator PROXMIRE. Yes, I will put this in the record at this point, without objection.

[The following information was subsequently supplied for the record:]

32-118—74——4

ACTUAL AND FULL EMPLOYMENT FEDERAL REVENUES, EXPENDITURES, AND SURPLUS (+) OR DEFICIT (−), NIA BASIS, ANNUALLY AND SEMIANNUALLY AT ANNUAL RATES, WITH AND WITHOUT OVERWITHHOLDING, CALENDAR 1972

	Actual			Full employment[1]		
	Revenues	Expenditures	Surplus	Revenues	Expenditures	Surplus
With overwithholding included in revenues:[2]						
1972	228.7	244.6	−15.9	244.0	242.6	1.4
1st half	224.2	240.5	−16.3	240.5	238.3	2.2
2d half	233.3	248.7	−15.4	247.5	246.9	.6
Excluding overwithholding:						
1972a	219.6	244.6	−25.0	234.9	242.6	−7.7
1st half	215.1	240.5	−25.4	231.4	238.3	−6.9
2d half	224.2	248.7	−24.5	238.4	246.9	−8.5

[1] The potential GNP in 1958 dollars is assumed to have grown at the rate of 4 percent per annum since the 4th quarter of 1965. This estimate is consistent with unemployment of 4 percent.
[2] The net increase in overwithholding for calendar year 1972 was $9,100,000,000 at an annual rate.

ACTUAL AND FULL EMPLOYMENT FEDERAL REVENUES, EXPENDITURES, AND SURPLUS (+) OR DEFICIT (−), NIA BASIS, ANNUALLY AND SEMIANNUALLY AT ANNUAL RATES, CALENDAR 1973 AND 1974

	Actual			Full employment[1]		
	Revenues	Expenditures	Surplus	Revenues	Expenditures	Surplus
1973	265.4	264.7	0.6	269.5	263.7	5.8
1st half	258.0	260.5	−2.5	262.2	259.3	2.9
2d half	272.7	269.0	3.7	276.9	268.1	8.8
1974[2]	297.5	304.2	−6.7	306.0	302.1	3.9
1st half	291.8	299.4	−7.6	298.4	297.6	.8
2d half	303.3	309.0	−5.7	313.6	306.6	7.0
1974a[2]	297.5	302.1	−4.6	306.0	300.0	6.0
1st half	291.8	295.2	−3.4	298.4	293.4	5.0
2d half	303.3	309.0	−5.7	313.6	306.5	7.0

[1] The potential GNP in 1958 dollars is assumed to have grown at the rate of 4 percent per annum since the 4th quarter of 1965. The estimate is consistent with unemployment of 4 percent.
[2] The actual totals for 1974 were estimated by the Office of Management and Budget. The 1st set of figures shown for 1974 include $2,100,000,000 worth of rupees expected to be transferred to the Indian Government in the first half of 1974, while the 2d set of figures exclude it. The rupees were accumulated in payment for sales under Public Law 480. Since payment was made in foreign currency rather than in dollars, the sale was treated as an outlay in the unified budget in previous years, while it was treated as a sale which is netted against Government purchases in the national income accounts budget. Consequently, when the rupees are transferred to the Indian Government, the transaction has no effect on the unified budget but does increase expenditures on the national income accounts basis.

Full-Employment Budget Balances in the 1974 Economic Report—A Statement by the Council of Economic Advisers

It has been long recognized that the full-employment budget surplus, like other budget balances, can be estimated in several different ways to serve different analytical purposes and that a single number is not equally useful for all. At the same time, it has also been recognized that different and competing budgets may confuse public understanding.[1] Mindful of this risk, the Council has stressed a single concept, the budget on the national income accounts basis, throughout its Report while also highlighting the most recent totals and balances in the official, unified budget.[2]

[1] See *Report of the President's Commission on Budget Concepts,* 1967, p. 2.
[2] *Economic Report of the President,* 1974, pp. 29–31, 75–80.

For specific analytical uses, however, new estimates of the full-employment balances were reported and discussed on pages 30–31 of the Report. These alternative estimates were prompted by the effect of the large recent changes in rates of inflation on the full-employment budget and by mounting evidence that a fixed 4 percent rate of unemployment may have become increasingly less suitable to represent a constant degree of utilization of the labor force. The estimating procedures employed are explained in this statement at much greater length than was possible in the *Economic Report*.

The path of output that is desired in the long run has traditionally been identified with potential GNP consistent with 4 percent unemployment. From the fourth quarter of 1965 to the fourth quarter of 1969 potential output was assumed to have grown at 4 percent per annum in real terms, but the rate was assumed to be 4.3 percent from the fourth quarter of 1969 to the fourth quarter of 1973. It now appears that the higher rate of growth adopted for the most recent years cannot be sustained. As a result of the lower average hours worked and the modified trend of participation rates recently estimated by the Bureau of Labor Statistics, the growth rate has been reset to 4 percent the fourth quarter of 1969 to the present. Since technical revisions have always been necessary from time to time, this revised series of potential GNP is entirely traditional and consistent with past practice. The full-employment budget balances derived with it are shown first in Table 1, page 31, of the Report.

Without an adjustment for changes in the rate of inflation, changes in the full-employment budget surplus still do not isolate changes in discretionary fiscal policy from the automatic effects of the economy on the budget. Because federal revenues respond much more to a change in the rate of inflation than federal expenditures, the full-employment budget surplus automatically appears to have risen more when inflation rises. Since this is an effect of the economy on the budget, it should not be credited to fiscal policy. Rather it is evidence of a built-in stabilizing effect of the budget. Taking out the effect of changes in the rate of inflation on the budget gives a better measure of fiscal policy shifts produced by discretionary policies alone rather than by a mixture of discretionary actions and changes in the rate of inflation. Hence, changes in the inflation-adjusted full-employment balances are shown also in Table 1 of the Report.

While potential output at 4 percent unemployment should not be taken to represent the short-run target of the economy at all times, even its use as a long-run target has become increasingly questionable. The key element in the measurement of potential output is the unemployment rate, but the welfare and efficiency implications of given unemployment rates may change over time because of continuing changes in the composition of the labor force. Variable unemployment rates consistent with a constant degree of utilization of the labor force can be calculated in a number of ways. One such estimate attempting to preserve the degree of utilization prevailing in 1955–56, traditionally regarded as full-employment years, is applied in the Report. It is derived holding the unemployment rates of the civilian labor force constant at their 1956 levels in each of four sex-age categories: Males and females 16–24 years and males and females 25 years and over. Applying the weights each of these groups actually had in the labor force for subsequent years yields an estimate of total unemployment that rises from about 4.1 percent in 1956 to 4.6 percent in 1973. The balances of the Federal budget derived from the resulting alternative estimate of potential GNP are shown in the last column of Table 1 in the Report.

I. THE METHOD USED TO CALCULATE THE FULL-EMPLOYMENT BUDGET BALANCES

Apart from the use of potential GNP as a criterion of economic performance and as a long-run target variable, potential GNP figures directly in the calculation of the full-employment budget surplus. Applying the actual GNP price deflator (or the deflator as it would have been if inflation had continued at last year's rate in the inflation-adjusted estimates) to potential GNP in 1958 dollars, yields the estimate of potential in current dollars. As described on page 78 of the Report, the shares in potential GNP of taxable personal income, corporate profits, and wages and salaries are then projected and, for the past, the average tax rate observed each quarter is used to calculate the full-employment revenues derived from each component of potential GNP.

Total potential GNP in current dollars is used as the tax base for indirect taxes. For future quarters, the appropriate average tax rate must be estimated. This is done by taking account of changes in tax laws already scheduled for future years and of the gradual rise in the average tax rate on personal incomes, a rise produced by the growth of incomes subject to progressive taxation.

While potential GNP enters directly into the calculation of full-employment revenues, the unemployment rate that is regarded as consistent with any given estimates of potential GNP enters into the calculation of full-employment expenditures in the Federal budget. The only adjustment to actual expenditures made by the Council involves unemployment benefits.[3]

Estimates of potential GNP in current dollars thus form the basis for all estimates of the Federal budget balances at full employment. Differences in the balances reported in Table 1 of the Report are due entirely to differences in the potential GNP estimates and not to any other differences in method. Hence, the alternative time series of potential GNP—the revised traditional series and its inflation-adjusted equivalent, both consistent with 4 percent unemployment, and the variable unemployment rate series of potential GNP—are described in the next three sections to clarify the alternative full-employment budget estimates shown in Section V.

II. THE REVISED OFFICIAL SERIES OF POTENTIAL OUTPUT

Starting with the first quarter of 1970, the overall growth rate assumed for potential GNP was raised from 4.0 percent to 4.3 percent primarily as a result of preliminary indications of an accelerated growth in productivity.[4] However, it now appears that the faster growth in productivity was not sustained. In addition, average manhours worked per year declined at a more rapid rate than had been anticipated.

Prior to the revision, the growth of potential GNP was estimated as the sum of a 1.8 percent rise in the labor force (and employment), a 0.2 percent decline in average annual hours of work, and a 2.7 percent rise in ouput per manhour per year since the fourth quarter of 1969. Instead, the Council's revised estimate now involves a 1.8 percent rise in the labor force, a 0.3 percent decline in average hours per worker, and a 2.5 percent rise in output per manhour.[5] Since two of these growth rates are smaller, potential GNP is now assumed to rise by only 4.0 percent per year, rather than by 4.3 percent, as in the official series published prior to February 1974.[6] The alternative estimates of potential GNP are shown in Table 1 for the years 1969 through 1974.

TABLE 1.—ALTERNATIVE ESTIMATES OF POTENTIAL GNP IN 1958 AND IN CURRENT DOLLARS

Calendar year	Actual GNP		Old potential GNP		Revised potential GNP		Revised potential GNP adjusted for changes in rate of inflation	Variable unemployment[1] potential GNP	
	Real	Nominal	Real	Nominal	Real	Nominal		Real	Nominal
1969	725.6	930.3	727.9	933.3	727.9	933.3	927.6	714.7	916.4
1970	722.5	977.1	758.4	1,025.8	757.0	1,024.0	1,023.5	745.8	1,008.7
1971	745.4	1,055.5	791.0	1,120.0	787.3	1,114.9	1,121.6	779.2	1,103.4
1972	790.7	1,155.2	825.0	1,205.2	818.9	1,196.2	1,195.9	811.9	1,186.1
1973	837.3	1,288.2	860.6	1,324.1	851.6	1,310.3	1,283.4	845.1	1,300.3
1974	[2] 843.1	[2] 1390.3	897.7	1,480.3	885.6	1,460.4	1,460.8	876.6	1,445.5

[1] The unemployment rates are 4.465 percent for 1969, 4.500 for 1970, 4.536 for 1971, 4.572 for 1972, 4.608 for 1973, and 4.645 for 1974. The adjustment for changes in the rate of inflation can again be made by applying the implicit GNP price deflator in the second column of table 2 to real potential.

[2] Estimated.

[3] Since 1971 it has been assumed that if the unemployment rate consistent with a given potential GNP estimate is x percent while the actual unemployment rate is u percent, then unemployment benefits will be smaller at full-employment by 1.25 (u—x) billion dollars. Prior to 1971 a smaller adjustment factor has been used.

[4] See the 1970 *Economic Report of the President,* pp. 84–85.

[5] This is roughly compatible with the new average annual growth rates published in U.S. Department of Labor, Bureau of Labor Statistics, *Monthly Labor Review* 96 (December 1973), p. 28. In that source, the 1968–80 growth rate of the labor force is projected to be 1.79, the decline in hours 0.34, and the growth of productivity that can be inferred from the growth rate of total GNP (3.97 percent) minus the growth of total manhour input is around 2.5 percent.

[6] See the forthcoming issue of U.S. Department of Commerce, *Business Conditions Digest.*

III. THE ADJUSTMENT FOR CHANGES IN THE RATE OF INFLATION

The revised estimates of potential GNP in 1958 dollars are converted to current dollars by multiplying by the implicit GNP price deflator. An alternative estimate is obtained by eliminating the effects of changes in the rate of inflation from year to year. This is done by extrapolating the rate of price change observed from the fifth to the first quarter prior to any year through that year. The resulting quarterly estimates of the implicit GNP price deflator are then averaged to yield a new price factor which is applied to the revised estimate of potential GNP in 1958 dollars. These factors and their percentage deviation from the actual GNP price deflator as well as the actual fourth-quarter to fourth-quarter rates of inflation which are held constant one year beyond the date of occurrence are shown in columns 2–4 of Table 2.

The sole purpose of adjusting estimates of potential GNP for changes in the rate of inflation is to allow full-employment balances to be derived from which the effect of changes in the rate of inflation has been eliminated. Increases in the rate of inflation tend to raise revenues automatically by a slightly larger percentage than they raise GNP. Because of the progressivity of the personal income tax and because taxable corporate profits tend to change more than in proportion to a change in the price level, the percentage growth of revenues is about 1.1 times as large as the percentage growth in nominal GNP produced by higher rates of inflation, even though payroll taxes do not keep up in the short run.

TABLE 2.—IMPLICIT GNP PRICE DEFLATORS, THEIR PERCENTAGE DIFFERENCE AND THEIR 4TH-QUARTER TO 4TH-QUARTER RATES OF CHANGE

Calendar year	Actual (1)	GNP price deflators adjusted for changes in the rate of inflation (2)	Percentage difference of (2) from (1) (3)	Rate of inflation 4th quarter to 4th quarter [1] (4)
1968	122.30	121.92	−0.31	4.11
1969	128.21	127.44	−.60	5.33
1970	135.23	135.21	−.01	5.35
1971	141.60	142.46	.61	3.60
1972	146.10	146.05	−.03	3.35
1973	153.86	150.71	−2.05	7.05
1974	[2] 164.90	164.95	.03	

[1] The annual rate of inflation from the 4th quarter of the preceding year to the 4th quarter of the year shown on each line is reported in this column.
[2] Preliminary forecast.

Since only about 40 percent of Federal expenditures are tied more or less automatically to changes in the consumer price index or in the cost-of-living, and another 20 percent rise semi-automatically with the price level, the quasi-automatic response of expenditures to a rise in the rate of inflation is considerably lower in the short run. Assuming the acceleration of inflation was not anticipated in budget planning at the start of the year, expenditures rise by a rate which is only about half as large as the percentage growth in nominal GNP produced by additional inflation.

Hence the elasticity of revenues with respect to changes in the price level which are all regarded as unanticipated is taken to be about 1.1 while the expenditure elasticity is only around 0.5. These elasticities are applied to the percentage differences in the alternative price deflators shown in column 3 of Table 2 to estimate the effect of changes in the rate of inflation on revenues and expenditures. Since major changes in the rate of inflation have occurred only from 1972 to 1973, it will be seen that the estimate of the 1973 full-employment balance of the Federal budget is the only one that is substantially affected by the inflation adjustments in recent years.

Since these adjustments are designed only to offset the effects of changes in the rate of inflation in any year on the full-employment budget balance calculated for that same year, regardless of changes in the rate of inflation in prior years, it is implicitly assumed that budget planners have fully adjusted to last year's price level plus last year's rate of inflation in this year's budget. Longer adjustment lags may, in fact, prevail in some programs.

IV. CHANGING UNEMPLOYMENT RATES AT FULL-EMPLOYMENT

In 1962, the Council made the judgment that the economy was operating at 100 percent of potential in the third quarter of 1955 when the unemployment rate, as now measured, was 4.1 percent. Since then the growth rates that have been assumed for potential GNP have been defined so as to maintain a rough coincidence between potential and an unemployment rate of 4 percent. The correspondence has never been precise. For instance, when output rose to equal potential GNP in the third quarter of 1965, the unemployment rate was 4.4 percent. In the following downturn, output fell to the level of potential GNP in the third quarter of 1969 when the unemployment rate was 3.6 percent, and it has remained below potential since.

Because unemployment rates respond only with a lag to a change in the growth of output, a steadier path of output might still have involved an unemployment rate of around 4 percent at potential. However, measures of the labor force and of employment and unemployment undergo improvement from time to time and the welfare implications of given unemployment rates may change.[7] Variable unemployment rates may thus have to be used to preserve the original meaning,[8] and policy significance of the potential GNP estimates. Because of cumulative changes in the composition of the labor force, these rates gradually rise from 1955 to 1974. They are expected to stabilize later in the seventies before beginning to decline as demographic trends cause the proportion of young workers in the labor force to recede.

The composition of the labor force has changed cumulatively from 1956 to the present. Males 25 years and over accounted for 58.9 percent of the total civilian labor force in 1956, but their share had fallen to 47.9 percent in 1973. Correspondingly, the share of females 25 years of age and over jumped from 25.8 to 28.2 percent. The weight of younger persons in the labor force increased also, with the percentage of males 16 through 24 years of age rising from 8.9 percent of the civilian labor force in 1956 to 13.2 in 1973 and that of females from 6.5 percent to 10.6 percent over the same period. The latter two groups have unemployment rates that are at least twice as high as those of the entire labor force. Official unemployment rates, however, do not reflect changes in the composition of the labor force since they are constructed simply by dividing the number of all unemployed by the head count of the labor force.

To illustrate the significance of the changes in labor force composition, unemployment rates were held fixed at the 1956 level within each of four age-sex groups distinguished involving persons 25 years of age or older and persons 16 through 24 years of each sex. Applying the weight each of these groups actually had in the labor force during subsequent years to the fixed unemployment rates of each, and adding, shows that the overall unemployment rate would be raised from 4.11 percent in 1955 to 4.61 percent in 1973 merely as a result of changes in the composition of labor.

If these unemployment rates are used to estimate the labor force participation rates, manhours, and the average labor force productivity, a new estimate of potential GNP can be derived in 1958 dollars as shown in the appendix. In the last step, this calculation involves multiplying the estimate of potential labor force productivity, measured by GNP per manhour, by potential manhour input. The potential labor input is defined by estimating participation trends and trends in average annual hours worked at the changing full-employment rates which have been calculated from 1955 through 1973 and then smoothed and extrapolated to 1976.

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[7] This has been emphasized by James W. Knowles, *The Potential Economic Growth in the United States*, Study Paper No. 20 prepared in connection with the Study of Employment, Growth, and Price Levels (Washington, D.C.: Joint Economic Committee, U.S. Congress, 1960), p. 8.

[8] Knowles, p. 7, gives the following definition: "For each year, the potential output level represents the amount the economy could produce at some stipulated rate of use of the labor force and of capital, and under the assumption that productive resources are used at something approaching the economy's notion of a least-cost combination of inputs."

The resulting estimates of potential GNP can be compared to the revised estimates shown in Table 1 which are based roughly on a fixed unemployment rate of 4 percent. These estimates differ surprisingly little in recent years as the difference in unemployment rates was widening, probably because capacity shortages and the lower quality of marginal labor inputs would have depressed the average productivity of labor at high levels of employment. For instance, in 1973, the difference between the revised potential GNP involving an employment rate of 96 percent, and the variable unemployment rate potential, calculated at an employment rate of 95.39 percent, is 0.76 percent,—only slightly larger than the difference in the employment rates.[9] Furthermore, comparing actual GNP to potential GNP estimated with variable unemployment rates shows that the economy was operating within 1 percent of its potential in 1973.[10]

V. THE RESULTING FULL-EMPLOYMENT BUDGET SURPLUS ESTIMATES

The old and the revised official estimates of potential GNP in Section II, the adjustment for changes in the rate of inflation described in Section III, and the variable unemployment rate potential in Setcion IV can now be used to estimate the full-employment balances of the Federal budget. The method used to derive full-employment revenues and expenditures from potential GNP was described in Section I; it is identical for all five estimates. The results are shown in Table 3.

The difference between full-employment revenues and expenditures yields the budget balances given in the upper part of Table 4. This table is identical to the one appearing on page 31 of the 1974 *Economic Report*, except for the addition of columns 2 and 6 and of the inflation-adjusted full-employment balances in column 4. The latter were not made explicit in the *Report* to avoid confusing the general reader. The reason is that changes in the full-employment budget surplus are not calculated by taking the difference of the entries for successive years in this instance, but by comparing the entry in column 3 to the entry in column 4 in the succeeding year.[11]

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[9] By contrast, Okun's "law" would imply that the percentage difference in GNP is about three times as large as the difference in the employment rates. However, Okun's "law" applies to cyclical effects rather than to the measurement of the differences between alternative long-run growth paths.

[10] Since the variable unemployment rate used to define full-employment was 4.6 percent in 1973 while the actual unemployment rate was 4.9 percent, Okun's "law" holds in this cyclical application.

[11] Similarly, changes in the inflation-adjusted variable unemployment rate balances are calculated by subtracting the entry in column 5 from the entry in column 6 in the succeeding year.

TABLE 3.—ESTIMATES OF REVENUES AND EXPENDITURES USED TO DERIVE THE FULL-EMPLOYMENT BUDGET ESTIMATES IN TABLE 4, NIA BASIS

Calendar year	Actual		Full-employment estimates[1,2] Old potential		New potential		With infl. adj.		Variable U.		With infl. adj.	
	Rev.	Exp.	Rev.	Exp.	Rev.	Exp.	Rev.	Exp.	Rev.	Exp.	Rev.	Exp.
1969	197.3	189.2	198.4	189.6	198.4	189.6	197.1	189.0	194.8	189.9	193.5	189.3
1970	192.0	203.9	207.1	202.7	206.7	202.7	206.7	202.7	203.6	203.3	203.6	203.3
1971	198.9	221.0	[3] 217.6	[3] 218.6	216.5	218.6	218.0	219.3	214.3	219.3	215.7	220.0
1972	228.7	244.6	236.7	242.6	234.9	242.6	234.8	242.5	232.9	243.3	232.8	243.3
1973	[4] 265.4	[4] 264.7	272.4	263.7	269.5	263.7	263.4	260.9	267.5	264.4	261.5	261.7
1974	[5] 297.5	[5] 302.1	310.1	300.0	306.0	300.0	306.1	300.0	302.9	300.8	303.0	300.8

[1] The $9,000,000,000 increase in net overwithholding is excluded from 1972 full-employment revenues.

[2] The difference in full-employment (4-percent rate) expenditures and variable unemployment (x percent rate) expenditures is due to adjusting for unemployment compensation by multiplying (x−4) by $1,250,000,000 from 1971 on and by lesser amounts in prior years.

[3] Working in millions of dollars, the difference rounds to −1.1, shown in table 4.

[4] The difference rounds to 0.6.

[5] Estimated by OMB. Expenditures exclude transfer of $2,100,000,000 worth of rupees to the Indian Government expected in the 1st half of 1974.

TABLE 4.—FULL-EMPLOYMENT BUDGET SURPLUS ESTIMATES CONSISTENT WITH ALTERNATIVE ESTIMATES OF POTENTIAL GNP AND WITH NEW POTENTIAL GNP SERIES ADJUSTED FOR YEAR-TO-YEAR CHANGES IN THE RATE OF INFLATION (NATIONAL INCOME ACCOUNTS BASIS)

Calendar year	Actual surplus or deficit (−) (1)	Full-employment budget surplus or deficit (−) based on: Old potential GNP (2)	New potential GNP (3)	Previous adjusted for changes in rate of inflation (4)	Variable unemployment potential GNP (5)	Previous adjusted for changes in rate of inflation (6)
	Levels					
1969	8.1	8.8	8.8	8.1	4.9	4.2
1970	−11.9	4.4	4.0	4.0	0.3	0.3
1971	−22.1	−1.1	−2.1	−1.3	−5.0	−4.3
1972	−15.9	−5.9	−7.7	−7.7	−10.4	−10.5
1973	0.6	8.7	5.8	2.5	3.1	−0.2
1974	[1] −4.6	10.1	6.0	6.1	2.1	2.2
	Change from previous year					
1970	−20.0	−4.4	−4.8	−4.8	−4.6	−4.6
1971	−10.2	−5.5	−6.1	−5.3	−5.3	−4.6
1972	6.2	−4.8	−5.6	−5.6	−5.4	−5.5
1973	16.5	14.6	13.5	10.2	13.5	10.2
1974	−5.2	1.4	0.2	0.3	−1.0	−0.9

[1] Estimated by OMB.

For instance, for 1972, column 3 shows a full-employment deficit of $7.7 billion. If the 1972 rate of inflation had continued through 1973, the 1973 surplus would have been $2.5 billion. Hence, the increase in the full-employment surplus from 1972 to 1973 would have been $10.2 billion if the rate of inflation had not increased from 3.35 percent in 1972 to 7.05 percent in 1973. Since it actually did increase, the full-employment surplus was an estimated $3.3 billion higher, or $5.8 million rather than $2.5 billion, with the difference attributed to the effect of higher rates of inflation on the full-employment budget.

Apart from this instance, year-to-year changes in the full-employment budget balance are remarkably similar for all of the full-employment series, as shown in the lower part of Table 4. Hence, discretionary fiscal policies can be identified *ex post* and formulated *ex ante* by working with changes in the full-employment budget surplus derived from any consistent set of measures of potential GNP.

The level of the budget balance, as opposed to changes therein, is relevant to the analysis of economic policy in another respect. The level of any actual surplus or deficit over time affects consumer wealth and the stock of money or government debt held by individuals and private institutions. In addition, the borrowing costs of business may be affected. For instance, if the government has a surplus and retires debt, interest rates will fall and the increased savings will be used for capital formation if private investment demand is strong and sensitive to the level of interest rates. This effect of the actual budget balance is explored on pages 37–38 of the 1974 *Economic Report.*

APPENDIX TO "FULL-EMPLOYMENT BUDGET BALANCES IN THE 1974 ECONOMIC REPORT": VARIABLE-RATE MEASURES OF FULL EMPLOYMENT AND THE RESULTING SERIES OF POTENTIAL GNP [1]

Potential output has been defined for almost 20 years as the level of real GNP consistent with 4 percent unemployment. Unemployment rates, in turn, are derived by dividing the number of unemployed workers looking for work by the head count of the labor force.[2] This measure is therefore insensitive to changes in the composition of unemployment, whether by skill levels or by age-sex cohorts. If systematic changes in the characteristics of the unemployed have, in fact,

[1] This appendix was prepared by George M. von Furstenberg, Senior Staff Economist, CEA.

[2] For a more complete definition and an explanation of changes in the measurement of unemployment see U.S. Department of Labor, Bureau of Labor Statistics, *Employment and Earnings* 13 (February 1967); pp. 3–4; and *Manpower Report of the President* (Washington, D.C., March 1973), p. 119.

occurred, then neither the output loss expected from less than full employment nor the welfare loss due to involuntary unemployment can be gauged correctly by taking the difference between actual unemployment rates and 4 percent at all times. The losses will not remain a fixed multiple of any given difference in the unweighted employment rates.[3]

For instance, assume the proportion of secondary workers in the labor force rises. Then if these workers have lower productivity, work shorter hours, and have higher relative opportunity costs at the margin of entry into employment,[4] both the output loss associated with any given excess of the actual unemployment rate over 4 percent and the welfare cost to the unemployed will be declining over time. This has two related implications. Since the elasticity of substitution between primary and secondary workers is imperfect, the effective *level* of the excess supply of labor fails to be a constant function of the difference between the actual unemployment rate and 4 percent. Changes in the composition of the labor force also affect the overall *elasticity* of labor supply to the extent the elasticities differ by cohorts.

To obtain a more welfare and policy relevant measure of potential output and ultimately the full-employment budget surplus, the unemployment rate which will be taken to represent full employment at different times must therefore be allowed to vary. Only a crude standardization by age-sex cohorts is attempted. This is done by following the assumption commonly made in potential output estimates that the economy was operating at or very close to potential in the base year, 1956. Holding the 1956 unemployment rates for males 16 through 24 years of age (8.60 percent), females 16–24 (8.43 percent), males 25 years of age and over (3.07 percent), and females 25 and over (3.94 percent) fixed and applying the shifting annual weights of each of these groups in the actual labor force from 1955 through 1973 yields a new potential unemployment rate, U*. This changing rate rise from 4.1 percent in 1955 to 4.6 percent in 1973 as shown in Table 1.

Before U* is used in later estimates, it is smoothed by regressing the natural logarithm of the ratio of the calculated rate to the base rate on time trends (T_1= −1 in 1955, 0 in 1956, 1 in 1957, and on up to 17 in 1973; T_2= 0 from 1955 through 1964, 1 in 1965, 2 in 1966, and so on up to 9 in 1973). The results show that U* rises gradually at an annual rate of 0.5 percent from 1955 to 1964, and at a higher rate of almost 0.8 percent per annum after 1964. In the base year, U* is required to be equal to the official unemployment rate, U. The smoothed level of U* is meant in all subsequent references to full employment, and a glossary of all the variable names is provided at the end of this appendix. With t values in parentheses, the smoothing equation is:

$$(1)\ \log U^*_t - \log U_{1956} = \underset{(25.05)}{0.004701}\ T_1 + \underset{(6.80)}{0.003197}\ T_2;$$

$\bar{R}^2 = 0.9915$, $D.W. = 0.675$, $S_e = 0.0034$.

Given the time path of (smoothed) U*, the labor force participation rates are estimated in the first section with this new definition of full employment. In Section II, the trends in potential manhour inputs and in average labor force productivity are reestimated for this unemployment path before the new series for potential output consistent with these trends can be derived in Section III.

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[3] Okun's "law" implies that any given percentage point deviation of the unemployment rate from 4 percent changes output by 3.2 percent of potential output. See Arthur M. Okun, "Potential GNP: Its Measurement and Significance", in American Statistical Association, *Proceedings of the Business and Economic Statistics Section* (1962), pp. 98–104. Variations in the response of the Output gap to unemployment rates are analysed in George L. Perry, "Labor Force Structure, Potential Output, and Productivity," *Brookings Papers on Economic Activity* 2 (3: 1971), pp. 533–565, esp. pp. 546–47 and pp. 555–59; O. Eckstein and R. Brinner, *The Inflation Process in the United States* (Washington, D.C.: Joint Economic Committee, U.S. Congress, 1972); and A. P. Thirlwall, "The Recent 'Shift' in the U.S. Phillips Curve," *Industrial Relations* 12 (October 1973), pp. 297–306.

[4] Conceptually, the relative opportunity cost of working for those wishing to work is defined as follows: The numerator is formed by taking the integral of the marginal utility of leisure schedule, with maximum daily leisure time available, and this minus the daily hours required in the job open to the worker, as the upper and the lower bound, respectively. Dividing by the total utility of daily earnings, which is equal to the integral over the marginal utility of income schedule up to the limit of daily earnings, yields a rate of substitution defined as the relative opportunity cost of accepting a job rather than not working. The higher this ratio, the lower the welfare cost of not finding a job. For involuntary unemployment to occur, this ratio has to be less than 1.

TABLE 1.—THE CHANGING UNEMPLOYMENT RATES REPRESENTING FULL EMPLOYMENT

[In percent]

	The calculated rate	The smoothed rate (U*)
Year:		
1955	4.108	4.114
1956	4.134	4.134
1957	4.140	4.153
1958	4.149	4.173
1959	4.172	4.192
1960	4.208	4.212
1961	4.225	4.232
1962	4.232	4.252
1963	4.265	4.272
1964	4.304	4.292
1965	4.346	4.326
1966	4.387	4.360
1967	4.407	4.395
1968	4.416	4.430
1969	4.454	4.465
1970	4.491	4.500
1971	4.529	4.536
1972	4.578	4.572
1973	4.614	4.608
1974		4.645
1975		4.682
1976		4.719

Note: The projections for 1974–76 are explained in sec. III.

I. THE ADJUSTED LABOR FORCE PARTICIPATION RATES

The total labor force and population concepts used in this study exclude employment in the armed forces, both civilian and military, and the institutional population, to achieve consistency with the officially reported civilian unemployment rates. Since persons 16 years and over are included in both measures without a cut-off for the elderly, labor force participation rates will be sensitive to the proportion of the population 65 and over. Furthermore, labor force participation is known to respond to the demand for labor which varies with the employment rate. Moreover, time trends have been found significant in labor force participation equations fitted by other researchers.[5]

Time trends are merely an *ad hoc* device for allowing for observed changes in participation rates due to unidentified causes. Hence, an attempt is made to avoid the use of direct trend variables in this equation by entering instead the growing employment shares of those groups, particularly the young, whose importance in total employment has grown persistently for the last twenty years.

In estimating the employment share of males 16 through 24 years of age, allowance must be made for the size of employment in the armed forces. Enlarging the armed forces reduces the share of young males in total civilian employment since their share of the total manpower in the armed forces is almost 60 percent, compared to only about 12 percent in total employment (1972). Hence, the number of males 16 through 24 years of age and in the armed forces (AF) was divided by the non-institutional population (P) of such males to form the variable (AF/P) 16–24. In addition, the total employment rate (E/L) and the time trends T_1 and T_2, already described, were used as explanatory variables of employment shares.

A rising time trend T_3 was added for the period starting in 1969 ($T_3=0$ from 1955 through 1968, 1 in 1969, and so on up to 5 in 1973). This variable was significant only in explaining the employment shares of females 16 through 24 years of age and of older females. The total employment rate of the labor force, on the other hand, was not consistently significant in the equation for females 25 years of age and over, indicating that the cyclical sensitivity of their employment is about average, in contrast to the above average sensitivity of the employment of young persons, both male and female.

The preferred regression equations for all three groups are shown below. Males 25 years and older constitute the excluded group. These older males still accounted for about 50 percent of total employment in 1972, with females 25

[5] For similar estimates for earlier periods see N. J. Simler and Alfred Tella, "Labor Reserves and the Phillips Curve," *Review of Economics and Statistics* 50 (February 1968), pp. 32–49, and Perry, "Labor Force Structure," pp. 544–52. For an evaluation of previous estimates of the size of the potential labor force see Joseph L. Gastwirth, "Estimating the Number of 'Hidden Unemployed' ", *Monthly Labor Review* 96 (March 1973), pp. 17–20.

years and over (F 25+) about 28 percent, younger males (M 16–24) 12 percent, and younger females (F 16–24) 10 percent of total employment.

The equation for the employment share of young males is given below. Throughout t-values are reported in parentheses.

$$(2)\ \log (E_{M16-24}/E)_t = \underset{(-39.30)}{-2.2049} + \underset{(14.27)}{0.01701}\ T_1 + \underset{(4.37)}{1.9801} \log (E/L)_t -$$

$$\underset{(-4.72)}{-1.0266} (AF/P)\ 16\text{–}24;\ \overline{R}^2 = 0.9866,\ D.W. = 0.933,\ S_e = 0.0145.$$

The employment share grows at a trend rate of 1.7 percent per year. Increasing the overall employment rate by one percent causes the share to rise by almost 2 percent, indicating that the participation response of young males is far above average.

Raising the percentage of young males in the armed forces by one point reduces their employment share by one percent. This outcome is appropriate since the draft was in effect during most of the estimation period. The draft affects both employed and otherwise non-working young males. Hence, if 1 percent of the persons in this age group are drafted, one would expect civilian employment to be reduced by the same percentage in this group. On the other hand, for voluntary enlistments, a unitary relation might be too low. Assuming that there are alternative employment opportunities available to enlistees, civilian employment would be reduced by more than the percentage increase in the armed forces' share of the population of young males simply because only about 60 percent of the non-institutional males 16 through 24 years of age are gainfully employed.

The equation for the employment share of young females is:

$$(3)\ \log (E_{F\,16-24}/E)_t = \underset{(-90.41)}{-2.7133} + \underset{(8.38)}{0.01670}\ T_1 + \underset{(5.19)}{0.3500}\ T_2$$

$$\underset{(-2.19)}{-0.02102}\ T_3 + \underset{(3.16)}{1.7766} \log (E/L)_t;\ \overline{R}^2 = 0.9888,\ D.W. = 1.66,\ S_e = 0.0188.$$

The coefficients of T_1 and E/L are remarkably similar for young males and females. However, the employment share of young females grows three times as fast from 1965–68, and twice as fast from 1969 on, as that of males. After 1969, the annual rate of growth is about 3 percent (0.0167+0.0350—0.0210).

The equation for the employment share of older females is:

$$(4)\ \log (E_{F\,25+}/E)_t = \underset{(-366.65)}{-1.3487} + \underset{(13.70)}{0.00696}\ T_1 - \underset{(-2.13)}{0.00393}\ T_2;$$

$$\overline{R}^2 = 0.9470,\ D.W. = 0.522,\ S_e = 0.0082.$$

Neither T_2 nor log $(E/L)_t$ were found to be consistently significant in this equation. The employment share of females 25 years of age or more grows by 0.7 percent annually from 1955 through 1968 but the rise is cut in half after 1968. Since these growth rates are far below those for the employment shares of the younger age groups of both sexes and since the employment rate was not significant, this variable will not be used to explain changes in the total labor force participation rates over time.

Equations (2) and (3), however, can be solved for the respective potential employment shares by substituting the complement of the shifting full-employment rates for E/L. Solving with (E/L)*=1—(U*/100), the resulting series are added to form a single variable, (E16—24/E)*, giving the employment share of youths. Adding the share of persons 65 and over in the total civilian population 16 and over (P65+/P), as already described at the beginning of this section, and including the employment rate (E/L) yields the equation for total participation rates (L/P):

$$(5)\ \log (L/P)_t = \underset{(-7.49)}{-0.2777} + \underset{(1.80)}{0.1632} \log (E/L)_t + \underset{(10.14)}{0.6760} (E_{16-24}/E)^*_t -$$

$$\underset{(-7.79)}{-2.6116} (P_{65+}/P)_t;\ \overline{R}^2 = 0.8514,\ D.W. = 1.65,\ S_e = 0.0039.$$

The cyclical response of labor force participation rates should be reflected fully in the coefficient of E/L since the employment share of young persons, (E16–24/E)*, was adjusted to potential to explain the upward drift in participation rates free of cyclical disturbances. For this reason, the coefficient on the employment rate variable is found to be surprisingly weak. The coefficient of (E16–24/E)* is, however, quite plausible. It would be expected to be above unity if the growing employment share of the young had been produced solely by a rise in their participation rates; since their population share grew also, it would be expected to be less than 1.

As anticipated, a rising percentage of elderly persons lowers participation rates since the participation rates of persons 65 and over are only about 16 percent (1972), compared to 60 percent for the population 16 and over, as a whole. However, the coefficient of the age variable is too high since increasing the number of persons 65 or over in the total population by 1 percent of the latter can reduce labor force participation rates by at most (P/L), or 1.67 percent, assuming that all persons entering the old-age bracket were previously in the labor force and leave it upon reaching the age of 65. Hence, the coefficient of the age variable must be picking up some additional factors correlated with the population share of the aged.[6]

Though there are reservations about some of the coefficients in the labor force equation, the equation was again solved by substituting $(E/L)^*=1-(U^*/100)$ for E/L to obtain potential participation rates. A listing of the actual and potential participation rates is presented in Table 2. It shows that the two measures remain quite close in spite of the temporary drop in participation rates that occurred in the early sixties. Potential participation rates tend to be only slightly higher in periods of high unemployment than the actual rates or the rates fitted from regression equation (5). Multiplying the potential participation rate, $(L/P)^*$, by population[7] yields the potential labor force, L*, and multiplying L* by $(1-(U^*/100))$ gives potential employment, E*. L* and E* are shown in the last columns of Table 2.

TABLE 2.—ACTUAL AND POTENTIAL LABOR FORCE PARTICIPATION RATES, THE POTENTIAL CIVILIAN LABOR FORCE AND POTENTIAL EMPLOYMENT, 1955–76

Year	Labor force participation rates (percent)		Potential (millions)	
	Actual	Potential	Labor force	Employment
1955	59.28	59.68	65.456	62.763
1956	59.98	59.59	66.116	63.383
1957	59.62	59.55	66.856	64.079
1958	59.48	59.58	67.753	64.926
1959	59.28	59.58	68.709	65.828
1960	59.39	59.61	69.886	66.942
1961	59.32	59.53	70.706	67.713
1962	58.77	58.73	70.563	67.562
1963	58.68	58.77	71.990	68.914
1964	58.71	59.01	73.550	70.393
1965	58.85	59.23	75.081	71.833
1966	59.17	59.30	76.126	72.806
1967	59.56	59.38	77.352	73.953
1968	59.64	59.58	78.943	75.446
1969	60.10	59.78	80.634	77.034
1970	60.38	60.06	82.659	78.939
1971	60.17	60.39	84.846	80.998
1972	60.38	60.60	86.853	82.682
1973	60.76	60.86	88.817	84.724
1974		61.08	90.505	86.302
1975		61.35	92.668	88.330
1976		61.57	94.512	90.052

Note: The projections for 1974–76 are derived in sec. III. To obtain E* from L*, U* is calculated to be 4.645, 4.682, and 4.719 for 1974, 1975, and 1976, respectively, using equation (1).

[6] Since P65+/P rises from 0.125 in 1955 to 0.139 in 1972, adding time trends tended to affect the absolute size of the coefficient of this variable. For instance, adding T_2, which came closest to being significant at the 1 percent level, changed the coefficient to −1.16, but the overall fit was worse.

[7] Information from the 1970 Census resulted in an increase in the previous population estimate for 1972 by 800,000. Since labor force participation rates are multiplied by population to obtain L* and ultimately E*, which is used in the estimation of potential GNP, the jump in the Census population series was smoothed by assuming the undercount began with 80,000 in 1963 and grew by equal increments of 80,000 per year until it reached 720,000 in 1971. However, since the series for total manhours is based on the employment totals reported in *Employment and Earnings*, which were revised only starting with 1972, the H used in equation (6) and EH and E*H* used in the last term of equation (7) are all based on actual or potential employment and hours estimates without adjusting the series prior to 1972. All data prior to 1960 exclude Alaska and Hawaii. See *Manpower Report of the President* (Washington, D.C.: March 1973), p. 119.

II. POTENTIAL MANHOURS WORKED AND POTENTIAL PRODUCTIVITY

The estimate of the potential number of employees, E*, must be combined with an estimate of potential manhours worked per year and employee to derive a measure of the total potential labor input. Since business establishments report hours paid for rather than hours worked, a new series was calculated by the Bureau of Labor Statistics based on the *Current Population Survey* concept of hours worked. Total manhours worked annually can be divided by the number of employed persons (E) to obtain average hours worked per year (H). The order of magnitude of H, which is the dependent variable in the equation for manhours, is 2,000. H is regressed on the time trends, T_1, T_2, and T_3, previously identified, and on the official unemployment rate, U.[8]

$$
(6)\quad \underset{(122.59)}{H_t=2{,}103.14}-\underset{(-13.59)}{7.5236T_1}-\underset{(-3.57)}{11.2656U_t}\quad \bar{R}^2=0.9114,\ \text{D.W.}=1.52,\ S_e=13.07.
$$

By substituting U* for U in (6), the estimates of potential hours, H*, are derived which are shown in Table 3. Multiplying E* by H* yields the measures of potential labor input, E*H*, also shown in Table 3. Dividing these measures by the actual manhour input, EH, yields a cyclical variable to explain variations in the average productivity of labor, GNP/EH. In addition, the time trends T_1 through T_3 are tried again. The preferred run for output per manhour is:

$$
\begin{aligned}
(7)\quad \log\,(\text{GNP/EH})_t &= \underset{(197.28)}{1.2317}+\underset{(24.80)}{0.02679T_1}-\underset{(-2.38)}{0.00457T_2}\\
&\quad -\underset{(-3.99)}{0.5855}\log\,(\text{E*H*/EH})_t;\quad \bar{R}^2=0.9934,\ \text{D.W.}=1.99,\ S_e=0.0115.
\end{aligned}
$$

By setting actual manhours (EH) equal to potential manhours (E*H*) in the last term of equation (7), so that this term drops out, estimates of potential labor force productivity [(GNP/EH)*] are derived. Multiplying by E*H* then yields alternative series of potential GNP through 1973.

TABLE 3.—THE ALTERNATIVE ANNUAL SERIES OF POTENTIAL MAN-HOURS PER EMPLOYEE AND TOTAL POTENTIAL MAN-HOUR INPUT, 1955–76

Year	Potential man-hours per employee, H*	Total potential man-hours, E* H* (billions)	Year	Potential man-hours per employee, H*	Total potential man-hours, E* H* (billions)
1955	2,074.33	130.191	1966	1,985.28	144.541
1956	2,049.69	129.916	1967	1,982.31	146.597
1957	2,035.24	130.417	1968	1,979.54	149.348
1958	2,024.97	131.474	1969	1,956.01	150.680
1959	2,016.98	132.775	1970	1,941.33	153.247
1960	2,010.44	134.584	1971	1,930.35	156.354
1961	2,004.90	135.759	1972	1,921.44	159.254
1962	2,000.09	135.131	1973	1,913.87	162.151
1963	1,995.83	137.541	1974	1,907.25	164.599
1964	1,992.02	140.224	1975	1,901.34	167.945
1965	1,988.50	142,839	1976	1,895.98	170.737

Note: The projections for 1974–76 are derived in sec. III.

III. ESTIMATES OF POTENTIAL GNP THROUGH 1976

Before potential GNP can be projected beyond the data period, several components must be generated for future years, starting with the changing unemployment rate used to represent full employment in this study, U*. Since equation (1) contains only time trends, U* can be calculated to be 4.645 percent in 1974, 4.682 percent in 1975, and 4.719 percent in 1976. Implicitly this extrapolation procedure assumes that the relative importance in the labor force of the groups with above-average unemployment rates in 1956 will continue to grow.

Equation (5) for labor force participation rates contains no time trends so that the input values for the potential employment share of the young

[8] The equation is similar to the one used by Perry for average weekly hours in "Labor Force Structure," p. 541. The employment share of the young, E16–24/E, was also tried but the decline in the average annual hours worked is so smooth that this variable proved statistically insignificant.

$(E_{16\text{-}24}/E)^*$ and for the population share of the old (P_{65+}/P) must be generated before that equation can be solved for future years. For the elderly, this is done by using Series D population projections. The potential employment share of persons 16 through 24 years of age, however, must first be estimated by using equation (2) and (3),[9] and adding the potential employment shares of young males and young females. With these inputs and with E/L set equal to $(1-(U^*/100))$ substituted into equation (5). as before, potential labor force participation rates are obtained from 1974 through 1976; they were added to Table 2.

Multiplying these rates by P yields L* and multiplying L* by $(1-(U^*/100))$ yields E* for future years, with the resulting values already shown in Table 2. Next, the equation for average manhours is solved by setting U equal to U* and running the time trends on through 1976 in equation (6). With the last term in equation (7) again set equal to zero, the time series estimates of potential output per manhour are obtained. They are converted to estimates of potential GNP for 1974, 1975, and 1976 (in 1958 dollars) by multiplying by the total potential labor input measures E*H*. This series is shown as GNP^*_2 after actual GNP in column 2 of Table 4.

TABLE 4.—ACTUAL GNP AND ALTERNATIVE ESTIMATES OF POTENTIAL GNP (GNP*)

[In billions of 1958 dollars, 1955–76]

Year	GNP actual (1)	GNP*2 (eq. 7) (2)	GNP*3 past official (3)	GNP*4 since 1969 with BLS revisions (4)
1955	438.0	432.3	438.8	438.8
1956	446.1	446.7	454.2	454.2
1957	452.4	462.2	470.0	470.0
1958	447.3	479.2	486.4	486.4
1959	475.9	497.1	503.5	503.5
1960	487.7	517.3	521.1	521.1
1961	497.2	535.4	539.3	539.3
1962	529.8	546.6	558.2	558.2
1963	551.0	570.5	578.5	578.6
1964	581.1	596.2	600.3	600.3
1965	617.8	619.6	622.8	622.8
1966	658.1	639.5	647.1	647.1
1967	675.1	661.6	673.0	673.0
1968	706.6	687.3	699.9	699.9
1969	725.6	714.7	727.9	727.9
1970	722.5	745.8	758.4	757.0
1971	745.4	779.2	791.0	787.3
1972	790.7	811.9	825.0	818.8
1973	837.3	845.1	860.6	851.6
1974		876.6	897.7	885.6
1975		913.5	936.2	921.0
1976		948.3	976.5	957.9

Note: The past official estimates shown in col. 3 are prepared by the Council of Economic Advisers. They were published in previous issues of U.S. Department of Commerce, "Business Conditions Digest." The series in col. 4 will appear in future issues, starting in February 1974.

For comparison, the past official potential GNP series and the new series incorporating the recent BLS revisions which apply only to the years since 1969 are shown in the last two columns of Table 4. Due to changes in the measurement of productivity and of the average hours worked per year, the BLS revisions imply a growth of potential output of 4 percent, compared to 4.3 percent in the past official series.

It appears that the potential GNP series obtained with consistent estimates based on the shifting unemployment rate, U*, is around 2 percent lower than the old official series in recent years but less than 1 percent lower than the new official series incorporating the BLS revisions. The percentage gap between the series in column 4 of Table 4, which represents the new official estimate of GNP at around 4 percent unemployment, and GNP^*_2 is a function of the difference between the variable unemployment rate, U*, and 4 percent unemployment. The gap between the actual GNP in column 1 and the variable-unemployment rate estimates of potential in column 2, in turn, is a function

[9] To solve equation (2). the percentage of males 16 through 24 years of age in the armed forces must be projected for 1974–76.

of the difference between the actual unemployment rate, U, and U*. The latter estimate, which is analogous to the basic Okun equation, is shown below.

$$(8)\ (GNP/GNP^*_2)_t - 1 = \underset{(-14.18)}{-2.8686}\ ((U_t - U^*_t)/100);\ \bar{R}^2 = 0.8859,$$
$$D.W. = 1.54,\ S_e = 0.0104.$$

Using the system of equations entering into GNP*₂, the equivalent of Okun's reduced form coefficient can now be determined structurally from the identity:

$$(9)\quad GNP = (GNP/EH)EH = (GNP/EH)\ (1 - U/100)\ (L/P)PH.$$

Substituting from equation (5) for the participation rate, L/P, from equation (6) for manhours per year and employee, H, and from equation (7) for output per manhour, GNP/EH, and differentiating with respect to U yields—2.995 with 1972 magnitudes. This structural coefficient is well within one standard deviation of —2.87 found in the reduced form equation (8). This tends to confirm the consistency of the variable unemployment rate estimates of potential GNP.[10] These estimates are used to calculate one of the alternative full-employment balances shown in the 1974 *Economic Report.*

GLOSSARY

AF: Persons employed in the armed forces, both civilian and military.
AF 16–24: Number of males, 16 through 24 years of age, in the armed forces.
D.W.: Durbin Watson statistic, with serial correlation inversely related to its size.
E: Number of persons, 16 years and older, employed.
E*: Potential employment.
E M 16–24: Employed males, 16 through 24 years of age.
E F 25+: Employed females, 25 years or older.
GNP: Actual GNP in 1958 dollars.
GNP^*_1: One of i measures of potential GNP.
H: Actual manhours worked per year and employee.
H*: Potential manhours worked per year and employee.
L: Civilian labor force, persons 16 years and over.
L*: Potential civilian labor force.
P: Non-institutional population excluding the armed forces.
P 16–24: Non-institutional population of males 16–24 years of age, including the armed forces.
P 65+: Non-institutional population, persons 65 and over.

$\bar{R}^2$=Coefficient of determination, adjusted for degrees of freedom.
S_e=Standard error of estimate.
t=Time subscript.
T_1=Variable taking the value of —1 in 1955 and growing by increments of 1 per year.
T_2=Variable taking the value of 1 in 1965 and growing by increments of 1 per year. The value of T_2 is zero for all years prior to 1965.
T_3=Variable taking the value of 1 in 1969 and growing by increments of 1 per year. The value of T_3 is zero in all years prior to 1969.
U=Official unemployment rate of the civilian labor force.
U*=Changing unemployment rate used to represent full employment.

Senator PROXMIRE. We will recess until 10 o'clock tomorrow morning to hear Secretary of the Treasury Shultz.

[Whereupon, at 12:40 p.m., the committee recessed, to reconvene at 10 a.m., Friday, February 8, 1974.]

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[10] Further support is provided by the consistency of the component estimates with the findings of other researchers. For instance, the coefficient of U in the average annual hours equation (6) is almost precisely 52 times the comparable coefficient found in the average weekly hours equation by Perry, and the Durbin-Watson statistics are similar. See "Labor Force Structure," p. 541. Furthermore the annual rate of growth in potential productivity of 2.68 percent from 1955 through 1964 in equation 7 also agrees with the findings of Perry and Denison. See Edward F. Denison, "Comments," *Brookings Papers on Economic Activity* (3:1971), p. 570.

THE 1974 ECONOMIC REPORT OF THE PRESIDENT

FRIDAY, FEBRUARY 8, 1974

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

The committee met, pursuant to recess, at 10:10 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman of the committee) presiding.

Present: Representatives Patman and Conable; and Senators Proxmire, Humphrey, Bentsen, and Javits.

Also present: Richard F. Kaufman, general counsel; William A. Cox, Lucy A. Falcone, Sarah Jackson, Jerry J. Jasinowski, John R. Karlik, Courtenay M. Slater, and Larry Yuspeh, professional staff members; George D. Krumbhaar, Jr., minority counsel; Leslie J. Bander, minority economist; and Michael J. Runde, administrative assistant.

OPENING STATEMENT OF CHAIRMAN PATMAN

Chairman PATMAN. The committee will please come to order. Mr. Shultz, we are delighted to have you this morning accompanied by Mr. Paul Volcker of the Treasury Department. Since you are the Secretary of the Treasury, you are one of the most important people we have around here now to answer the questions that we would like to propound to you, and we will do the very best we can. We are operating under handicaps because some of our people could not get in this morning. They did not come down as early as you came down or as early as I came down. So we will have to forgive them.

As I told Mr. Stein yesterday, the economic outlook for 1974 is a distressing one. We have the prospect of serious unemployment, serious inflation, and exorbitant interest rates. Housing is in a state of depression. The energy shortage has turned it into major disruption, and price rises in food now plague the American consumer. I am especially concerned that your own outlook is for a poor year, and that many experts are even more pessimistic, particularly in regard to unemployment and inflation.

Meanwhile, the administration is not providing much in the way of programs to correct these serious problems. The President's only program for dealing with rising unemployment is to propose some minor improvements in the unemployment compensation program. In the energy field, your main solution to our problem seems to be rising prices.

This is a very rough way to ration fuel, especially for the average family. Of course, it is nice for the energy industry. Their profits are

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sky high. And when it comes to inflation, the best you have to offer is the market. Since we are in a bad situation already on this score, I am afraid that leaving it to the market will just make it all the worse.

This morning we realize that the most serious problems we have right now is the terrible situation of housing. I do not see any vigorous efforts in your program, Mr. Shultz, to get us out of the depression in housing and begin to provide the homes that are badly needed in this country. And before I yield to you I would like you to answer this question in your statement, Mr. Shultz.

I wrote a letter to the President yesterday morning. It was delivered to him about noon yesterday. And I said:

> DEAR MR. PRESIDENT: The Banking Committee will begin consideration of legislative proposals concerning the economic stabilization program in the near future. The Committee is anxious to have your proposal before us as soon as possible so it will be able to make its recommendations to the Congress on the future of the controls program.
>
> It is my understanding that Mr. Dunlop broadly outlined the Administration's position on controls before the Senate Banking Committee yesterday—that was the day before yesterday, of course—and that recommendations were made on behalf of the Administration. In order for the Committee to analyze, our Committee to analyze and appraise your proposals, it will be necessary to have specific legislative language by Wednesday, February 13th.
>
> If you will be so kind as to supply the Committee with draft legislation by this date, the Committee will be in a much better position to make and justify its recommendations to the House.
>
> Sincerely,

Signed by me as chairman.

If you will tell us what you think about the prospect of getting this information by the 13th, Mr. Shultz, it will be appreciated.

You may proceed, sir, with your statement.

Do you have a prepared statement?

Secretary SHULTZ. Yes, sir,

Chairman PATMAN. All right, you may proceed as you desire, sir.

STATEMENT OF HON. GEORGE P. SHULTZ, SECRETARY OF THE TREASURY, ACCOMPANIED BY PAUL A. VOLCKER, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS

Secretary SHULTZ. Thank you, Mr. Chairman. Let me take up the question you raised in your letter to the President. We did make available our analysis of the current situation under controls and the recommendations for what should be done in the area of the Economic Stabilization Act last Wednesday before the Senate Banking Committee. Senator Proxmire was among the Senators present.

We are prepared to testify before your committee, sir, at your call, and we could do it tomorrow. We could do it any day. We are ready with our proposals. As far as the precise legislation language is concerned, we had thought we would be able to have that ready by today. In consultation with members of the Senate committee as they were talking with us about that, the word we got was, well, the 18th is as good as today because we will not be here. And so we geared ourselves now to that.

Chairman PATMAN. The 18th?

Secretary SHULTZ. The 18th, when the Congress returns.

So that is the track that we are on at the moment. We can speed it up. But it is just a question of taking more time to clear the precise language within the executive branch. But we know what we want to propose and we are very well along on the precise legislative language, and we would like if we could, to deliver that to you when we deliver it to the Senate Banking Committee.

Chairman PATMAN. But since you are ready, Mr. Shultz, suppose we would like to do it sometime next week, to hear your testimony and the administration's?

Secretary SHULTZ. The only days that would be tough for me, although Mr. Dunlop could do it, would be Monday or Tuesday. We have an international meeting on oil that will go, probably, through both of those days.

Chairman PATMAN. Well, if we will do it Monday or Tuesday we will expect to hear from you. But if we cannot, we will do it the 18th.

Secretary SHULTZ. Well, I could do it Wednesday morning, or Mr. Dunlop could do it Monday or Tuesday, if you would like. But I cannot be here.

Chairman PATMAN. Well, we will take it up with you if we want to make a start at that time. I appreciate your cooperation.

Secretary SHULTZ. OK, Mr. Chairman.

Mr. Chairman, Senator Proxmire, since your review of the economy last summer, we have witnessed an abrupt change in world economic circumstances. The cutback in oil production and the precipitous increase in oil prices have dramatically affected prospects for world production, employment, price stability, and balance-of-payments equilibrium. The lives of people in all parts of the world are directly affected, with potentially devastating effects on those in the poorest countries who can afford it least.

Mr. Stein and his colleagues on the Council of Economic Advisers have discussed with you the prospects for our domestic economy in light of these developments. My statement today will concentrate on the world economic environment and its implications for our policies in the period ahead.

The oil crisis developed late in 1973. It came on top of a situation already characterized by worldwide shortages of foodstuffs and industrial raw materials and the most serious general inflation since the World War II period.

To a considerable extent, these conditions were an outgrowth of world boom. The major industrial countries for the first time since the Korean war found themselves facing similar cyclical situations, with strong demand pressures, strains on capacity, and rapid inflation. Price increases, summarized in the first table attached to this statement,[1] were of depressing magnitude.

For the major industrial countries as a group, consumer prices increased about 9.5 percent. U.S. consumer price increases, at 8.8 percent, were only slightly less than average. The pressure on commodity prices was reflected in the much sharper wholesale price increases in almost all countries, with the increase in the United States amounting to 15.5 percent.

As this contrast suggests, what the world experienced last year was essentially a commodity price inflation. World commodity prices rose two or three times as fast as prices of finished goods and services, and the pressure on commodities accounted fully for the accelation in rates

[1] See table I, p. 70.

of inflation. Food prices alone may have been responsible for half the increases in consumer prices in the major industrialized countries, and toward the end of the year particularly, energy prices also contributed heavily.

Supply deficiencies at a time of worldwide boom were the principal factors behind the escalation of commodity prices. The combination of natural forces which led to inadequate harvests over the past 2 years—there were in fact a fall in worldwide agricultural production per capita in 1972—produced a scramble for food supplies in a world accustomed to worrying about surpluses. Shortages of other raw materials, such as nonferrous metals and timber, also developed.

Domestic markets in some countries, where currencies appreciated during the year, were partially shielded from the strong international price pressures. Others, whose currencies depreciated, such as the United States during the first half of the year, were not only fully exposed to the world trend, but had to absorb an additional source of inflationary pressure. But these exchange rate changes—which made an essential contribution to restoration of international payment balance—should not obscure the main point that no country could escape a pervasive worldwide phenomenon.

The cuts in oil production imposed in the Middle East, for essentially noneconomic reasons, then, created supply difficulties in another critical area, and the resulting increases in oil prices dramatically altered world economic prospects. From a $2 per barrel range in September, we saw open-market prices of crude rise to in excess of $15 per barrel within a brief period.

The low point of oil production seems to have been reached in November. By January, production was about at the same levels as consumption, which has of course been reduced. With easing of supplies and the continuing efforts to reduce consumption around the world, arm's length market prices have declined. By the end of January, it appeared that spot market prices had fallen to the $10 to $11 per barrel range.

There can be no certainty how greatly consumers—and their governments—will be inclined to reduce their consumption in the light of the higher prices. But it seems likely that the consumption this year at anything even approaching present prices would be significantly less than what the free world could produce through responsible and efficient use of existing and planned facilities. It seems likely, therefore, that market forces will push in the direction of further reductions in the open-market price of oil in the international market.

Just to put a few numbers out, Mr. Chairman, in 1973 as we calculate it, the output of petroleum on a world basis was about 47.8 million barrels per day, and the low point that I referred to got down to 43.2 million barrels. The January production was about 46.2 million, and that is about 8 percent below what had been estimated before the crisis to be the January production.

Now, the consumption in January, as calculated, was about the same as the production, about 46.2 million barrels, and this with the fact that stocks were drawn down by only about 100 million barrels, which I understand is about 5 percent of stocks. So it was not a large amount.

Now, our estimate of what the potential for output is, if all of the producing countries produced all they could, is about 51.4 million barrels. Our estimate of demand at a price of about $8 is a rate of consumption at around 46.4 million barrels. Our estimate of demand at a price of $4.50 is around 50.3 million barrels.

Now, what I am trying to suggest with these numbers is that there is a lot of pressure on this price, and as we have said on other occasions, including in Rome, we think that the price has gone up too fast too far, and should come down and will come down, and as a matter of observation, as I noted a minute ago, has come down from the exotic levels that took place at the end of the year.

Moreover, looked at as an economic phenomenon, I am convinced the current levels of international oil prices are neither sustainable nor tolerable over a longer period. As we look ahead, additional sources of energy can and will be developed at lower cost. Yet, compared to earlier years, the future cost of energy will be high. This implies a fundamental change in the world economy—a reevaluation of one of the basic tenets of a world industrial society built on the assumption of relatively cheap and plentiful oil.

Fortunately, in areas other than oil a few encouraging signs are visible in the battle against inflation. Food production is expanding rapidly, and with normal weather a record crop is in prospect this year. The prospective slowdown of the boom in the industrial countries should temper pressures on raw material and commodity prices. Also, for the United States, the recent strengthening of the dollar and consequent fall in the cost of our imports can help dampen inflationary pressures.

Internationally, one possible danger is that attempts will be made to maintain exorbitant commodity prices through the exercise of sheer monopoly restraint on supplies. It should be possible to avoid this danger without confrontation through a constructive dialog aimed at identifying and meeting the legitimate needs of consumers and producers alike.

At home, it is important that the effects of the rise in commodity prices are not aggravated by irresponsible pricing policies or abandonment of the responsible pattern of wage settlements we have seen in the past year—a process that in the end would only be self-defeating by twisting the cost-price screw another turn.

Finally, as we pass from overheated boom and face the new problems, of production and employment imposed by energy shortages, we must not lose sight of the inflationary dangers of lax budgeting or excessive money. We should be, and we are, prepared to adapt our monetary and fiscal policies flexibly as the need is demonstrated. But as we appraise that need, let us recognize that more money is not a substitute for more oil.

The prospect that the world was moving toward a better balance-of-payments equilibrium has been vastly altered by the recent oil price increases.

There have been suggestions that current price levels imply a $75 billion jump worldwide in the annual costs of imported oil. These estimates assume the price rise comes on top of previous forecasts of oil consumption. This same calculation would imply an increase of perhaps as much as $10 billion in the annual oil import costs of the less developed countries which are not oil producers, an amount exceeding the total official assistance they have been receiving. These calculations are obviously purely technical. In fact, no one knows what prices the consuming nations will be paying for oil imports this year. Higher oil prices and conservation measures do lead to reduced oil consumption and a lesser volume of imports. With higher revenues, oil exporters will expand their purchases, mainly from industrial countries.

Even making some allowances for these factors, there have been estimates that the investible funds of oil producers could increase this year by more than $50 billion. This would imply a deterioration in the current account position of the rest of the world of a corresponding magnitude. The implications of a change of this magnitude, coming with such abruptness, are difficult to comprehend. For a number of developing countries, the calculations must plainly have an air of frightening unreality. They simply do not have the funds to pay, or any realistic prospect of repaying loans in the large volume that would be required. Nor can industrialized countries find the consequences acceptable, even though in the aggregate they can anticipate large flows of investment from the oil producers.

We must therefore act promptly to bring the problem within manageable proportions, both by reducing its magnitude and by developing cooperative techniques for handling it. In doing so, we believe we can be working with, and not against, the legitimate aspirations of the oil exporters for fair compensation for their resources, and for stable and profitable investment outlets.

The consequences of failure are evident. We are already beginning to see tensions mount as countries begin to react to the prospect of swollen oil import bills. The exporting countries can have no real interest in the actions which severely disrupt the economies of their customers.

Obviously, the pressures and the means for handling them are not evenly distributed among all nations. The United States and some other countries could, if necessary, through their own actions cope with the problems which these oil price increases create, although the impact on the United States will be a good deal more serious than many seem to realize. The United States was prospectively the world's single largest importer of oil, and under any foreseeable circumstances, our oil import bill will soar in the near term. Oil imports were expected to represent a bigger proportion of our total imports than is true of most major European countries.

On the other hand, our strength is that, even in the short term, we are in a better position than many to conserve on our consumption of oil and to cut back our oil imports. We are the world's largest producer of oil, with many good possibilities for increasing our output, and over the longer term we are capable of becoming fully independent of foreign oil.

In fact, some think that at prices something like the present, we would be an exporter of oil.

While I would discount substantially the fact that in December we had the largest monthly trade surplus in our history—over $940 million—we fortunately do not start from a deficit balance-of-payments position.

The strong turnaround in the U.S. balance of payments last year is traced in an attached table.[1] Although the final figures for the fourth quarter are not yet available, we expect that they will confirm that the marked improvement in the trade balance was accompanied by better results in the other accounts.

[1] See table II, p. 71.

Mr. Chairman, no matter what the precise impact on the United States and other countries is individually, the very substantial adjustments the world now faces present a sharp and fresh challenge to our ability to work together in the common good.

The challenge needs to be met on four fronts, each crucial to the whole: by devising new forms of cooperation to deal with the energy situation; by completing our negotiations for reform of the international economic system and to liberalize world trade; by maintaining the momentum of development; and by working to restore the fabric of international stability torn by inflation, payments imbalances, and now the oil crisis.

First, energy cooperation.

We hope that the international energy meeting to be held next week will succeed in reaching a common analysis and understanding of the energy problem, and will begin to define the nature and scope of new forms of cooperation to deal with it. The agenda for the meeting includes questions of reliable supply, conservation, development of alternative energy sources, research and development, emergency sharing of supplies, and financial management. We are looking forward to consultation with developing countries, and we want to lay the base for costructive discussions with producing nations.

What we want is not confrontation, but cooperation, in the conviction that in the end producers and consumers both will find a large common interest in reconciling their needs in a manner which is consistent with economic stability, open trade, and rapid development.

All nations need to have confidence that goods they need will not be arbitrarily restricted, and that, conversely, markets will not be closed to them. All will benefit from increased supplies of energy. All need a framework of financial stability.

Let me turn to monetary and trade reform.

Our efforts to reform the international monetary system were reassessed in the light of uncertainties relating to the oil situation at a meeting of the Committee of Twenty in Rome last month. The committee decided it should complete its work on the main features of a reformed monetary system as quickly as possible—hopefully, and I believe there is a good basis for that hope, at its next meeting, scheduled for mid-June.

At the same time, we recognized that in some areas, the desired approach could only be implemented over time in an evolutionary way, and that a number of important operating characteristics of the system would need to be worked out in detail later.

It was also agreed that, in light of recent developments, intensive attention should be given to certain needs that are both immediate and doable, in order that elements of reform of particular relevance to present conditions can be put in place as promptly as possible.

One critical requirement is to find new procedures for improving the effectiveness of the International Monetary Fund and continuing cooperation among financial officials. A long step toward that objective was taken by agreement that a 20-member Council of Governors would be established in the IMP, or, pending the formal and legal establishment of the Council, a temporary committee.

The Council would meet regularly, three or four times a year, with broad and continuing authority to manage and adapt the monetary system, to oversee the continued operation of the international balance-of-payments adjustments process, and to deal with sudden disturbances which might threaten the monetary system.

The Council, or the temporary committee, would come into being when the C–20 finishes its work, and will be charged with continuing the evolutionary process of reform within the context that the C–20 has established.

Other aspects of reform will also be included in the substantive agreement that we expect the C–20 will reach in June. One need is to establish techniques for valuing the SDR in situations—like the present—in which most of the major currencies are floating, and more important elements of an agreement on that point were developed in Rome.

More broadly, the long discussion of the need to develop codes of conduct to guide the operation of the adjustment process should be brought to a conclusion. I am encouraged that discussion on appropriate guidelines for floating will become intensive in coming months, and some convergence of approach seems to be developing.

Developments of the past year lead us also to consider new priorities in the trade negotiations. More emphasis is needed with respect to restrictions on the supply of internationally traded commodities, alongside the traditional emphasis on access to markets.

The barter deals some countries are negotiating with oil producers raise anew the old questions about the role of bilateral trading arrangements in a multilateral order, and how they may be placed within a framework of generally agreed rules. I think it essential that the debate on these issues—and debate it will be, for there is certainly no consensus—should be initiated promptly.

And I believe, Mr. Chairman, from all I understand, the meeting in Geneva yesterday, which is moving following the Tokyo Declaration in the round of negotiations, went off very well, and there is a good spirit there and a common appreciation of the importance of maintaining a set of rules and understandings around the world.

The tensions inherent in the major trade and balance-of-payments adjustments that countries will experience shortly—even with more reasonable oil prices—underscore the importance of maintaining the impetus toward trade liberalization. The difficult problems ahead can be solved more easily within a context of expanding world trade, encouraged by renewed progress toward trade liberalization.

I hope the Congress will move expeditiously to complete action on the trade legislation before it. Few things would be more damaging to the prospects for cooperative solutions to our common problems than the appearance that the United States was faltering in its commitment to a liberal and reformed international trading order.

Let me turn now to economic development.

The third task I cited earlier was to maintain the momentum of economic development. I have already emphasized the new burden on developing countries from the higher oil prices. I see no way that aspect of the problem can be reasonably handled, unless those oil producers with excess funds provide grand and other concessional assistance to offset the soaring cost of oil imports to the LDC's.

There was considerable discussion in Rome about how the oil producers would make guarantees with fair rates of interest, and we said to them in Rome that that is not the name of the game. You have got to provide some ways, through grants or highly concessional terms, if the developing countries are not to have their plans short circuited.

But such assistance devised to meet new needs in no way can substitute for the assistance programs now in place financed by the industrialized world. Indeed, the need for maintaining, and even expanding in an orderly way, those programs is at least as urgent as before. The new problem of the oil situation simply cannot be an excuse for further compounding the extreme difficulties of the poorest people in the world, further widening the gap between the "haves" and the "have-nots."

The United States is being asked—and properly so—to bear a fair share of that cost. We cannot, in my judgment, fail to answer that call without severely damaging the entire fabric of the cooperative world order that we promote. In that context, the action by the House of Representatives last month in voting down the bill for replenishment of the resources of the International Development Association is particularly disturbing.

And, Mr. Chairman, I would want to say here that I appreciate very much the support that you gave for that effort and the support that your committee gave for that effort, and we stand behind you and we want to continue the fight for that legislation because it is so essential.

We want to work closely with the Congress in the period ahead with the objective of carrying out our share of this joint effort—a share, I should point out, that has been reduced at our request to one-third from the 40-percent level maintained earlier.

As we move ahead in those areas, we need to deal on a continuing basis with the threats to international economic stability inherent in the present situation. Temptations for individual countries to seek their economic salvation at the expense of their trading partners are present.

Fortunately, it is equally apparent that such actions would not only be self-defeating in their immediate objective, but could leave us all worse off, caught in a maze of controls, restrictions, and dislocations that impair growth and stability. The need is to make sure that that intellectual understanding of the common danger is, under the pressure of swiftly moving events, made effective in our national decisionmaking.

In approaching this problem against the background of large imbalances in international payments, sudden changes in payments flows, and rapid inflation, I believe there is a general consensus that, for the time being, a general system of par values and fixed exchange rates would not be workable or desirable. While the sizable changes in exchange rates in the past year have posed some problems, floating rates have probably worked better than any other system that could have been devised during the past year.

We have seen trade and investment continue to prosper and businessmen and bankers have been able to accommodate to the new situation. At the same time, the new uncertainties created by the rise in oil prices emphasize again the need for exchange rate policies which are internationally responsible, whether par values or floating rates are used, if the destructiveness of competitive devaluation is to be avoided.

A floating regime, like a par value system, requires agreed principles of good conduct if conflicts are to be avoided. We believe criteria relevant in the par value system are also relevant to floating.

For instance, under either regime, the aim should be to avoid prolonged imbalances, and significant movements in reserves can help tell us when governments unduly resist market forces and suggest when policies need to be adapted. In either regime, we should not use widespread controls on trade or capital to maintain as undervalued exchange rate. As I suggested earlier, in coming months I hope we can reach agreement on broad guidelines to help assure cooperation behavior in this area.

At the end of January, the United States was able to announce the effective elimination of our capital controls programs, a move that had been urged upon us by many Members of the Congress. And I might say, a statement put out by a subcommittee of the Joint Economic Committee just before our own meeting was a very helpful document.

This move was, of course, made possible by the improvement in our balance-of-payments position and the stronger performance of the dollar. We also felt that, at a time when many countries are concerned about how they might finance deficits in their current balance of payments, ending of our controls could provide an important element of reassurance. I am gratified that the move has been widely accepted as constructive, and a number of other countries have also reduced controls.

Mr. Chairman, the problems in the year ahead pose the greatest challenge to the spirit of international cooperations since we viewed the ruins of World War II. Our success in the past quarter century in finding cooperative solutions gives us grounds for hope that we can do so again. If we are to expect of our partners the responsible conduct now required, we must not fail in our own responsibilities.

Thank you, Mr. Chairman.

Chairman PATMAN. Would you like to insert the tables you have in connection with your statement, Mr. Shultz?

Secretary SHULTZ. Yes, sir. We have some corrections on one of those tables.

Chairman PATMAN. Without objection, the tables will be inserted, as corrected, in the record at this point.

[The tables referred to follow:]

TABLE I.—PRICE INCREASES IN MAJOR INDUSTRIAL COUNTRIES, 1969-73 (AVERAGE ANNUAL RATE OF INCREASE)

	Consumer prices [1]		Wholesale prices [1] [2]	
	1969-72	1973	1969-72	1973
United States	4.6	8.8	3.9	15.5
Canada	4.0	9.1	4.6	18.1
Japan	6.0	15.0	3.0	13.5
United Kingdom	7.2	9.9	7.1	10.0
France	6.1	8.7	6.3	13.5
Germany	4.9	7.0	3.9	8.3
Italy	5.4	11.3	6.2	28.0
Total OECD	5.0	9.6	4.3	14.2

[1] Percentages for 1973 are calculated for the latest 12-mo period available.
[2] Since aggregate wholesale price indexes are not generally available, indexes are those of the wholesale prices of manufactured goods, or closest available alternative.

Source: OECD, Department of Labor.

TABLE II.—U.S. BALANCE OF PAYMENTS, 1970–73

[In billions of dollars]

	1970	1971	1972	1973 [1]
Exports	42.0	42.8	48.8	70.3
Imports	39.8	45.5	55.7	69.5
Trade balance	2.2	−2.7	−6.9	.8
Investment income and other services	1.5	3.5	2.3	0 to +1
Unilateral transfers	−3.2	−3.6	−3.7	
Current account balance	.4	−2.8	−8.4	+1 to +2
Government capital flows, net	−2.0	−2.4	−1.3	−1
Long-term private capital flows, net	−1.4	−4.4	−.2	
Balance on current account and long-term capital	−3.0	−9.6	−9.8	0 to +1
Short-term capital and errors and omissions	−1.7	−13.1	−4.8	−8 to −9
Net liquidity balance [2]	−4.7	−22.7	−14.6	−8
Official reserve transactions balance [2]	−10.7	−30.5	−11.1	−5½

[1] 1973 figures, except for the trade figures, are estimates or preliminary.
[2] Excluding SDR allocations.

Note: Totals may not add because of rounding.

Chairman PATMAN. I will reserve my time for interrogation until after the other members of the committee have had an opportunity to do so.

All right, Senator Proxmire. You are recognized.

Senator PROXMIRE. Mr. Shultz, congratulations on a most profound and conscientious appeal that we recognize our responsibility to the world community. I think this may not be the most popular kind of presentation, but I think in the long run it is a highly desirable one, and I think it is most commendable.

I would like to ask you first, however, on what you talk about when you say how important it is for us to keep our own inflation as low as possible, and we act responsibly, particularly with respect to prospective wage increases and so forth. Frankly, I cannot see anything that the administration is recommending that enables us to do this effectively.

You propose a big budget, a large budget increase. You propose the abandonment of wage-price controls. You fail to propose any kind of standby action that will enable the Government to move effectively and swiftly to stop price increases. Now, I know it is a very difficult situation. It is hard to design a budget that can go both ways, that can counteract recession and at the same time retard inflation. The same thing for monetary policy.

I also agree with you that comprehensive wage-price controls are not realistic under present circumstances.

But is it not desirable, if only from the standpoint of public psychology—but I think also from the standpoint of realistic and effective action—that we provide some kind of governmental machinery that will enable us to have some effect on price increases?

As you know, when you finished testifying before the Senate committee the other day, Mr. Burns, a conservative economist, a man with whom I am sure you often agree, sometimes disagree, proposed a system in which boards would be created—not the President, but ad hoc committees would be created—which could hold hearings in pacesetting industries and we could hold up wage or price increases for 30 to 45 days while public attention is focused on the impact of those wage and price increases. They would not have any mandatory power, but at least you would have this focus of public opinion and of congressional attention, too, so that we could get action more expeditiously.

Is this not just about the minimum that should be expected of Government?

Secretary SHULTZ. Well, in our proposal that we made to you we proposed a continuation of the Cost of Living Council, giving it a variety of duties. I believe the most important of which is continuing and intensive work on the problems of supply of scarce commodities. And I believe we have done some good work in that area.

We also proposed that the Cost of Living Council be empowered to hold hearings to require information to be able to require people to come to the hearings, and of course we can construct these hearings in a variety of ways, we would think. The Cost of Living Council can hold the hearings directly itself, as we have done quite extensively this past year. We could create an ad hoc group of people who presumably are expert or have some special insights into the problems of a particular industry or collective bargaining situation, and examine the situation that way and hold the situation up to public scrutiny.

Senator PROXMIRE. But you do not actually hold up specific wage or price decisions so that the public would have some assurance that you are not going to get a runaway situation. In view of what happened last year, with the deterioration of the 1, to 3 percent—depending upon your index, I guess—in real income for many, many Americans who are stuck with the 5½ percent guidelines, there is going to be pressure to increase wage settlements this year, as you know. And also, there is an anticipation of substantial inflation. The Council of Economic Advisers predicts 7 percent. So that if we do not have some opportunity, it seems to me, to hold these up temporarily while we look at the specific wage and price increases, you are not going to get any effective control of this very vital element in inflation, wage costs.

Secretary SHULTZ. Well, I do not disagree with you or Mr. Burns on the desirability of having a Government group, perhaps, constructed in different ways for different occasions—and it seems to me that is the way in which Mr. Burns has proposed it, as I read his testimony—and we have also proposed it that way—examining proposed wage and price decisions in particular sectors.

I would not agree that these should be limited or especially focused on so-called pace-setting industries, by which I take it is meant oligopolistic industries, because, at least as we observed the record of inflation in the past year, the problems for the most part have been in competitive sectors. So I think we need to examine those sectors and be able to dig into them, and see whether there is anything in particular that might be recommended.

Senator PROXMIRE. Well, we would certainly welcome any language you can give us to clarify the industries that ought to have this kind of power for.

Secretary SHULTZ. Pardon me.

Senator PROXMIRE. It would be very helpful if you could suggest language that would clarify and sharpen the areas where we should hold up a wage or price increase subject to this kind of hearing.

I know you do not favor the principle, but if we do—you see, what concerns me, Mr. Shultz, what you told us the other day and what I got from what you said, that if the Congress provided comprehensive controls the administration did not like, they could just veto the bill and go with nothing. And you would not have——

Secretary SHULTZ. I did not say that.

Senator PROXMIRE. Well, I got that impression. Perhaps you did not say it. But we have a situation where you have some bargaining power here. You are asking practically for the elimination of controls anyway, and I am just wondering if the kind of modest, limited proposal that Mr. Burns made would, if we put that into the bill, if that would be veto bait.

Secretary SHULTZ. Well, we think that the modest workable proposal that we suggested to you is in some respects broader than what Mr. Burns suggested, in that, although I think he also proposed the possibility of hearings.

Whether or not it is a good idea to be able to hold up a wage or a price decision, I think, is debatable, and that is one that we might want to work along on.

But I would like to make a remark on the question of coverage. I believe the Cost of Living Council—or whatever organization is given this duty—should not focus on any particular small group of industries, because our experience is that our inflation problem seems to shift and it is by no means the case that it comes particularly from the industries which have——

Senator PROXMIRE. Let me just say I would agree wholeheartedly with that. But it seems to me there are only a few industries, a relatively few in which price decisions are made in this particular way, in which they are determined in advance, so that you could apply legislation of this kind. Obviously, you could apply it in the steel industry. Perhaps you could apply it to the automobile industry. It would be very hard to apply it in retail industry because, of course, that is so fractured, even though it is a very important part of our economy, that you just could not apply it there.

You could apply it, though, where there are conscious decisions made in this way, where you have national unions. It seems to me you have a different kind of a situation.

Secretary SHULTZ. Well, you have to watch that you do not get into the position of that well-known story of the drunk who was looking around the lamppost, and he was approached by somebody, and they said, "Well, what are you doing?" And he said, "Well, I lost the key to my car and I am trying to find it." And the man said, "Let me help you, where did you lose it?" And he said, "Where, down the street there by the corner." And he said "Well, why do you not look down there?" And he said, "Well, the light is better here."

Senator PROXMIRE. I see your story, but if you have got to have a light to find it you might as well look in the place where you have a prospect of finding it anyway.

Secretary SHULTZ. The trouble is that if you say the only people we might be able to clobber and somehow get after are large unions, but if they are not the problem, then you may be doing more harm than good.

Senator PROXMIRE. Let me ask you this. Your excellent analysis of the impact of international developments in the coming year tells us one thing loud and clear, and that is that no one but no one can foresee what will happen. You point out the fantastic elasticity of demand for oil. You say that if only 46 million barrels a day, as I understood you to say it, are produced, worldwide, that the price would be about $7. If 51 million barrels, which is the capability of production, the price would drop to $4.50.

Secretary SHULTZ. No.

Senator PROXMIRE. Is that wrong?

Secretary SHULTZ. These are estimates and everybody is groping in the dark here because the prices are so far away from anyone's experience that you do not have a good base to work from. Our estimate is that if the price is in the neighborhood of $8, demand is likely to be on the order of 46.5 million barrels a day.

If the price were to be in the neighborhood of $4.50, we would expect the demand to be around 50.5 million barrels a day.

Senator PROXMIRE. Well now, that makes my point even more strongly. Obviously, if you were an oligopolistic seller, if you are one of the six countries that are the big exporters of oil—and they have shown they know how to combine now and know how to get enormous profit out of it—what you would do is to limit your production. When you do that you increase your income by more than 50 percent and you preserve that black gold in the ground that you do not otherwise have to lose. Any wise group of sellers is going to see that, even if they have substantial leakage or their organization is not very tight.

But what I am saying is, there is a real prospect that it could, unfortunately, continue to give us a price at least as high as we have now and perhaps higher as they see that they can enormously increase their income by simply cutting down on their production.

Secretary SHULTZ. Well, there is a fallacy for them in that, and I do not think it is widely recognized, and I think it is important that it be recognized. Of course, it is true, as a matter of observation, during the cutback period that some oil producers have produced all out. They have produced more than they had been expected to and normally did, presumably because they thought these prices were quite good, and that the oil above the ground was worth more than below the ground. That must have been the belief on which they acted.

Other countries cut back. We do have a situation where one or, perhaps, two countries have a very high proportion of the total, so that you do have a lead country that can make all the difference.

But the great fallacy or problem that I think is often overlooked—and which is important—derives from the standard financial practice of discounting money in the future. That is, we all know that if you have $1 today it is worth more to you than a promise of $1 a year from now. Why?

Because you can earn a rate of interest on what you have today. So you have to discount that future flow. Now, if you take an interest rate of 8 percent, and you try to make a calculation of what the price would have to be at some future time to justify keeping the oil in the ground now, you get some rather interesting numbers.

Senator PROXMIRE. Well, my time is up. But the point is, Mr. Shultz, by keeping the oil in the ground they get more money today—50 percent more, 70 percent more, on the basis of your other statistics, $8.

The wisdom of restraining their production is so enormous that I do not know how they could resists it.

Secretary SHULTZ. Well, let me explain it to you.

Chairman PATMAN. Excuse me, Secretary Shultz. Senator Proxmire's time has expired.

Secretary SHULTZ. Well, I am very anxious to complete this point, if I could, Mr. Chairman, because I think it is a matter of great importance.

Chairman PATMAN. All right, go ahead.

Secretary SHULTZ. If you had an interest rate of 8 percent, the price of a barrel of oil would have to rise to $13.50 by 1980 to equal the investment return from a price of $8.50 per barrel in 1974. Now, you can change the rate of interest and you can change the base price and so forth, and you can figure out a whole matrix. But that is one.

Now, what that says to you is—first, ask yourself, is it likely that the price of oil will be higher by 1980 than it is now? And I think the answer to that is very, very clear— no, because of the great surges in supply that are coming from sources of oil and other energy that was not economic at $2 a barrel, but a price four times that—$8 a barrel or so—these alternatives are going to be very economical.

Now, that fact has to sink in and it is the economic reason why, at these prices, producers have it in their advantage, short- or long-term, to produce the oil. This is the time when they have the oil and others do not.

Senator PROXMIRE. I just have to respond, Mr. Shultz, that if you can get more money this year by restraining demand—I mean restraining your production—much more money, 50 percent more by holding your productiton down 10 percent, you are going to hold it down 10 percent. If you get more money now, you do not get it 8 or 9 years from now. You have 60 or 70 percent more money now, according to your own statistics on the elasticity of demand and the prices you gave us.

Chairman PATMAN. Congressman Conable.

Representative CONABLE. Mr. Secretary, let me begin by expressing publicly and for the record the sense I have of the general confidence here on Capitol Hill in your tenure as Secretary of the Treasury and the hope that you will continue in this position as long as it is consistent with your own personal hopes. We appreciate the job you are doing, and we have great confidence in you personally.

I have noted what you have said here, sir, about the developing countries, and frankly, that is a considerable concern of mine and I am confused by it. Senator Proxmire has talked about the economic situation, but the politician situation seems to me to provide quite a dilemma for the oil-producing nations. I understand that the increase in the price of oil that they have been able to enforce this year up to this point has had a simply staggering impact on the developing world.

How much more is the developing world going to have to pay for the same level of oil consumption than they would have had to pay at last year's prices?

Can you tell me generally?

Secretary SHULTZ. Well, if they have the same level of consumption—but, of course, this depends on the price—they might pay $8 or $10 billion more, which is more than the total amount of concessionary aid which flows to them and more than their reserves. This is an amount such that it is clear that that figure is only a mechanical calculation. It cannot happen because they do not have the money.

Representative CONABLE. Well, the combinations of the OPEC countries resulting in cutbacks and price increases have apparently been aimed at the industrialized world, and yet they seem to be having a much greater impact on the developing world—inevitably, disastrously so.

I note what you say about IDA and your disappointment with the action on the part of the House of Representatives. Frankly, I supported IDA, but I was very much in a minority when that happened. One of the big arguments—it appeals to domestic politicians, I might say—is, why should we continue to support foreign aid for countries who are going to be exploited to such a degree by the oil-producing nations? Simply with the result that any economic aid benefit we can confer is going to be diverted ultimately into the hands of the oil-producing nations. It is a very difficult argument; and I wonder if the oil-producing countries understand this, the impact their action is likely to have on us. And in our obvious and often expressed obligations to contribute in the development of the less privileged part of the world——

Secretary SHULTZ. I think the developing non-oil-producing countries are in a desperate situation, more desperate than anyone can really appreciate. You understand these things intellectually, but it is very hard to get them into your gut and appreciate what they really amount to. I think it is not too far off to say that oil equals fertilizer, and the lack of fertilizer equals famine, and that is what we are going to have in many of these developing countries as a result of what is going on.

It is a very, very desperate situation for many of them. Now, how should we react to that?

Well, I believe very strongly that we have this problem, it is a very difficult, desperate problem, and we need to point it out, work at it, try to develop a more manageable problem and then see how to manage it.

In the meantime, let us not cut and run. Let us not abandon the world. Let us not abandon our principles. Let us not abandon the things we are trying to do, but keep the structure of a cooperative and progressive world order in front of us. Let us not just throw in the towel any say, well, we do not give a damn for anybody else. All we care about is the United States, and we can make it. We can. Because, with all of our problems, we are rich and we are wasteful of energy, and we can handle it.

But it is not good for us, really, economically, politically or in any other way to take that attitude. And, I would say, it is not good for the soul, either. So I think we need to maintain our sense of our responsibilities, and the workability of these things will not go down the drain because we have to work at the other side of the problem. Everyone recognizes that. And if we just abandon everything, then we really lose our ability to work constructively with others.

Representative CONABLE. Mr. Secretary, I agree with what you say. It makes good sense, and it is just. I cannot understand why the oil-producing nations do not understand that their action is going to be damaging primarily to the developing world, instead of to us. And I should think they would worry about giving us an excuse to cut out on our obligations.

Are they so trapped in their rhetoric that they are likely to continue this concerted action they are making to their own ultimate political detriment because they have depended strongly on the support of the developing world, politically in the U.N. and in other places?

They are obviously going to destroy this support by such heavy-handed tactics.

Secretary SHULTZ. I do not think that anybody appreciates what is going on. Think of it. In September you had a price of $2. In November and December you had people wildly scrambling around and bidding way up above $15, some exotic prices I would not even mention. By now, short-term contracts are being made in the area of $10 to $11. I think it is coming down. I said so a month ago.

When people make these calculations and projections that everybody is trying to make, and you see these numbers, they are unreal. And it takes a while for them to sink in.

Now, we have been, I think it is fair to say, in the forefront in trying to appreciate this situation and point it out to people. And we made a big effort at the Rome meeting to do so, not in a confrontational spirit with the producers, but in a spirit of trying to understand what is going on and why it is so difficult and troublesome and disastrous for some. And I think the point is sinking in, and we hear reports this morning of suggestions, I believe, by the Shah that some new kind of bank be set up into which the producers might put money, and the money would be loaned on concessional terms.

Well, I do not know whether that represents a concrete proposal or anything. But apparently he said something along those lines. I would just say it represents the fact that as people look at all of this and try to appreciate it, dimensions become a little more clear, the unworkability of it becomes more clear, and then we make progress. And this is the way we do it. But it has been a stunning event, and it has happened so fast that I think it has gotten beyond the comprehension of most of us.

Representative CONABLE. And Mr. Secretary, to date the offset concessions, extended by the oil-producing nations to the developing world have been minuscule compared to the disaster that was visited upon them.

Is that not correct?

Secretary SHULTZ. That is absolutely right.

Representative CONABLE. Thank you, Mr. Chairman.

Chairman PATMAN. Senator Javits.

Senator JAVITS. Thank you very much, Mr. Chairman.

Mr. Secretary, I welcome you here and I would like to join Congressman Conable in appreciation for your services and the enormous burden of work you carry. Similarily with Mr. Volcker who assists you so ably.

Mr. Secretary, obviously the United States must take precautions for the possibility of a recession. This is anticipated as a possibility, even by the Council of Economic Advisers, though they hope it will right itself in the latter part of the year.

Now, two obvious measures present themselves: First is the continuance of the Economic Stabilization Act so you would at least have standby authority to step in in the price-wage situation, and second is emergency action respecting unemployment, which would include public service jobs and an extension of the Federal 13 weeks of extra unemployment compensation, the provision for which expires within 2 months.

Can you tell us what plans the administration has in mind in respect of this expectation that there may be a recession that could worsen, both in the fields I have mentioned, to wit, wage and price levels and unemployment, or in any other fields that bear upon this question?

Secretary SHULTZ. In the field of stabilization, we presented an extensive analysis before the Senate Banking Committee earlier this week, including a proposal that the Cost of Living Council be maintained and be empowered to work on problems of supply and also to examine individual wage and price situations and have the power to hold hearings, either itself or through ad hoc boards, and to be able to bring people to those hearings and require information of them, and so on. And we think that those things are appropriate.

At the same time we proposed that the system of mandatory authority for mandatory controls in the health area be maintained while the Congress is considering the health area legislation this year. We think that we have a method of handling the cost problem that at least is keeping inflation under control at the moment, and we think it would be unwise to throw it away while you are considering more extensive legislation. You might want to incorporate it in some manner, or, if you decide you do not, well then, it ends. But, in the meantime, we keep the controls in place.

Of course, it is true that, in the petroleum area, the authority for price controls exists now through February 1975 by the terms of the Allocation Act that was passed by the Congress a few months ago. So that is in place.

So that is our recommendation on the stabilization area. We will have statutory language to implement it before you shortly, and that is the program there.

Now, on the question of UI, if I am not mistaken, Senator, I can remember talking with you back when I was first nominated as Secretary of Labor, and we talked about what kind of programs would be good, and we talked about unemployment insurance and the need for reform, and we agreed on quite a wide-ranging set of things.

There was an important reform passed in 1970, I believe; the President proposed one further major reform. It is not a minor matter, to put on Federal standards for benefit levels of State programs, so that the benefit levels would be adequate. This has been proposed and proposed as a matter for State action, and for reasons that I think are clear nothing has ever happened. I should not say nothing has ever happened. The standards set forward have never been attained. And so I believe that should be done. It was proposed by the President, I think, last March. There has not been 1 minute of hearings on the subject in the Congress in all this time.

It is a major proposal. It is very important. We would be a lot better off today if there had been some action on it, and so I think there should be some action on it.

Now, I think we also have learned from the operation of the amendments passed the last time this subject was examined that the trigger mechanism for the Nation as a whole and State by State was basically a good concept for the extension of benefits, but that it did not fully recognize the disparity that can take place within a State of what is going on in different labor market areas. So the President has proposed that we amend the law to put the problem of the level of insured unemployment and the rate of increase of the rise onto a labor market area basis, as well as a State and national basis. And so you have that proposal before you, and I think both of those things are very important. They would contribute to a fight against any recession on an overall basis, and they would be very good for the individuals that would receive benefits as a result of them.

Senator JAVITS. Well now, the trigger on and off has the difficulty, of course, that it relates to varying rates of unemployment and does not relate to a continuing level of unemployment. That is, when it gets to, say the 6-percent level.

Do you not think that is an additional precaution that has to be cranked in?

Secretary SHULTZ. I would certainly think that is an important subject to discuss. I think we do have to be careful not to turn the system of unemployment compensation, which has an insurance concept with it and has served this country very well, into a welfare system. If we have an area where unemployment persists at a very high level for very extended periods of time, it is essentially not a problem to be handled by an unemployment insurance concept, but by some other method.

Senator JAVITS. Because it could not be handled for very long anyhow. It is only a 13-week span, so we really are dealing with a carryover proposition.

Secretary SHULTZ. Right.

Senator JAVITS. But as to the public service jobs, the administration accommodated $250 million for this fiscal year, which according to our figures is enough for 30,000 jobs. And of course, when you begin to talk about the rise in unemployment even to 5, 5½ percent, you have a much bigger area there.

Now, this morning with Senator Nelson, Senator Williams, Senator Kennedy and other Senators, I introduced a bill to give us a standby capability for 500,000 jobs, bearing in mind that under the previous public service jobs program we had 300,000 jobs in 2 years, and probably less of an emergency in regard to them than we might face now.

Secretary SHULTZ. What do you estimate the cost of that to be?

Senator JAVITS. $4 billion, expendable only as needed, and within the control of the President and the Congress.

I think it would be most unfair to ask you for an opinion on a piece of legislation we just introduced. But I do ask you as to the intentions of the administration, if you are in a position to testify respecting them in that area. I would point out that all of the safeguards which we have in the manpower act the President signed, we are putting within the framework of my new bill. But if there is some administration policy about which we could be advised, I think it would be very helpful to the country. I do not mean to, as I say, corner you on the issue of our bill or this specific figure.

Secretary SHULTZ. Well, it is the President's view that in the light of the uncertainties that are facing the economy, that we should be ready to move in various directions, both in terms of tightening down or using the Federal budget and other tools to help where help may be needed. We should have a variety of measures in mind which might be useful, and among those the President is quite ready to consider public service employment as one remedy.

I would have to add on my own behalf that I have accepted the fact that everybody seems to think this is a great idea. I think it has its limitations, and our experience is that it is very hard to make the gross additions to employment that you seem to be getting in a public service job program turn out to be anywhere the net that you get. And so I think it has some problems of management, and it also has some other types of difficulties that you and I have discussed before and do not want to belabor.

You have won and I have lost. But I am right. That is what I am saying. [Laughter.]

Senator JAVITS. In any case, the administration is thinking along those lines, and is interested in seeing what can be done.

Is that a fair statement?

Secretary SHULTZ. Yes, it is.

Senator JAVITS. Well, I thank my colleague very much. I think that is very helpful.

Now, just one last thing, Mr. Chairman. I think I have a minute or two. And that is on this terrific crunch which we face in the energy, and you have pointed out, and you should as Secretary of the Treasury, the unbelievable impact of an addition of $50 billion in this year to the adverse foreign exchange balances, both on the plus and the minus side—that is, the industrial world and the developing world lose the $50 billion, and they come into the hands of relatively very few people, Arab sheiks.

What I would like to know is, is the administration doing any thinking about what can be done in the event that people do not listen to reason and that the French go on and make bilateral deals to undermine the rest of the free world, that the Arab sheiks prove adamant to put their money in Swiss banks, which in turn, because there are no numbers in the account, infiltrate these billions throughout the world and subvert our economic systems, that they are joined by the producers of many other things—I understand the bauxite producers are meeting in Africa right now.

In other words, do we have any contingency plans, Mr. Secretary, or are we thinking about them, if this thing really gets nasty and threatens to bring the world down?

Or is our only hope that we are going to talk cooperation to our allies and sweet reason to these oil producers?

Secretary SHULTZ. I think it is important to not only talk cooperation, but act cooperation, and to maintain our sense of balance in the face of a problem that is sudden and large. The burden of my testimony was along the lines of how you maintain that sense of balance, and I do not think it is just a matter of exortation that can be seen to be in the interest of everyone to do that.

Now, I myself think that the basic prbolem, or one of the basic problems, with some of these bilateral deals, in addition to the pouring of arms into that area——

Senator JAVITS. Which is horrendous.

Secretary SHULTZ [continuing]. Is that the people making them may be making very bad deals, that is, deals at very high prices in which they are going to be stuck. The high prices tend to encourage the idea that those prices may be acceptable, which they basically are not.

But anyway, if they make deals that are bad and they are stuck with them, then that creates an imbalance that is, of course, mostly bad for the people who made the deals, bad for the individual Frenchman, but do have a spillover onto the rest of us. And so I think that they represent a real problem. I believe that the nature of the situation needs to be constantly analyzed and pointed out and thought about and gotten into the stream of discussion. It is my judgment that at these exotic prices it is not a stable situation and it would not work. And as we have seen, and as I have testified, the prices have been coming down. People's views have been shifting. And I think that it is important, and I know that perhaps we can score technical points back and forth here, but it is very important for people to start thinking about the rate of discount applied to oil in the ground and the tremendous efforts that are being spurred by these high prices to find alternative sources of energy, and the determination that many are exhibiting to develop a greater sense of independence. I think we need to translate our own Project Independence to a sort of world independence, and we need to notice that with the North Sea oil that has been found the UK and some other countries in Europe may be independent before we will. This is a gigantic oil find in the North Sea.

So I think there is a structure and response that is hard evidence, a reality that we need to bring to the front of people's minds and to get them to see the implications of it.

Senator JAVITS. Mr. Secretary, my time is up, and I am grateful to the Chair. I would just like to say affirmatively in answer to what you have said, that I think we may have to rethink international law to see whether any peoples in the world have the right to starve or freeze the others because they happen to be sitting on a particular group of resources. This may be one of the most challenging problems of the future for the next 30 years.

And, Mr. Chairman, I ask unanimous consent that a resolution adopted in the Senate bearing upon what the Secretary said yesterday on the agenda for the Washington Energy Conference may be made part of our record.

Chairman PATMAN. Without objection.

[The resolution referred to follows:]

93D CONGRESS
2D SESSION

S. RES. 279

IN THE SENATE OF THE UNITED STATES

FEBRUARY 6, 1974

Mr. JAVITS (for himself, Mr. MANSFIELD, Mr. HUGH SCOTT, Mr. ALLEN, Mr. BEALL, Mr. BIBLE, Mr. CASE, Mr. JACKSON, Mr. MATHIAS, Mr. MCGEE, Mr. PERCY, Mr. TALMADGE, Mr. BROOKE, Mr. CRANSTON, Mr. NELSON, Mr. BROCK, Mr. STAFFORD, Mr. HUMPHREY, Mr. SCHWEIKER, Mr. TAFT, Mr. DOLE, Mr. MCGOVERN, and Mr. PELL) submitted the following resolution; which was considered and agreed to

FEBRUARY 7, 1974

Reconsidered, amended, and agreed to

RESOLUTION

Expressing the sense of the Senate regarding the Washington Energy Conference.

Whereas the oil embargo by certain states in the Middle East and the enormous increase in the posted price of crude oil threaten irreparable harm to the economies of all consuming countries of the world and ultimately to the producing countries themselves, and will result in balance of payments deficits of great magnitude for virtually every oil consuming country; and

Whereas these enormous transfers threaten to destabilize the international monetary system, could lead to competitive devaluations, trade warfare harmful to all nations and a dangerous renewal of the arms race in the Middle East: and

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Whereas the increased cost of imported oil for the developing countries in 1974 is estimated at almost $10,000,000,000, more than the total amount of aid made available to these countries from all public sources in 1973; and

Whereas the Washington Energy Conference, called by the President, is designed to provide a legitimate and essential forum for the discussion of the common problems faced by the oil consuming nations: Now, therefore, be it

Resolved by the Senate, That it is the sense of the Senate that the Washington Energy Conference should consider:

(1) Conservation measures in major oil consuming countries which are necessary to reduce demand, and should be a major part of the policy adopted in concert by the oil consuming nations;

(2) Procedures for the emergency sharing of oil resources which could be acted on subject to the constitutional processes of each country;

(3) Guidelines for bilateral agreements between individual oil consuming and oil producing countries, which in the present situation of embargo and skyrocketing prices could prove very harmful to the interests of the major oil consuming nations, and could incur the danger of introducing excessive and sophisticated arms into the oil producing nations beyond their legitimate needs for their own security;

(4) Coordination of research efforts in developing conservation practices and alternative sources of energy;

(5) The responsibility for and the means to help to alleviate the plight of the developing countries in the oil crisis; and

(6) Closer coordination of fiscal and monetary policies to prevent excessive strain on the international monetary system and the currencies of oil importing countries.

SEC. 2. It is further the sense of the Senate that the United States should continue to use its best efforts to bring about conditions of peace and stability in the Middle East.

Chairman PATMAN. I want to ask you just a few questions that I do not believe will provoke too much discussion.

Do you want to make a comment?

Secretary SHULTZ. Well, I wanted to just make one comment along the line of Senator Javits' last comment. I think that as we bring to you our testimony on the trade bill in the Senate, we too feel we should focus on problems of access to supply. Most trade negotiations and preoccupation in the trade area has dealt with the problem of access to markets, and it may very well be that we should as part of any general trade negotiations have some agreements that direct themselves toward access to supply. Maybe we need a "least favored nation" concept of some kind on supply. I do not know, but we need to work at this problem more than we have.

Thank you, Mr. Chairman.

Chairman PATMAN. Mr. Shultz, in your discussion of changes in the financial system at pages 38 and 39 of the Economic Report of the President, you talk of fostering more competition among financial institutions. You go on to say this will allow interest rates to play a greater role in allocation funds. Among your recommendations, you start with phasing out interest rate ceilings.

Why do you want to phaseout interest rate ceilings, Mr. Shultz?

Secretary SHULTZ. So that people can compete for funds with each other.

Chairman PATMAN. Compete for funds?

The only time I have ever known that to come up since I have been a Member of Congress was in 1951 when we had maintained funds for 14 years at 2½ precent to keep down the cost of war, and that saved the country, of course, many millions of dollars a year. And at the end of that 14 years—Mr. Truman incidentally paid $29 million on the national debt before he went out by reason of this savings on the interest rates—the Federal Reserve Open Market Committee and the Federal Reserve Board, including the Federal Reserve Board and some of the presidents of the Federal Reserve banks got together and attempted to do just exactly what you have suggested here, phasing up interest rates.

And Mr. Truman had a confrontation with the Federal Reserve Board. He hit the roof. He called the committee together in his office in the White House. And one of the reports was that he called them names; in any case he said that this should not happen. It would, of course, absolutely cancel out all the savings that had been made during the 14 years of a low-interest rate to keep down the cost of war.

And he indicated that he was going to oppose it, and if necessary, he would get on the television and the radio, and he was going to denounce them and do it by name. They had kind of a rough session.

But instead of carrying out this threat to phase up the interest rate—I mean, the set price on the interest rates—they changed it and went back to the old rule. And so Mr. Truman won that confrontation. It is the only one a President has ever had with the Federal Reserve, and of course it was the only one that has ever been won.

Now this, of course, is quite a big problem the way I see it. Phasing out interest rate ceilings—in that case we know it would have amounted to tens of billions of dollars. And during the next 2 years that Mr. Truman was in, for the next 2 years that Mr. Truman was in office—that is, that was in 1951—interest rates did not go up 1 penny. They stayed at 2½ percent, just like they had been for the previous 14 years.

So I think that is a pretty good example of what can happen if you phase them out now.

You say too, social projects deserving priorities, such as low- and moderate-income housing, should be taken care of with subsidies instead of regulation.

Would you spell out what you have in mind by subsidies, to give us an indication what you mean by it, Mr. Shultz, in that particular regard?

Secretary SHULTZ. Well, Secretary Lynn is really the person to do this, and I know he has thought a great deal about this problem.

As a general proposition, I think—and I believe he feels—that we are better off with a welfare system that provides cash to people which they then decide how to spend, rather than a welfare system that essentially provides things to people that we think they should have. Therefore, I would favor a type of subsidy that is a kind of income approach to the problems of the poor. That is on the assumption that the reason why a person is poor is that he or she does not have money, and the way to cure it is to provide money.

Chairman PATMAN. We would not be dealing with welfare, rather than regulation of housing?

Secretary SHULTZ. When you mentioned subsidy, I took it that the concern was on the housing for the poor, and my response was to suggest that the problems of the poor exist in many areas—food, housing, medical, other types of expenditures—and they should better be thought of comprehensively.

And I believe you asked me what we had in mind in that statement. As I have said, in conversations with Secretary Lynn and others on this, this is the general line of their thinking.

Chairman PATMAN. I was quoting what was said in the report. The word "subsidy" was used there. But I did not use it, except in quoting what was said in the report, and I just wanted to know what you meant by subsidies.

So, do you know of any regulations now that are impeding housing, Mr. Shultz?

You know, we are really in bad shape on housing.

Secretary SHULTZ. Yes; I think that is right. We think there are, at the same time, some plus signs. And perhaps Secretary Volker could discuss these in terms of some of the trends and availability of funds and financial institutions and so on. We are very concerned about it. We think it is a real problem, and we think work should be done on it.

Chairman PATMAN. Certainly we would be glad to hear from Mr. Volcker.

Mr. VOLCKER. Well, as you know, Mr. Chairman, the rate of housing starts has been trending downwards recently, and rather sharply for a period of time, and I think this movement has reflected to a very considerable extent some congestion that arose in financial markets last summer and losses of funds, particularly to savings institutions that traditionally put a large volume of their money in mortgages.

I think you can make a case that this squeeze on those institutions was aggravated by interest rate ceilings that were too low at the time.

Chairman PATMAN. And by the July 5 order of the Federal Reserve Board.

Mr. VOLCKER. At that time—I guess it was July 5th—the interest rate ceilings were raised somewhat, which I think on balance——

Chairman PATMAN. I know, which made it higher for people who were buying homes.

Mr. VOLCKER. It made it possible for these institutions to compete for money in the money market.

Chairman PATMAN. By raising the rate?

Mr. VOLCKER. By raising the rate, therefore obtaining a larger share of funds for housing. But nonetheless, there was a squeeze, and we are still feeling the effects of that. But I think the most recent evidence does show some turnaround in the basic financial situation. These institutions are again——

Chairman PATMAN. May I comment on that, Mr. Volcker?

I think there is evidence that the Federal Reserve is determined to make it hard on the savings and loans operating principally under the Federal Home Loan Bank Board. They were set up by a law that was passed at the request of President Hoover. I was here at the time, and we held out great promise to the housing industry on the basis of that law.

But it has been changed around; I think it was a giant step in the direction of the Federal Reserve putting all the financial institutions out of business except the member banks of the Federal Reserve System; that is, including the mutual savings banks and the credit unions, as well as the savings and loans.

Mr. VOLCKER. I do not really think the actions were designed in that direction, Mr. Chairman, nor did they have that effect. And these steps were worked out in conjunction with the Federal Home Loan Bank Board.

The purpose in general was to permit institutions of all types, and to encourage them, to compete more effectively in the market since that time, which is shown by the fact that they have attracted additional funds and their flows are now positive instead of negative, and that is an encouraging sign for the future.

In fact, we see some signs of mortgage rates coming down and increased availability to mortgage money. Now, these things happen with a lag. But they do happen. During the summer, when things were very tight, there was enormous support given the savings and loan associations through the Home Loan Bank Board. The Home Loan Bank Board, I think more forcibly, certainly in larger volume than ever before in its history, did follow those policies which it is designed to follow to give support to this industry during a period of strain.

Chairman PATMAN. I appreciate your comments. They will be helpful. But my time has expired, and I will yield to Senator Bentsen.

Senator BENTSEN. Thank you very much, Mr. Chairman.

Secretary Shultz, you stated that there will be no recession in 1974. Of course I know we can all avoid a recession by changing the definition of a recession, and I hope we do not resort to that in this situation. But most of the forecasts I have seen are rather pessimistic. The one we saw yesterday was such. We have seen the final sales of goods and services decline in real terms in the fourth quarter. Real earnings have been declining as compared to last year. Automobile production is down.

Secretary Volcker was just talking about housing starts being down.

At what point would you try to do something to stimulate the economy? And what would you do?

Secretary SHULTZ. The President has present a budget which is more in deficit than we might otherwise like, but which, nevertheless, when enacted—if enacted—will provide a certain measure of support to the economy. The President, almost a year ago, proposed a major change in the system of unemployment compensation that would, if the Congress would even hold a hearing on it, given people some encouragement that the individuals who receive unemployment compensation would be benefited, but also as this system operates—quickly, flexibly—it would tend to give support to the economy.

There are many other measures that we could talk about that are available to help stimulate and which the President is prepared to use.

Senator BENTSEN. What type of measures would you propose?

Secretary SHULTZ. Well for example, there is always an ongoing stream of projects of one kind or another that are in some degree financed by the Federal Government. Typically, these projects are in a state where, if you wanted to, you could make them go forward on a speedier basis. And so there is that kind of thing that could be done.

We have just been talking about housing, and there are some special measures which could take place. We would hope that the Congress would act with reasonable speed on the budget so that where items are legitimately, on their merits, budgeted to increase, the authority to go ahead and spend that money is approved and it can be done.

Senator BENTSEN. Well Mr. Secretary, we would hope on the other side that if the executive branch decides it wants to do some of these thing to stimulate the economy, that they are brought to our attention, not as a reaction to crisis, but in trying to control the events and brought to us in time for us to try to do something about them and to give them adequate hearings, and to bring about the remedial legislation that is necessary.

Secretary SHULTZ. That is the spirit in which the President offered his unemployment compensation proposals, I believe last March sometime.

Senator BENTSEN. Well, the CEA tells us that the administration's budget as proposed is approximately neutral in its impact on the economy.

Would you agree that there are important aspects of the current inflation that are outside the realm of fiscal policy, and would you agree that a restrictive fiscal and monetary policy leading to higher unemployment would hardly be the way to try to hold down the price of food?

Secretary SHULTZ. I agree with that. I think that our inflation problem this past year has been, as I said in my testimony, essentially a commodity price inflation of food in the early part of the year, of energy sources and of many other kinds of raw materials—largely things traded on world markets. These gigantic price increases have been triggered by a variety of factors, including the existence of a worldwide boom.

Senator BENTSEN. Well, Mr. Secretary, it seems like more than ever before we are part of the world community.

Is it possible that perhaps we should be looking to some new approaches that have not been used in the past by this country, that some of the old programs just have not worked as far as controlling inflation?

What is your reaction to the monetary correction, the inflation factor that is used to adjust wages and even fix securities?

It has been done in Brazil.

What has been your reaction to that?

Secretary SCHULTZ. Are you speaking, for example, of cost of living escalators and collective bargaining contracts and things of that kind?

Senator BENTSEN. That is right.

Secretary SCHULTZ. Well I think that——

Senator BENTSEN. Well, in Brazil, of course, they have applied it in a much broader spectrum. They have even gone to fixed secuities and applied it there.

Secretary SHULTZ. Yes, I realize that. And it is something to think about. They have had real success with it.

In my own mind it is a subject to study very carefully—and not jump at—because it seems to me that it implies a set of expectations that may weaken your determination to fight inflation as hard as you perhaps otherwise would, although I would have to agree that the Brazilians have had great success with what they have done, and it deserves careful examination.

Senator BENTSEN. It seems to me that tight money as a means of controlling inflation really has been pretty well discredited in what we have seen this far. And I think to really just keep on killing off the housing industry every 2 or 3 years for little relative impact on prices just has not been worth the price that has been paid.

I would like your thoughts on that.

Secretary SHULTZ. I would not say that we have had especially tight money in the past 2 years, depending upon your definition. But I would describe tight money as reflecting what is happening in the money supply. Interest rates have gone up. Demand has been extraordinary. That is what has driven up the interest rates.

Senator BENTSEN. I note there was not a request in this instance for a budget ceiling.

Would you care to comment on that?

Secretary SHULTZ. Well, I think as the year goes along you might want to consider a budget ceiling and work within it. The reason why it was not included this year, whereas in past years it has been, is simply that the economic outlook has large elements of uncertainty in it. To say that we now think there should be a ceiling of X, whatever it is, but we also feel that there is a lot of uncertainty, would seem to be a contradiction in terms. So the President's stance is more like, "Here is what we think is the right position as of now. We recognize uncertainties. We will continue to observe them, and if we have changes to recommend we will be ready to recommend them."

Senator BENTSEN. Mr. Stein said yesterday that the key economic issue is not how we will get through 1974, but how we shall get through the next generation. And I am concerned about 1974, but I share Mr. Stein's concern and believe that we better be more concerned with the long term direction of the American economy. And it seems that in this action we have reacted to crises rather than controlling events when we were talking about the energy problem.

Yet, I can see another one that will be facing us and is beginning to come on, and that is the problem of raising capital, long-term capital for the growth of this country, and the competition we are going to have with other nations. When I read about U.S. Steel and the rest of the steel industry saying they are going to have to give up part of their markets to the Japanese and to the Europeans because they cannot raise the capital, this is of great concern to me.

What are we going to be doing about capital formation?

What is Treasury doing in trying to assist in that regard?

Secretary SHULTZ. Well, we think that the basic ingredient in raising capital is to have the situation such that that capital can earn a good rate of return. The basic problem in the steel industry is that its rate of return has not been adequate. A basic problem in domestic oil exploration is that its rate of return, until the kind of prices that we now see, has not been as good as it might have been. And so on.

And so, I think, along with Mr. Stein—I do not know whether you share his view on this or not—the sooner and the more firmly we can embrace the principles of a market system and an enterprise system and turn away from the notion that we can control this economy from Washington and tell everybody what prices and rates of return and everything they should have, the better off we will be.

Senator BENTSEN. Well, Mr. Secretary, when I look at a situation where McDonald Hamburger has a book value that is a fraction of its market value, and its market value today is well over a billion dollars, and then I look at U.S. Steel, with a market value far below its book value, and I see this country short on steel and long on hamburgers.

Secretary SHULTZ. Is it really long on hamburgers?

Senator BENTSEN. Long on hamburger stands. We find that it can raise capital to build hamburger stands, but are having a difficult time raising capital to build steel plants. This gives me a great deal of concern for the productive capacity and the future of this country. When they tell me that we have become over 50 percent a service-oriented society, I just do not believe that we can continue to build this country taking in other people's washing. We have to continue to encourage the building of our manufacturing capabilities for our export trade and for serving the interest of our domestic economy as well.

And I again say that I am deeply concerned over the capital formation and availability of capital for the long-term growth, and I do not see the statement made as the resolution of the problem.

Secretary SHULTZ. I agree with you. I think it is a central problem, and I have touched on some aspects of it that we have to work on and what my beliefs in that area are.

I think in the field of tax policy, we need to maintain the incentives there and be careful that we do not unduly disrupt. My own feeling is that it was a mistake to abandon the investment tax credit, for instance, in 1969, and we did ourselves a good turn by putting it back in. On the whole, the tax laws, as they affect the cost of capital, are a very insensitive part of this problem.

I believe also—and I share, I think, your view in this—that the nature of our capital markets, particularly our equity markets, is a matter of great importance to us. I know you have been working on that, and we felt that we should inform ourselves better than we had been on that subject, and that is also an important part of the total picture.

Senator BENTSEN. Thank you, Mr. Secretary. My time is up.

Chairman PATMAN. Senator Proxmire.

Senator PROXMIRE. Three or four times this morning, Mr. Secretary, you have indicated that if Congress would only get off its lazy behind and get behind on the unemployment compensation program that the President has sent up we would have a better, healthier situation with respect to combating recession.

Secretary SHULTZ. Right.

Senator PROXMIRE. Well, I wonder about that, because what did the President send up?

He sent up an unemployment program which, according to the budget, would not have any effect until 1977. It would not have its real bite until 1979. He has never sent subsequent material up that would give us any indication that it would have any bite possibly in 1974 or 1975 or 1976.

Secretary SHULTZ. Even if the regulations providing for Federal standards for benefit levels were enacted, if they had been enacted last year, of course, you have to provide time for the States to conform with the legislation, and the State legislatures meet sometimes every other year. I guess most meet every year now. But I think that with the incentive of that Federal standard, they could all know what is going to have to be adhered to by everybody, so that the competitive nature of this among the States would have been taken out of the picture. And with the importance that everyone sees in the problem now, we would see State actions coming along very rapidly, just as we did with the last reform of the unemployment insurance systems, when the States followed once the Federal Government had led the way.

Senator PROXMIRE. But Mr. Shultz, in order to provide unemployment compensation that would help in any oncoming recession this year, it seems we have to have funds that would take up the slack until the States could act. As you know, States usually meet in the odd numbered years. We have to wait until 1975 when they act, in order for that to be effective. I suppose that is not until 1977 that you have it in your budget.

At any rate, this seems to me to be a pretty weak antirecession program, if that is what you keep coming back to.

Secretary SHULTZ. It is not the whole program. As I have said many times, it is a piece. It is a piece that, having long been a student of unemployment insurance. I feel particularly strong about, and was especially disappointed when the President made his very forthcoming recommendations and very controversial one from the standpoint of many, when it was ignored totally, absolutely ignored by the Congress.

Senator PROXMIRE. Well now, let me get back quickly to what you were discussing in the main thrust of your statement. I have gone over it once again. I read it last night and I reread it, and as I said, it has excellent substance to it. But it seems to indicate that if there is anything we can expect this year it is that the effect of the world economy on our own economy is very, very uncertain and hard to predict. We know that last year perhaps the most important element in our inflation was the impact of the world economy in all kinds of ways—food, energy, and so forth.

But we do not know what the effect is going to be now. You break your speech down into several components, and in each of these areas it seems to me that the action in the world is likely to be very unpredictable. Energy cooperation—very doubtful that we can get that. Monetary and trade reform—I would say it is doubtful that we can get that. We hope we can get it. Economic development—once again, doubtful. Resisting a temptation to seek economic salvation at the expense of trading partners, a beggar-thy-neighbor policy—maybe nations will resist that. We hope so, but it is certainly very doubtful that they will.

Now, under these circumstances, should not the administration, should not this Government of ours have some kind of standby program available to combat a highly inflationary effect or a depressing effect on our economy?

What I am thinking of, for example, is an effective early warning system with respect to food. We exported far too much feed grain last year, including the sale to the Soviet Union. If we had an effective, comprehensive, early warning system, it seems to me we could help avoid that. Perhaps licensing exports, and thereby having a capacity to move rapidly to stop inflationary exports, conditional sales contracts with a timing factor indicated so that we could slow down deliveries in the event that we found that that delivery would have a serious effect on inflation in this country.

How about that kind of a program?

It follows logically, it seems to me, from your presentation.

Secretary SHULTZ. Well, it is a rather disturbing picture that you put in front of us. It seems to me what your statement suggests is that we want to be a good citizen of the world, but if we find that others do not come along the way we would like we should say to hell with it and retreat and stop trying to do the constructive things.

Senator PROXMIRE. Mr. Shultz, I am not saying that at all. I am just saying, we ought to know what effect our cooperation, our participation, our exports are going to have. We might then decide whether we can pay the price or not. But we ought to know it.

I am convinced that if we had known what effect the Russian wheat sale had, if we had known what effect our other very large exports of feed grain to Europe and Japan and so forth would have, we could have adopted another policy that probably in the long run would have been wiser for us and would not have had a devastating effect elsewhere in the world.

Secretary SHULTZ. Well, in the proposal that we made to you Wednesday in the Senate Banking Committee for a Cost of Living Council with a list of duties, one of the duties that we listed there was to consider the question of a better monitoring and information system on exports and imports. We recognize the importance of this problem. We also recognize, having worked on it——

Senator PROXMIRE. What do you mean, consider?

Everybody knows we need a better system.

Secretary SHULTZ. Well, you find yourself with great repercussions as soon as you start to move substantively and strongly into the area of export controls, and as soon as you start licensing and as soon as you start collecting information you find that people react to that. They do not just give you information on what they had planned to do. They react. Their behavior is affected by what the Government does. And the tendency is for everybody to hedge themselves by suggesting that they are going to export more than they probably are.

Senator PROXMIRE. Well, I could not agree with you more. But, that we should recognize our responsibility as a world citizen and a leading world citizen, certainly the leading citizen in the free world in terms of power, in terms of influence, and so forth.

But I just cannot understand why we should not get this information so we know precisely what we are doing. We can move either way on that kind of a basis. But we should know it. We are dealing now with countries which are not all entirely poor and developing. We are dealing with a number of countries that are very affluent, two or three of which have a higher per capita income than we have in this country. You have West Germany and Sweden. So it is a different kind of a world than 20 years ago.

Secretary SHULTZ. We think it would be nice to have valid neutral information, neutral in the sense that it does not cause things by itself that are undesirable. And so we want to figure out, if we can, how to get that. It is not obvious. It is not an easy problem, because of the fact that it does cause people to change their behavior.

Now, I think that your statement implies that if we had known everything we now know, we would have put some form of export controls on our agricultural products. I would question that.

First, I think you have to consider, as I understand it, that there is great substitutability among the agricultural products. We put controls on soybeans. We found that the minute we did it, we had to put—I forgot how many—controls on some 20 other commodities. If export controls were put on wheat, I think we would have to, frankly, go across the board.

Senator PROXMIRE. Well, supposing——

Secretary SHULTZ. Well, what we would have would be a broad program. Now, as soon as you say that, what have you said about the other kind of problem we were talking about?

We have been complaining about the problem of access to oil. Well, I think we can take some pride in the world that our markets are open. We have provided access to supply. We have said, we will compete on price with others that want to buy in our market, and we have kept it open. And I think it is a very good thing to do.

Now, I do not think that there are never any circumstances when you should use export controls, and we have export controls right now on scrap steel. But it is a matter to be gotten into with great care.

Senator PROXMIRE. Well, Mr. Shultz, the problem I have with the philosophy that you are giving us now is that it seems to me that the Government could just not seem to act anywhere, but with respect to inflation, domestic inflation, Arthur Burns proposed a very modest way of trying to restrain, at least temporarily, while we look at price increases with no mandatory effect, to much, with respect to the terrific inflationary impact——

Secretary SHULTZ. I do not see why you just keep saying something that is not true. We did make a proposal to you last Wednesday.

Senator PROXMIRE. That would not hold prices at all.

Secretary SHULTZ. That would provide for hearings and so on, as you have just suggested.

Senator PROXMIRE. But they would not hold up price increases.

Secretary SHULTZ. That we can discuss and argue about. I think it is an arguable point.

Senator PROXMIRE. And again, with respect to what was a devastating impact on inflation last year, the world economy with our enormous exports, you would argue against export controls, sir. There is a respectable argument in that direction. But you would also go so far as to say we should not really find out what impact——

Secretary SHULTZ. I did not say that. I said that it is difficult to find out, and we did make the proposal to you that we should consider ways of doing it. It is not an easy thing to do. You trigger off behavior changes. You receive information. The information seems to suggest certain things to you. You find out that the information is not correct. And in the stampede for action, action, do something, you find yourself doing the wrong thing.

Senator PROXMIRE. Well, I am just arguing that a person who is informed, even if sometimes information is not completely accurate or comprehensive, is in a much better position to know whether to act or not to act, than if he is not.

Secretary SHULTZ. If he has misleading information, he is not better off.

Senator PROXMIRE. My time is up.

Chairman PATMAN. Congressman Conable.

Representative CONABLE. Thank you, Mr. Chairman. Mr. Secretary, I am a little bit concerned about the trade situation. We have, of course, pending legislation in the Senate now. We have the basic authority we need from the House bill. But we are going to have to move quite quickly with this. I expect we will find some restlessness on the part of our major trading partners because they want to be sure that we are serious about trade negotiations. It seems to me that we have the environment for a possible trade war with all the disruptions of the energy shortage pressing on us. Some of our major trading partners—Japan is an example—are very likely to have a severe economic impact from the increased cost of oil. Certainly, those that are going it alone and making their bilateral deals on oil are fixing a price that is high enough so that they are likely to have considerably greater upthrust in the cost of their production than we are with our good fortune of having substantial domestic production.

And so the economic effect is going to be rather severe in some of these countries, with probably considerable poorer economic performance than we have ourselves. I think sometimes the American people forget this, with our concentration on our own troubles.

But I am concerned about the possibility that economic stagnation abroad may result in, first of all, policies of economic nationalism with respect to imports into those countries so troubled, and then also a very vigorous and aggressive export program. If they were having a lot of domestic prosperity, they would not perhaps have to push their exports as much as they may in the kind of economic environment we will have.

Does this not all add up to the fact that we better get on with negotiations pretty quickly, and not dally in the way to trying to achieve adequate trade legislation?

Secretary SHULTZ. Yes, I agree with that completely. And as I said, I am encouraged by the fact that the meeting yesterday in Geneva, from all reports I have heard, as an opening meeting was very good and cooperative. I think people do see the problem, and everyone is conscious of the importance of not having a situation deteriorate. And that, I think, gives us some hope that it will not.

Representative CONABLE. Well, am I not correct that we are likely to see a major export program on the part of these nations that are having severe economic problems as a result of the energy shortage?

Secretary SHULTZ. There is always that temptation, to try to solve your own problem on trade account. However, anyone who can add can see that for the industrial world as a whole it is impossible by definition. That is, if you stipulate, as I think you must, that large reserves are going to pile up in a few countries that are major oil exporters but not importers, and the trade accounts are not in balance and what must eventually balance payments is investment funds. And I think a major problem is that the emergence of these reserves has come about so rapidly and in such size that there is a great deal of uncertainty about where those investment flows will go and how. And therefore people are uncertain about how this balance is actually going to be struck. And that poses difficulties.

Representative CONABLE. We have had kind of a de facto devaluation on the part of the French recently in their float.

Are we likely to see a lot of devaluation of other currencies in response to sharply increasing domestic inflation in those countries, which is itself a response to the increased cost of energy?

Secretary SHULTZ. Well, first on the French float. I do not think we are really in a position to complain very much about it, because all through these discussions of monetary reform we have argued that in any system a country should have the option to float, and the French by and large have argued against us. And so they exercised an option to float, and at the same time we have operated within a framework of an agreement to maintain orderly markets. And they and we did work together with other countries to do that. And the tendency for the French franc to move way off stopped, and it has come back, and there has been a more or less stable situation for the last few days or so in exchange markets.

So I do not see that the situation now is falling apart. Quite the reverse. Everyone has made the kind of statements that we have made around here so much to each other that we are all getting more and more aware of the problem. And maybe in that context, we can solve it.

Representative CONABLE. And that, of course, is the spirit of the meeting of the oil consuming nations next week?

You do not really expect a lot of concrete action there, do you, so much as an exploration of the common problem that we all share, and some development, perhaps, of a cooperative approach in trying to deal with it without specifics?

Secretary SHULTZ. Well, I think that there are areas that we can try to be specific about, such as getting a much better fix on the likely consumption patterns at different levels and other things.

I wanted to say that we took a step earlier this week that I think is a mark of good faith in the problem of competitive devaluation and so on. We raised the interest rate on Eximbank loans from 6 to 7 percent, and we did that with some, I hope, warranted confidence that others will also do that, so that we do not have a kind of competitive interest rate. And I think that is a step that we have taken. It is not a major thing, but it is important, and others, I hope, will follow along.

Representative CONABLE. Mr. Secretary, I have before me a Library of Congress Congressional Research Service summary of the rise in the price of crude oil on the world economy. And admittedly, we are dealing with some figures here which you would not want to express an opinion about. But I wonder if you would agree with these three basic conclusions generally about the impact of the price increase on the economic problems of the world?

First of all, they study says that inflation already is a serious problem, and will be given a further stimulus, a whopping 3 percentage points will be added to the rate of price increases in consumer countries generally in 1974.

Second, it says that domestic demand, hence output, employment, and real income, might be reduced significantly in 1974 by some 2 percentage points more in the consumer countries generally than otherwise might have been the case. And of course, there is lots of room for argument about what figures you are talking about there.

And the third conclusion the study comes to is that acute balance-of-payment problems will face most countries, notably nonoil producing, less developed countries, but also Japan, the United Kingdom, and Italy, in 1974.

Are those conclusions generally correct?

I am not asking you to agree with the figures involved, but would that be a summary of the probable impact of the higher oil prices on the world economy?

Secretary SHULTZ. Well, I think the directions of change are clear, and what the magnitudes will be is harder to estimate. But the directions are, I think, as you suggested.

Representative CONABLE. So that in all three of these areas—inflation, domestic demand, and acute balance-of-payment problems—we can see very specific aggravation of the world economy, and that it is going to have an impact generally, not just in this country, but in the world as a whole?

Secretary SHULTZ. Right.

Representative CONABLE. Thank you, Mr. Secretary.

Chairman PATMAN. All right, Senator Humphrey.

Senator HUMPHREY. Thank you, Mr. Chairman.

Mr. Secretary, just to get down to the very contemporary question which may not have been dealt with thus far, a headline matter every day is the independent truckers and what is going on in our field of transportation. Yesterday we were told that it appeared there was a settlement. Today's news is somewhat uncertain as to that settlement. By the very nature of the independent truckers themselves they are not closely organized.

What is the outlook as you see it for a settlement?

And let me give you the other side of the question in case there is not one.

What do you think the impact will be on the economy?

Secretary SHULTZ. Well, I think that the legitimate concerns that have been expressed by Mr. Fitzsimmons and the Teamsters Union, the trucking companies, and by the independents have been recognized, and everything that we can do is being done to meet them. And the Congress has reacted very quickly to the need for a resolution that allows the ICC to act on a shorter time schedule on rate increases, and so on. And so I think that things that legitimately should be done are being done, and under those circumstances it seems to me we have a good reason to expect that people will go ahead and perform and drive their trucks.

Now, as you pointed out, it is hard to deal with a situation where you have many different groups and nobody speaks for anybody, except certain segments. But I think the method of doing it is to try to see across the board in the industry and recognize what are the legitimate grievances being expressed here—and usually people do not erupt unless there are some legitimate grievances. You have got to take that seriously, and find them, deal with them, and do it cooperatively, as I think somehow between the Congress and the executive we seem to have managed to do.

Now, I would say one further thing. When it comes to a situation where you seem to have some and the threat of more physical violence and efforts along those lines to prevent people from doing things that they want to do, then I think we have a law and order problem, and we must meet it, always with great firmness.

Senator HUMPHREY. Why has not the President called these people into the White House to talk to them directly, rather than leaving this to his surrogates and his subordinates?

Secretary SHULTZ. Well, they have been met with, and I think that on the whole they have been worked with in a good way, and I do not know that it is always the best thing to call people into the White House.

As a general proposition in labor disputes in the Nixon administration—and I have had some hand in this myself—we have tried to keep dispute settlement problems at the level of the professional mediators and not escalate everything. And I think on the whole that has worked out. We have a good tone in collective bargaining last year and this year. We have a much improved situation, for example, in the railroads. And I think on the whole that is a good principle to try to settle things lower down than that, and with the professional mediators. And it also helps the professional mediators to do their job, rather than just be viewed as way stations on the way to the oval office.

Senator HUMPHREY. Well, I tend to agree that that is an overall sound basic formula. But there are times that executives have to act otherwise. I have not had much chance to be an executive, except as a mayor of a city. But I know that when there was a strike in my city that got out of hand there was no time to have the clerks handle it. There was a time when the mayor had to step in, and there is a time that a governor has to step in, and there is a time that a President has to step in. And particularly, when you get a combination here where you have problems of violence, you have legitimate grievances that were being listened to by a host of people who could do very little about it.

Now I grant you this past weekend, with Mr. Simon particularly taking a hand, that considerable effort was made, and I happen to think Mr. Simon is trying to do a good job. I have worked very closely with him.

By the way, I have had a man in the field in my State and have had a daily report as to what is happening in the State of Minnesota. And the independent truckers strike is no matter to be left to somebody that is working on a formula. We have got to have the trucks and we have got to have them moving. We move poultry and we move eggs. We move grain and we move things to market that are absolutely essential, not only for our State but for the Nation.

And if this proposed settlement does not click, I do not think that we ought to be going on the basis of textbook analysis and formulae. If the President of the United States can take time to meet some head of state, can take time to meet somebody that has become a dairy queen or the azalea queen, he can take time to meet with people who are in charge, or supposedly have something to say about these things.

The reason I am saying this now is because I felt this so strongly, and somewhere somehow it has got to be said. You just cannot ignore it. You cannot leave these matters just drifting off with Governor Shapp—as great and fine as he is in Pennsylvania—and Bill Simon—as good as he is as the energy czar, and some mediators, when in fact we know that the settlement is not, has not been readily seized upon. And if it is not, I think we have a right to know what the impact would be upon the Nation.

What about the possibility of rollback, for example?

That happens to be one of the No. 1 points that the truckers want, the rollback in diesel oil prices. They not only want the right to pass through.

Why it took so long for them to get around to have the same rights that other people have anyway—that is, namely, that if your costs go up you have a right to pass through on rates—is beyond me.

Secretary SHULTZ. Well, I can explain that to you.

Senator HUMPHREY. The ICC.

Secretary SHULTZ. Right.

Senator HUMPHREY. Yes, I have had a lot of feelings about the ICC over the years. Whether we ought to be able to make a quantum jump around them occasionally——

Secretary SHULTZ. Well in this case, apparently they had a statute to contend with that inserted a time period between when they got an application and when they could act. And we have a situation which has arisen because of higher fuel prices, and we have been talking here all morning about these world prices of crude and what has happened to them. And if you want the oil you are going to pay.

We hope the prices are coming down, and they seem to be. But you are going to pay what the other people will pay, and those prices are going to get reflected through. There is not any way to dodge that. You might as well be realistic.

Senator HUMPHREY. I want to be realistic.

Secretary SHULTZ. And then when that happens, it happens suddenly and with a very significant amount. You have got to have some way of dealing with the passthrough problem quickly, and the ICC and the statute setting aside that situation made for great difficulty.

Senator HUMPHREY. And all they had to do was come on up and say, we had an emergency and we want to do something about it, instead of sitting there picking their nose.

Secretary SHULTZ. And that was done. Action was taken by the Cost of Living Council. We do have a volatile pricing rule. In other words, there are ways of dealing with this kind of problem.

Senator HUMPHREY. Well, my point is that while it was constantly being talked about in the press and the media as an emergency, it was not being dealt with on that basis. That is my point.

Secretary SHULTZ. If I could just say one word on the personality side——

Senator HUMPHREY. I say I do not think it has been settled yet. I have to be very frank with you.

Secretary SHULTZ. It may not be, and at the same time it is not necessarily the case because people have further demands that those demands should be acceded to.

Senator HUMPHREY. That is correct.

Secretary SHULTZ. And we cannot just get into this peace-at-any-price frame of mind.

Senator HUMPHREY. That is why I think that the man at the top has sometimes got to call them in the room and look them right dead in the eye and tell them what the facts of life are, and not have somebody that is in the outside office. I have never found that to work in anything, never have yet. Whenever there in my political life, when responsibility has been centered upon a particular individual I have generally found that when it got right down to where it was tough, where you had to bite the bullet, that the juniors and the assistants and the associates were not the ones that could do it, because the other side knew that there was still a higher place to go.

Secretary SHULTZ. I do not know what textbook you were referring to earlier, but I think, leaving textbooks aside, there are arguments to be made about where and when is the appropriate level to try to handle something. And I would just like to put in a plug here for my fond friend Bill Usery who stayed up night after night after night trying to work this out as the mediator. And I think if there is any hero in this from our side of it, he is the hero.

Senator HUMPHREY. I think that is true.

Secretary SHULTZ. He has done a marvelous job of working with people and trying to bring about an understanding.

Senator HUMPHREY. I give him full praise and compliment. He is a remarkably good man. But there comes a time that even men in that capacity need further support, and I think that time has come. And I do not think this time is going to be settled without it.

Secretary SHULTZ. Well, I hope you are wrong, and I hope your statement does not get passed around as a further invitation to these innumerable groups. There are just dozens and dozens of them. I do not know whom you meet with. That is one of the problems. So we do not want to encourage any little group of 50 people to think, well, we are not going to settle this until I meet with the President of the United States. That is not a good way to do it.

Senator HUMPHREY. I agree with that, and my statement is not designed to do that. It is designed to let people know that there is such a thing as law, that laws are adjustable, that there is such a thing as equity, and that the Congress and the administration is capable of giving it.

Quite frankly, the enforcement of these prices on fuel across the country has not been good. There has been gouging. There has been black marketing. And I know we do not like to build a big bureaucracy, and I know the IRS has been trying to do a good job. It is fine to try to do a good job. It is good to put a battalion of soldiers up against three divisions and give them all kinds of medals after they are dead and say they did a good job, but they were rolled over.

The simple fact is that there has not been good price enforcement on the matter of fuel oil across the country. And you do not have to be very smart to know it, and Mr. Secretary, I respect you highly. This is not personal at all. You are one of my favorites in this Government. But all anybody has got to do is get in his car and go across the country. You can see it all over the whole place.

There is one gimmick going on after another. There has been more; actually, we have trained more people on how to skim the law in the last 6 months or 3 months on this oil and gas thing than almost any other time I can think of. In order to get gas you have got to get your car washed. In order to get gas you have to go and get yourself some new sparkplugs. And you have got a price of diesel fuel here in one town up here and another price over here.

And everybody knows it, and it just seems to me that somewhere along the line somebody has got to say this is going to stop and we are going to make whatever changes are necessary in terms of fair play for the passthrough. If there is a rollback we will try to have a rollback, and if we make a rollback we will enforce it. And if they do not roll back we will penalize them and do whatever is necessary. And I do not think that has been done.

I just wanted to get it off my chest. I do not think it has been done. I know it has not been done in my State. I have a man in the field every day. I have had long reports every day. It is just not being done. And we are beginning to experience violence out in my home State, and we are not accustomed to that sort of thing in our area, in the rural areas of our State where these independent truckers are working. Something has got to be done about it.

Secretary SHULTZ. Senator, if I may, I would like to compliment you on, I thought, a very compelling description of why it is almost impossible to make price controls work under conditions where you have great shortages. And remember, when we talk about enforcement, as far as I understand it, we have something like 216,000 gasoline stations in this country. So that is quite a policing job, and it makes you think maybe that is not the way to do it. The system we have relied upon prior to this great binge that we have been on in the area of controlling everything, maybe, is better, because it has built into it a method for handling large numbers of dispersed units of sales.

Senator HUMPHREY. Well, it is not easy, and I know that. I just want to say, Mr. Secretary, that when I drive to work in the morning—I just live a little ways from here, and sometimes I do not drive. I even pick up a ride—but I have seen more cars lined up to get into a Sunoco station than I thought they had even built. And there is something screwy that is happening here.

How did all this gas disappear?

It is unbelievable.

Secretary SHULTZ. I agree with you. You see these lines everywhere, and I think the move that was made the other day seems to me to be constructive, because the surveys show that a very high proportion, apparently, of the people who were lined up there are topping off their tank. They do not have that much gas that they want to buy, but they are lining up. And so the notion that you ought to have some amount that you have to buy at least, I think should be helpful in that regard.

But is a very great aggravation and difficulty.

Senator HUMPHREY. My time is up, but I would like to come back again.

Chairman PATMAN. Senator Proxmire.

Senator PROXMIRE. Mr. Shultz, maybe I am wrong. You did not answer Senator Humphrey's question as to what effect this truckers strike is going to have on the economy when it continues. I think that is enormously important, so we will have a better idea of how necessary it is for us to take some kind of Federal action.

There is speculation that people will actually be in serious hunger, that the stores are not going to have the produce that we need to keep ourselves functioning.

Secretary SHULTZ. It is obvious that if all of the independent truckers stop driving and the situation gets constricted by various moves that people want to make to get the teamsters to stop driving all around the country, that it is a national disaster, and we cannot have it.

You do not have to start making calculations or anything. All you have to do is state that to make it clear.

Senator PROXMIRE. It has already begun to have an adverse effect.

Secretary SHULTZ. It has begun to go in the other direction. I just hope that the kind of noises that people will make around Washington can help it go in the other direction, instead of the reverse.

Senator PROXMIRE. Well, I think we all agree with your and Senator Humphrey's statement that violence never has a place. It is completely counterproductive.

Secretary SHULTZ. I share that with Senator Humphrey completely.

Senator PROXMIRE. Mr. Shultz, I hate to bring this up because I seem to be clashing with you so much this morning, and I join with Senator Humphrey. I have admiration for you.

Secretary SHULTZ. I always feel like a pincushion when I get through with this Joint Economic Committee. I never know what you are going to ask. If you testify before a substantive committee, you know, here is the subject matter. But this is sort of——

Senator PROXMIRE. Well, that is right. You are Secretary of the Treasury, and you have a great deal of responsibility for the budget. What concerns me—and I want to hit it directly now—is the size of this budget. Here we have you in the administration, came into office on a reduce and hold down Government spending program, to a considerable extent. Your philosophy is congenial with that position.

Secretary SHULTZ. Right.

Senator PROXMIRE. And yet you have an enormous increase, you have an increase from $274 billion to $304 billion. It is a big percentage increase, the biggest dollar increase in our history by quite a bit in peacetime, and apparently, way down at the bottom on your list is to reduce taxes.

Now, it seems to me you can put in a budget ceiling and you can combat recession by relying on a tax cut to stimulate the economy if you feel that the budget is getting too big. Let me point out that in the last 14 years the budget has increased from less than $100 billion to more than $300 billion. It has gone to a significantly higher proportion of the gross national product in the last 14 years. It has gone to a higher proportion of the gross national product than it was at the peak of the war.

Furthermore, what is even more insidious is the fact that we have a combination of an increase in Federal, State and local spending that is even more appalling, an increase since 1961 from about 29 percent of the GNP to about 36 percent of the GNP.

Now, this is completely contradictory to your position and the position the President has always taken in the past.

Is there no limit to this kind of thing?

And then on top of this, let me say that you are proposing two programs that have great appeal and will probably go through with big majorities. But they are going to be fantastically expensive.

The National Health Insurance program—the New York Times said this morning that the cost of the Kennedy and Nixon programs are about the same, about $70 or $80 billion when they get going full tilt.

And then a guaranteed annual income, and heaven knows what the cost of that will be. With every election year we will increase that one, without question. There does not seem to be any end in sight.

So I would like to ask you to take just a minute or two to give your response to what seems to be a contradiction. If you were John Kenneth Galbraith or Leon Keyserling, I might understand this. But as George Shultz from the Friedman school of economic restraint and the University of Chicago, it is very hard to understand.

Secretary SHULTZ. Well, I can only respond, Senator, that I wish people like you and I had more influence around here. [Laughter.]

But the fact of the matter is that we do not, and spending goes on. And that is a fact of life. I have observed that. And since it is a fact of life, the idea of just cutting taxes way down all of a sudden—when it seems to be the disposition or the political will, so to speak, to spend more and more just gets us into a terrible trap.

It needs to be pointed out, you see, why we have such a big increase this year. Well, for openers, something like $23 billion is just foreordained. There is nothing you nor Senator Humphrey, nor Chairman Patman, nor Congressman Conable, nor anybody else can do about it. It comes about through massive increases every year in payments on Social Security, and it seems as though——

Senator PROXMIRE. Well, you have these programs that are not mandated and you can reduce other programs. You can reduce the space program.

Secretary SHULTZ. Well, let us go. I am with you.

Senator PROXMIRE. I think you can reduce the military program and still have the strongest military force in the world. But that is a matter of debate and discussion.

Secretary SHULTZ. It sure is.

Senator PROXMIRE. I think we can cut back some of our public works programs. I think the highway program is another program that we are going to pave every square inch of our country before we are through with concrete.

Secretary SHULTZ. Well, we tried to do that last year. We thought that, well, here is a situation—every 8 years, assuming Presidents get reelected every 8 years, right after reelection and before there is another election too close—maybe there is a change, if you get a President that has got the guts to say, "No, we are not going to spend that money. We are going to cut out these crummy programs."

And that is what he did. And look what we got. We have just impounded et cetera.

What this is all about is not impoundment. It is about the lecture that you gave me. It is about the desire of people to have bigger Government, and somebody took a strong, tough stand that looked like it might succeed to get the reverse, and that has brought a reaction.

Senator PROXMIRE. Well, the President has a different kind of big Government that he wants. He disagrees with the Congress. He does not want the big domestic programs. He wants the big military programs. He wants a big space program.

Secretary SHULTZ. No, no, no. That does not hold up.

Senator PROXMIRE. Sure.

Secretary SHULTZ. The size of the military budget in relation to other budgets has dropped precipitously during the President's term. And I must say, not being an expert in this area at all, but nevertheless, seeing some of the foreign affairs side, that I am for spending what we need to spend on national defense, and I wonder if we are spending enough, particularly in the R. & D. area and in some of the areas of procurement. So much of that budget is going into retirement pay and personnel cost and so on, which just chew up that defense budget.

Senator PROXMIRE. There is no question about that. But there are lots of areas, you know, that we could discuss that I think we could cut back.

Let me get into something else quickly, because the hour is getting late and I know the other members would also like to follow up.

You spoke—and I think very appealingly—of the devastating effect the oil shortage is having and is going to have on developing countries. It is just an effect in which you are likely to have starvation, especially the secondary effect of lack of fertilizer and so forth.

Is the administration considering the sharing of U.S. energy resources? And I realize that would be enormously difficult to do politically.

But is there any consideration of that, either our domestically produced oil and coal, or oil that would otherwise be imported into the United States, with some of these developing countries? Is there any possibility of that?

Secretary SHULTZ. Well, if you say that you think that the consuming countries ought to be willing to cooperate with each other and have that mean something other than words, then the subject of sharing in an emergency comes up. And we think it is a topic we should be willing to discuss.

Now, as far as the developing countries are concerned, by definition they have very little to share. That is the problem. The non-oil-producing ones. And I believe that as a general proposition, the efforts that have been made, project by project, through our own AID programs, through the World Bank, through the Inter-American Bank, the Asian Bank, perhaps through the African Bank if that ever comes to pass as Senator Humphrey has proposed, have been basically good and moving in the right direction.

But we have a very difficult situation, and it may be that the most useful and perhaps dramatic thing we can do—of course, it depends on our own supplies—is to have something to say about food, and not how we are going to restrict our exports of it, but how we are going to try to help other people with it.

Senator PROXMIRE. You see, I have the same feeling that was expressed earlier, that somehow there is a lack of vigorous, forceful economic leadership here in Washington. You get it when Gov. Milton Shapp has to take over as the principal negotiator in the interstate truck strike. You get it when there does not seem to be any forceful, effective anti-inflation program, or any clear, specific antirecession program, for that matter.

Secretary SHULTZ. Do you want me to argue back every time?

We have gone through this, I do not know how many times. This is about the 10th round here.

Senator PROXMIRE. You see, the problem is that the people in this country are entitled to some kind of a determined effort to solve our problems. But the administration's attitude is to just let things go. If the Congress wants to move ahead with an inflationary spending program, the administration won't fight it. We fought it before; we will let it go this time. We cannot do much about the international effect on prices. We cannot do much about recession. We cannot do much about this truck strike. Let other people handle it.

Secretary SHULTZ. I really do resent the idea of coming up here year after year and being subjected to that kind of talk. And you know as well as I do that we are working very hard. We have many things we are trying to do. They are basically constructive. They are not even controversial on the whole, and everybody agrees on them. And to turn everything around and try to make it into as though we are not doing anything, and everything is going to pot and we do not care and so on, is just a gross misrepresentation, and I am tired of it, frankly.

Senator PROXMIRE. So am I. My time is up.

Chairman PATMAN. Well, on my reservation of time, I would like to ask you two or three questions. That is all I care to ask.

Mr. Shultz, the Federal budget includes $29 billion for interest on the public debt. I notice this figure has just about doubled since the present administration took office. That, of course, is quite a record.

Does not this $29 billion include about $4 billion paid on the Federal Reserve portfolio, $79 that is in the New York Federal Reserve Bank?

What is the point of taxing people to pay this $4 billion over to the Federal Reserve, which is an agent of the Federal Government?

Do you not think this is a violation of the constitutional requirement that taxes and expenditures must be authorized by the Congress, since this was not authorized?

Secretary SHULTZ. I believe we have entertained this question before, Mr. Chairman.

Chairman PATMAN. Not this particular one.

Secretary SHULTZ. We have a written response to you on the record. But Mr. Volcker perhaps can untangle this.

Mr. VOLCKER. Well, in this case, Chairman Patman, the Federal Reserve, as a resullt of those interest payments, does make certain earnings, and they pay all those earnings over to the Treasury.

Chairman PATMAN. They pay it over to whom?

Mr. VOLCKER. The Treasury.

Chairman PATMAN. And taxes are paid by the taxpayer, and the Treasury pays to the New York Federal Reserve Bank in behalf of the Open Market Committee. And in other words, you have taken it away from the taxpayers when it had already been paid once, and you make them pay the $4 billion.

Mr. VOLCKER. The Federal Reserve bank and the other Federal Reserve banks turn around and pay it back to us, so we do not have to tax the taxpayers for that $4 billion. We pay it to the Federal Reserve and they pay it back to us.

Chairman PATMAN. They pay it back to you. Well, they paid $495 million just to the Federal Reserve banks.

Mr. VOLCKER. Well, they do have some operating expenses that they have to pay for.

Chairman PATMAN. Why should we pay for the operating expenses? They are tax-exempt expenses.

Mr. VOLCKER. Somebody has go to pay for them. They are involved in a governmental function, and this is an expenditure of Government.

Chairman PATMAN. I know. An establishment of this kind, the biggest establishment of its kind in the world—it is up in what you might call the quadrillions and they cannot even pay their operating expenses on a tax-exempt basis. I think something ought to be done about seeing what is happening.

Mr. VOLCKER. They pay their operating expenses as anybody else does, and all the rest of their earnings come back to the Treasury.

Chairman PATMAN. It is a little different institution than that, though. I beg your pardon.

Now Mr. Shultz, do you not feel that the exorbitant interest rates that we have had in recent years are very harmful to our economy?

Secretary SHULTZ. I would rather have lower interest rates, which translates as I wish we had a lower rate of inflation.

Chairman PATMAN. Well, of course, my answer to that would be that since the interest rates really cause inflation you cannot have the inflation if you do not raise the interest rates 8 or 9 percent. You know, on June 9, 1969, the interest rates went to 8½ percent, and since that time they have gone up. As interest rates go up, as you know, Mr. Shultz, everything that is offered for sale goes up, even the goods on the shelves. That causes inflation, and the prices go up. Inflation increases. There is a race between the two, just like there was in World War II.

You had a race between prices and wages. Prices go up, wages went up. It almost went out of the roof before they could get it under control.

So I think it is obvious that the high interest rates have caused inflation, and another thing is when the Federal Reserve buys Government bonds with the Government money and then do not cancel the bonds. They have put the money out, and in this case it is $79 billion, and left it out, and also the bonds. That is double inflation.

Is it not?

Secretary SHULTZ. Well, I think, Mr. Chairman, at least in my view, the interest rate tends to measure inflation, rather than cause it, recognizing that everything is interacting with everything else.

Chairman PATMAN. Well, everything does not go back to the chicken and the egg, and I do not think this does. If that is your opinion, it is your opinion. But I think the inflation has been caused by the increased interest rates which have been exorbitant, excessive, usurious, and no attempt has been made by the administration to stop it.

People are paying 30 percent interest in this country right today clear across the Nation, and that Committee on Dividends and Credit has the power over this, but they have never exercised it. I cannot understand it, why people are being required to pay that even on the books of the mercantile stores. They are required to pay 18 to 24 percent, and up to 30 percent, and nobody ever says a word about it. It is causing poverty. We have millions of people in poverty now. This is causing more. They get into poverty. They owe these excessive debts and excessive interest rates, and they can never get out.

Do you not think that is harmful to the country?

Secretary SCHULTZ. Well, I think the operation of the economy is a fabulously complex and difficult thing to understand and work with, and often some elements in its operation need to be disciplined, but these are very unpopular, in part because they are just that—a discipline. So I do not know sometimes what is bad is good, or what may look bad in the short run but is necessary in the long run.

Chairman PATMAN. I will not pursue it further at this point.

Senator PROXMIRE. I would like to say that I have been apparently a little harsh in my questioning. But I did not mean to be, and there is absolutely nothing personal about it, and I hope you fully understand that. And because I do not only have an admiration for you—I think you are a very fine person and I hope you can find some way of staying in Government. We need you badly.

Chairman PATMAN. I join Senator Proxmire in his statement about having admiration for you. We know how hard you work. I know I do. And these other people know. You work awfully hard. I have never known a public official to work harder in my life, and I know you are conscientious and honest and sincere, and you are working for what you believe to be in the public interest, just like I am working in what I believe to be in the public interest.

Senator PROXMIRE. The only difference is he is wrong. [Laughter.]

Secretary SHULTZ. Well, I thought we just finished agreeing with each other that everybody else is wrong.

Chairman PATMAN. And I want to thank you for the committee, Mr. Shultz and also Mr. Volcker, for your attendance here this morning. We appreciate it very much. Thank you, and you are excused. The committee stands recessed.

[Whereupon, at 12:50 p.m., the committee recessed, to reconvene at 10 a.m., Friday, February 15, 1974.]

[The following information was subsequently supplied for the record:]

RESPONSE OF HON. GEORGE P. SHULTZ TO ADDITIONAL WRITTEN QUESTIONS POSED BY CHAIRMAN PATMAN

Question 1. Original Treasury Department estimates of Federal Receipts for Fiscal 1974 assumed that individuals would adjust their withholding tax schedules to eliminate over-withholding. As most individuals chose not to make this adjustment, your receipt estimates turned out to be too low. What have you assumed with regard to over-withholding in your projection of Fiscal 1974 revenues? How much do you estimate over-withholding to be in Fiscal 1974 and 1975?

Answer. There has been little evidence of taxpayers' filing new W-4 forms in order to conform to the withholding structure introduced in 1972. Current fiscal year 1974 receipts estimates therefore include no major adjustments for reducing the overwithholding associated with the switch to the new structure in 1972.

As measured by individual income tax refunds, estimated overwithholding reflected in fiscal year 1974 receipts is about $23 billion and about $28 billion in fiscal year 1975. Historically, the major cause of overwithholding has been voluntary overwithholding by taxpayers who prefer receiving tax refunds to making final payments. For either year only a small fraction of these refunds—about $7 billion—are associated with the 1972 changes in the withholding structure.

Question 2. For purposes of estimating corporate tax receipts in Fiscal 1974, the Treasury assumes that calendar 1974 corporate profits will be $124 billion. How is this total divided between profits in the petroleum industry and profits in the remainder of the corporate sector? What is the change in profits from

1973 to 1974 in the petroleum industry? In estimating the profits of the petroleum industry, what assumptions were made regarding the prices of crude oil and of petroleum products? In estimating corporate tax receipts, what allowance was made for the fact that the average tax rate in the petroleum industry is far below the average for all corporations?

Answer. There are indications that calendar year 1974 will witness a large increase in petroleum industry profits—but a somewhat larger decrease in the profits of the remainder of the corporate sector. One estimate sets the domestic petroleum profits in calendar year 1974 at approximately $14 billion (up from $7 billion in calendar year 1973)—with the profits in the remainder of the corporate sector dropping by about $9 billion. This estimate assumes crude oil prices at near current levels.

The Treasury Department does not normally attempt to divide corporate profit forecasts among industry groupings and apply varying average tax rates to them. A similar result may be achieved through an alteration in the overall average tax rate applied against all corporate profits when dictated by observed trends in recent receipt experience. Such experience occasioned a downward adjustment in the average tax rate for the budget estimate of corporate receipts. The resulting estimate was consistent with one obtained by dealing separately with the petroleum industry.

THE 1974 ECONOMIC REPORT OF THE PRESIDENT

FRIDAY, FEBRUARY 15, 1974

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

The committee met, pursuant to recess, at 10 a.m., in room 345, Cannon House Office Building, Hon. Henry S. Reuss (member of the committee) presiding.

Present: Representative Reuss.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; Michael J. Runde, administrative assistant; Lucy A. Falcone, John R. Karlik, L. Douglas Lee, and Courtenay M. Slater, professional staff members; and Walter B. Laessig, minority counsel.

OPENING STATEMENT OF REPRESENTATIVE REUSS

Representative REUSS. Good morning. The Joint Economic Committee will be in order for a continuation of its annual hearings on the President's economic report with testimony on the distribution of income in the United States and how the tax system changes that initial distribution through payroll and income taxes and through the forgiveness of taxes in the form of tax subsidies.

In the past 25 years, since the end of World War II, the United States has on the whole been remarkably unsuccessful at changing the distribution of before-tax income. The income gap between the lower and the highest quintiles has narrowed for 3- to 5-year periods, but then moved back close to previous levels as recessions caused increased unemployment, especially among those in the lower income quintiles. Since 1968 the gap between the richest 20 percent and the poorest 60 percent has widened as the Nixon recession brought on an increase in joblessness of over 2 million workers. After a brief recovery in 1973, the outlook for 1974 is another round of rising unemployment. Further, even though 1973 was a high employment year, and should have improved the share of income going to those in the lower quintiles, it was also a high inflation year. The consumption items experiencing the highest rate of inflation in 1973—food, fuel, and housing—constitute a much larger share of the lower income family's budget than that of other families. So that in real terms, the poor and the near poor may have been much worse off in 1973 than the income distribution statistics will indicate.

In addition to income support programs, the United States has relied heavily on the income tax system to change the distribution of income. Our personal income tax system is ostensibly a progressive

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one. But a study prepared by one of our witnesses today shows that the system is essentially a proportional one. The growing importance of social security taxes in the past 10 years has accentuated this tendency. In 1960, payroll taxes constituted 16 percent of total Federal tax receipts; in 1975 they are expected to be 29 percent of total tax receipts. We expect to discuss with our witnesses this morning how the tax system should be changed to effect a more equitable distribution of income.

We also will receive testimony on an important part of the Federal budget which has never been adequately emphasized in the administration's official budget. The tax expenditure budget, which now totals over $70 billion, constitutes 25 percent of the fiscal year 1975 budget. Forgiveness of taxes for corporations, businesses, and individuals has a profound impact on the economy. Unfortunately, both the Executive and the Congress have largely ignored them in spite of the growth in their relative importance in recent years.

Our witnesses this morning are eminently qualified to discuss these issues. Prof. Edward Budd from Pennsylvania State University is an expert in the distribution of income, and has previously provided valuable testimony to the committee. Mr. Ben Okner, in collaboration with Joseph Pechman at the Brookings Institution, has done a number of studies on the tax system and especially on tax subsidies. Our third witness, Mr. Samuel Hastings-Black, is counsel to Tax Analysts and Advocates, a public interest research group. He has recently prepared a compilation of the various tax subsidies and their impact in fiscal 1975.

It is a pleasure to welcome our witnesses to the committee and we look forward to hearing this testimony.

We will first hear from Prof. Edward Budd of Pennsylvania State University. Mr. Budd, please proceed.

STATEMENT OF EDWARD C. BUDD, PROFESSOR OF ECONOMICS, PENNSYLVANIA STATE UNIVERSITY

Mr. BUDD. I have been asked to comment on chapter 5 or the distribution of income in the economic report of the President. I have time for only a few comments, the majority of which will be general in nature. Given the short notice for the hearings I was unable to prepare a prepared statement for submission at this time.

The first question I would like to ask about this chapter is what was its purpose? The chapter is not policy oriented, for hardly any policy questions are raised.

Much of their discussion of the distribution of earnings, for example, is quite apart from what might be done about mitigating inequality although it might be useful to professional economists in developing a theory of inequality in the distribution of earnings. Is this chapter simply background material for some as yet unspecified programs, such as the reform of welfare to which the chapter alludes?

It seems to me that there ought to be several concerns and purposes of public policy with respect to income distribution. For one thing, there ought to be concern with the distributional impact of certain kinds of economic changes, such as the energy crisis or the food shortage, changes which might be offset by public policy if these distributional effects are viewed as undesirable. Other examples to which there is a bit of reference in the report might be the effects of inflation and unemployment.

A second concern would not only be with these economic changes and impacts but with the impact of Government programs whose primary purposes might be other than distributional ones, such as programs to clean up the environment. Finally, there are programs or policies that might be directly designed to effect redistribution which were best illustrated by transfer payment or tax policies to which Representative Reuss alluded in his opening statement.

The report alludes to goals of economic policy in judging distributional programs, but I would like to put those goals in a somewhat different way. It seems to me, along with the Council, that there does need to be a concern with the bottom of the distribution. Whether one calls it low income or poverty, no individual should be forced to fall below a minimum standard of consumption. But it seems to me there is concern in policy with what might be called income security or stability for those above the poverty line or, what may be the same thing, concern with short-run relative positions in the income distribution and how they are likely to be affected by some of the events to which I referred before.

Third, while it is hard to generalize on what ethical judgments here might be, I think in general nonfunctional inequality is frowned on. What we have to ask is whether the degree of inequality that we have is really necessary to achieve some other objective of economic policy.

With respect to areas in which I think research might be undertaken or continued in connection with this particular part of my statement, I think we ought to know something about the impact of the energy crisis on the distribution of income and what might be done to mitigate its impact. What effect do gasoline shortages and rationing have on this? What are the effects of the food shortages and the relative rise in food prices on distribution. It seems to me one obvious statement that can be made is that if we were to conclude that the distribution of money income had remained unchanged after a drastic rise in food prices, the distribution of real income would have become more unequal. Another thing we might be concerned with is what kind of effect rationing and price control has had on distribution.

There has been some work, some research, done on the effects on distribution of inflation and of changes in the level of unemployment, but it seems to me that there is room for considerably more research of this sort, to ask different kinds of questions and perhaps do things that haven't yet been done. I did one of these studies a few years back but, unfortunately, in that study my colleague and I had to assume that all wages changed by the same proportion, even though different wages are affected differently by inflationary pressure. Unfortunately, the Council has very little to say about these matters in its chapter on income distribution.

I was asked explicitly to comment on trends in the distribution of income in the postwar period. The Council has almost nothing to say about this except to content itself with the statement that the distribution of income has been pretty much unchanged over in the postwar period as a whole. What that ignores, of course, are movements in the distribution within the postwar period.

To come up with conclusions on this we need a series on size distribution to do it. The CPS is the only continuing series that we have. The other series available, unfortunately, do not run the entire gamut of the postwar period. Furthermore, the comparisons for the CPS are for money income and it might well be that other income concepts would be more appropriate for comparing inequality. Indeed, the Council notes that there would be some modification that would be occasioned by the inclusion of imputed income and the deduction, of certain kinds of taxes. This is noted in their section on omitted sources of real income and in equality of well-being.

Unfortunately for that table, however, it does not use the best source and it gives the impression that the inclusion of imputed income serves to uniformly reduce inequality even though by rather small amounts. If one uses BEA's family personal income distribution series, however, and utilizes the breakdowns that are available in it one will note that what the inclusion of imputed income does is to raise slightly the shares of both the bottom two quintiles and the top 5 percent and, hence, to reduce the share of the middle group. This, of course, is why the results that they get for their single-valued measure of inequality are so very small: There is a reduction in inequality in one part of the distribution and an increase inequality in another part of the distribution. The reason why the share of the 5 percent is increased is because they get the major share of any imputation for interest.

It seems to me that for comparisons over time the most appropriate income recipient unit to use is families. From the welfare point of view what we are interested in is the welfare of families, because the family is the fundamental distributional and consuming unit as well as the fundamental property owning unit. Now, we must recognize, of course, that families differ in size and in needs. Indeed, I would note that here is an important area in which some research needs to be done so that we can appropriately allow for the fact that families differ in size and in other characteristics, although some work in preparing income distribution has already taken account of this fact.

Restricting ourselves then to the distribution of money income among families in the postwar period, we do find that if one takes 1947 and 1948 as a base, there has been little change between then and 1971 and 1972, whereas it is worth noting that from 1947–48 to the early sixties there was some tendency for distribution of income to become a bit more unequal at the bottom and a bit less unequal at the top. The top and the bottom groups seem to have lost just a little bit relative to the middle of the distribution.

From about 1960 or 1961 on, however, there seems to have been some reduction in inequality, at least if we use the CPS. That reduction continued up until about 1968 or 1969; then, as the result of rising unemployment and other economic factors there was a reversal of that trend. The share of the bottom quintile, which had risen from about 4.7 percent in 1961 to about 5.6 percent then began to decline.

The distribution of wage income for families also appears to have followed a similar trend.

On the other hand, when we look at the distribution of income among persons rather than among families, it seems that the distribution over the entire period has tended to become somewhat more unequal. This seems to be suggested by looking at the distribution of money income and by looking at the distribution of wage and salary income.

The results I have cited are only, of course, for income before tax. We do not have a continuing series on the distribution of income after tax, since the CPS is a before-tax distribution. But we do know that the rise of the social security tax by about 6 percentage points over the post-war period has tended to make the distribution of income a bit more equal at the very bottom but more unequal at the top. The share of the bottom 20 percent tends to be a bit larger in income net of social security taxes, largely because that group does not rely as heavily on wage income for its income.

On the other hand, the upper limits to the tax and the fact that the upper groups again rely less on wage income than an other income types such as property income has meant a rise in their share. Britain finds, for example, that between 1951 and 1969 the share of the top 5 percent rose by seven-tenths of a percentage point more or about 3.5 percent more in earnings after social security tax than before that tax.

I don't have much time left, but I would like to make a few comments on the determinants of inequality in the distribution of family income, to which a good part of the chapter in the Council's report is devoted. And I would like to briefly indicate to you how I would go about laying out the problem.

As I noted before, from a welfare point of view, we are primarily interested in the distribution of income by families and by unrelated individuals, possibly adjusted for differences in family size and needs. The first step in determining how that distribution occurs in the earnings or labor income of the individual family member: Whether they choose to participate in the labor force; whether they can find employment or not; how many hours a week they choose to or can find work, and at what wage rate. The next step is to determine the effect of combining the earnings of individual family members into the family's earnings. That raises such questions, for example, as if there are just two earners in the family, or two potential earners such as a husband and wife, what is the effect on inequality of combining the husband's and wife's earnings into one wage income for the family.

Then to these earnings must be added the unearned income of the family such as transfer payments and property income, the latter being dependent on the ownership of property. Such income is probably not attributable to any individual within the family, although it is usually treated that way in the statistics.

The first point I want to make is that the report confines istelf almost entirely to earnings and has almost nothing to say about inequality arising from the ownership of property. This might appear otherwise because the Council often uses the words "income" and "earnings" interchangeably, even though most of the time they mean earnings. I recognize why this ambiguity arises; it is because the CPS is usually tabulated by size of income instead of by earnings. If one is looking around for important areas for research, it seems to me we need to do more research on the reasons for inequality in the distribution of property income and of property ownership. This is, I might add, receiving increasing attention in the profession.

The very brief discussion of the effect on the family size distribution of combining earners and earnings into family, I find quite inadequate and incomplete, although certainly the Council is more cautious in drawing conclusions on this subject than other economists have been.

One of the most important characteristics of the postwar period that I have mentioned is the fact there does not seem to be any consistent trend in the inequality of distribution among families, whereas there appears to be a rising trend in the inequality in the distribution of earnings among persons. I think more research needs to be done in accounting for the disparity in these particular occurrences. What, for example, is the implication of increasing labor force participation rates among women for inequality of the distribution among family income. I don't think it necessarily operates to reduce inequality in the latter.

Now, for one specific comment—I see I have already used up too much time—it seems to me in discussing earnings, the Council places too much weight on the importance of experience and on-the-job training in explaining earnings differentials. There is, of course, an age-income differential, but this is the thing to be explained and not to be relabeled as "experience," which then appears to become an explanation for that differential. Some of the Council's analysis of this I find quite unclear.

I don't have time to attempt an interpretation of charts 8 and 9, which appear to treat the real income profiles of cohorts of men born in selected years and real incomes for men in different age groups. The Council, it seems to me, tends to deal too much in terms of cohorts, which simply lump together different factors that can account for the different pattern of earnings with age.

I also found their use of cohorts as somewhat unsatisfactory in the context of their discussion of dead-end jobs on page 152. This problem is interpreted as meaning that the jobs whites choose have rising earnings with age up to a point, and the earnings of jobs that blacks choose have no such tendency to rise. Table 39 certainly shows that on a cross-section basis, the ratio of the earnings of black males to white males declines with age. Over time, however, the ratio of the earnings of blacks to whites has narrowed. Hence, if one looks at a given cohort over time, the black-white earnings ratio seems to have been relatively constant. But I find this latter observation rather irrelevant. It simply shows the effect of a mitigating circumstance—that is, the secular decline in the black-white differential—which may or may not be with us in the future and, for those that are concerned by the fact that the ratio of black earnings may decline with age relative to white earnings, is small consolation.

There are a number of other difficulties with the discussion in this chapter that I might mention, but I lack time to do so.

I perhaps also ought to make some comments on the latter part of the report on the poverty discussion and on the governmental transfer programs. As I remember these sections, they are largely a review for those who are unfamiliar with them. The discussion of the transfer programs are of a similar sort. However, there is nothing which tells us how these programs might be modified to achieve more desirable results.

There is one table at the end of the Council's report, on the effect of certain kinds of transfer payments on inequality in the distribution of income. However, since they tell us that their measure of inequality can only be interpreted in terms of showing whether inequality is more and less, the tables imply demonstrates the obvious, that when a social security program is introduced, if there were none in existence before, inequality is reduced, and that the public assistance program again reduces inequality. Of course, we do know that these programs have increased in importance during the 1960's. Indeed, I would suspect this is the single most important factor in explaining the rise of the share of the bottom quintile of the distribution from that which existed, say, in 1959 and 1960, up to the peak that it reached in 1969.

Thank you.

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

Mr. Hastings-Black, welcome. Would you proceed. Your prepared statement and that of Mr. Okner, under the rules, and without objection, have been received into the record, so you proceed in any way you like.

STATEMENT OF SAMUEL HASTINGS-BLACK, STAFF ATTORNEY, TAX ANALYSTS & ADVOCATES, WASHINGTON, D.C.

Mr. HASTINGS-BLACK. Thank you very much, Mr. Reuss. I wonder if a member of the staff could bring down a copy of my prepared statement for Professor Budd and Mr. Okner.

Mr. Reuss, I am a tax attorney and not an economist, so I feel a little overshadowed in this company. I am here primarily to present for your record the estimated tax expenditure budget for fiscal 1975, which was prepared by Tax Analysts & Advocates.

I am reminded of the rule I learned when I was in the military, if a general was given a briefing it had to be at least a colonel who was presenting the charts. Now I have learned that if one is presenting data about tax expenditure, there has to be a lawyer presenting the material.

Representative REUSS. Kissinger was a corporal, so take heart. [Laughter.]

Mr. HASTINGS-BLACK. Now he has generals turning his charts.

Representative REUSS. All right, do not take heart. [Laughter.]

Mr. HASTINGS-BLACK. To continue, I am a staff attorney at Tax Analysts & Advocates, the public interest law and research firm, and I am here to present our tax expenditure budget estimates. We believe this is the first time that the estimates have been made available on a prospective basis.

Our estimates indicate that over $78 billion of Federal efforts to stimulate the economy, or to achieve various social goals, are not analyzed or even discussed in any detail in the executive branch's budget. This is a sum one-fourth as large as the entire fiscal 1975 program.

It is our position that the annual debate on the goals and costs and the effectiveness of Federal programs is seriously deficient if tax expenditures are omitted from the discussion.

The tax expenditure budget presents in a few cases some startling contrasts to the budget as submitted by the executive branch. I draw your attention to the two pie charts in the prepared statement which we have prepared. The charts indicate, among other things, that the annual Federal effort is significantly more oriented toward business enterprise, in the tax expenditure budget than would appear from the Office of Management and Budget's presentation of the "other" fiscal 1975 budget. I don't mean to say that this is good or bad or indifferent or that these programs work well or don't work, but it certainly is a fact that we spend over $29 billion in tax expenditures each year primarily for private business activity and, if this is a fact, we certainly ought to talk about it.

The tables at the end of my prepared statement also show that significantly more Federal effort is directed toward the natural resources, the commerce and transportation, and the housing categories in the budget through the tax expenditure avenue than through the route of annual Federal outlays, and yet these annual tax expenditures, as you know, receive almost no annual scrutiny. In fact, the Office of Management and Budget is going backward, if anything, as far as its attitude toward tax expenditures is concerned.

Last year's special analyses presented a certain amount of rather useful information about tax expenditures in the income security field, and included those figures in the totals concerning Federal effort in the income security programs. This year's special analyses omit, except for one sentence, I think, any discussion of tax expenditures. That one sentence, which is in the aid to State and local government chapter, simply says something like "There are also such things as municipal bonds and deductions for State and local taxes." That is the extent of the Office of Management and Budget's discussion of tax expenditures in the special analyses this year.

On page 34 of this year's budget the Office of Management and Budget claims that tax expenditure budget estimation is very difficult. Apparently, the Office of Management and Budget feels this difficulty is so great that it can responsibly ignore a budget one quarter again as large as the one they are proposing. We would argue that it is possible that a preferable alternative is to do the best one can to estimate this tax expenditure budget and to try to improve one's capability. If the risk of being slightly wrong were enough of an excuse to avoid publishing budgets you wouldn't have seen the Office of Management and Budget publishing anything during the last 8 years or so.

There are a few specific things which this committee and its staff might be able to do to improve the present situation. I think both the Office of Management and Budget and Treasury could be asked to testify on what they believe is the proper role of tax expenditure estimates in the annual budget cycle, and I should think that because these agencies have both said that estimating these things is very difficult, you ought to ask them specifically why it is difficult.

The committee might also invite Treasury to testify on Treasury's own estimating programs. Treasury has backup materials for its estimates, including some recently developed materials from the Office of Industrial Economics which, to the best of my knowledge, have not been released to the public. The Congress could probably use these in discussing ADR and the investment tax credit.

Something that we at Tax Analysts feel is very important is to see if Treasury would be willing, if given the resources, to carry on cost effectiveness analysis in the tax expenditure area. I realize that Treasury's dollar resources are within the province of the Appropriations

Committee, but nevertheless, I have asked people who work with tax expenditure problems, if Treasury could have a few more million dollars where should they spend it? The answer is to try to do some analysis of tax expenditures rather than trying to crank out a few extra numbers each year.

Another crucial problem that this committee might make a contribution toward solving is upgrading the Congress' presently almost nonexistent capability to analyze the effectiveness and defects of tax expenditures. The study this committee has made on Federal subsidies and the hearings in 1972 and the compendium on tax expenditures were a very valuable contribution to the literature. We need more of that kind of work, but more than that we need an institutionalization of the process of looking at the tax expenditure budget. I am not sure I know how that institutionalization should take place. Perhaps the staffs of the planned budget committees could carry on this kind of work.

Last, a political note: I believe that the tax expenditure concept offers a new kind of rhetoric to those people who favor a simple, progressive tax system.

Tax expenditures are very vulnerable to the charge of waste. Almost no proponent in the House or the Senate of a new kind of tax expenditure could—at least in the present day—be able to defend a new tax expenditure program as an efficient way of spending Government resources. Tax expenditures suffer from some of the same problems of reducing inflation and deficits that outlays do. I think, as Ben Okner may be planning to point out, there are also some problems with the income redistribution effect of tax expenditures. It is possible, Representative Reuss, that these rhetorical weapons in the long run may do more to improve the way we deal with tax expenditures than any compilation of numbers.

[The prepared statement of Mr. Hastings-Black follows:]

PREPARED STATEMENT OF SAMUEL HASTINGS-BLACK

THE FISCAL YEAR 1975 TAX EXPENDITURE BUDGET

Mr. Chairman, members of the Committee. My name is Samuel Hastings-Black and I am a staff attorney at Tax Analysts and Advocates, the public interest law and research firm. I am here to present our Tax Expenditure Budget estimates for Fiscal Year (FY) 1975. We believe that this is the first time that estimates of the Tax Expenditure Budget for a future fiscal year have ever been made available.

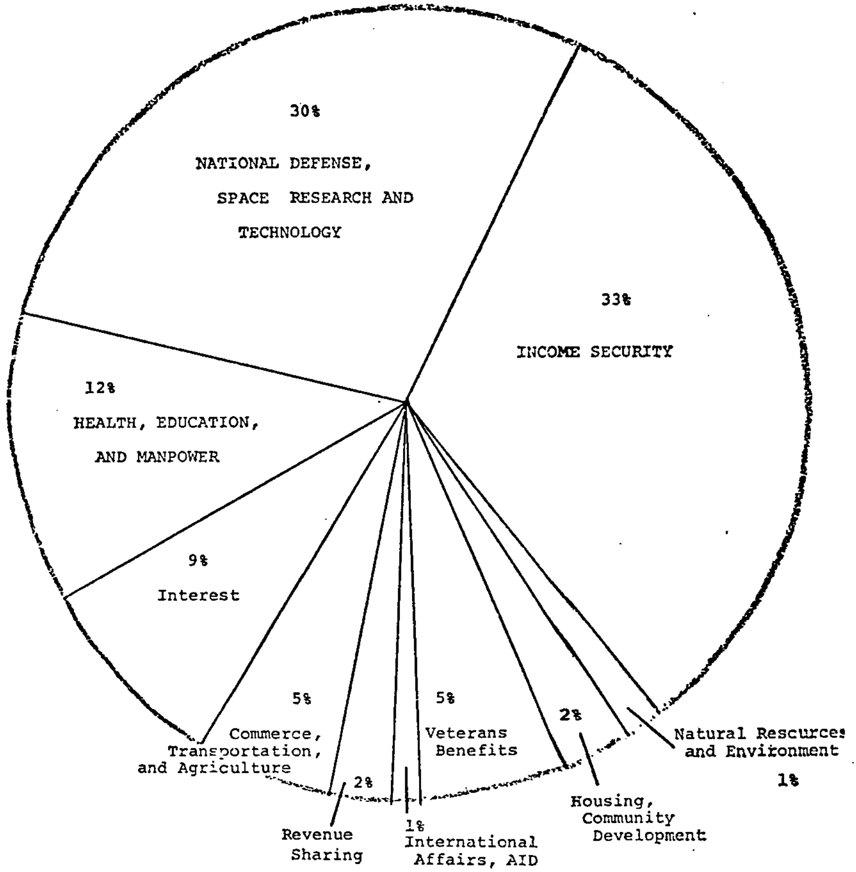
The estimates made by Tax Analysts and Advocates indicate that over $78 billion of federal efforts to stimulate the economy, or achieve various social goals, are not analyzed in the Executive Branch's budget. This is a sum one-fourth as large as the entire proposed FY 1975 program. We feel that the annual debate on the goals, costs, and effects of federal programs is seriously incomplete if tax expenditures are omitted.

The FY 1975 Tax Expenditure Budget presents, in some cases, a startling contrast to the Budget as submitted by the Executive Branch. For example, compare figures 1 and 2 on pages 118 and 119, respectively.

The charts indicate that the annual federal effort is significantly more oriented toward business enterprise, in the context of the individual and corporate income tax systems, than would appear from the OMB presentation. This is not to say that this is good or bad, but it certainly is a fact, and if we are spending $29 billion through the tax system this way we certainly ought to talk about it.

Analysis of the detailed tables we have prepared, which appear at the end of my prepared statement, also show that significantly more federal effort is directed toward the Natural Resources, Commerce and Transportation, and Housing sectors through the Tax Expenditure Budget than through federal outlays. Yet these annual tax expenditures receive almost no annual scrutiny.

Figure 1. PROPOSED FISCAL YEAR 1975 BUDGET BY FUNCTION



If we could add these two charts together, we would have a much better picture of the federal impact on the economy in FY 1975. However, both the way the Executive Branch presents the budget, and the very organization of the Congress, prevent systematic analysis of this more realistic picture.

OMB is actually going backward in its analysis of tax expenditures. FY 1974's *Special Analyses* presented a certain amount of useful discussion of tax expenditures, especially in the income security chapter. In this year's *Special Analyses*, however, almost all mention of tax expenditures was omitted.

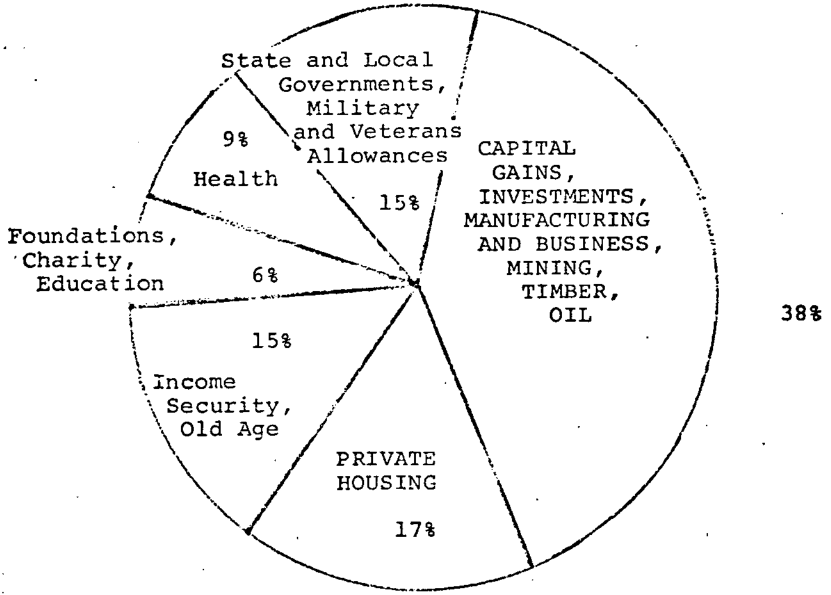
OMB claims, on page 24 of this year's Budget, that Tax Expenditure Budget estimation is difficult. This difficulty is so great that OMB feels it can responsibly ignore a Budget one-quarter again as large as the one OMB proposed. When one is confronted with a $78 billion budget, however, perhaps a preferable alternative reaction might be to estimate it as best one can and to start refining one's capability to estimate. If the risk of being slightly wrong were enough of an excuse to avoid publishing budgets, OMB wouldn't have published anything since the beginning of the Vietnam War.

There are opportunities for this Committee to improve on the present situation.

Both OMB and Treasury might be asked to testify on what they believe is the proper role of Tax Expenditure Budget analysis in the annual budget cycle. These two agencies could be asked to elaborate on the difficulties of making prospective Tax Expenditure Budget estimates.

The Committee might invite Treasury to testify on that Department's own tax expenditure estimating activities. The Committee might seek Treasury coopera-

Figure 2. FISCAL YEAR 1975 TAX EXPENDITURES BY FUNCTION



tion in releasing any background materials that Department might have on its published Tax Expenditure Budget estimates, including any studies made by the new Office of Industrial Economics. Treasury could be asked to explain the methodology of its Tax Expenditure Budget estimates.

Over a period of time, the Committee could seek more, and more detailed Tax Expenditure Budget estimates from Treasury, perhaps requesting a breakout of estimates by standard industrial and business classifications. Simply forcing Treasury to estimate more numbers, however, would be of limited value.

Much more importantly, the Committee could determine what additional resources Treasury needs to conduct more cost-effectiveness analysis of the Tax Expenditure Budget, and could try to help Treasury get those resources.

Even if Treasury did provide cost-effectiveness analysis of the Tax Expenditure Budget, the Congress would still lack the capability to conduct its own analytical work. Something seems amiss when the Congress has no way to look at the effectiveness of $78 billion worth of federal activity. By contrast, the General Accounting Office is capable of doing an excellent job of cost-benefit analysis of spending programs. I do not have any easy solutions to this problem; but perhaps the staffs of the planned budget committees could carry on this work.

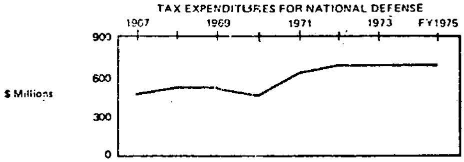
Last, I believe the Tax Expenditure Budget concept offers a new rhetoric to those who favor a simple, progressive tax system. Tax expenditures are currently extremely vulnerable to the charge of waste. Almost no proponent of a tax expenditure proposal would ever be able to offer cost-benefit analysis to support such a bill or amendment. In periods of reasonably full employment, new tax expenditures can be as inflationary and as deficit-increasing as direct outlays. It may be provable that the incidence of many tax expenditures is such that the middle class is paying for the tax benefits of the upper class. These rhetorical weapons, in the long run, may do more than any compilation of numbers to focus public attention on the Tax Expenditure Budget.

FEDERAL INCOME TAX EXPENDITURES, CY 1971-1972 AND FY 1975

(millions of dollars)

Note: Categories are listed in the order they appear in OMB budget documents. Items of tax expenditure included are listed for each category. Numbered footnotes apply only to the category and are explained immediately below the category. Lettered footnotes apply to items in a number of categories and are set out at the end of the table.

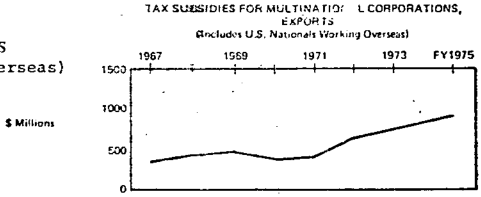
NATIONAL DEFENSE



	1971	1972	FY 1975 Individuals
Exclusion of benefits and allowances to armed forces personnel ...	$650	700 (a)*	700

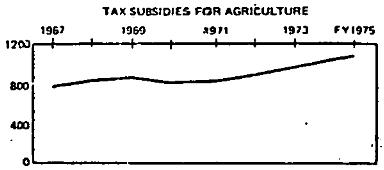
*For lettered footnotes, see end of table.

MULTINATIONAL CORPORATIONS, EXPORTS
(includes U.S. nationals working overseas)



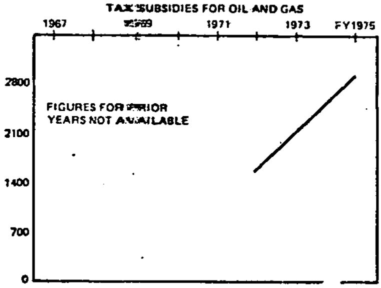
	1971	1972	FY 1975 Corporations	FY 1975 Individuals
Exemption for certain income earned abroad by U.S. citizens	$50	50		60
Exclusion of income earned by individuals in U.S. possessions ...	10	10		10
Lower rate for Western Hemisphere trade corporations ...	75	50	100	
Exclusion of gross-up on dividends of less-developed country corporations ...	55	60	80	
Deferral of income of controlled foreign corporations	165	325(a)	350	25
Exclusion of income earned by corporations in U.S. possessions ...	80	80	80	
Deferral of tax on domestic international sales corporations (DISC) ...	none	100	240	
TOTAL	$435	675	945	

AGRICULTURE



	1971	1972	FY 1975 Corporations	FY 1975 Individuals
Capital gain treatment; expensing in lieu of capitalization	$840	900	60	1040
TOTAL	$840	900	1100	

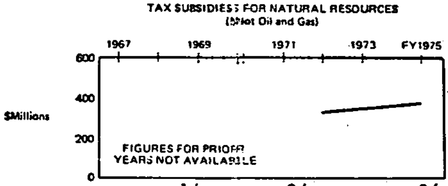
OIL AND GAS



	1971 1/	1972 2/	FY 1975 2/ Corporations	FY 1975 Individuals
Expensing of intangible drilling costs, instead of capitalization ..	305	600	700	100
Excess of percentage over cost depletion .	705	1400	2350	250
TOTAL	1010	1600 3/	2900 3/	

See numbered footnotes following Natural Resources

NATURAL RESOURCES
(exclusive of oil and gas)



	1971 1/	1972 2/	FY 1975 2/ Corporations	FY 1975 Individuals
Timber: capital gain treatment for for certain income	$175	175	180	80
Expensing of exploration and development costs, instead of capitalization	20	50	60	
Capital gain treatment of iron and coal royalties....	5	5	5	
Pollution control depreciation in excess of straight line	15	25	40(g)	
Excess of percentage over cost depletion ...	280	300	350	10
TOTAL	495	525 3/	690 3/	

See footnotes, p. 122.

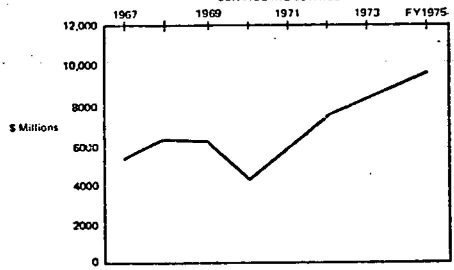
1/ When Treasury published its CY 1972 tax expenditures for Natural Resources (including oil and gas), it stated that it had revised its method of estimating intangibles, exploration and development costs, and the percentage depletion figure. Treasury explained its changes as relating to definition and concepts. The major conceptual difference is that on the old basis the estimate for intangibles was made on the basis that percentage depletion was already repealed. Treasury's new methods are not readily apparent; TA/A was unable to change Treasury's prior year figures. Therefore, the CY 1971 figures in the table are broken out from Treasury 1971 figures for Natural Resources and direct comparisons to the 1972 and 1975 figures are not proper.

2/ The 1972 and Fy 1975 figures are broken out from the larger Natural Resources category. The methods used to make the 1975 estimates are comparable to those for 1972.

3/ The 1972 and FY 1975 figures are not strictly additive. These two totals, which are also used in the graph, use a procedure of estimating assuming all these preferences are repealed. Thus, these totals are more accurate characterizations of overall revenue effect.

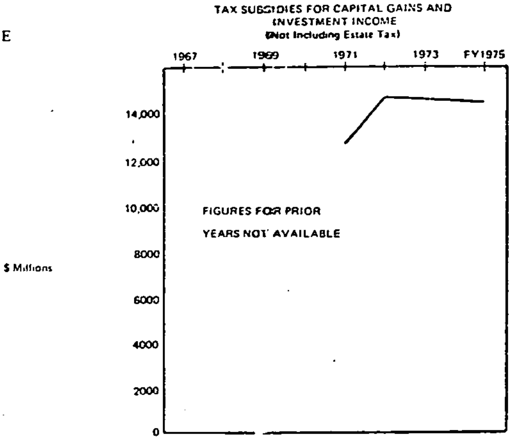
MANUFACTURING AND SERVICE INDUSTRIES

TAX SUBSIDIES FOR MANUFACTURING, AND SERVICE INDUSTRIES



	1971	1972	FY 1975 Corporations	FY 1975 Individuals
Investment credit	1800	3800	4100	800
Depreciation on buildings (other than housing) in excess of straight line	480	500	400	200
Asset (accelerated) depreciation range (ADR)	700	860(a)	1490	10
Lower rate for capital gains:corporations (other than farming and timber) (b)	380	400	390	
Tax-exemption of credit unions	40	90(a)	110	
Deductibility of interest on consumer credit	1300	1100		1300
Expensing of research and development, instead of capitalization	545	570	650	
Deferral of tax on shipping companies	10	30	40	
Rail freight car accelerated depreciation	45	80(a)	10(c)	
Exclusion of employees' meals and lodging, paid by employer	170	170		170
TOTAL	$5970	7600	9670	

CAPITAL GAINS, INVESTMENT INCOME
(not including Estate tax)

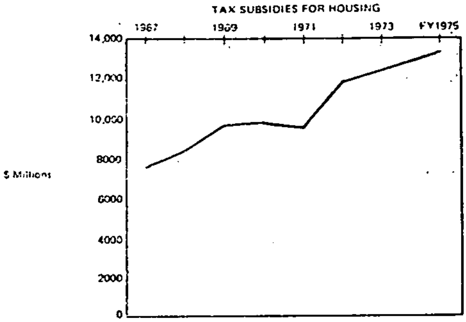


	1971		FY 1975 Individua's
Dividend exclusion	$300	300	340
Deduction of half of long-term capital gains individuals (not farming or timber) (b) ..	5600	7000	6500
Exclusion by employees of premiums on group term life insurance paid by employer	500	550	650
Failure to tax policyholders on interest on life insurance savings ...	1100	1200	1450
Exclusion of all of capital gains on assets held at death ...	4900 1/	5400 1/	5400 1/
Deferral of capital gains tax on appreciated assets transferred as taxable gifts ...	350 2/	350 2/	350 2/
TOTAL	12,750	14,800	14,690

1/ Effect of taxing at ordinary rates, with present income splitting, averaging, and capital loss deductions. No offset for marital deduction or the $60,000 exclusion. This revenue figure would be $7.5 billion if the loss from the estate tax base were not taken into account (estate tax revenue would fall by $2.1 billion). This netting of second-level effect has not been taken into account elsewhere in these tables. CY 1971 and 1972 estimates are by TA/A; this item has not been included in recent Treasury tables.

2/ This is the annual revenue deferment. The bulk of appreciated property transferred as taxable gifts (usually to spouses and children) is and remains in the hands of high income classes who do not rapidly turn over their portfolios. Thus the deferment of capital gains tax may continue indefinitely. The deferment is at least long enough that the annual deferment of revenue, $350 million, is permanently lost to Treasury. This estimate was described in more detail in Tax Notes, Nov. 5, 1973 under H.R. 7126. These three figures are by TA/A and are in addition to the items included in the Treasury tables.

HOUSING

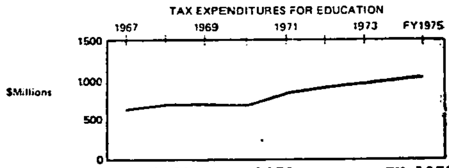


	1971	1972	FY 1975 Corpo-rations	FY 1975 Indi-viduals
Excess bad debt reserve deductions by financial institutions .. 1/	$400	400	360	
Deductibility of interest on mortgages on owner-occupied homes ...	2400	3500		4500
Deductibility of property taxes on owner-occupied homes ...	2700	3250		3800
Depreciation on rental housing in excess of straight line ...	500	600	500	
Housing rehabilitation accelerated depreciation ...	25	40	5(c)	40(c)
Failure to tax imputed net rent on owner-occupied homes ...	3600 2/	3500 2/		3900 2/
TOTAL	$9625	11290	13225	

1/ This item has been changed from Treasury's "commerce and transportation" category to "housing" here because the excess bad debt reserve deductions have been tied to the issuance of mortgages.

2/ The estimates of the tax effect of including net imputed rent as taxable income are based on the estimates of net rent contained in the National Income Accounts, as the amounts which would be added to gross income. These are not Treasury figures.

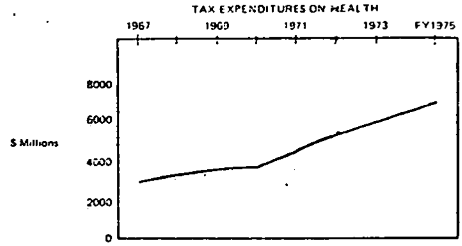
EDUCATION[1]



	1971	1972	FY 1975 Individuals
Parental personal exemption for a student age 19 or over ...	$550	640	710
Deductibility of contributions to educational institutions ...	275	275	330
TOTAL	$825	915	1040

1/ This table omits a Treasury table item, scholarships and fellowships, on the grounds that these are properly classed as gifts.

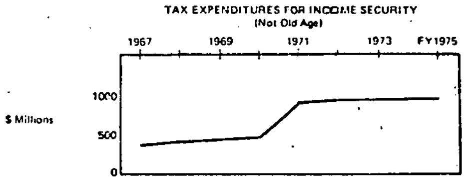
HEALTH



	1971	1972	FY 1975 Individuals
Exclusion of disability insurance benefits (nongovernment plans) ...	$155	175	225
Additional exemption for the blind	10	10	10
Sick pay exclusion	120	225(a)	250
Exclusion of workmen's compensation	320	375	450
Exclusion by employees of employer-paid accident and accidental death premiums ..	30	35	45
Exclusion by individuals of employer-paid medical insurance and care expenses ...	2000	2500	3500
Deductibility of individuals' medical insurance and care expenses ...	1900	1900	2300
Casualty loss deductibility	165	150(a)	150
TOTAL	$4700	5370	6930

1/ There is some ambivalence as to whether these items should be included in a tax expenditure list. Some economists believe that a proper computation of net income involves a deduction for health expenditures (and casualty losses). Others see the health-related deductions as a "loss-sharing" effort by the government, a kind of health insurance. If the latter, then the program 1) definitely is a tax expenditure and 2) is highly regressive. The insurance covers no losses of poor families, a small percent of the health expenses of middle class families, and 70% of the expenses of wealthy families. This same "upside-down" structure applies to all itemized deductions and tax subsidy deductions enjoyed by individuals.

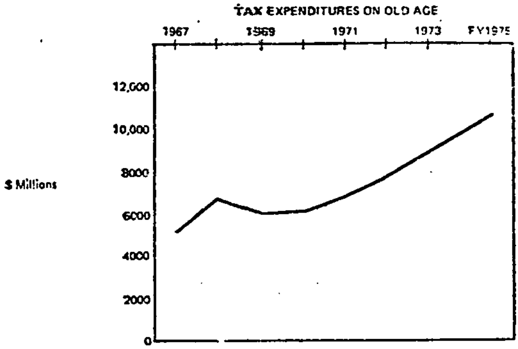
INCOME SECURITY (not old age)



	1971	1972	FY 1975 Corporations	FY 1975 Individuals
Failure to tax unemployment insurance benefits ...	$800	700		700
Failure to tax public assistance benefits	65	65		70
Privately financed supplementary unemployment benefits ...	5	5		5
Credit to corporations for employing welfare recipients (WIN program) ...	1/	5	5	
Deduction for child care expenses...........	30	180		180
Accelerated depreciation of child care facilities ...	1/	5	5	
TOTAL	$900	960	965	

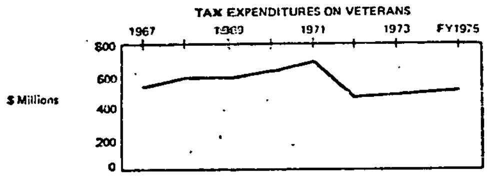
1/ Provision not in effect

OLD AGE



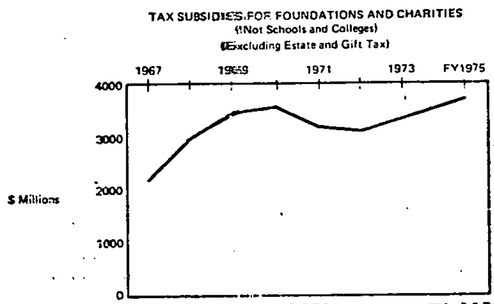
	1971	1972	FY 1975 Individuals
Additional exemption Retirement income credit Failure to tax social security pensions	$3250	3550	5700
Exclusion of self-employed pension contributions and related earnings ..	250	200	200
Exclusion of employer's pension contributions and related earnings ...	3650	4000	4800
TOTAL	$7150	7750	10700

VETERANS' BENEFITS



	1971	1972	FY 1975 Individuals
Exclusion of certain veterans' benefits ...	$700	480 (a)	525

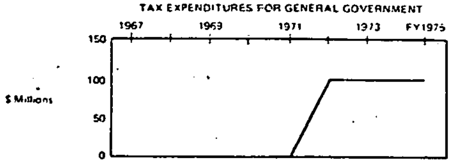
FOUNDATIONS AND CHARITIES



	1971	1972	FY 1975 Individuals
Deductibility of contributions by individuals to foundations and charities (other than educational) ..	$3200	3100	3700
Exclusion of capital gains on certain assets donated by individuals to charities..	1/	—	—
TOTAL	$3200	3100	3700

1/ Estimate not available; informal Treasury estimate is in the $100 million range. Not included in total.

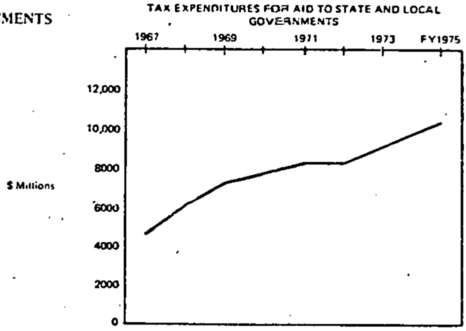
GENERAL GOVERNMENT



	1971	1972	FY 1975 Individuals
Credit and deduction for campaign contributions	1/	100	100

1/ Provision not in effect

AID TO STATE AND LOCAL GOVERNMENTS



	1971	1972	FY 1975 Corporations	FY 1975 Individuals
Tax exemption of interest on state and local bonds ...	$2600	2900	2400	1300
Deductibility of state and local nonrealty taxes ...	5600	5300		6700
TOTAL	8200	8200	10400	
GRAND TOTAL ($ millions)	$57,450	$64,965	$78,280	

(a) Changes in the 1972 figures as compared to 1971 which are due wholly or in part to revised data and/or new sources of data and/or improved estimating methods.
(b) Assumes present restriction on capital losses is maintained.
(c) Equipment placed in service, and rehabilitation outlays in the latter half of FY 1975, are not eligible for such accelerated depreciation.

NOTE.—Standard estimating practice is to regard the differences between calendar years and the following fiscal years as not major, except in special cases involving the effective date of a new law, etc. TA/A's FY 1975 estimates were made using standard methods, (although without Treasury's extensive computing resources), and therefore the FY 1975 figures may be taken as approximations of CY 1974 amounts.

Representative REUSS. Thank you very much, Mr. Hastings-Black. Mr. Okner, please proceed.

STATEMENT OF BENJAMIN A. OKNER, SENIOR FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, D.C.

Mr. OKNER. Thank you, Representative Reuss.

I guess I have come in as kind of a cleanup batter here. I am going to try to integrate to some extent the remarks of Professor Budd and Mr. Hastings-Black, and talk about tax expenditures and the distribution of income. Most of my remarks will be on tax expenditures, but I will conclude with some thoughts that I have on how they affect the distribution of income.

As we have already heard, tax expenditures in fiscal 1975 are estimated to be somewhat over $78 billion. What that means in effect is that the Federal budget outlays which were estimated at $304 billion for 1975 were seriously understated. In fact, the total outlays should have been recorded at almost $383 billion. That means somewhere along the line the OMB lost about 20 percent of the total budget.

Now, the OMB and the executive agencies are very careful workers and they check their numbers; no one, least of all me, thinks they really lost this money or it somehow got misplaced. As a matter of fact, these numbers were not overlooked but were deliberately omitted. There is a statement to that effect on page 34 of the budget which Mr. Hastings-Black already mentioned.

There is also a discussion of why they were omitted which I found particularly interesting, and I would like to comment on that in more detail. They seem to give four reasons for omitting tax expenditures and—if I paraphrase somewhat—they breakdown as follows: First, it is hard to estimate tax expenditures. Second, the cost of any particular tax provision depends on whether you are going to eliminate only that provision or a whole series of provisions at the same time.

The third reason was that the total impact of the changes on receipts depends on whether tax rates are changed on a broadened tax base. And the fourth reason and I would like to quote this because it is a rather esoteric argument to find in a budget document, is the statement that:

> The concept requires a standard for comparison of the actual tax base and there is substantial disagreement on what this standard should be.

All of these statements are true but I think that they either miss the point or indicate a serious misunderstanding on the part of the administration and the OMB of the purpose of tax expenditures budgets. There is an implicit assumption underlying all of these arguments other than considerations of difficulty that the reason you prepare tax expenditure budgets is so that people like me can come up before congressional committees and argue for tax reform, broadening of the tax base, getting a fairer income tax, and so forth. That is a reason and a use for tax expenditure budgets. I don't want to denigrate that. I have done it, before this committee.

But there is at least an equally important, perhaps more important, reason for preparing these budgets at least from the standpoint of the Congress and the Appropriations Committees. That is simply their utility as a tool for evaluating the efficiency of these implicit expenditures which take place automatically through the tax system, versus explicit cash outlays, and the relative efficiency of achieving desirable social goals, be it in the health field, the oil field or any other field.

There are different ways of achieving economic objectives. One of them is through tax subsidies. The other is through explicit budget expenditures. Underlying all my remarks, and I will make it explicit, is the fact that I like to see things in the budget, out in the open, and subject to congressional scrutiny and change. I don't like implicit expenditures over which the Congress really exercises no control, and that is exactly the situation that you have in the case of tax expenditures.

I would like to comment just briefly on a couple of the reasons the administration gave for omitting tax expenditure estimates. It is true that it is hard to estimate tax expenditures. It is also hard to estimate actual budget outlays, yet the OMB and the executive agencies do a fairly good job on that, and figures over the last several years, at least in the aggregate, have been within 1 or 2 percent of actual outlays.

We now have new tools, computers being the most notable, and it is far easier today to estimate tax expenditures than it was 5 or 10 years ago. Such estimates do depend on assumptions, but they are the same kind of assumptions regarding economic activity, GNP, unemployment, and so forth, as are required for actual budget estimates.

There is no particular reason why future estimates of tax expenditures are more difficult to make than are past ones. The Treasury Department and the Joint Committee on Internal Revenue Taxation for at least the last 2 years have prepared tax expenditure budgets and these are public, printed documents. I have been in this game, and it is really no more difficult to estimate tax expenditures for 1972, for which data are still incomplete than it would be to make some assumptions and projections and estimate them for 1974 or 1975. It is difficult, but not impossible. I really have to reject that as a reason for not preparing them.

The second and third arguments against tax expenditure budgets, having to do with changing costs depending on whether you eliminate only one provision or many at the same time, is true. It says so right in the document I referred to, the tax expenditure budget prepared by the Ways and Means Committee and the Joint Committee on Internal Revenue Taxation. It is stated in the tax analysts and advocates document, and everybody who prepares such estimates knows that and says it. If the Congress is not aware of this fact, then I should say it again and underscore it for your benefit.

What is not said, however, is that the estimates of total tax expenditures which you get by summing the individual components, the tax analysts' $78 billion for example, are too low. Such an estimate of the total expenditures understates the aggregate because it doesn't take into account the interactions that ordinarily will push taxpayers into higher tax brackets and thereby increase the revenue effect.

There are a few instances in the tax code, very complex provisions, where, in fact, interactions will reduce total tax expenditures as compared with the sum of the components. But these are very rare and they will not have a large impact in the aggregate.

The third reason given by the administration contains the implicit assumption that the purpose of the tax expenditure budget is for tax reform and that tax rates are going to be lowered. Any change in tax rates is going to change the revenue effect of changes in other provisions. If you leave all the provisions alone and raise tax rates, the tax expenditure budget will increase. If you leave all the provisions unchanged and lower statutory tax rates, the tax expenditures estimates will drop. It seems a silly reason to me. I do not quite understand it.

The final reason given in the budget has to do with the lack of a standard of comparison. That is really of value primarily for scholarly discussions regarding the proper definition of a comprehensive tax base. If I can simplify greatly, what it says is that there is no consensus among experts on what provisions should or should not be on any given list of tax expenditures. In practice, all this means is that some items that might appear on my list of tax expenditures would not appear on somebody else's list. Again, I say, yes, that is true. So what?

Let me turn to the tax analysts' budget for 1975. The first question I think you are likely to raise is whether those numbers are any good. Are they worth printing, are they worth putting on paper? The only honest answer I can give you is that I do not know, but I will follow that quickly by saying I have no reason to think that they are not.

The assumptions upon which they are based, the GNP assumptions and so forth, are very close to the figures that are generally being used by economists in projections for 1974 and 1975. Without going through detailed worksheets and assumptions on each of the many items, I would say that I don't find any glaring, serious things that cause me to stop and say, "Hey, that really looks like it is way out of line."

However, I want to emphasize that it is possible to change underlying assumptions when you are preparing tax expenditure budgets and come up with very different numbers for any of the particular items. We now have estimates the Treasury has published for the years 1967 through 1972. Many of these figures were estimates for which it is now possible to go back and check the accuracy, not of all the items, but of the items that did appear eventually on individual and corporation income tax returns. It is possible to go back and check those, and I would be very interested in seeing a comparison for a few of those years, at least on some of the items, so as to evaluate the accuracy of estimates in this area.

I guess the major shortcoming in the tax analysts' budget that I found is the lack of distributional data. For 1971 and 1972, the Ways and Means Committee and Joint Committee on Internal Revenue Taxation presented estimates of how the benefits from the various tax expenditures to individuals would be distributed among adjusted gross income classes. In table 2 of my prepared statement I show three different provisions and the estimated distribution of the estimates as well as the total for all provisions for individuals. The major point to be gleaned from that table is that tax expenditures are not solely of benefit to high-income taxpayers. The three provisions I picked all involved total expenditures of about $3 to $3.5 billion in 1972. The special provisions for the aged, blind, and disabled are clearly of major benefit to low-income taxpayers. The deductibility of mortgage interest for homeowners is of most benefit for those in the middle-income ranges, and the deductibility of charitable contributions, other than for education, are of greatest benefit to those at the top of the income scale.

Nevertheless, if you look at the estimated distribution of the benefits of all of the provisions, almost half of the benefits do accrue to taxpayers with adjusted gross income of $20,000 and over, and by virtually any definition of income, those would have to be considered high-income people. Overall then, in 1972, tax expenditure benefits to individuals were definitely slanted heavily toward the high-income group.

I would like to take just a few more minutes and talk about the income distribution chapter in the economic report of the Council of Economic Advisers and what we can glean from it. There is a rather good discussion of what has happened or, more correctly, has not happened to the income distribution during the past 25 years, and it is pointed out that direct personal taxes appear to have had little effect on relative inequality in the distribution of income during this period. I should point out that those data are lacking in many respects; it would take me quite awhile to go into what is wrong with them. But I think the general conclusion is correct. The Federal tax system, and I could even broaden it, on the basis of work that I have done recently to include all taxes, but certainly the direct personal taxes at the Federal level, have had little effect on the distribution of income. This means, in effect, if I turn it around, that there is really very little effective progression in the existing tax system.

Now, if you couple this with the fact that existing tax preferences are running somewhere in the $75 to $80 billion range it suggests that tax progressivity could be increased significantly if some of these preferences were eliminated.

Let me be very explicit, I am now getting into tax reform and shifting from the use of tax expenditure budgets for program evaluation and budgeting.

Some tax expenditures, if we took a careful look at them, might be quite efficient. They may be more efficient as a means of achieving desired social objectives than any direct expenditure programs that are likely to be devised. Yet, I think it would be strange if we couldn't find a sizable portion of the $78 billion tax expenditure pie that could not be eliminated to increase overall tax progressivity.

I do want to put in the caveat, however, that when talking about tax reform, one must take account of the statements that were in the budget and say that if you were to pick a list of items that totaled, say, about $40 billion and eliminated them, you cannot expect Federal revenues would increase by $40 billion as a direct result. For one thing, equity would require that any kind of alteration or removal would have to take place over some kind of a phase-in period so it would take several years in order to get up to a full level. Second, I think that any substantial reduction in preferences and especially any reductions that primarily would hit high-income individuals, definitely ought to be accompanied by a reduction in statutory tax rates. Otherwise, I think, you do run into possible impairment of work and investment incentives within the economy. However, there is enough room within the total so you could both increase progressivity and revenue. I might add, you could also increase horizontal equity—that is, equal treatment of equals—at the same time. Then some millionaires are not paying zero taxes, while others pay effective tax rates of 50, 60, and 65 percent. I happen to believe that one ought to treat millionaires fairly, as well as lower and middle income individuals.

The reduction in tax preferenecs and the increase in progressivity would definitely be helpful as a step toward equalizing the overall distribution of income. However, while necessary, this is really not sufficient because most poor families are now exempt from the individual income tax. In 1972, for example, the latest year for which we have statistics, almost 14 percent of all unrelated individuals and families had incomes that were below the poverty level, and for these people it is obviously impossible to increase aftertax income by any changes in the income tax law. They don't pay taxes, so you can't decrease their tax other than through instituting refundable credits. The only feasible strategy for helping such families has to involve increased cash transfer payments.

Last January, the President, in his state of the Union message, indicated that there will be a new welfare reform proposal sent up sometime this year, accompanied with a new income maintenance program. If what the administration wants to do is to, one, clear up the "welfare mess," and two, effect some significant amount of income redistribution at the same time, it seems to me that the program must have at least two essential elements: It has to be a program that offers a subsantial nationwide minimum income guarantee for those at the very bottom through increased transfer payments, and it has to include an agenda for increasing tax progressivity for those at the very top of the income distribution by eliminating many of the inefficient tax preferences.

Parenthetically, I think it would also be desirable to include some reform of our regressive social security payroll tax system which now hits the lowest income earners especially hard.

As far as I can see, if one is serious about wanting to redistribute income in this country, there simply is no other way to proceed.

Thank you.

[The prepared statement of Mr. Okner follows:]

PREPARED STATEMENT OF BENJAMIN A. OKNER [1]

TAX SUBSIDIES AND INCOME DISTRIBUTION

On February 4, the President submitted to the Congress his budget for fiscal year 1975. As is well known by now, total 1975 budget receipts are estimated at $295.0 billion and total outlays at $304.4 billion. However, according to the estimates prepared by Tax Analysts and Advocates (TA/A), more than $78 billion of federal "tax expenditures" were omitted from the fiscal 1975 budget. In other words, money plus tax outlays should have been recorded at $382.7 billion rather than $304.4 billion (Table 1).

TABLE 1.—ESTIMATED BUDGET OUTLAYS AND TAX EXPENDITURES, CLASSIFIED BY FUNCTION, FISCAL YEAR 1975

[Dollar amounts in billions]

	Budget outlays	Tax expenditures	Total	Tax expenditures as percentage of total
National defense	$87.7	$0.7	$88.4	0.8
International affairs and finance	4.1	.9	5.0	18.0
Space research and technology	3.3		3.3	
Agriculture and rural development	2.7	1.1	3.8	28.9
Natural resources and environment	3.1	3.6	6.7	53.7
Commerce and transportation	13.4	24.4	37.8	64.6
Community development and housing	5.7	13.2	18.9	69.8
Education and manpower	11.5	1.0	12.5	8.0
Health	26.3	6.9	33.2	20.8
Income security	100.1	11.7	111.8	10.5
Veterans benefits and services	13.6	.5	14.1	3.6
Interest	29.1		29.1	
General government	6.8	0.1	6.9	1.4
Aid to foundations and charities		3.7	3.7	100.0
General revenue sharing—Aid to State and local governments	6.2	10.4	16.6	62.6
Allowances	1.6		1.6	
Undistributed intragovernmental transportation	−10.7		−10.7	
Total	304.4	78.2	382.7	20.4

Sources: The Budget of the United States Government, Fiscal Year 1975, p. 41 and Tax Analysts and Advocates, Tax Notes, "Fiscal Year, 1975 Tax Expenditure Budget," (Washington, Jan. 21, 1974), pp. 4-19.

[1] The author is a senior fellow at the Brookings Institution, Washington, D.C. The views expressed are his own and do not purport to represent those of the officers, trustees, or other staff members of the Brookings Institution.

One might well ask how the Office of Management and Budget (OMB) could overlook such a sizable amount—over 20 percent of the total—when preparing the President's budget. The answer, of course, is that the tax expenditures were not overlooked. They were deliberately omitted. In fact, there is a statement to that effect on page 34 of the Budget.[2]

WHAT IS A TAX EXPENDITURE BUDGET?

Before proceeding, I think it would be useful to define the concept of a Tax Expenditure Budget. While there are many ways to express the same basic notion, I believe that the following statement from the Budget sums things up quite precisely: "Tax expenditures are [the dollar value of] benefits to individuals or corporations that result from tax exclusions, tax deductions, preferential tax rates, or tax deferrals."[3] A tax expenditure budget is simply an orderly compilation and presentation of individual tax expenditures.

Tax expenditure figuures—like the other budget figures—are estimates. This is true whether they are for a past period or a future one. If for a future year, they require the same kinds of assumptions regarding the expected level of economic activity and other economic variables as are needed for the revenue and expenditure items presented in the regular budget.

WHY PRODUCE TAX EXPENDITURE ESTIMATES?

It is useful to stop and ask why tax expenditure budgets should be produced. Some people—maybe most people—may think of such budgets primarily in the context of tax reform. I have done so myself before this Committee. By pointing out the revenue lost because of some tax provision, it is possible to bolster one's case for its elimination. While this is a valid reason for supplying policymakers with tax expenditure information, it is not the only or most important one.

Information on the expenditures made in the form of federal revenue foregone should be used, along with the figures on expected money outlays, as an evaluation tool when considering the total federal budget. Both in the Executive Branch and in the Congress, there are numerous decisions that must be made each year in comparing alternatives means of achieving various objectives. Without considering the estimated outlays already committed through the tax system, it is impossible to compare the alternatives accurately and reach a decision on whether a given means is the best way to achieve a particular goal. This fact was recognized in writing the budget control bills being considered by the Congress: both H.R. 7130 and S. 1541 require that tax expenditure data be submitted to, and considered by, the appropriate budget committee each year. These are extremely important provisions and are to be commended.

WHY NOT PRODUCE TAX EXPENDITURE ESTIMATES?

While many people would agree on the usefulness of tax expenditure estimates, the Administration gives several reasons for their omission from the Budget. Paraphrasing its statements these are:

1. It is difficult to estimate tax expenditures;
2. The estimated cost of any particular tax provision depends on whether only that provision is changed or whether several provisions are changed simultaneously.
3. The total impact of the changes on federal receipts depends on whether tax rates on the broadened tax base are reduced;
4. "The concept requires a standard for comparison with the actual tax base, and there is substantial disagreement on what this standard should be."

While the statements are accurate, I do not believe they adequately make a case for not preparing tax expenditure estimates.

The preparation of tax expenditures—both for past and future years—*is* difficult. It is also difficult to make estimates of the regular monetary receipts and expenditures for a year that will end some 18 months after the budget is submitted. Yet, the Executive agencies and the OMB have prepared estimates that have been within 1 or 2 percent of the actual figures for the last several years. The use of the electronic computers and other new estimating techniques have

[2] Unless otherwise indicated, all references to the Budget are to *The Budget of the United States Government, Fiscal Year 1975* (Washington, 1974).
[3] Budget, p. 34.

contributed significantly to reducing the difficulty of revenue estimating in recent years. The continued use of such tools should substantially reduce the computational difficulty of preparing future tax expenditure estimates.

It *is* true that the revenue cost of any particular tax provision depends on whether other provisions are simultaneously changed. This occurs because removal of several provisions at the same time will ordinarily push taxpayers into higher marginal tax rate classes. Thus, the aggregate revenue gain from removing several provisions is usually greater than the sum of the revenue gain from the individual provisions. This is well understood by these who prepare revenue estimates and should also be clear to policymakers. In the TA/A estimates for fiscal 1975, as well as Treasury Department estimates for past years, there is an explicit statement that each estimate was made under the assumption that all other provisions remain unchanged. In practice, this procedure means that the total amount ($78 billion in the case of the TA/A estimate for fiscal 1975) *is too low.*

The next reason given by the Administration for not preparing tax expenditure estimates is that simultaneous statutory tax rate reduction would eliminate much or all of the expected revenue gain. Again, it *is* true that the revenue effect of eliminating tax provisions will be changed if tax rates are lowered at the same time. But it is also true that changing tax rates will affect the costs of tax preferences either with or without structural changes in the provisions. As in the preceding argument, there again seems to be the implicit assumption that the principal use of the tax expenditure budget is for tax reform, rather than program evaluation purposes.

The final reason presented for not preparing tax expenditure estimates is of value primarily for scholarly discussion regarding "the proper definition" of the comprehensive income tax base. Simplifying greatly, the statement says that there is no consensus among the experts on what provisions should be included in the list of tax expenditures and which should be excluded on the grounds that they are needed to obtain a "proper" definition of taxable income or because they are part of the rate structure.

In practice, this means that some items that would appear in my tax expenditures list may not appear in someone else's list. Again, I think the revelant question concerning the compilation of tax expenditures is the purpose for which the estimates are hard to be used. In the TA/A estimates, for example, "rate differentials, personal exemptions, and the low-income allowance are not listed. Nor are the * * * effect of income splitting and head-of-household treatment, [or] the standard deduction * * *"[4] If the Congress were considering total reform of the individual personal income tax, I would definitely want to have some of these items on a list of tax expenditures. On the other hand, when the Congress considers a particular program—say, federal health expenditures—there is no reason to expect that the kind of fundamental change implied in altering the tax structure would be relevant. The discussion should be limited to the efficiency of the outlays made implicitly through the tax system versus explicit cash outlays.

WHAT ABOUT THE TA/A 1975 BUDGET?

The first question likely to be raised concerning the 1975 TA/A figures is whether "they are any good." As indicated earlier, all tax expenditure figures are estimates based on certain assumptions. The 1974 current and constant dollar GNP forecasts used by TA/A are very close to the figures generally being used by economists. Also, their fiscal 1975 federal budget outlay figure is only slightly below the $304 billion amount presented in the Budget. It would be impossible to make a definitive statement about each item in the tax expenditure budget without checking the detailed assumptions and worksheets underlying it. However, on the basis of past estimates and what I think is likely in the future, I do not see any TA/A estimate that appears to be glaringly erroneous.

It should be emphasized, however, that it is possible to change the underlying assumptions and come up with tax expenditure figures that are quite different. For items that eventually appear on individual or corporation income tax returns, it is possible to go back and check the accuracy of past estimates. Thus, for

[4] "Fiscal Year 1975 Tax Expenditure Budget," *Tax Notes*, Vol. 2 (Tax Analysts and Advocates, January 21, 1974), p. 5.

many of the items in past tax expenditure compilations,[5] the Treasury Department could now compute actual tax expenditure amounts for some of the years in the 1967–72 period. It would be extremely interesting to see a comparison of the estimated and actual tax expenditures and to use it as a guide for evaluating the accuracy of individual estimates.

TABLE 2.—PERCENTAGE DISTRIBUTION OF ESTIMATED TAX PREFERENCE BENEFITS RELATING TO THE AGED BLIND, AND DISABLED, THE DEDUCTIBILITY OF MORTGAGE INTEREST ON OWNER-OCCUPIED HOMES, THE DEDUCTIBILITY OF CHARITABLE CONTRIBUTIONS (OTHER THAN EDUCATION), AND ALL PROVISIONS FOR INDIVIDUALS, BY ADJUSTED GROSS INCOME CLASS, 1972

[In percent]

Adjusted gross income	Aged, blind, and disabled provisions	Deductibility of mortgage interest	Deductibility of charitable contributions (other than education)	All provisions for individuals
Under $5,000	48	1	1	7
$5,000 to $10,000	31	11	9	15
$10,000 to $20,000	11	48	26	31
$20,000 to $50,000	7	33	26	23
$50,000 and over	3	7	38	24
Total	100	100	100	100

Source: Derived from U.S. Committee on Ways and Means, "Estimates of Federal Tax Expenditures," prepared by the staffs of the Treasury Department and Joint Committee on Internal Revenue Taxation (Washington, June 1, 1973), table 2, pp. 7–9.

The major shortcoming in the TA/A budget is the omission of any distributional data. For calendar years 1971 and 1972, the Treasury Department has provided the estimated distribution of the benefits from provisions affecting individuals by adjusted gross income classes. As indicated in Table 2, almost half of all tax preferences benefits accrue to taxpayers with adjusted gross incomes of $20,000 and over. But, not all such benefits accrue to the rich. All three of the specific preferences shown in the Table involved total benefits of $3.0 to $3.5 billion in 1972, but the distributions of the total by adjusted gross income differ substantially. The aged, blind, and disabled provisions are clearly of most benefit to low-income families;[6] the mortgage interest deduction is of greatest help to those in the middle-income ranges, and the charitable contributions deduction is of major benefit to those at high-income levels.

Again, the value of such information is not limited to tax reform or determining "who is not paying his fair share of taxes?" In evaluating program effectiveness, one of the major concerns should be the extent to which programs benefit the target populations for which they are intended. There are usually many interesting dimensions on which to array program beneficiaries (e.g., age, region, urban/rural, etc.), but it is hard to think of instances where income level would not be of interest to policymakers along with the other characteristics.

TAX PREFERENCES AND THE DISTRIBUTION OF INCOME

As you know, the *1974 Annual Report of the Council of Economic Advisers* which accompanied *The Economic Report of the President* contains an entire chapter on the distribution of income in the United States. It contains an excellent discussion of what has happened (or more correctly, what has not happened) to the income distribution during the past 25 years, and some of the reasons for the observed stability. Or particular interest for the discussion today is the fact that direction personal taxes appear to have had little effect on the relative inequality in the distribution of income.

[5] Figures for calendar years 1967–72 were published in U.S. Committee on Ways and Means, *Estimates of Federal Tax Expenditures*, Prepared by the Staffs of the Treasury Department and Joint Committee on Internal Revenue Taxation (Washington, June 1, 1973).

[6] It is tempting to label units with low adjusted gross income as "poor." However, this may be erroneous since the adjusted gross income concept excludes many types of income that are counted in defining the poverty population.

The fact that the existing direct personal taxes have had only a small effect on the relative distribution of income means that there is little effective progession in the tax structure. And this coupled with the fact that the existing tax preferences are extremely costly[7] suggests that progressivity could be increased significantly if some preferences were eliminated. Of course, it might be determined that when compared with possible alternatives certain tax subsidies are more efficient than direct expenditures for achieving desired social goals. Yet, it would be strange if it were not possible to find a sizable portion of the $78 billion tax expenditure pie that could not be eliminated to increase overall tax progressivity.[8]

The reduction of tax preferences and the accompanying increase in progessivity would be a helpful step toward equalizing the overall distribution of income in the United States. But while necessary, this is not sufficient because most poor families are now exempt from the individual tax.

In 1972, there were 5.1 million families plus 4.9 million unrelated individuals—almost 14 percent of all such units—with incomes below the poverty level. For these groups, it is obviously impossible to increase after-tax income by any change in the individual income tax law (other than instituting refundable credits). The only feasible strategy for helping such families must involve increased cash transfer payments.

In his State of the Union message last January, the President indicated that the Administration plans to renew its request for welfare reform and a new income maintenance program this year. If the Administration goal is to effect a significant degree of income redistribution through these measures, it would seem desirable to include as elements of such a package: (1) a program that offered a substantial nationwide minimum income guarantee; and (2) an agenda for increasing tax progressivity by eliminating many of the inefficient tax preferences.[9] If one is serious about wanting to redistribute income, there simply is no other way to accomplish this goal.

Representative REUSS. Thank you, Mr. Okner.

It has been pointed out by several of the witnesses that the budget, on page 34, simply gives up on any attempt to State tax expenditures, and then goes into a long paragraph about how it would have a nervous breakdown if they tried to do it. You gentlemen were quite polite about all that. But don't you think the real reason why Mr. Ash and company are not willing to do this is that this administration depends in large part for its campaign support on contributions from those who enjoy these loopholes, and hence it does not want to get itself into an embarrassing and tiresome discussion about it. Is there any doubt in anybody's mind that that is really what is going on?

Mr. OKNER. Well, Mr. Reuss, you know there is the old story about the questioner who asks "whether you have stopped beating your wife." I find your question somewhat in the same category. It is certainly a possibility to which one would attach a strong probability on the basis of events during the past year. But I couldn't say with certainty. I will ask the others if they want to comment.

Representative REUSS. In your prepared statement, Mr. Okner, you mention that Congress, in writing the budget control bills now being considered, required that tax expenditure data be submitted to and considered by the appropriate budget committee each year. I wish that were wholly true. Unfortunately, the bill that passed the House didn't

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[7] The $78.3 billion cost of the items in the fiscal 1975 TA/A tax expenditure budget amounts to 44 percent of the $177.0 billion of individual and corporation income tax receipts estimated for 1975.

[8] It is naive to think that eliminating preferences whose total cost is estimated at, say, $40 billion in fiscal 1975 would immediately generate that amount of additional revenue. Equity would require that such a removal be phased-in over a period of time. In addition, any substantial reduction in preferences probably would (and should) be accompanied by reductions in the statutory tax rates in order to avoid impairment of work and investment incentives.

[9] In addition changes to reduce or eliminate for low-income earners the highly regressive social security payroll tax would be a highly desirable part of an income redistribution package.

contain that provision, and whatever help you can give us to see that the Senate bill, which now has the provision in it, continued to have it and that the provision prevails in conference, would be much appreciated.

Mr. OKNER. I would very much like to see it strengthened. Even the Senate bill is rather loose and ambiguous in the definition of exactly what the administration is required to submit. A strong provision would be a definite advantage.

Representative REUSS. Mr. Budd, the Bureau of the Census quintile studies, which have been going on since 1947, are less than completely helpful, are they not? For one thing, they are before taxes and hence they don't show the effective taxes. Second, they understate the share of the top quintile by excluding capital gains, and probably understate the share of the lowest quintile by excluding nonmoney transfers like medicaid and food stamps and housing allowances. Would you agree with that; would you agree that is a valid criticism?

Mr. BUDD. That is certainly true. I was looking at my estimates of how much those shares might be changed by the inclusion or exclusion of those items. But it is not clear to me how those would affect the secular trend of income. It certainly is true that the inclusion of medicare would serve to raise the share of the bottom group. The BEA does include medicare benefits in its income estimates and, consequently, gets a higher figure for the share of the bottom than does the Bureau of the Census money income concept.

Representative REUSS. The series is likewise less than completely helpful, is it not, because it includes money income but doesn't show the effect of inflation on income. It is demonstrable that an inflation such as we are now having, which is unusually severe in its price rises on commonly used commodities like food and fuel and housing, bears unduly on those of lower income.

Mr. BUDD. Yes, that is correct.

Representative REUSS. Yet these quintile studies don't show that.

Mr. BUDD. If the price index of the kind of price changes you get move adversely against certain kinds of income groups, as they have recently, particularly in terms of the effect of inflation on food prices, then these figures will not reflect that.

On the other hand, if all prices kind of move up together, then one would not have to modify these estimates for that kind of general inflation as distinct from the kind of relative price change inflation that we had recently. I think that is a point I alluded to at the very beginning of my statement.

Representative REUSS. Wouldn't it be a useful thing for the country if somebody did construct each year this kind of income share study, taking into account, as the Census Bureau study does not, taxes, nonmoney transfers, and differential effects of inflation.

Mr. BUDD. It would be very useful. However, taking account of the differential effect of inflation would be very difficult to do properly. It really requires us to have different kinds of price indexes for different income size groups in the economy. Certainly, I think we ought to have distributional statistics which will be after income taxes, as we now have the Bureau of Economic Analysis series after social security taxes, and I would hope that we would get that series after personal income taxes as well. In fact, the old Bureau of Economic Analysis series was shown on an after Federal personal income tax basis.

Representative REUSS. Am I correct, Mr. Budd, in gathering from your testimony that the quintile of families which has probably done worst in relative terms, is the second from the bottom quintile, those who currently make between $5,600 and $9,300 a year?

The evidence in favor of that assessment of their lot is, first of all, in the naked income figures. They started out in 1947 with 11.8 percent total income—I am reading the figures from the table on page 140 of the economic report—and they ended up in 1972, the most recent year for which we have figures, with only 11.9 percent, having gone down from 12.4 percent in 1966. That is one-half a percentage point for this relatively working poor group. And then you look at exogenous factors. This is the group that has been hit hard by increases in the payroll tax because they are working and they start paying that tax on the first dollar they make. This is the group that has been hit very hard by inflation in the costs of fuel, food, interest rates, housing, and medical care.

I don't want to put words in your mouth, but I would just ask you and also Mr. Okner and Mr. Hastings-Black whether I am on the trail here of anything or not.

Mr. OKNER. Yes, I think you definitely are. I won't take you all the way back to the 1947 period, but—and I don't have the reference or the volume with me—in last year's volume of "Setting National Priorities," we had a very interesting chart which indicated the 1969–73 changes in Federal individual income tax and payroll tax for families at different income levels. Despite a substantial drop in effective income tax rates due to the Tax Reform Act of 1969 and The Revenue Act of 1971, net, the group between—and here I will have to go from memory—it seems to meb it is about $8,200 to $11,300, had a net increase in their tax bill because of the very sharp increase in social security payroll tax during the 1969–73 period. So, middle income or slightly below median income families was especially hard hit by the tax system and particularly the social security tax system in that period.

Representative REUSS. Yes, I view the total performance as consisting of three things, of which only one is shown by the Census Bureau figures: Category 1, crude money income.

Mr. OKNER. That is right.

Representative REUSS. Category 2, taxes; category 3, inflation. This second from the bottom quintile seems to me to have been rocked and socked by all three, and they got little or none of the medicaid, housing allowances, and food stamps.

Mr. OKNER. Their incomes are too high for that.

Representative REUSS. Some might have at the bottom but not much.

Mr. BUDD. I do have the figures here.

Representative REUSS. What do you think, Mr. Budd?

Mr. BUDD. In a chart prepared for me by my colleague, Dan Radner, which shows change in the shares of various quintiles, the share of the second quintile—the 20th to the 40th percentile group—fell from 12.5 percent in 1958 to 11.9 percent in 1972, and of all of these share groups that share showed the most pronounced decline.

There is also a very slight decline in the share of the middle quintile. The fourth quintile shows almost no change, and the top quintile seems to ride a rollercoaster, rising sharply up to 1961, falling rather sharply to 1967, and then rising again up to 1972.

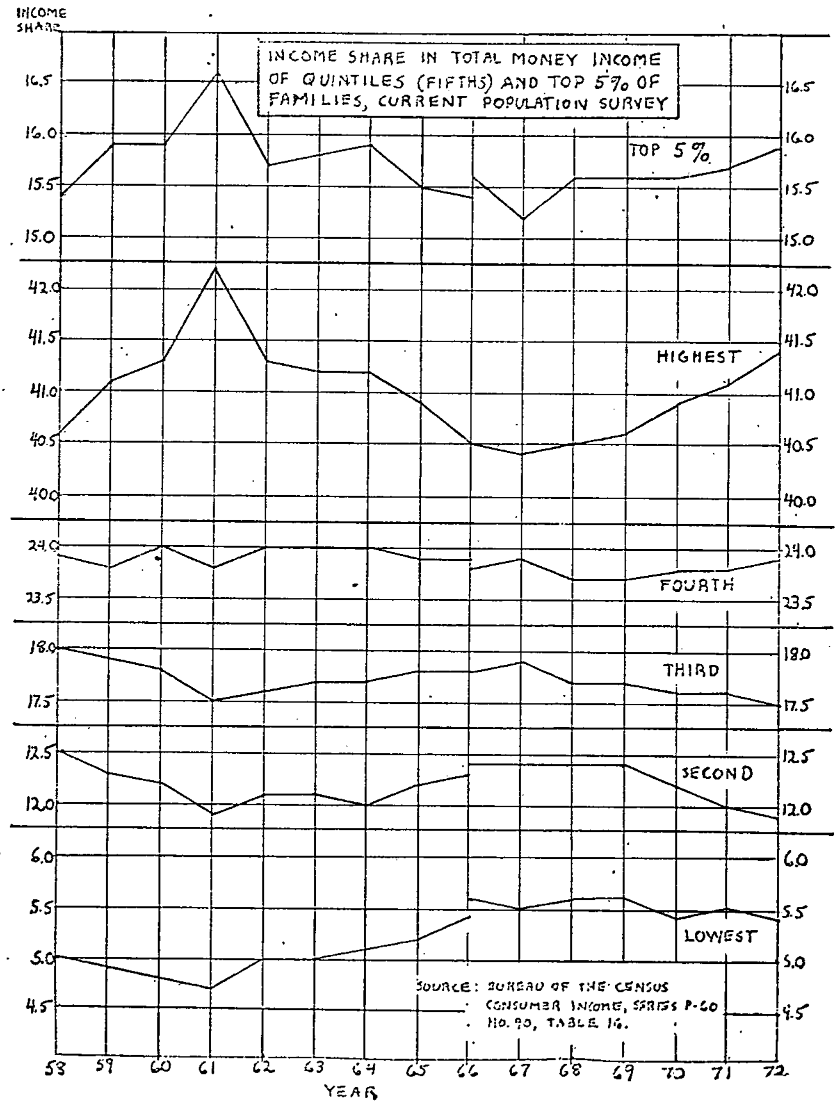
On the other hand, of course, largely, I think, through the rise in transfer payments, the bottom quintile has gained.

Representative REUSS. May we have a copy of this?

Mr. BUDD. Yes. This is my only copy.

Representative REUSS. Would you send that to us. It will be included in the record at this point.

[The following chart requested by Representative Reuss and additional information and charts were subsequently supplied for the record by Mr. Budd:]



Additional Information Submitted by Edward C. Budd

Distribution of Income

The chapter in The Economic Report of The President of the distribution of income seems to be lacking in purpose or focus. Certainly the focus is not on public policy, for few policy issues are raised. While most of the material on earnings distributions, for example, might be useful as background material in understanding some of the reasons for th substantial degree of inequality in the distribution of earned income (i.e., income from human labor) that exists in our society, the discussion itself is not related to any kinds of policy proposals, either general or specific. The last section of the chapter on government transfer programs does little more than describe the present system of taxes and transfers with virtually no suggestions for its revision or reform.

Further, it is not clear to whom the chapter is addressed. Interested layman will find it difficult to understand, and its usefulness for professional economists, particularly experts in the field, is quite limited. Particularly frustrating is the lack of documentation of the many studies alluded to in the chapter and the failure to document, except in the most general terms, the sources of data used.

Measurement of Inequality

For little apparent reason, the Report places considerable emphasis on one particular single-valued measure of inquality: the variance of the natural logarithm of income. While a rather technical discussion of this measure is given in the appendix to the chapter, it may be helpful to describe its characteristics more simply. It is based on the percentage, rather than the dollar, difference between any given income and the average or mean of the distribution as a whole. To illustrate, the log-variance gives greater weight to a $4,000 deviation below a hypothetical mean of $12,000 than to a $4,000 deviation above that mean. Indeed, the latter deviation would have to be $6,000 (or the income $18,000) in order for it to have the same weight in the index of inequality as the $4,000 deviation below the mean (implying an income of $8,000). For this reason, the log-variance is said to give more weight to inequality in the lower part of the distribution as compared with the upper. Further, because the measure requires that the deviations from the mean be squared, larger deviations are given proportionately greater weight than are smaller ones.

Unfortunately, it is difficult to give a common sense interpretation of the index's meaning. A smaller value obviously implies less inequality, but how *much* less, we cannot say. For example, while Table 35 of the Report shows that the log-variance for the distribution of money income is .75, and for disposable family personal income (i.e., after adding imputed income to and deducting direct taxes from money income) is .52, it would be incorrect to infer that inequality is only two thirds as great for the latter income concept as for the former. By contrast, if the Gini concentration ratio (another widely used single-valued measure of inequality) falls by a third, we can say that the average dollar difference among all (possible) pairs of incomes has been reduced by a third.

There is a more serious difficulty with this (indeed, any single-valued) measure of inequality: concentration on an "average" measure of change may obscure widely differing movements in inequality in different parts of the distribution. If, for example, the income shares of the bottom and top income groups fall and that of the middle group rises, it can be inferred that inequality has moved in opposite directions in two parts of the distribution: it has decreased in the upper part, and increased in the lower part. A measure of the net or average change in such a case is not likely to be of much interest.

For these reasons I prefer not to rely on a single measure, but to look directly at the change in the income shares of different quantile or fractile groups. The Council in its Table 34 uses fifths or quintiles (and the top 5 percent of recipients), although the methods is not limited to the almost universal practice of dividing the distribution into five groups of equal size. This "share" method, in addition to permitting us to look at the changes occurring in different parts of the distribution, can easily be interpreted in terms of changes in the average income of a group relative to the average income for all groups taken together. If, for example, the bottom quintile (or 20 percent) receives 5 percent of total income, its average or mean income is only one quarter (5/20), or 25 percent, of the average income of all recipients. If, in turn, its share rises to 6 percent, its mean income will now be 30 percent of the overall average instead of 25 percent. It would clearly not be appropriate to characterize the one percentage point share rise as insignificant, for it implies a 20 percent (5/25) increase in the income of the lowest quintile relative to everyone else's. Small (percentage point) changes in shares may mask the underlying percentage changes in relative mean incomes.

TABLE 1.—SHARE OF TOTAL MONEY INCOME, AND MONEY PLUS IMPUTED INCOME, OF SELECTED GROUPS OF FAMILIES, RANKED BY SIZE OF INCOME, 1964

Income group	Percent share in income— Money (1)	Percent share in income— Money+imputed (2)	Percentage point change, (1)−(2) (3)	Percent change, [(1)−(2)]÷(3) (4)
Lowest quintile	3.93	4.15	+0.22	5.6
2d quintile	10.67	10.71	+.04	.4
Lowest 40 percent	14.60	14.96	+.26	1.8
41st through 95th percentiles	65.85	65.46	−.39	−.6
Top 5 percent	19.55	19.68	+.13	+.7
Top 1 percent	7.79	7.84	+.05	+.6

Source: E. C. Budd, D. B. Radner, and J. C. Hinrichs, "Size Distribution of Family Personal Income: Methodology and Estimates for 1964," Bureau of Economic Analysis Staff Paper No. 21, June 1973.

Table 35 of the Report can be used to illustrate these points. The table shows that the log-variance of income is reduced from .75 to .68 (or .07) when various items of imputed or nonmoney income (exclusive of medicare) are added to money income. What it dose not show is that the inclusion of imputed income raises the share of the top income groups as well as that of the bottom (primarily the lowest quintile), thus reducing the shares of the middle and upper groups. Table 1 below shows, for example, that the share of the bottom two quintiles was increased by 2 percent; that the top 5 percent, by about 1 percent; and the share of the middle 41st through 95th percentiles reduced by approximately 1 percent. While it is true that much of the nonmoney income is received by the bottom group, particularly those living on farms and the aged, a large share of imputed property income—rent and interest—accrues to the top, with proportionately less going to the middle groups.

The same thing is true of personal contributions to social insurance (mostly employee social security taxes). Deducting these (a step necessary to go from the sum of money and imputed income to BEA's concept of family personal income) increases the shares of both the lowest quintile and the top 5 percent (and hence reduces the share of the 21st through the 95th percentiles) by about 2 percent.

Concepts of Income and of Recipient Units

The most widely used series for making comparisons of inequality in the postwar period, and the one used by the Council, is the Current Population Survey of the Bureau of the Census. Indeed, it is the only one encompassing the entire postwar period. Unfortunately, it does have limitations. Because of the underreporting of income by respondents to this and other field surveys, the shares of the lower income groups (particularly the bottom quintile) and of the top 5 percent tend to be understated relative to those in the middle.

The Census concept of money income before taxes is not necessarily the most appropriate one for measuring family well-being. The effect of adding the imputed income items included in BEA's family personal income concept has already been noted above. But other types, such as capital gains, employee fringe benefits, and possibly the value of leisure time enjoyed by family members are left out of account. Further, the series is confined to measuring inequality in the receipt of annual income, not income over some longer period of time.

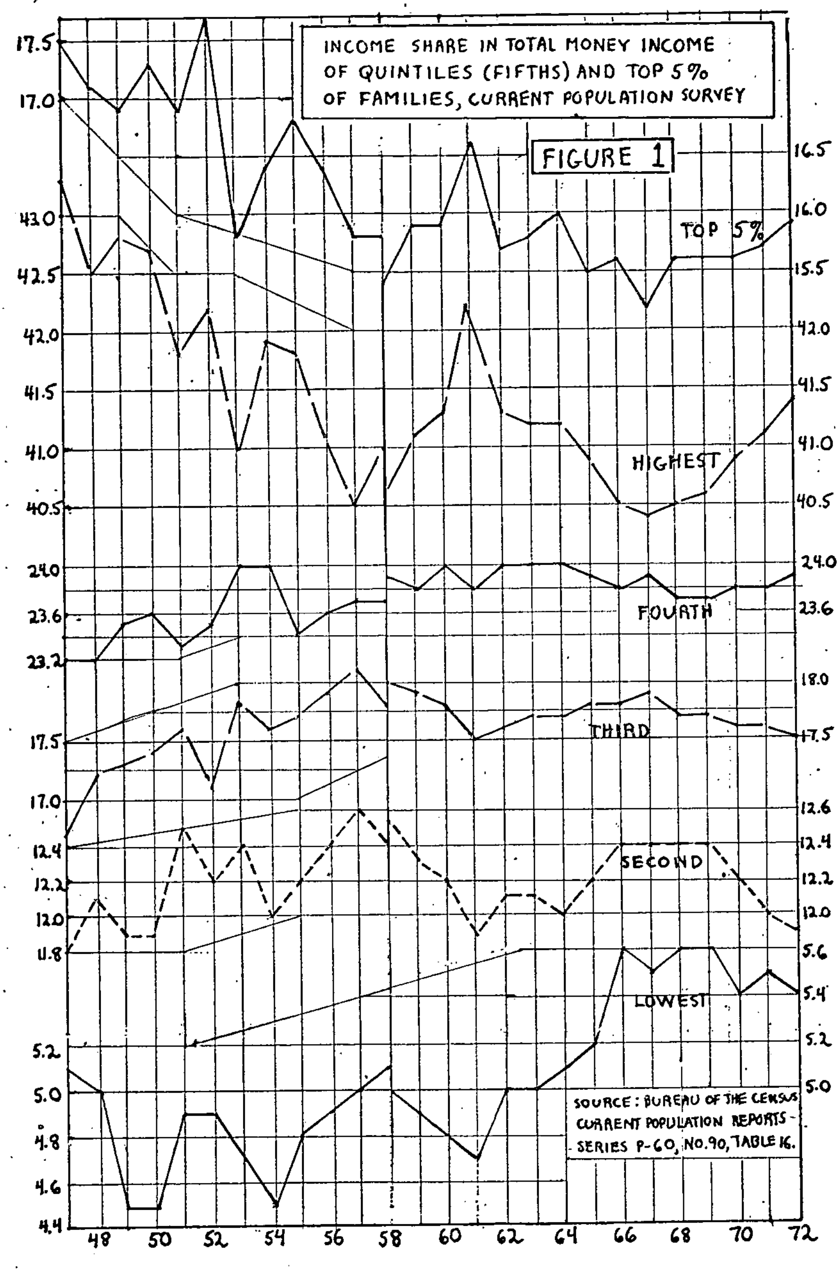
The series used by the Council and the one I discuss below is for families and leaves out "unrelated individuals" (single person consumer units). For a number of reasons that I cannot examine here, the data for the latter units are even less satisfactory than for families, and it is difficult to make the two types of units comparable. The family unit is, it seems to me, the appropriate one for comparisons of well-being, for it is the fundamental consuming and property-owning unit as well as the important unit within which redistribution from earners to nonearners and among earners themselves takes place. The distribution of earnings among persons is of interest primarily as a determinant of the family distribution. We know very little about the way in which the family distribution is affected by changes in the distribution of earnings among individuals and changes in the labor force participation rates among individual family members. Further research could certainly contribute to our understanding of the relationship between the family income distribution and the distribution of income and earnings among persons.

The primacy of the family distribution might be questioned on the grounds that families themselves differ in size and in the needs of their indivdual members. Certainly one ought not just to look at the distribution among families without separate allowance for their differing characteristics and size. The definitions of poverty thresholds, of course, take account of some of these characterstics. Some interesting work has been done in this area, and it could well profit from further research efforts.

Changes in the Distribution of Income in the Postwar Period

The Report has little to say about changes in inequality, confining itself to the observation that the U.S. family distribution has been relatively stable over the postwar period as a whole, except possibly for a small decline in the share of the top 5 percent. Since the Council's Table 34 gives income shares for only five selected years, I have charted in Figure 1 the annual data from the CPS for the 1947–72 period. (In order to emphasize movements in shares rather than their levels, I have not shown the origin, and have used different scales for the two lowest quintiles compared with the others.)

When presented in this way, the series seems to be dominated by year-to-year variation. Changes within sub-periods can nevertheless be distinguished. In an earlier study, I noted a tendency towards increased inequality in the lower part of the distribution and decreased inequality in the upper part, from the late forties (1947–48) to the early sixties (1960–61). Several size distribution series, in addition to the CPS, indicate a fall of about 3 to 4 percent in the relative mean incomes of the two lowest quintiles and the top 5 percent and a consequent rise of 2 to 3 percent in the relative mean incomes of the groups lying between them. This trend is also evident in Figure 1 for the same terminal years. The share of the lowest quintile declined somewhat; that of the second, after rising in the late fifties, was virtually unchanged; the shares of the third and fourth quintiles rose; and those of the highest quintile and the top 5 percent fell.


INCOME SHARE IN TOTAL MONEY INCOME OF QUINTILES (FIFTHS) AND TOP 5% OF FAMILIES, CURRENT POPULATION SURVEY
FIGURE 1
TOP 5%
HIGHEST
FOURTH
THIRD
SECOND
LOWEST
SOURCE: BUREAU OF THE CENSUS CURRENT POPULATION REPORTS - SERIES P-60, NO. 90, TABLE 16.
17.5
17.0
43.0
42.5
42.0
41.5
41.0
40.5
24.0
23.6
23.2
17.5
17.0
12.4
12.2
12.0
11.8
5.2
5.0
4.8
4.6
4.4
16.5
16.0
15.5
42.0
41.5
41.0
40.5
24.0
23.6
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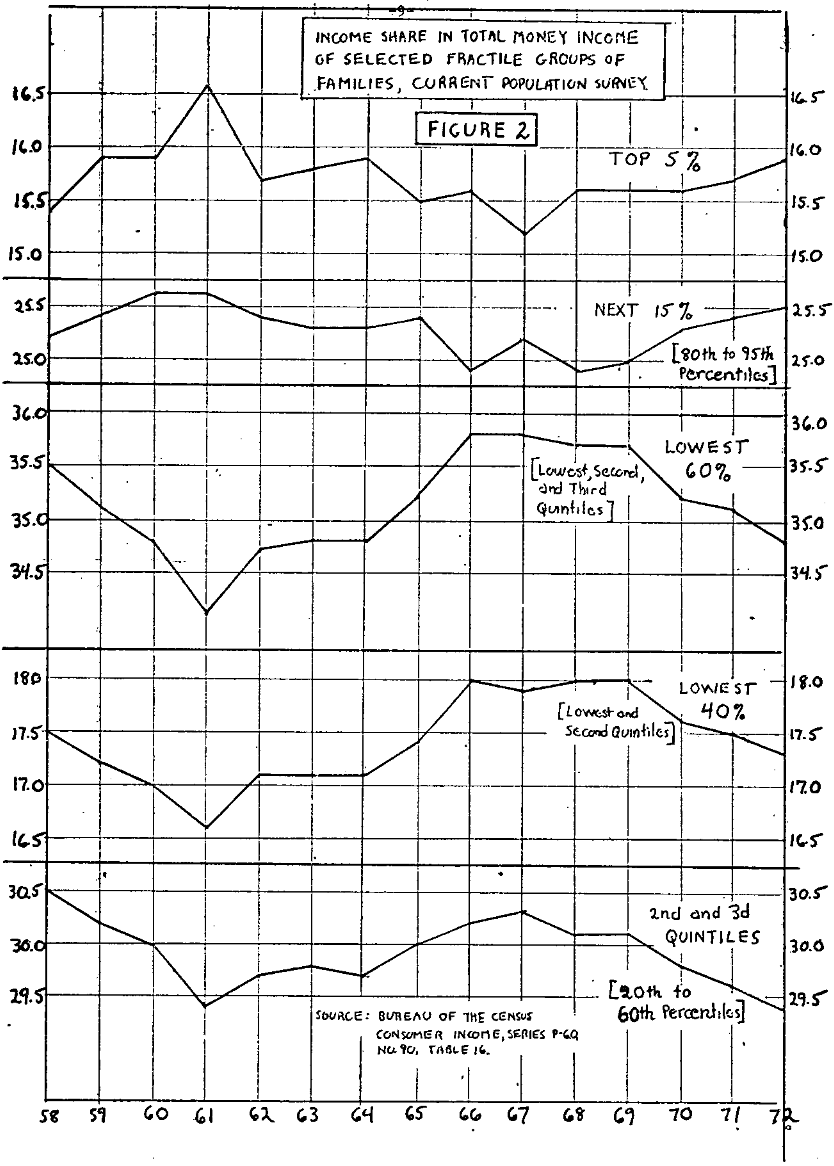
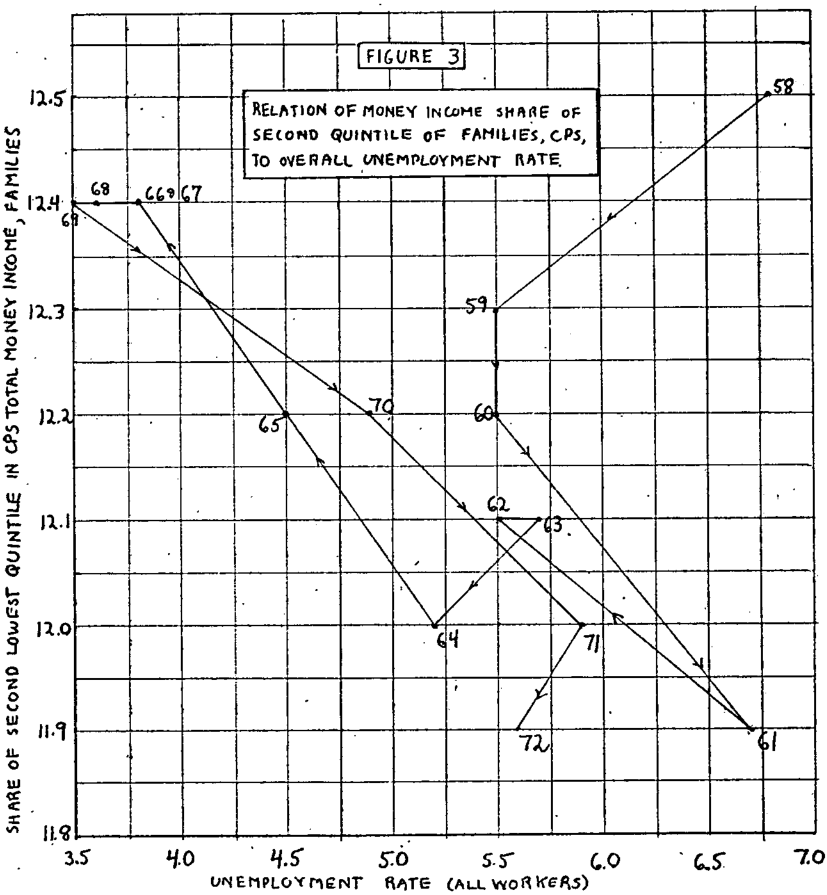
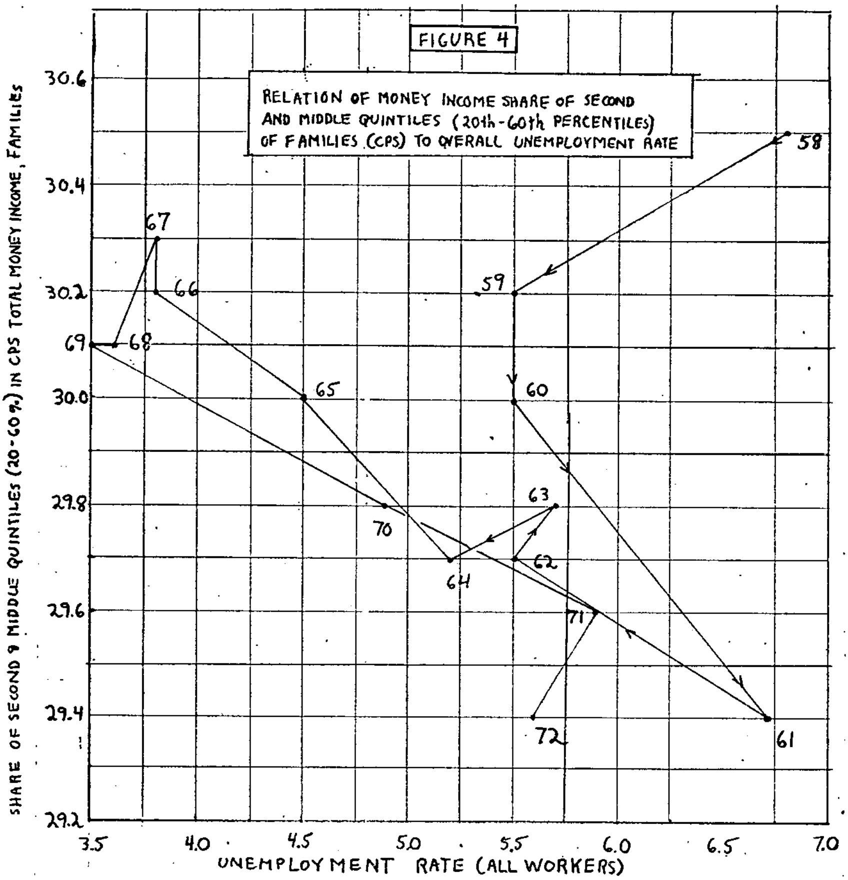


Figure 2 presents detail on the movement of the shares of selected fractile groups for the period 1958–72. (These years were selected because the shares are based on special computer tabulations by Census; for earlier years, the share data have had to be estimated from the underlying size distributions.) An inspection of that figure shows a fairly consistent decline in inequality in all parts of the distribution from 1961 up to 1966 or 1967. The rise in the share of the bottom quintile is particularly evident, going from 4.7 percent in 1961 to 5.6 percent in 1966, implying almost a 20 percent increase in the mean income of that group relative to the average for the distribution as a whole. Virtual constancy in the distribution prevailed from 1966 to 1969. Since 1969 there has been a significant shift towards more inequality. Between 1969 and 1972 the share of the lowest two quintiles fell by 0.7 percentage points or by 4 percent, and that of the highest quintile rose by 0.9 percentage points or by 2½ percent.

These changes have some puzzling aspects. While the increase in transfer payments undoubtedly helps to account for the increased share of the lowest quintile over the period as a whole, the sharpest increase in that share, from 1961 to 1966, was associated with a fall in money transfer payments (exclusive of Medicare and food stamps) as a percent of personal income from 7.6 to 7.2 percent. In 1972, by contrast, that percentage had risen to 9.8. Furthermore, changes in the relative importance of various income types should have resulted in less, rather than more, inequality. It is also possible that part—though by no means all—of the increased share of the highest quintile may be a statistical artifact, resulting from improved reporting in the CPS by upper income groups of wage and salary income.





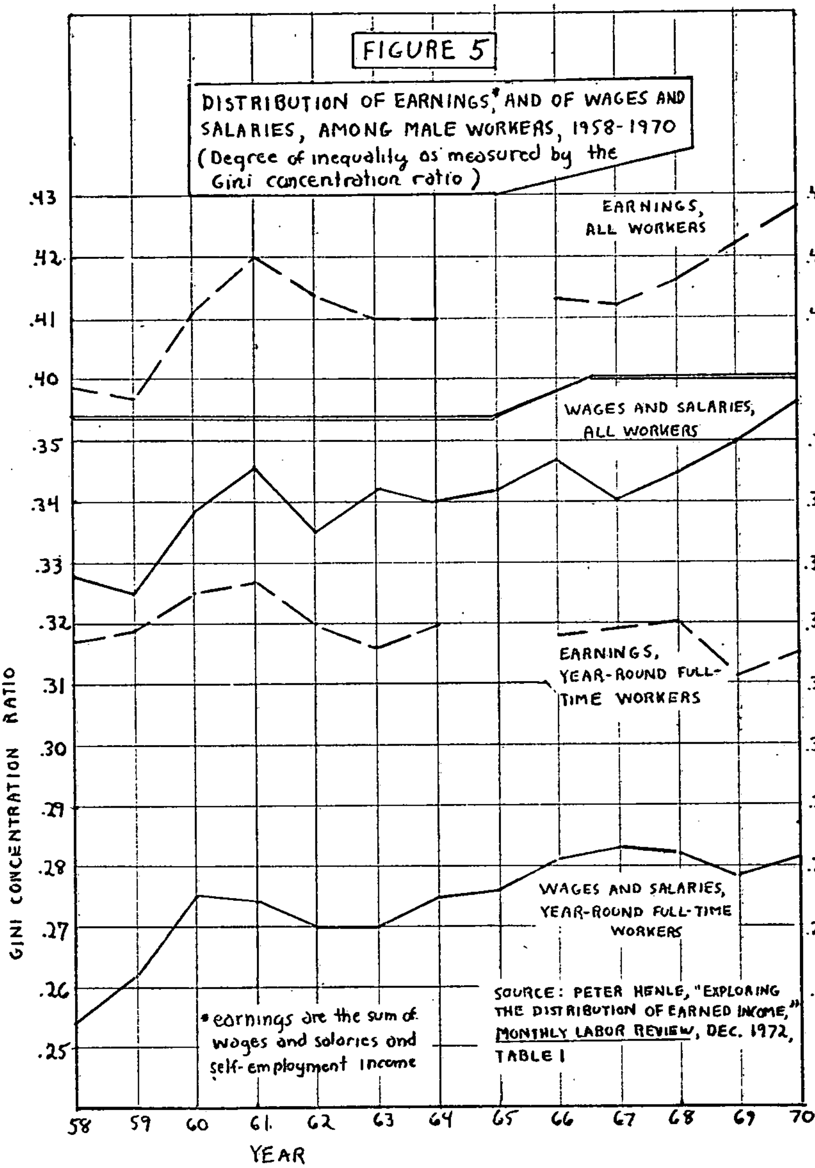
One important factor, also noted by the Council, is the effect of variations in unemployment. In Figures 3 and 4, I have plotted, for the same years used in Figure 2, the shares of the second quintile, and the share of the second and middle quintiles combined, against the overall unemployment rate. The inverse relationship is quite evident for most years, suggesting that cyclical forces can account for most of the changes in the shares of these groups, at least between 1960 and 1971. Other forces were apparently dominant in 1958–1960 and 1971–1972. The relationship for the lowest quintile (not shown in the graphs) is not as evident, partly because it is obscured by the secular rise in the share of the lowest quintile in the same period, and partly because the bottom is less dependent than the two quintiles above it on wage and salary income. It is the degree of inequality of this latter income type that is most affected by recessions.

I have not mentioned the possible effect of inflation, the rate of which has sharply increased in recent years. While the relationship between unemployment and inequality is well-established, evidence on the relationship between inflation and inequality is less conclusive. Some economists have even found inflation to be a slightly equalizing force. An econometric study completed by David Seiders of the Federal Reserve Board and myself several years ago, based upon U.S. experience over the postwar period, did show some small redistributive effect away from the bottom two quintiles and tthe top 5 percent, and toward the middle groups (41st to 95th percentiles). For example, a 5 percentage point increase in the inflation rate (e.g., from 5 to 10 percent per annum) in our model reduced the share of the bottom by 0.7 percent, that of the top 5 percent by 0.5 percent, and increased the share of the middle by 0.25 percent.

My discussion of changes in inequality among families over the postwar period has necessarily been based on the distribution of money income. While I have previously commented on the effect on inequality of going from the Census money income concept to BEA's concept of family personal income for a given year, it is not possible to examine changes in inequality over the entire period using the latter concept. One comment I can make concerns the effect of the rise in the social security tax on employees in the postwar period. Since earnings in the CPS are inclusive of the employee's share of the tax, the Census series does not reflect the redistributive effect of the significant rise in this tax in the past 20 years. Because of the upper limit of the tax, and the fact that the lowest quintile and the top group are less dependent on earnings for their income, increased tax rates should have raised the shares of these latter groups, particularly the top 5 percent relative to the middle. John Brittain found in a recent study of the social security tax system that the share of the top 5 percent rose by 0.7 percentage points, or by 3.5 percent, more in earnings after tax than before tax, between 1951 and 1969, when the tax rose by 6 percentage points. These results, it should be emphasized, are for earnings rather than total money income.

A further point on temporal changes concerns the possible differences between the distribution of money income and of real income. If the same price index were applicable to all income size groups, the two distributions would be identical. But we know both that the composition of expenditure among families differs by size of income and that the prices of various goods and services do not all change in the same proportion. Between 1972 and 1973, for example, the Consumer Price Index exclusive of food rose by 4.0 percent; the CPI for food alone, by 14.2 percent. Thus, the price of food relative to other consumer goods and services rose by 10 percent in just this one year alone. Since the lower income groups spend a larger proportion of their income on food, we can be sure that, whatever the increase in inequality in the distribution of money income between 1972 and 1973 that may be shown by the CPS, it would have been even greater had the distribution been based on real income—money income deflated by a cost of living index applicable to each income group. This relative price effect needs to be clearly distinguished from that of pure inflation, where all prices increase in more or less the same proportion, the effect of which I referred to earlier. We know little about the impact of differential price changes on income distribution, and I believe this would be a fruitful area for further research.

I want finally to comment on the apparently diverse movement of inequality among individual persons as compared with that for families. Whether the size distribution series is for men or for women; for total money income, earnings only, or wage and salary income; or, if confined to earnings, for all workers or only for those working year-round, full-time, the results generally show a rise in inequality both for subperiods and for the period as a whole. Figure 5, drawn from a study of male workers by Peter Henle, and based on special tabulations of the CPS for the period 1958–1970, illustrates the finding. (This chart is based on a single-valued measure of inequality, the Gini concentration ratio, rather than income share data used in my other charts. Higher values of the ratio correspond with a greater degree of inequity. As noted earlier, the use of such an index is based on the assumption that there are no offsetting changes in inequality in different parts of the distribution.) Only the series for the earnings of year-round, full-time male workers (inclusive of self-employed) shows virtual constancy. The crucial distinction here is between the family distributions on the one hand and the individual person (or earner) distributions on the other, not between total money income and earnings or wages and salaries. Changes in the distribution of wage and salary income among families more or less parallel the family distribution of money income, for the years for which both sets of data are available.



While general agreement among economists on this point is lacking, I argued earlier that the family (and unrelated individual) distribution was the relevant one for welfare comparisons. This does not necessarily mean that the distribution of income among persons is unimportant. Persons are, after all, members of families, and we need to understand more how changes in the distribution of income among families is affected by changes in the corresponding persons' distributions. No one, to my knowledge, has been able to reconcile the diverse movements of the family and persons' distributions in the postwar period, and I would recommend this as an important area for further research.

An Agenda for Further Research

I have been asked in particular to comment on areas where research efforts might be particularly rewarding. Some of the suggestions made earlier in my statement will be summarized here. We are just beginning to ask questions about the distributional effects of a number of important economic problems and policies that have been designed to deal with them; the fact that I refer only to three of them in my first three agenda items does not mean that others are not worth investigating.

(1) The distributional impact of the "energy crisis." This might include such questions as the effect of the substantial rise in energy prices (e.g., fuel oil and gasoline prices) on size distribution, and the distributional effects of various proposals to remove price controls on natural gas.

(2) The distributional effect of recent food shortages and soaring food prices. I have already emphasized the importance of being able to measure the effect of differential price changes on income distribution; both this and the preceding research suggestion would require some resolution of this problem. The recently completed Survey of Consumer Expenditure would undoubtedly be an important data input for such a study.

(3) The effects of fluctuations in the level of economic activity, including variations in the level of unemployment and in the rate of inflation. Economists have been busy in this area, working on either the unemployment and real output side, or on the price or inflation side, and sometimes on both together; indeed, T. C. Whiteman and I have been working on a study which involves simulating the effect of variations in the unemployment rate on the size distribution. However, until these studies produce more consistent results, additional work will be justified, in view of the overwhelming importance of these twin problems.

(4) The relation between family income and earnings distributions on the one hand, and the corresponding distribution of earnings among individuals and their labor force participation rates on the other hand. Why has the distribution of income among families moved differently from the distribution among persons, whether males or females? What has been the effect of the increased labor force participation rate of wives in the postwar period on the family distribution? The Council is considerably more cautious in inferring the effects of working wives on the family distribution than others have been, but does say that "the increase in the proportion of wives with earned income evidently did not lead to increases in the relative inequality of family income, partly because husbands' and wives' annual earnings have not been positively correlated." (p. 141.) The extent of this correlation, and the forces tending to raise or lower women's earnings relative to men's, are all pieces in this puzzle that need to be put into place. The earnings of family members other than the head of the family and spouse (if any) must also be considered in any study of this problem.

(5) Welfare interpretations of family income distributions are currently hampered by differences in family size and composition and in the needs of individual family members. The family distribution includes such diverse units as an aged, retired married couple; a 35-year-old head with wife and four young children; and a divorced woman with two older children living with her. For many purposes, it is not practical to use separate distributions of families by size of family and socioeconomic characteristic of the head (or members), and we need methods for adjusting the units themselves of weighting them differently. Much of the recent research in this area has been devoted to the definition of poverty thresholds for families, by size and socioeconomic characteristics. Such work needs to be extended to families in all parts of the size distribution.

(6) A problem closely related to the two preceding ones is the effect of the inclusion in families of adult family members and subfamilies (e.g., a married couple, with or without dependent children, related to and living with the head; a divorced or separated family member with dependent children). What happens to the size distribution when such units leave the family and move into separate quarters? There has been considerable speculation on the effect of the "undoubling" of family units in the postwar period (the proportion of subfamilies to families, for example, has fallen from perhaps 10 percent after World War II to less than 2 percent today), but to my knowledge, no serious empirical studies of this effect exist.

(7) Extension of the income concept to such nonmoney income types as capital gains and fringe benefits. A substantial amount of work has already been done on the distribution of in-kind transfers and subsidies. A number of imputed income types are now included in BEA's estimate of family personal income, including some transfers in kind (food stamps, Medicare), and work is being done on the others. Indeed, considerable research effort has been devoted to the whole problem of the tax and transfer system, and much is currently underway. Because so much has been done in this area (except for fringe benefits), the payoff to additional efforts may be smaller here than elsewhere.

(8) Most size distribution estimates are based on annual income. What would be the effect on such distributions if the unit's income were measured for a period longer than one year? There has been considerable interest among economists in this question; indeed, it is commonplace to assert that annual distributions substantially overstate the "true" degree of inequality. Unfortunately, serious research efforts have been hampered by lack of data on recipients' income over more than two years, and I would urge as the only satisfactory approach to this problem the support of panel studies which would follow the same people over a number of years.

While lengthening the time period may improve the meaningfulness of the income data, it creates further problems for the definition of the recipient unit. The proportion of units who receive income for the full period diminishes as the length of the period is increased, and one then has the problem of interpreting a distribution composed of both full-period and part-period recipients. This problem is compounded when the distribution is based on family units. Not only does the proportion of "part-period" families increase with time, as new families are formed and old ones disappear through separation or divorce, or death of the head, but the composition and size of the family, as well as its earnings, are likely to alter as well, as individual family members join and leave. Questions in a panel survey must be asked that permit us to deal with these difficulties.

(9) I want to add that the problem of part-period earners, part-period family members, and part-period families in the interpretation of even *annual* distributions is a serious one, and one in which we are in real need of more research. The "reconstruction of families" as they existed during the preceding or "income" year by the Bureau of Labor Statistics in its Consumer Expenditure Survey has been the single most important source of noncomparability between the BLS and the CPS size distributions. The Census has never tried to adjust for part-period family units or family members; the CPS measures the preceding year's incomes of whatever units (persons or families) happen to exist on the date of the Survey (March of the following year). I would urge that questions be included in the CPS that would permit us to make adjustments for "part-period" recipients, families, and family members.

(10) The determinants of inequality in the distribution of property income, and in the distribution of property ownership. The Council has almost nothing to say about this aspect of inequality, even though they continually make use of the word "income," when their discussion actually refers to "earnings" and the distribution of earnings (from human labor). Inequality in the distribution of property income is, I suspect, much more a function of inequality in the distribution of property ownership than in variations in the rate of return on property (in contrast with income from human labor). We need to know much more about how property is accumulated over the life of a family through saving and the accumulation of capital gains, how it is affected by the initial selection of mates (do rich marry rich, and poor marry poor?), and how it is passed on to the next generation, through bequests at the time of the head's or spouse's death, or through gifts and transfers while they are still alive. How is the distribution of wealth affected by pattern of distribution of bequests and gifts to heirs and children? For example, is it more or less equally divided among dependent children? What implications does this have in turn for their accumulation of property?

The profession is devoting more of its time to these questions, and might devote even more if the data base on wealth distributions were more adequate. We have not had a field survey on the ownership of wealth in over a decade now, and more could also be done in mining estate tax returns, although James Smith has already made considerable progress in the latter area.

(11) There are a number of research possibilities suggested by the Council's discussion of earnings distributions, and I note only one of them: the relationship between age and earnings. There are many puzzles in the relationship, and they cannot all be answered by the human capital model, which tends to treat such differences as due primarily to differences in "schooling" and "on-the-job

training." I believe a much broader approach to this problem than that taken by the Council is needed. In any case, the reader should be warned away from Charts 8 and 9, the construction and interpretation of which are particularly hard to grasp.

(12) A final suggestion belongs, perhaps, near the beginning: the distributional impact of wage and price controls and rationing. Since such programs are most often defended on equity grounds, it is time we learned something about their actual effects. Studies of our experience during World War II and the Korean War might be in order, despite data deficiencies that will inevitably arise.

There are a number of criticisms of this chapter that could be made, but I thought it better to orient my statement to topics neglected in the Report and to emphasize areas that are in need of further research.

Representative REUSS. I show you now a chart entitled, "Distribution of Aggregate Income, 1947–72," prepared by our Joint Economic Committee staff, and previously introduced into evidence, which takes year by year the income shares of the lowest three-fifths of families and of the highest one-fifth of families. I ask you to look at that chart with me and tell me whether it is not true that since 1968 the lowest three-fifths of American families sustained a loss of relative position up to 1972, the last year for which we have figures, more sustained than at any other time since the series was first created in 1947.

Mr. BUDD. I really would have to study this particular chart.

Representative REUSS. I would like to have your reaction after you have studied it, and you might also comment as to whether since 1968, during the period 1968 to 1972, the highest one-fifth has not experienced a more sustained rise in its share of income than at any time in the previous history.

Mr. BUDD. Of course, in looking at these figures one wants to get kind of a commonsense interpretation of them, I think, and share estimates of this sort do lend themselves to that kind of interpretation. For example, if the share of the second quintile declined from 12.5 to 11.9 percent that, in effect, is a six-tenths of a percentage point decline, which means that the average income of that group has fallen relative to the average for the distribution as a whole by about 5 percent.

Of course, it doesn't mean their dollar income has actually fallen. It could have risen in this period but it does show that relative to others it has declined. Then if one wants to ask what happened in this same period to the share of the top 5 percent of families, which rose from about 15.4 percent to 15.9, it implies that their relative income has risen by 3 percent. So you can, in effect, add those two figures and say that the relative income of the second quintile compared to the relative income of the top 5 percent has fallen by about 9 percent.

Representative REUSS. Now, taking into account what we have said, at least in a rough and commonsense way, about the income share receipts of the lowest three-fifths of American families in the last 4 or 5 years, and taking further into account the fact that the only tax increases in the last couple of years have been in the payroll tax which particularly affect families with incomes of below $13,000 a year, and taking further into account the fact that for more than a year now we have had a very severe inflation concentrated in food and fuel, I will ask each one of you this question, would you agree that it would be wise to take prompt steps to redress the imbalance in income distribution which has obviously occurred, not only from the standpoint of equity, not only from the standpoint of civil tranquillity, but also from the standpoint of insuring an adequate overall purchasing power for the goods our economy is capable of producing?

My own proposal is that we could well right now reduce the payroll tax on workers making $5,000 a year or less to practically zero and then phase out the reduction at about $7,000 a year income so that you had a substantial exemption for the lowest income people from their social security tax. This would cost in revenues on the order of $7 billion. I would accompany that by an income tax reduction from raising the standard deduction and the minimum deduction say from 15 to 20 percent so as to give a declining tax benefit to all of those paying income tax up to about $15,000 a year, thus covering the lower three quintiles. That total program would result in a revenue loss of around $10 billion which I would attempt to recoup by plugging the most obvious $10 billion worth of tax loopholes so that it would have no net budgetary impact. This on the theory that the proposed budgetary stimulus is just about right.

If anyone disagrees with that, of course, he can prepare the budget in any way he pleases. At any rate, to recapitulate I would like your views on whether you think it would be good to have an immediate income redistribution program along the general lines suggested. If you think there should be such a program, but think that the two proposals—relieving the payroll tax, and the lower rungs of the income tax—are not the way to do it, tell us what you think is the way to do it. Any volunteers? Mr. Okner.

Mr. OKNER. Why don't I start at this end. I am in general agreement with your objective. I am not sure that I would pursue it exactly in the way you outlined. For example, I don't think I would be in favor of raising the percentage standard deduction but probably would go along with an increase in the low-income allowance. I agree that the payroll tax regressivity should be ameliorated, if not eliminated, and this can be done through an exemption plus low-income allowance. I am always in favor of plugging loopholes.

But I do think it is important to remember the point I made earlier. There is simply no way through the tax system to get to those people who are really at the very bottom of the income scale. If you have no earners, then you are not going to be affected by a cut in the payroll tax nor will you be affected by the low-income-allowance increase unless you make it refundable.

Representative REUSS. I should have added, as you did in your prepared statement, that all of this to be superimposed upon the minimum income proposal of Mr. Nixon, fixed up to be made adequate.

Mr. OKNER. OK.

Representative REUSS. And finance that as you can and will.

Mr. OKNER. OK, then I buy it.

Mr. HASTINGS-BLACK. I certainly agree that this kind of proposal is one of the best directions we could go if we are trying to redistribute income downward. The first priority ought to be either a negative income tax or some kind of income security program and after that we can go on to such things as ameliorating the impact of the payroll tax and changing the incidence of the income tax system. But I would say income security first.

At some point in the list of priorities, I would say health insurance comes in. I have heard it argued that health insurance is more important to the lowest income groups than tax reform. You can reform and reform the income tax system but you are not going to do anything for the very poor, except with refundable credits. My experience is that the poor have less contact with the tax system. If there is a refundable credit, they won't get it. Support for that view is contained in the administration's admissions that the retirement income credit is either not gotten or gotten at a lesser amount than the taxpayer was eligible, in by almost half the cases.

Representative REUSS. I would just add one comment: When you say first minimum family income for the first quintile and then payroll and income tax reform at some later time for the second or third quintile——

Mr. HASTINGS-BLACK. Not necessarily at a later time. Politically it may be smart——

Representative REUSS. All right. I say at exactly the same time for two reasons: One, I really believe that as a matter of equity the $7,000-a-year family has a terribly tough time and really for humanitarian reasons deserves some attention right now.

Second, from the political standpoint, you aren't going to get a H.R. 1 welfare proposal to rise from the ashes if you are going to tell the $7,000-a-year and the $8,000-a-year and the $9,000-a-year family that their case is being overlooked.

Mr. HASTINGS-BLACK. That makes a lot of sense.

Representative REUSS. That is a political matter, but I think a legitimate one. They ought to be done at once in a package, and I gather you agree.

Mr. HASTINGS-BLACK. Yes.

I would like to ask Mr. Okner a question. You said all the tax expenditures don't change the distribution of income. One, is that what you said, and two, does that crank in the corporate tax expenditures?

Mr. OKNER. No, it isn't what I said but, yes, it does. [Laughter.]

What I said or what I meant to say, is that if you look at the overall effect of Federal, State, and local taxes on the distribution of income in the United States under a host of different assumptions regarding who pays the corporation income tax and so forth, you find that over more than 80 percent of the total income spectrum there is just no effect.

Stating it somewhat differently, taxes as a percentage of income are constant for virtually all families and individuals in the United States. That is the total tax burden.

Mr. HASTINGS-BLACK. Another way of saying it, the national tax system, including State, local, and Federal does not affect that much redistribution of income.

Mr. OKNER. That is right.

Mr. HASTINGS-BLACK. At Tax Analysts we have been looking at the income redistribution effects of Federal tax expenditures, using the Treasury figures, considering both the corporate and individual tax expenditures. Depending on one's assumptions about corporate tax incidence—this is a very preliminary analysis which we haven't published—there may be redistribution from near the median-income levels to the highest brackets, $20,000 and above, in the tax expenditure system, so that one of the effects of the tax expenditure in the budget we prepared to be to redistribute income from the $7,000 to $10,000 to $15,000 class to the $20,000 to $100,000 and up classes.

Representative REUSS. I hope you will continue your researches.

Mr. HASTINGS-BLACK. We will.

Representative REUSS. Mr. Budd, now let me turn to you for an expression of your opinion on the proposition I put which I recapitulate briefly as saying that the bottom three quintiles, in one way or another, have sufficiently been buffeted by the winds of tax discrimination, inflation, and basic income maldistribution in recent years so that something ought to be done about it. That something ought to be: One, a minimum family income plan, a la Mr. Nixon's proposal; two, tax forgivenesses to the lowest income group on the payroll tax and on the income tax, to be paid for by plugging those loopholes which contribute most to the lack of progressivity in the overall structure.

Would you have a feeling as to the desirability of such a proposal?

Mr. BUDD. I certainly agree with you on the need for a minimum income guarantee and a negative income tax. That may well have some implications for those in the second quintile, of course, and they may possibly benefit a little from that.

Representative REUSS. A few crumbs will drop upward.

Mr. BUDD. I would have to study it to see how much effect it would have on the second quintile. I think it is certainly true that our current welfare programs, the tremendous expansion in welfare and social security has primarily affected the bottom quintile; that is certainly true. The market forces and other things that have been operating, as well as the rise in the social security tax, have apparently served to reduce the share of the second quintile.

I have never been enthusiastic about the social security tax and have often felt we would be better off if that were integrated in with the income tax. However, I recognize that it seems to be about the only tax that can be raised. We all know the effect, the regressive effect, of the social security tax, which seems to have its biggest regressive effect in the second quintile. So I am certainly sympathetic to your proposal of somehow amending the social security tax at the bottom if we are going to retain it, to reduce this regressive effect.

I perhaps might want to think more about your proposal for modifying the income tax deduction. Maybe there is something to be said for raising the low-income allowance as well as increasing the standard deduction. Of course, we must remember in any kind of plan where we are redistributing income, the redistribution has to come from somewhere, and perhaps what the implication of all this is is that the redistribution that has occurred, at least in the short run in the sixties, in favor of the bottom has been more at the expense of the quintiles immediately above it than it has been at the expense of the top, and I think this reflects possibly your concern that maybe some of that redistribution now ought to come more directly from the top down to the second and third quintiles.

Representative REUSS. And would you be sympathetic to that?

Mr. BUDD. I am sympathetic to that, yes, although I don't think we can always take the position that people in particular quintiles ought to be protected in their position. After all, the average income of, say, those in the second or third quintile may be double or triple that of those at the bottom. These comparisons obviously require ethical judgment, and I am very interested in your reaction here because it goes back to something I said at the very beginning, that there is a generally accepted judgment that at least in the short run people's income positions ought to be protected against sudden arbitrary changes that occur. It isn't just a question, as the Council's chapter implies, of an allowance for the bottom. I think there is a case, an important case, that can be made for protecting the relative positions, at least in the short run, of those immediately above it.

Incidentally, there is one thing I want to point out which is implicit in most of these discussions when you are dealing with income share data. You don't want to make too many inferences from them because people are shifted about in the distribution from year to year, and somebody who is hard hit by a particular type of economic event who was previously in the second quintile may now be brought down to the bottom quintile by it. Of course, each year the families are ranked by the size of their incomes in that year, and we don't observe that in the distribution statistics. So I think to some extent we may want to look at where particular individuals or particular groups are being shoved around in the distribution and that isn't always brought out by concentrating on these quintile estimates. The Lorenz curve method on which these quintiles are based is a method that involves rearranging recipient units each time.

Representative REUSS. Let me come back to a point you just raised. You said let's not be quintile wacky here, let's not say that every quintile is always entitled to its percentage share. Surely that is a good thing to remind us of. However, where I perceive, as I think I do, that the second and third quintiles have been unduly hit by governmental action, it was the Government that raised their payroll tax; it was the Government, Mr. Butz, who, in his zeal to secure added farm income, goosed the prices of bread and milk and everything else; it is the Government, very largely by section 32 of the Taft-Hartley Act, whatever it is, that has something to do with the wages which go into the naked income figure determinant. So that if you perceive that things are getting worse in a democracy that is supposed to be reasonably egalitarian, that ought to be some sort of an early warning that we ought to consider doing something about it—not consciously, perhaps to forever improve the lot of the poorest two-thirds of the Nation, but see that it doesn't deteriorate too much.

Is that a good principle of political economy as far as you are concerned?

Mr. BUDD. Right, I accept that philosophy.

Representative REUSS. Another question, Mr. Budd. You have responded very generously to the suggestion in our letter of invitation that you discuss research needs. I jotted down what I take to be your suggestions, and if I have got them wrong or you have got any others, please tell me.

(1) The effect of inflation and unemployment on income distribution.

(2) Income from property and distribution of property ownership.

(3) Effect on income distribution of increasing labor force participation of women.

Mr. BUDD. I wanted the latter more generally to inquire into what is the general effect of combining individual earnings into family income and family earnings. The labor force participation of women is just one of these. There is evidence that the Council cities that there is increasing inequality of distribution of women's income. There is no evidence that their income has tended to rise relative to the men's. How does this affect the change in inequality of family income? These seem to me to be part of the kind of thing I had in mind where we would be able to make some statements about what happens when, say, women's earnings decline relative to men, what is that going to imply to the family income distribution.

Representative REUSS. Thank you.

Mr. Hastings-Black, in your prepared statement you have a very interesting chart on tax subsidies for oil and gas, showing, I think, the steepest upward trend line of any tax subsidized group for the years for which you have figures; that is, 1972 to 1975. You estimate that tax benefits to the oil and gas industry are going to increase in the period between those 2 years by 81 percent from $1.6 billion to $2.9 billion.

Does your estimate include the tax benefits oil companies receive from the foreign tax credit?

Mr. HASTINGS-BLACK. No, it doesn't, Mr. Reuss. We put some effort into trying to come out with a number there, and so far we haven't succeeded. It is, I would say, among the most difficult of all the estimates.

The capital gains estimates are difficult, too, but the excess credit figure might be even more difficult than the capital gains estimates.

Representative REUSS. Do you support abolishing or reducing some of the existing tax subsidies to the oil and gas industry?

Mr. HASTINGS-BLACK. Professor Budd, in his testimony, raised the question of what is the effect on income distribution of the energy crisis. Another way to ask that question is to ask what is the income transfer from rising oil and gas prices. There isn't any question that the income transfer from rising oil and gas prices is going to be from consumers to the equity holders in the oil and gas industry, which, of course, fall generally into the higher income brackets.

One way to reverse that income transfer is to put an extra, a new kind of tax, on the oil industry, on oil income, and put the proceeds into the general revenues. That would certainly accomplish some reverse income transfer.

There is some feeling that instead of adding a new tax we should just take away some of the old tax benefits. That would be another way to accomplish this. That would take tax expenditures away or tax benefits away from equity holders in the oil and gas industry and put revenue back into the general revenues which are spent in a more progressive fashion than the tax expenditures on the oil and gas industry are spent. Certainly those are ways to accomplish that.

The foreign tax credit, the fact that it is not in here doesn't mean that it does not pose problems. As a noneconomist, I detect a consensus among a large number of economists, I would say the majority, that the tax credit itself is a sensible feature of our present income tax system. But, at the same time, I have seen compelling evidence that at present business income is receiving excessive foreign tax credits. With some of the proposals for change that have been bandied about recently, you could cut down on these excess credits. The excess credits are no doubt a tax expenditure and they are a tax subsidy to the carrying on of business activity abroad rather than in the United States. I think the weight of opinion among economists is that we should strive for tax neutrality toward the making of an investment decision; whether you are going to make the investment in the United States or overseas, you shouldn't deliberately construct a tax system which subsidizes overseas investments nor penalizes them.

But not only to do we have this excess credit problem in the oil and gas and the other extractive industries, but you have a whole set of tax expenditures for multinational corporations. Not included in TA/A's tax expenditure budget are other arguably excess credit items which could have added perhaps another $300 million to our multinational corporations tax expenditure figure.

Representative REUSS. Gentlemen, thank you very much. You have thrown a great deal of light on the vexing subject of income distribution and tax expenditures and we are grateful to you.

Mr. HASTINGS-BLACK. Before we close, Mr. Reuss, can I ask that two reports be inserted into the record at this point? One is on the assumption underlying our oil figures, and, second, is a more complete exposition of the tax expenditure budget.

Representative REUSS. Without objection they will be admitted in full in the record at this point.

Mr. HASTINGS-BLACK. Thank you.

[The reports referred to follow:]

SPECIAL REPORT FROM TAX ANALYSTS & ADVOCATES—THE REVENUE COSTS FOR ENERGY TAX INCENTIVES: UNDERLYING ASSUMPTIONS

(By Gerard M. Brannon)

The abundance of inquiries by Congress and the Nixon Administration into suspected profiteering by oil companies during the energy shortage has resulted in renewed interest in the special tax benefits for producers of energy from natural resources.

For example, the House Ways and Means Committee will initiate hearings on the Administration's "windfall profits" tax February 4 and the energy subcommittee of Senate Finance Committee recently completed hearings. Even the multinational subcommittee of the Senate Foreign Relations Committee has gotten into the act with sessions last week on the foreign tax credit as it relates to the oil companies.

Essential for a rational discussion is some understanding of the cost of such subsidies. Tax Analysts and Advocates recently estimated that the revenue lost from all tax expenditures would total $78.3 billion in fiscal 1975 and that the major tax subsidies available to oil and gas producers, apart from the foreign tax credit, would rise to $2.9 billion in fiscal 1975 from $1.6 billion in calendar 1972. The 81% increase, due mainly to the skyrocketing price of oil, was the largest increase of any category in the TA/A study. (See Tax Notes, January 21, page 4.)

While TA/A carefully qualified its estimates, noting in some detail the extreme difficulty of making such projections, it seems fair to be more specific about assumptions that were relied on, at least for the controversial oil and gas estimate.

Our estimates for the tax year of 1974 (which would approximate those for FY 1975) are:

	Millions
Percentage depletion:	
Oil	$2,200
Natural gas	350
Coal	350
Uranium	10
Deduction for intangibles	400
Deduction of development costs:	
Coal mines	50
Uranium Mines	5
Transitional revenue gains:	
Percentage depletion	250
Deduction for intangibles	550

We offer the numbers in an attempt to illuminate debate. We welcome any alternative calculations that others may offer.

PERCENTAGE DEPLETION

It might seem like this allowance is like the recovery of capital deduction which business takes as depreciation for two reasons: (1) a taxpayer taking percentage depletion foregoes cost depletion, (2) the name percentage depletion sounds like cost recovery. In fact, percentage depletion is unrelated to cost. It is simply a percentage of income which is tax free.

Oil and Gas

The percentage depletion allowance is 22% for oil and gas. The production of crude petroleum in the U.S. in 1974 will be about 4.1 billion barrels. (Fact Sheet accompanying White House Energy Message January 23, 1974.) This represents no growth from 1972 and one would expect that the sharply rising price of crude would stimulate efforts to increase production from current wells. (See *Oil and Gas Journal*, December 24, 1973.) A 4.1 billion barrel production estimate looks conservative but we use it.

The current average price for crude oil is the difficult estimate. The ceiling price on "old" oil is $5.25 but about half of the crude sold is "new" oil which sells at prices well above $7.00. We guess that the average price for domestic oil will be $6.50 for 1974. (The price on foreign oil is irrelevant because the foreign tax credit will cover any tax on foreign production.)

In 1970–71 when the oil price was about $3.25 the net value of percentage depletion was 15%. This was lower than the statutory 22% for several reasons.

Some wells were limited by the 50% of net income limitation and did not qualify for a full 22%.

Use of percentage depletion involves giving up cost depletion which might average 4%.

Use of percentage depletion involves minimum tax in some cases.

As the price of oil rises to $6.50, these offsets become less important. The cost depletion which is lost does not get much larger; net income should grow faster than gross, reducing the bite of the 50% limitation; regular tax should rise enough to reduce the impact of the minimum tax. We put the net value of percentage depletion in 1974 at 17% of gross, which we also regard as a conservative figure.

Combining these assumptions, we have:

1. Gross income of $27 billion ($6.50 × 4.1 billion).
2. A net percentage depletion deduction, in excess of cost depletion, of $4.6 billion. ($27 billion × 17%.)
3. A tax saving of $2.2 billion ($4.6 billion × 48%).

The most uncertain part of our projection is the price. A change in price of $1 will change gross income by $4.1 billion, the deduction by $900 million and the tax savings by $430 million.

This leads to the following range of estimates for the net revenue loss from percentage depletion on oil—

Price of crude:	Revenue loss in billions
$6.25	$2.1
$6.50	2.2
$7.00	2.4
$7.50	2.6

With the Persian Gulf price of oil in the range of $8.00 and with announced plans for further OPEC tax increases, a world price of $9.00 seems plausible in the near future and it is difficult to see how the U.S. price can be held below the world price for very long. By 1975 and 1976, domestic output of oil should be up sharply in response to this high price and recent high drilling rates. After 1976, with the opening of the Alaska pipeline, the production could jump by about ⅓ and the revenue loss from percentage depletion should approach $4.0 billion.

Natural Gas

The gross value of natural gas at the well head in 1973 was about $4.9 billion. (*Oil and Gas Journal,* January 24, 1973.) With the net value of percentage depletion of 15%, this yields a net deduction of about $750 million for 1974 and a tax saving of $0.35 billion. This should grow very gradually as long as natural gas price regulation continues with the price of new gas being slightly higher than the price of old gas and not much growth in output (except for associated gas discovered in drilling for oil). If natural gas prices are de-regulated this revenue cost could grow sharply.

Coal and Uranium

In the special tabulation of percentage depletion by the Internal Revenue Service for 1960, the effective rate of allowable depletion was 13% for uranium and 5% for coal. These figures were lower than the statutory rates, which were 23% (now 22%) for uranium and 10% for coal, because of the net income limitation. Putting the cost of foregone cost depletion at 15% of percentage depletion, as was the case for oil, we estimate the net value of these allowances as 11% for uranium and 4% for coal. To allow for better coal prices we raise the 4% to 5%.

The value of mine output of coal in 1973 was $4.8 billion for uranium, U_3O_8 (the so-called yellow cake on which depletion is allowed), $170 million. Assuming some modest continuing price increases, we get a revenue cost from percentage depletion of $130 million for coal and $10 million for uranium.

INTANGIBLE DRILLING COSTS

Intangible drilling costs are those expenses associated with drilling and exploration other than the drilling rigs and pipes. They include engineering costs, salaries, and so on.

If one were building a factory, such costs would have to be capitalized and deducted over the tax life of the structure. However, oil companies may deduct the intangible drilling costs in the year in which they are incurred, if the wells are successful. Costs of dry wells also may be deducted immediately but this is not considered a departure from usual accounting principles, though many economists would argue otherwise.

A convenient way to describe the revenue loss from the deduction for intangibles is to assume that percentage depletion already has been repealed. This makes the revenue loss from the intangibles deduction the difference between the tax saving due to current deduction versus the saving due to a deduction based upon the capitalization of the intangibles.

If the deduction for intangibles were repealed but percentage depletion remained in effect, the apparent revenue gain would be higher because the capitalization of intangibles would show up in higher cost depletion and most companies would still use percentage depletion. What would happen is that the net value of percentage depletion—the excess over cost depletion—would be lower. Thus, repeal of the deduction for intangibles without removal of percentage depletion would reduce tax expenditure levels to zero for intangibles. The excess of percentage of cost depletion also would be reduced. However, what actually would be happening is that as the intangible drilling costs were capitalized, the charge would show up as an increase in cost depletion. Thus, the difference between cost and percentage depletion would decrease and this would give the appearance of lowering the value of the percentage depletion benefit whereas its actual value to the oil company would be unchanged.

Still Tricky Without Depletion

Even assuming a repeal of percentage depletion, the revenue estimate for intangibles is tricky.

If the intangible drilling costs for producing wells were constant year after year, immediate deductions would be worth no more to an oil company than capitalization because all the fractional amounts on the various drilling projects would total as much as taking the entire amount for each project in its first year without being able to take further deductions in the future.

Apparently, outlays on development wells (most of which are successful) grew gradually up to 1971 when they reached a level of $1.3 billion. We assume for the purpose of our estimates that these totals jumped by 20% annually from 1972 through 1974. The difference in tax savings (revenue losses) between deducting this increase immediately instead of spreading it over the life of the wells amounts to an estimated $400 million.

Remember, too, that the Treasury's estimates do not take into consideration the fact that repeal of the provision will have transitional effects that will make the revenue gain in the early years more than it will be in the long run. This is because as oil companies are required to capitalize the intangible expenses, they will build up their cost depletion accounts, which will eventually wipe out the transitional revenue gains to the Treasury. The transitional gain alone in 1974 would be $550 million and this would decline at about $50 million a year.

The same kind of transitional gain would occur if percentage depletion were repealed in 1974 but it would be only about $250 million, and it would decline at a rate of about $25 million a year.

The transitional revenue gain is left out of tax expenditure tables because it is a one-time occurrence, even though the "one" time is a 10-year period. Adding the transitional revenue gain to the tax expenditure estimate would produce a deceptive figure.

Mine Development Expenditures

Estimating problems on the immediate deduction for mine development expenditures for coal and uranium are the same for intangible drilling costs for oil and gas wells. The revenue effect depends on the rate of growth of these expenditures as well as their size. A good deal of basic data is offered in the December 1972 U.S. Energy Outlook, a publication of the National Petroleum Council.

For the purposes of our estimates, we assumed that investment will increase output by 5% a year, starting in 1974, and that the part of required investment due to the deduction for development costs comes to $5 per ton of capacity. This is growth investment over and above replacing capacity that has been used up. This yields a revenue loss estimate of $50 million in 1974.

For uranium we assume mine development expenses of $1 per pound of U_3O_8 and enough investment to provide a growth in capacity of 15 million pounds per year. This produces our revenue loss of $5 million.

Special Report From Tax Analysts & Advocates—Fiscal Year 1975 Tax Expenditure Budget

If last year's documents are any indication, there will be no mention in next week's presentation of the Fiscal Year 1975 federal budget of an estimated $78.3 billion of tax expenditures.

These expenditures, which are taxes foregone because of exceptions made to generally accepted tax principles, are directed in large dollar amounts to multinational corporations, the oil and gas industry, banks, homeowners, investors, and business in general.

For example, the oil and gas industry received tax benefits of $1.6 billion in calendar 1972 and TA/A estimates this will rise to $2.9 billion in fiscal 1975. This 81% increase is the largest of any category in the detailed tables.

Last year, in the FY 1974 budget, mention of a few of these subsidies, about one-fourth of the dollar total, was made in only two places in the 2,872 pages of budget documents (*Special Analyses*, Special Analysis K, pp. 163–179; Special Analysis N, p. 211). Last year's budget cuts were accompanied by extravagant claims of Office of Management and Budget (OMB) cost-benefit analysis activity, but nowhere in the entire government is there systematic cost-efficiency analysis of tax expenditures, gigantic though they are. While programs involving $10 million are the victims of impounded funds, tax expenditure programs costing billions, the effectiveness of which is unknown, go unchallenged from year to year.

The subsidies are listed—but not analyzed—about six months after the end of each calendar year, which would be the summer of 1975 or later for FY 1975. But in order to have a more reasonable picture of the role of government in the economy, which is a central purpose of having a budget at all, we need to have tax subsidy estimates for the future, not just the past. Accordingly, in conjunction with next week's publicity on the FY 1975 budget, TA/A here publishes its estimates of the FY 1975 tax expenditure budget.

Admittedly, there are more problems with forecasting the smaller tax expenditure figures that the larger tax spending budget is comprised of. In fact, when the first tax expenditure figures were developed by the Treasury Department and published in January 1969, the Treasury felt it had not developed its forecasting techniques well enough to include tax expenditure estimates for the then-proposed fiscal 1970 budget.

However, techniques have improved and, in spite of the remaining technical difficulties, TA/A believes that it is important to make such projections and to include them in the annual budget. This will enable citizens to examine the total fiscal commitment of the federal government to an activity or category of activities, not just the commitment as measured by the direct budget outlay and obligation figures.

Obviously, however, the TA/A estimates of FY 1975 tax expenditures are not as solid as Treasury estimates of the value of tax expenditures for previous years.

What Is a Tax Subsidy?

The terms "tax expenditure" and "tax subsidy" (tax expenditures for essentially private activities) are capable of systematic definition, using a standard economic concept of income. A rigorous definition, however, proves impractical for political and journalistic discussion. A systematic definition would include among tax subsidies such things as the tax-free status of imputed net rent of personalty (cars, clothing, etc.); bequests, and charities' receipt of gifts. These things fall outside the ordinary scope of the ongoing national debate about income and estate taxes.

A more useful definition is one which draws upon common experience. Under such a definition, a "tax subsidy" is a conscious departure from generally accepted tax accounting principles defining net income. These principles draw importantly on theoretical concepts, especially the Haig-Simons concept of income, but allow for deviations to serve practical ends. Most of the deviations, which admittedly require the exercise of judgment and are open to criticism, are due to difficulty of measurement, negligible dollar amounts, acceptance of the separate-entity theory of corporations, and problems of tax administration. Fundamental aspects of progressivity such as rate differentials, personal exemptions, and the low income allowance are not listed. Nor are the foreign tax credit, the effect of income splitting and head-of-household treatment, the standard deduction or estate and gift tax data.

There is broad agreement, to which Treasury is a party, as to inclusion of a majority of the items. Here other experts legitimately raise questions about whether the family should be the tax unit, that corporate investment is doubly taxed, etc. Tax Notes has and will examine these viewpoints in other issues. There seems little doubt, however, as to the utility of having a better prospective picture of the way the federal government relates to the economy. The budget will omit $78 billion of tax subsidies—though that figure is equal to over 25% of the entire unified budget. Current estimates are for a FY 1975 budget of between $290 billion and $300 billion compared with $270 billion for FY 1974.

Review of Tax Expenditures

Just as the House Appropriations Committee is a focal point for review of all government outlays, House Ways and Means Committee approval is essential to all tax expenditures. There are crucial differences, at least formally, in the relationship between the House (and Senate) appropriations committees and the $300 billion budget, and Ways and Means and its $78 billion tax subsidy budget. Dozens of federal agencies, working through OMB, request money annually from two dozen-odd congressional authorizing committees, each with its own staff and subject area jurisdiction. These authorizing committees make decisions which limit the appropriations committees. By the time the appropriations committees finish their work, the substantive expertise and authority of the authorizing committees have been applied.

Not so with tax expenditures. Neither the many Executive agencies, nor OMB, nor the non-tax congressional committees have a formal role in looking at tax spending. Only Treasury and the White House are extensively involved within the Executive Branch. There are grounds for saying that the other entities are involved, sporadically, peripherally, or informally, but the question is much open to debate. In any case, when these tax ideas get to Ways and Means, there is no subcommittees-with-staff structure to facilitate the application of subject matter expertise to the problems. While the technical tax advice available to the Ways and Means Committee is excellent, the staffs of Ways and Means and the Joint Committee on Internal Revenue Taxation usually get spread rather thin and must give primary attention to the technical aspects of tax legislation.

It is possible to praise too generously the annual review which the agencies OMB, the authorizing committees, and the appropriations subcommittees give to the regular budget. Nevertheless, a number of independent viewpoints have at least an annual crack at the outlay programs. In the tax subsidy area, however, there is no annual systematic review anywhere in the government. There is no governmental program to study the effectiveness of these programs. Some tax preferences—for railroad rolling stock, pollution control, coal mine safety, low income housing, child care, and job training—are due to expire during 1975–1977. This will at a minimum force passage of extensions, with or without committee research and hearings. But the Mills-Mansfield bill of 1972 to require regular (not annual) hearings and markups on renewal of a much larger number of (indeed, most) tax expenditures, now seems dead. Ways and Means conducted a reasonable effort last year to review most of the major issues, but this is not expected to be a regular occurrence.

FISCAL YEAR 1975 TAX EXPENDITURE BUDGET BY FUNCTION

Overview

In June, 1973, Treasury and the Joint (Congressional) Committee on Internal Revenue Taxation published estimates of Federal income tax expenditures for the preceding calendar year. This retrospective publication schedule may be a permanent fixture. It denies the Congress. the public. business, and the academic community the ability prospectively to gauge the total impact of the federal fiscal system on the economy.

What TA/A has done is to prepare two tables. The first (summary) one uses the same categories which appear in the last June's Treasury/Joint Committee pamphlet (their latest data is from CY 1972) and shows comparable figures for 1975.

A first glance at the summary table indicates that increased oil profits will yield, for the natural resources industry, larger tax subsidies than ever before. This, in turn, points up an interesting aspect of tax subsidies: the higher your dollar profit (or income), the more subsidy you get. This phenomenon results from Congressional enactment of tax "incentives" available at fixed rates on unlimited amounts of profit.

International affairs, showing a 28% increase, is rising principally due to the domestic international sales corporation (DISC) subsidy for exports.

Health, labor and welfare shows a sizable increase because of increases in social security benefits, medical expenditures, and pension plan growth.

State and local financing reflects increasing state and local taxes (with subsequent deductions) and issuance of tax-exempt bonds.

SUMMARY TABLE—ESTIMATED FEDERAL INCOME TAX EXPENDITURES, CALENDAR YEARS 1971–72[1] AND FISCAL YEAR 1975

[In billions of dollars][2]

	1971	1972	Fiscal year 1975	1972–75 relative change (percent)
National defense	[3] $0.7	0.7	0.7	
International affairs	.4	[4] .7	.9	28
Agriculture	1.0	1.1	1.4	27
Natural resources	1.3	[5] 1.9	[5] 3.4	79
Commerce and transportation	14.4	17.8	20.0	12
Housing and community development	5.6	7.4	9.0	22
Health, labor, and welfare	18.4	20.2	25.9	28
Education	.9	1.0	1.2	20
Veterans benefits and services	.7	.5	.5	
General government	(6)	.1	.1	
Aid to State and local financing	8.2	8.2	10.4	27
Total (details do not add due to rounding)	[3] 51.7	[5] 59.4	[5] 68.6	16

[1] Roughly reflect fiscal years 1972 and 1973.
[2] 1971–72 figures and from Treasury; fiscal year 1975 figures are from TA/A.
[3] Estimates of the components of the categories were prepared on the assumption that each item would be eliminated from the law without any other changes in the law with respect to the other items. If 2 or more changes in the law are made, the aggregate revenue effect will frequently be larger than the sum of the revenue effects of the individual changes. Accordingly, the subtotals of the categories, and the grand total, are, generally, slightly lower than a more refined estimate would provide.
[4] Changes in the figures from 1971 to 1972 not only reflect change in the tax laws, in utilization of the items, and in personal income and profit levels, but also ,in some instances, reflect revised and/or new sources of data and/or improved estimating methods.
[5] The 1972 total has been reduced from the Treasury total as to approximate the revenue gain from combined repeal of both intangible and excess depletion deductions. The 1975 total is computed on the same basis, as are the grand totals at the bottom. Comparison to the 1971 natural resources category is misleading. The error in comparing the grand totals is relatively small, however. The detailed table on the next few pages adds some major items to the Treasury list, and its total tax expenditure figure for fiscal year 1975 is $78,300,000,000. Hence the references to this higher figure in the preceding text.
[6] Provision not in effect.

Inflation has caused two sorts of increases in these figures. First, inflation raises the prices of deductible items, resulting in larger deductions and larger revenue losses. Second, inflation is usually accompanied by rising dollar incomes, which pushes individuals into higher marginal tax brackets, resulting in higher revenue losses for each dollar of deduction. Of course, wage inflation increases dollar tax receipts as well as dollar tax expenditures.

As real median income rises, tax expenditures rise, because more wage-earners are moving into higher marginal brackets. Stated another way, the deductions taken by such persons result in higher revenue losses—they are deducted against higher bracket income.

Detailed Estimates

The detailed table shows the Treasury estimates for calendar years 1971 and 1972, and TA/A's estimates for FY 1975.

FY 1975 assumptions are based on estimated GNP figures for CY 1973 and CY 1974 of $1287 billion and $1386 billion respectively (current dollars). Real growth, in constant 1958 dollars, is assumed to provide respective GNP figures of $837 and $851 billion. 1975 figures were extrapolated at 1974 growth rates. OMB states that it is using "flexible projections", meaning that it is hedging its figures even more. TA/A has little expertise in macroeconomic forecasting and has used consensus forecasts. These are offered at face value.

The FY 1975 unified budget was projected to be approximately $300 billion. Variations from this amount will not affect the tax expenditure figures greatly. Items within the federal budget, though, can have substantial impact on tax expenditures. The largest of these is social security payments; in this specific case, published figures, reflecting the January, 1974, benefit increase were used.

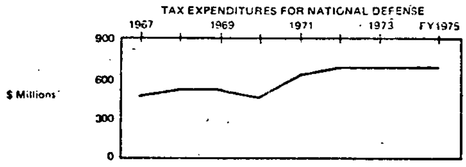
Changes have been made from the Treasury format, however: the timber item was moved from agriculture, and pollution control was moved from health, labor and welfare; both were transferred to natural resources. These two changes are in accordance with OMB categories. Employer-paid meals and lodging were transferred from health, labor and welfare, to manufacturing and service industries; bad debt reserves were transferred from commerce and transportation to housing; individuals' capital gains were transferred from commerce to investment income. Life insurance items were transferred from health, labor and welfare to investment income. These changes were made on a common sense basis; OMB categories are silent as to where these items should be. Last, casualty losses were transferred from health, labor and welfare to health because of the similarity between casualty and health deductions. Generally, items were changed to break out fundamentally different subcategories and to enable comparison to OMB's figures on the budget, expected out on January 28, 1974.

FEDERAL INCOME TAX EXPENDITURES, CY 1971-1972 AND FY 1975

(millions of dollars)

Note: Categories are listed in the order they appear in OMB budget documents. Items of tax expenditure included are listed for each category. Numbered footnotes apply only to the category and are explained immediately below the category. Lettered footnotes apply to items in a number of categories and are set out at the end of the table.

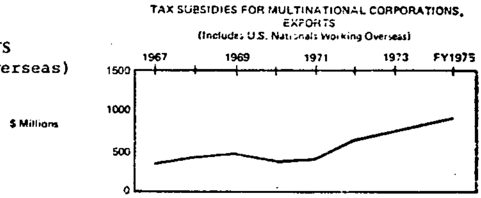
NATIONAL DEFENSE



	1971	1972	FY 1975 Individuals
Exclusion of benefits and allowances to armed forces personnel....	$650	700 (a)*	700

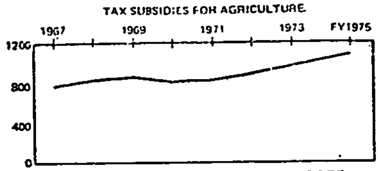
*For lettered footnotes, see end of table.

MULTINATIONAL CORPORATIONS, EXPORTS (includes U.S. nationals working overseas)



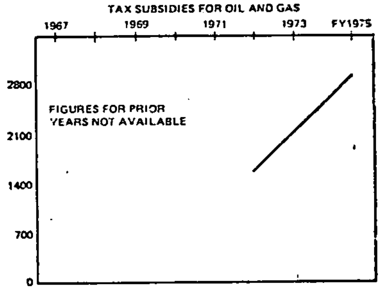
	1971	1972	FY 1975 Corporations	FY 1975 Individuals
Exemption for certain income earned abroad by U.S. citizens	$50	50		60
Exclusion of income earned by individuals in U.S. possessions ...	10	10		10
Lower rate for Western Hemisphere trade corporations ...	75	50	100	
Exclusion of gross-up on dividends of less-developed country corporations ...	55	60	80	
Deferral of income of controlled foreign corporations	165	325(a)	350	25
Exclusion of income earned by corporations in U.S. possessior ...	80	80	80	
Deferral of tax on domestic international sales corporations (DISC) ...	none	100	240	
TOTAL	$435	675	945	

AGRICULTURE



	1971	1972	FY 1975 Corpo-rations	FY 1975 Indi-viduals
Capital gain treatment; expensing in lieu of capitalization	$840	900	60	1040
TOTAL	$840	900	1100	

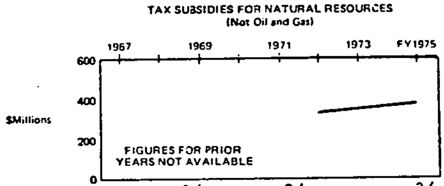
OIL AND GAS



	1971 1/	1972 2/	FY 1975 2/ Corpo-rations	FY 1975 Indi-viduals
Expensing of intangible drilling costs, instead of capitalization ..	305	600	700	100
Excess of percentage over cost depletion .	705	1400	2350	250
TOTAL	1010	1600 3/	2900 3/	

See numbered footnotes following Natural Resources

NATURAL RESOURCES
(exclusive of oil and gas)



	1971 1/	1972 2/	FY 1975 2/ Corpo-rations	FY 1975 Indi-viduals
Timber: capital gain treatment for for certain income	$175	175	180	80
Expensing of exploration and development costs, instead of capitalization	20	50	60	
Capital gain treatment of iron and coal royalties....	5	5	5	
Pollution control depreciation in excess of straight line ...	15	25	40(g)	
Excess of percentage over cost depletion ...	280	300	350	10
TOTAL	495	525 3/	690 3/	

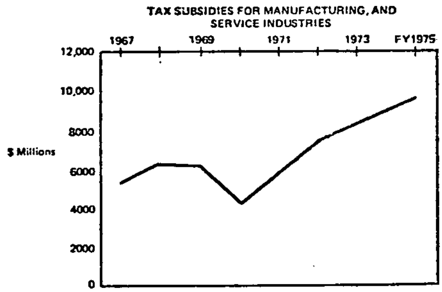
See footnotes, p. 166.

1/ When Treasury published its CY 1972 tax expenditures for Natural Resources (including oil and gas), it stated that it had revised its method of estimating intangibles, exploration and development costs, and the percentage depletion figure. Treasury explained its changes as relating to definition and concepts. The major conceptual difference is that on the old basis the estimate for intangibles was made on the basis that percentage depletion was already repealed. Treasury's new methods are not readily apparent; TA/A was unable to change Treasury's prior year figures. Therefore, the CY 1971 figures in the table are broken out from Treasury 1971 figures for Natural Resources and direct comparisons to the 1972 and 1975 figures are not proper.

2/ The 1972 and Fy 1975 figures are broken out from the larger Natural Resources category. The methods used to make the 1975 estimates are comparable to those for 1972.

3/ The 1972 and FY 1975 figures are not strictly additive. These two totals, which are also used in the graph, use a procedure of estimating assuming all these preferences are repealed. Thus, these totals are more accurate characterizations of overall revenue effect.

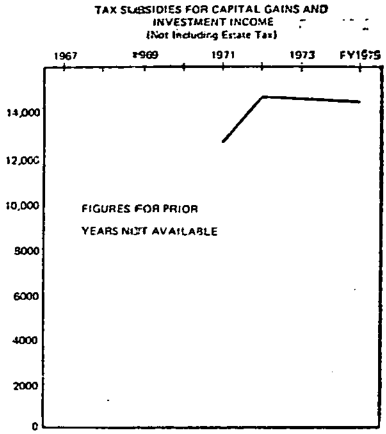
MANUFACTURING AND SERVICE INDUSTRIES



	1971	1972	FY 1975 Corpo-rations	FY 1975 Indi-viduals
Investment credit	1800	3800	4100	800
Depreciation on buildings (other than housing) in excess of straight line	480	500	400	200
Asset (accelerated) depreciation range (ADR)	700	860(a)	1490	10
Lower rate for capital gains:corporations (other than farming and timber)(b)	380	400	390	
Tax-exemption of credit unions	40	90(a)	110	
Deductibility of interest on consumer credit	1800	1100		1300
Expensing of research and development, instead of capitalization	545	570	650	
Deferral of tax on shipping companies	10	30	40	
Rail freight car accelerated depreciation	45	80(a)	10(c)	
Exclusion of employees meals and lodging, paid by employer	170	170		170
TOTAL	$5970	7600	9670	

CAPITAL GAINS, INVESTMENT INCOME

(not including Estate tax)



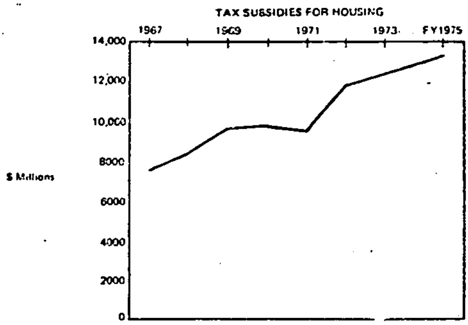
$ Millions

	1971		FY 1975 Individuals
Dividend exclusion	$300	300	340
Deduction of half of long-term capital gains individuals (not farming or timber) (b) ..	5600	7000	6500
Exclusion by employees of premiums on group term life insurance paid by employer .	500	550	650
Failure to tax policyholders on interest on life insurance savings ...	1100	1200	1450
Exclusion of all of capital gains on assets held at death ...	1/ 4900	1/ 5400	1/ 5400
Deferral of capital gains tax on appreciated assets transferred as taxable gifts ...	2/ 350	2/ 350	2/ 350
TOTAL	12,750	14,800	14,690

1/ Effect of taxing at ordinary rates, with present income splitting, averaging, and capital loss deductions. No offset for marital deduction or the $60,000 exclusion. This revenue figure would be $7.5 billion if the loss from the estate tax base were not taken into account (estate tax revenue would fall by $2.1 billion). This netting of second-level effect has not been taken into account elsewhere in these tables. CY 1971 and 1972 estimates are by TA/A; this item has not been included in recent Treasury tables.

2/ This is the annual revenue deferment. The bulk of appreciated property transferred as taxable gifts (usually to spouses and children) is and remains in the hands of high income classes who do not rapidly turn over their portfolios. Thus the deferment of capital gains tax may continue indefinitely. The deferment is at least long enough that the annual deferment of revenue, $350 million, is permanently lost to Treasury. This estimate was described in more detail in Tax Notes, Nov. 5, 1973 under H.R. 7126. These three figures are by TA/A and are in addition to the items included in the Treasury tables.

HOUSING

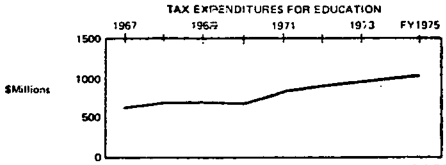


	1971	1972	FY 1975 Corpo-rations	FY 1975 Indi-viduals
Excess bad debt reserve deductions by financial institutions .. 1/	$400	400	360	
Deductibility of interest on mortgages on owner-occupied homes ...	2400	3500		4500
Deductibility of property taxes on owner-occupied homes ...	2700	3250		3800
Depreciation on rental housing in excess of straight line ...	500	600	600	
Housing rehabilitation accelerated depreciation ...	25	40	25(c)	40(c)
Failure to tax imputed net rent on owner-occupied homes ...	3600 2/	3500 2/		3900 2/
TOTAL	$9625	11290	13225	

1/ This item has been changed from Treasury's "commerce and transportation" category to "housing" here because the excess bad debt reserve deductions have been tied to the issuance of mortgages.

2/ The estimates of the tax effect of including net imputed rent as taxable income are based on the estimates of net rent contained in the National Income Accounts, as the amounts which would be added to gross income. These are not Treasury figures.

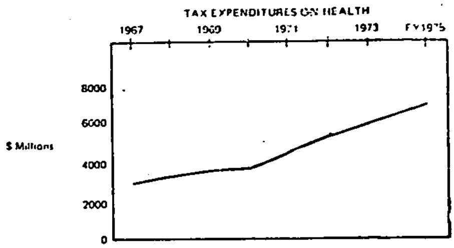
EDUCATION[1]



	1971	1972	FY 1975 Individuals
Parental personal exemption for a student age 19 or over ...	$550	640	710
Deductibility of contributions to educational institutions ...	275	275	330
TOTAL	$825	915	1040

1/ This table omits a Treasury table item, scholarships and fellowships, on the grounds that these are properly classed as gifts

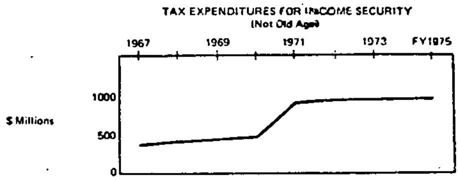
HEALTH[1]



	1971	1972	FY 1975 Individuals
Exclusion of disability insurance benefits (nongovernment plans) ...	$155	175	225
Additional exemption for the blind	10	10	10
Sick pay exclusion	120	225(a)	250
Exclusion of workmen's compensation	320	375	450
Exclusion by employees of employer-paid accident and accidental death premiums ..	30	35	45
Exclusion by individuals of employer-paid medical insurance and care expenses ...	2000	2500	3500
Deductibility of individuals' medical insurance and care expenses ...	1900	1900	2300
Casualty loss deductibility	165	150(a)	150
TOTAL	$4700	5370	6930

1/ There is some ambivalence as to whether these items should be included in a tax expenditure list. Some economists believe that a proper computation of net income involves a deduction for health expenditures (and casualty losses). Others see the health-related deductions as a "loss-sharing" effort by the government, a kind of health insurance. If the latter, then the program 1) definitely is a tax expenditure and 2) is highly regressive. The insurance covers no losses of poor families, a small percent of the health expenses of middle class families, and 70% of the expenses of wealthy families. This same "upside-down" structure applies to all itemized deductions and tax subsidy deductions enjoyed by individuals.

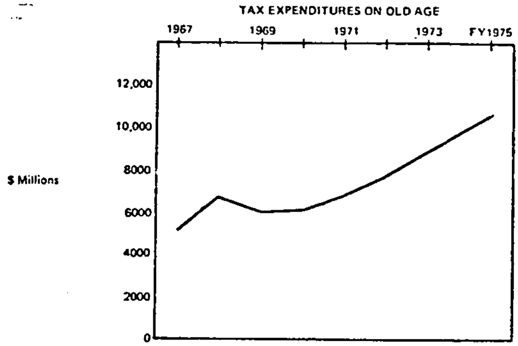
INCOME SECURITY (not old age)



	1971	1972	FY 1975 Corporations	FY 1975 Individuals
Failure to tax unemployment insurance benefits ...	$800	700		700
Failure to tax public assistance benefits	65	65		70
Privately financed supplementary unemployment benefits ...	5	5		5
Credit to corporations for employing welfare recipients (WIN program) ...	1/	5	5	
Deduction for child care expenses..........	30	180		180
Accelerated depreciation of child care facilities ...	1/	5	5	
TOTAL	$900	960	965	

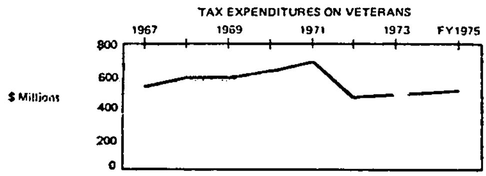
1/ Provision not in effect

OLD AGE



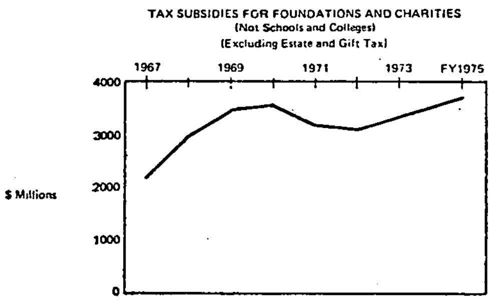
	1971	1972	FY 1975 Individuals
Additional exemption Retirement income credit Failure to tax social security pensions	$3250	3550	5700
Exclusion of self-employed pension contributions and related earnings ..	250	200	200
Exclusion of employer's pension contributions and related earnings ...	3650	4000	4800
TOTAL	$7150	7750	10700

VETERANS' BENEFITS



	1971	1972	FY 1975 Individuals
Exclusion of certain veterans' benefits ...	$700	480 (a)	525

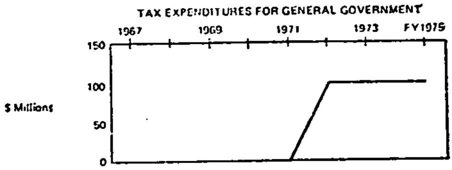
FOUNDATIONS AND CHARITIES



	1971	1972	FY 1975 Individuals
Deductibility of contributions by individuals to foundations and charities (other than educational) ..	$3200	3100	3700
Exclusion of capital gains on certain assets donated by individuals to charities..	1/		
TOTAL	$3200	3100	3700

1/ Estimate not available; informal Treasury estimate is in the $100 million range. Not included in total.

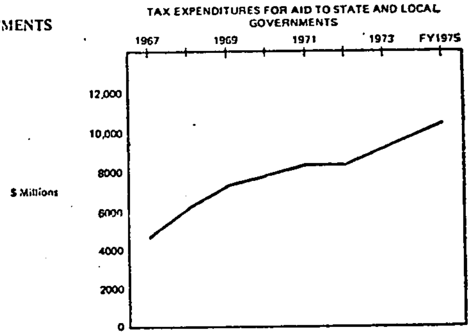
GENERAL GOVERNMENT



	1971	1972	FY 1975 Individuals
Credit and deduction for campaign contributions	1/	100	100

1/ Provision not in effect

AID TO STATE AND LOCAL GOVERNMENTS



	1971	1972	FY 1975 Corporations	FY 1975 Individuals
Tax exemption of interest on state and local bonds ...	$2600	2900	2400	1300
Deductibility of state and local nonrealty taxes ...	5600	5300		6700
TOTAL	8200	8200	10400	

	1971	1972	FY 1975
GRAND TOTAL ($ millions)	$57,450	$64,965	$78,280

(a) Changes in the 1972 figures as compared to 1971 which are due wholly or in part to revised data and/or improved estimating methods.

(b) Assumes present restriction on capital losses is maintained.

(c) Equipment placed in service, and rehabilitation outlays in the latter half of FY 1975, are not eligible for such accelerated depreciation.

Note: Standard estimating practice is to regard the differences between calendar years and the following fiscal years as not major, except in special cases involving the effective date of a new law, etc. TA/A's FY 1975 estimates were made using standard methods, (although without Treasury's extensive computing resources), and therefore the FY 1975 figures may be taken as approximations of CY 1974 amounts.

Conclusion

Up until now, the Office of Management and Budget seems to have not been aggressive enough to force cost-benefit analysis and future estimating of tax expenditure figures. (This would not be without precedent; the Federal Republic of Germany and the state of California both review tax preferences annually.) The Congressional leadership, and the chairmen of the substantive Hill committees have not been aggressive enough, especially when confronted with Ways and Means Chairman Wilbur D. Mills, D-Ark., to assume a role in shaping tax policy where it interacts with specialized sectors of the economy.

There are signs that things on the Hill may be changing. The House-passed budget reform bill, as rewritten by the Rules Committee and amended on the floor, contains a requirement that the tax expenditure figures be included in the budget. The Rules Committee staff indicates that some members of Congress aspire to regular review and adjustments to tax preferences. Another important factor is that Chairman Mills seems to be maintaining a lower profile these days.

In the Senate, nontax bills have been successively referred to two different committees when a bill crossed jurisdictional grounds. TA/A believes that this should be done with tax bills which are of particular concern to other substantive committees. An alternative would be simultaneous referral or even joint sessions of designated members or subcommittees.

The question is not when these changes will occur, but how soon. Listing tax expenditures is not to assert that they should be repealed, but only a statement that they are there. Placing expenditures for health in the tax expenditures list, for example, is only to describe one thing the government does about health. It is logical to have data available, and it is logical to have more data than less, as long as one can swim—not drown—in it.

Hence, there should be a bias toward adding an item to the tax susibidy list when the pro's and con's of worrying about adding it seem balanced. On the other hand, wallowing in huge quantites of numbers each January is no substitute for leisurely examination of them in July.

In the long run, we will probably have tax expenditure review. The question is really when. Will it be the next administration which takes the step, or this one? If the House version of the budget reform bill prevails, it may be this one.

Representative REUSS. Thank you again. We will now stand in recess until next Monday in the same room at 10 o'clock in the morning.

[Whereupon, at 11:50 a.m., the committee recessed, to reconvene at 10 a.m., Monday, February 18, 1974.]

THE 1974 ECONOMIC REPORT OF THE PRESIDENT

MONDAY, FEBRUARY 18, 1974

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

The committee met, pursuant to recess, at 10:05 a.m., in room 345, Cannon House Office Building, Hon. William Proxmire (vice chairman of the committee) presiding.

Present: Senators Proxmire and Humphrey; and Representative Reuss.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; Richard F. Kaufman, general counsel; William A. Cox, Lucy A. Falcone, Sarah Jackson, Jerry J. Jasinowski, John R. Karlik, L. Douglas Lee, and Courtenay M. Slater, professional staff members; Michael J. Runde, administrative assistant; Leslie J. Bander, minority economist; 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. Today we are pleased to welcome Mr. Roy L. Ash, Director of the Office of Management and Budget, to testify on the Economic Report of the President and the economic outlook from the point of view of the Chief Budget Officer in the Government.

The United States faces two serious and apparently contradictory economic problems. In the first place, we are suffering from rampaging inflation. We are facing unprecedented peacetime hikes in the price indexes and rises which surpass even the worst war years. Serious year after year inflation could become a way of life if we do not stop it soon. Wages are likely to take off after prices in the coming year and if they do, 1973 will look like a year of price stability.

In the second place, we are seeing a slowdown in the economy, a fall in industrial production, a reduction in growth, and an increase in unemployment.

There are three major economic instruments available to the Government to help attack these problems. The first, wage and price controls are to be abandoned almost entirely on April 30th. The second, monetary policy, is to remain neutral to perhaps slightly expansionary, because interest rates are already exceedingly high and there is fear of too great a contraction at a time of increasing unemployment.

Finally, there is fiscal policy—the policy we deal with today.

Now, Mr. Ash, let me be blunt about this. I do not believe you could have picked a worse policy.

32-118—74——12

In the first place, at a time of colossal inflation and price rises, you propose the biggest peacetime budget increase in the history of the country. A $30 billion increase on top of last year's $28 billion increase. So the budget is a highly inflationary instrument at a time of high inflation. And I might say that it will not pay for all of the administration's proposals.

The administration has proposed a $1 billion program of extended unemployment benefits and extended coverage. You have also reintroduced proposals which would raise the level of benefits. But table 15 which shows a 5-year projection of the costs of new proposals reveals that there is no money in the budget for new employment programs until 1977. Even the cost of the existing program—estimated at $7 billion—may be too low, especially if the estimate of 5.5 to 6 percent unemployment proves too optimistic.

Second, the administration has increased publicly assisted housing by 100,000 units since the budget was prepared. Funds for this are not in the budget.

And, of course, that would increase spending. So it would seem that the budget will be even larger than has been proposed, although it is the biggest peacetime increase we have ever had.

The difficulty, Mr. Ash, is that the budget, it seems to me, is a poor instrument for purposes of stimulating the economy. What we have—after transfer payments and interest are excluded—is a budget which boosts the military budget by $7.1 billion—or 8.8 percent—while the civilian programs rise by only $3 billion—or 4.8 percent.

The Bureau of Labor Statistics studies indicate that there are fewer jobs for the buck with military spending than for almost any other Government activity. Further, since it satisfies no economic needs—builds no homes, produces no food, supplies no shortages—it is the most inflationary kind of spending we have.

So what you have done, essentially—is to increase the most inflationary spending and the least job-producing spending at a time when we need jobs and should be dampening down inflation.

And those programs like housing, which produces vast ripples throughout the economy, which increases jobs at a very high rate and increases supply in areas where there are still great unmet needs—as well as such high job-producing activities as inflation and public service job programs—are essentially neglected.

Your budget is highly inflationary at a time of driving inflationary momentum. It is a low job-producing budget when we desperately need jobs.

I apologize for the length of this opening statement, but I just cannot resist making one further point, Mr. Ash.

One of the most perplexing problems you have in the Office of Management and Budget and we in the Congress have to confront in holding down spending to counteract inflation is the long-range program with its built-in increases and the overwhelming political pressure to expand and increase these programs, imposing an immense burden on future Budget Directors and future Congresses.

This year, as you say in your statement, you call for two programs that are going to be enormously expensive as the years go on with built-in burdens that will make increased spending irresistible. I refer, of course, to comprehensive national health insurance and a guaranteed annual income. Neither of these programs—as you say, will be in the 1975 budget. But both of these programs are likely to be increasingly expensive. They are likely to shove more and more uncontrollable spending on future Congresses. They are almost sure to be inflationary.

Of course, these programs have great appeal. Yes, indeed, we need them. But we should go into them with our eyes wide open to their inflationary effect and I do not think anyone in the administration and the Congress has discussed them as I think they should be discussed.

And I hope we can discuss this inflationary economy this morning. For the Joint Economic Committee, I think that is one of our responsibilities.

I want to welcome you to the committee, and I look forward to your statement.

STATEMENT OF HON. ROY L. ASH, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET, ACCOMPANIED BY FRED MALEK, DEPUTY DIRECTOR; DALE McOMBER, ASSISTANT DIRECTOR; AND JACK CARLSON, ASSISTANT TO THE DIRECTOR

Mr. ASH. Thank you very much, Mr. Vice Chairman.

I think we all agree with the desire to have a budget that is not inflationary and, at the same time, contributes to the maximum economic well-being of the country, particularly through sustaining as high a level of employment as possible. I would hope that during the course of our discussion we could take up the points that you have raised one by one. Preceeding that, we would like to make a formal statement and go over just a few charts that provide the point of view that was taken into account in preparing the budget that is now before the Congress.

The President's budget for 1975 pursues a number of major objectives: The proper fiscal balance to keep the economy on the track to sustained high employment and more stable prices; a strong defense force in support of our efforts to build an enduring structure of peace in the world; a comprehensive energy program to deal with current shortages and to reestablish our ability to be self-sufficient in energy; and basic reforms of grant-in-aid programs—reforms embodying the new federalism philosophy of strengthening the role of State and local governments, and of the individual citizen.

Before addressing these points, I would like to make two general observations about the budget.

First, the most sweeping initiative included in the budget, of course, is the President's proposal for a comprehensive national health insurance plan, the one to which you have referred. Also, the President has called once again for the cooperation of Congress in an effort to bring about major reform of the welfare system. Neither of these proposals, however, is expected to be enacted and established in time to affect 1975 budget totals significantly.

Second, the new initiatives should not obscure the importance of the $300 billion or so budgeted for existing programs. That is an enormous amount of money, and I think we owe each taxpayer our assurance that every effort is being made to improve the performance of ongoing Government activities. The budget reflects this concern through proposals to rationalize the structure of Government—particularly in the energy area—and through stepped-up efforts to improve the management of Federal programs. These efforts have placed emphasis on the tangible results that programs achieve. This has involved working with departments and agencies on the development of specific program objectives, then setting deadlines for their achievement. This process requires the analysis and evaluation of the performance of ongoing programs, and the development and implementation of significant program improvements. Applied Government-wide, this effort is helping to insure that the taxpayer does indeed get his worth for his tax dollar.

ECONOMIC POLICY

During the latter part of 1973, the economy was operating at close to full capacity. Simultaneously we experienced a shortage of energy. These factors have combined to produce high rates of inflation in 1973 that can be expected to continue in the first half of 1974.

Major shortages of basic resources in peacetime are a unique economic experience for us. The situation dictates a prudent but flexible budgetary policy. If we try to use the fiscal stimulus of large budget deficits to compensate for the loss of jobs resulting from energy shortages, the result will be a classic case of too many dollars chasing too few goods—thereby pushing up prices further. And I am sure that this is a matter that you had in mind when you made the comment that you did.

On the other hand, the budget must support a high enough level of demand and employment to prevent the economic slowdown from cascading beyond the impact of energy shortages.

The budget for 1975 should accomplish this delicate task. The budget recommends total outlays of $304.4 billion for 1975, compared to $274.7 billion for 1974. These figures are expected to result in moderate budget deficits of $4.7 billion in 1974 and $9.4 billion in 1975. But on the full-employment budget basis, as conventionally defined, we will have surpluses of $4 billion in 1974 and $8 billion in 1975. These full-employment surpluses include the sizable increase in budget receipts resulting from inflation. Since inflation increases full-employment receipts more sharply and more immediately than it does outlays, these full-employment surpluses do not indicate that spending should be higher. The fact that these surpluses anticipated in 1974 and 1975 will be largely the product of inflation is the reason that we must plan to achieve them—to provide restraint against further inflation.

Moderate full-employment surpluses in 1974 and 1975 will help prevent price adjustments in the area of energy resources from spilling over into a general inflation throughout the economy. Also, they will preserve for us the flexibility to take targeted actions, if necessary, to offset any economic dislocations that may result from energy shortages.

Because of the uncertain economic outlook, the President has directed, as a precautionary measure, that contingency plans be prepared for use in the event that the slowdown in the rate of growth is greater than we now anticipate. The President's proposal to extend the duration and coverage of unemployment benefits in high unemployment areas is an example of the type of action that can, with the approval of Congress, be taken. It would not be appropriate for me to speculate at this time as to what other specific measures might be taken, if the need arises, but I would to share with you the direction of our thinking. We are considering both measures which would increase budget spending, and a few actions which would affect cash receipts. We are seeking options that can be targeted—that is, that would help ease any unemployment that may become concentrated in particular areas. High priority is being given to devising measures that would take effect as quickly as possible and terminate easily or automatically when no longer needed.

Any such measures should support the automatic stabilizers that already exist in the tax structure and in the budget.

NATIONAL DEFENSE

Turning to defense spending, the budget anticipates a $6.3 billion net increase in military spending, from $79.5 billion in 1974 to $85.8 billion in 1975. This net increase does not represent a major departure from past defense budget strategies. Rather, it reflects three major factors: The pay and price increases necessary to maintain our existing defense strength. This accounts for over $5 billion of the total increase requested; minimal increases to improve the readiness of our Armed Forces; and the necessary cost of developing future weapons systems.

Defense outlays will continue to represent a declining share of the budget and of our gross national product.

ENERGY

The 1975 budget provides funds for the various elements of a comprehensive energy policy to deal equitably with current shortages and to reestablish our ability to be self-sufficient in energy. This policy has three major facets: The first involves the task of rapidly increasing our domestic energy supplies. This means stepping up our production of oil, gas, and coal, and accelerating the development of nuclear power. A second aspect involves slowing the growth in demand for energy through the elimination of nonessential uses and through more efficient energy utilization.

The third aspect of our energy policy involves greatly accelerating our energy research and development programs. This is where the major budget impact of our energy programs occurs: The budget proposes spending over $1.5 billion for direct energy R. & D. in 1975, compared to $698 million in 1973. Outlays for fossil fuel and other nonnuclear research will more than triple.

The joint government and private effort in energy research and development is expected to receive over $10 billion in Federal support during its first 5 years. This will complement an even larger energy research and development investment by the private sector.

THE BUDGET AND NATIONAL PRIORITIES

Even a casual glance at the 1975 budget shows a pattern of Federal spending priorities markedly different from that which prevailed only a few years ago. Twenty-nine percent of the 1975 budget is allocated for defense—including military retirement. Nondefense Federal operations, defined as activities where the Government goes into the marketplace and buys something or hires someone, account for 10 percent of the total on a net basis. Another 7 percent of Federal spending goes for interest on debt held by the public.

This leaves about 54 percent of all spending in the form of grants to State and local governments or benefit payments directly to individuals—primarily under social insurance programs, such as social security and medicare.

The increasingly indirect role the Federal Government is assuming in our national life expresses the New Federalism philosophy. Instead of commanding a major portion of the economy directly and attempting to impose priorities on State and local governments, the Federal Government is assuming the role of simply collecting taxes from taxpayers with one hand and redistributing these funds to recipients with the other hand. The strings attached to grants in the past are being removed or relaxed, and at the same time we are stressing cash, rather than federally specified in-kind assistance to individuals. This means that control over final spending decisions is increasingly being decentralized away from Washington; it is being returned to the people and to State and local communities. People and communities are getting more Federal money to spread as they see fit. This is what the New Federalism is all about. The objective is not simply to diminish the direct role of the Federal Government across the board, but rather to permit such level of government, and the private sector on the responsibilities it can handle best.

The relative shift away from direct Federal operations toward payments to individuals and grants to States and local government is much more than just a change in the form of Federal spending. The sharp growth in grants and transfer payments coincides with a relative increase in human resource program. These now make up about half the budget, compared to 34 percent in 1969. Defense outlays, which make up the bulk of direct Federal operations, have dropped from 44 percent of the 1969 budget to a proposed 1975 share of 29 percent.

With your permission, Mr. Vice Chairman, I would like to discuss a few of the highlights of the 1975 budget by use of some charts.

Let us go to the first chart—"Budget Totals Since 1973" [1]—which deals with this year's outlays and revenues compared to those of earlier years.

Senator PROXMIRE. These charts will be printed in the record at the end of your statement.

Mr. ASH. Thank you.

I will make just a couple of comments to interpret that.

Obviously, both the outlays and the revenues for 1975 are up over 1974, which in turn are up over 1973. And you have made the observation that outlays are up by $30 billion in 1975. They are up by $30 billion, and outlays in the previous year are up as you say by $28 billion.

I think these increases reflect the phenomenon of dealing with geometrically increasing numbers, whether they are population growth, gross national product growth, or Federal Government operations growth. I should make an observation that will put those growth numbers into context. First, the 11 percent growth rate in outlays between

[1] See chart, p. 182.

1974 and 1975 is not phenomenally large, relative to growth rates of other years.

Senator PROXMIRE. Could I interrupt to ask for a clarification of these figures? What you have there is the actual spending in 1974, and not the request. What you have in 1975, of course, has to be the request. The supplementals, and so forth, could be much higher.

Mr. ASH. What I am saying is that the 1974 outlays number of $274.7 billion represents our estimate, at this moment, of outlays in 1974, including those that derive from all supplementals that have been submitted alongside the budget itself.

The 1975 outlays are those expected from the budget, all supplementals for 1974, and all prospective actions that are before the Congress, in whatever form, at this point.

Senator PROXMIRE. What I am saying is, on the basis of all past experience, the $304.4 billion is going to be higher, that is really equivalent to the $268.7 billion you asked for last year, is that not correct?

Mr. ASH. It may be higher. It really depends upon congressional actions. If we look at 1975 outlays as an example, the biggest part of the difference between the current estimate of $274.7 billion and the $268.7 billion in the budget submitted a year ago, represents congressional actions taken on the President's budget during the last session of the Congress. There is no reason to guarantee that the Congress will not act similarly this year, but $304.4 billion is the recommended level of 1975 outlays that the President put before the Congress. The Congress may, of course, take a different view.

Senator PROXMIRE. Take your time now. But I would point out that as you say, congressional actions under the President's budget. Most of those actions were requested by the President, certainly with respect to the Middle East war, for example, and other actions, which turned out to be necessary, is that not right?

Mr. ASH. No. As a matter of fact, if we deal with the year 1974—and I presume that is the one you have in mind—the President's budget last year called for $268.7 billion in outlays. And he submitted additional supplemental requests that would have brought the total up to about $270 billion in outlays. Congressional actions added $3.8 billion over and above Presidential requests and supplementals. The Presidential requests would have resulted in a balanced budget at $270 billion for fiscal 1974. Congressional actions over and above the Presidential budget, over and above the Presidentially submitted supplementals, accounts for most of the difference.

Senator PROXMIRE. I want to question you on that a little later.

Mr. ASH. All right, sir. We will go back to the particular programs that make up that increase as you wish.

In regard to 1975, I want to adopt your point, and that is that $303.4 billion is the Presidentially submitted proposal to Congress. And Congress, of course, may view it differently and want to act otherwise.

The 1975 outlay increase of $30 billion, or approximately 11 percent, is not the highest percentage increase during the last 10 years. It is only the fifth highest percentage increase; there have been higher percentage increases in budget outlays in 4 of the past 10 years.

But let me put it in one further context, and then we will move to the next chart.

The percentage of the gross national product represented by Federal Government outlays has remained virtually constant now for a number of years. Since after 1968, outlays have represented approximately 20 to 21 percent of gross national product. So the point I want to make is that while the numbers are increasing in absolute amounts, we have maintained Federal Government outlays at approximately a constant percentage of gross national product, which is one measure of the ability to afford Federal expenditures.

If you wish, we can go to the next chart—"The Budget Dollar" [1]—which provides one further overlay that I think is significant. And this is a broadview of the composition of revenues and outlays.

On the revenue side, individual income taxes provide about 42 percent of our income in 1975, approximately the same percent as this year. The Federal Government expects to realize $129 billion in revenues from that source, or about 11 percent of all personal income in the country.

Corporate revenues, which account for 16 percent of Federal Government income, are derived from $48 billion of corporate income tax, which is approximately 40 percent of corporate earnings during the year.

Social insurance receipts are half from employers and half from employees. Together they account for 28 percent of our total revenues.

But the income side is not the significant side from the point of view of changes over a period of time. The truly significant changes have occurred on the other side of the budget, which is where the money goes. And I think the significant observation to make is that over the years we have changed the role of the Federal Government, from one of carrying out a significant number of Government operations to basically becoming a transfer agent. The Federal Government has become a transfer agent in that more than one-half of the moneys realized from revenues are now paid out in payments to States, localities, and individuals, in large part to spend as they will.

You will note that 54 cents out of every dollar is not spent to carry out Government programs, but in fact, is spent to put moneys into the hands of individuals and States and governments. That is the new nature of the role of the Federal Government, one that decentralized not only authorities to make spending decisions but also decentralizes the resources with which to make those decisions.

One point that should be made is that the Federal Government now provides approximately 20 percent of the funds spend by State and local governments, and 20 percent of those funds are given to those State and local governments with virtually no strings attached to spend as they will. So we are moving in the direction of decentralization of decisionmaking and the expenditure of resources.

I think another point on the chart is significant because it is small. Other Federal operations—that is, the conduct of virtually all Federal activities and operations other than defense—accounts for only 10 cents of each dollar of Federal expenditures. Defense, at 29 cents of each dollar, is the lowest that it has been in many years.

And now, let us look a little more at defense. Let us go to the next chart—"Defense Outlays as a Percent of GNP" [2]—and then we will come back to the one on "Changing Priorities."

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[1] See chart, p. 183.
[2] See chart, p. 184.

There are many ways to talk about defense. One is how large it is and the other is how small it is. You have made some comments as to how large the defense budget is and that it will increase by $6.3 billion from 1974. Yes; it is true that it will increase by that amount. But let us look at another measure of defense that I think is an even more significant one.

Over the years the defense budget as a percentage of our gross national product—that is, the proportion of the goods and services produced by this country that are given over to maintaining our survival and our security—has become smaller and smaller. The 5.9 percent of 1975 gross natitonal product that we will spend to maintain security in this country is the lowest percentage of our gross national product in 25 years, the lowest since 1950. And if we look at some of the specific reasons why, we find that we have reduced personnel, military personnel from 3½ million in 1968 to 2.2 million today. We have reduced civilian personnel to 1 million. In effect, we are substantially reducing not only the levels of personnel, and the amount of material being procured, but in its broadest and more total sense, we are reducing the burden on society to maintain our national security. We think at this stage we have a very prudent level of defense expenditures. And just to put it in one further context, if today we were spending not 5.9 percent of our gross national product for defense but merely the average level of our gross national product that we have spent for the years 1960 to 1968, we would be spending not only $85 billion, but more like $125 billion. We have in effect realized a $40 billion peace dividend, and we are using it for our domestic programs.

There are many ways to look at defense, but I merely call your attention to the fact that when we look at defense in its proper setting, which is as a proportion of all that goes on in this country, you will find that we are able to maintain national security at a lesser charge to our citizens than we have for about a generation.

Now, let us go to the chart on "Changing Priorities." [1] It is merely a reflection of the mix. And it is a reflection of what I have just indicated earlier that we have recovered from our defense expenditures billions and billions of dollars. We are now expending those revenues, along with other increments of revenues that we have generated over these last few years, for human resources programs. Just since 1969, defense expenditures will have gone from 44 percent of our total expenditures down to 29 percent. Human resources will go from one-third in 1969 to one-half in 1975. Or to put it another way, defense expenditures in absolute amounts will have increased 8 percent since 1969—not 8 percent per year, but 8 percent. Human resources programs will have inceased 140 percent in that same period of time. We have truly changed our priorities.

The final chart—"Federal Grants to State and Local Governments" [2]—reflects what I have indicated earlier, the decentralization of Government that has been achieved over these last few years. You will note that in 1965 approximately $10 billion of Federal moneys were flowing into the hands of State and local governments to spend. Now that number is over $50 million. A big portion of those funds, as you know, are for human resources programs; others are for highways,

[1] See chart, p. 183.
[2] See chart, p. 184.

for environment and general revenue sharing, the latter, of course, may be spent for whatever lawful purposes the States and localities wish to spend those moneys for.

So we have changed priorities. And we have decentralized government. And we have operated with a continually decreasing burden for defense. These are the characteristics of the 1975 budget and a trend that was set into motion a number of years ago and that is continuing.

I will leave my comment at that point, Mr. Vice Chairman, and then we will all be available for questions.

I should introduce those with me who will be available to join in answering any questions that you may have. First, on my right, Mr. Fred Malek, Deputy Director of OMB, and second, Mr. Jack Carlson, Assistant to the Director. On my left, Mr. Dale McOmber, Assistant Director of OMB.

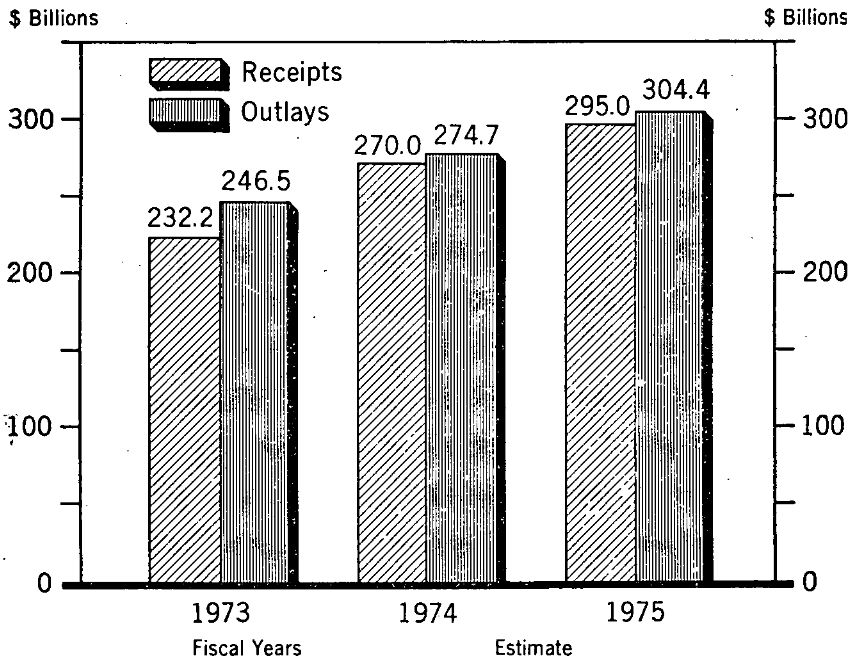
And among us we hope to be able to answer any questions that you may have.

Thank you, Mr. Vice Chairman.

Senator PROXMIRE. Thank you, Mr. Ash.

[The charts referred to in Mr. Ash's statement follow:]

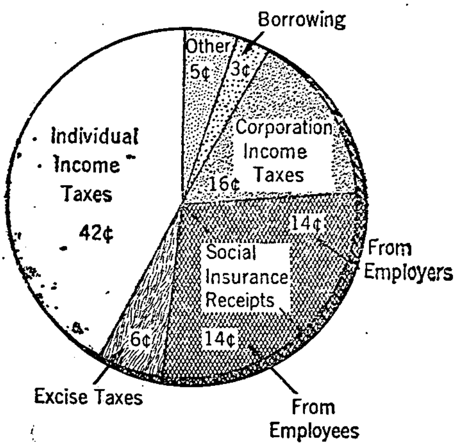
Budget Totals Since 1973

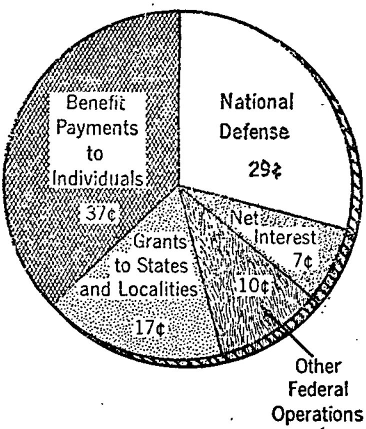


The Budget Dollar

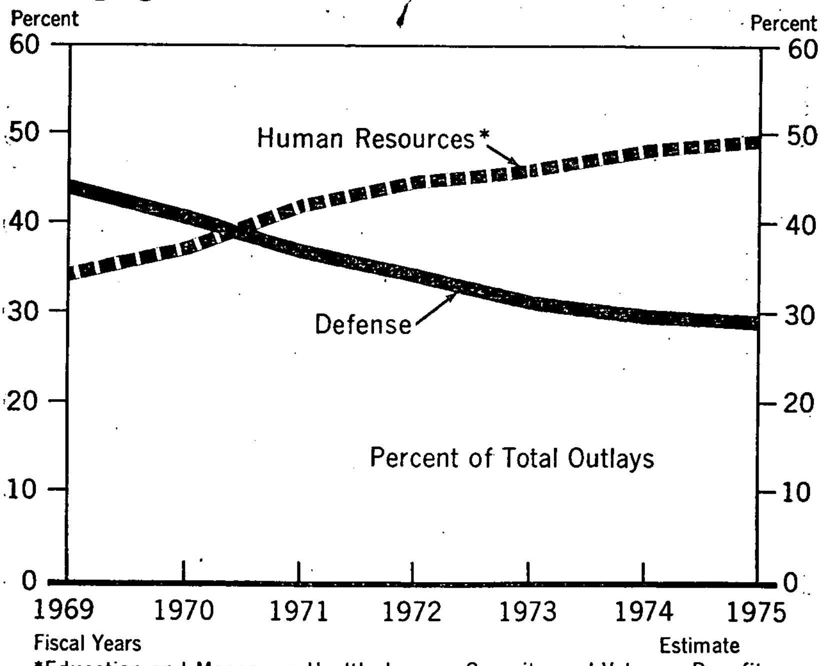
Fiscal Year 1975 Estimate

Where it comes from... Where it goes...



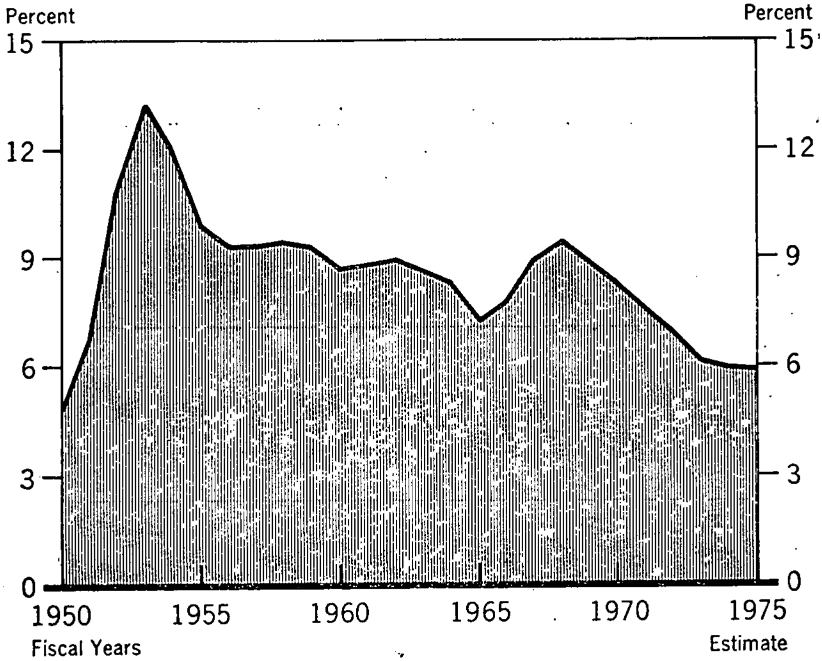


Changing Priorities



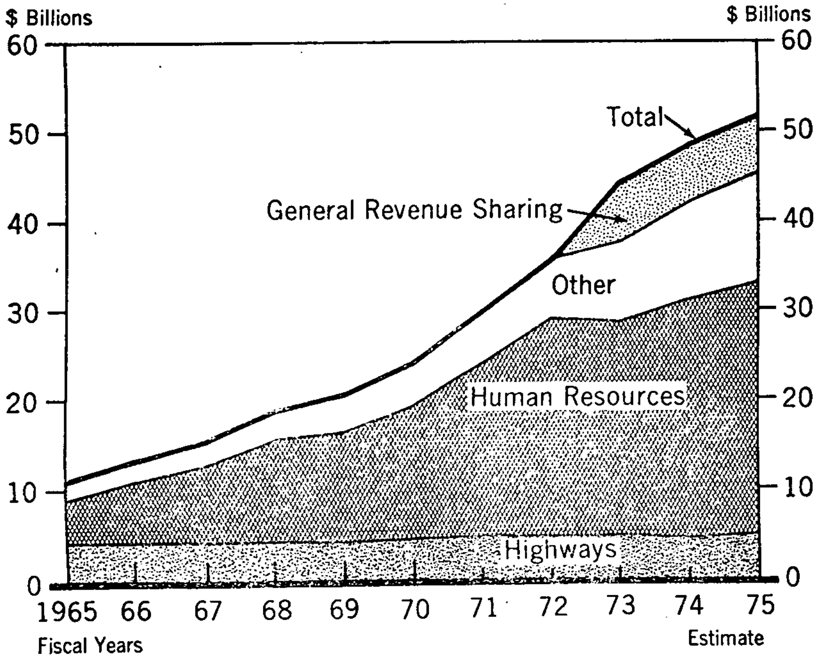
*Education and Manpower, Health, Income Security, and Veterans Benefits

Defense* Outlays as a Percent of GNP



* Department of Defense — Military & Military Assistance

Federal Grants to State and Local Governments



Senator PROXMIRE. Could you delineate for us the specific anti-inflation features and antirecession features of this budget? First, is the $30 billion increase in the budget, no matter how you slice it or rationalize it a $30 billion increase, as I have pointed out, over last year's final spending, a $36 billion increase over last year's requested spending, and the comparison is about a $36 billion increase? Is that not inflationary?

Mr. ASH. A budget always has the task of walking a fine line. And we think we have walked the fine line this time. We have fought inflation by having a full employment surplus of $8 billion in fiscal 1975.

Now, I am sure that we all know——

Senator PROXMIRE. Let me just take a minute on this full employment surplus thing. This depends on the assumptions you make as to when the budget becomes inflationary. Now, Mr. Fellner of the Council of Economic Advisers and Mr. Stein seem to think that when we get unemployment below 5 percent, then the effect on the economy is inflationary. So if you have a deficit at 5 percent full employment and you have in this budget, this is an inflationary budget in that sense too, not only from the standpoint of a big increase in spending, but also from the standpoint of the full-employment concept.

Mr. ASH. Let me then elaborate my point of an $8 billion full-employment surplus. That $8 billion full-employment surplus, as you know, is calculated using the conventional 4-percent base for establishing a base unemployment level. Even if that 4 percent were changed to some other number—and we do not suggest that it be so changed—say, to 4.7 or something like that, as some have suggested, there would still be an approximate full-employment balance. I think most economists would agree, at a full-employment balance or at a full-employment surplus—and this is a full-employment surplus on the conventional basis—a budget by definition is not inflationary.

Senator PROXMIRE. I am not so sure. It depends upon the kind of spending that you have. Will you not agree that military spending is inflationary because it satisfies no economic needs, when you build aircraft carriers you do not sell them in the supermarket. But when you provide more housing it increases the supply of houses, and when you provide manpower training it increases the supplies of skilled labor, so that Government expenditure can be counterinflationary.

Mr. ASH. The main advantage of military spending is that when we spend whatever money we spend for defense we are increasing the supply of survival and the supply of security. And that, I would guess, most people would put as the highest order product that they would like out of Government spending. So in that sense it provides a real, tangible value, and one that I would think we would most——

Senator PROXMIRE. When you take that position, of course, you can defend any level of military spending. You can defend a $200 billion military budget and say you have to have it. The argument that I have, and that many people in Congress have, is that we are wasting funds in the military area, in our bases overseas, in our procurement policies, in our excess of admirals and generals, all kinds of waste. But at any rate, the point I am making is that military spending by itself is more inflationary than other Government spending, it provides no economic service; is not that correct?

Mr. Ash. No; I disagree. I only made the basic point that I did so that we would not overlook it when we were talking about the purpose of military spending. Military spending itself does create a significant number of jobs, whether they be Government jobs or private sector jobs. In producing that end product of value, which is security, we do employ a great number of people, and it is a fairly productive use of the talents of those people.

Senator Proxmire. I call your attention, Mr. Ash, to the report that we have from the Bureau of Labor Statistics that a billion dollars of defense spending produces 57,000 jobs. While a billion dollars spent on educational services provieds 104,000 jobs. Right there it seems to me, that if you have a budget which is heavily weighted as I think it is in the area of military spending and is lightly weighted in the area of providing public service jobs, that it tends to be inflationary regardless of its size. And this is a big budget.

Mr. Ash. I think it is generally conceded—and I do not know what particular data you have—but it is generally conceded that military spending does provide a considerable number of jobs in this economy. In fact, one should look at this both ways. Not only does it provide jobs, but to pick up your argument—and it is one that I think we should all take some credit for—it should be noted that over the last 5 years, we have, through the policies of this administration, been able to reduce significantly the number of people both in the miltary services and in the contractors that have been employed in military-type activities and convert their employment to civilian product employment. So certainly that is an advantage of moving them to other kinds of jobs.

Senator Proxmire. I am talking about this particular kind of budgget. If you take the position you have with the highest kind of priority on military spending, then it seems to me that that may be correct, I do not think it is, but it may be. But to be honest about it your budget does have many inflationary aspects.

We disagree on that. Let us go into something else.

At the end of World War II the budget dropped by $60 billion, from a much smaller base. At the end of the Korean war the budget dropped $8 billion. Again, at the end of the Vietnam war we have exactly the reverse situation. Last year, as you pointed out, we had a $28 billion increase in the budget. This year it is a $30 billion increase in the budget. Much of the increase this year is in military spending. This is completely in contradiction of all of our historical experience. There has never been a war—I challenge you to name any war in our history—when we did not cut spending overall after the war was over and sharply reduced military spending.

Now, when you recognize that element, and also, Mr. Ash, recognize the fact that the State and local spending has increased very greatly, partly because of revenue sharing, because of the very policies which your administration is recommending, we see an increase in the percentage of the gross national product going to government—as I say, it is either in the State or local area, or in the military area, very largely—we see a percentage increase from about 32 percent overall to about 36 percent.

Mr. Ash. Do you wish me to comment on those two points?

Senator Proxmire. Yes, sir.

Mr. Ash. The first one dealt with the end of the Vietnam war, and the other one with the total level of government costs.

Senator Proxmire. I want you to comment on both of them, and the fact that instead of having a peace dividend as everybody said we would have, the military has swallowed up all of the peace dividend and gotten $8 billion on top of that.

Mr. Ash. Let me comment on your points, then.

The end of World War II and the end of the war in Korea were both abrupt. And because they were both abrupt, there was an immediate change year to year. In this particular case, given the nature of the involvement in Southeast Asia, the President, when he was elected 5 years ago, undertook a program of disengagement and undertook a program of bringing that war to an end. But it was impossible to do it abruptly, and do it successfully. And consequently, the level of military activity was brought down over a number of years. Today we are operating at a level of defense expenditures which, on a constant dollar basis—because the value of the dollar has been changing over these years—is one-third less than at the peak of the Vietnam war. We have made the very kind of reduction that you are talking about. The fact is that it was not so dramatic because there was not such an abrupt end. But it is there. It is not only there, and those moneys, as I have shown by the charts, have been used by other programs, but we did not have to wait for the war to totally end in Vietnam in order to begin to redirect those resources to other programs. We began, starting in 1969, 1970, 1971, 1972, 1973, and 1974, so that those other programs benefitted even as we were disengaging from Vietnam. We did not have to wait for the war to be over and then have an abrupt reduction.

So the saving is there. It has been made, and it has been made without waiting for the war to come to an absolute end; it has been made in the process of ending the war. You need only look back at the chart that showed defense as a percentage of GNP, or express defense in constant dollars, to see that we have taken about $40 billion out of the defense level from the peak that it reached in 1968.

Senator Proxmire. My time is up. But what you are saying in effect is that the military swallowed the peace dividend bite by bite instead of all at once.

Mr. Ash. Not a bit, I am not saying that one bit.

Senator Proxmire. They did, they swallowed it—we are spending $8 billion more than we were last year, we spent more in 1974 and 1973, incredible. You are spending billions more than at the height of the Vietnam war.

Mr. Ash. I said just the opposite. We have taken $40 billion out of the level of defense spending. And I am sure you would agree it is proper to adjust for constant dollars given the changing value of the dollar over that time. So this has not been a swallowing bite by bite. Quite the contrary, on a constant dollar basis we have cut $40 billion. In effect, this $40 billion is being used for other programs. To put it another way, $40 billion is equivalent to a 30-percent reduction in personal income taxes that would otherwise have to be paid if we were today financing our defense as it was at the peak of the Vietnam war.

Senator Proxmire. My time is up.

Congressman Reuss.

Representative REUSS. Thank you, Mr. Vice Chairman.

Mr. Ash, I am glad to see that you are giving thought to a possible recession and are making contingency plans, though you do not state exactly what they are. I have been concerned about that, too. And one of the things that I think we ought to do right now is to grant a substantial tax decrease to the lowest three-fifths of American families, those making $13,000 a year and less. The people at the bottom would be helped by your very commendable welfare reform. But I am thinking of the people making between $6,500 and $13,000 a year. They, as you know, have suffered, relatively speaking, under Mr. Nixon's administration, and what with high inflation and increased payroll taxes, they are having a particularly tough time. And, therefore, I advocate a substantial cut in the payroll tax and in the income tax targeted at the low- and moderate-income taxpayer, those making $13,000 a year and less. I think it would be good from the standpoint of equity, and I think it would be good from the standpoint of providing adequate demand in the economy to keep the economy going. Are you for or against that proposal?

Mr. ASH. First, I am not sure I would accept the premise that those people have suffered under the Nixon administration relatively. They have not. Their own income, even after adjusting for taxes and prices, has increased over the years of the Nixon administration.

But now, let me go to your specific point.

Representative REUSS. I think I can show you something that will stagger you as it staggered Mr. Stein the other day. I have a little chart which, using your own figures, will show just that. I have sent for it, and it will be here in a minute. But I will note your dissent for the moment, and we will refer to that later.

But what do you think of my proposal?

Mr. ASH. Our thought about this year and the possible need of taking any action over and above that set forth in the budget is predicated on the possibility that there may be a spotty, short-term economic downturn, rather than a general one. And if that possibility occurs—and it is only a possibility—we believe the actions we should take should be more specific to the problem rather than more general. For instance, the criteria that we are applying would put that kind of proposal as a low priority compared to other possible actions that we would take. It is not a short-term action; that is, it is an action that perpetuates itself in future years. It may not be as directable to particular pockets of need as other kinds of programs. It may not have as quick a response time, which is clearly important. We believe that if there is any need to take further steps, they should be ones with a quick response time and immediate action. We think this proposal might not meet the criteria as well as would some other actions, and, therefore, we would consider other actions before we would consider that one you have mentioned.

Representative REUSS. So to come to the point, you would not favor a tax cut for the $13,000 a year and under families at this time?

Mr. ASH. We would favor other actions under a contingency plan before we would favor that. As an example, the unemployment compensation proposals that have been before the Congress, some for almost a year, and other additions suggested even this last week, we would think would be of much higher priority.

Representative REUSS. I have a little difficulty reconciling your unwillingness to do anything about the tax position of the below $13,000 middle American with the fact that the administration is now vigorously supporting, I regret to say with the help of the Ways and Means Committee, including some Democrats on it, the so-called Keogh plan extension which would give a $7,500 a year tax bonanza to the doctor and lawyer and other professional people making in the $50,000 a year range, letting him escape taxation on that entirely under the guise of thrift. How can you reconcile the fact that you are ready to give away more than $200 million of the Federal revenues to help the $50,000 a year doctor or lawyer with the fact that you are not proposing to do anything for the very hard-pressed modest-income families?

Mr. ASH. I should allow the Treasury Department to comment on that, they having the responsibilities in taxation areas.

Representative REUSS. Any volunteers?

In the absence of the Treasury, I will comment. I think it is one of the biggest rip-offs hitherto perpetrated. And it comes with unusually bad grace from an administration that is unwilling to do anything for the really hard-pressed people.

Mr. ASH. You know last year we did put before the Congress a tax reform proposal which we still think is worthy of congressional consideration. It does have as its objective a more equitable distribution of the tax burden, and also represents an attempt to simplify the tax structure. We would commend that for reconsideration this year.

Represenative REUSS. Your statement that taxes are something for the Treasury, not for the Office of Management and Budget, bothers me a bit too, because this committee has urged the Office of Management and Budget for some time to include in its annual budget presentation a tax expenditure budget.

On pages 34 of the budget document, you announce that you are not including anything about tax expenditures. And then you have a long paragraph about how difficult tax expenditures are to figure out, and how it would fret you to prepare anything for us on it. It seems to me that the example you have just given is abundant evidence that you ought to heed our advice. And here you tell me that you do not even know about a big deal whereby the Treasury is trying to give away $200 million a year to doctors and lawyers in the $50,000 income bracket. Now, something that costs the budget $200 million a year certainly seems to me worthy of notice. Could you not take another stab at preparing a tax expenditure budget? Would it not help you as well as us?

Mr. ASH. That, as you know, has come up a number of years in a row. A considerable amount of tax expenditure information has been provided to the Congress. I think just recently there was a historical series covering all of the years from 1967 to 1972.

Representative REUSS. That is 2 years old, of course. And what we wanted was the same tax expenditure information on fiscal 1975 as is contained in the budget with respect to expenditures. The revenues are equally hurt by a tax giveaway to doctors and lawyers of $200 million, and by a straight appropriation which would give every doctor or lawyer making $50,000 a year a Government check for $3,000 or $4,000, or whatever the amount is. That would be a little harder to get through, but it has the same fiscal effect.

Mr. ASH. As you know, there are considerable differences of opinion on tax expenditures and what should or should not be one. Should personal exemptions be one? Should standard deductions be one? Should graduated tax rates be a tax expenditure? It is not as simple as you suggest it might be. And furthermore, I believe that those data that have been compiled and submitted could be very useful in any policy consideration of tax expenditures. There is not that much change over the years. If the objective is to consider the policy implications, I would think that the data that are provided go a long ways toward allowing you and ourselves to do so.

Representative REUSS. There was testimony Friday before this committee that $78 billion is the amount of tax expenditures in this year's budget. That is a lot of money. Do you not think it would be helpful to include that?

Mr. ASH. There are data provided on it. Those data are provided independently by the Treasury Department rather than provided through the budget process. And so I believe that the very fact that you have, and we have, data of that kind does suggest that we are all prepared to deal with the subject. I think the Joint Committee on Internal Revenue Taxation publishes such data each year. So I think that since we do have those data available to us, they just do not have to be included in the budget.

Representative REUSS. Those are only for the past, though.

Mr. ASH. Yes. And those data of the past, I would believe, are pretty useful. In fact, they are about as useful as one needs for the kind of policy judgments and considerations that have to be given.

Representative REUSS. Would you be good enough to have your staff review the $78 billion projected tax expenditure items that were provided to this committee on Friday by people from Tax Advocates and also the Brookings Institution, and give us your idea as to whether those items are legitimate items or whether you would have any projected changes in it. I think it would be helpful to us. They made the effort. I think we owe it to them to get your views on whether it is a worthy effort, or whether it can be improved on.

Mr. ASH. What we would do, sir, would be to ask the Treasury to respond since it is in their field of expertise.

Representative REUSS. Right.

[The following information was subsequently supplied for the record:]

RESPONSE OF HON. ROY L. ASH TO REPRESENTATIVE REUSS' REQUEST FOR A REVIEW OF THE "FISCAL YEAR 1975 TAX EXPENDITURE BUDGET" PREPARED BY TAX ANALYSTS & ADVOCATES

(Prepared jointly by the Treasury Department and the Office of Management and Budget)

On June 1, 1973, the House Ways and Means Committee published "Estimates of Federal Tax Expenditures." The estimates for calendar years 1967 through 1972 were prepared by the staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation. These estimates provided the basis for the FY 1975 estimates made by Tax Analysts and Advocates which were presented to the Joint Economic Committee on February 15, 1974. Their FY 1975 estimates are essentially extrapolations of the data provided to the Congress last June based on their own assumptions about the growth and composition of GNP. Tax Analysts and Advocates used a somewhat different scheme for categorizing individual tax expenditures items by functional program area than was used by the Treasury-Joint Committee staff.

As the Treasury Department and Joint Committee on Internal Revenue Taxation staffs indicated, "There are differences in points of view as to the 'tax expenditure' concept, including differences as to the items which should be included in, and excluded from, such a listing." A number of tax experts believe the "tax expenditure" concept to be unsound for the reason that many so-called "tax expenditure" items represent not special tax benefits but rather a legitimate attempt to arrive at a fair measure of income and ability to pay. Further—and perhaps even more fundamentally—it is unrealistic to consider such items apart from the general system of rates. Many of the items are essentially methods of sharing general rates, an elimination of any substantial portion of them would probably be accompanied by a downward revision in rates. For all of these reasons the Treasury Department's participation in the preparation of tax expenditure estimates has been confined to supplying the particular numbers (subject to the limitation described below) requested by Congress, and should not be construed as an endorsement of the position that any particular item or items are a disguised subsidy.

As an indication of the difficulties inherent in identifying what should and should not be regarded as a tax expenditure. Tax Analysts and Advocates included a few items in their list that were not included in the June 1, 1973, report: the deferral of capital gains tax on appreciated assets transferred as taxable gifts, exclusion of all capital gains on assets held at death, and failure to tax imputed net rent on owner-occupied houses. Moreover, one item that was on the Treasury Joint Committee list was excluded by Tax Analysts and Advocates: the failure to tax scholarships and fellowships.

The Treasury-Joint Committee staff report listed some limitations to the estimates of tax expenditures—limitations that of course apply equally to the estimates made by Tax Analysts and Advocates—that bear repeating.

1. The estimate of each tax expenditure is made independently of any other tax expenditure item. As a result, if two or more items were to be eliminated, the result of the combination of changes being made at the same time might produce a lesser or greater revenue effect than the sum of the amounts shown for each item individually. This, of course, also means that the addition of the various tax expenditure items is of quite limited usefulness. This is why totals are not shown for table 1, except in a footnote.

2. In the case of many of the items, especially those for which information is not available on tax returns, the lack of data makes estimates quite tenuous. Where information is not available on tax returns, it has been necessary to obtain information from whatever sources are available, and, when sources are limited, to make assumptions on which to base the estimates.

3. The estimates for the various tax expenditure items do not take into account any effects that the removal of one or more of the items might have on investment patterns, consumption, or other aspects of economic activity. In other words, the estimates shown do not take into account the induced effects of changing the provisions. Repeal of a provision, therefore, would not necessarily raise the revenue associated with removal of that provision.

4. Often, tax expenditure items which have been added in recent years do not become fully effective until the lapse of several years. As a result, the eventual annual cost of some items added in recent years is not fully reflected in the year 1972. Conversely, if various items now in the law were to be eliminated, it is unlikely, in many cases, that the full revenue effects shown would be realized until an extended period of years has passed.

5. In some cases, if a tax expenditure item were to be eliminated, it is probable that Congress would, at least to some extent, desire to deal with the underlying problem by a direct expenditure program. The effect of any such program is not taken into account in the estimates shown. In addition, if some of these provisions were removed from the tax laws, this removal might be accompanied by revision in tax rates, personal exemptions or the minimum standard deduction, as has happened in the past. This has not been taken into account in the estimate.

6. There are features of the law which are not taken into account in the estimates shown. For example, personal exemptions, the minimum standard deduction, the foreign tax credit, and the effect of income splitting and head-of-household treatment, as well as the graduation in the rate structure of the individual income tax, are not taken into account in these tables. Also, the effect of estate and gift taxes is not shown nor is the interrelationship of these provisions with some of the tax expenditure items taken into account.

7. Differences in personal income levels and corporate profits can also account for differences in the cost of tax expenditure items from year to year. Also, some tax expenditure items themselves may be larger or smaller from year to year, wholly independent of tax considerations.

The problem of aggregating individual estimates into totals, either by program area or into a grand total, requires special emphasis. In some cases the revenue gain to the Treasury would exceed the sum of the estimates for two individual items if both tax preferences were repealed. For example, if interest income from State and local government securities were made taxable and capital gains were taxed at ordinary rates, many individuals would be pushed into higher tax brackets than if just one of these sources of income became fully taxable, hence the combined effect on revenue would be greater than the sum of the two separate estimates. In other cases if two items were repealed, the revenue effects would be smaller than the sum of the individual items. For example, if the deductability of mortgage interest payments and homeowner property taxes were repealed, many individuals who now itemize their deductions would opt for the standard deduction thus limiting the revenue gain to the Treasury.

Anyone interested in the subject of tax expenditures should be wary of simple aggregations. Those who prepared the estimates published by tax analysts and advocates indicated their awareness of the problem of aggregation in the specific instance of depletion allowances and the expensing of intangible drilling costs but went ahead and made aggregate estimates in other program areas. In particular, their grand total of $78.3 billion for fiscal year 1975 should only be considered in view of these inherent limitations.

Representative REUSS. Now, if you take a look with me at this point of family income. Let us just start with the Eisenhower years. I have a little chart [1] over here. Take the highest fifth of the families in 1953—they were getting something like 41 percent of total income. That continued at about that level until 1962, and then in 1962 their share began to diminish, until Mr. Nixon's arrival in 1968. And there it starts a very nice climb, which continues to the present day.

And then look at the position of the lowest two-fifths of American families. I also have it in the lowest three-fifths, it comes to about the same. But the lowest two-fifths is roughly those families that get, by current figures, below $10,000 income a year. Take, again, 1953. There we find that they are getting 17 percent of total income. And that stays stable during the fifties, and then in 1962 it starts a very salubrious upward climb, reaching its height, again, in 1968. And then it went into a tailspin, as you can see. So it is now back to where it was in 1953. In other words, there has been a transfer of income under Mr. Nixon's administration from the lowest two-fifths to the top one-fifth. What would you think? Have you been doing something wrong?

Mr. ASH. I am seeing the chart for the first time, but I am prepared to make my observations.

First, you have used the zero suppression technique of charting which is generally not considered valid. But I will comment on it anyway.

Representative REUSS. You considered it valid in your social indicators which you brought out over the weekend, except you cut off the last year or two.

Mr. ASH. We do not have zero suppression in our budget charts. I made sure that there was none in the budget this year.

But to take those numbers, and adjust for that effect, you will note that the highest fifth of the families went from what looks like about 40 in 1968 to 41.4 in 1972. Certainly, that series of numbers does not square with the visual impression of the direction of those lines. And

[1] See chart 2, submitted for the record by Representative Reuss, hearing day of Feb. 7, 1974, p. 22.

that is what, of course, zero suppression does; it creates a visual impression different from the underlying fact. The same conclusion could be drawn from the lower two-fifths that went from, say, 18 to 17.3. Thus, one observation is that the optics of the chart does not reflect the true dimension of what you are saying.

The second observation that I would make is that this does not in any way say that the lowest two-fifths of families did not double, triple, or quadruple their income during this same period of time. This is a distribution of total income. It makes no reference to whether those at the lowest or the highest improved their lot, and both could have improved their lot tremendously with just slightly different relationships between them. So that point is left open here. It is my assertion that the lowest half improved their lot. I will see if I can find the data to support it.

[The following information was subsequently supplied for the record:]

Average income before taxes (using the definitions of the Census Bureau) of families in the lowest two quintiles more than doubled between 1947 and 1972. When price increases are taken into account, the average family income of this group rose by about 77 percent between 1947 and 1972, and 4½ percent between 1968 and 1972 alone.

The Census figures on the distribution of income do not include in-kind benefits, such as Medicaid, Medicare, Food Stamps, and public housing. Federal outlays for these programs, which go largely to low income individuals, have risen dramatically in recent years.

Mr. Ash. Thirdly, such phenomena tend to flow somewhat with the changes of the business cycle. What is missing on the chart are the years 1973, 1974, and 1975, which should show, consistent with that business cycle effect, a reversal of the trend through 1972.

So with those three comments I would suggest that we all refer to other data before we draw any hard conclusions, because this chart has a number of points of vulnerability. The chart does not indicate, furthermore, whether it is before or after taxes, which, of course, makes a lot of difference.

Representative Reuss. Of course it is before taxes. And when you figure in the fact that most of the loopholes are concentrated in the upper fifth, and when you further figure in that the only tax increases in the last couple of years, the payroll taxes, have fallen with uneven force on those below $13,000 a year in income, you make it worse when you put it in terms of after taxes.

Mr. Ash. Taxes work the other way in the particular years shown here. I think it should be modified for the tax effect as well. So what I would suggest is, while I take cognizance of what is presented there, I think the chart is not presenting data that gives either of us an understanding of what is actually going on. Instead, the data has been selected to suggest the conclusion that the actual facts would probably deny.

Representative Reuss. My time is up. But I am disappointed, because your unwillingness to recognize the direction in which those lines are going, I think, accounts for the unwillingness of the administration to do anything about the economic plight of the lowest three-fifths of American families. If we could get agreement on where we are going, then I think this Congress and this administration could get together on a program that would redress the imbalance. But we will talk about this some more. My time is up.

Mr. Ash. Just so that I can understand this chart and see what data I can get, does that include payments made to those various recipients by the Federal Government? Since 1969, the Government has doubled its payments to very low-income families. Federal benefits to low-income persons will be $32 billion in 1975. Are those Government payments included?

Representative Reuss. Cash payments are. In-kind payments, like food stamps, medicaid and housing allowances are not. However, my main point is not about the lowest one-fifth, who get those payments, but about the second and third quintiles—people who do not get these noncash transfers, but they have been catching it on the chin from inflation and from increased taxation as well as from the shares of income going against them. And what I want to try to awaken in the mind of the administration is the fact that this is a group that is being very badly hurt. And it seems to me middle America needs some help.

Mr. Ash. I think it was awakened a number of years ago. Federal Government programs have, over the last 5 years particularly, gone in the direction of helping the very people that you have identified. Starting 5 years ago, there was a substantial awakening and substantial action to move funds in that very direction. Presumably, your chart does not include the Federal Government programs which we would all hope would be responsive to the very kind of need that you have identified.

Representative Reuss. There has been a big rhetorical argument about helping moderate-income people, but the economics has moved in the other direction.

Mr. Ash. I think if you will look at the Economic Report you would find some very revealing data that would, I think, support very substantially the actual redistribution of national income and wealth in the direction that you should have.

Representative Reuss. I, too, have figures from the Economic Report. And if you will look at the other chart, the Economic Report tried to make the point that things have stayed about the same from 1947 to 1972. Actually, when you break it down, however, you see that the lowest two-fifths and three-fifths had a big falling-off since 1968, and the top one-fifth had a big come back. So the wholesome tendency that had started got sidetracked under this administration. I am suggesting that we had better put it back on the track again before we have a real recession.

Mr. Ash. The real data, I think that people are interested in is what they have to spend and what it will buy. On that basis—and that is what it is all about—the lowest two-fifths have substantially increased their ability to buy goods and services in the marketplace. I think that is the key. The relative distribution of one group of people versus another is another aspect, but what people spend is the money they have, and if that increases, and it will buy more, that is the first measure of what their interests are and what is important to them.

Representative REUSS. You try to tell a machinist's wife in Dayton or Milwaukee that she has got more spending power, and you will have a tough morning in the supermarket.

Mr. ASH. Certainly, over the last 5 years per capita disposable income has gone up about 16 percent after paying taxes, and after paying for higher prices. And I would think that on that basis—and there are many other indexes, but certainly that is one significant one—people are buying more goods and services that they ever bought before, regardless of any changes in values of the dollar or taxation.

Representative REUSS. Overall they are. My point is that the lowest two-thirds are having trouble.

Senator PROXMIRE. Senator Humphrey.

Senator HUMPHREY. Thank you, Mr. Vice Chairman.

It is good to see you again, Mr. Ash.

I would like to pick up where Congressman Reuss left off, and then I want to come back to questions that you and I were arguing about and discussing; namely, impoundment and other matters of such nature.

We have had some other witnesses from the administration here. We had Mr. Stein here. Mr. Stein is a good economist but a poor prophet. He predicted, of course, that inflation would be held down to about 4 percent. And I have a dinner coming from him on that basis. I predicted that he was dead wrong. Of course, this is a very difficult area, and there are many uncertainties.

But you seem to feel that the American people are just doing fine, that things have improved greatly. I sense from your conversation that you feel that the average working family—and they pay the bulk of the taxes, they do the bulk of the work, they are the people basically, in terms of the majority—you feel that they are able to buy more with what they get in their paycheck now than they were before. I am not interested in talking about what they could do in 1966. I am interested in what they were able to do in 1973, what they were able to do in January 1974, and thus far in February 1974. Because that average working family does not have the resources to carry them over long periods of time. Now, I want to openly challenge your assertion that they are doing better, that the American consumer is doing better today than he did before. As a matter of fact, I had asked the committee, the Joint Economic Committee staff, to prepare a study for me for the Subcommittee on Consumer Economics. Our staff report was published January 14, 1974. And it is only in one category of what we call disposal income, of all the units of measurement of income, that it looks better than it did before. And even that, may I say, was only in the last quarter in the year 1973. For example, real hourly earnings dropped 1.6 percent. Now, that is not a disputable figure, that is a fact. Real hourly earnings are what count. Real weekly earnings propped 1.7 percent. And real spendable weekly earnings dropped 3.1 percent.

Now, that is what Mrs. Smith had to buy with when she went on out to take care of the family shopping. That is what Mr. Smith had to pay the mortgage and the car repair bills, et cetera, et cetera. Even real per capita disposal income, which includes proprietors and professionals income, dividends, interest, and transfer payments, fell in the second quarter of 1973, and rose only slightly for the year.

Now, the whole problem in this disposal income stuff, Mr. Ash, is that it takes in all the big boys. It takes in all the oil company profits, it takes in all the big bonanzas. And then, you divide it up according to the number of folks you have around you. Well, no matter how big a bonanza you are in you can only eat so many bananas. What is the price of bananas and how much money do you have to buy bananas, that is what I am getting at.

And that is what I do not like about these figures that we get from the Government. They do not get at what Congressman Reuss was trying to point out. The fact is that a vast section of the American public today is not doing better.

And the fact is that the administration has admitted that for the next 6 months it is going to get worse. And that is some candor. And then they say, the following 6 months it will get better. Well, I tell you that for the next 6 months if it is much worse for the working family, for that person that is out on the assembly line, for the clerk that is working in a Safeway store, or Ware's liquor store, or Joe Schultz' drycleaning establishment, those are the folks we are really talking about.

This is what makes this economy go. The present programs and the present economic situations have not been to their advantage. Do you dispute that?

Mr. Ash. I certainly agree that that is what makes the economy go, the working people of this country make this economy go. I think we would probably all agree on that and by any measure you want they are better off than they were in 1940, in 1950, and 1960, and in 1968 or 1969, whichever you want to consider. Let us say 5 years ago, in 1969——

Senator Humphrey. But you know in my work, called politics, they say, what have you done for me lately? It is not whether they are better off than they were 2 or 3 years ago.

Mr. Ash. Yes. But the point that I made earlier to which you were taking exception, is that they were considerably better off 5 years ago. You are saying that that is not right, and I am saying that they are. It is true that this last year disposable per capita income has not increased very much.

Senator Humphrey. Let us get away from per capita disposable income, because that is a charade, a lot of bunk. It does not get down to 80 percent of the American people, and you know it and I know it. That includes all the income of the major proprietors, the professionals, the dividends, the interest, and the transfer payments, it does not have a thing to do with the guy that has had to close up his filling station, or the guy that is working in the drugstore, or the fellow that is on the assembly line out in the plant. Those are the people that are having trouble. They are the ones that are at the Safeway store, and the A. & P. If you have got an income of $50,000 a year and you are not really out playing the horses, you are going to do all right. But what about this $14,000 a year man, what about this $10,000 a year man? Is it not true that most of the taxes are collected from people who have $20,000 a year income or less, is that not a fact?

Mr. ASH. I do not have to have those data in front of me on where the taxes come from.

Senator HUMPHREY. It is true, is it not?

Mr. ASH. I would have to refer to the data to find out the source of taxation.

I will look it up and find out how much in taxes come from people in different income levels.

[The following information was subsequently supplied for the record:]

In calendar year 1972, individuals with adjusted gross incomes of less than $20,000 accounted for 56 percent of individual income taxes paid and 62 percent of individual income and social security taxes paid by employees.[1] These figures do not include the employer share of social security taxes, corporate income taxes and other receipts which accounted for over 40 percent of total Federal revenues in 1972.

Senator HUMPHREY. About 60 percent, is it not?

Mr. ASH. But I think it is a fact that we have an interest in all the people in this country. Per capita disposable income increased this last year, but it increased by an even larger amount over 5 years. Real average hourly compensation of the private nonfarm employee has gone up 1 percent in this last year. There are many indexes that we could all work from. I think that the thing that we should all be interested in is the income of all of the people of the country, the continual improvement in their income, what that income will buy, and what they have left over after taxes. That is really what it is all about.

Senator HUMPHREY. The figures that you quoted, was that real compensation per man-hour, total private income?

Mr. ASH. Yes, sir.

Senator HUMPHREY. Do you realize that on a historical basis that increased about 3 percent a year? And when you give me that jazz that it went up 1 percent a year, I am supposed to be clapping my hands.

Mr. ASH. You were suggesting that it went down.

We can all agree on certain conclusions. First, over any period of time, 5 years or 10 years or any time you want, this country has done an exceedingly good job of increasing the income available to all levels of our society. I do not think any of us would have objections to that.

Second, this last year has certainly been one that has varied from the long-term trend for many reasons that were not even within the control of anybody within this country. This does represent a challenge to all of us and it is something that we would hope to be able to respond to in this year and in the years after.

I think we pretty well all agree on the fundamentals. We can all select different statistics that will portray it one way or the other, but I think we have pretty much of a like mind on where we are and the short- and long-term trend, and, therefore, the particular challenge that we face to have a better year this coming year.

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[1] Includes self-employment tax and employee share of FICA taxes.

Senator HUMPHREY. Mr. Ash, we all want a better year, I know you do, and I do. But what bothers me is that we have difficulty arriving at set figures or a system of measurements around which we can find common agreement. I do not think we ought to be fooling the people. The President made a state of the Union address, he said that there will be no recession—and, of course, that stopped all the worries. The next day out came the report of the Economic Council that said there would be some indication of a recession for at least 6 months. We don't govern by fiat. We don't stop the tide by the king standing on the shore and saying, "The tide will halt."

Now, the administration continues to peddle the line that the average person is better off. For your own good I just want to say that it destroys credibility, it really does. Just go out and talk to the folks. I have one advantage that some people around this table don't have We operate a little family business. It is a small one. But people come in that store. Sure, they have got more money. But I want to tell you that the size of a Baby Ruth candy bar today compared to what it was a few years ago is a lot less. The price of Mentholatum has gone up, too. I don't care whether they have got more money or not. The question is, What does it buy, and what does it buy for many people, in terms of the weekly disposable income? Now, I don't want you to add in that weekly disposable income.

My neighbor out there, Waverly, runs a little restaurant, Ray's Place, they call it, a hamburger place. It is a pretty good place, it is really better than McDonald's. This is Ray's place out there and he would just love to be lumped in for his personal pride with Exxon. But he ain't. There are two different breeds, may I say. He is sitting out there trying to get by. You are trying to get by. You are trying to tell him that he never had it so good—Ray, you just don't realize how good it is. Poor old Ray can't get gas. Poor old Ray sees the interest rates going up. He wanted to rebuild this building—this is a true story—he wanted to put on new shingles and new siding, and so forth. And by the time he got through with that he had to sell the hamburgers for a dollar and a half apiece.

Now you are trying to tell the public that things are better off. I say to you that many things are better off, there isn't any doubt about it. Profits are better in some industries. The stock market is not better. Interest rates are better for the banker, no doubt about that. And wages have gone up. But I ask specifically, has the working man today—does his money that he gets in his payroll at the end of a week buy more today, this day of February, than it did a year ago?

Mr. ASH. Again, it comes down to definition——

Senator HUMPHREY. No, does the paycheck he got last Friday——

Mr. ASH. Let me answer it without a particular statistical reference. I think that is what we would both prefer to do. This year the workingman has not been getting the kind of increases over last year that that same workingman has had over a succession of years before that. That, of course, represents the challenge that we all have for the year ahead. I don't know whose statistics would say that this has been one of the best years in history. It certainly has not been. And that is, of course, the task we face. So it is a matter of putting in perspective one year out of many. We can certainly look at this year as one that was different from some others that preceded it.

Senator HUMPHREY. We can argue a lot about this. But may I ask you for a little information for our record?

Last year when the 1974 budget was presented, a great deal of attention was focused on page 50, a table entitled "Outlay Savings From Program Reductions and Terminations, 1973–1975."

Since there is no corresponding table in the 1975 budget, would you provide this committee for the record a table describing what has happened to each item listed in this table, that is, the table of a year ago, and also provide the figures showing the estimated outlays proposed in the 1975 budget for each item listed in the 1974 reductions and terminations table.

Now, you know there was a great fanfare about all these programs, that they were going to reduce all this new management concept that was going to come in. And that is why that table was in there. And I wanted to see how well you did, and just how many programs were you able to modify and determine any change. I recognize Congress has not always cooperated with you on this, or, to put it either way, we see a little differently from you. And that is a problem. But I think it would be well to have it for the record.

Mr. ASH. In anticipation of this kind of question, we have already started work toward doing that, it will be provided for the record.

[The following information was subsequently supplied for the record:]

OUTLAY SAVINGS FROM PROGRAM REDUCTIONS AND TERMINATIONS, 1974–75

[Fiscal years; millions of dollars]

1974 budget document			1975 budget document		
	Estimated savings			Estimated savings	
Proposed action	1974	1975	Status	1974	1975
PROPOSED ACTIONS REQUIRING SUBSTANTIVE LEGISLATION					
Department of Health, Education, and Welfare:					
Eliminate certain optional payment procedures under OASDI	$310.0	$310.0	Not yet accomplished but repeated essentially unchanged in the 1975 budget. Delay is due to the inaction of the Congress.		$345.0
Eliminate Federal financing for low-priority mediaid services to adults	75.0	100.0	Not yet accomplished but repeated essentially unchanged in the 1975 budget. Delay is due to inaction of the Congress.		75.0
Reform medicare cost-sharing and implement effective utilization review	616.0	1,300.0	Similar reform, combined with increased benefits are now proposed as a part of the comprehensive health insurance plan to become effective in January 1976. Savings shown reflect implementation of effective utilization review.	$30.0	40.0
Improve structure of public assistance programs	158.0	158.0	Not yet accomplished but repeated essentially unchanged in the 1975 budget. The increased savings expected in 1975 reflect a reestimate based on better data. Delay is due to the inaction of the Congress.		203.0
Veterans Administration:					
Eliminate duplicate burial benefits	54.0	54.0	do		85.0
Bring pensions into closer alignment with need	223.0	227.0	No longer planned because substantive legislation was not enacted		
PROPOSED ACTIONS NOT REQUIRING SUBSTANTIVE LEGISLATION					
Funds Appropriated to the President:					
Foreign economic assistance:					
Reduce programs of the Agency for International Development below levels previously budgeted.	62.0	170.0	The 1974 savings will be achieved but it is unlikely that all savings for 1975 will be obtained.	78.0	64.0
Office of Economic Opportunity:					
Reassign OEO activities and discontinue direct Federal funding of community action organizations leaving support to local decision.	328.0	390.0	Not yet accomplished but repeated essentially unchanged in the 1975 budget. The Congress appropriated funds to continue OEO and direct funding for Community Action operations through June 30, 1974.	45.0	285.0
Department of Agriculture:					
Reduce the cost of farm price support programs consistent with rising farm income prospects and achievement of foreign sales agreements: Reducing direct payments to farmers; stopping export subsidies; increasing crop loan interest; terminating old crop loans; and tightening storage facility loan eligibility.	1,219.0	1,234.0	Being accomplished as scheduled. Farm-price support payments were substantially changed by the Agriculture and Consumer Protection Act of 1973.	1,048.0	1,253.0
Terminate rural water systems and waste disposal grants which are replaced by loans, or to extent consistent with Water Pollution Control Act, EPA financing.	100.0	150.0	Not yet fully accomplished but repeated in modified form in the 1975 budget. Decrease in estimated savings reflects reestimates and the release of some funds for "hardship" applications.	55.0	50.0

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Decrease the large interest subsidy to the Rural Electrification Administration through use of Rural Development Act 5 percent insured loans vice 2 percent direct loans.	373.0	695.0	Being accomplished as scheduled. The REA has been transferred off budget	373.0	695.0
Eliminate cost-sharing for installation of soil and water management practices on private lands and make corresponding reductions in technical assistance given through conservation programs.	258.0	259.0	The 1975 reduction will be substantially less than anticipated because the proposal was modified and cost estimates increased.	210.0	90.0
Limit the special milk subsidy to institutions not receiving subsidized milk through free and reduced price child feeding programs.	59.0	77.0	No longer planned. Action blocked by the Congress		
Achieve economics in Forest Service through tightened management, reduced State forestry support, and shifting construction of forest roads to timber purchases.	94.0	106.0	Being accomplished in modified form. Considerably less savings than anticipated.	50.0	59.0
Curtail anticipated growth in Agriculture extension programs and reduce Federal support for agricultural research of primarily local benefit and low-national priority.	34.0	34.0	Congressional additions to these programs have reduced the expected savings	3.0	3.0
Department of Commerce:					
Phaseout Economic Development Administration programs in favor of more focused and consolidated efforts to stimulate economic development.	35.0	56.0	The President accepted congressional action to extend this program through 1974. The 1975 budget proposes a further 1-year extension at a reduced level to permit the transition to a new program.	−13.0	10.0
Redirect or defer selected R. & D. programs of the National Oceanic and Atmospheric Administration which are not directly focused on national objectives or not critical now.	41.0		Some of the savings are not being achieved bcause termination of the National Data Buoy research was deferred pending reevaluation.	26.0	
Limit planned expansion of selected science and technology programs of National Bureau of Standards which could be delayed without significant adverse impact.	10.0	7.0	Being accomplished as scheduled	10.0	7.0
Provide planning funds directly to States for support of regional commission and eliminate Federal participation.	27.0	44.0	The President accepted congressional action to extend this program through 1974. The 1975 budget proposes a further 1-year extension to permit the transition to a new program.		
Department of Defense—Military:					
Reduce military and civilian personnel and other operations costs	1,200.0	400.0	Being accomplished as scheduled	1,200.0	400.0
Reduce procurement of Safeguard, aircraft, missiles, and ships	650.0	1,300.0	do	650.0	1,300.0
Limit growth in research, development, test, and evaluation associated with Safeguard, and other programs.	200.0	200.0	do	200.0	200.0
Reduce construction associated with Safeguard deployment, bachelor housing, and family housing.	50.0	200.0	do	50.0	200.0
Limit new spending for all-volunteer force and other legislation	400.0	500.0	Being accomplished although not all the legislation has been passed yet	400.0	500.0
Tighten operations of revolving and management funds	200.0	100.0	Being accomplished as scheduled	200.0	100.0
Department of Defense—Civil—Corps of Engineers:					
Slow scheduling of less critical navigation and flood control projects while meeting essential flood control, power, and water supply demands.	471.0	650.0	Being accomplished as scheduled. The savings in 1975 are now estimated to be slightly higher than anticipated last year.	471.0	685.0
Department of Health, Education, and Welfare:					
Health:					
Strengthen medicare cost control and eliminate unnecessary advance payments for hospitals.	277.0	431.0	Reform of payment methods has been accomplished in modified form. Cost control reforms are no longer planned.	197.0	
Strengthen medicaid management	175.0	200.0	Being accomplished in modified form	110.0	90.0
Rely on Federal health financing mechanisms to pay depreciation charges in place of medical facilities grant program, and achieve quality care objectives through the professional standards review in place of the regional medical program.	189.0	266.0	Not yet accomplished but repeated essentially unchanged in the 1975 budget. Congressional and court action restored this program for fiscal year 1974. Savings are expected to be achieved in fiscal year 1976.		36.0

OUTLAY SAVINGS FROM PROGRAM REDUCTIONS AND TERMINATIONS, 1974–75—Continued

[Fiscal years; millions of dollars]

1974 budget document			1975 budget document		
	Estimated savings			Estimated savings	
Proposed action	1974	1975	Status	1974	1975
Department of Health, Education, and Welfare—Continued					
Health—Continued					
Phaseout over an 8-year period, Federal financing for local mental health programs.	$63.0	$75.0	Not yet accomplished but repeated essentially unchanged in the 1975 budget. Congressional and court action restored authority for this program through fiscal year 1974.		$10.0
Eliminate duplicative preventive health program grants	53.0	53.0	No longer planned	$1.0	
Phaseout training grant over a 3-year period and control the level of new research grants selected in nonpriority areas.	57.0	67.0	Being accomplished in modified form. Congressional action restored part of the savings sought.	51.0	64.0
Focus health manpower training support on areas of special need	49.0	54.0	Not yet accomplished but repeated in modified form in the 1975 budget. The Congress and the courts did not agree to this proposal for fiscal year 1974.		66.0
Education:					
Substitute education revenue sharing for the Federal funding component of certain education programs and discontinue the Federal role in some areas:					
Foreign language and area training programs	13.0	14.0	No longer planned		
Land grant college support	10.0	10.0	Not yet accomplished but repeated in modified form in the 1975 budget. Congressional action restored this program for fiscal year 1974.		13.0
University community services	15.0	15.0	Not yet accomplished but repeated essentially unchanged in the 1975 budget. Congressional action restored this program for fiscal year 1974.		15.0
State departments of education	36.0	13.0	No longer planned		
Payments to local school systems for certain federally related students.	119.0	120.0	Not yet accomplished but repeated as a 1-year phaseout in the 1975 budget. Congressional action restored this program for fiscal year 1974.		187.0
Public libraries and school library resources	49.0	135.0	Not yet accomplished but repeated essentially unchanged in the 1975 budget. Congressional action restored these programs for fiscal year 1974 after part of the savings had been achieved.	15.0	99.0
Certain narrowly focused categorical programs	53.0	76.0	Not yet accomplished but repeated in modified form in the 1975 budget. Congressional action restored these programs for fiscal year 1974 after part of the savings had been achieved.	43.0	46.0
Substitute private market mechanism for Federal capitalization of direct student loans.	264.0	288.0	Not yet accomplished but repeated in modified form in the 1975 budget. Congressional action restored authority for this program through fiscal year 1974. Savings in fiscal year 1976 are estimated to be nearly $300,000,000.		
Income security:					
Limit outlays through the operation of the administration-supported statutory ceiling on social services grants (already enacted by the Congress).	2,700.0	4,700.0	Being accomplished as scheduled. Additional savings are being obtained	2,800.0	5,400.0
Adjusted the growth rate for vocational rehabilitat on program	31.0	26.0	Some savings were achieved in 1974, however, congressional action has blocked further reductions.	25.0	

Limit to 5 years Federal funding responsibility for Cuban refugees	58.0	98.0	Not yet accomplished but repeated in modified form in the 1975 budget. Congressional action has delayed the phaseout of this program for fiscal year 1974.	33.0	89.0
Institute quality control for social services research and training	31.0	62.0	Savings were achieved in 1974, however, Congressional action has blocked some of the reductions in 1975.	31.0	25.0
Eliminate overpayments and payments to ineligible recipients of public assistance and introduce management improvements.	592.0	592.0	Being accomplished. Estimates of savings were revised to reflect better data	773.0	384.0
Department of Housing and Urban Development:					
Temporarily suspend new commitments under housing subsidy programs	305.0	612.0	Some of the reforms are no longer planned. Others are being achieved and repeated in modified form in the 1975 budget.	124.0	263.0
Terminate categorical community development programs in favor of urban special revenue sharing:					
Model Cities		435.0	Repeated in modified form in the 1975 budget	10.0	385.0
Urban renewal		180.0	Not yet accomplished but repeated in the 1975 budget. The increased savings expected in 1975 reflect revised estimates based on better data.		530.0
All other	7.0	130.0	Repeated in modified form in the 1975 budget	8.0	113.
Department of the Interior:					
Reduce construction activity on some roads and other capital improvements of relatively low priority in national parks, public lands, and Indian areas to less than anticipated rates in 1973 and 1974.	10.0	13.0	Not yet accomplished but repeated in modified form in the 1975 budget. The increased savings expected in 1975 are due to the elimination of marginal Bicentennial projects.	7.0	45.0
Schedule water resources development construction by Bureau of Reclamation at less than anticipated rates except for hydropower and water supply projects.	123.0	113.0	Being accomplished as scheduled. Additional savings expected reflect revised estimates.	152.0	177.0
Reorient saline water program to emphasize research on new technologies and deemphasize construction of large-scale test plants of known technology.	14.0	21.0	Being accomplished as scheduled	15.0	22.0
Constrain land purchases for Federal recreation and wildlife areas and grants to States for purchase of recreation areas in 1973 and 1974 below anticipated levels	61.0	46.0	Repeated in modified form in the 1975 budget: The target has not changed but the estimated timing of savings has been revised.	23.0	88.0
Increase in rate of lease sales on Outer Continental Shelf to increase domestic oil production thereby reducing outlays.	1,010.0	510.0	Being accomplished and repeated in modified form in the 1975 budget. The substantial increases in estimated receipts are due to higher prices for leases. The estimates shown do not include the additional oil leases announced since the 1975 budget was prepared.	4,910.0	3,910.0
Reduce other costs not accounted for in program	2.0		Being accomplished as scheduled	2.0	
Department of Justice:					
Review prison construction program for its relationship to State and local facilities and impact on alternatives to incarceration on Federal prison population.	28.0		No longer planned. Alternatives identified and construction continued		
Return responsibility to functional agencies for Community Relations Service technical assistance program.	4.0	4.0	Being accomplished as scheduled	4.0	4.0
Department of Labor:					
Reform manpower training programs administratively to accomplish the purposes of manpower special revenue sharing.	354.0	250.0	No longer planned. The Congress and the administration cooperated in the development of new legislation which accomplished the essential objectives of decentralization and decategorization.		
Phasedown the emergency employment assistance program consistent with the increase in new jobs in the private sector.	670.0	700.0	Being accomplished as scheduled. Estimates of 1974 savings have been revised slightly.	609.0	700.0
Increase efficiency of employment and unemployment insurance services	35.0	35.0	Being accomplished as scheduled	35.0	35.0
Tighten the operations and management in the Department of Labor	10.0	10.0	do	10.0	10.0
Allocate proper unemployment benefit costs to the Postal Service	26.0	26.0	do	26.0	26.0

OUTLAY SAVINGS FROM PROGRAM REDUCTIONS AND TERMINATIONS, 1974–75—Continued

[Fiscal years; millions of dollars]

1974 budget document			1975 budget document		
	Estimated savings			Estimated savings	
Proposed action	1974	1975	Status	1974	1975
Department of Transportation:					
States are deferring highway projects because of a lack of legislative authority.	$83.0		Being accomplished as scheduled	$83.0	
Defer lower priority Coast Guard construction and research contracts	14.0	10.0	do	14.0	$10.0
Reschedule FAA equipment purchase and long-range research that are not essential to air safety.	35.0		do	35.0	
Reorder high-speed rail research and development, placing greater emphasis on near-term needs and deferring projects where results are not required for several years.	41.0	5.0	do	41.0	5.0
Reduce operating subsidies for AMTRAK	27.0		No longer planned due to the failure to secure passage of needed legislation and an unexpected cost overrun of AMTRAK.		
Focus UMTA research and development on immediate improvement programs and hold up contracts for some hardware developments awaiting additional studies and evaluations.	26.0	5.0	Being accomplished as scheduled	26.0	5.0
Rephase intermodal transport research and development, focusing on immediate problems. Reduce selected research and development projects whose results are not required in the near term.	7.0	6.0	do	7.0	6.0
Increase efficiencies of Coast Guard operations	10.0	3.0	do	10.0	3.0
Increase efficiencies of FAA operations	20.0		do	20.0	
Department of the Treasury:					
Delay construction of Federal Law Enforcement Training Center to assure resolution of environmental impact of problems.	12.0		Being accomplished. Delay in construction now projected through fiscal year 1975 because of a court review of the environmental impact statement.	12.0	12.0
Reduce personnel, travel, and related costs	9.0	9.0	Being accomplished in modified form	6.0	6.0
Atomic Energy Commission:					
Reduce Plowshare program to permit further economic and environmental study.	3.0	3.0	do	3.0	3.0
Reduce space electric power and propulsion programs because of no current mission requirements.	12.0	18.0	do	12.0	18.0
Defer selected lower priority projects in the nuclear materials, weapons, civilian reactor, and research programs.	21.0	46.0	No longer planned primarily because of the importance of energy research in developing the technology to meet future energy demands.		
Reduce inventory and working capital requirements (1973 savings were projected to be $56,000,000).	−35.0		Action was not taken because of changes in working capital requirements		
Environmental Protection Agency:					
Actions related to Federal Water Pollution Control Act amendments of 1972	950.0	1,950.0	Being accomplished as scheduled	950.0	1,950.0

General Services Administration:					
Provide more efficient guard service in public buildings	3.0	3.0	do	3.0	3.0
Require more effective supply practices	25.0		do	25.0	
Reduce new computer procurements by improving utilization of existing equipment.	9.0		do	9.0	
National Aeronautics and Space Administration:					
Delay the space shuttle to provide for a more orderly program buildup	45.0	75.0	Being accomplished. The space shuttle is being delayed longer than estimated in the 1974 budget.	55.0	108.0
Reduce other manned space flight	47.0	10.0	Being accomplished. Action was more successful than originally anticipated	50.0	52.0
Defer the High-Energy Astronomy Observatory to allow NASA to study same program objectives at lower cost.	68.0	56.0	Being accomplished. Program redefinition was completed earlier than expected and the program was begun ahead of previous plans.	58.0	52.0
Cancel application technology satellite-G because research can be funded by industry without Government support.	17.0	16.0	Being accomplished as scheduled. Increased savings in 1974 reflect reestimates	19.0	16.0
Reduce nuclear power and propulsion research since prospective applications are in the distant future.	16.0	18.0	Being accomplished. NASA reinstated a portion of the program in response to congressional action thus reducing savings.	13.0	17.0
Cancel experimental STOL aircraft because of uncertainty on the timing of a commercial market.	34.0	20.0	Being accomplished as scheduled in 1974. A reduced cost STOL technology program is inclded in the 1975 budget.	33.0	13.0
Reduce NASA personnel and administrative expenses consistent with program reductions.	24.0	24.0	Being accomplished as scheduled. Personnel reductions were accomplished faster than expected.	30.0	31.0
Veterans Administration:					
Reform veterans benefits administratively to align benefits and need	160.0	160.0	No longer planned		
Reschedule construction activities	55.0	65.0	Being accomplished as scheduled. Program savings estimates were changed reflecting better data and lower costs.	33.0	38.0
Restructure medica lresearch in line with current medical needs	13.0	27.0	Being accomplished. Congressional action blocked part of these savings	11.0	20.0
Civil Service Commission:					
Limit the level of the intergovernmental personnel assistance grant program pending evaluation.	1.0	5.0	Being accomplished as scheduled	1.0	5.0
Allocate proper retirement costs to the Postal Service	285.0	105.0	Not yet accomplished but repeated in modified from in the 1975 budget	355.0	204.0
National Science Foundation:					
Reductions due to curtailment of lower priority programs and other selective reductions.	32.0		Being accomplished as scheduled	32.0	
Small Business Administration:					
Reduce direct business loan program of Small Business Administration as needs are met by increased participation of private banking community through SBA guaranteed loans.	41.0	34.0	do	41.0	34.0
Subversive Activities Control Board:					
Terminate as a result of court decisions limiting workload	.4	.4	do	.4	.4
Tennessee Valley Authority:					
Slow scheduling of construction activity on projects underway and postpone increases in other programs.	30.0	25.0	Being accomplished. Estimated savings have been revised	25.0	27.0
Washington Metropolitan Area Transit Authority:					
Use bond proceeds to even out level of Federal contribution to subway construction.	13.0		Being accomplished as scheduled	13.0	

Mr. Ash. I should also use this occasion to say that during last year on many, many occasions the Congress did find a way to work out mutually agreeable resolutions on some of those programs that were identified in last year's budget. I would compliment rather than criticize the Congress on some of the actions taken regarding last year's programs.

Senator Humphrey. Thank you. We will pass that along to our colleagues, Mr. Ash.

You also have indicated that now initiatives in this budget for the coming year does not obscure the $300 billion being spent on other programs. What are the new initiatives? I have looked for them. You say the health insurance proposal is a sweeping initiative. Where is the money in the budget for this? And I don't even see any provision in the 1974 budget. And again the welfare. All the budget says is that we need a program that works. What kind of initiative is that? I don't see any proposal. In other words, Mr. Ash, I think it would be good for us to know what new initiatives you see in the budget. I haven't seen any and the staff here hasn't been able to recognize it.

Mr. Ash. First, on the health insurance program, as you observe, and as was set forth in the materials provided to the Congress, the outlays that would be derived from that program will have their first full-year impact in 1977. Therefore the outlays are not in the budget, except as they are included in the prospective 5-year outlay level. But that is a very broad and general view. And they are not included in 1975 and 1976.

As to the welfare reform, I think that here may be the best thing that we can together do is to design a program between the administration and the Congress. What we believe should be done to bring that about is to agree upon criteria and objectives and then design a program.

We all know over the past years the problems that have arisen by having presented redesigned programs and then arguing about them. Let's design one together on the basis of an agreed upon criteria and program goals. We have specifically stayed back from putting in a program of detailed design so that we could work out with the Congress a program of welfare reform.

Other specific programs are listed on page 320 of the budget. Economic adjustment assistance is a new program. Consolidated educational grants is a new program. The Better Communities Act is a new program. There is the unemployment insurance reform. Then in transportation there is the unified transportation assistance program.

Senator Humphrey. Those are reorganizations of existing programs.

Mr. Ash. Not necessarily. Some of them are a combination of a new program along with a rearrangement of old programs. But they are new initiatives in one way or other, and in most cases they have some new and different dimension to them over and above what has existed in earlier programs. But I agree with you, many of them encompass an attempt to deal with old programs at the same time, that being the only reasonable way to do it.

If you are going to have a new program, let's look at the old existing ones and form them all into a better package of similar kind.

Senator Humphrey. I would hope that you might follow up and inform the appropriate Members of Congress on your suggestion as to welfare. It has been debated for a long time. The administration came forward with something I thought had many good features in this program.

There was an effort made in the Senate to take the Ribicoff proposal as an intermediate position. I believe after this inflation battle that we have in the Congress, and in the executive branch of the Government, that we should have some kind of a working task force this year that might come up with a program satisfactory to both the executive and the legislative, and much more helpful to the taxpayer and the welfare recipient.

Mr. ASH. I would certainly argue for it. And that is why we set it out as we did, without specifying a particular program design.

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

Senator PROXMIRE. Mr. Ash, last week you differed with Mr. Simon over the seriousness of the energy crisis, especially on how long you thought the energy crisis would last. I believe you indicated that the fuel shortage would be of relatively brief duration, and by the end of the year we could expect a substantial improvement, and that the crisis would be pretty much over. Yesterday Mr. Bonner, the head of Gulf Oil, indicated that we would have an energy crisis for years. And John Sawhill, Mr. Simon's deputy, indicated the same thing.

Mr. Simon went further and suggested that you keep your cotton-picking hands off energy policy. Now, anybody who has been around Washington any length of time knows that the Office of Management and Budget does not keep its cotton-picking hands off anything. You get into everything. And that is part of your responsibility.

We have to have a coordinating agency in Washington. And you may be faced with an enormously expensive program, something around 17,000 bureaucrats, and possibly a $1 billion program, if you have rationing.

So you have to be involved in it and know about it.

I would like to ask you if you can tell us whether you stand by with the position you took last week when you said the energy crisis would be over this year, and whether you have any ideas on coordinating energy policy to improve the situation?

Mr. ASH. I clearly stand by the position I took last week, which was very correctly reported in the New York Times.

There were other incorrect reports of the statement that I made last week, which, of course, I cannot associate myself with, because those were not correct reports of my statement. But I do commend anybody who wants to know what I truly did say to the New York Times article on the subject.

What we have, if I understand the recent new material correctly, is a mountain being made out of a semantic molehill. There are no differences, to my knowledge, between the position that I have and the position that Bill Simon has. And both of our positions are consistent with the President's statement that we will break the back of the enery crisis this year.

Now, breaking the back of the energy crisis does not mean solving forever all of the problems. We will have solved some of them this year, and we will have set in motion other actions that will deal with others——

Senator PROXMIRE. Let me ask you, as far as the consumer is concerned, does this mean by the end of this year we will not have to line up for gas, and by the end of this year that the sharp increase in gasoline prices will be pretty much over, that they will stabilize? What does this mean for the consumer when you say the energy crisis will be broken, its back will be broken?

Mr. ASH. During the course of this year, and particularly at this time, we have had some very traumatic experiences. They are partly derived out of panic, and further out of the need to rearrange our distribution systems for the limited amount of energy supplies that we have and the requirement that we find patterns and new means of conservation.

I think we all believe that during the course of this year we will have faced most of those kinds of issues and successfully dealt with that traumatic crisis so that we will, in effect, as the President said, break the back of the energy crisis.

Then for a number of years we will face the problem that our domestic supplies of energy are not sufficient to our domestic needs, and we will have to continue to work to increase the supplies.

Senator PROXMIRE. Let me be as specific as I can. Let's assume that the embargo continues for some time. Would you still feel that it would be possible to break the back of the energy crisis in the sense that consumers would no longer face sharply rising prices, that they no longer would face long gas lines?

Mr. ASH. The answer to that is yes, providing——

Senator PROXMIRE. It means that we will have to line up at the pump next year, is that correct?

Mr. ASH. I will go so far as to adopt that construction. But I want to make sure, in contrast to last week, that the "providing" gets in any statement I make, because that is what was left out last week. The answer is yes, provided that consumers take those actions that they must take to reduce their consumption of energy supplies. We are going to have to learn how to live with a lesser level of energy product available to us.

Senator PROXMIRE. Mr. Ash, you know very well that the consumers have taken tremendous conservation actions already, and they have reduced their consumption by 10 or 15 percent. And the President also said it was a remarkable response. I just wondered if we can—we still have long lines and escalating prices.

Mr. ASH. That reduced level of energy consumption must be maintained. We have got to live with, say, 93 percent of all the energy we had before, even as our economy is growing, and even as we now have less energy available from foreign sources.

Senator PROXMIRE. I understood Mr. Sawhill to say yesterday that the shortage would be 15 to 20 percent, and Mr. Bonner to say 25 to 30 percent.

Mr. ASH. We should all just sit down and look at the same data and the same definitions. I am talking about 7 percent of our energy supply. They were talking about petroleum supply. And those are two different bases. We can talk about either base——

Senator PROXMIRE. Talk about the latter base.

Mr. ASH. The problem here is that the statistics get confused because of a failure to look at the definitions that accompany those statistics.

So if you wish to talk about petroleum, let's talk about 15 percent less petroleum. We now must learn how to live with 15 percent less petroleum than we had before. Some of it we can meet by substituting other products, notably coal. And maybe some gas. The other, though, we have to meet by a combination of conservation actions and the development of further petroleum resources, which take a period of time.

Senator PROXMIRE. What you are really saying, as I understand it, is that the energy crisis back will be broken this coming year provided the consumer learns to live with this acute shortage of petroleum, if he adjusts to a situation whereas before he expanded his consumption by 5 or 7 percent a year, now he will have to contract his consumption by 15 percent or so in gasoline and 8 percent in all energy, and then live with that.

Now, isn't that asking for an extraordinarily painful adjustment that is going to go on, and to be honest with the consumer, he is going to have to face this difficult outlook for 2 or 3 years or 4 years at least and maybe more?

Mr. ASH. As you pointed out, he has made those adjustments. There has been a substantial and successful set of actions by the consumer to reduce his consumption of energy and particularly reduce his consumption of petroleum.

Senator PROXMIRE. How about price?

Would you say that prices will stabilize at the present level?

Mr. ASH. Prices are largely a function of, first, what goes on outside of our control—that is, what is done by foreign governments and foreign countries—and second, what we have to pay to bring alternate sources of energy into use in this country.

Senator PROXMIRE. What I am saying, Mr. Ash, is that if there is this 15-percent shortage of petroleum and 7-percent shortage of energy generally, will it be practical or likely that we could expect prices to stabilize at their present level, or will they have to go up higher in order to achive a balance between supply and demand at a higher level.

Mr. ASH. That is hard to predict precisely, because we are attempting to predict what Arab countries will do and what other countries of the world will do, whether they be other consuming countries or other producing countries. We have to realize that in petroleum products we are in a world market. We bid against other world buyers. We bid for a product made largely outside of this country. The forces at work in the marketplace cannot be insulated by our omission.

Senator PROXMIRE. The price has gone up 45 percent in the last year, from $3.60 to $4.25 to $5.25 for old oil, and even more sharply for new oil.

As you know, domestic prices have gone up very sharply, too. It is true that is caused partly because of the embargo, very largely because of it, but domestic prices have gone up too.

Mr. ASH. In fact, I had hoped, and many in the industry had hoped, that the Congress would not have added on to the Alaskan Pipeline bill the amendment that had the effect of removing the stripper wells from price controls. But on the other hand, that was done by the Congress, and those wells were removed from price controls. And, of course, their prices can go up because they are not controlled.

Senator PROXMIRE. That is about 10 percent, is it not, of the total?

Mr. ASH. Maybe 13 or so. And, of course, the whole pricing structure is affected when that oil, along now with other new oil, is uncontrolled.

Senator PROXMIRE. You cannot tell me, then, you cannot assure me that breaking the back of the energy crisis means that prices will not continue to go up? I take it from what you said that you think they may very well continue to go up. You may very well also have to have long lines, because certainly a very important part of consumer reduction and consumption is because you have to wait in line, and people for that reason are not driving as much; if they didn't have to wait in line there would probably be more driving, is that correct?

Mr. ASH. As we Harvard Business School graduates know, one cannot repeal the inexorable laws of economics any more than one can repeal the inexorable laws of physics. We know we cannot command an airplane to stop in the air because we know our physics.

Senator PROXMIRE. Of course, we can't. All I am saying is that the assertion, which the President seems to go along with in a different way, that you made last week, that the back of the energy crisis will be broken this year, just does not seem to stand up on the basis of price, on the basis of inconvenience. I think consumers have been adapting very painfully, but this does not break the back of the crisis.

Mr. ASH. I think it would. I think we will find, or I predict that we will find, that during the course of this year we will break the back of the energy crisis.

Senator PROXMIRE. And break a lot of other backs in the process.

Let me just get back to one thing for a couple of minutes. I think I have got the figures now to clear it up.

I have before me a chart from the Department of Defense which shows in constant dollars fiscal year 1974 military spending and fiscal year 1975. If you compare operation and maintenance in the 2 years, that is up by $600 million, procurement is up, and R.D.T. & E. is up by $600 million. And furthermore, in 1974 you have new weapons which were put in because of a very late supplemental just in the last few weeks, new weapons which should really be in the 1975 budget. If we make that transfer, we find that the increase in these four principal expenditure items goes from $52.3 billion to $57.9 billion, or by $5.6 billion in constant dollars. And therefore as far as the operation and maintenance, procurement and R.D.T. & E. is concerned, we will have an increase in real military spending in the coming year of about 10¼ percent.

Now, it seems to me, when everything else in our economy is taking a beating, and the war is over, that this is something that we should have great concern about.

Let me ask you this question: I have been told that shortly before the budget went to press a decision was made to increase the defense budget by $5 billion. Can you tell me if this happened and if you or anyone on your staff talked to the Pentagon or White House about increasing the defense budget by $5 billion?

Mr. ASH. We work with the Defense Department as we do with all other agencies, in preparing their budget. Of course we talked to them in preparing their budget. We talked to them in the normal course of preparing the budget. We talk to to all agencies shortly before we prepare the budget. In the normal process of working out their budget, we have talked to the Defense Department—just as we did with all other departments and agencies.

Senator PROXMIRE. Then you would not deny, though, that there was a $5 billion increase that was proposed and accepted shortly before the budget was printed in the defense budget?

Mr. ASH. Actually what we did was to work out the total increase, which was not $5 billion in outlays but $6.3 billion. This was part of working out the total budget with the Defense Department, as we worked it out with everybody else. There is no difference in any way in the process of dealing with the defense budget and the process of dealing with any other budget.

Senator PROXMIRE. What I am getting at, you accepted an increase in the budget, defense budget of $5 billion in the last day or two before it went to press.

Mr. ASH. Not at all. We had worked out many days before, as part of the normal process of working with the Defense Department, that the increase would be $6.3 billion in outlays and an even greater amount in total obligational authority. But this was the normal process.

Senator PROXMIRE. What I am talking about was that the increase between 1974 and 1975 was not in current dollars it was in constant dollars, so inflation was taken out of the picture, a much bigger increase if you had it in current dollars.

Mr. MALEK. Mr. Vice Chairman, I would like to point out that the report prepared by your own staff, on an advance look at the 1975 budget, they estimated that increased defense expenditures for military pay—and I remind you, we have ended the draft and have a higher cost per soldier today than we did—for inflation and the added cost of procurement, and for the added fuel cost borne by the military, would result in about a $6.5 billion dollar increase in 1975 over 1974. Working with the Defense Department, we have attempted to find areas in their overhead that could be reduced, so that some measure of modernization and improved readiness could be built into the budget, in addition to these other increased costs.

Senator PROXMIRE. I am not debating for the moment the wisdom of that. I am just saying as a matter of fact that you have this very substantial increase. We are talking here about obligational authority.

Our staff made a study of outlays, which is, of course, quite different, and the figures are different. As far as obligational authority is concerned, however, there was this massive increase in real expenditures in the defense sector. It may or may not be warranted. We can make a strong case that it is not.

I would like to follow up on what Senator Humphrey was talking about. I would just like to underline the statistics. The fact is that the compensation of workers in 1973 without allowing for inflation increased by around 6 percent, 5½ percent was the guideline and that was accepted with remarkable statesmanship on the part of working people, as you know. At the same time the consumer price index went up more than 8 percent, something like 8.4 percent.

On that basis the average working man lost between 2½ and 3 percent in real income in 1973. It is true, as Senator Humphrey pointed out, that profits are higher, and some people in the economy did very well. But the working man, whose compensation abided by the guideline, took it on the chin, isn't that correct?

Mr. ASH. Not just as you have calculated, no, sir. In addition to the cash increases that were negotiated in many industries last year, there were a number of other benefit payments that added to that——

Senator PROXMIRE. I am allowing fully for the fringe benefits when I say 6 percent a year. But even allowing for that, it was well below the increase in prices.

Mr. ASH. I think when one takes into account those payments it gets up pretty near to 7 percent——

Senator PROXMIRE. Inflation was over 8 percent.

Mr. ASH [continuing]. Of total increased pay. And then, of course, one needs to adjust for the fact that there were slightly more hours worked by the average worker last year than the year before——

Senator PROXMIRE. Right. But in January of this year the number of hours worked is lower than it has been in a long time, it dropped very sharply, and overtime has been diminished. So the weekly earnings are down even on a current dollar basis over December and January, and in real terms, they suffered substantially.

Mr. ASH. You were making a comparison of last year and the year before. So I thought to make it complete, I would put in other factors that bore upon last year compared to the year before. If you want to change and talk about this year relative to last year, let's pick out some data about pay increases and other things. But we need to keep amounts separate from our averages and we should look across the board at all of it.

Senator PROXMIRE. On the basis of what I have seen the number of hours in 1973 were overall, through the year, not an improvement on what they were in 1972.

Now, maybe I can be corrected on that. And it dropped sharply in 1974, January, and also December of 1973.

My time is up.

Congressman Reuss.

Representative REUSS. Senator Proxmire has been talking about an $85 billion defense budget. I want to talk about much smaller items. But they are important. Let me give you one of them.

About a dozen years ago many of us became upset because the Department of Agriculture was paying subsidies of scores of millions of dollars to the dragline and drainage people to dry up some of the best duck breeding marshes out in the Dakotas. And this seemed like a senseless waste of taxpayers' money, since then the Department of the Interior had to come around in a year or two and pay the same farmer to put the acres back into wetlands, which was their best use. So we put an amendment, which I authored, into the appropriations bill of 1962, which has been in every agricultural appropriations bill since then, and which says in a nutshell that subsidies by the taxpayers to farmers to drain wetlands valuable for wildlife, for breeding ducks and geese, should cease. That has been in effect ever since, and it has been good for the people, and good for the wildlife.

I was quite shocked to find in the budget document this year that the Office of Management and Budget, of all people, asking that the Reuss amendment be taken out.

We couldn't quite believe our eyes.

We called the Office of Management and Budget. And they said, yes, we thought that would be a good idea. We expect controversy about it, however. Well, you are surely right about that. And you have got it.

Why did you do a thing like that? Why spend millions of the taxpayers' dollars now to ruin the greatest water fowl producing area we have left in this country?

Do you know about this?

Mr. ASH. Having consulted among ourselves here, we find that we would probably be better off if we were to answer that very specific question for the record. And we will do so.

Representative REUSS. Would you please. In a way I am glad to hear that none of you four gentlemen know about this, is that right?

Mr. ASH. Not enough to answer the question that specifically.

Representative REUSS. I am glad to hear that, because it indicates that some zealous flunkey in the OMB, all on his own—I mean this—has dreamed up an outrageous thing. And I hope your statement will indicate that you will take it out. We will beat you on the floor anyway.

Mr. ASH. We know about it, but we will answer for the record. It is not that we don't know about it, but I would want to make sure that what we know about it is a fact before I answer. It is something that we did consider in the budget preparation, but I do not feel I know the facts well enough to be able to answer now.

Representative REUSS. I will look forward to your answer.

Mr. MALEK. I am sure you recognize, Mr. Reuss, that we have no zealous flunkies in the OMB.

Mr. ASH. I am not sure whether the word to eliminate is flunkies or zealous.

[The following information was subsequently supplied for the record:]

The 1975 budget proposes the consolidation of a number of similar cost-sharing programs (i.e., Rural Environmental Assistance Program, Great Plains Program, Water Bank Program) into a single program, the Rural Environmental Program. Accordingly, the appropriation language relating to the old program was proposed for deletion. This does not mean, however, that cost-sharing or technical assistance would be provided for the drainage of wetlands as prohibited by the so-called Reuss amendment. On the contrary, the new program also would preclude such assistance.

Representative REUSS. Now, let me ask another question. We have a chart, which I would like the staff to put up, prepared for us by the Library of Congress, showing actual and potential GNP. It shows two estimates of potential GNP, the old one of 4.3-percent potential growth rate, and a new estimate which the Council of Economic Advisers considers far more accurate than a 4-percent potential growth rate. The point I make is that the revision in these estimates affect the full-employment budget calculation which is derived from an estimate of potential GNP. OMB's estimate of the full-employment surplus in the unified budget derives from these revised estimates of potential GNP.

If the old GNP potential had been used instead, the full-employment surplus would have been some $3 to $4 billion larger. Whichever measure is used, the full-employment surplus rises from the fiscal year 1974 to the fiscal year 1975. Now my question is, Why does the administration regard a rising full-employment surplus as the correct budget policy when by every available indication the economy is moving toward a recession? Why does it appropriately move toward a full-employment deficit in 1971, but not today in 1974?

Mr. Ash. I think I can answer that, and then if you wish us to augment it, we can do that.

This year is certainly different than 1971. At that time we had a different economic setting. We did not use the capacity of the country as fully as today. We did not have the commodity pressures on prices. To the extent that we had an internal inflation problem, it was more cost push than the kind that we have now. At this time, we look at an economy that has many constraints on its ability to produce at increasing levels. We are working right now at capacity, and we have energy and other forms of constraints on our ability to use additional stimulus without having that stimulus translated directly into further inflation.

Furthermore, inflation itself has an interesting effect on the budget. It increases receipts before it increases outlays. And since it increases receipts before it increases outlays, when there is a changing rate of inflation from 1 year to the next, that changing rate—if the change is upward—will increase receipts before expenditures. We, in effect, have to set that aside and deliberately have a full-employment surplus at a time when we are moving to a higher level or have moved to a higher level of inflation. Similarly, we would have just the opposite situation if we were moving the other way on an inflation rate.

So the combination of the two factors—one a different economy fundamentally, and two, the effect of inflation or the very relationship of receipts to outlays—suggests that the proper policy this time is to have a full-employment surplus and not move toward balance.

What we did this year was to change an assumption that we had had in earlier years as to what constituted a normal sustainable rate of real growth. And we moved it to 4 percent, where heretofore it had been slightly over that, 4.3. The full-employment budget was calculated on 4 percent, which had the effect of reducing somewhat the indicated full-employment surplus from what it otherwise would have been. It would have been $4.7 billion higher than the $8 billion, or almost $13 billion. But we felt that 4 percent was a more realistic rate to predicate that calculation upon, and made that adjustment.

So there are the factors that went into that calculation and attributed to our belief that we should stay back from the line of full-employment balance rather than walk right up to it. This was done in order to avoid the inflation that would otherwise have come.

Representative Reuss. You do not think the fact that industrial production has declined now for 20 months running calls into question the assumption that we are at full capacity?

Mr. Ash. No. I think when you look at the composition of that reduction, it to a great extent derives out of energy and energy-produced declines, unemployment, and industrial production.

The automobile industry was by far the biggest single component in that reduction. So what we have this year, as we see it, is a more spotty economic decline, rather than a generalized one. What we should not do, then, is to throw more general stimulus into an economy. This would, in some cases, merely translate to higher prices. That is our view. And I am sure you have discussed this at length with the Council of Economic Advisers as well.

Representative Reuss. I call your attention to the most recent month of January's industrial production, which was not by any means entirely energy blamable. Almost every product category declined. So let's both watch it.

Mr. ASH. Sure. This certainly is not exclusively the automobile. There are some secondary effects of energy that trace their way into all kinds of areas. What our basic belief is—and we still hold to it, but we certainly are willing to change if evidence arises to the contrary—that we will be going through these declines early this year, but we will be moving out later in the year. We should take those actions consistent with that view of the economy, and conversely, not take those actions that would be inconsistent with that view.

Representative REUSS. Thank you very much.

Senator PROXMIRE. Senator Humphrey.

Senator HUMPHREY. Mr. Ash, I know that both of my colleagues here have asked you a good deal about the energy shortage and the exchange that took place between yourself and Mr. Simon. I want to say that I think Mr. Simon was more realistic. And I do not know what your full statement was, and therefore I do not want to dwell on it.

Are you aware of the study made by the Joint Committee on Atomic Energy on energy needs in the years between now and the year 2000?

Mr. ASH. I am, yes. I have spent a fair amount of time covering that study, having met with Congressman Holifield in particular and gone over this with him and I have otherwise given attention to that very study.

Senator HUMPHREY. That study indicates that the energy crisis would have been with us, Arabs or no Arabs, and that it would have been an active accumulating crisis, at least for the next 5 years, isn't that a fact?

Mr. ASH. It will be a continuing problem. We are now down to the business of semantics and the definitional difference between a crisis and a severe problem. That apparently is the whole issue. But I have certainly agreed, and have said that it will be a continuing problem for a long 5 years.

Senator HUMPHREY. Of course I meant the first relief that you could read or see would be in 5 years, because Mr. Bridges, who was the expert of that committee in that report, noted that any decision that will affect the output of different types of fuel insofar as fossil fuels are concerned, those decisions have already been made and will be translated into effect about 1978.

Mr. ASH. I agree. The first relief in terms of getting new domestic supplies available to us will be a number of years hence. There are many other factors of relief which precede that. The first is conservation, and the second is substitution of some existing domestic product for others. We have already converted a number of utility plants from oil to coal. An early relief can be in the area of natural gas, which requires only a change in the regulatory processes. So there are many kinds of relief that can come first. But if you define relief to be the first significant new sources of U.S. energy, particularly petroleum, it will be a number of years. In the case of the Alaskan pipeline, it could be sooner than 1978. We should see oil coming from that, perhaps, in 1976 or 1977.

So there is a succession of early steps to relieve the immediate crisis. Conservation is large among those. Rearrangement of our distribution and production systems also loom large among those.

But that just deals with the front edge of the crisis. The long-term problem, as you have just indicated, Senator, does have a long leadtime, and it is certainly something that we should work on.

The statement that you just made, to which I subscribe, is probably consistent with Bill Simon's views and statements. I think we would all agree, if we could just agree on the same words to characterize the difference between a crisis, a severe problem, and all the words that surround that.

Senator HUMPHREY. The point that I seek to make is, without trying to get into debate about it, it is important for you, Mr. Ash, myself, or any public official to tell the American people the naked truth, namely, that the demands for fuel and energy in the next decade, 20 years, far exceed any plans that are now on the drawing board to meet those needs, including, may I say, very severe conservation measures. I held hearings a year ago on this when no one was particularly interested. We Americans have what I called physiological politics, full stomach, do nothing, empty stomach, do something. You don't really get concerned until the crunch is on. Even if there had never been an Arab or an oil well in Saudi Arabia, and we had never imported a barrel, we are headed down disaster lane in terms of the projected national growth of this country, the types of energy that we need, and the machines that are being designed through modern technology and the kind of energy that those machines require.

Nobody was paying any attention to it.

Which gets me to this point. Mr. Stein in his speech in New York not long ago mentioned the possibilities of some planning. And I had happened to be one that long contended that we needed a greater capacity of Government planning.

I realize that OMB does some long-term planning, long leadtime, 2 years, 5 years. But we have got to have some kind of planning simply to forewarn imbalances and problems so that timely action can be taken against these imbalances or problems by both public policy and private enterprise. Now, when I talked to Mr. Stein about it, I found a responsive answer. What is your view about having some planning in this Government, so that we look a little bit further than the next bandaid or the next political economic aspirin tablet, or the next new Darvon pill that we have to swallow, or whatever you may be taking to ease your pain? What about the long-term health of this economy, not only in fuel?

But just let me raise the point to you. If you think we have got a crisis in fuel today, wait and see what we are going to have in food in a few years. This is going to look like you are in paradise, because the food prices worldwide are going to make the fuel crisis look as if it never happened.

Now, mark well what Hubert H. Humphrey said in this statement, because I predicted a year ago we were going to have some food problems. The Department of Agriculture willy-nilly goes along figuring that it is going to be all right if God just makes it rain at the right time. But in the meantime, with the Japanese cutting off the fertilizer from India, with the petroleum industry incapable of producing the fertilizer that is needed for two-thirds of the hungry people of the world—and we represent the third that is half well fed—there is going to be an unbelievable food crisis.

Now, what kind of planning do you think this Government ought to be engaged in? Because, mark my words, if there is a food crisis, it is not going to hurt us. We will still have enough to eat, except the food prices will go sky-high. What kind of planning is the OMB doing on this? I have talked to the Council of Economic Advisers about it. Do you really look at the 10 years down the road?

Did Fay Moynihan come over and tell you what the outlay is for this area?

Did your people meet with any of the representatives of the African countries that were here in the United Nations? I met with them.

Did your people of OMB have a chance to talk with the food and agriculture people in Rome last March?

Did any of your people attend the conference in Munich?

Did any of you get the bad news on the horizon?

I am a congenital optimist, that is one of my weaknesses. But I am getting to be a little pessimistic. And it is doing something to my personality, all these things that I feel are going to happen.

What are your plans?

First of all, do you agree with Mr. Stein on that?

Mr. ASH. First, I agree with virtually all that you have said. Nobody has paid much attention to you and to others in time past, and they did not pay any attention to the President in 1971 when he gave his energy message. I myself proposed a Department of Energy and Natural Resources 3 years ago, and not much attention was paid to setting up a structure to deal with the problem. So I have concluded after 1 year in Government that governments can work on only one thing at a time; and second, it must be a crisis before they do so. I think that is about what you have said in more colorful language.

As to this business of planning, I agree with you. I think that what we must do is not to manage the economy, but to be more knowledgeable and intelligent and forward-looking about what we can expect. In fact, maybe we just want to use the word forecasting to start. The problem with the word plan is that in many people's minds it immediately conjures up Government control and management of societies and the economy. If we could work this out, we might be a long way down the road toward doing what has to be done.

Let's start first with forecasting how things will be if we do nothing. Having looked at that, we can see what the Government's involvement in changing that prospective course should be. We must do a better job of looking further ahead and anticipating what might happen.

Now, what are we doing specifically? The job of OMB is not to do all the work in Government. We cannot. The job is to hopefully make sure that the work which has to be done by the executive branch gets done by those whose job it is to do it. In the particular case that you have mentioned, we have, underway within the executive branch of the Government a complete analysis of prospective commodity shortages of metal ores and other basic resources. This was cited in the budget, and, I think in the state of the Union message as well.

In fact, one of the associate directors of OMB is going to be in New Delphi sometime within the next month. One of the subjects he will discuss there is the food situation.

While our job is not to do everybody's work—we could not possibly do it—we do attempt to make sure that the right questions are posed and that somebody is working to answer them with competence and toward some deadline. We believe that we have posed the very kind of questions that you suggest in a philosophical way. I would hope that in this Government and in this country we could do more forecasting and foreseeing, without this being viewed as a step toward a planned economy, in the sense that a socialist government operates a planned economy.

We tend to get partly hung up on the word planned. If we can think of better language, we would be better off, and yet do the work.

So I would agree with what you have said. I am sure that you do not mean, any more than I mean, that planning means directing. It means knowing and being postured to act if, in fact, action is called for and not acting if the Government should not be active.

With that understanding, which I believe we share, I certainly subscribe to everything you have said on the subject.

Senator HUMPHREY. I think your answer is very responsive and sensible, and I thank you for it.

I passed 3 or 4 years, Mr. Ash, in working on the proposal which has been published in documentary form in this committee. We have to try to institutionalize within the framework of all the technical branches and the legislative branch better ways of forecasting—and I think that is a good word—the word planning has some bad connotations—but whatever it may be, we have to start looking ahead. And I hope the media, this committee, might be able to have our staff work with your staff in terms of some of these commodity problems as we see them, because we are very much concerned, and I am spending a good deal of time in the food sector. This is an area in which I am interested myself, and I hope to be a knowledgeable man about it.

For example, the other day I talked to the Fertilizer Institute. I was trying to get the fertilizer for a town in Minnesota called Good Thunder. But anyway, it is a rich agricultural area, highly productive area, but it depends on fertilizer. They had no fertilizer. And when I called Mr. Wiener of the Fertilizer Institute to see if we could do something, I do not blame him for being a bit provoked when he said, "You know, it would have been very interesting and very helpful if, when the Department of Agriculture decided that they were going to open up for planning for productive purposes 60 million acres, 47-some million a year ago, and 20-some million this past year, if they had indicated to the people in this industry that this was going to happen. Or they might have given some advance notice because, he said, "there just is not any way that you can open up land much faster than you can put up a petrochemical plant to produce fertilizer."

All those figures that we see today about production, mark my words, they are based upon lots of good hope, good luck, prayer, and the 23d Psalm, and loads of fertilizer.

Now all the other we are going to get, but the fertilizer we are not going to get, because it is not there. And some of these calculations are going to be translated into increased prices in this country, and famine worldwide.

My 10 minutes is up.

Senator PROXMIRE. I am not going to take long. I am almost through.

As I pointed out in my opening statement, the budget the President has presented to Congress is an incomplete budget. Nothing is in there for the proposed new health insurance program, and the proposed welfare reform program is not described at all.

I can understand that these programs will not be in operation in time to affect fiscal 1975 outlays very much, so perhaps it is legitimate to leave them out of the budget. But Congress would like to get some information about them as soon as possible.

When do you expect the President's welfare reform program to be presented?

Mr. Ash. First, we will not present a completed package, but work out some of the key parts of it with the Congress. As to timing, I would see us starting in the next month or two, so that we can get to work, and so we can hope to have some outcome even during this session.

As you know, the health insurance proposal is already before you, and we have the cost estimates.

Senator Proxmire. What are the cost estimates?

Mr. Ash. Those are that in that first full year there will be a $6 billion increment of Federal Government expenditure.

Senator Proxmire. And you do not expect it to be passed in time to be put into effect in fiscal 1975, it will be July of 1975 before it begins to——

Mr. Ash. The program has transitional provisions for employers costs. These were deliberately put in to moderate the problems of transition.

Senator Proxmire. But you anticipate no cost at all in fiscal 1975?

Mr. Ash. Nothing over and above the existing programs. We, of course, continue the present Federal programs.

Senator Proxmire. That is right. But there is a substantial increase over the present programs once this is in effect.

Mr. Ash. Sure. But the full impact would not be felt until 1977. One of the things we learned last year——

Senator Proxmire. Not in the 1977——

Mr. Ash. Before there is a full year impact.

Senator Proxmire. I understand. The increase is to take care of the people with low incomes, is that not right?

Mr. Ash. That is right.

Senator Proxmire. And the provision would be simply insurance like that paid for by employers and employees, is that not right?

Mr. Ash. Yes, and Federal outlays will be $6 billion over and above existing programs.

Senator Proxmire. Then you anticipate that there will be no benefits for modest- to low-income people until 1977?

Mr. Ash. They will receive additional benefits when the program is designed and goes into effect. We have present programs for those same people, as you know, medicare and medicaid.

Senator Proxmire. In the next election year.

Mr. Ash. And what we learned last year as to the special revenue sharing type programs is that if we did not provide an effective transition from one set of programs to another, we made it much more difficult to consider a prospective new, more comprehensive and complete program. So this one was designed to allow time for transitional steps.

Senator PROXMIRE. This would go into effect in calendar 1976, the summer of calender 1976. And the housing allowance would go into effect, presumably, we understand, in 1976. So in an election year you will have benefits for the low-income people in health, and you will have benefits for low-income people in housing in 1976, is that right?

Mr. ASH. Probably about the same as 1968, 1964, 1960, and all other similar years.

Senator PROXMIRE. I would not deny that, I think that is right. Both the Congress and the President have been very guilty, I think, on that score. I think it has played real hob with a sensible, fair——

Mr. ASH. I think standing at this time on this program——

Senator PROXMIRE. We cannot criticize you on this because we are just as guilty as you are.

Mr. ASH. I would put this a little differently in the case of health insurance. If you look at the perplexity of that program, the time it will take for congressional consideration, and the time it will take to implement it, it is probably exceedingly realistic to have it start with about the lag that this one will have.

Senator PROXMIRE. It would be exceedingly realistic to have it start also 5 months before the Presidential election.

Mr. MALEK. If I may make a point on this, Mr. Vice Chairman, I think we have to recognize that a health insurance proposal by this administration is nothing new. We have in the past submitted legislation to this effect. It has not been acted on by the Congress.

The new proposal that we are submitting, as I am sure you can appreciate, is a very complex one administratively, and it will take some time in order for the State and private carriers to gear up to handle such a transition.

Senator PROXMIRE. Your own unemployment compensation program too does not begin to take effect until 1976, at least the one unemployed program that you have suggested. It does require action by the States, and there is nothing in the budget for it.

Mr. MALEK. I think you are talking about income assistance as opposed to unemployment.

Here again, in 1969 the President submitted welfare reform legislation. I think that to consider this new effort to work with the Congress on legislation to reform the welfare system as tied to the election year is misleading.

Senator PROXMIRE. There are two sets.

The first set has to do with raising the average level of cooperation. Nothing appears in the budget for this until fiscal 1977. Obviously this will do nothing to help us through 1974 or 1975. It would not be until July of 1976 that there is anything in it.

Mr. ASH. You may remember that it was a year ago that we proposed that first unemployment legislation. It was not enacted last year. We are now putting it on the premise that it may be enacted this year. Had it been enacted last year, it would have gone into effect a year earlier.

So we are merely putting these proposals before the Congress and making our best estimates as to when they might be acted upon.

I think if you look at last year's budget, you would find that the unemployment proposal would have been effective one year earlier.

Senator PROXMIRE. The first set, as I say, would not have effect until calendar 1976. The second set had to do with broadening eligibility, and lengthening the duration of benefits. Now, these proposals would apply to fiscal 1974, as I understand, if they could get in the budget.

Mr. ASH. They would.

Senator PROXMIRE. What would you expect additional outlays for this to be in the year 1975?

Mr. ASH. That matter, of course, is most contentious because at this moment we are uncertain about future changes in the economy.

We have put in the budget the continuation of the same program of unemployment compensation, and I think it shows outlays——

Senator PROXMIRE. You see, Mr. Ash, this budget says we are going to have to spend $304.4 billion in the coming fiscal year. But it does not include this unemployment compensation package which will increase that.

Now, later when we spend more, I suppose that you or some other budget director will come down and tell us that we have exceeded the President's request.

Mr. ASH. I find our estimate for unemployment outlays is clearly a greater dollar number than we had last year. And I will find it for you. The budget does contemplate an increase in the level of unemployment outlays by the unemployment trust fund are estimated to rise by $1.3 billion, from $5.850 billion in 1974 to $7.166 billion in 1975.

Senator PROXMIRE. But the money, as I understand it, is to fund existing programs to a higher level of unemployment, which we have. There is nothing for the new proposal the President made last week, is that correct?

Mr. ASH. Your statement is correct. What we need to do is, first, get that legislation enacted and then, second, try to price it out in its final form.

Senator PROXMIRE. So to this extent the budget understates the amount Congress has been requested by the administration to provide?

Mr. ASH. As you know, estimating unemployment compensation is very difficult so far ahead of time. We are making estimates for a period that begins 4½ months from now and ends 16½ months from now. We estimated 1975 outlays of $7.2 billion. We have to realize that this number——

Senator PROXMIRE. I know it is very difficult. You have one of the most difficult jobs in government. You have to do this long before expenditures occur. But that is the problem. We know that we are going to have, if the President's recommendations are carried into effect, more expenditures.

Mr. ASH. It could be more and it could be less.

Senator PROXMIRE. It has to be more if the recommendations mean anything.

Mr. MALEK. Mr. Vice Chairman, I think the point here is that as we move through the year, new legislation is proposed. It is not possible always to foresee that and include it in the budget document.

Senator PROXMIRE. As we broaden the eligibility and as we lengthen the duration of benefits, there is obviously going to be more money expended; if the benefits are greater and the length of eligibility is extended, there is going to be more money, right? It cannot be less.

Mr. Ash. It will be more than it otherwise would have been. But what it otherwise would have been is not the most precise number in the budget.

Senator Proxmire. How much would the mass transit program submitted by the President last week be in fiscal 1975?

Mr. Ash. The outlay impact is fully included in the budget. Those numbers are——

Senator Proxmire. Is there not an extra $700 million for urban mass transit that is not included?

Mr. Ash. Let me ask McOmber to speak to that.

Senator Proxmire. You show one item of $700 million, but there is an additional item of $700 million that is not included, as we understand it.

Mr. McOmber. Sir, it is true that the transportation assistance program would add an increment over the existing programs.

I am not familiar with your $700 million figure. I am familiar with the fact that there is $200 million in outlays that would be added to existing programs. Those are shown in table 15 of the budget, and they are included in the allowance for contingencies, which we do have in the budget total.

Senator Proxmire. As I understand it, the President has proposed an additional program, in addition to that, as we understand it.

Mr. McOmber. No, sir. The program that is outlined in table 15 is the one that was sent out last week for transportation assistance.

Senator Proxmire. We are talking about one program of capital grant, and another program for optional funding. The latter, as I understand it, is not included, $700 million for each. Do you know about that?

Mr. McOmber. Senator, we did contemplate that complete package in the program outlined in various parts of the budget. It was included in the budget total.

Mr. Ash. Maybe what we should do is reconcile budget data with your staff members and make sure that we are all resting on the same numbers with the same definitions.

[The following information was subsequently supplied for the record:]

The Unified Transportation Assistance Program (UTAP), which the President sent to the Congress on February 13, 1974, includes limited funding for operating assistance to improve public transportation services. In 1975, $700 million of the transit obligations allocated by formula will be available for transit operating assistance at State and local option.

The outlays resulting from UTAP are covered by the outlays shown in the budget for existing urban mass transit and highway programs plus the additional amounts shown in Table 15 of the budget. The $200 million in outlays shown in Table 15 reflects increased obligations under UTAP and the possible use of some of the funds for operating assistance, which would be spent more quickly than obligations for capital projects.

Senator Proxmire. I am just about through. I have one more item that I would like to cover.

As you know, Mr. Ash, this committee has an interest in Federal subsidy programs. A few years ago we asked for a study by a distinguished scholar at Columbia University. We found out that there was no study at all of subsidy programs, or at least none in the English language; there was some in German.

We also found that $38 billion of something like a $68 billion Federal subsidy program, $38 billion was in tax expenditures.

Now, we have been very concerned about the benefits from these programs, what they cost, and whether they achieved their objectives efficiently. Two years ago our staff made what I regard as a very important step in understanding how these large sums of money are spent. But that was only a first step. In order to understand these programs better, it is essential that we have available up-to-date and accurate information on the various subsidy programs. Will the Office of Management and Budget supply to this committee estimates of the cost of the subsidy programs based on the most recent U.S. budget?

Can you do that for us?

Mr. McOMBER. We will be happy to provide you with a better spelling out of the details.

Mr. ASH. Would you be happy to provide us with the budget to do so? This is a very manpower-consuming task. The data that you have in front of you that are quite current. I understand that you have 1972 information. I know of no reason that any additional information would change that which you already have.

Of course, our special analysis goes some way toward——

Senator PROXMIRE. Can you not do this with the same manpower at the same time as you put together the Federal domestic assistance catalog?

Mr. ASH. It is a big job.

Senator PROXMIRE. I cannot think of anything that the taxpayer should be more entitled to know as to whether his money goes into subsidies, however efficient it is, or anything that could be more helpful as to congressional policy and governmental policy, than to determine what these subsidies are, where they are going, and how efficient they are and whether they are working.

Mr. ASH. We did, of course, work with you to put together a very thick report on the whole subject. I think that this report is just so current that it would be the one we would all want to work with in considering any policy change.

Senator PROXMIRE. We would like to have that updated. And we would like to have a lot more information on it than we have. We will spell it out in a letter indicating precisely what we would like to have.

Mr. ASH. I am reminded that there is a fair amount of that information already shown on page 84 of the special analysis.

The real issue here is, that there are a lot of data that are apparently just as valid today as when they were provided, which was in recent times.

Senator PROXMIRE. This is only credit subsidies, which is a very small part of the total?

Mr. ASH. That is right.

Senator PROXMIRE. We found that to be only about 12 or 15 percent of the total.

Mr. ASH. Rural environment assistance, emergency credit, health facilities construction—in fact, some of the programs we tried hard, as Senator Humphrey reminded me, to deal with last year——

Senator HUMPHREY. Deal with?

Mr. ASH. We tried.

Senator PROXMIRE. We would like very much to have an analysis of the tax subsidy program in particular.

Mr. ASH. Could we not start by reviewing the 1972 data to see whether it is deficient today? It may turn out that the 3-inch stack of papers that was put together just recently is still quite valid for any kind of analysis of policymaking that you may want to make. Is that a good place to start?

Senator PROXMIRE. That is fine. The reason that we would like to have this from you—as you know, the Congress is going through all kinds of agonies in trying to adopt its own budget reform bill. When we get it we are going to have some really painful decisions to make when we set a ceiling and try to live within it. This will be one of the most helpful things we could have in living within that ceiling, if we knew where our subsidy money is going, and what is efficient, and what is not, and what we can do to reform it and improve it.

Mr. ASH. We should probably start by definiting what is a subsidy, whether it be a tax or subsidy. This, of course, requires a lot of time. You should know—not that it pertains to any of your committee—that the one budget that was reduced by the Congress last year was the budget of OMB. Everything else seemed to go up. If we could get a little assistance on that, it might help.

Senator PROXMIRE. The office of OMB.

Mr. ASH. Yes, sir.

Senator PROXMIRE. I will tell you, I wish you would increase your staff, and particularly the number of people on the defense part of it.

Mr. ASH. We could use some help, I must say.

Senator PROXMIRE. I am getting to be the Wright Patman on defense, as he is on interest rates. But I think that is where we have the opportunity to make some really substantial improvements.

Mr. ASH. All we need to do is find a supporter for OMB and we will be in good shape.

Senator PROXMIRE. I will be happy to support that.

Mr. ASH. Thank you.

Senator PROXMIRE. Senator Humphrey.

Senator HUMPHREY. Thank you very much.

Mr. Ash, we only get one or two chances a year like this.

I want to talk to you a little bit about the oil excess profits tax proposal. It was estimated recently by Mr. Walter Heller, whom I am sure you are familiar with, that 1974 oil company profits after taxes will increase by some $16 billion, because of the enormous price increases for crude oil permitted by the Cost of Living Council, or for whatever reason, because of the enormous increase in prices. This would be more than double the already high profits of 1973. The so-called emergency windfall profits tax proposed by the administration would collect an estimate $3 billion of this amount, or less than one-fifth of the increase in profits, and less than one-eighth of the estimated total profit. That tax proposal is structured so that some of its incidence would fall on the consumer rather than on the industry's profits. Now, do you believe that this is a measure that truthfully and fully carries out the President's pledge that the industry will not be permitted to profit unduly from the shortage of energy?

Mr. ASH. First, I believe that Walter Heller's numbers are probably more optimistic on behalf of the oil companies than their profits actually will be. But let us put that aside and talk about the principles involved.

Secondly, this tax, as proposed by the administration, will fall on producers, not on consumers. I do not want to repeat the very comprehensive response of Secretary Shultz, who is testifying before, I believe, this committee, made an excellent case to the economists, politicians, consumers, and whoever is interested, as to why this is not a consumer's tax but in fact a producers' tax.

Senator HUMPHREY. For the purpose of argument only, though—there has been some argument about this—let us assume that this is a producers' tax. You are reading this as an emergency windfall profits tax proposal.

Mr. ASH. Sure. The tax takes away the one-time profit that comes from the imbalance of supply and demand; that is, providing an opportunity to make more than a normal and reasonable and proper level of profit. And I do not want to belabor the point because I know you know the answer as well as I. I think you will agree that we do not want to deny any industry, oil or other, a profit sufficient to attract the capital which that industry needs for the tremendous amount of investment that it is going to have to make in the future. That does not mean that any industry should have an excess return. But certainly a comparison of 1973 versus 1972 is not really the best measure of determining how much profit is enough. The profit that should be earned is that sufficient to compete with other demands on capital, and attract the capital into those uses that have a very high priority national interest.

But I am merely making a speech that you could make as well, if not better, than I.

Senator HUMPHREY. Let us take a look at that. You think Mr. Heller's figures might be a little strapped—larger than you would give. Mr. Heller, however, prepares these figures as economic consultant for financial institutions. And he is president of the American Economics Association, and he has a fine reputation as an economist. Now, I will shave it a billion dollars. In this city of Washington we apparently do not worry much about that. Let us take $15 billion excess profits, new profits over and above—which were good profits in 1973, the oil industry was not receiving assistance under the program in 1973, it was doing pretty well—now, if you get an extra $15 to $16 billion, the administration says that it is going to see that there is no profiteering out of this emergency—the words, the rhetoric—whoever writes this material should be given an increase in pay, because that person or persons are doing a good job, it is very convincing—there will be no price gouging—which is happening on every State and every corner of the United States—there will be no increase in—no profiteering. Now, the administration's proposal by its own estimates is about $3 billion. Do you call that an excess profits tax, according to what we used to know as excess profits? Now, I am talking of $3 billion out of the $15 billion new money, the new profits.

Mr. ASH. I know that Walter Heller does have a fine reputation. I did not want in any way to suggest anything to the contrary. But I also know that a number of economists who also have fine reputations seem to differ from time to time. I am only observing these differences.

Senator HUMPHREY. What do you think the figure is?

Mr. Ash. I do not happen to have the figure—

Senator Humphrey. If the administration speaks of windfall profits you might have some idea.

Mr. Ash. I do not happen to have that particular number in my mind. That does not mean that it is not firmly——

Senator Humphrey. What should be an excess profits tax rate?

Mr. Ash. The excess profits tax rate should be that rate which removes profits over and above those necessary to command the resources needed to invest in that industry. Each industry, if it is to survive, and particularly if it is to expand, must command capital out of the capital market. If the oil industry does not make a profit sufficient to command capital, it will not get the capital, and we will not get the oil. So excess is an excess over what is required to get the oil out and produce it, and also, at this stage in this country's development, to attract into that industry more money than it has ever required before. The oil industry is going to go into the capital market, and perhaps second only to the Government, will be attempting to compete to get massive amounts of capital for investment. The industry must have sufficient return to be able to do this. Any excess over that is the excess profit.

Senator Humphrey. Can we talk about excess profits in emergency situations such as we had in World War II, for example, and now we have got a situation—and every time the price of that crude oil goes up it does not hurt the oil company, the Arabs can raise that crude oil up to $50 a barrel and the oil companies will make more money, because they are all in it to get it. They have not nationalized all this oil. We are all the time talking about these countries over there raising the price of crude. Well, the oil in Saudi Arabia, that is not all owned by Saudi Arabia, part is owned by Saudi Arabia and part by Aramco——

Senator Proxmire. If the Senator would yield, the fact is that the higher the Arab countries raise their price the bigger the tax deductions for U.S. oil companies.

Senator Humphrey. They have, indeed.

But my point is that it is estimated that there will be profits for the oil industry of $25 to $30 billion this coming year, for all the oil industry. The oil industry's declaration of intent for investment to the Department of Commerce is about $10 million. So I am enough of a businessman to know that you do not always have to have cash on the line when you go into the public money market, when you really start to invest you do not always take it just out of earnings. Earnings relate to the inducement of others to invest in your company.

Mr. Ash. Exactly.

Senator Humphrey. And here is the oil industry with profits not less than $25 billion, between $25 to $30 billion, with a declaration of intent this past—just 2 or 3 months ago with $10 million of investment—and I am now being told that we have got to look at this whole matter of excess profits, which is the basis of whether or not there is any real incentive left to invest. I want to tell you, that is plenty of incentive. And I think that the administration's so-called emergency windfall profits tax needs to be explained to the American people in the light of what has been happening to us. The American people today are being taken for a ride on gas and oil. And even though the trips may be shorter, and the waiting period longer, they are being taken for a ride. And the oil companies, with all of their public relays and all of their explanations, are making money faster than they can count it. And they get more special tax privileged than any other industry. And I have yet to see a major tax reform program come down from the administration to do something about this new kind of enterprise—I will be careful of my language about what kind of enterprise I think it is. When you consider how much they paid in taxes to the Federal Government of the United States—what is the amount—less than a billion, very small—on most of this they get this big tax credit for their payment to the foreign governments.

Fine, well and good. But we have got a country to run over here, too, and it is the American consumer that is buying a lot of this gasoline. The administration has proposed the abolition of the depletion allowances on foreign oil extraction and revision of the U.S. tax credit for royalty and taxes paid to foreign countries to which I have just alluded, can you tell us how much you estimate would be collected for fiscal 1975 if these revisions that the administration has proposed; namely, the abolition of depletion allowances and foreign oil extraction were adopted?

Mr. Ash. The Treasury has the particular number. We are anticipating congressional action that will support the President's proposal to tighten the foreign tax credit and eliminate the foreign depletion allowance for oil companies.

The additional corporate income tax revenues expected from the special windfall profits tax are set forth in the budget. That will give rise to a few billion dollars, which are included in the total revenues shown in the budget.

Senator Humphrey. I have been told that the carryovers of depletion allowances would cover many of the profits for several years. I do not know. I just ask the question as a point of information.

Mr. Ash. We are proposing the elimination of all foreign depletion allowance for oil and gas so that there would not be any carryover.

Senator Humphrey. Does your proposal have a retroactivity clause?

Mr. Ash. No, it is not retroactive. There is a carryover in the sense of having been used to determine earlier income.

Senator Humphrey. But the carryover would still continue?

Mr. Ash. As you know, almost all tax laws are prospective only. It is generally considered bad tax legislation to legislate taxes retroactively.

Senator Humphrey. I understand that. The contingency plans for recession that you mentioned in the budget, the word flexibility, target areas—this budget, by the way, has language in it much different than the budget a year ago, and in many ways I think it is a much better budget. Now, my question as I have expressed it here today, is that the trouble with much economic policymaking is that we stumble from one crisis to another with the Congress generally about two steps behind the problem instead of ahead of it; namely, because there has been no advance, they keep no forecasting or planning, or whatever word they wish to use. Without indicating any priority order, would you detail some of the alternatives that the Congress should consider or that the administration would present if things got a little bit more out of hand than they are.

In other words, if more unemployment were to be set, if the economy began to show signs of weariness and severe recession. I notice the other day that the Secretary of the Treasury made some reference to this. I saw it in the New York Times. What proposals are you going to offer us?

Mr. ASH. I will put the first two in priority order, and then will discuss other possible actions without indicating priority. I think the first priority is that action be taken as early as possible on the budget itself, this would be of great use, because one of the objectives of the budget is to respond to the economic needs of the country.

The second priority, is to take up the unemployment compensation proposals that also are before the Congress.

Beyond that, other possibilities are to speed up payments that otherwise might be made or programs, such as construction, that are already on the books. By this I do not mean new programs that will not have an effect for the long time, but ongoing ones that can be sped up during the period when we can most use them.

I think Secretary Shultz talked about looking at refund of income tax withholding, this is one possible way to put cash in the hands of people who would have a high propensity to spend, although some of the money might be put into savings.

Another possibility is aid to State and local governments, specifically the manpower revenue-sharing program that gives rise to a public service employment. We would hope that the cities and States themselves, with the program now underway, would be able to apply it locally to best fit their needs. Certainly we stand ready to review what is going on and what additional needs there might be in that area.

Senator HUMPHREY. What would you think about expansion of public service?

Mr. ASH. As you know, that program was incorporated into the broad Comprehensive Employment and Training Act that passed last year, and is now law. We did add in a substantial amount for areas with high unemployment, which can be used for public service. This is part of the general fund for comprehensive manpower assistance, which will total over $2 billion in 1975. And we would like to encourage those who administer the fund in the States and the cities, to strongly consider public service where it seems to be a solution to their particular problem. Others may see the problem differently. But certainly that program should be considered if it fits local circumstances and needs.

Senator HUMPHREY. Can I interpret your commentary, Mr. Ash, then, to be that you are sympathetic to a stimulation of the use of the public service employment program if needed?

Mr. ASH. Not that generally across the board, but where needed.

Senator HUMPHREY. Where needed.

Mr. ASH. Because there is some evidence—and I think we should all be mindful of it—that some public service programs do not add on incremental jobs, they just shift the burden of paying for those jobs from the State and cities to the Federal Government. If they do not add on incremental jobs, they have not really done what we wanted them to do. So if we can employ public service where it actually adds on incremental employment, then I think it is something to look with favor on. If it does the opposite it should be avoided.

Senator HUMPHREY. Does the administration intend to defend its impoundment in the outstanding court suit that seeks a release of the impounded funds, or will the administration end these suits by releasing the funds in question? The reason I asked that, I notice that Edwin Dale of the New York Times said you can retire the word impoundment from your title. Does this statement imply the release of the fiscal 1973 HEW funds, or does it also apply to other impoundment such as highway money, rural, sewer and so forth?

Mr. ASH. As you know, we did release those HEW funds. On the matter of the water purification grant program and on the matter of highway trust funds, the issues are totally different and we are continuing the process of reserves, the process of apportionment. As we talked about at such length last year, the practice of establishing reserves, has a long history. I would not go into the history again, we have covered it. As to reserves presently outstanding, I believe that proper authority exists to continue the kind of reserve process that we have been using.

I notice that Senator Proxmire, in some of his comments, suggested that maybe we should not be spending so much of the highway funds and that we should impound more in that area. Maybe the two of you can resolve it between yourselves.

Senator HUMPHREY. Maybe what we ought to do is try to get an agreement between you, OMB and us in the Congress as to what we mean by impoundment, a definition.

Mr. ASH. I think it would not hurt one bit to deal with the subject of definition. I would rather use the words reserve and approtionment, which are pretty well defined. Impoundment is a vernacular word not a word of art, and that is probably one reason we get into trouble. Let us get back to the words of art, so that we can know what they mean.

Senator HUMPHREY. It is getting kind of late in the day for me to get into that.

Senator PROXMIRE. I would like to sum up by saying, Mr. Ash, that you have now appeared before us for 3 hours. I think you are an extraordinarily articulate, intelligent person. And you have done as good a job as could be done, I think, with a very sorry case. It seems to me that this budget aggravates both inflation and recession. Now, that is not easy to do, but I think this budget does it. If you take the budget, 80 percent of this enormous increase is in two areas: Social security and military spending, both economically sterile. No. 1, in social security benefits, medicare, medicaid and so forth. We have to do it. It is desirable. But it produces no economic muscle, it does not produce any economic strength. It is really an economic sterile problem. And it is inflationary.

The other big area is in the military area. As I pointed out, in three very vital categories there is a real increase in real materials, not money materials but in constant dollars an increase of more than 10 percent.

Now, then, you look further and you find that in the education area your special analysis shows that you have a decrease in real spending for education. This is where you provide muscle for society and your economy, this is where you are strengthening yourself economically. But you do not do that. So I think that this appears to be another example of a failure on the part of the Federal Government to provide the kind of economic leadership that we need. It is beyond me to know why this administration does not do that. I disagree with President Nixon on many things, but I think he has been a forceful President up until this year, whether because of the impeachment Congress or because of Watergate, or whatever it is, I just do not see any forceful, direct leadership to either combat inflation or to combat recession. I cannot see anything in here that specifically provides for what we are going to do when unemployment increases, if it does. And I see very little in here that is going to help us combat inflation. Indeed, as I indicated, the size of the budget, and the increase of the budget, and the stirility of the budget is likely to aggravate both depression and recession.

If you would like to respond to that, go right ahead.

Mr. ASH. I do not intend to make a speech which would be, in many respects, to the contrary. Maybe the problem with this budget is that it is just right—it neither hits the stops on one side nor the stops on the other side.

Senator PROXMIRE. If you want recession and inflation at the same time, it is just right.

Mr. ASH. Actually, the budget contributes to holding down inflation by having a full-employment surplus, which is the posture to have to hold down inflation. On the other hand, it has an actual deficit which itself has a degree of stimulus in it. So having gone down the middle course, it sounds like the criticism is that we have not gone to the stops on one side or to the stops on the other.

Senator PROXMIRE. I am not saying that at all. I am saying that the budget should be smaller. In fact, the counter budget that I proposed was a lower budget. That was a budget that counteracted the recession more effectively, because we put money into housing where we have more jobs, and money into public service employment, and took money out of the military.

Mr. ASH. The Joint Economic Committee staff suggested that $297 billion was too low.

Senator PROXMIRE. Well, I disagree with the staff quite often.

Mr. ASH. Well, they suggest that your figure would be too low, and even $2 billion more than yours would be too low, and it should be higher than that to deal with the economy at the moment. So maybe our problem is that we were caught between the chairman and the staff, and we found a middle road. I cannot say much more than that.

Senator PROXMIRE. If you are in that position, go with the chairman.

Thank you very much.

The committee will convene tomorrow morning to hear from the experts on the energy crisis.

[Whereupon, at 1 p.m., the committee recessed, to reconvene at 10 a.m., Tuesday, February 19, 1974.]

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