642

THE 1974 ECONOMIC REPORT OF THE PRESIDENT

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-THIRD CONGRESS

SECOND SESSION

PART 2

FEBRUARY 19, 20, 21, AND 22, 1974

Printed for the use of the Joint Economic Committee

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THE 1974 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, FEBRUARY 19, 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 345, Cannon House Office Building, Hon. William Proxmire (vice chairman of the committee) presiding.

Present: Senators Proxmire, Humphrey, Javits, and Percy; and Representatives Griffiths, Widnall, and Blackburn.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; Lucy A. Falcone, John R. Karlik, L. Douglas Lee, and Courtenay M. Slater, professional staff members; Walter B. Laessig, minority counsel; and Michael J. Runde, administrative assistant.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. The committee will come to order. This morning we welcome as our first witness, Mr. John T. Dunlop, Director of the Cost of Living Council. He will be followed later this morning by Mr. John Sawhill, Deputy Director of the Federal Energy Office, who will be testifying in place of Mr. William Simon.

Mr. Dunlop, within the last few days we have received at least two very depressing pieces of news in regard to inflation. First, the wholesale price index for January was released last Friday. It showed sharp increases in just about every major category. Food prices and fuel prices went up sharply, accounting for a large part of the total increase.

It should also be pointed out, however, that 10 out of 12 nonfuel, nonfood components of the wholesale price index also rose and rose by substantial amounts.

Most disturbing of all, perhaps, is to look at what has been happening to prices of consumer goods at wholesale, the stage which is the immediate forerunner ot the consumer price index itself.

Consumer foods at wholesale have risen 23.4 percent in the last year. Even more startling, consumer nonfood finished goods have risen about as much—almost as much—23 percent.

What this means is, we are going to have a price increase bubble on top of a price increase bubble. The first will come when controls end. The second will come as these wholesale price rises filter through

the economy. These breathtaking wholesale price figures are only the first piece of bad news we have had recently.

The second is the Agriculture Department's forecast for food prices for 1974. The Department expects retail food prices to rise between 8 and 12 percent this year. Given the well observed tendency for these forecasts to understate the true situation, many felt that we can anticipate a retail food price hike of at least 12 percent, if not possibly more in 1974.

Dismal as though these latest price statistics are, they still do not tell the whole story. The real inflation problem in 1974, as I see it, will be a different one than we experienced in 1973. The world commodity price explosion that has caused so much trouble in recent months may or may not end.

Worldwide economic slowdown recession may cause these raw material prices to fall, or at least to stop rising. On the other hand, the energy crisis may cause prices to explode further internationally and food prices may continue to rise, especially if hopes for bumper crops should be disappointed.

The new TNT-explosive element in the situation, may well be price pressure in the manufacturing service sectors; 1974 is a heavy year for collective bargaining. Of course you are one of the outstanding experts in the world.

Wage demands will be large because workers will be trying to recover the ground they have lost this year in terms of real income.

And they will recognize the certainty of a big inflation this year, with even the administration predicting a 7-percent inflation. Productivity gains will be slim because of the decline in output. As far as the causes of inflation are concerned, 1974 will look more like the cost pressures of 1970–71 and the demand pressure of 1973.

This is the very type situation in which the administration made a judgment in 1971 that controls could have a positive role to play. But what has been the administration's response to a similar outlook for 1974?

The Council of Economic Advisers devoted many pages of their annual report to explain why price controls cannot be expected to work. The Energy Office has devoted much effort to explaining why fuel prices have to go up.

The administration has no anti-inflation program. Fiscal and monetary policies are neutral. We have no program to prevent another internationally induced food or material inflation. Controls will be gone. Virtually what is left to fight inflation then? Seminars, study, rhetoric, but no action.

Mr. Dunlop, I appreciate that you personally are trying very hard to do the best you can to fight inflation under these impossible circumstances. You presented a fine analytical statement to the Senate Banking Committee last week and you submitted a similar statement to this committee in advance of this morning's hearing. Your statement is good until it gets to the recommendations. Then I think it falls apart.

I interpret this to mean that the administration has not yet agreed upon a program, or even the general outlines of a program. Here we

are, after 1973, when our economy suffered the worst inflation in 25 years with no policy or program by the Federal Government to do anything effective about it.

Mr. Dunlop, I understand that you will put your prepared statement in the record, and if you would like to make remarks for 10 or 15 minutes, summarizing your recent thoughts on this, we would welcome that very much.

STATEMENT OF HON. JOHN T. DUNLOP, DIRECTOR, COST OF LIVING COUNCIL, ACCOMPANIED BY JAMES McLANE, DEPUTY DIRECTOR

Mr. DUNLOP. Thank you, Mr. Chairman. I have with me, as you know, this morning, Mr. James McLane who is Deputy Director and he may also join with me in answering some of your questions.

I appreciate this opportunity to present a proposal of the administration and to answer your questions. Since these proposals were detailed earlier, I thought it might be appropriate to limit myself in these brief remarks this morning to some general introduction and to comment on some questions that have been raised with me by Members of Congress, members of the staff, and others.

The first group of remarks that I have really grow around the question: What have we been trying to do with controls in the difficult economic environment that you described?

Now the inflation in primary prices in 1973–74, as you know, was worldwide, unexpected, and far beyond the range of our earlier experience. Let me give you a couple of examples. Scrap, which is essential to steel production was a year ago $30 or $40 a ton and it sells today for $115 to $130 a ton and some above.

The cash price of No. 1 hard red winter wheat, in Kansas City last Friday was $6.11 a bushel, the highest price ever reported. Prior to 1972, the highest price was $2.97 in December of 1947. Cotton prices in Memphis reached 92¾ cents last September. They are still in the 70 to 75 cent range, compared to an average of 35 cents in 1972 and in the years of the preceding decade.

The rise of world crude oil prices need no statistical citation. Thus the full range of primary commodities, feed grain, fiber, metals, and energy, have reflected a surge of inflation.

We know the explanation of this unprecedented era is a simultaneous boom in the advanced countries as evidenced by the very rapid rate of expansion in the last half of 1972 and early 1973, the decline in agricultural output here of about 7 percent, the oil embargo and the dollar devaluations which further raised our prices of imports and made our exports more attractive.

This past year the country has learned as never before how closely our economy is related to the rest of the world. Now, in this era of difficult economic times, wage and price controls in my view cannot be a powerful tool to constrain the inflation. But we have sought to use controls to make five major contributions which are consonant with economic expansion and high employment levels.

Let me state what those five contributions are, in response to the first group of questions. First we have sought to allow the passthrough of the cost of import, which is absolutely necessary to the domestic economy, as in the case of imported oil, and to allow domestic prices to be high enough so that a serious drain of additional exports to world markets would not create business hardships and unemployment, as in the case of fertilizer.

Most important, at the same time as we have sought to protect the American consumer by providing no more than a dollar-for-dollar passthrough of imported costs, we have allowed prices of domestic products like aluminum and copper to rise gradually toward world levels only when necessary to preserve our supply. That is the first thing we have tried to do.

The second thing we have tried to do is to constrain price increases at finished goods levels in the face of the large cost increases derived from these primary price explosions. Such constraint has been achieved through the devices of prenotification, labor productivity offsets, strict accounting of costs actually incurred not to include anticipated costs, and in some cases further postponement or denial of price increases which were otherwise cost-justified.

And, three, we have sought to constrain the impact of these price increases on wages by programing to improve collective bargaining and to moderate wage increases by recognizing a need to provide equitable adjustments in individual cases. And I have some additional tables on that matter, Mr. Vice Chairman, that I will present to you.

Senator PROXMIRE. Without objection, the tables will be included in the record.[1]

Mr. DUNLOP. Fourth, we have sought to provide all available means through Government policy to increase supply through productivity.

Fifth, we have sought to pursue the policy of graduated control on a sector-by-sector basis.

This is how we have tried to use price controls in this very difficult economic environment, and I think any dispassionate observer in the economic environment of 1973 and 1974, with these large, worldwide primary increases in prices, will agree that wage and price controls can only have very limited impact to restrain inflation, and that there are risks that controls will effect substantial economic damage.

It is my judgment that in this difficult and complex economic setting, the economic stabilization program has made an incremental contribution to wage and price restraint.

Nonetheless, the authority should, with the exception of a few sectors, be allowed to lapse. That is the first set of comments.

The second set of comments that I want to say a word about more briefly is to give you a general appraisal as I see it of controls. In any appraisal of controls it is essential, as the detailed testimony on page 39 of my prepared statement points out, to avoid two extreme positions that are often advanced—and I do not know which one I would oppose more strongly.

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[1] See tables 1 and 2, p. 237 and p. 238, respectively.

One view is that controls can do no good, they can only do harm, and they make no contribution to the constraint of inflation and that controls are an entirely unwarranted interference with the free market.

The other view is that direct controls are a powerful and ready tool in the fight against inflation and should be a permanent and continuing part of the Government arsenal.

In my judgment, neither view is supportable by experience. Wage and price controls can make an incremental contribution to price stability, or they may cause adverse effects on production, depending on the profile of inflation and the way in which the controls are designed and administered.

Moreover, short-term and longterm consequences should be distinguished. The consequences of controls, for me, are pragmatic in a quantitative manner. For the past year, the evidence and conclusions as to the results of controls have been collected and analyzed on pages 17 to 35 in my prepared statement.

The third question I would like to say a word about is: What about the environment of 1974 and why take off controls and the authority for mandatory controls, which is part of one of the questions you asked, Mr. Chairman.

The first half of the year 1974 gives evidence of being characterized as you have said by severe inflationary pressures from the same fundamental forces that characterized, I think, 1973, except that there is generally expected to develop less pressure on the capacity as the year develops in certain industries.

The table on page A–150 of my prepared statement shows a number of projections on inflation for the first quarter of 1974, generally showing declines in price increases through the year.

These projections—I was asked in another area—are in fact based on the assumption that controls will lapse by April 30, 1974. The economic environment of 1974 will require in many industries and within many firms considerable readjustments because of the substantial energy crisis, temporarily higher adjustments in some instances, permanently higher adjustments in some material like feedstock costs, with a rapid variation for demand of products as well.

For example, the automobile industry made an adjustment to the higher demand for smaller cars and the relative drop in the demand for large cars. The plastics industry faces an acute readjustment to permanently higher costs of feedstock, more than likely.

A number of industries face adjustments toward or away from lower profits, depending on demand and capacity and the conditions.

Large adjustments in transportation costs will require major reviews in many sectors. Long-term capacity decisions are required today in many, many industries. International markets also involve considerable uncertainty at this time.

In these circumstances, it is our considered judgment that the need for flexibility of decisionmaking in industry in the period ahead is of paramount importance to protect jobs and efficiency and that this need overrules incremental contributions that wide spread controls

might make on price stability in the economic environment expected after April 30.

Accordingly, we have recommended that with the exception of a few sectors, controls should lapse. I want to suggest to you, Senator Proxmire, that the decontrol process has not been abrupt or precipitous. It has been spread gradually over 9½ months, since July 18, 1973.

The testimony on page 12 of my prepared statement sets forth the sectors already decontrolled. Since that compilation, the Cost of Living Council has further decontrolled the following sectors: Steel drum reconditioning firms, marine terminal prices, ferrous scrap and nonrubber shoes, and we will continue on this course through the days and weeks ahead.

In the case of all significant sectors, we have sought and received commitments in the public interest as to price, capacity, net sales, and industrial relations procedures. Anyone familiar with the experiences of 1946 or 1952, I think, can contrast our current course with the more disorderly retreat from controls in those earlier periods.

The last group of questions that I am addressing myself to is also one you talked about; namely, the future agency. The main purpose of this brief introduction is to focus attention on the proposed continuing of the Cost of Living Council as described on pages 57 and 58 of my prepared statement.

Most of the proposed activity, we have been doing this year to a limited extent as a part of the mandatory wage and price controls.

The administration's recommendations are based on three fundamental principles. The first is that the Federal Government must have a continuing and deep concern with the rate of inflation.

Even apart from the primary tools of fiscal monetary policy, since wage and price controls are not judged to be effective instruments for restraining inflation in the period ahead, there should be in the Government an institutional focus of concern and activity upon these specific sectors to restrain inflation.

Second, the widespread impact of the Federal Government on particular sectors such as agriculture, construction, and transportation, has significant consequences for inflation. The Government should see that its activities take into account the inflationary potential of its policy. And in these times, public policy should involve supporting legislation to restrain price and wage inflation.

On pages 16 to 18 of my prepared statement, Senator Proxmire, there are listed a number of the supply actions which the Cost of Living Council initiated in this past year. And it is that type of activity that we have in mind, specifically, and that we intend to expand.

Three, the Government can and should use its influence and leadership with private parties and State and local governments to restrain prices and costs and to increase productivity. In some problem areas, such activities involve labor, management, Government advisory committees.

I would like again, Senator Proxmire, to draw attention to the recommendation that the Federal Advisory Committee Act be amended to permit tripartite participation. You will find that on pages 61 and 63 of my prepared statement.

In conclusion, while this prepared statement is long, it spells out the administration's position on the future of controls and the future of the Cost of Living Council after April 30. It may be helpful to try to indicate what the new Cost of Living Council is not proposed to be.

It is not a planning agency since its activities are intended to focus on inflation. Nor is it proposed as another Council of Economic Advisers, or another mediation and dispute agency.

On the other hand, it is more than a price and wage review board in that it regards supply problems and Government actions affecting supply essential to its proposed mandate. And it is more than a cabinet committee on price stability such as was established by President Johnson in 1968 and published studies.

Its main preoccupation is intended to be Government supply actions, or private activities designed to restrain short-term or long-term inflation in problem sectors of our economy.

Finally, apart from monetary and fiscal policy, the recommendations constitute in my view the most practical and effective means for fighting inflation under the economic conditions that now lie ahead. Your description of them I do not quarrel with substantially at all.

While opinions may differ over how best to confront the complex problem of inflation, no one should confuse the proposal to end mandatory wage and price controls to be a lack of concern over inflation.

The recommendations constitute in our judgment the most effective means to restrain inflation in particular sectors in the circumstances that lie ahead.

That concludes my brief remarks that I wrote for myself, Senator Proxmire, to open this up. I would like to introduce for the record a set of wage tables and a general statement on the fundamentals of wage stabilization which I have written and used elsewhere. Thank you.

Senator PROXMIRE. Without objection, it is so ordered.

[The information referred to above for the record and the prepared statement of Mr. Dunlop follow:]

TABLE 1.—CHANGES IN EARNINGS AND COMPENSATION PER HOUR, PRIVATE NONFARM ECONOMY

Period	CPI	Average hourly earnings index, adjusted for overtime and interindustry shifts [1]	Average hourly earnings, unadjusted for overtime and shifts	Compensation per manhour [2]
Year-over-year percentage change:				
1969	5.4	6.7	6.6	7.0
1970	6.0	6.7	5.9	7.3
1971	4.3	7.0	6.5	7.0
1972	3.3	6.3	6.4	6.9
1973	6.2	6.2	6.6	7.6
Percent change from December to December [3]:				
1969	6.1	6.5	6.5	7.0
1970	5.5	6.8	5.8	6.8
1971	3.3	7.0	6.6	6.8
1972	3.4	6.3	6.2	7.1
1973	8.8	6.7	7.2	8.0

[1] Adjusted for overtime (in manufacturing only) and interindustry employment shifts.
[2] Includes wages, salaries and employer contributions to Social Security and fringe benefits.
[3] Compensation per manhour is calculated as 4th quarter over 4th quarter since this series is only published quarterly.

TABLE 2.—CHANGES IN WAGES IN MAJOR COLLECTIVE BARGAINING AGREEMENTS (1,000 WORKERS OR MORE) WITHOUT COLA ADJUSTMENTS AND WITH ESTIMATED COLA ADJUSTMENTS

Period	CPI [1]	Percentage change			
		1st year wage increases in major labor agreements	1st year wage increases in major labor agreements including estimated COLA's	Annual rate of wage change over life of major labor agreements	Annual rate of wage change over life of major labor agreements including estimated COLA's
1970	5.9	11.9	13.0	9.0	10.1
1971	4.3	11.6	12.4	8.1	8.9
1972	3.3	7.3	8.2	6.4	7.3
1973	6.2	5.8	7.6	5.2	7.0

[1] CPI percentage changes are calculated on a 4th quarter over 4th quarter basis.

FUNDAMENTALS OF WAGE STABILIZATION

1. The stabilization of compensation needs to be closely linked with dispute settlement under collective bargaining. In this country the development of wage policy and its implementation in particular cases is not likely to be viable without the use of tripartite machinery. If a wage satbilization program does not enjoy substantial support, participation and acquiescence from labor and management organizations, each work stoppage runs the danger of becoming a strike or lockout against the stabilization program and the government. A viable wage stabilization program requires some arrangement and understanding with labor and management leaders.

The tripartite structure is essential to maintain continuing communications with labor and management, to gather and to analyze the facts on wages, salaries, benefits and other economic conditions, to secure a degree of acceptance of policies and decisions, to correct inevitable mistakes, and to secure constructive attention to both short-term and longer run collective bargaining problems confronting the parties. Moreover, the terms for any continuation of a wage stabilization program need to be reassessed periodically with labor and management representatives, and their views as to the viability of any program deserve the most serious consideration.

2. Constructive and reinforcing relationships need to be established between the wage stabilization agency and the mediation and dispute settling agencies of the government. In the "guidepost" era of the 1960's the relations between Council of Economic Advisers and the mediation agencies have been characterized as often indifferent or hostile. While mediators and arbitrators are understandably more likely to be interested in agreement and settlement outside of wage stabilization standards than in strict compliance with stabilization rules, they are nonetheless concerned with final resolution of disputes rather than continued controversy over stabilization standards. In these circumstances it is possible—and essential—to establish close liaison and working relations between stabilization authorities and mediators so that dispute resolution is more in line with acceptable stabilization limitations.

3. An effective stabilization program cannot be developed by limiting attention to large companies or to collective bargaining agreements covering a thousand or five thousand workers. This view reflects no understanding of the interrelationships among wages or settlements among agreements in the same industry or locality. The higher the level of employment, the tighter labor markets and the more distorted wage relationships have become from traditional patterns, the less valid is the attention exclusively to the large firm or settlement.

In some industries such as construction, newspapers and food retailing small units may set patterns which significantly determine wage decisions in far larger groups. Union rivalries, and at times those of managements or their associations, may produce settlements in small units which are decisive for a whole industry. Indeed, the process of leapfrogging, whipsawing and setting new and higher patterns involves careful attention to wage leaders and followers. Size is often not a decisive determinant of pattern setting, particularly for some items of compensation.

4. Inflationary periods are fundamentally characterized by distortions in traditional or emerging wage and benefit differentials that are perceived by some parties to be inequitable. One craft, occupation, company or industry is found to be markedly higher or lower compared to others to which it has been conventionally compared. The task of wage stabilization is to achieve new and more stable or maintainable wage relationships appropriate to the future state of the labor market or industrial relations. The concepts of "wage inequities" and "appropriate stabilized wage or benefit differentials" among occupations, localities and product markets are at the center of the analysis of the process of wage inflation, the formulation of policy prescriptions, the design of an information system respecting wages and benefits, as well as central to the operations of an administrative agency charged with stabilization responsibilities. Indeed, the definition and restoration (or establishment) of appropriate wage and benefit relationships over some period is the central business of wage stabilization.

At the outset of a wage inflation period, some wage rates and benefits move first and further and others lag. Some collective bargaining agreements are typically fixed in duration with specified increases for two, three or even five years. Other wage rates and benefits under agreements or in the unorganized sectors may be free to move sharply, thereby changing traditional or economically appropriate wage and benefit differentials. The inflationary period may be associated with sharp changes in employment in particular sectors or substantial improvements in current or prospective profits in particular enterprises or in living costs. These changes in wage determinants may result in new wage and benefit levels which become targets for related groups to meet or exceed when other wage decisions are to be made.

The course of the average wage for the economy depends on the way the whole complex of wage rates change. In a decentralized national wage system, particular decisions are made about individual wage rates and benefits or clusters or contours of each. No one makes decisions as to the general wage and benefit level or average level of compensation.

5. The resort to a single number, guideline or formula is an unacceptable basis for wage stabilization. A number such as 3.2 percent or 5.5 percent does not constitute a wage policy.

(a) A single figure becomes a floor at which collective bargaining negotiations tend to start, and employees come to believe that they are at least entitled to that number by grant of the government. Union representatives who settle agreements at such a figure or lower are seen by workers not to have been very effective or not to have done their job well.

(b) Employers or their representatives are tempted in the face of a strike, and too many succumb, to settle for a higher figure and then to argue before the stabilization agency that the agreement they have signed should be reduced. Such experiences are extremely deleterious to responsible collective bargaining in the future.

(c) No single number can be equally appropriate for all circumstances. Indeed, as has been noted, the very nature of inflation is that relative differentials have been distorted, and a single uniform number only perpetuates distortions and inequities rather than moving to correct them. There are high wage and low wage firms, industries and occupations; wage levels range from Alaska to the rural south and northeast. Some employees have had frequent increases in the past, while others have not had adjustments for a number of years. The Labor-Management Advisory Committee statement of February 26, 1973 expressed the view that "No single standard or wage settlement can be equally applicable at one time to all parties in an economy so large, decentralized and dynamic."

(d) There is no simple or uniform means of valuing complex fringe benefits such as pensions which is equally applicable to all firms with different age distributions, work experience and employee populations and which provides a basis to define permissible increases in these divergent circumstances. The form and associated regulations of the stabilization program have created a complex pricing mechanism for wage and salary and fringe benefits which is quite different from the common practice of collective bargaining and personnel policies; they impose a single uniform concept and measurement across all industry. A stabilization program rather needs to define separable standards for many separate benefits, bearing in mind industry and locality practice as well as national experience.

6. One of the most complex problems for a wage stabilization program concerns the assessment of complex work rules, working conditions or other economic conditions of the working place outside of wages, salaries and benefits. The problems of appraisal arise either when changes are made more favorable to the worker (less favorable to the management) or when they are more favorable to the management (less favorable to the workers). An absolute and single ceiling on wages and benefits may encourage union negotiators to seek more leisure on the job or more favorable (and more costly) working conditions. Few stabilization programs have been able to deal with such questions. On the other hand, less stringent working rules for management, which lower costs, tend to create demands for higher wage and benefit levels. While these productivity changes are often difficult to measure and to evaluate, their most serious problem is that compensating wage and benefit increases may spread to other related employees who have not made the same productivity and cost-saving adjustments.

7. A wage stabilization program must be addressed not alone to organized employees, but should also apply to wages, salaries and benefits of employees not covered by collective bargaining as well as to executive compensation. A wage stabilization program should apply to public as well as to private employment. A wage stabilization program needs to be comprehensive not merely on general grounds of equity, but also because wages, salaries and benefits of different groups of employees are in fact interrelated and impact on each other. This view should not preclude the development of particular stabilization programs for particular industries or sectors.

8. The use of a fixed dollar low-wage standard, particularly when mandated by law, raises complex problems for a stabilization program. The issue is not whether certain low-wage job classifications should be permitted relative freedom to be increased, but whether a single number (such as $3.50) is equally applicable to all localities and regions of the country and to all industry groups. In some circumstances almost the whole wage structure is below a specified number while in others only a few occupations or employees are below the single figure. A relatively low wage for laborers in the construction industry in a rural state may be much higher than the bottom end of a distribution in the garment industry in New York; each may deserve attention under a stabilization program on grounds of being "below standard," and not exert any undue upward pressure on other wages, quite apart from any figure used uniformly across the country for all industries and localities. Both the parties and stabilization authorities need to consider the internal integrity of the particular wage structure through which a substandard criteria cuts and the consequences of any increases on grounds of substandard on other wages in the same or related establishments. All this cannot readily be compressed into a single uniform figure for all localities and industries.

9. Every wage stabilization program operative over a period of years becomes prey to experienced parties who find it possible to circumvent the regulations and achieve substantially larger increases than intended by the program. The greater the degree of self-administration in the program and the greater the resort to general regulations (as distinct from case-by-case processing), the more likely such gamesmanship. The automobile settlements of 1973 are illustrative where the pricing of cost-of-living escalator clauses, the exclusion of the higher costs of specified or fixed health and other benefits, and the carry-forward of qualified benefits from the previous two years—all strictly in accordance with the regulations—resulted in wage and benefit increases in excess of 5.5 or 6.2 percent.

10. One of the fundamentals of wage stabilization concerns the conditions of the wage level and structure necessary to eliminate controls. If controls are eliminated with considerable distortions and inequities remaining in the wage structure, then the chances are high for further wage induced increases as groups seek to restore or to enhance their relative positions. If wage and benefit differentials are in relative balance, as they appear to be at the end of 1973, then the prospects for substantial increases to correct perceived inequities are much less. Further, if the general state of industrial relations is relatively peaceful, as appears to be the case in 1973, the prospects for wage distortions and further inflation is small, arising from prolonged and bitter strife.

However, substantial wage changes may arrive on decontrol from other factors influential in wage setting, such as increases in living costs, profits and the extent of tightness in labor markets. The development of these factors in 1973 poses problems for wage and benefit levels in 1974.

PREPARED
STATEMENT OF JOHN T. DUNLOP

DIRECTOR, COST OF LIVING COUNCIL

BEFORE

THE JOINT ECONOMIC COMMITTEE

FEBRUARY 19, 1974

Mr. Chairman, I am happy to have the opportunity today to review the Economic Stabilization Program. In order to be of the most help to this Committee, this statement is rather comprehensive and contains a number of appendices. I intend to present orally only parts of the statement and to summarize others; accordingly, I request that the entire statement, with attachments, be included in the record.

The statement is divided into four major sections.

First, it briefly reviews the major wage and price developments of 1973 and relates them to the Economic Stabilization Program.

Second, it reports on the consequences of the wage and price stabilization efforts in 1973, including:

(a) the economic effects of controls,

(b) the problems -- both alleged and real -- that were created by the program,

(c) the changing perceptions of consumers, business and labor during the course of the year with respect to the effects of the program.

Third, the statement briefly summarizes some major principles learned from current wage and price controls, as well as from earlier incomes policy experiments in the United States and in Western Europe.

Fourth, the statement addresses the future: the state of the economy ahead, alternative legislative approaches for the period after April 30, 1974 and recommendations for legislation for this Committee to take under consideration.

This statement makes reference to the various pages of the appendices which include further statistical information or elaboration of information only mentioned or summarized briefly in the main text. The Cost of Living Council stands ready to provide additional factual material that the Committee may request for its deliberations.

I. 1973 IN RESTROSPECT

The following basic points emerge from a review of the economic developments of the year as they relate to wage and price controls:

- 1973 was a most unusual year in economic terms, with with rapid inflation, which was largely unforeseen and unexpected by all analysts.
- The inflation was world wide, reflecting a surge in demand which particularly affected primary materials prices.
- Domestic prices increased in part because of exchange rate changes.

- Approximately two-thirds of the inflation was concentrated in food and energy despite the fact that these parts of the economy were under even more stringent price controls than in Phase II.
- One should distinguish between stabilization measures that seek to constrain inflation through wage and price controls, and measures that are designed directly to increase supply and capacity.

A Year of Surprises

In retrospect 1973 was a most unusual year in economic terms. As everyone now knows, the year saw rapid inflation unmatched since the end of World War I, except for the period immediately after World War II (1946-48) and the outbreak of the Korean War (1950-51). Wholesale prices were 18.2 percent higher in December, 1973 compared to December, 1972 and the Consumer Price Index increased 8.8 percent in the same period. (The WPI increase for the average of 1973 over the average of 1972 was 13.8 percent and the average CPI increase was 6.2 percent.)

These price increases were the more disturbing since they were largely unforeseen and unexpected by all analysts regardless of economic or political persuasion. Both government and private forecasters were projecting 1973 inflation in the GNP deflator of about 3 percent.[1] None of the forecasters came close to anticipating what actually happened. The GNP deflator actually increased 5.3 percent.

1/ Appendix A, Pg A-1 shows the 1973 forecasts of a large number of economists and econometric models.

The year has raised the most serious questions as to the adequacy of economic data and methods of analysis and forecasting, particularly with respect to prices. As the incoming President of the American Economic Association, Professor Walter Heller said[2], "Economists are distinctly in a period of re-examination. The energy crisis caught us with our parameters down. The food crisis caught us, too. This was a year of infamy in inflation forecasting."

For me the year has reinforced the limitations of aggregate economic tools and has emphasized the validity of the view that detailed data and analysis of separate sectors and markets are essential to understanding and forecasting, and even more vital to economic policy making, certainly in the peculiar economic environment of 1973-74.

The forecasts of food prices are illustrative of the extent to which price increases were unexpected. For example, on February 13, 1973 the Department of Agriculture stated that retail food prices for 1973 would average around 6 percent above 1972, and on May 8 it stated that "prices may average 9 percent above 1972." The actual year over year increase in retail food prices, including food at home and food away from home, was 14.5 percent. The December 1973 figure was

2/ Quoted in Washington Post, January 3, 1974, p. A-24.

20.1 percent over December 1972. The record of most other farm price forecasters was no better.

During the year, the Cost of Living Council strongly urged that we examine critically this shortfall in prediction to see what could be learned as to technical methods and administrative arrangements to improve the quality of agricultural forecasting in the future. A careful review has been made and a number of measures already have been taken including bringing other agencies into the quarterly outlook review sessions, improving the methods of estimating livestock numbers and an overall review of forecasting techniques.

The most important single source of the underestimation in 1973 was the failure adequately to relate the United States economy to the world economy, particularly when large agricultural stockpiles no longer served as a buffer. It must be recognized, however, that some uncertainties in food price forecasting will always remain as a result of weather, disease and the like.

International Commodity Inflation

After the first quarter of 1973 it became reasonably clear that the entire Western world was facing a major inflation in primary product prices. This development was related to the very high levels of output in Japan, Western Europe and the United States in 1973. The rapid rate of increase in output was itself an independent factor creating

inflationary repercussions since there was less time to adjust to high output levels. Special factors, including weather, reduced the output and the stock of agricultural commodities. The devaluation of the dollar and its further decline in international markets in the early months of the year accelerated the dollar price inflation in primary commodities.

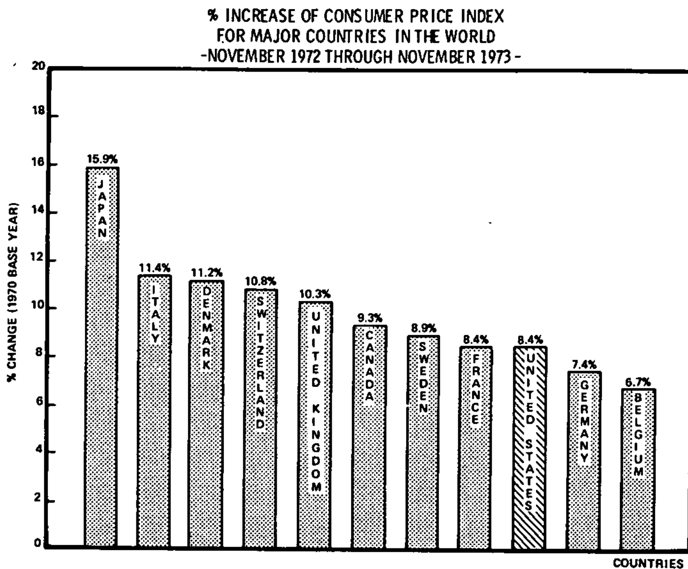
The *Economist* index of world commodity prices in dollars increased 46.2 percent for all items in the year ending January 2, 1974. Food prices rose 38.6 percent, fibers 21.3 percent and metals 86.7 percent in the same period. [3]

In the United States, food and energy prices alone accounted for 68 percent of the increase in the WPI and 62.8 percent of the increase in the CPI. The WPI for the United States for Fuels and Related Products and Power rose 65.1 percent in the period December 1972 to December 1973. With a weight of 7.1 percent in the WPI these prices contributed 25.5 percent to the change in the WPI, or more than three times their normal share. [4]

3. Appendix B, Pg. A-2 contains a series of graphs which show the steep increase in world commodity prices.

4. Appendix C, Pg. A-14 shows the relative contributions of various sectors to increases in the CPI and WPI.

It should be noted, however, that the worldwide inflation in primary products was associated in 1973 with a lesser rate of inflation in consumer prices in the United States than in most other advanced industrial countries. The petroleum crisis may be expected to have an even greater relative effect in other countries. The following chart reflects changes in the CPI in the past year for various countries.



The inflation of 1973 was further perplexing since large parts of the economy, particularly the important sectors of food and petroleum, were under mandatory price controls through virtually the entire year. Moreover, these controls were more strict than the regulations of Phase II.

The year compels reflection on the inherent limitations of direct wage and price controls to deal with the virulent commodity inflation experienced in 1973. The perspective of the year also renders ludicrous the often repeated view of the early months that inflation could be curbed if only the "stick" were to be taken from the "closet" and applied to inflationary sectors or if the rules were made more stringent.

Stabilization Principles and Actions During 1973

A review of 1973 reveals a series of major themes which characterized price and wage policies under the Economic Stabilization Program over this period. These themes remained despite the change in form of the price regulations--an initial period of self-administration (Phase III), a second freeze, a period of tough mandatory controls after July 18, 1973 (Phase IV). 5/

Price Stabilization Themes During 1973

On the price side, our actions reflected the following basic tenets:

- Recognition from the outset that certain sectors, notably food, health, construction and petroleum

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5. Appendix D, Pg A-16 contains a more detailed review of specific actions taken during 1973 by the Economic Stabilization Program.

required special attention and regulation in 1973. [6]

- Mobilization of government activity to encourage larger supply and greater capacity.
- A constraint on profit margins. [7]
- A general limitation that price increases should be no greater than cost increases actually incurred, reduced for increased labor productivity.
- Price increases, even when fully cost justified, should be delayed to "spread the bulge" of the impact of primary commodity price increases. The principal means for creating such lags were a thirty day prenotification period and the requirement that costs must be fully incurred before prenotification. This prenotification process typically caused a lag in price increases of from 60 to 90 days. The coverage of these rules was extended from firms with $250 million in sales during Phase III to include firms with over $100 million in sales.
- Some cost justified price increases should be prohibited when they would yield prices which were judged to be unreasonably inconsistent with stabilization

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6. Appendix E, Pg A-41 demonstrates that increases in the CPI were not significantly related to the change from Phase II to Phase III.

7. Appendix F, Pg A-42 shows the variations in profits before taxes as a percentage of sales and in relation to equity for all two-digit manufacturing industries.

goals -- too much too soon. Section 150.154(c)[8] in the regulations was used to preclude some increases under these circumstances. These reserve powers provided a basis for significant decisions in the steel, rubber tire and automobile industries.

- Some price increases should be allowed even though they would not be fully cost justified. Price increases in aluminum and copper were allowed above cost justification because of the need to retain products in this country and to reduce the flow of domestically needed supplies into exports. In other cases higher prices were necessary to encourage increased domestic supply and capacity, such as in cement and fertilizer.
- Some domestic prices should be allowed to approach world prices for internationally traded primary commodities, such as food grains, feed grains, oilseed products, nonferrous metals, cotton, wool and scrap.
- Simplicity and fairness are both required. A desire for a single set of regulations generally applicable to all enterprises should be mitigated

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8. Section 150.154(c): "The Council may issue an order deferring a price increase, in whole or in part, if it finds that proposed price increase is of such magnitude and would have such an impact upon the economy as to be unreasonably inconsistent with the goals of the Economic Stabilization Program."

by the need for more specific, realistic rules in separate sectors of the economy such as insurance, health, construction, wholesale and retail trade and food. In addition, some firms were granted exceptions because gross hardship or inequity would have resulted from adherence to the general regulations.[9/]

- Gradual elimination of controls on a sector-by-sector basis should begin. Prices and wages typically have been decontrolled together. In the decontrol of a sector, the Cost of Living Council, as a matter of policy, has sought appropriate commitments as to the course of future prices and increased capacity. The tables below outline these exemptions. Twenty-eight percent of the CPI and 56.7 percent of the WPI are currently

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9. Of the exceptions sought during Phase IV through December 31, 1973, twenty-one percent wanted increases in prices absent the necessary cost-justification; another fifteen percent needed adjusted base period profit margins. Other grounds for exception were requests for: price relief to ensure that short supply items would generate sufficient return on investment to make continued production worthwhile; alteration of base price or base cost period; immediate cost pass-through without waiting the required thirty days; alteration of base price or base cost period; immediate cost pass-through without waiting the required thirty days; relief from Special Rule #1, (steel sheet and strip); and requests for separate treatment of loss divisions or subsidiaries to permit greater price increases.

covered by the program, compared to 47.7 percent and 73.9 percent respectively at the beginning of 1973.

Phase IV Exemptions

Sector	Date Exempted	Sector	Date
Copper Scrap	July 26, 1973	Aviation Insurance (Passenger Hazard)	Dec 28, 1973
Long Term Coal Contracts	Aug 12, 1973	Broomcorn Brooms	Dec 28, 1973
Lumber (Certain SIC's)	Aug 12, 1973	Camps	Dec 28, 1973
Public Utilities	Aug 12, 1973	Manufactured Animal Feeds	Dec 28, 1973
Fertilizer & Fertilizer Mat.	Oct 25, 1973	Mobile Homes	Jan 21, 1974
Stripper Wells	Nov 21, 1973	Recreational Vehicles	Jan 21, 1974
Cement	Nov 27, 1973	Semiconductors, Transistors, Integrated Circuits	Jan 21, 1974
Honey	Nov 27, 1973	Steel manufacturing operations with less than $50 million in annual sales.	Jan 25, 1974
Alfalfa Pellets	Nov 27, 1973	Tax Exempt Organizations	Jan 25, 1974
Workshops for the Blind	Nov 28, 1973	Petrochemical Feedstocks	Jan 30, 1974
Lead, Zinc, Tin, Ferronickel and Less Nonferrous Metals	Dec 6, 1973	Tires and Tubes	Jan 30, 1974
Motor Vehicles	Dec 10, 1973	Retail Trade	Feb 1, 1974

SUMMARY OF COVERAGE AND EXEMPTIONS STATUS OF THE ECONOMY DURING PHASES II, III, AND IV

	PHASE II on Jan. 1, 1973		PHASE III on June 1, 1973		PHASE IV on Sept. 10, 1973		PHASE IV on Feb. 6, 1974	
	%Covered	%Exempt	%Covered*	%Exempt	%Covered	%Exempt	%Covered	%Exempt
Consumer Price Index	47.7%	52.3%	42.6%	57.4%	42.6%	57.4%	28.0%	72.0%
Wholesale Price Index	73.9%	26.1%	73.9%	26.1%	69.4%	30.6%	56.7%	43.3%
Labor Force (Wages and Salary)	46.0%	54.0%	44.1%	55.9%	44.1%	55.9%	37.9%	62.1%

*Includes mandatory and self-administered coverage during Phase II

Source: Cost of Living Council
February, 1974

Wage Stabilization Themes During 1973

Now, I would like to turn to the themes that have characterized wage stabilization in 1973.

- Stabilization efforts should be closely linked to the collective bargaining process. The statement of the

Labor-Management Advisory Committee of February 26, 1973 provides an expression of that interrelationship.[10/] If a wage stabilization program does not enjoy substantial support, participation or acquiescence from labor and management organizations, each work stoppage runs the danger of becoming a strike or lockout against the stabilization program and the government -- as we have witnessed in Britain.

- Tripartite machinery should be used to maintain continuing communications with labor and management, to analyze wages, salaries, benefits and other economic conditions; to secure a degree of acceptance of policies and decisions; to correct inevitable mistakes; and to secure constructive action on both short-term and longer-run collective bargaining problems confronting the parties. A tripartite Food Industry Wage and Salary Committee and a tripartite Health Industry Wage and Salary Committee were established to assist the Council in these critical industries.[11/] The Construction Industry Stabilization Committee, established on March 29, 1971 before the Cost of Living Council, is continuing its operations.

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10. Appendix G Pg A-67 contains the complete text of the statement.
11. At the end of the statement there is a brief note which highlights the basic incompatibility of the provisions of the Advisory Committee Act and the requirements of tripartite committees.

- Constructive and reinforcing relationships should be established between our wage stabilization efforts and the mediation and dispute settling agencies of the government. While mediators and arbitrators understandably are more likely to be interested in agreement and settlement than in strict compliance with stabilization rules, they are nonetheless concerned with final resolution of disputes rather than continued controversy over whether settlements conform with stabilization standards. Close informal relationships with Federal Mediation and Conciliation Service staff made it possible for the wage stabilization effort to proceed with full knowledge of the course of collective bargaining on key contracts. These ties also made it possible for those engaged in negotiation to be aware of the impact that stabilization policy ultimately might have on the results of their efforts.
- The Construction Industry Stabilization Committee should reflect not merely concern with improving industrial peace and moderating the once very high rates of increase of wages and benefits in this industry, but also should evoke a deep concern and involvement in assisting the parties to improve the long-term performance of collective bargaining. This Committee has stimulated the adoption of new dispute settling machinery in branches of the industry,

has broadened the geographical structure of bargaining where appropriate, has introduced differential rates for specialized branches of the industry such as housing and has reviewed work rules and improved productivity with due regard to the interests of workers and contractors. 12/

- Considerable attention should be devoted to the achievement of new, more stable and maintainable wage relationships appropriate to the future stability of labor markets and industrial relations. Distortions in traditional or emerging wage and benefit differentials which are perceived by some parties to be inequitable are characteristic of inflationary periods.
- A single number, guideline or formula cannot be the basis for wage stabilization. In the words of the Labor-Management Advisory Committee: "No single standard or wage settlement can be equally applicable at one time to all parties in an economy so large, decentralized and dynamic." In fact, a single number tends to become a floor at which collective bargaining negotiations start, and employers are tempted in the face of a strike to settle for a higher figure in the hopes that the stabilization agency will subsequently reduce it. Further, there is no simple way of valuing complex fringe benefits that is applicable to all firms and industries.

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12. Appendix H. Pg A-69 contains a complete text of the statement of policy for 1973.

- The wage stabilization program should be applied to wages, salaries and benefits of nonunion employees, as well as to collective agreements.
- A stable climate within which controls could be eliminated should be created. If controls are eliminated when many distortions and inequities remain in the wage structure, the chances are high for further wage-induced inflation as groups seek to restore or enhance their relative positions.
- Executive compensation regulations should be consonant with the rest of the wage and salary stabilization program. The regulations were revised to accomplish this purpose.

The period of stabilization has also been characterized as one of labor peace. Although the number of work stoppages has increased (in part attributable to the greater number of contract expirations with shorter-term agreements), the incidence of work stoppages has declined, so that in those terms 1973 was the best year in the past ten.[13]

A summary of the operations of the Economic Stabilization Program in both the price and wage areas -- price prenotifications by industry, case load, compliance and enforcement activities and the like -- is contained in Appendix J, Pg. A-73.

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13. Appendix I, Pg A-72 shows both the number of idle man days and idle man days as a percent of total workdays. Idle man days as a percent of total days worked declined in 1973 from 1972.

II. RESULTS OF THE CONTROLS PROGRAM

The second major part of this statement concerns the results of the Economic Stabilization Program. As indicated at the outset, the results of the program can be assessed in terms of the effects on prices and wages, the problems that have resulted from the economic controls and the changing perceptions of the public, business and labor.

Effects of Controls on Prices and Wages

It is not easy to specify the consequences of direct controls on the movement of wages and prices because it is impossible to know precisely how they would have moved in the absence of controls. There are wide differences of view as to the independent effects of controls: some believe controls have had no perceptible effect while others seem to think that direct controls can and do significantly constrain the rate of inflation. Still others urge that while controls may have a short-term restraining influence, wages and prices tend to bounce back in a short time to levels they would have achieved without controls.

A simple comparison of wage and price movements before controls and under controls, or during two different periods of controls, does not constitute an appropriate appraisal of the impact of controls. The fact that consumer prices rose at the annual rate of 4.5 percent in the year before August, 1971 and at the annual rate of 3.2 percent from August, 1971 to December, 1972 does not constitute an acceptable basis

for judging the effectiveness of Phase I and Phase II controls in reducing the rate of inflation. The relevant question is what prices would have done without controls. Similarly, the CPI rose 8.8 percent from December, 1972 to December, 1973 compared to 3.4 percent in the preceding year. Only the most careful and sophisticated analysis could suggest whether the independent impact of controls was more or less effective in Phases III and IV compared to the earlier stages of the controls program.

Effects of Controls on Particular Sectors

It is nonetheless possible to make some informed judgments about the effects of controls on particular sectors of the economy on the basis of detailed knowledge of these sectors.

Construction

The particular form of the present controls program in the construction field has probably had a significant restraining influence. First year collective bargaining agreements in construction were increasing at the rate of 17 percent in 1970. With the advent of controls on March 29, 1971 the rate of increase dropped to 10 to 11 percent in 1971. Wage rates and fringe benefits increased at the still lower rates of 5.8 percent in 1972 and 5.4 percent in 1973. The rate of work stoppages dropped from one out of every three negotiations in 1970, to one out of six in 1971, to one out of eight in 1972 and to one out of sixteen in 1973. While these figures do not prove that controls made a contribution, detailed knowledge of the factors

influencing wages in that industry, in the environment of 1971-73, suggests that it is difficult to explain these results in terms other than the contribution of the particular stabilization program designed for that industry.[14]

Health Care

In the health care field controls probably restrained the rate of price increases.[15] The average annual increases in the medical items in the consumer price index which had ranged between 6.3 and 7.1 percent a year in the period 1967-71, averaged an annual rate of 3.4 percent in the period November 1971, to January, 1973. The rate of increase in semi-private room rates in hospitals, which increased 19.8 percent in 1967 and in the range of 12-14 percent in the period 1968-71, dropped to 5.4 percent under the controls program. Expenses per admission dropped from increases of 14.4 percent in 1966-69 to 11.6 percent in 1969-71, to 8.9 percent in 1972 and to 7.4 percent in 1973. While these measures are not conclusive, they support the judgment, based on knowledge of the health care sector, that controls have constrained cost increases.[16]

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14. D. Q. Mills has estimated that the program reduced the rate of annual increase in wage rates and benefits in the construction industry by 2.5 percentage points. See, "Research Note: Explaining Average Earnings Increases in Construction: 1953-72." (Unpublished paper)

15. Stuart Altman, "Control of Hospital Costs Under the Economic Stabilization Program," Federal Register, Vol. 39, No. 16, January 23, 1974, pp. 2693-2701.

16. Appendix K, Pg A-85 discusses the cost structure of the health care industry and reviews price increases since 1960.

Food

In contrast with the health and construction industries, price controls probably have had a very limited impact on food prices in Phases II, III and IV of the Stabilization Program. Widespread compliance with the dollar and cents cost pass-through regulations of Phase IV provides considerable evidence that despite the effectiveness of controls in accomplishing what they were designed to do, namely, to restrict markups and profit margins of manufacturers and retailers in the food industry, the food price inflation of 1973 was caused by factors beyond the control of the regulations.

Consumer food prices accelerated from annual rates of increase of 3.0% in 1971 and 4.3% in 1972 to an unprecedented rate of 14.5% in 1973. The overwhelming cause of the sharp rise was a 36% increase in agricultural prices at the farm level in 1973. Farm prices have been exempt from controls throughout the stabilization program. The major factors accounting for the rapid increase in farm prices were the devaluation of the dollar, which contributed to the 88 percent increase in the value of agricultural exports in 1973, and the reduction in the volume of food marketed in the United States in 1973. As a consequence, the share of the retail food dollar going to the farmer jumped from 40 to 45% in 1973, and the income of farm proprietors rose 32.7 percent compared to 11.9 percent for total national income during 1973. 17/

17/ Appendix L, Pg. A-94 shows the historical relationship of farm income to national income and as a percent of market value.

Another way of specifying the impact of the controls program on food prices in 1973 is to examine the breakdown of the $18 billion rise in consumer food expenditures last year. Approximately two-thirds of this additional $18 billion went directly to the farm operator. This breakdown is even more pronounced in the most troublesome sector in food in 1973--beef--where 88 percent of the rise in expenditures went to feedlot operators and cattle ranchers.

The $6 billion increase that went to food processors and distributors was used almost exclusively to cover higher costs incurred for components such as packaging materials, transportation, and wages. After deducting for higher costs and taxes, corporate profits in the food industry rose by $100 million, less than 2 percent of the rise in the marketing bill ($6 billion) and about one half of one percent of the increase in consumer food expenditures.

Effects of Controls on Wages and Benefits

The following table reflects the stabilization of wage rates and benefits in major collective bargaining agreements in 1973 compared to each of the preceding three years. Other measures of wages, such as average hourly earnings or labor compensation per hour, reflected other influences but also showed the impact of the stabilization program. 18/

18. Appendix M, Pg. A-96 shows three month changes in the average hourly earnings index. See Economic Report of the President, February, 1974, Pg. 102-3.

PERCENTAGE CHANGES IN WAGES AND BENEFITS
MAJOR COLLECTIVE BARGAINING AGREEMENTS
AVERAGE ADJUSTMENTS: 1970, 1971, 1972, 1973
(CONTRACTS COVERING 1000 WORKERS
OR MORE) 1/

	AVERAGE ADJUSTMENTS			
	-1970-	-1971-	-1972-	-1973-
1. WAGE RATES ALONE (1000 workers or more)				
a) First year changes in-				
All industries..........................	11.9	11.6	7.3	5.8
Manufacturing...........................	8.1	10.9	6.6	5.9
Nonmanufacturing........................	15.2	12.2	7.8	5.6
Construction 2/.........................	17.6	12.6	6.9	5.2
b) Annual Rate of Change Over Life of Contract in-				
All industries..........................	9.0	8.1	6.4	5.2
Manufacturing...........................	6.0	7.3	5.6	4.9
Nonmanufacturing........................	11.6	8.9	6.9	5.4
Construction 2/.........................	14.9	10.8	6.0	5.2
2. WAGES AND BENEFITS COMBINED (5000 workers or more)				
a) First year changes in-				
All industries..........................	13.1	13.1	8.5	7.1
Construction 2/.........................	19.6	14.1	7.5	5.9
b) Annual Rate of Change Over Life of Contract in-				
All industries..........................	9.1	8.8	7.4	6.1
Construction 2/.........................	15.6	12.0	6.6	5.5

1/ Possible changes in wages resulting from cost-of-living escalator adjustments (except those guaranteed in the contracts) are omitted from all the tables.
2/ None of the settlements tabulated contained an escalator clause.

Econometric Studies of Controls and Results

A number of studies have been made in an effort to compare the actual course of wages and prices during the period of controls with the course expected on the basis of previous historical relationships between economic variables. While there are differences in the scope and methods of these studies, they constitute systematic efforts to assess the separate contribution of controls. 19/

The conclusions of these studies also differ, at least in emphasis, but in general they suggest that controls may have reduced the increase in prices by one or two percentage points by the end of 1972 and that the impact of controls on wages was smaller. 20/

19. Appendix N. Pg. A-97 lists these studies and discusses them in more detail.

20. Two assessments by analysts who were intimately involved in the program are illustrative:

"Virtually all econometric models used to appraise Phase II, including our own research, indicate that during the six quarters of controls there were: (1) an average reduction in the annual rate of inflation (at the aggregate, final consumption level) of about 2 percentage points; and (2) a small or (ambiguous) alteration in the rate of change in wages." Robert F. Lanzillotti and Blaine Roberts, "The Legacy of Phase II: An Inside View of Controls," a paper presented to the American Economic Association annual meetings, December 1973.

Daniel J. B. Mitchell and Arnold R. Weber in "Wages and the Pay Board," a paper presented at the same time, appear to regard the wage estimate to be too low. "But it is known that despite their extensive coverage, Phase II wage controls were most heavily focused on new union adjustments...Thus the econometric approach tends to lose the impact amidst the general 'noise' which characterizes all economic data series."

The effects of controls on prices were reported to be largely concentrated in the services and retail trade sectors of the economy with little or no effects on the rate of price increase during Phase II in the manufacturing sector.

At the request of the Cost of Living Council several recent studies have been made to appraise the impact of the wage and price controls program through 1973. The Wharton group advised that their simulation suggested that wages increased at a rate below what they otherwise would have increased by 1.3 percentage points and consumer prices increased at a rate lower than they would have without controls by 1.0 percentage points. A study based on the Federal Reserve Board, MIT, Penn Model concluded that by early 1973 the controls program had depressed non-farm prices 2.3 percent below what they otherwise would have been, and this effect was maintained through 1973. A study by Paul H. Earl using DRI models, on the other hand, suggested that wage and price controls have had no significant impact on dampening inflation.

This hearing is not the place to appraise such econometric studies, but it is important to report the range of effects of controls on wages and prices estimated by these professional simulations. Most citizens, in my view, are likely to be surprised at the small impact estimated for controls, since August, 1971.

Other Effects

These statistical studies, it may be argued, tend to underestimate the impact of controls in several ways. Controls may tend to reduce the extent of inflationary psychology. Further, by providing for much more "orderly" movements, and by preventing substantial distortions in relative wages, and to a lesser extent in relative prices, controls tend to reduce the tendency of inflationary movements, once under way, to feed on themselves. On the other hand, some part of the estimated effects of controls could represent only a temporary suppression of inflation.

Any appraisal of the impact of controls must also consider the effects upon other governmental policies, particularly monetary and fiscal policy. It may be argued that controls allowed a more expansive fiscal and monetary policy than otherwise would have occurred. Robert J. Gordon has held that in Phase I and Phase II nominal GNP rose about 1.85 percent faster under controls than it would have without controls. "Thus the controls have provided a boost to real output growth..."21/

On the other hand, it may be argued that the presence of controls contributed to a greater fiscal stimulus through Congressional appropriations than was appropriate.

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21. Robert J. Gordon, "Wage Price Controls and the Shifting Phillips Curve," Brookings Papers on Economic Activity (2/19/72), Pg. 412.

Cost of Controls

In any full balance sheet on controls, an estimate should also be made of the administrative costs to government, to industry and to collective bargaining parties. The outlays of the federal government on controls have been at the annual rate of about $100 million a year, with Phase II a little more expensive and Phase III less expensive.22/ Several studies of the costs to business of complying with the regulations have produced estimates between $721 million and $2 billion a year.23/

Industrial Relations

There are, of course, longer term costs of a controls program which need to be assessed. In the collective bargaining area my deepest concern is over the effects of controls upon the habits of mind and responsibilities of labor and management. It has been far too easy for some managements to sign agreements they know are inappropriate to avoid a strike and then to go around and seek to have the stabilization agency reduce the settlement. Such tactics are extremely deleterious to long term collective bargaining. Some unions have likewise presented issues to the stabilization agencies rather than face the problems directly. Since wage stabilization agencies have been genuinely tripartite, where collective bargaining agreements are involved this past year, we have sought to guard against such

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22. Appendix O, Pg. A-106 shows the annualized cost to the federal government for implementing the Economic Stabilization Program.

23. Appendix P, Pg. A-108 shows the results of various studies by NAM, Battelle and the Economic Stabilization Program IRS Industry Monitors.

dangers. Moreover, every effort has been made to contribute to the long-run development of constructive industrial relations as in the food, construction, health and cement industries by helping the parties to work on their persistent problems.

IMPACT OF CONTROLS

There are also potential short and long-run costs of price controls on output of particular products, and capacity expansion. Most business leaders and their spokesmen argue that price controls have now introduced something called serious "distortions" and shortages into the American economy. (Parenthetically, most seem less concerned about the adverse effects of wage controls.) As the NAM Survey on Wage and Price Controls concluded, "Controls have shown themselves in practice even more damaging and disruptive than the committed pessimist might have imagined ... Wage and price controls have succeeded in eroding the sound foundation on which the world's strongest economy rests ... Our conclusion, then, is a very simple one: Controls have caused tremendous disruptions and dislocations; controls have not only failed to contain inflation, they have helped to fuel its fires."[24/]

It is difficult to discern the truth in this matter. It is understandable that no business executive relished more constraints on his freedom of action already restricted by many internal and external forces. The resentment is greater when these constraints come from

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24. NAM Survey on Wage and Price Controls, December 21, 1973, Pg. 37.

government bureaucrats with complex and changing regulations that do not well suit any particular business. It is also understandable that, in the absence of controls, prices in a sector would be higher and complaints might be focused more on prices and profiteering than on the difficulty of securing output.

There are, however, many short and longer term forces at work in the economy putting pressures upon business -- forces that have little or nothing to do with controls. For example, enterprises often shift inputs from less profitable to more profitable products as economic conditions change. Output and capacity are short in many areas simply because new plant and equipment expansion was not undertaken before controls were imposed. The charge that Phase IV price controls have seriously discouraged corporate capital investment appears largely unsubstantiated by statistics reflecting capital expenditures and appropriations.[25/] The following table shows that net investment in the United States in the years before 1970 represented a much lower fraction of gross national product than in other industrial countries during the same period. Therein lies the main cause of the lack of capacity today rather than in the effects of recent controls.

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25. Appendix Q, Pg. A-110 provides a more detailed analysis of particular areas where controls are alleged to have induced distortions.

Net Domestic Investment* and as Percent of GNP
(Millions of U.S. Dollars)

Country	1950		1955		1960		1965		1970	
	Amount	1%	Amount	1%	Amount	1%	Amount	1%	Amount	1%
United States	$32,843	11.4	$35,626	8.8	$36,835	7.2	$52,093	7.5	$61,645	6.2
Canada	1,866	11.0	2,865	10.6	3,789	10.4	6,294	13.0	7,981	10.5
Japan	N.A.	-	2,539	10.6	8,589	20.0	16,010	18.2	42,928	21.6
United Kingdom	2,075	5.6	3,800	7.1	6,075	23.6	10,017	27.9	11,319	9.3
Germany	1,919 1/	8.2	6,128 1/	14.3	10,640	15.0	17,933	15.9	29,317	15.7
France	1,846	6.5	4,166	8.6	7,032	11.4	14,241	14.3	22,982	15.5
Netherlands	513	10.3	1,058	13.4	1,635	14.4	3,039	15.8	5,579	17.7
Italy	N.A.	-	2,895	12.0	4,749	13.5	6,032	10.2	11,767	12.6
Sweden	1,115 2/	19.3 2/	1,857 2/	20.3 2/	1,653	12.7	2,945	14.3	4,071	13.2
Belgium	N.A.	-	695	7.6	1,013	8.8	2,131	12.5	3,237	12.5

Office of the Secretary of the Treasury
Office of Tax Analysis

March 27, 1973

* Figure obtained by subtracting "depreciation and other operating provisions" from "gross domestic fixed asset formation".

1/ Excludes the Saar and West Berlin.

2/ Amount of "depreciation and other operating provisions" not available making amount and percentage larger than in actuality.

Source: OECD, National Accounts of OECD Countries.

Higher oil prices and shortages also have temporarily, and in some cases more permanently, reduced capacity and changed the flow of materials.

I would be the first to agree that wage and price controls are capable of creating, and have in fact in some instances created, counter-productive dislocations in economic activity. For instance, the profit margin rule may encourage an unnecessary expense including some wage increases, to avoid going over base period profits. The approach of the end of a fiscal year may lead to the temporary withholding of goods from a market to escape violation of the profit margin rule. Or, a domestic price constraint may lead to the stimulus of exports at higher prices, thereby creating domestic shortages. Or, previously low profit items, which were marginally produced with available materials, may be discontinued when controls preclude price increases greater than costs. Or, price ceilings or freeze prices may lead to the discontinuance of production, as was dramatized in the case of the killing of baby chicks and the slaughter of pregnant sows in early July, 1973.

The firm policy of the Cost of Living Council has been to investigate carefully each alleged shortage or serious distortion to determine to what extent price controls were responsible and what corrective action should be taken. This is a difficult task requiring patience and professional detachment.

I do not accept the conclusion that wage and price controls are the major factor contributing to shortages in the American economy at this time. A Survey of the National Association of Purchasing Managers (December, 1973) found rather that high levels of demand were the primary cause of shortages and disruptions. The National Association of Business Economists (December, 1973) reported that the primary cause of shortages was the high level of domestic

and foreign demand rather than distortions directly traceable to price controls. Such testimony is the more credible since these two groups strongly favor the discontinuance of direct controls.

Thus, in an economy operating at high levels, with many primary industries that did not build adequate capacity in the past before the imposition of controls, it is inappropriate to hold controls responsible in the main for shortages. Further, it may be that when controls hold prices below levels they would otherwise reach, shortages are exhibited because of higher demand than would exist at higher, uncontrolled prices. In either case, the physical quantity of supply is the same. Thus such "shortages" need to be distinguished from other distortions.

In any case, the stabilization agency has a responsibility to review each situation -- and to continue such reviews -- to determine conscientiously what are the independent effects of controls on shortages and major distortions and, when these problems are serious, to take steps within its powers to investigate and ameliorate these adverse effects. That we have tried to do and will continue to do as long as mandatory controls continue.

In Sum -- Benefits and Costs of Controls

The effects of controls are thus complex and to probe all the avenues of possible impact is precarious. There is room for disagreement on some questions. How is one to sum it all up?

In my view, controls may have a small and incremental

effect to constrain inflation for short periods. They may more clearly have favorable impacts on some particular sectors for a period, particularly if attention is directed to longer-term or structural problems of the sector. Controls tend to run down as games are played with the regulations and as compliance declines.

Controls are a special purpose and limited tool to constrain inflation, rather than a general purpose policy. Their potential for adverse effects on output and efficient production needs always to be watched carefully. This problem becomes more serious the closer the economy is operating to capacity and the more significant are international interrelationships involving products important to the domestic economy. Controls tend also to have an adverse effect on responsible collective bargaining.

Perceptions -- Consumers, Labor and Business

Having now dealt with results of the program on prices and wages, it may be as important to consider what people have thought about the program: the perceptions of the public, labor and business.

One of the reasons that price and wage controls tend to wear out is that they depreciate in their acceptability. Nobody likes price increases, and thus it is not surprising that citizens want their government to put a halt to increases like King Canute who sought to halt the tide. However,

attitudes frequently change after a period of price and wage controls. The limitations and costs of such efforts become clearer.

Consumer Attitudes

The past year has seen marked fluctuations and shifts in consumer attitudes toward wage and price controls. The large price increases early in 1973 were perceived to be due to the move from Phase II to Phase III. 26/ Public opinion seemed to think that a move back to Phase II or a freeze would stop inflation. As you recall, this is essentially what was done beginning in June. As a result, when shortages developed, many attitudes changed from what they were in the first six months of the year.

Public opinion surveys now show significantly less desire for price freezes than earlier in the year. In addition, they reveal a greater willingness to dispense with controls altogether.

Labor and Management

The Labor-Management Advisory Committee unanimously adopted the following statement on July 10, 1973, in opposition to the continuation of wage and price controls:

> "The Labor-Management Advisory Committee is deeply concerned that there are tendencies for wage and price controls to be regarded as the solution to the problem of inflation. Indeed, there are some who strongly advocate and support such a program with the objective of making controls a permanent feature of the American economy.

26. Economic Report of the President, February, 1974 pp. 103-5.

> "The Labor-Management Advisory Committee believes that continuing wage and price controls are incompatible with the best interests of the people of the United States. They impede responsible collective bargaining. They prevent the achievement of the most productive and efficient economy. They are not responsive to the needs of our citizens. They compromise our competitive position with other nations in international trade.
>
> "The only way to extricate the country from wage and price controls is to resolve firmly to phase them out. We believe all wage and price controls should be eliminated as soon as possible in such a way as to make the further extension of the Economic Stabilization Act unnecessary."

At its November 13, 1973 meeting the Labor-Management Advisory Committee reiterated its view that:

> "...the stabilization act which is scheduled to expire April 30, 1974, should not be renewed and that no legislative authority to administer wage and price controls should be enacted for the period thereafter."

Organized Labor View

Labor previously has taken the position that it was not opposed to mandatory controls on wages and prices as long as they were equitable. More recently, however, many labor leaders have expressed the view that the mandatory controls are not equitable and advocate the abolition of such controls. 27/

Business Attitude

The business community has also shown changes in attitudes toward controls as the year has progressed. For example, on May 31, 1973 the National Small Business Association wrote the President advocating "...a return to the stringency

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27. AFL-CIO, Policy Resolutions Adopted by the Tenth Constitutional Convention, December, 1973 pp. 8-11.

of Phase II controls, in order to quench the fires of accelerating inflation." This, of course, stands in direct contrast to the testimony you have heard earlier in these hearings from representatives of the business community as well as to the expressions of opposition to continued controls which I have heard.

These changes in attitude toward controls tell us that 1973 was an educational year. The country has learned a good deal more than it knew a year ago about what can be done and what cannot be done to constrain inflation through direct wage and price controls.

III. PRINCIPLES REAFFIRMED

The 1973 experience, in conjunction with historical experience in the United States and incomes policy efforts in other countries, suggest that there are a number of principles which should be borne in mind in looking ahead.

1. Economic goals are several in number and are not always fully consistent in character.

   All western countries aspire to a series of goals which seldom, if ever, are fully consistent with each other. They desire to achieve full employment, price stability, economic growth, a rise in productivity, labor-management peace, freedom from government regulation, and a balance in their international accounts consistent with their international objectives. Much more often than

not, one set of national objectives can be achieved only at the expense of other objectives. Assigning priorities to these goals, and the extent to which they are achieved, are essentially political questions, and quite appropriately involve extended debate. A dramatic example during 1973 was the conflict between maintenance and acceleration of exports to advance our international economic and political objectives (improving our balance of payments and protecting the dollar) versus imposition of export controls, which would have been a necessity to restrain further domestic prices of basic commodities. Acceleration of exports turned the U.S. trade balance around from a $6.36 billion deficit in 1972, to a $1.68 billion surplus in 1973, but it also put pressure on domestic supplies and prices.

2. Primary tools -- monetary and fiscal policy, international exchange rates and trade policies -- must be consistent with stabilization.

The primary tools for constraining inflation involve appropriate combinations of monetary and fiscal policy and the attainment of suitable international exchange rates. If these fundamental policies are not compatible with moderate price and wage stability, there is little that price and wage controls can do independently to restrain inflation to any significant degree.

3. <u>Wage and price controls, at best, are a limited and special purpose tool.</u>

   They can make an incremental contribution, in some circumstances and in some sectors, to reduce wage and price inflation to a degree. The success of health care price controls and of construction wage controls in restraining inflation in those sectors from 1971 to the present are examples of successful application. But direct controls are not a powerful means to constrain inflation for long.

4. <u>Wage and price control programs tend to wear out.</u>

   Programs of wage and price controls in western countries have had a relatively limited life. They tend to run down and wear out.

   After just a few years economic conditions have changed so that controls can actually become a part of the destabilizing forces they were designed to mitigate. They tend to create or aggravate problems in the production and distribution system (as occurred with broilers, and copper scrap in 1973). Controls are frequently the subject of widespread gaming, if not violation; or they become so burdensome to consumers, producers and parties to collective bargaining that regardless of earlier support they are no longer sustainable. Since the economy is very complex, as controls age

they tend to become more complex, as we have seen with the move toward specialized, detailed regulations for petroleum and food processing during 1973.

Legislative modification has historically been a major way through which direct controls have become less effective. As a result of the objections of various producer groups, statutory exemptions have been made for particular groups or statutory special rules have been enacted for sectors which administrators earlier had rejected. For example, in 1946 pressure from producer groups resulted in such an unadministrable legislative package that President Truman vetoed it. Since May 1, 1973, 69 bills or amendments have been introduced in the Congress to modify directly or indirectly the scope of the present stabilization statute. Several have been enacted involving stripper wells and levels of gasoline distribution. 28/

28. Appendix R, Pg. A-125 contains a comprehensive survey of legislative activity related to the Economic Stabilization Program from May 1, 1973 to January, 1974.

Legislative bodies also have diluted or redistributed the statutory authority for stabilization, as happened in the Agriculture and Consumer Protection Act of 1973. 29/

5. Appraisal of controls must avoid two common but extreme positions.

In appraising the contribution of direct wage and price controls it is essential to avoid two extreme positions which are often advanced. One view is that controls can do no good and make no contribution to the restraint of inflation and that they are an entirely unwarranted interference with the "free market." The other view is that direct controls are a powerful and a ready tool in the fight against inflation which should be a permanent and continuing part of the government arsenal. In

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29. "The President shall make appropriate adjustments in the maximum price which may be charged under the provisions of Executive Order 11723 (dated June 13, 1973) or any subsequent Executive Order for any agricultural products (at any point in the distribution chain) as to which the Secretary of Agriculture certifies to the President that the supply of the product will be reduced to unacceptably low levels as a result of any price control or freeze order or regulation and that alternative means for increasing the supply are not available."

Public Law 93-86, 93rd Congress, August 10, 1973, Section 815(b).

my judgment neither view is supportable theoretically or by experience. During the last 12 months, for example, controls have made a contribution in the health and construction areas, while they have been impotent to deal with agricultural price increases. Indeed, the freeze had to be relaxed early in the food and copper scrap areas to prevent shortages from becoming intolerable.

6. There are different environments in which controls are appropriate; price inflation resulting from world price increases is difficult to contain. The history of inflationary periods suggests that no two inflationary periods are the same and that there are, therefore, various types of environments in which controls might be used. For example, the pent-up demand-pull experience of post-World War II (1946-48) was quite different from the cost-push periods of the middle 1950's and the late 1960's. Similarly, the inflation related to the period of high capacity operations during 1973 was quite different from the period of inflation characterized by slack demand, as occurred during 1971.

Demand, supply and costs interact quite differently in these periods and affect the capacity of direct controls to restrain wages and prices. If there is considerable slack in the economy, wage and price controls may be expected to have minimal distorting effects upon output, capacity and supply and can be expected to co-exist with a low rate of inflation as was the case with Phase II. If, on the other hand, the economy is operating near capacity levels, then the use of wage and price controls has greater potential adversely to affect supply, as has occurred in the nonferrous metals and fertilizer areas during the past year.

Moreover, to the extent domestic prices may be held artificially below world prices, which would tend to encourage exports of products under controls, export controls may also become necessary. They were necessary for a time last summer with respect to soybeans. But even such a Draconian approach more generally applied would not prevent the higher price of imports from raising domestic costs and prices. Petroleum is a perfect example. Either the average domestic price rises to reflect higher prices for imports, as the present regulations provide, or there will be no imports.

While it is possible to influence to a degree the rate at which primary price increases flow through to finished prices at wholesale and retail levels, the worldwide inflation cannot be appreciably prevented from affecting domestic price levels.

7. Large economic units are easier to control, but the inflationary problems are not necessarily concentrated in such sectors.

   It is axiomatic that it is easier for government price controls to control prices that are already administered by private administrators than it is to control highly competitive markets. Analysis of price increases since 1968 in relation to industry concentration suggests that no correlation exists between sector concentration and sector inflation.[30/] In addition, a good deal of conventional wisdom about price behavior in concentrated industries, in my view, is open to serious question, as shown in the same Appendix S.

   During Phase II lumber and cattlehide prices were particular problems. Yet both of these markets are highly competitive. During the past year, raw food products and other raw material prices have accounted for two-thirds of the rise in prices. Yet, many of these products are actively traded in highly competitive auction markets.

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30. Appendix S, Pg A-149 analyzes the relationship between industry sector concentration and actual price behavior.

8. Supply and capacity actions as part of a stabilization program are distinguishable from direct wage and price controls.

The vigorous pursuit of added supply and capacity is an important, although separable, element of an anti-inflation program. [31/] A federal policy which focuses on those sectors with inflationary problems and ensures that government and industry do everything possible to relieve bottlenecks and bolster supply, and in cooperation with labor and management in the sector, can make a considerable contribution to price stability. In addition, administration of price controls can be linked to increases in supply, in capacity, or the opening of old capacity as has been done by decontrol of petrochemical feedstocks, zinc, fertilizer, and cement and by adjusting the regulations to allow for the pass-through of higher prices for "new" oil.

9. Detailed data and analysis of individual economic sectors are essential to the development of policies to constrain inflation. Aggregate data alone are not sufficient.

The failure of any government or private forecaster to anticipate the rate of inflation in 1973, and the limited usefulness of macroeconomic tools to project likely developments for 1974 suggest the importance of developing less aggregated data and analytical tools.

31/ Appendix D, pg., A-16 reviews the specific supply actions undertaken during the last year.

This would enable the government and private decision makers to discuss more completely the impact of alternative courses of action. This lack of sectoral information is particularly disturbing when one considers that capacity operation in an economic expansion is experienced unevenly. There are always some bottlenecks. The rate at which output can be increased without serious shortages, run-up in prices, or both is limited by the interrelationship of these constraints and the rate at which they can be relieved. We need to understand better where the constraints will be, when they will be encountered, how soon they will arrive and by what means they can be relieved. The only way to understand such problems is to develop much better data and analytical tools in cooperation with each sector.

10. A stabilization program must live with seeming contradiction.

In any stabilization program inevitably there are a number of seeming contradictions. In making difficult administrative and policy choices, a program must learn to live with these contradictions and deal with them in a coherent way.

- Despair that stabilization can accomplish nothing versus enthusiasm for the ability of controls to restrain wage and price increases.
- Avid pursuit of short-term price stability versus undue restrictions on supplies which

are essential to the economy, the restriction of which might cause greater inflation in the future.

- Use of the stabilization program to preserve and enhance institutional arrangements versus its use for social and economic reform.
- Adoption of short-term interest in limiting prices versus longer range objectives of making the economy less inflation prone over the years through structural and institutional change.
- Prompt and rapid action on complex matters versus ensuring that decisions are based on an exhaustive appraisal of facts.
- Relatively easy entry into controls versus the difficulty of getting out.
- Attention to policies and principles expressed in general regulations universally available and applicable versus regulatory consideration of special problems and difficulties of the smallest and most humble case.
- Treatment of all parties with dispassionate and scrupulous fairness versus accommodating complaints of groups which are powerful enough to cripple or destroy the program.
- Assembling an able and dedicated staff to deal temporarily with intrinsically difficult and

novel questions versus avoiding permanence, bureaucracy, and interference with industry and collective bargaining.

- Basing decisions to alter the program on economic soundness versus political expedience.

These are, as I said, fundamentals of broad application -- broader than the circumstances of 1973.

IV - THE FUTURE

Finally, Mr. Chairman, I would like to say a few words about the state of the economy in 1974, about the legislative alternatives that might make some contribution toward economic stabilization in this period and to make some legislative recommendations on behalf of the Administration.

State of the Economy Ahead

The inflation rate is widely forecast to be high in the first quarter of 1974, with or without wage and price controls. There is a likelihood that food prices will continue to increase appreciably until mid-year. Most forecasts project a decline in inflation rates during the year, beginning in about the second quarter. 32/

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32. Appendix T, Pg. A-150 highlights the differences among economic forecasters about what the 1974 inflation rate might be.

The decline in inflation rates beginning about mid-year is widely forecast whether or not controls in general are terminated on the first of May. It seems likely that by mid-year most of the bulge of costs derived from the rapid run-up in 1973 of primary commodity and raw materials prices in 1973 will have been passed through. The main reasons for expecting some further price bulge if the economy were to be fully decontrolled are:

1. a likely realignment of some prices;
2. the removal of prenotification delays which we estimate to be about 60 days or more on the average, the temporary speed-up in the rate at which price increases can go into effect without controls, and
3. a widespread upward pressure on prices associated with market testing and attempted margin widening.

Price increases during the first part of the year, even with controls, involve mainly petroleum, food and a number of price adjustments already allowed by the Cost of Living Council on grounds of cost justification or on the basis that price increases are necessary to keep supplies in this country. Examples of these sectors are steel, rubber, nonferrous metals and textiles and apparel. In other sectors, such as paper and chemicals, a bulge may occur when controls are removed because the equilibrium price level is higher than the price level under controls. Also, the health sector is one

which may experience large increases if decontrolled, somewhat independent of conditions in the general economy, due to its unique characteristics discussed more fully in Appendix K.

The economic future in this country and abroad is particularly uncertain over the next three months, especially with the worldwide energy crisis, the large rise in energy costs and the impact of changed levels of economic activity, caused by the energy problem, upon wages and prices here and abroad. 33/

Legislative Alternatives

The Cost of Living Council is continuing on the course established by the President on July 18, 1973 -- administering tough controls but gradually decontrolling the economy by sectors where that can be done safely or where the controls are most harmful. The objective has been to gradually feel our way out of controls in such a way that we do not detour back into a swamp of even more permanent controls. The extent of the economy under controls is contracting as shown in the table on page II. Further, as seen earlier, the views of the American people toward controls have been changing over the past months. In these circumstances, it is our view that the Administration has the obligation to present fully the facts and the policy alternatives with respect to the Economic Stabilization Program to the Congress, in addition to making its recommendations. By setting forth our views of the alternatives, it is hoped that the Cost of

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33. Appendix U, Pg. A-151 shows the varied effects of fuel price increases on costs for various industries.

Living Council can be of most help to this Committee and to the Congress.

The following are among the various legislative alternatives that have emerged from our extended consultations with interested labor, business and consumer groups, as well as with members of the Congress, including the members of our oversight committees. It may also be helpful to indicate some of the questions that have emerged in discussions regarding each alternative.

1. <u>Extend the present Act for eight months or a year.</u> Last year the Administration on January 11, 1973 requested a simple extension of the Act for one year. The Congress completed the legislation with six amendments only a few hours before the legislation would have expired at midnight April 30, 1973. The uncertainty surrounding the legislation was itself a factor tending to encourage price increases in the event that Congress imposed freezes or rollbacks of prices, which were widely discussed at that time.

In the present setting I am genuinely concerned that many amendments would be placed on the present statute in the interest of producers who feel that they need statutory protection or exemption from possible stringent controls. Phase IV has been tough. It is reasonable to expect that a great many amendments will be offered, a number of which could be expected to pass. Appendix R, which I have already referred to, lists the 69 bills and amendments submitted since April 30, 1973 to

exempt sectors or to provide more liberal price standards. After 2 1/2 years of the Economic Stabilization Program, a realistic appraisal suggests that an administrable extension of the law in its present form is unlikely.

2. General Standby Legislation. This approach would go back to the 1970 legislation with broad general authority to the President to continue controls or to impose wage and price controls on a general basis or in particular sectors of the economy. Such general legislation likewise could be expected to be subject to widespread amendments sponsored by particular groups who feel aggrieved or who expect to be aggrieved under continued authority to invoke mandatory wage and price controls. Standby authority would tend to foster repeated government intervention throughout the economy, creating uncertainty and adversely affecting managerial decisions in the private sector.

The suggestion has sometimes been made to include automatic triggers in such broad authority, based on CPI, WPI, and hourly earnings indices rather than to leave the decision to Presidential discretion. A review of possible trigger points in the context of our history does not inspire great confidence in the idea. Moreover, the easy anticipation of such publicly known trigger points could well become a major factor encouraging instability and inflationary developments.

3. <u>Price and Wage Review Board</u>. There has been a family of suggestions to establish a wage-price review board made by a number of people, including Representative Henry Reuss, the late Walter Reuther, Chairman Arthur Burns and former Price Commission member Robert Lanzillotti. Each offers, however, differences of view regarding the functions and authority of such a board. Dr. Lanzillotti's proposal goes like this. The Employment Act of 1946 would be amended to make "price stabilization" an additional national goal and to create a Stabilization Board with a fixed number, (e.g., seven public members) appointed by the President, with Senate confirmation, for terms comparable to those of the Federal Reserve System or the Federal Trade Commission. Their function would be to monitor price and wage movements in key sectors of the economy with the right to limit, after holding public hearings, prospective or actual price and wage increases on the basis of predetermined norms or guidelines. Such an agency would be expected periodically to assess and report to the Congress the price ramifications of various governmental policies and private actions, thus including in the public debate the inflationary consequences of past or contemplated actions.[34/]

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34. Robert F. Lanzillotti and Blaine Roberts, "The Legacy of Phase II: An Inside View of Controls", paper for the A.E.A. meeting, December,1973.

A critical question among various types of review boards is whether the board has authority to impose its views on price and wage decisions as with mandatory control or whether it can only report and recommend. If the wage and price review board were only to report and advise, many of the objectives or benefits of the approach could be achieved in more informal ways. If the wage and price review board is to have powers to change wage and price decisions, a number of points should be raised.

- There would be a tendency for a semi-judicial procedure to result in standards and guidelines for all wage and price decisions to provide the press and public the means to measure wage settlements and price decisions. I am strongly opposed to such a single standard for pay or price adjustments in a dynamic economy where wage and price structures are never in perfect balance whether established by a price and wage board or another stabilization agency.
- The approach is premised on the view that inflationary forces arise or originate in large companies or unions and, if these can be held in restraint, smaller firms and units will also restrain wages and prices. This simplistic conclusion has widespread appeal but is of doubtful validity, especially in periods of excess demand. Indeed, in the past year inflationary pressures on the price side, aside from petroleum, have been greatest in the most competitive sectors as I have pointed out earlier. Wage settlements in small units may

industry or in other industries.

- A great many inflationary problems have their roots in particular policies of the government, as in agricultural and transportation policies. A price and wage review board operating in a semi-judicial manner in a thirty day period is not likely to make much of a contribution to identifying inflationary sectors of the economy and stimulating change in private policies to enhance supplies and enlarged capacity. Such a wage and price review board is not well designed to encourage less inflationary policies through stimulating federal actions to increased supply.

4. An agency to deal with fundamental longer term inflationary conditions. Short of mandatory wage and price controls, there are a series of activities and measures which the government could undertake to contribute to moderation in the rate of inflation. These activities involve a focus within the federal government to see that its own impact on prices and wages is noninflationary and at the same time encourage private parties, as well as local and state governments, to adjust their policies and practices to contribute to a less inflationary economy.

In the government sector, for example, such an agency could substantially expand existing data

on wages and benefits, prices and costs, industrial capacity and other pertinent data for particular sectors; encourage measures to increase productivity; review various programs and activities of government agencies which may have adverse effects on supply and cause higher prices on a sector-by-sector basis, and make recommendations on how the public sector can yield larger supplies and achieve economic stabilization.

With respect to private sector activity, such an agency could review industrial capacity, demand and the supply outlook in various sectors, working with industrial groups and appropriate government agencies to encourage price restraint; work with labor and management in sectors having special problems, and with appropriate government agencies to improve the structure of collective bargaining; continue to monitor, after April 30, 1974, the various commitments made to the Cost of Living Council as part of the decontrol process; and coordinate public and private efforts to improve productivity.

RECOMMENDATIONS

Mr. Chairman, on behalf of the Administration we submit the following recommendations to this Committee:

First, the President, in his State of the Union Message on January 30, 1974, stated the Administration's basic policy: "As we cope with the challenge of inflation, we must recognize the clear lesson of recent years: While direct controls over prices and wages can help fight inflation in the short run, they have a very limited useful life. Inevitably, their eventual effect is to create or aggravate significant distortions in production and distribution. Accordingly, I will continue to watch the wage-price situation closely and to pursue a policy of gradual, selective decontrol, except in particularly troublesome areas."

This is the course the Cost of Living Council has been on since the President established Phase IV on July 18, 1973, which provided for tough controls and at the same time a policy of gradual decontrol on a sector-by-sector basis.[35] This is also the course we intend firmly to stay on through April 30, 1974 when the present Economic Stabilization Act expires.

This policy permits the Cost of Living Council to continue to seek, where appropriate and where feasible, various inflation reducing commitments in the public interest in exchange

35. This statement at p. 12 sets forth the sectors of the economy decontrolled since Phase IV was announced and also shows the fraction of the economy remaining under controls as measured by the CPI, the WPI, and the proportion of the labor force.

for simultaneous decontrol of prices and wages. In various sectors these commitments have concerned such matters as a limit on prospective price increases or margin increases for a period ahead; diversion of supply to the domestic market; start-up of closed plants for a season; new capacity expansion; a joint labor-management committee, with the assistance of neutrals, to consider common economic and industrial relations problems; and the providing to the government of more adequate statistical information. These commitments, in some cases, may help to spread out and reduce the expected post-controls bulge. This policy also involves careful attention to shortages and dislocations in the economy to see that any adverse effects on supply and output generally induced by controls is minimized, but with moderated price increases, through modification or elimination of control regulations.

We, therefore, recommend that this policy of gradual decontrol be allowed to continue to operate through April 30, 1974 by administrative action under the Cost of Living Council without further legislative amendments.

Second, the Federal Government must have a continuing and deep concern with the rate of inflation. The Administration is of the view that primary reliance should be placed on budgetary and monetary policy as well as on international trade and exchange rate policy, to constrain domestic inflation. Under the economic conditions anticipated in the year ahead, the problems created by a full program of mandatory wage and price controls outweigh the contribution such controls can make to price stability.

There are a series of activities and measures which the government can, and should, undertake to contribute to moderation of inflation that do not have the drawbacks of mandatory controls. These activities require a body within the Federal Government to see that its own direct impact on prices and wages is less inflationary and to encourage private parties, and local and state governments, to adjust their policies and practices to contribute to a less inflationary economy.

Among the activities to be undertaken are the following, briefly stated, and without detailed elaboration:

- Monitor decontrol commitments.
- Review various programs and activities of governmental agencies and departments which may have adverse effects on supply and cause higher prices on a sector-by-sector basis; make recommendations for changes to achieve greater supply and price restraint.
- Work with labor and management in various sectors having special problems, as well as with appropriate agencies, to improve the structure of bargaining and the performance of the sector in the interests of inflation restraint. 36/
- Review industrial capacity, demand and the supply outlook in various sectors, working with

---

36. The applicability of the Federal Advisory Committee Act to tripartite committees is a matter of serious concern. Under the present conditions, the effectiveness of tripartite committees for problem solving is greatly diminished. (See Note at end of statement.)

industrial groups and appropriate agencies to encourage price restraint.

- Improve the wage and price data bases for particular sectors to improve collective bargaining and for effective inflation restraint.
- Consider a monitoring system for more current information on export and import commitments and flows.
- Conduct public hearings to permit public scrutiny of inflationary problems in various sectors.
- Encourage attention to the need to increase productivity in public and private industry.
- Have authority to require reports on prices, wages, imports and exports and to compel attendance at public hearings to explain price and wage decisions.

We recommend that for the period after April 30, 1974, the Economic Stabilization Act be revised and amended to provide for the continuation of the Cost of Living Council to perform the above type of functions in the interest of inflation restraint.

Third, there are several sectors of the economy where wage and price controls can have a positive effect and may be necessary for a period after April 30, 1974. In the petroleum area, including the price of crude oil (except stripper wells), mandatory price controls have already been extended to February 28, 1975 by the Emergency Petroleum Allocation Act of 1973 (P.L. 93-159) to cover refiners, resellers and retailers.

Responsibility for price regulations in this area, originally developed by the Cost of Living Council, were transferred (along with appropriate staff) to the Federal Energy Office on December 26, 1973. Price controls in this sector are no longer the responsibility of the Cost of Living Council.

The health care area is another sector where the continuation of the Phase IV regulations for an interim period is in order. The controls program has moderated the rate of inflation in this sector (See Appendix K). The Administration has proposed, and other legislation is now pending, to expand a national health insurance system. The lessons of the cost explosion following the introduction of Medicare and Medicaid suggest that cost constraints are essential to the introduction of a national health insurance program, even though the magnitude of the prospective additional outlays may not be as large as in the mid-1960's. It is prudent that the present controls in the health care sector be continued until the Congress has addressed the important subject of a cost constraint program in national health insurance legislation.

While there may be reasonable differences of opinion over the question of the need for authority for wage and price controls in other sectors after April 30, 1974, the health care area is the only one in which we favor authority for mandatory controls at this time. We shall continue to review other particular sectors as the Cost of Living Council proceeds with the program of gradual sectoral decontrol.

We <u>recommend</u> that the authority of the Economic Stabilization Act be extended after April 30, 1974 to apply to the health care sector until enactment of the national health insurance legislation.

Fourth, in view of the rapidly changing economic scene and the process of gradual decontrol, it is essential that close liaison be maintained between the Congress and the Cost of Living Council to develop appropriate legislative language to effectuate the above recommendations. The Administration looks forward to working with the Congress to develop specific legislation that will meet the needs for a continued and practical stabilization effort.

Note: Federal Advisory Committee Act applied to Tripartite Committees.

Our Labor-Management Advisory Committee and tripartite advisory groups, such as our Health and Food Industries Wage Advisory Committees, are essential parts of the Economic Stabilization Program.

There is obvious public interest in securing the advice and counsel of leaders of labor and management on the impact, from their perspective, of various forecasts and possible policy alternatives which the government considers for the economy generally and for particular sectors. Unemployment levels, wage levels, productivity and work practices, the collective bargaining process and issues of work stoppage and industrial peace are very much affected by the economic policies which the government pursues. In turn, these factors themselves heavily influence economic conditions. The opinions of respected leaders in labor and management on these related subjects represent an important part of the internal deliberative process of the agency in reaching policy decisions. We want and need their most candid advice. Therefore, meetings with those groups must be conducted in such a way as to encourage that candor.

Public meetings as called for by the Federal Advisory Committee Act would preclude the achievement of this goal in two ways. We need to have in these committees a full discussion of all the alternatives that are open to the government and to the private parties. Public discussion

of some of the options could well lead to inflationary speculation in anticipation of government actions which may not be taken even though they could be carefully explored with an advisory committee before a definite course of action is decided upon.

Moreover, public meetings would force a change in the nature of the discussions, regardless of the topics being considered. The division of membership of the bipartite and tripartite committees ensures competing points of view. In addition, the members individually have special experience which they can bring to bear on our problems. Where this experience involves specific organizations, the members would not feel free in public meetings to be as open about those organizations practices and policies or to interact as constructively.

The Council is particularly concerned with the order issued on November 9, 1973, by the U.S. District Court for the District of Columbia in the case of Nader vs. Dunlop, (Civil Action No. 769-73). In that order the Council was directed to

> "hold all future meetings of their advisory committees open to public access except to the extent that there is a specific finding made by the Director of the Cost of Living Council that the meeting, or a portion thereof, is to discuss a document which is specifically exempt from disclosure under the Freedom of Information Act, 5 U.S.C. §552(b).

Although each closed meeting of a Council advisory committee held since the issuance of that order has been for the express purpose of discussing a specific exempt document, and has been preceeded by the required finding, the utility of those committees to the Council has been severely limited.

Tripartite committees under the stabilization program should be exempted from the Federal Advisory Committee Act.

APPENDICES

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APPENDIX A

A-1

1973 FORECASTS

	1973 GNP Billions of $	Real Growth in GNP	Price Increase*	Percent 1973 Average Unemployment
ACTUAL (Preliminary Data)	$1,288.2	5.9%	5.3%	4.9%
CEA		7.0	3.0	4.5**
Economists				
Paul J. Markowski-Weis, Voisin	$1,268	6.6%	3.5%	5.0%
Maurice Mann - Western Pa. National Bank..	1,266	6.3	3.0	4.9
Norman Robertson-Mellon National Bank & Trust......	1,266	6.2	3.5	5.1
Gary M. Wenglowski-Goldman Sachs..............	1,266	6.2	3.4	5.3
Daniel S. Ahearn-Wellington Fund............	1,265	6.0	4.0	4.9
Arthur Brickner-Savings Bank Assn. of N.Y..........	1,265	6.5	3.5	5.2
Bert A. Gottfried-Research Institute of America	1,264	6.0	3.5	4.8
J. Robert Ferrari-Prudential Insurance.......	1,263	6.0	3.5	5.2
William Wolman-Argus Research.............	1,263	5.9	3.6	5.1
Sam I. Nakagama-Kidder, Peabody............	1,262	6.4	3.0	5.0
James M. Dawson-National City Bank,Cleveland	1,261	6.0	3.5	5.0
Donald E. Woolley-Bankers Trust..............	1,261	5.9	3.6	5.3
James C. Cooper-Irving Trust...............	1,260	6.3	3.1	4.9
M. Louise Curley-Scudder, Stevens & Clark............	1,260	6.1	3.2	5.0
William W. Tongue-University of Illinois at Chicago.....	1,260	5.9	3.0	4.8
John W. Kendrick-The Conference Board.......	1,262	6.3	3.1	5.0
Murray L. Weidenbaum-Washington University, St. Louis......	1,260	6.0	3.5	5.0
Robert J. Eggert-RCA.........	1,259	5.7	3.5	5.1
Kerwin B. Stallings-Morgan Guaranty............	1,258	5.8	3.3	5.1
Albert H. Cox, Jr.-Lionel D. Edie.............	1,257	5.0	4.0	5.2
Daniel A. Hodes-GT&E.........	1,257	5.3	3.7	4.9
A. George Gols - Arthur D. Little...........	1,256	5.0	4.0	5.0
Gordon W. McKinley-McGraw-Hill................	1,256	5.8	3.3	5.1
Richard S. Peterson-Continental Illinois National Bank.....	1,255	5.9	3.3	5.1
Irwin L. Kellner-Manufacturers Hanover......	1,254	5.9	2.8	4.9
Econometric models				
RSQE, Univ. of Michigan.....	1,270	7.1	3.1	4.6
MAPCAST, General Electric...	1,267	5.6	4.1	5.3
Chase Econometrics..........	1,265	6.3	3.3	5.0
Wharton, EFA, Univ. of Pa...	1,261	6.0	3.2	5.0
Univ. of California at L.A..	1,260	6.0	3.3	5.1
Townsend-Greenspan..........	1,259	6.1	3.2	5.1
Data Resources..............	1,258	5.7	3.5	5.0
Fair, Princeton Univ........	1,250	6.0	2.6	5.3

*GNP DEFLATOR

**Goal for end of the year

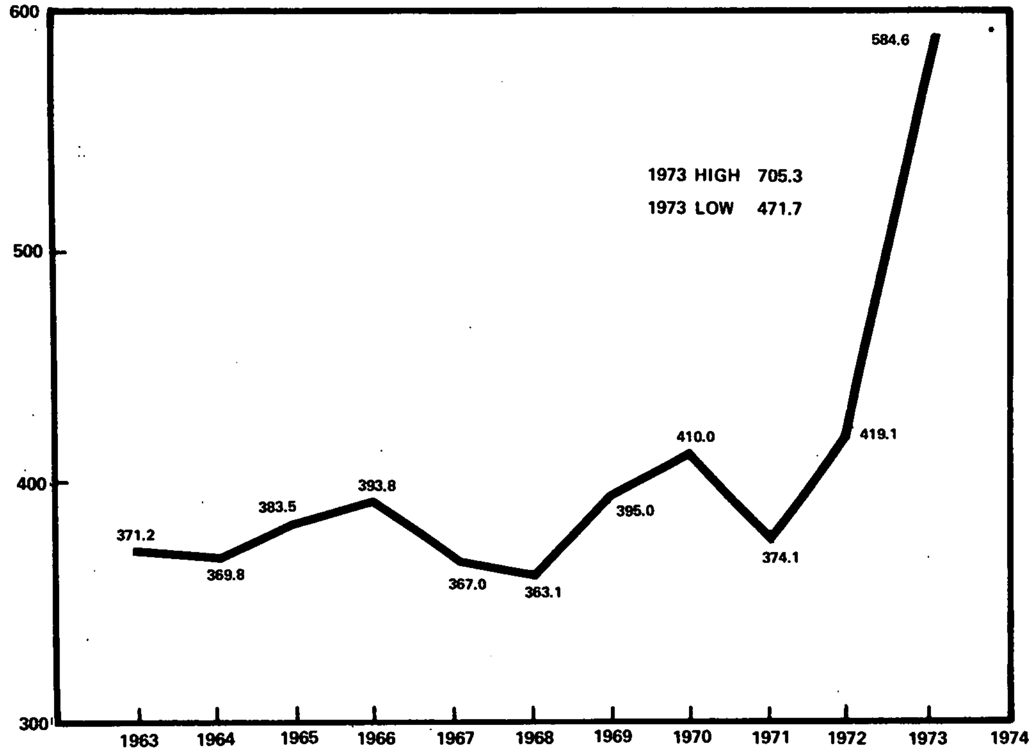
Source: Business Week, December 23, 1972; and Cost of Living Council

APPENDIX B

33-074 O - 74 - 6

COMMODITY SPOT INDEX
(MOODY'S)

DEC. 31, 1931 = 100

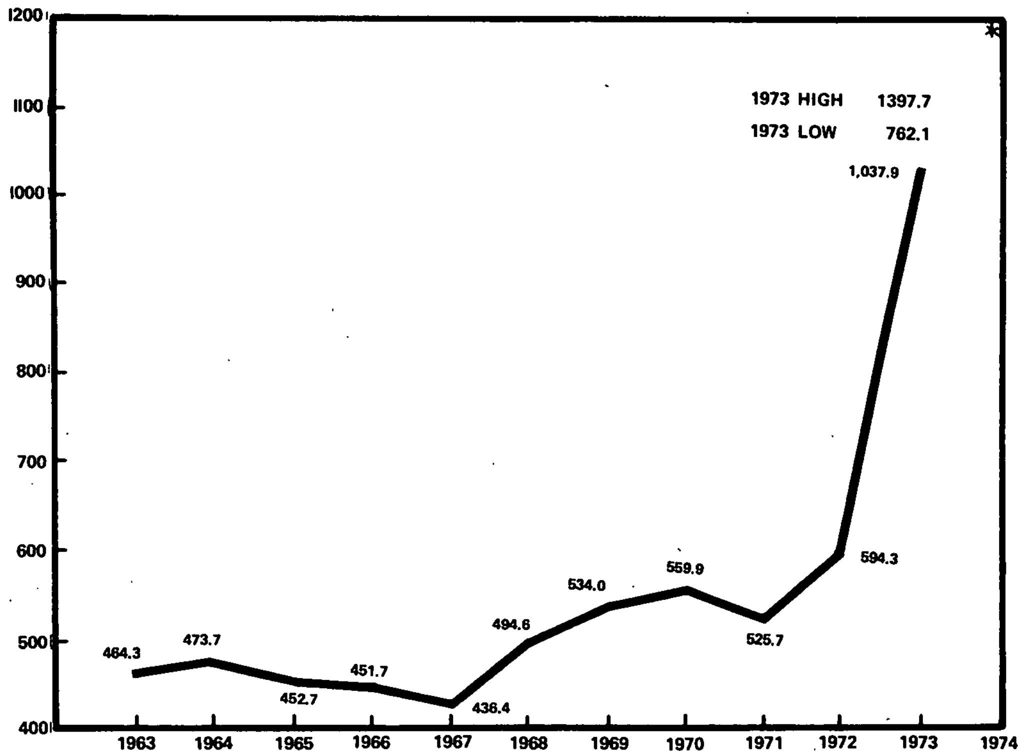


*JAN.18, 1974 INDEX 706.8

SOURCE: MOODY'S INDUSTRIAL MANUAL

REUTERS UNITED KINGDOM COMMODITY INDEX

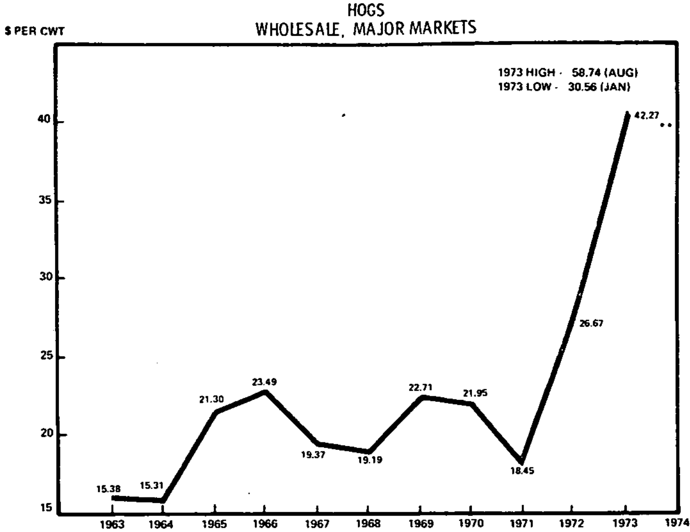
SEPT. 18, 1931 = 100



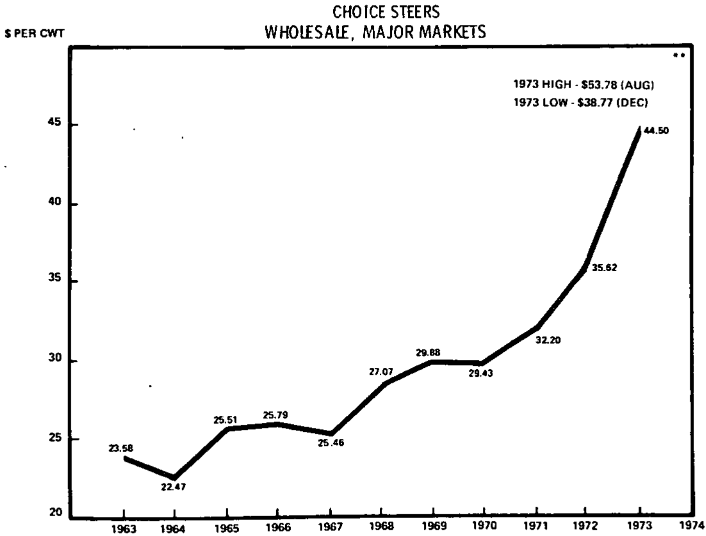
*JAN. 22, 1974 INDEX 1433.1

SOURCE: WALL STREET JOURNAL

A-4

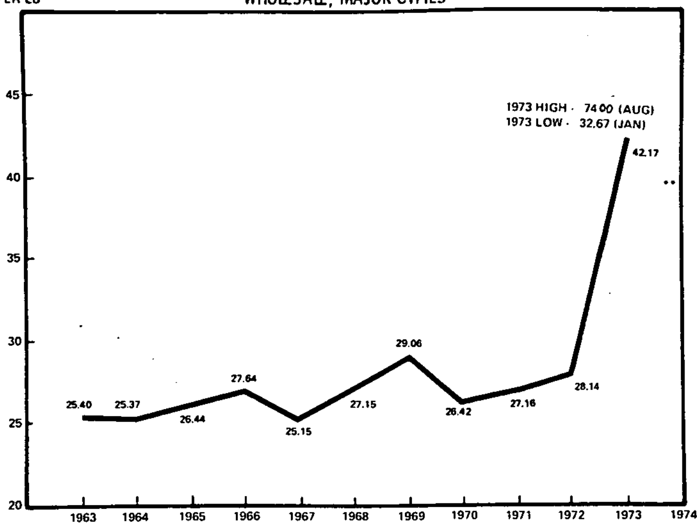


**SPOT PRICE, JAN. 31, OMAHA, $40.75

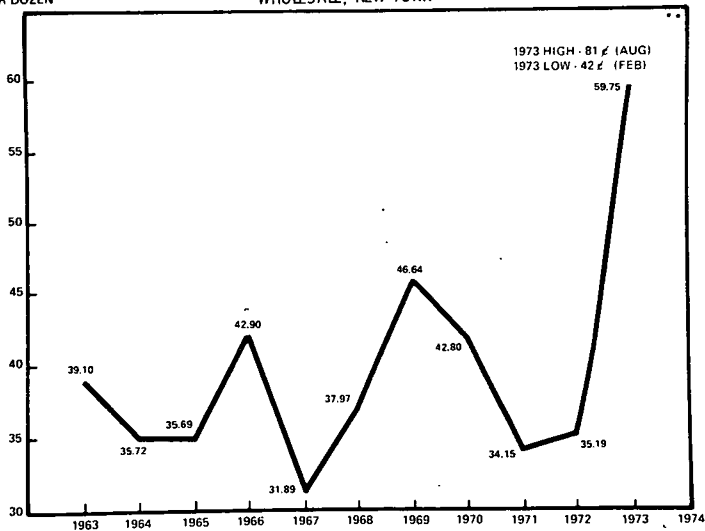


**SPOT PRICE, JAN. 31, OMAHA, $47.75

A-5



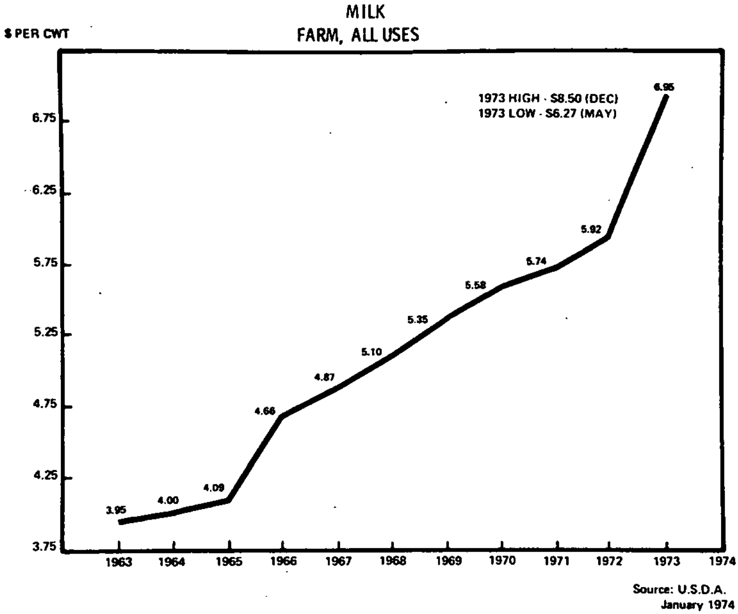
• •SPOT PRICE, JAN. 31, NEW YORK, 39¢



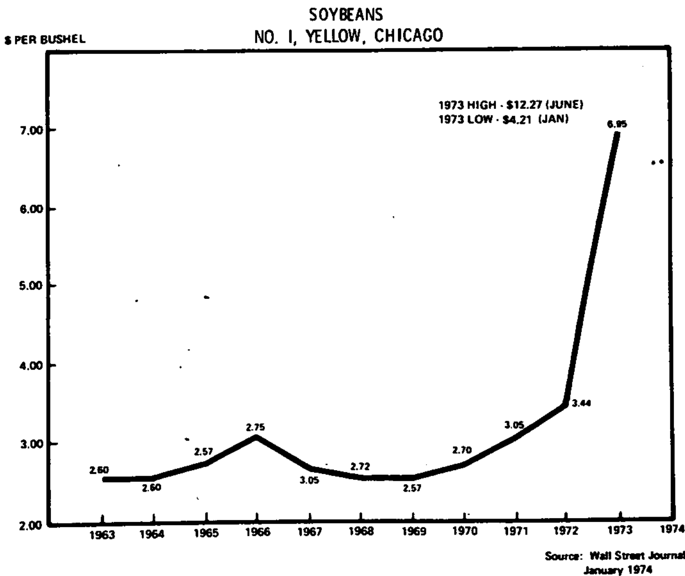
* LARGE WHITE

**EGGS SPOT PRICE, NEW YORK, LAST WEEK OF JAN., 74¢

A-6



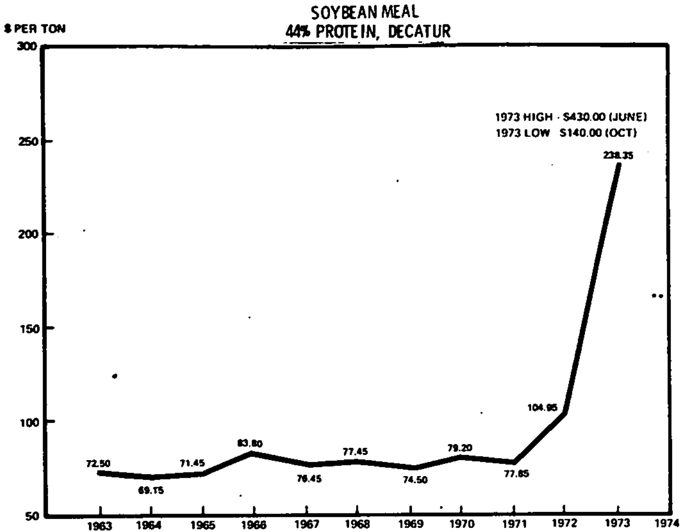
Source: U.S.D.A.
January 1974



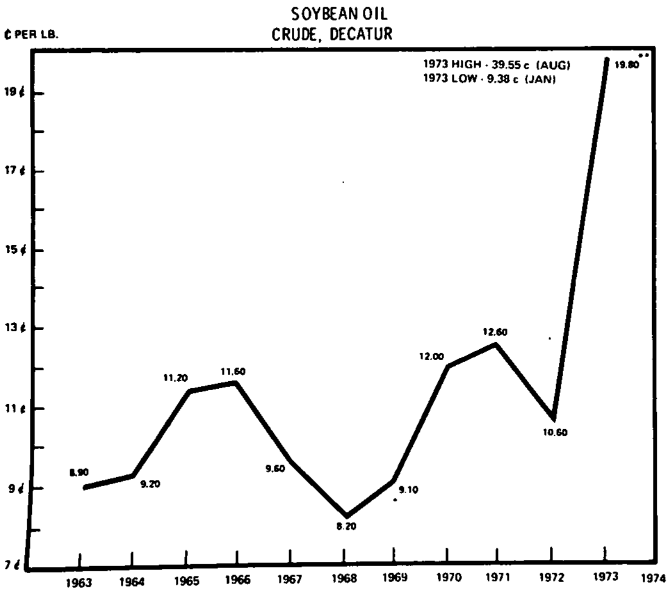
Source: Wall Street Journal
January 1974

••SPOT PRICE, JAN. 31, CHICAGO, $6.39

A-7

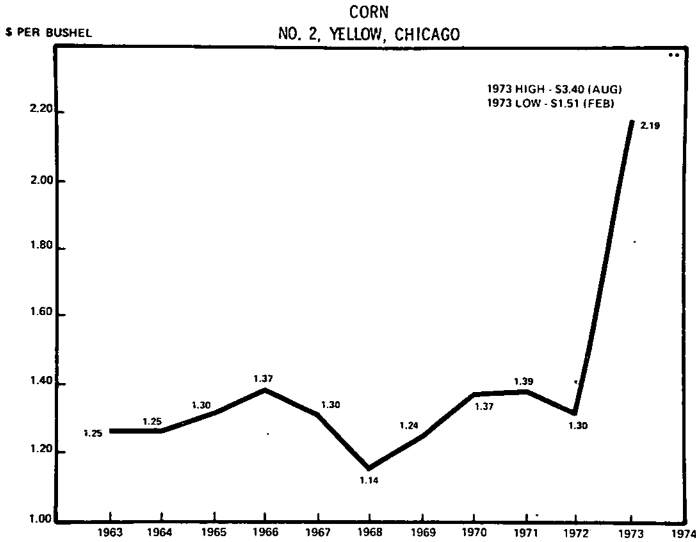


**SPOT PRICE, JAN. 31, CHICAGO, $169.00

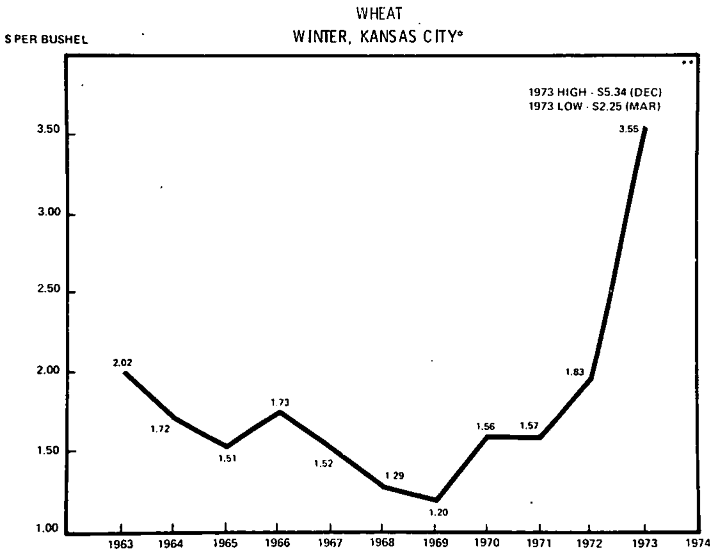


**SPOT PRICE, JAN. 31, CHICAGO, 32.60¢

A-8

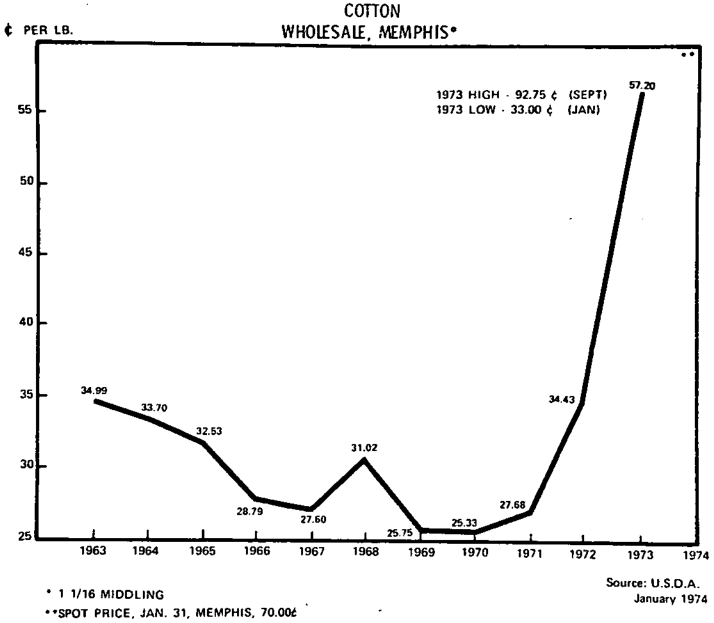


**SPOT PRICE, JAN. 31, CHICAGO, 1974, $3.02



*NO. 1 HARD WINTER, ORDINARY PROTEIN
**SPOT PRICE, JAN. 31, KANSAS CITY, $5.52

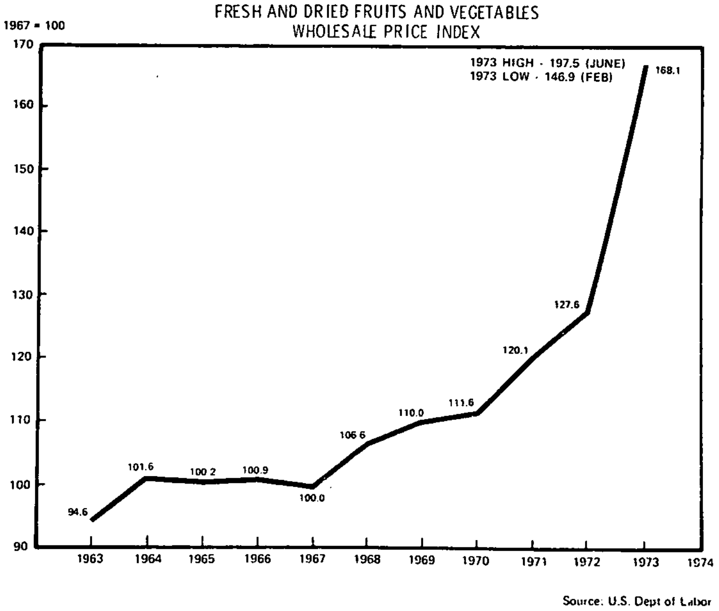
A-9



* 1 1/16 MIDDLING

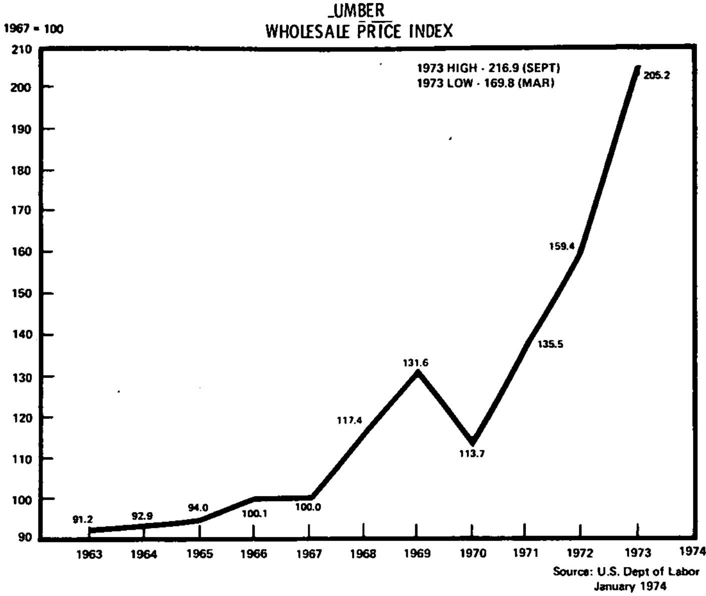
**SPOT PRICE, JAN. 31, MEMPHIS, 70.00¢

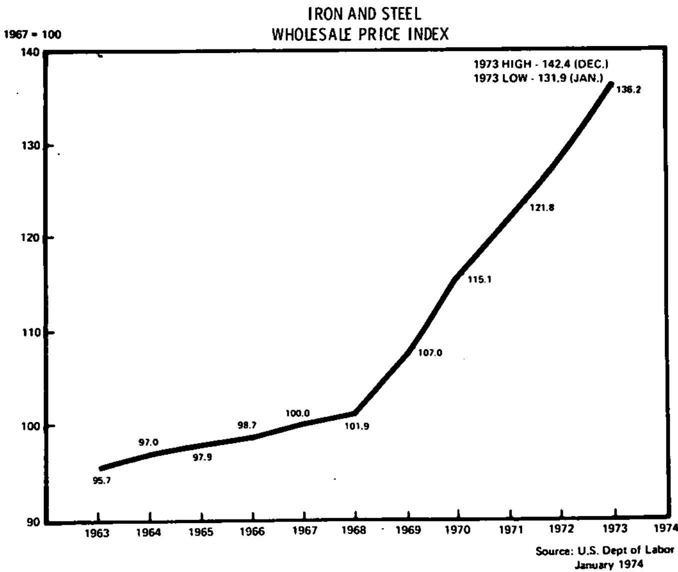
Source: U.S.D.A.
January 1974



Source: U.S. Dept of Labor

A-10





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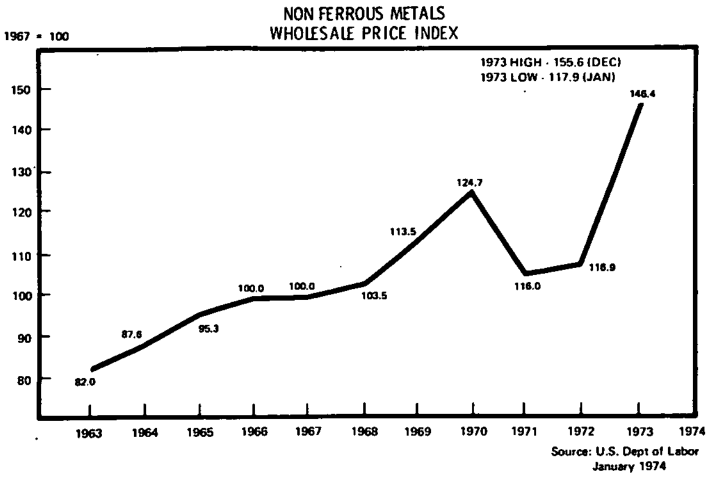
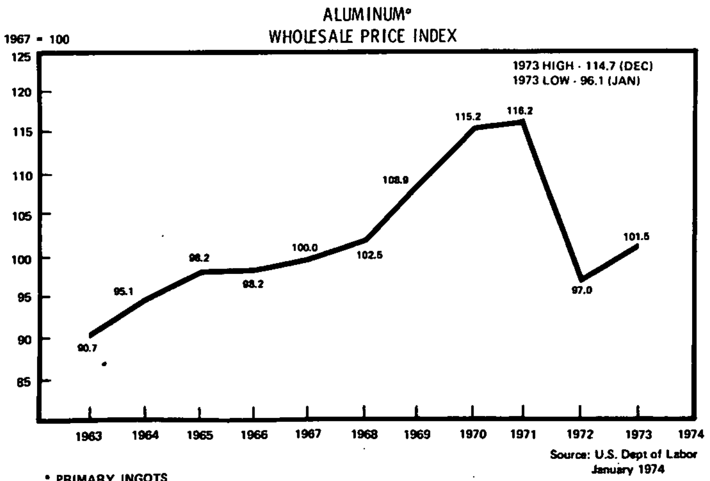
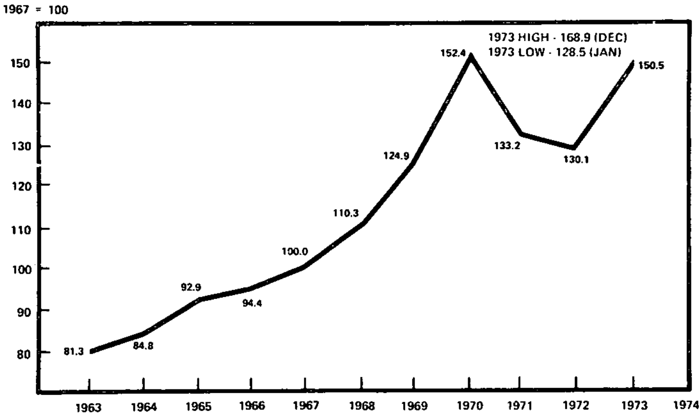




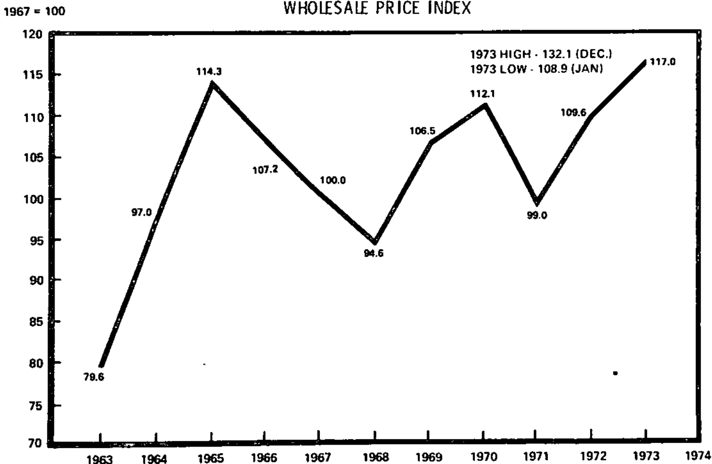
* PRIMARY INGOTS

A-12



Source: U.S. Dept of Labor
January 1974

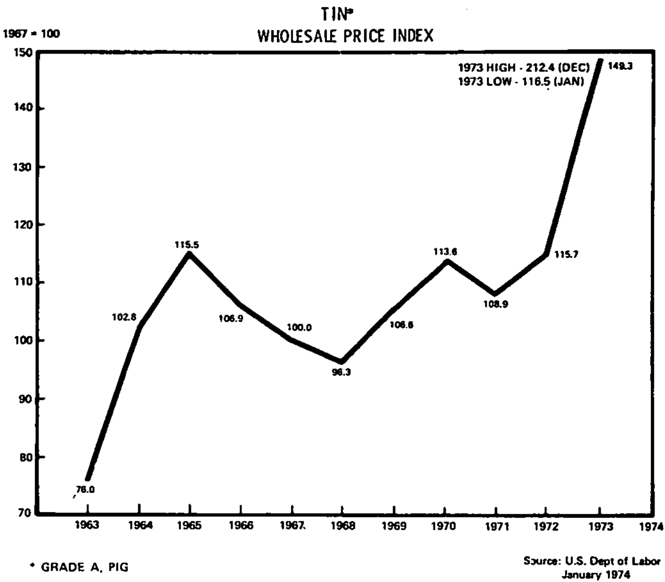
* WIREBAR, DOMESTIC ORIGIN

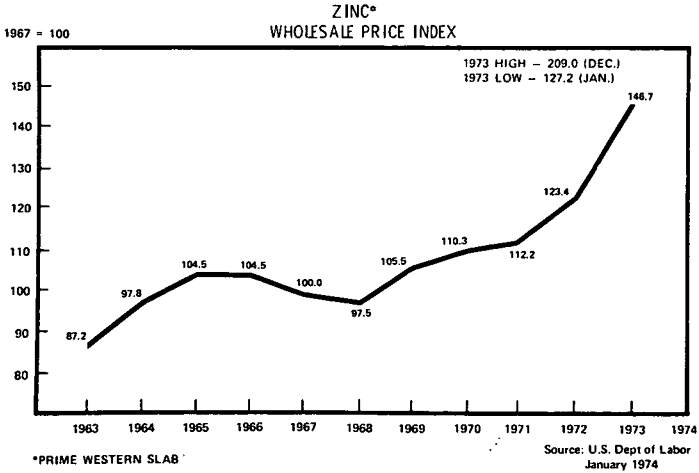


Source: U.S. Dept of Labor
January 1974

* COMMON PIG LEAD

A-13



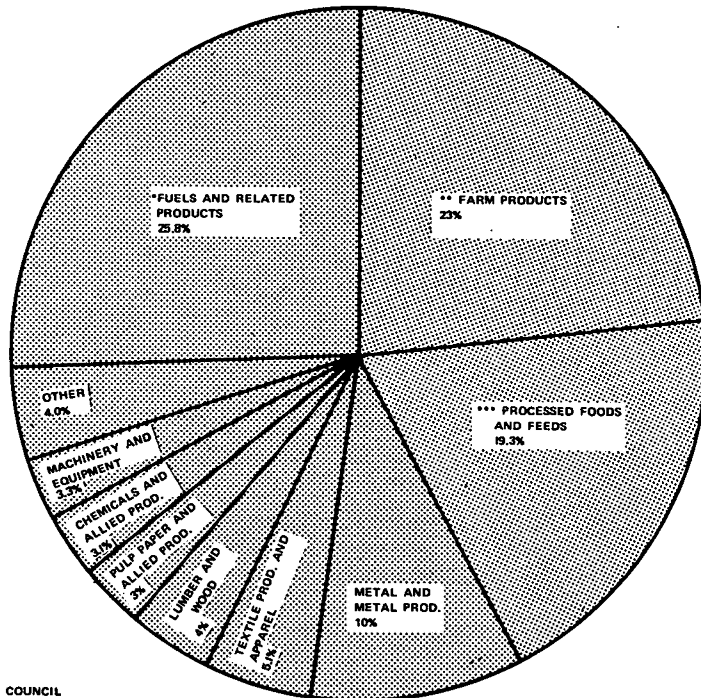


APPENDIX C

PERCENT CONTRIBUTION TO CHANGE IN WHOLESALE PRICE INDEX[1]
DECEMBER 1972 - DECEMBER 1973
(BY MAJOR COMMODITY GROUPINGS)

* FUELS AND RELATED PROD.

A) COAL	.7%
B) COKE	.3%
C) GAS FUELS	.6%
D) ELECT. POWER	1.0%
E) CRUDE PETROL	.8%
F) PETROLEUM PRODUCTS	22.4%
	25.8%



** FARM PRODUCTS

A) FRESH AND DRIED FRUITS AND VEG.	1.9%
B) GRAINS	6.1%
C) LIVESTOCK	2.6%
D) LIVE POULTRY	.6%
E) PLANT AND ANIMAL FIBERS	3.5%
F) FLUID MILK	4.7%
G) EGGS	.9%
H) HAY, HAYSEEDS AND OIL SEEDS	2.2%
I) OTHER	.5%
	23.0%

*** PROCESSED FOODS AND FEEDS

A) CEREAL AND BAKERY PRODUCTS	3.6%
B) MEATS POULTRY AND FISH	5.7%
C) DAIRY	2.0%
D) PROCESSED FRUITS AND VEG.	.5%
E) SUGAR AND CONFECTIONARY	1.1%
F) BEV. AND BEV. MATERIALS	.4%
G) FATS AND OILS	2.2%
H) MISC. PROCESSED FOODS	.8%
I) MANUF. ANIMAL FEEDS	3.0%
	19.3%

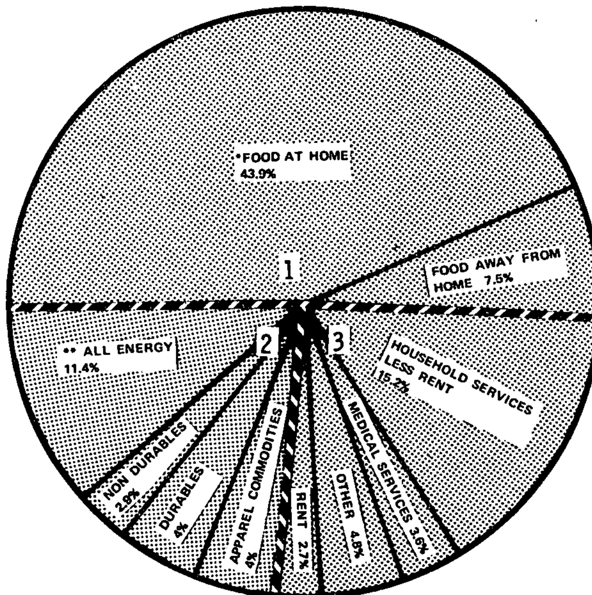
SOURCES: BLS/COST OF LIVING COUNCIL
JANUARY 1974

[1] DETAILS MAY NOT ADD TO TOTALS DUE TO ROUNDING

PERCENT CHANGE IN W.P.I. FROM DEC. 1972 TO DEC. 1973 18.2%

PERCENT CONTRIBUTION TO CHANGE IN CONSUMER PRICE INDEX DECEMBER 1972 - DECEMBER 1973

A) CEREALS AND BAKERY PRODUCTS	7%
B) MEATS, POULTRY AND FISH	18%
C) DAIRY PRODUCTS	7%
D) FRUITS AND VEG.	4.9%
E) OTHER FOODS AT HOME	7%
* FOOD AT HOME	43.9%



A) GASOLINE AND MOTOR OIL	6.0%
B) FUEL OIL AND COAL	3.4%
C) GAS AND ELEC.	2.0%
** ALL ENERGY	11.4%

PERCENT CHANGE IN CPI DURING THIS PERIOD = 8.8%
CONTRIBUTION OF MAJOR GROUPS

1.	FOOD TOTAL	51.4%
2.	COMMODITIES LESS/FOOD	22.3%
3.	SERVICES	26.3%
		100.0%

SOURCE: COST OF LIVING COUNCIL
JANUARY 1974

APPENDIX D

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REVIEW OF ECONOMIC STABILIZATION ACTIVITIES

January 11, 1973 to January 31, 1974

PRICE STABILIZATION

Supply/Demand Management Actions

Actions taken during the year underline the government's awareness that ultimately the answer to inflation lies in better management of supply and demand forces, including modification of government policies which could lead to inflation.

- A number of actions were taken by the Federal Government to increase domestic supplies of food, to reduce pressure on prices and to promote higher farm incomes by increased farm production.

  - Review by the Cost of Living Council of U.S. Department of Agriculture marketing orders and agreements, marketing guides, and purchases of food for distribution programs.

  - Elimination of all direct subsidies on export of farm products.

  - Permission for farmers to use set aside acreage for year-round grazing of livestock.

  - Elimination of mandatory acreage set-aside requirement under the 1973 wheat program which increased wheat production by 12%.

  - Sale of stocks of grain owned by the Commodity Credit Corporation

  - Elimination of quotas on meat imports.

  - Return of diverted cotton and feed grain acres into production.

  - Liberalization of cheese import quotas resulting in importation of a total of 47 million pounds additional cheese imported during the year. Quotas were suspended again from January until March to allow an additional 100 million pounds to be imported.

  - Increase in non-fat dry milk imports by 265 million pounds over the usual quota of only 1.8 million pounds.

- Temporary embargo of exports of soybeans and other agricultural food stuffs.

- Follow up of National Commission on Productivity recommendations to increase productivity and reduce costs in the food sector, including petition to the Federal Trade Commission to permit backhaul by motor carriers of food products. In a statement issued on December 26 the FTC agreed to permit backhaul allowances.

- Overall reduction of P.L. 480 foodstuff shipments by over 50%.

- Experiments with unit trains to transport fresh fruit and vegetables from California to the East Coast which reduced delivery time significantly.

- Increase of rice acreage allotment by 20%.

- Increase of domestic 1973 sugar requirements by 300,000 tons.

- Expansion of dairy import quotas by 56 million pounds of butter and 22.6 million pounds of butter oil.

- Establishment of milk price support level at lowest level required by law -- 75 percent of parity. Class I milk prices, regulated by USDA, were not allowed to increase in October and guaranteed minimum prices were not permitted to be established for the remainder of the marketing year, until March, 1974.

- Elimination of wheat import quotas for the remainder of the current crop year.

- Actions to increase the supply of lumber were taken to combat sharp increases in domestic prices.

  - Ten percent increase over 1972 levels in the amount of timber cut from national forests for both 1973 and 1974. On January 28, 1974, the Secretary of Agriculture confirmed that this goal had been met for 1973.

  - Agreement with the Jananese to reduce their log purchases from the United States by 8% in fiscal year 1974.

  - Implementation of a plan to use scarce railroad cars more efficiently for lumber shipments.

- The energy crisis was anticipated by actions early in 1973 to increase the supply of petroleum products.

- Legislation was requested to de-regulate prices for natural gas at the well head so that economic incentives could lead to expanded supplies of natural gas.

- The Secretary of the Interior was instructed to triple the acreage leased on the continental shelf for drilling for oil and gas.

- States were requested to delay implementation of more stringent environmental standards so that current coal production could be used for critical fuel needs.

- Volumetric quotas on oil imports were terminated to permit an increase in imports for short term needs, while creating additional long term incentives to expand domestic supplies.

- To provide an additional incentive to mine coal long term coal contracts were exempted from controls in early August.

- A series of changes was made in the mandatory price regulations for the petroleum industry to provide incentives for increased production of fuel oil so that shortfalls in petroleum imports and domestic production would have minimal impact on basic economic activity.

- Actions were taken to increase the supply of basic metals to blunt sharply rising domestic prices in response to world demand.

  - Stockpiles of basic materials no longer needed for national security reasons were released.

  - Legislation was requested to provide additional authority for the President to use stockpile sales to fight inflation. This legislation was signed by the President on December 31st providing for increased sales of aluminum, copper, and zinc among other metals.

  - Copper scrap was exempted from controls in July so that prices could increase to narrow the differential that had developed between domestic and international prices and reduce the incentive to export.

  - Mandatory price controls on zinc, lead, and other non-ferrous metals were eased toward the end of the year in exchange for informal commitments by some non-ferrous metals manufacturers to increase their production capacity.

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- Export controls were temporarily imposed on ferrous scrap to increase domestic supplies of this critical material input for iron and steel producers.

- New regulations for the health industry were issued after a period for public comment. These regulations provide additional incentives for improved management by hospitals to reduce increased prices resulting from unnecessary increases in the intensity of health care. For more detailed information see Appendix K.

A number of alterations were made during the year in the character of mandatory price controls as the impact of worldwide demand for basic commodities and lags in the response to fundamental supply actions became apparent. These changes reflected an awareness that direct control of prices can be useful as a short term complement to other, more fundamental, policies and that a price control program must be flexible to respond to change in the economic climate.

- From the beginning of 1973, mandatory Phase II price controls were retained in the food sector, where problems of sharply rising prices were anticipated, and in the health and construction sectors where longer term government intervention appeared necessary to achieve reasonable stability of prices.

- As international pressures on available supplies of beef and on feedgrains continued to cause sharp price rises despite policy changes designed to increase agricultural supplies, a ceiling on prices of red meats was imposed on March 29th. This ceiling continued until July 18th on pork and lamb prices, and on beef prices until September 10th.

- As price rises for other commodities and finished goods accelerated beyond the anticipated rates, price controls were selectively reimposed to restrain such increases until more fundamental supply actions and fiscal policies could achieve longer term stability.

  - On March 6th, major oil companies were brought under mandatory controls.

  - Prenotification requirements were reimposed on May 2nd on firms with sales greater than $250 million which had increased prices more than 1.5% since January 10th.

- On June 13th a price freeze of not more than 60 days was imposed to provide an immediate halt to the pass-through of a large number of anticipated price increases and to provide an opportunity for the development of more mandatory price controls tailored to meet the expected conditions of the latter half of the year.

- Beginning on July 18th, Phase IV was introduced on a staggered, sector-by-sector basis.

• Exemptions from the price controls were granted through the course of the year in cases where prices were anticipated, in sectors where continuation of price controls would result in reduced long-term supplies, and in sectors where commitments to increase supplies or to maintain stable prices were obtained.

  - Rent was exempted at the beginning of Phase III because of anticipated easing of pressures on supply of rental housing and expectations that the aggregate rate of rental increases would be moderate. Generally during the course of the year rent increases were moderate -- averaging an annual rate between 3.5 and 4.8%. In certain parts of the country where the rate of increase was larger, state and local governments considered, and in some cases adopted, rent stabilization programs designed around peculiar local needs.

  - After sharp increases earlier in the year, declines in lumber prices led to the exemption of lumber prices from mandatory controls at the beginning of Phase IV.

  - Fertilizer was exempted on October 26 in exchange for commitments for reduced exports and capacity expansion and continued operation of plants otherwise scheduled to be closed.

  - Cement was exempted on November 27 after the industry had agreed to increase productive capacity as quickly as possible to alleviate developing supply problems.

  - Certain nonferrous metals were exempted on December 6 with a commitment from some producers that immediate steps would be taken to improve domestic capacity and to continue to operate obsolete facilities.

- Automobile prices were exempted on December 6 in exchange for commitments from the industry for more price stability than could be required under Phase IV controls.

- Rubber tires and tubes were exempted from controls on January 30, 1974 in return for a commitment to limit passenger car tire wholesale and retail price increases and to increase production of small radial tires which were in short supply.

- Most petrochemical feedstocks were exempted on January 30, and prenotification and cost justification requirements were also removed for other chemical products, in order to help relieve feedstock shortages.

WAGE STABILIZATION

General Approach

Since the beginning of 1973, the operating philosophy of wage stabilization has been characterized by a desire to moderate wage increases while not interfering with the free collective bargaining process and not disrupting industrial peace.

- Tripartite machinery has been used to involve representatives of affected parties in resolution of precedent setting cases and in exploring broader measures to reduce costs and increase supplies.

- In certain key areas stabilization machinery has been used to rationalize and make more coherent the collective bargaining process.

- Emphasis has been placed on settlements with major "ripple effect" and on those quantitative parameters meaningful in terms of wage patterns; e.g., cents per hour increases for particular occupations in lieu of rigid adherence to a percentage standard.

- In selected cases informal contact with parties engaged in collective bargaining resulted in settlements which otherwise would have been inflationary.

- Close informal relationships with Federal Mediation and Conciliation Service staff made it possible for the wage stabilization effort to proceed with full knowledge of the course of collective bargaining on key contracts. Also, this relationship improved the awareness of those engaged in negotiations as to the impact that stabilization policy ultimately might have on their efforts.

These principles are fully consistent with the statement of the Labor Management Advisory Committee contained in Appendix G.

Mandatory Sectors

From the beginning of the year, mandatory wage controls were retained in three sectors of the economy where specialized problems merited special treatment: food, health, and construction. Wage adjustments in other areas were subject to self-administration of the general wage and salary standard, although the Council retained the power to challenge inflationary increases.

Food

On February 26 the specialized effort in the food industry was buttressed by the establishment of a tripartite Food Industry Wage and Salary Committee bringing together representatives of management, organized labor, and the public to advise the Council on appropriate action in this critically important industry. The tripartite committee;

- Advised the Council and the Labor Management Advisory Committee about policies necessary to meet the special problems of the food industry.

- Cooperated with labor, management, and government agencies to facilitate dispute settlement in 1973 while encouraging longer run dispute settlement machinery and procedures. The magnitude of the cooperative spirit which developed was reflected in the fact that very few appeals and requests for hearings resulted from initial Council resolution of disputed settlements, and only one lawsuit against a program decision resulted during the year.

- Worked with labor and management organizations in the food industry under collective bargaining agreements to improve the structure and performance of collective bargaining in the industry.

- Processed a large backlog of Phase II cases, many of which involved difficult questions of retroactivity because of time elapsed between the initial settlement and adjudication by the program.

- Resolved disruptions of historical collective bargaining relationships which had resulted from application of generalized Phase II machinery including (1) the disruption of historical time of related settlements, and (2) disruption of the traditional cent-per-hour patterns.

- Adapted to the Congressionally mandated low wage exemption which eliminated many food workers from coverage of wage controls.

- Refined coverage to provide equitable treatment to workers engaged in food transportation, canning, and agriculture.

- Improved relevant data available to the Council, particularly in the non-union area where requirements to report potentially large cent-per-hour increases that could disrupt historical relationships were highly beneficial. Development began on an improved food industry wage settlement data base so that parties and appropriate government agencies can better identify settlements likely to lead to inflationary trends.

Health

On April 20 a Health Industry Wage and Salary Committee was established to apply tripartite machinery to deal with unique problems related to wages in the health industry. This industry is unique in that market forces offer little incentive to management to resist inflationary increases paid by full cost third party reimbursers. Further, adjustment of wages through collective bargaining is less prevalent in the health industry than in other sectors.

This tripartite committee has:

- Reviewed pending and new health industry wage and salary cases filed with the Cost of Living Council and advised on their disposition.

- Advised the Cost of Living Council and the Labor-Management Advisory Committee on matters pertaining to wage stabilization policies necessary to meet problems of the health industry.

- Cooperated with labor and management organizations in the health industry and with appropriate government agencies to facilitate the settlement of disputes in 1973 within stabilization policies.

- Paid close attention to whether a particular increase might trigger a pattern of inflationary increases throughout a labor market.

- Developed a process for resolving exceptions to the general wage and salary standards related to labor market criteria rather than legalistic application of general purpose percentage criteria. The focus was on labor rate changes in addition to the percentage increase.

- Established close informal relationships with Federal Mediation Conciliation Service staff to lay the foundation for longer term consideration of anti-inflationary factors during the course of future negotiations.

Public Sector

Recognizing the need for a special office to deal solely with state and local wage cases, the Council established in June a Public Sector Division which reviews wage adjustments to determine if they are inconsistent with the goals of the Economic Stabilization Program. Since the division's inception it has issued challenges for the following major settlements:

Georgia - proposed wage adjustment of 25% for 400 state officials.

California - proposed wage adjustment of 6.8-11% for 183,000 state employees.

Louisville and Jefferson County, Kentucky - proposed adjustment of 7.8% for city officials and 11.2% for county officials.

Los Angeles - proposed salary adjustment of between 20-77% for 18 elected officials.

Warren, Michigan - proposed salary adjustments of between 79-107% for 12 city officials.

New York City - proposed wage adjustment of 10.2% for 11,360 firefighters.

Executive Compensation

Although under Phase II and Phase III rules executive and variable compensation increases could be apportioned to the appropriate employee unit as a whole, specific reporting of executive and variable compensation was not required. New regulations which took effect August 29, 1973, made executive and variable compensation limitations more restrictive. In particular, the establishment of "Executive Control Groups" was required and shifts of salary increases from lower echelons to the executive level were prohibited.

Construction

The Construction Industry Stabilization Committee reflects not merely the concern with improving industrial peace and moderating the once very high rates of increase of wages and benefits, but also a deep concern and involvement in assisting the parties to improve the long-term performance of collective bargaining. The Committee has stimulated the adoption of new dispute settling machinery in branches of the industry, broadening the geographical structure of bargaining where appropriate, introducing differential rates for specialized branches of the industry such as housing, and reviewing work rules and improving productivity with due regard to the interests of workers and contractors.

Self-Administered Sector

A high degree of voluntarism made extensive compliance efforts unnecessary, but in the following cases the Council found it necessary to intervene to prevent the implementation of destabilizing wage increases.

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MAJOR CHALLENGES

Number Employees	Company	Percentage Involved
3-4000	4 Airlines - Mechanics	6% - 7%
350	Western Empire Operators (office and clerical)	16%
700	Chicago Tool & Die (several thousand more will be affected indirectly)	14%
4,000	Anheuser-Busch	15%
1,500	Schlitz	15%
200	Chicago Grain Trimmers	20%
1,900	California Cement Manufacturers	9%
4,500	Commercial Printers New York City	8%
3,000	East Bay Mechanics	17%
80	American Bank Note (but affects directly all U.S. Treasury Engravers)	15%
200,000	Non-union Textiles (not actually challenged--agreed to roll back to 25¢)	Various, well in excess of 5.5%
10,500	West Coast Pulp and Paper	7.5% - 11%
7,000	Phillip Morris	11.5%

TOTAL WAGE CASES REVIEWED*

Number of cases - 1,005

Number of employees affected - 3,927,381

*Through December 31, 1973

PROCEDURES AND ADMINISTRATION

1973 marked enhanced awareness of the importance of continual frank communication between the government, the controlled entities and consumers. Throughout the year, the Council built on the experiences of Phase II and broadened the scope of consumer, industry, and labor input into the stabilization program.

- Five advisory committees were created to provide regular advice to the Council in specific problem areas.

  - The Labor Management Advisory Committee provided blue-ribbon advice on methods of improving the collective bargaining process and assuring wage and salary settlements consistent with productivity gains.

  - The Tripartite Health and Food Industry Wage and Salary Committees made recommendations on individual health and food industry wage and salary cases, including advice on facilitating settlements and improving collective bargaining results.

  - The Food and Health Industry Advisory Committees provided advice on the operations of the Stabilization Program as it relates to food and health prices. Both were instrumental in providing information to the Council needed to formulate regulation changes.

  - A Non-Union Construction Advisory Committee, established in November, provided input for policy decisions affecting the non-union construction sector, heard selected exception cases and reviewed and made recommendations on area-wide wage rate requests.

- In early February, the Council held a public hearing on oil pricing policies, specifically on the January home heating oil increases. As a result of the hearings the Council instituted mandatory rules for the major oil companies.

- In the spring, public hearings were held concerning lumber price performance with both producers and users invited to participate. A specific control scheme was published to focus the testimony. As a result of the hearings, the control strategy was not adopted.

- In late April, the Council held the first of a series of consultations with consumer spokesmen about short and long range stabilization policies.

- In June, the Council issued regulations implementing the public disclosure provisions of the Hathaway Amendment to the Economic Stabilization Act Amendments of 1973. With the initiation of Phase IV controls, the question arose whether the Amendment, written in terms of "reporting requirements under section 130.21(b) of the regulations of the Cost of Living Council in effect on January 11, 1973" would continue to be applicable.

- During the development of Phase IV, representatives of the Council consulted with over 400 individuals and groups concerning the basic approach that Phase IV should take.

- The initial set of Phase IV regulations, the first Economic Stabilization Program regulations released for public comments, elicited over 1,000 written responses and other numerous oral sessions. These comments were reviewed by the Council, and resulted in a number of important amendments to the final regulations. Since then, all major regulation changes have been released for public comments.

- Nine major public hearings have been held since August concerning substantial price prenotifications.

Auto Industry	August 28
Steel Industry	August 30 and 31
Paper Industry	September 19
Rubber Tire Industry	September 20
Soap and Detergent Industry	September 21
U.S. Postal Service	November 14 and 15
Auto Industry	November 20 and 21
Steel Industry	December 19 and 20
Rubber Industry	January 22

These hearings not only resulted in additional information for the Council but also provided the public with an opportunity to express their views on the impact of the prenotified price increase.

- While the Council has continued to provide for increased participation in the development and implementation of the program, it has also decentralized broad operating authority to the Internal Revenue Service. During the year, IRS compliance activity resulted in over 22,000 refunds and rollbacks.

- To improve the information gathering and decision making functions of the Council, there were three major reorganizations reflecting varying priorities through the year.

    - The Pay Board and the Price Commission were terminated in early January and their responsibilities were assigned to the Council's Wage Stabilization Division and Price Monitoring Division.

    - During the June 13th Freeze a Special Freeze Group under the direction of the Cost of Living Council was established.

    - When the Freeze was terminated and Phase IV developed on a sector-by-sector basis, the Food, Wage, Health, and Price Monitoring Divisions were established as distinct offices with their own specialized staffs to handle prenotification, exceptions and exemption requests and a new Energy Division was established in the Office of Price Stabilization. The old Compliance and Enforcement Division was revised to monitor the Council's internal operation as well as to maintain the liaison with the strengthened Internal Revenue staff. Also, a Public Sector Division was created to monitor state and local wage settlements.

- The basic legislative authority for the program was reviewed generally early in the year and the Congress enacted several amendments to the Administration's request for a simple one-year extension of the Economic Stabilization Act of 1970, as amended.

  The Senate moved relatively quickly to approve, with some amendments, a one-year extension to April 30, 1974. However, the House Banking Committee in early April reported out a bill that would have required a rollback of prices and interest rates to levels prevailing on January 10, 1973. Protracted debate on such proposals raised concern that the Economic Stabilization Act would expire before Congressional action was completed, and a temporary 60-day extension was discussed. Congressional action was completed, however, and the Act was extended for one year with only a few additional amendments on April 30, 1973. The long period of Congressional debate and discussion of stringent stabilization proposals may have encouraged firms to increase prices more rapidly in order to establish a more favorable base in any new controls program.

- The six amendments:

  - Authorized the President to allocate petroleum products.

  - Directed the President to define "substandard earnings" to mean earnings not less than those resulting from a wage rate of $3.50 per hour.

  - Prohibited use of the Act as a basis for impounding funds.

  - Added a provision requiring that "employees in all industries subject to controls... shall be treated equally for purposes of this title."

  - Required businesses to disclose certain data submitted to justify price increases.

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- Provided that no order with the effect of reducing wages or salaries could be issued unless the order was made on the record after an opportunity for a hearing, with an accompanying statement explaining the reasons for the decision.

- The Council's authority was also reviewed on several occasions by the courts, in response to specific challenges.

  - In Pacific Coast Meat Jobbers Association v. CLC, the Temporary Emergency Court of Appeals sustained CLC authority to enforce meat price ceilings.

  - In Anderson v. Dunlop, the Temporary Emergency Court of Appeals dissolved a preliminary injunction against enforcement of the retail gas price ceiling on the grounds that the plaintiff had failed to exhaust available administrative remedies. Several weeks later, TECA ruled in National Petroleum Refiners Association v. Dunlop that a challenge to the octane posting requirement did not involve substantial constitutional issues. That case was remanded to deal with the non-constitutional questions.

  - In Schirtzinger v. Dunlop, TECA denied the claim of unlawful discrimination and held that different treatment of refiners and retailers did not constitute a denial of due process.

  - In Consumers Union v. Dunlop, the District Court for the District of Columbia sustained the Council's interpretation of the provisions of the Hathaway amendment. The Temporary Emergency Court of Appeals reversed the District Court's decision on January 11, 1974 and ordered the Council to promulgate new public disclosure regulations. The Council has sought a rehearing of this decision.

  - In Nader v. Dunlop, the District Court for the District of Columbia ordered that future advisory committee meetings be open to the public unless the meeting involved discussion of a document itself exempt from disclosure under the Freedom of Information Act. The Council has not sought appeal of this decision.

- In Chrysler Corporation v. Dunlop, the District Court of the District of Columbia denied a preliminary injunction sought against the Council for deferring consideration of a prenotified price increase. The Temporary Emergency Court of Appeals remanded the case to the Distruct Court to make further findings of fact. This case was later dismissed as moot.

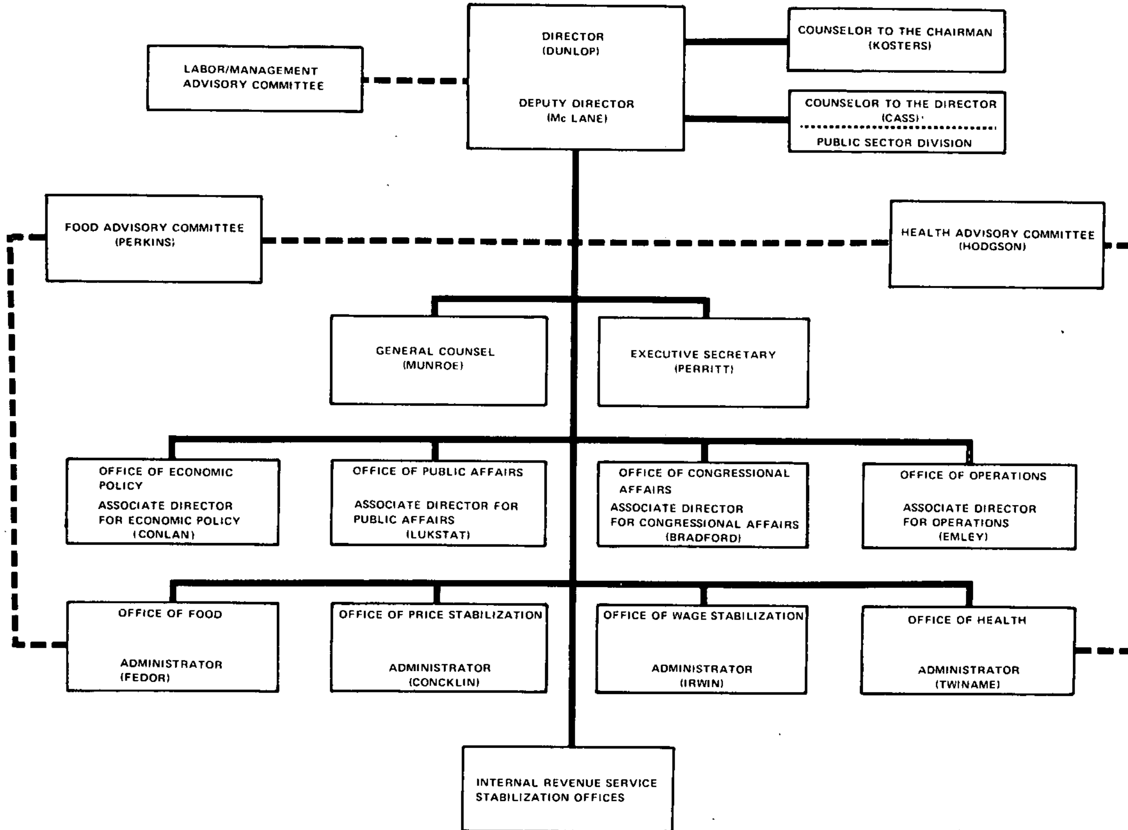
- In League of Voluntary Hospitals v. Local 1199, the District Court for Southern District of New York ruled that the Council's health wage and salary regulations were not arbitrary and capricious. This was upheld by the Temporary Emergency Court of Appeals on December 20, 1973.

- In American Nursing Homes v. CLC, the District Court for the District of Columbia granted an injunction against application of Cost of Living Council regulations to nursing home prices. This was stayed by the Temporary Emergency Court of Appeals on January 11, 1974 and the District Court granted the Council a rehearing on January 25, 1974. There has been no decision as yet on that rehearing.

- American Hospital Association v. CLC, filed in District Court for the District of Columbia on January 28, 1974 challenges the Phase IV health care regulations as they apply to acute care hospitals.

- In U.S. v. State of Ohio, the Temporary Emergency Court of Appelas upheld the Council's authority to regulate wages of state employees.

- In B.F. Goodrich v. Dunlop, suit was filed in the U.S. District Court for the District of Columbia challenging the Special Rule Number 2 and the "basket clause"; 6 C.F.R. §150.154. On January 30, 1974, the Cost of Living Council exempted rubber tires and tubes, rendering the lawsuit moot.



Cost of Living Council
February 1, 1974

COMPARISON OF PHASES II, III AND IV

	PHASE II	PHASE III	PHASE IV
GENERAL MANUFACTURING AND SERVICE			
Base Price	Highest price at or above which 10% or more of the units were charged during 30 days prior to August 15, 1971.	Phase II base price, or the average price charged during last fiscal quarter ended prior to January 11, 1973 or prices authorized or lawfully in effect on January 11, 1973.	Average price charged in last fiscal quarter ended before January 11, 1973.
Cost Pass-through	Full, profit margin maintenance.	Same as Phase II	Dollar-for-dollar pass-through only.
Cost Reachback	To date of last price increase or to Jan. 1, 1971, whichever was later.	To date of last price increase prior to Jan. 11, 1973, or to Jan. 1, 1971, whichever was later.	To base cost period (last fiscal quarter which ended prior to January 11, 1973), for manufacturing and service organizations.
Profit Margin Limitation	Could not exceed weighted average of margin in best 2 of 3 fiscal years ending before August 15, 1971; limitation did not apply until price above base price was charged.	Same as Phase II except Fiscal Years which ended after August 15, 1971, could also be used other than the one for which compliance was being measured.	Same as Phase III, except limitation does not apply until price above base price or Freeze II price (whichever is higher) is charged.

COMPARISON OF PHASES II, III AND IV

	PHASE II	PHASE III	PHASE IV
PROCEDURES AND COVERAGE			
Exceptions Criteria	Gross hardship or inequity.	Self-executing based on Phase II regulations.	Same as Phase II, but concept of "inequity" broadened to include market distortion.
Prenotification	In general, required of all firms over $100 million annual sales, 30 days before implementation; approval required.	After May 2, 1973, required of all firms over $250 million annual sales which had implemented price increases which resulted in WAPI exceeding 1.5%; 30 days before implementation.	Prenotified price increase may be implemented without specific approval in 30 days unless CLC suspends, denies or cuts back. Right reserved to reexamine price increases put into effect; required of all firms with over $100 million annual sales.
Reporting	Quarterly for firms over $50 million annual sales.	Quarterly for firms with annual sales or revenues of $250 million or more.	Same as Phase II, except monthly reports required for food manufacturers and petroleum refiners.
Small-Firm Exemption	60 employees or fewer and less than $50 million in sales, except in construction and health industries. Also did not apply to lumber firms with $100,000 or more in sales.	Same as Phase II.	Same as Phase II, except does not apply to gasoline sales or to construction firms with more than $1 million in sales. Lumber firms totally exempt in Phase IV.

COMPARISON OF PHASES II, III AND IV

	PHASE II	PHASE III	PHASE IV
FOOD			
Price Adjustments	Sames as general manufacturing and service	Continued under mandatory Phase II controls with some modifications-particularly meat ceilings imposed in March, 1973.	Food manufacturers controlled by gross margin on product-line basis. Allows an immediate pass through of raw agricultural product costs and requires price reductions when costs decrease. Price changes due to increase in other costs must be prenotified. Food firms subject to profit limitation whether or not any prices are raised. Food service and wholesale/retail generally subject to general Phase IV service and wholesale/retail regulations except no prenotification for food service and profit margin limitation always applies to food service and food wholesaling/retailing.

COMPARISON OF PHASES II, III AND IV

	PHASE II	PHASE III	PHASE IV
HEALTH	Special regulations.	Special regulations.	
Hospitals			Controlled on the basis of charges and expenses per in-patient admission with separate increase on out-patient service.
Nursing Homes			Limited to a 6.5% annual increase in realized revenue per day.
Medical Practitioners Including Physicians and Dentists			Limited to a 4 percent aggregate weighted price increase.
INSURANCE	Special regulations.	Subject to general price standard.	Formula for allowable trend factor modified from Phase II and III.

FOOD DURING PHASE IV (Detailed)

FOOD MANUFACTURERS	REGULATIONS	DIFFERENCE FROM MANUFACTURER
Control	Prices controlled on basis of gross margin rule relating total permissible revenues in current period to base revenues by product line. Permissible revenues may increase by an amount equal to the change in net allowable costs since the base period. Firm-wide profit margin limit always applies.	Food manufacturer controlled through product line gross margin; general manfuacturers through individual price increases above base level.
Cost Pass-through	Food raw material costs passed through dollar-for-dollar without prenotification and without "volatile" pricing authorization. All other pass throughs subject to prenotification for firms with annual sales exceeding $100 million (Tier I).	Same-all costs pass through on dollar and cent basis.
Prenotification	All non-raw material cost increases must be prenotified and may be used to increase revenues in 30 days unless CLC or IRS suspends, denies, or cuts back: Required of all Tier I food firms.	General manufacturers same as food except food need not prenotify with respect to food raw material costs.
Reporting	Monthly for costs and sales, and quarterly for costs, sales and profits	Food manufacturers requirement for monthly report differs from quarterly manufacturers' requirement.
Price Base Period	Any 4 consecutive fiscal quarters of 8 fiscal quarters, ending prior to May 1973. Meat industry has choice of 4 consectuive fiscal quarters of the 11 fiscal quarters ending prior to that date.	Choice of base period and wider base for food manufacturers.

FOOD DURING PHASE IV (Cont'd)

	REGULATIONS	DIFFERENCE FROM MANUFACTURER
Profit Margin Limitation	Subject to base period profit margin, whether or not prices were increased.	General manufacturers not subject to base period profit margin if prices not raised since Freeze II.
FOOD WHOLESALE AND RETAIL		
Control	Subject to control through percentage markup or margin over cost of goods on basis of merchandise categories. Food retailers, at the pricing entity level, may treat entire retailing operation as single merchandise category for control. Profit margin limit always applies.	Single pricing entity status for general merchandisers not permitted. Same except food retailers have store-wide merchandise category control and profit margin limit automatically applies to food wholesale/retail.
Pricing Base Period	Either one of the last 2 fiscal years ending prior to February 1973 or the most recent four consecutive fiscal quarters ending before February 1973.	Food retailers have one additional choice for base period.
Food Service Activities	Subject to Industrial Regulations except no prenotification required and profit margin limit always applies.	Food always subject to profit margin limit but no prenotification required.

APPENDIX E

Behavior of items in consumer price index during Phases II and III, classified by type of control applicable

Item and control status	Relative importance, December (percent of all items)		Percent change, annual rates[1]		Percent contribution to change	
	1971	1972	Phase II Nov. 1971 to Jan. 1973	Phase III Jan. 1973 to June 1973	Phase II Nov. 1971 to Jan. 1973	Phase III Jan. 1973 to June 1973
All items	100.0	100.0	3.6	8.3	100	100
A. Items exempt from Phases II and III[2]	11.3	11.5	4.4	5.5	13	7
B. Items subject to similar regulations in Phases II and III:						
Food	22.2	22.5	6.5	20.3	38	51
Public utilities[3]	4.8	4.8	4.2	2.8	5	1
Medical care services	5.6	5.6	3.9	3.8	6	2
Mortgage interest rates	3.7	3.7	-.8	1.8	-1	1
C. Items for which Phase II controls abolished or made self-administered:[4]						
Residential rents	5.1	5.1	3.8	4.4	5	3
Nonfood commodities	32.2	31.8	2.1	6.1	18	22
Services	15.2	15.1	3.3	6.2	16	13
Total A+B	47.6	48.1	4.8	11.7	61	63
Total C	52.4	51.9	2.6	6.0	39	37
Addendum: C excluding gasoline, motor and fuel oil, and coal	48.8	48.4	2.6	5.1	36	30

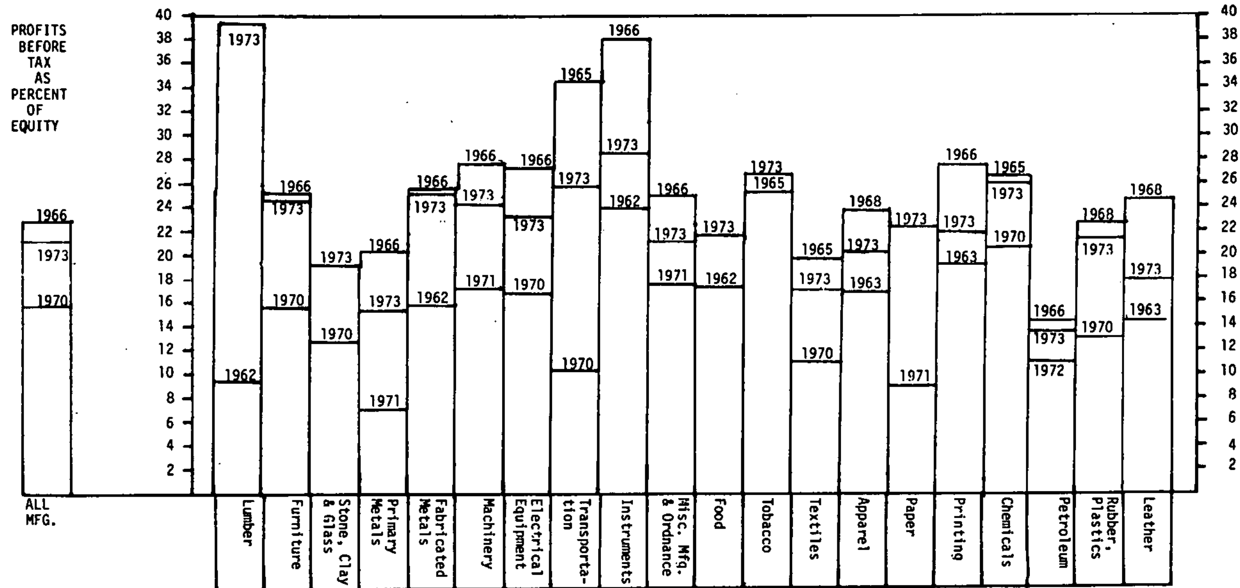
[1] Seasonally adjusted where possible. Major exceptions are property taxes, services, and residential rents.
[2] Major items are houses, used cars, and State and local taxes and user charges.
[3] Though the Phase II requirement for certification was dropped in Phase III, the basic regulations continued in force.
[4] Excludes components included in A and B above and does not take into account the small business exemption.

Note. Detail may not add to total because of rounding.

Sources: Department of Labor (Bureau of Labor Statistics) and Council of Economic Advisers.
Economic Report of the President, February 1, 1974, page 104

APPENDIX F

INDUSTRY COMPARISON OF PROFITS BEFORE TAX AS PERCENT OF EQUITY

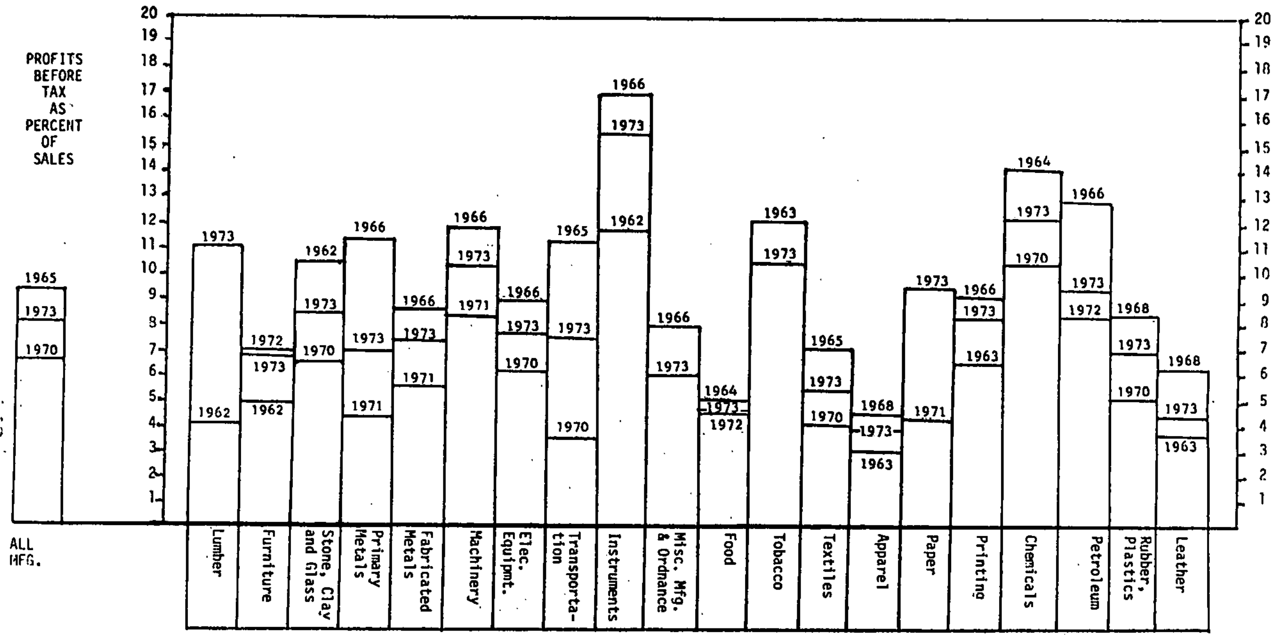


NOTE: Year on top is highest profit rate in 1962-1973 span.
Year on bottom is lowest profit rate in 1962-1973 span.
1973 (3 quarters only) is shown separately if it is not either the high or low rate.

SOURCE: Cost of Living Council

DATE: January 31, 1974

INDUSTRY COMPARISON OF PROFITS BEFORE TAX AS PERCENT OF SALES

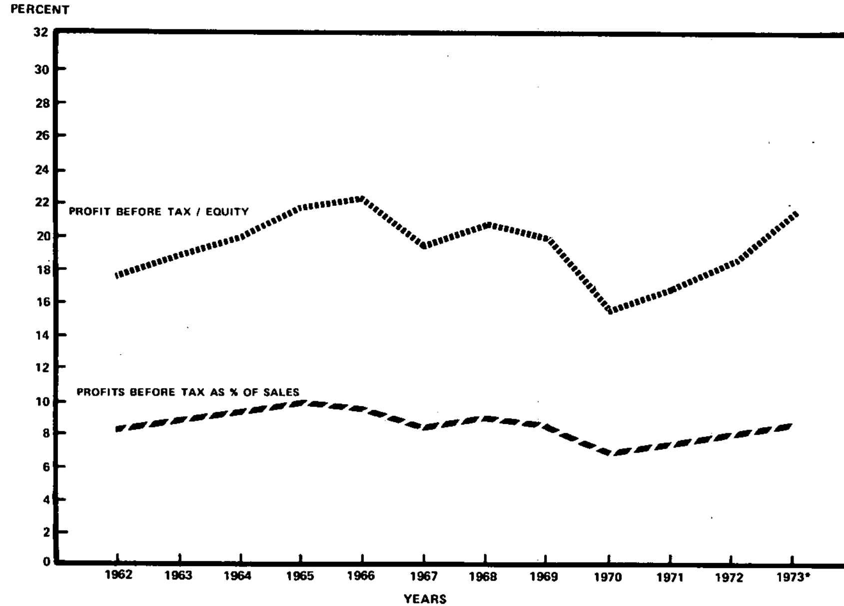


NOTE: Year on top is highest profit rate in 1962-1973 span.
Year on bottom is lowest profit rate in 1962-1973 span.
1973 (3 quarters only) is shown separately if it is not either the high or low rate.

SOURCE: Cost of Living Council

DATE: January 25, 1974

PRE TAX PROFIT MARGINS & PROFIT BEFORE TAX/EQUITY FOR ALL MANUFACTURING



	MANUF
1973 ESTIMATED PRE-TAX MARGIN	8.0
1970 THRU '72 AVERAGE MARGIN	7.0
1962 THRU '69 AVERAGE MARGIN	8.7

	MANUF
1973 ESTIMATED PROFITS PRE TAX/EQUITY	21.6
1970 THRU '72 AVERAGE	16.8
1962 THRU '69 AVERAGE	20.0

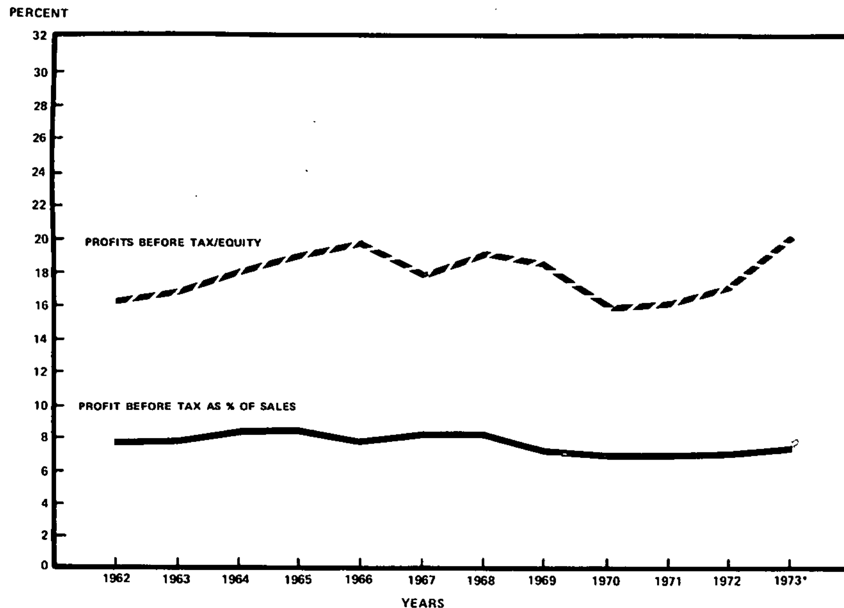
* NOTE: 1973 IS THROUGH THIRD QUARTER ONLY

DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL
DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTURING CORPORATIONS" FEDERAL TRADE COMMISSION

33-074 O - 74 - 9

PRE TAX PROFIT MARGINS & PROFIT BEFORE TAX/EQUITY FOR ALL NON DURABLE GOODS



NON DURABLE GOODS	
1973 ESTIMATED PRE-TAX MARGIN	7.6
1970 THRU '72 AVERAGE MARGIN	7.2
1962 THRU '69 AVERAGE MARGIN	8.2

NON DURABLE GOODS	
1973 ESTIMATED PROFITS PRE TAX/EQUITY	19.8
1970 THRU '72 AVERAGE	16.7
1962 THRU '69 AVERAGE	18.2

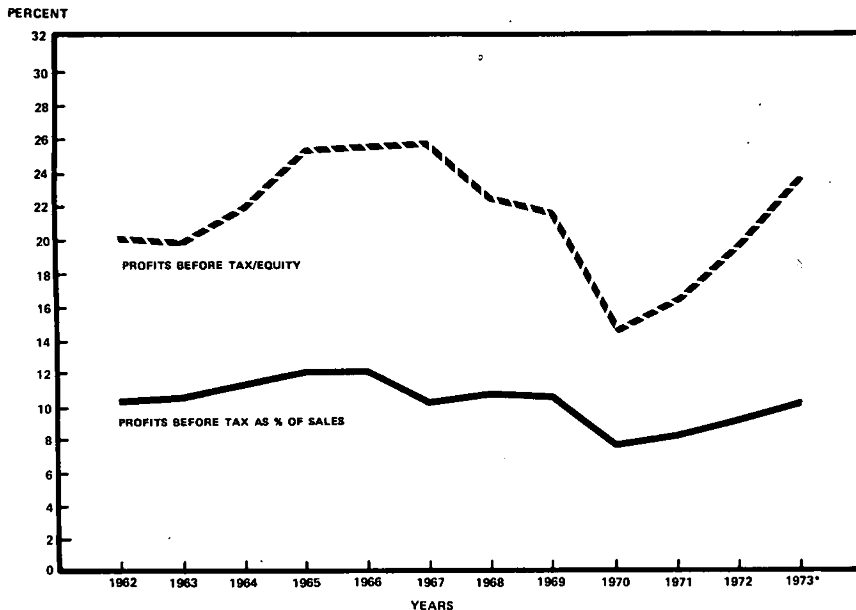
* NOTE: 1973 IS THROUGH THIRD QUARTER ONLY

DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL

DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTURING CORPORATIONS" FEDERAL TRADE COMMISSION

PRE TAX PROFIT MARGINS & PROFIT BEFORE TAX/EQUITY
FOR DURABLE GOODS



DURABLE GOODS	
1973 ESTIMATED PRE-TAX MARGIN	8.4
1970 THRU '72 AVERAGE MARGIN	6.9
1962 THRU '69 AVERAGE MARGIN	9.1

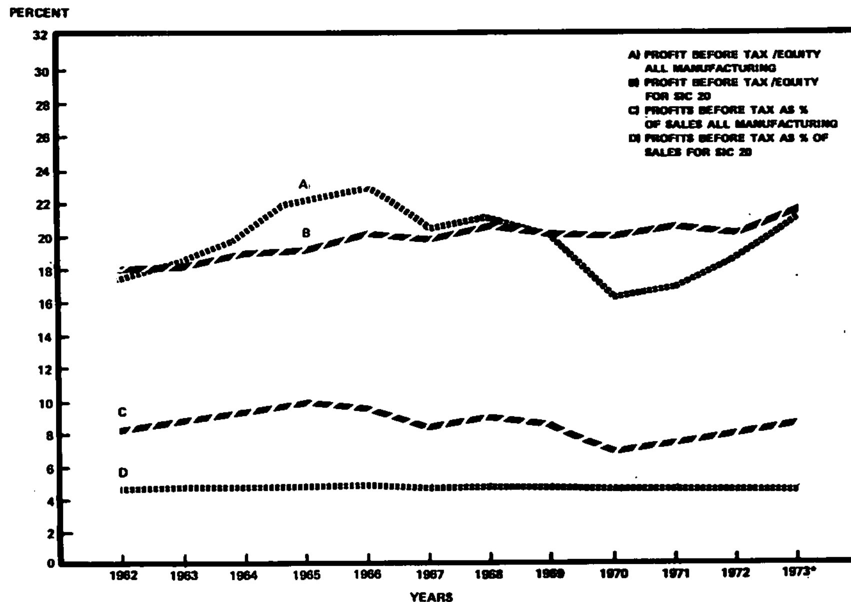
DURABLE GOODS	
1973 ESTIMATED PROFITS PRE TAX/EQUITY	23.5
1970 THRU '72 AVERAGE	16.9
1962 THRU '69 AVERAGE	21.8

* NOTE: 1973 IS THROUGH THIRD QUARTER ONLY

DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL
DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTURING CORPORATIONS" FEDERAL TRADE COMMISSION

PRE TAX PROFIT MARGINS & PROFIT BEFORE TAX/EQUITY FOR ALL MANUFACTURING AND FOOD (SIC 20)



	MANUF	FOOD
1973 ESTIMATED PRE-TAX MARGIN	8.0	4.6
1970 THRU '72 AVERAGE MARGIN	7.0	4.7
1962 THRU '69 AVERAGE MARGIN	8.7	4.8

	MANUF	FOOD
1973 ESTIMATED PROFITS PRE TAX/EQUITY	21.6	21.9
1970 THRU '72 AVERAGE	16.6	20.3
1962 THRU '69 AVERAGE	20.0	19.3

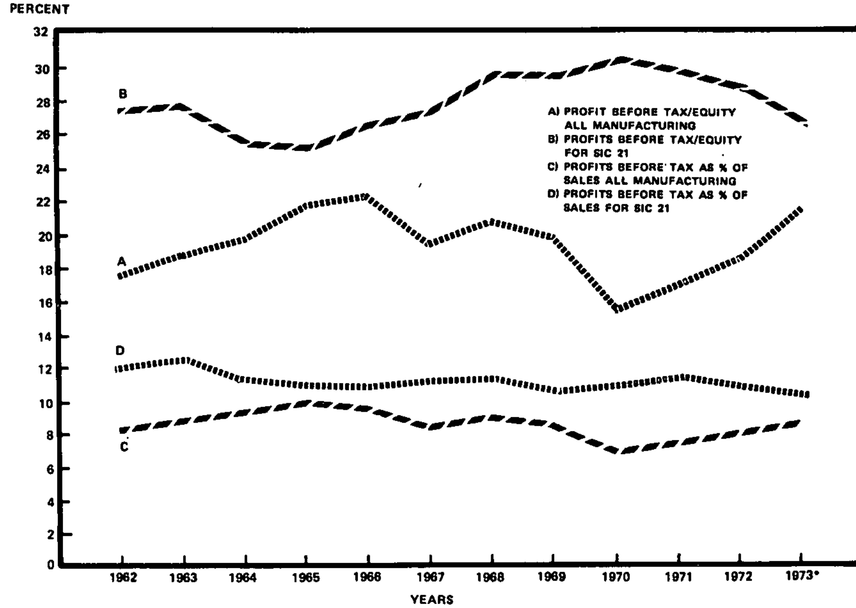
*NOTE: 1973 IS THROUGH THIRD QUARTER ONLY

DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL

DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTURING CORPORATIONS" FEDERAL TRADE COMMISSION

PRE TAX PROFIT MARGINS & PROFIT BEFORE TAX/EQUITY FOR ALL MANUFACTURING AND TOBACCO (SIC 21)



	MANUF	TOBACCO
1973 ESTIMATED PRE-TAX MARGIN	8.0	10.5
1970 THRU '72 AVERAGE MARGIN	7.0	11.2
1962 THRU '69 AVERAGE MARGIN	8.7	11.3

	MANUF	TOBACCO
1973 ESTIMATED PROFITS PRE TAX/EQUITY	21.6	26.5
1970 THRU '72 AVERAGE	16.8	29.4
1962 THRU '69 AVERAGE	20.0	27.3

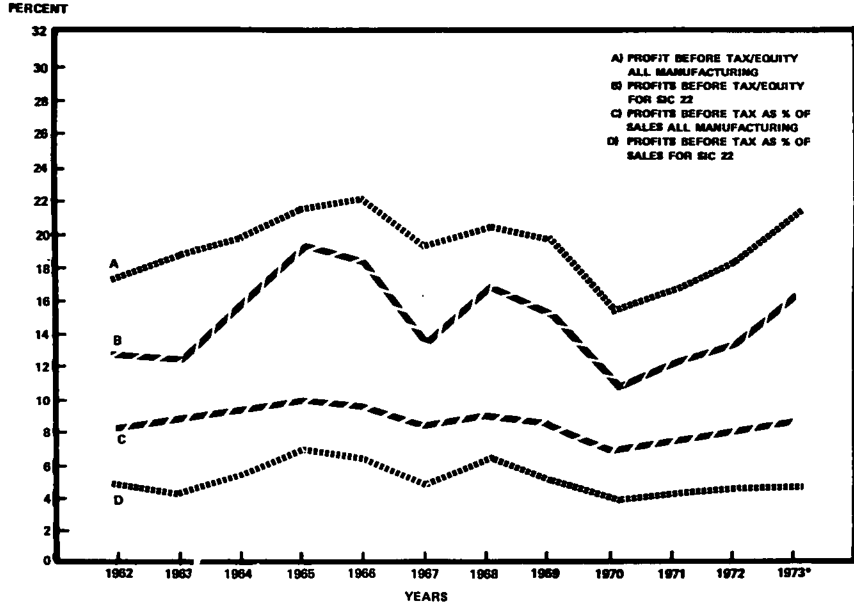
*NOTE: 1973 IS THROUGH THIRD QUARTER ONLY

DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL

DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTURING CORPORATIONS" FEDERAL TRADE COMMISSION

PRE TAX PROFIT MARGINS & PROFIT BEFORE TAX/EQUITY FOR ALL MANUFACTURING AND TEXTILE MILL PRODUCTS (SIC 22)



	MANUF	TEXTILE MILL PRODUCTS
1973 ESTIMATED PRE-TAX MARGIN	8.0	5.4
1970 THRU '72 AVERAGE MARGIN	7.0	4.4
1962 THRU '69 AVERAGE MARGIN	8.7	5.7

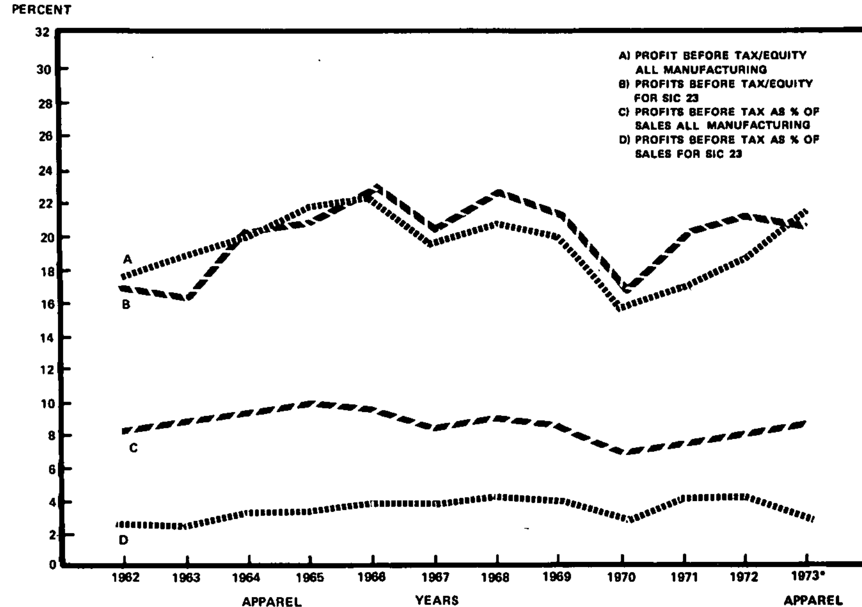
	MANUF	TEXTILE MILL PRODUCTS
1973 ESTIMATED PROFITS PRE TAX/EQUITY	21.6	16.9
1970 THRU '72 AVERAGE	18.8	12.4
1962 THRU '69 AVERAGE	20.0	15.6

* NOTE: 1973 IS THROUGH THIRD QUARTER ONLY

DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL
DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTURING CORPORATIONS" FEDERAL TRADE COMMISSION

PRE TAX PROFIT MARGINS & PROFIT BEFORE TAX/EQUITY FOR ALL MANUFACTURING AND APPAREL FINISHED FABRICS (SIC 23)



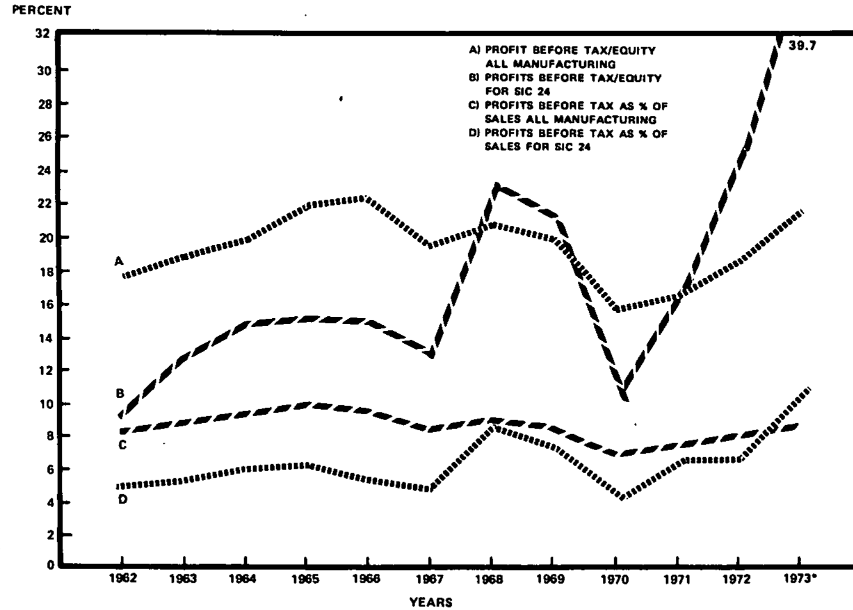
	MANUF	APPAREL FINISHED FABRICS
1973 ESTIMATED PRE-TAX MARGIN	8.0	3.8
1970 THRU '72 AVERAGE MARGIN	7.0	4.1
1962 THRU '69 AVERAGE MARGIN	8.7	3.8

	MANUF	APPAREL FINISHED FABRICS
1973 ESTIMATED PROFITS PRE/TAX EQUITY	21.6	20.1
1970 THRU '72 AVERAGE	16.8	20.0
1962 THRU '69 AVERAGE	20.0	20.6

NOTE: 1973 IS THROUGH THIRD QUARTER ONLY
DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL
DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTURING CORPORATIONS" FEDERAL TRADE COMMISSION

PRE TAX PROFIT MARGINS & PROFIT BEFORE TAX/EQUITY FOR ALL MANUFACTURING AND LUMBER AND WOOD (SIC 24)



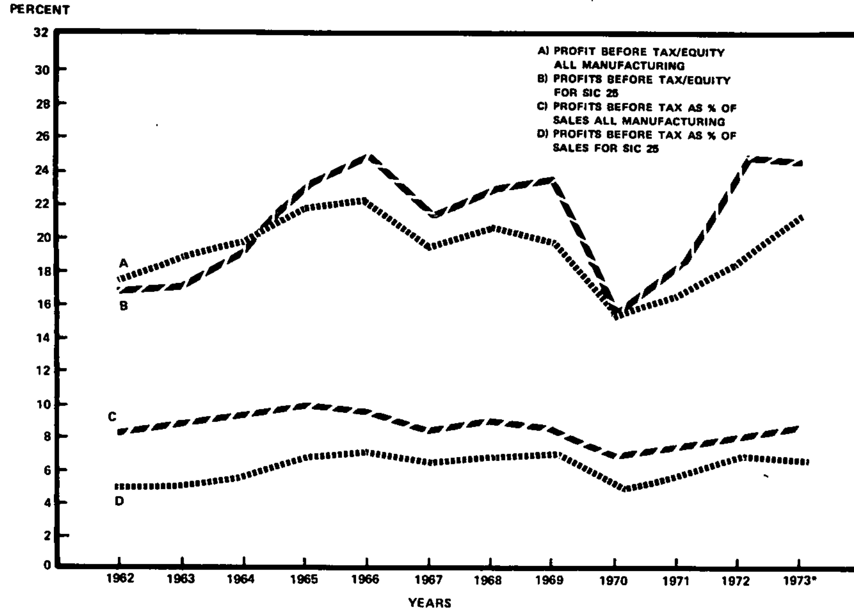
	MANUF	LUMBER AND WOOD
1973 ESTIMATED PRE-TAX MARGIN	8.0	11.0
1970 THRU '72 AVERAGE MARGIN	7.0	5.9
1962 THRU '69 AVERAGE MARGIN	8.7	6.1

	MANUF	LUMBER AND WOOD
1973 ESTIMATED PROFITS PRE TAX/EQUITY	21.6	39.7
1970 THRU '72 AVERAGE	16.8	17.9
1962 THRU '69 AVERAGE	20.0	15.8

NOTE: 1973 IS THROUGH THIRD QUARTER ONLY
DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL
DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTURING CORPORATIONS" FEDERAL TRADE COMMISSION

PRE TAX PROFIT MARGINS & PROFIT BEFORE TAX/EQUITY FOR ALL MANUFACTURING AND FURNITURE AND FIXTURES (SIC 25)



	MANUF	FURNITURE AND FIXTURES
1973 ESTIMATED PRE-TAX MARGIN	8.0	6.7
1970 THRU '72 AVERAGE MARGIN	7.0	5.9
1962 THRU '69 AVERAGE MARGIN	8.7	6.0

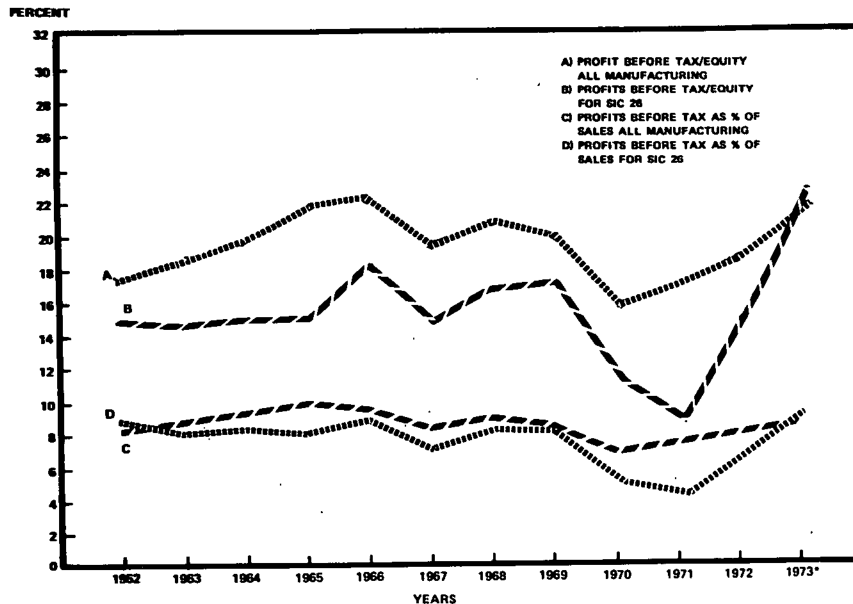
	MANUF	FURNITURE AND FIXTURES
1973 ESTIMATED PROFITS PRE TAX/EQUITY	21.6	24.3
1970 THRU '72 AVERAGE	16.8	19.6
1962 THRU '69 AVERAGE	20.0	21.2

*NOTE: 1973 IS THROUGH THIRD QUARTER ONLY

DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL
DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTURING CORPORATIONS" FEDERAL TRADE COMMISSION

PRE TAX PROFIT MARGINS & PROFIT BEFORE TAX/EQUITY FOR ALL MANUFACTURING AND PAPER (SIC 26)



	MANUF	PAPER
1973 ESTIMATED PRE-TAX MARGIN	8.0	9.4
1970 THRU '72 AVERAGE MARGIN	7.0	5.6
1962 THRU '69 AVERAGE MARGIN	8.7	8.4

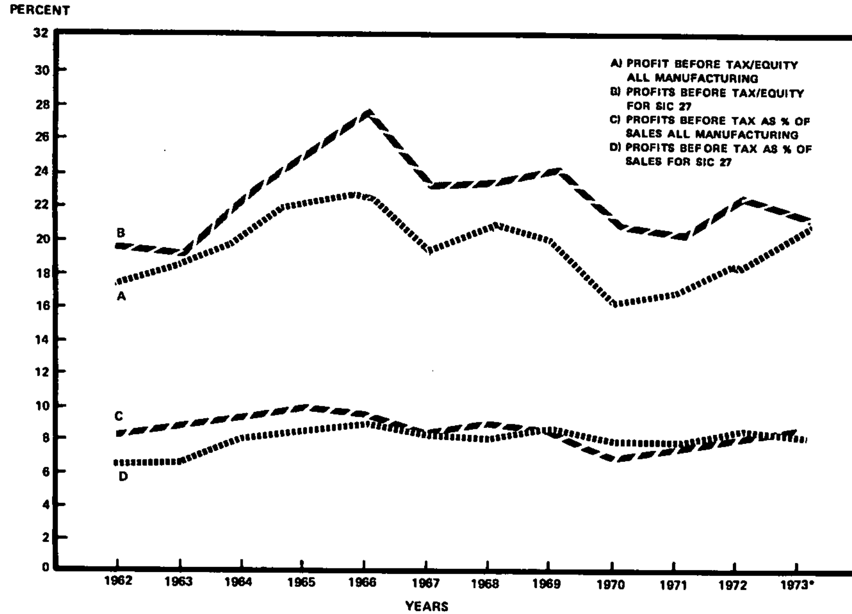
	MANUF	PAPER
1973 ESTIMATED PROFITS PRE TAX/EQUITY	21.6	22.3
1970 THRU '72 AVERAGE	16.8	11.9
1962 THRU '69 AVERAGE	20.0	16.2

*NOTE: 1973 IS THROUGH THIRD QUARTER ONLY

DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL
DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTURING CORPORATIONS" FEDERAL TRADE COMMISSION

PRE TAX PROFIT MARGINS & PROFIT BEFORE TAX/EQUITY FOR ALL MANUFACTURING AND PRINTING AND PUBLISHING (SIC 27)



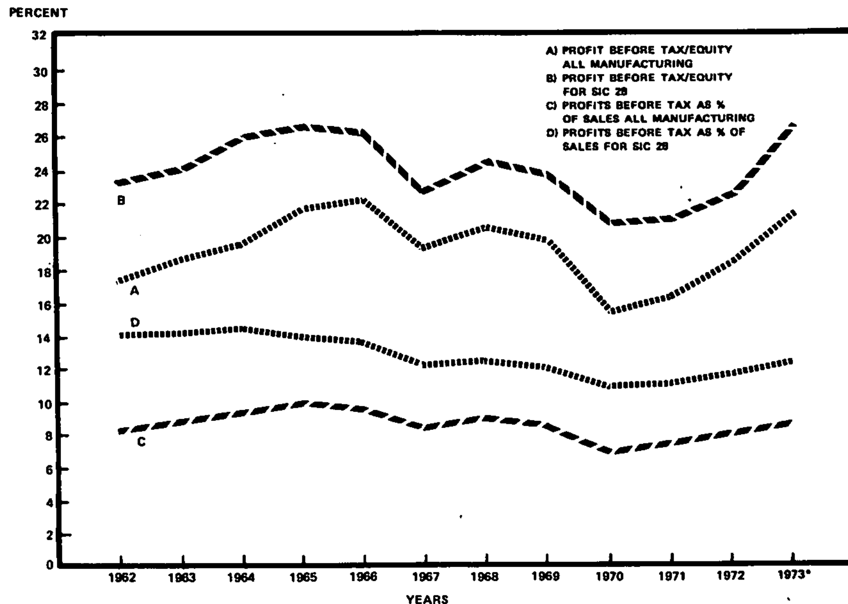
	MANUF	PRINTING AND PUBLISHING
1973 ESTIMATED PRE-TAX MARGIN	8.0	8.3
1970 THRU '72 AVERAGE MARGIN	7.0	8.1
1962 THRU '69 AVERAGE MARGIN	8.7	7.9

	MANUF	PRINTING AND PUBLISHING
1973 ESTIMATED PROFITS PRE TAX/EQUITY	21.6	22.0
1970 THRU '72 AVERAGE	16.8	21.3
1962 THRU '69 AVERAGE	20.0	23.1

* NOTE: 1973 IS THROUGH THIRD QUARTER ONLY
DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL
DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTURING CORPORATIONS" FEDERAL TRADE COMMISSION

PRE TAX PROFIT MARGINS & PROFIT BEFORE TAX/EQUITY FOR ALL MANUFACTURING AND CHEMICALS (SIC 28)



	MANUF	CHEMICALS
1973 ESTIMATED PRE-TAX MARGIN	8.0	12.1
1970 THRU '72 AVERAGE MARGIN	7.0	10.8
1962 THRU '69 AVERAGE MARGIN	8.7	13.2

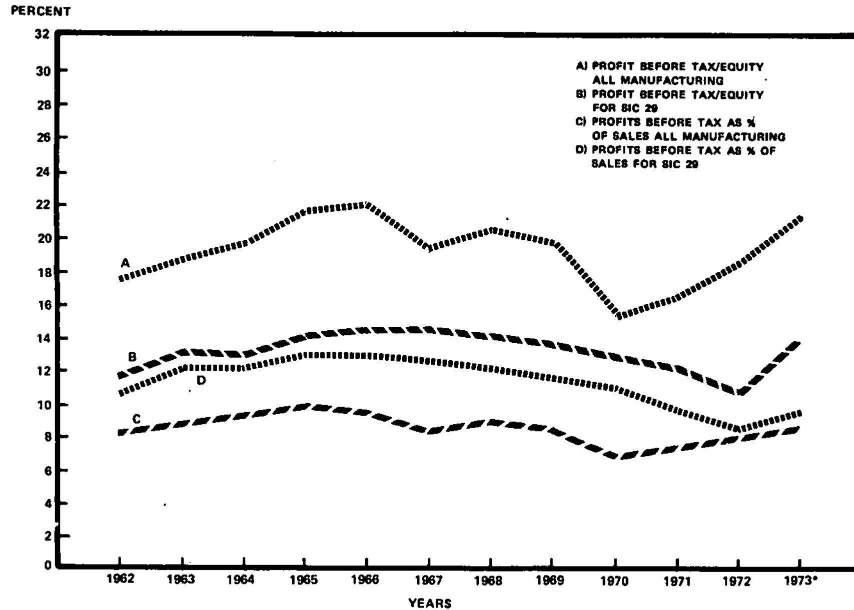
	MANUF	CHEMICALS
1973 ESTIMATED PROFITS PRE TAX/EQUITY	21.6	26.2
1970 THRU '72 AVERAGE	16.8	21.3
1962 THRU '69 AVERAGE	20.0	24.6

* NOTE: 1973 IS THROUGH THIRD QUARTER ONLY

DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL
DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTURING CORPORATIONS" FEDERAL TRADE COMMISSION

PRE TAX PROFIT MARGINS & PROFIT BEFORE TAX/EQUITY FOR ALL MANUFACTURING AND PETROLEUM (SIC 29)



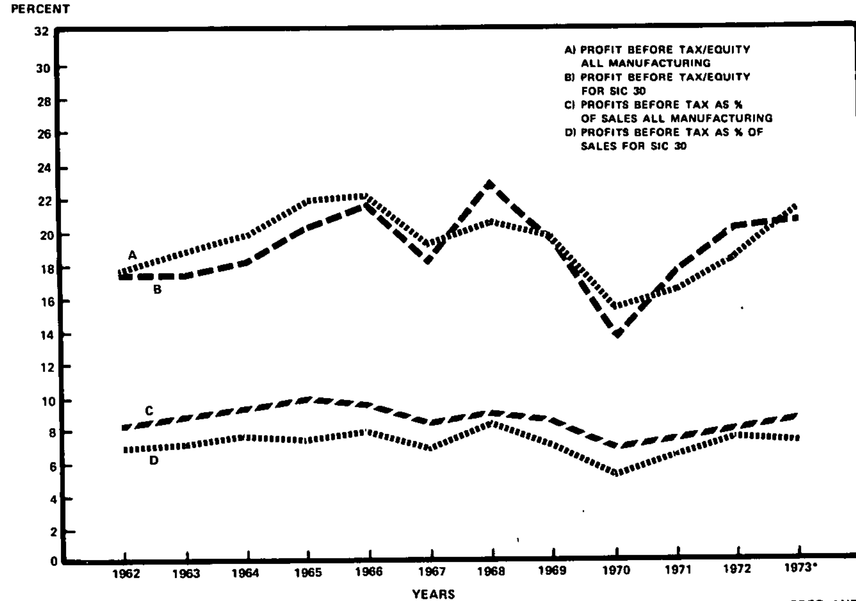
	MANUF	PETROLEUM
1973 ESTIMATED PRE-TAX MARGIN	8.0	9.5
1970 THRU '72 AVERAGE MARGIN	7.0	9.6
1962 THRU '69 AVERAGE MARGIN	8.7	12.1

	MANUF	PETROLEUM
1973 ESTIMATED PROFITS PRE TAX/EQUITY	21.6	13.8
1970 THRU '72 AVERAGE	16.8	11.9
1962 THRU '69 AVERAGE	20.0	13.4

* NOTE: 1973 IS THROUGH THIRD QUARTER ONLY
DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL
DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTURING CORPORATIONS" FEDERAL TRADE COMMISSION

PRE TAX PROFIT MARGINS & PROFIT BEFORE TAX/EQUITY FOR ALL MANUFACTURING AND RUBBER AND PLASTICS (SIC 30)



	MANUF	RUBBER AND PLASTICS
1973 ESTIMATED PRE-TAX MARGIN	8.0	7.0
1970 THRU '72 AVERAGE MARGIN	7.0	6.3
1962 THRU '69 AVERAGE MARGIN	8.7	7.2

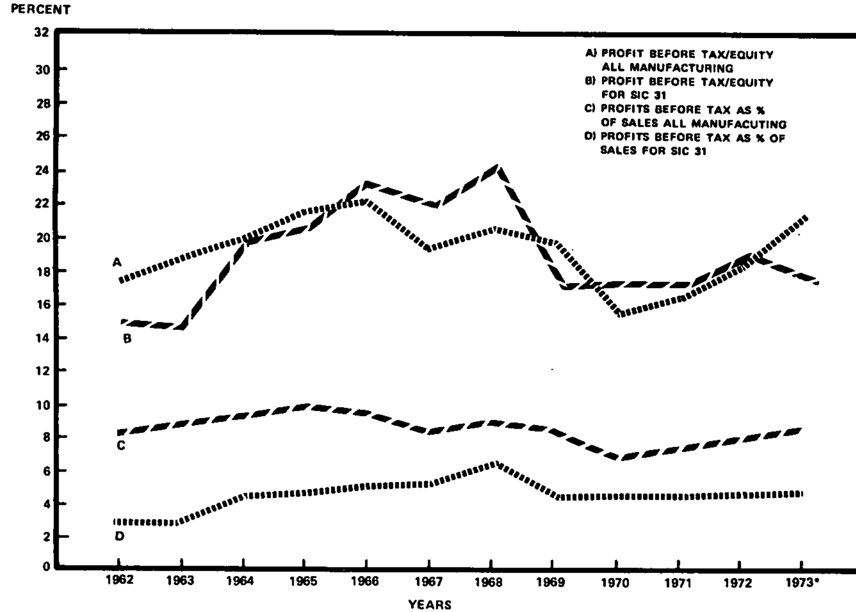
	MANUF	RUBBER AND PLASTICS
1973 ESTIMATED PROFITS PRE TAX/EQUITY	21.6	20.8
1970 THRU '72 AVERAGE	16.8	18.9
1962 THRU '69 AVERAGE	20.0	19.3

* NOTE: 1973 IS THROUGH THIRD QUARTER ONLY

DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL
DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTURING CORPORATIONS" FEDERAL TRADE COMMISSION

PRE TAX PROFIT MARGINS & PROFIT BEFORE TAX/EQUITY
FOR ALL MANUFACTURING AND LEATHER (SIC 31)



	MANUF	LEATHER
1973 ESTIMATED PRE-TAX MARGIN	8.0	4.5
1970 THRU '72 AVERAGE MARGIN	7.0	4.8
1962 THRU '69 AVERAGE MARGIN	8.7	4.8

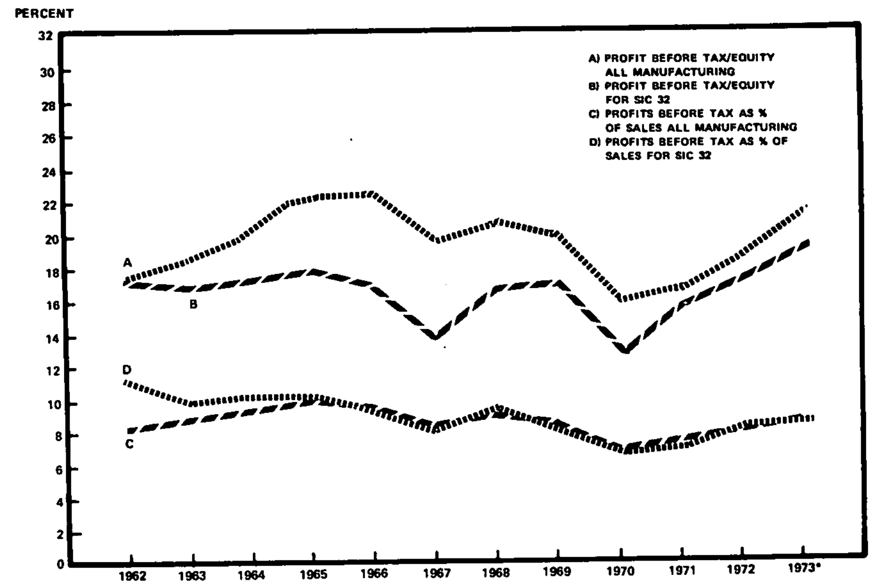
	MANUF	LEATHER
1973 ESTIMATED PROFITS PRE TAX/EQUITY	21.6	17.6
1970 THRU '72 AVERAGE	16.8	18.3
1962 THRU '69 AVERAGE	20.0	19.4

* NOTE: 1973 IS THROUGH THIRD QUARTER ONLY

DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL
DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTUIING CORPORATIONS" FEDERAL TRADE COMMISSION

PRE TAX PROFIT MARGINS & PROFIT BEFORE TAX/EQUITY FOR ALL MANUFACTURING AND STONE, CLAY & GLASS PRODUCTS (SIC 32)



	MANUF	STONE, CLAY AND GLASS PRODUCTS
1973 ESTIMATED PRE-TAX MARGIN	8.0	8.4
1970 THRU '72 AVERAGE MARGIN	7.0	7.4
1962 THRU '69 AVERAGE MARGIN	8.7	9.5

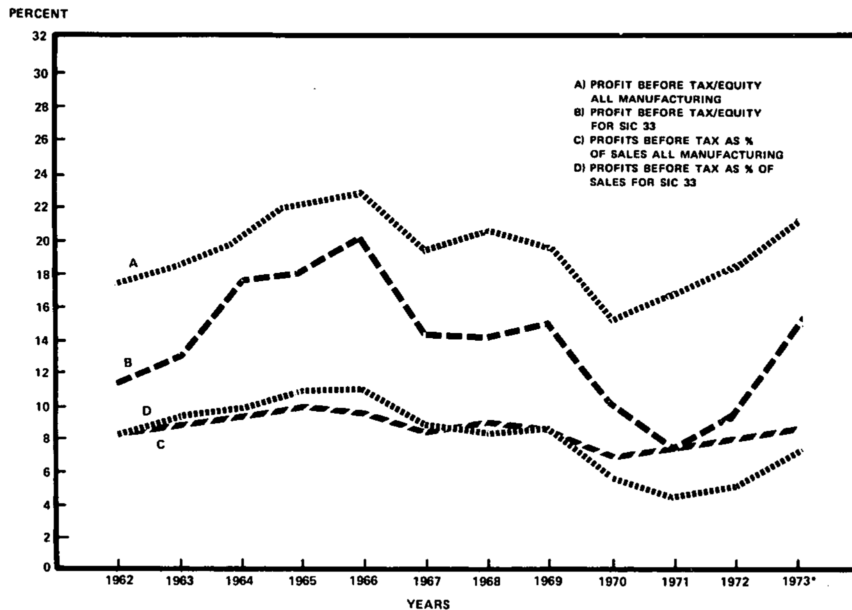
	MANUF	STONE, CLAY AND GLASS PRODUCTS
1973 ESTIMATED PROFITS PRE TAX/EQUITY	21.6	19.4
1970 THRU '72 AVERAGE	16.8	15.2
1962 THRU '69 AVERAGE	20.0	16.4

* NOTE: 1973 IS THROUGH THIRD QUARTER ONLY

DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL
DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTURING CORPORATIONS" FEDERAL TRADE COMMISSION

PRE TAX PROFIT MARGINS & PROFIT BEFORE TAX/EQUITY FOR ALL MANUFACTURING AND PRIMARY METALS (SIC 33)



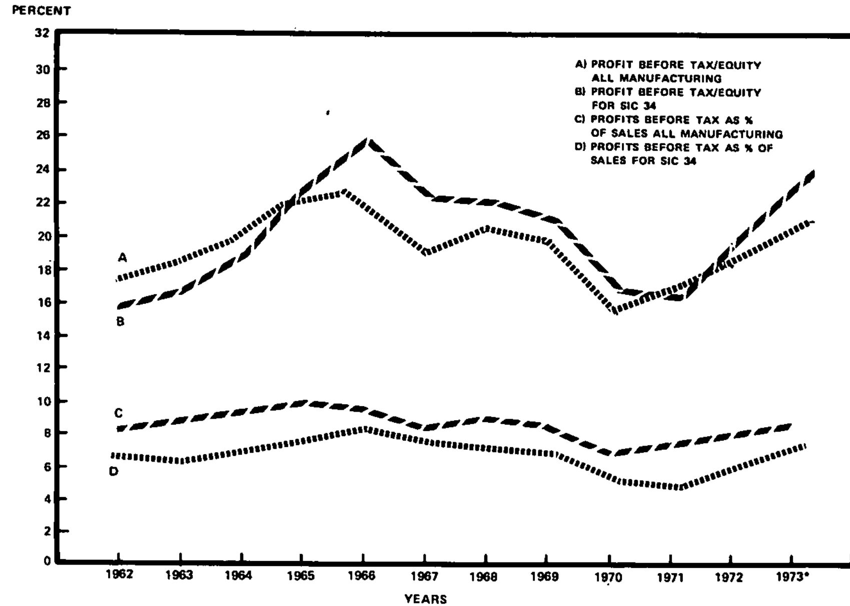
	MANUF	PRIMARY METALS
1973 ESTIMATED PRE-TAX MARGIN	8.0	6.9
1970 THRU '72 AVERAGE MARGIN	7.0	5.1
1962 THRU '69 AVERAGE MARGIN	8.7	8.2

	MANUF	PRIMARY METALS
1973 ESTIMATED PROFITS PRE TAX/EQUITY	21.6	15.0
1970 THRU '72 AVERAGE	16.8	8.9
1962 THRU '69 AVERAGE	20.0	15.0

* NOTE: 1973 IS THROUGH THIRD QUARTER ONLY
DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL
DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTURING CORPORATIONS" FEDERAL TRADE COMMISSION

PRE TAX PROFIT MARGINS & PROFIT BEFORE TAX/EQUITY FOR ALL MANUFACTURING AND FABRICATED METAL PRODUCTS (SIC 34)



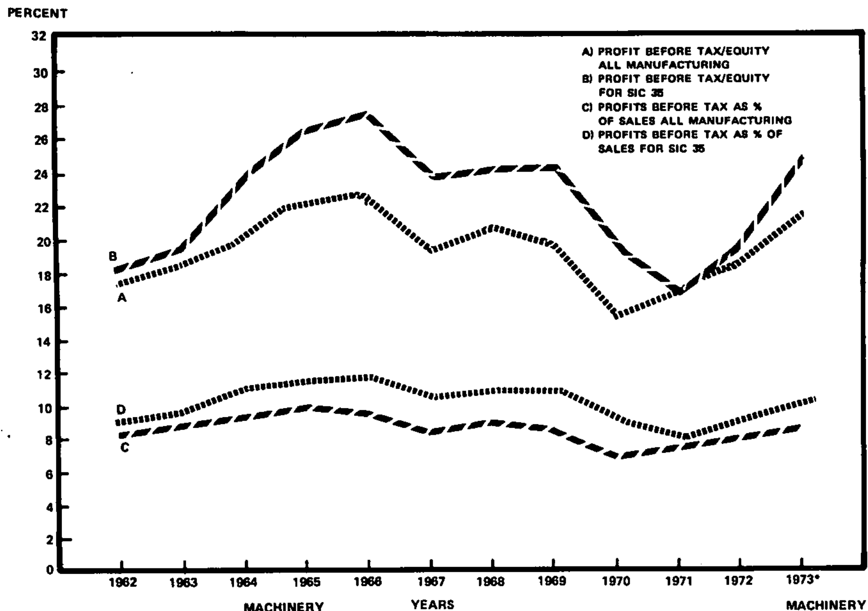
	MANUF	FABRICATED METAL PROD.
1973 ESTIMATED PRE-TAX MARGIN	8.0	7.3
1970 THRU '72 AVERAGE MARGIN	7.0	5.9
1962 THRU '69 AVERAGE MARGIN	8.7	7.3

	MANUF	FABRICATED METAL PROD.
1973 ESTIMATED PROFITS PRE TAX/EQUITY	21.6	25.1
1970 THRU '72 AVERAGE	16.8	17.6
1962 THRU '69 AVERAGE	20.0	20.7

*NOTE: 1973 IS THROUGH THIRD QUARTER ONLY
DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL
DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTURING CORPORATIONS" FEDERAL TRADE COMMISSION

PRE TAX PROFIT MARGINS & PROFIT BEFORE TAX/EQUITY
FOR ALL MANUFACTURING AND MACHINERY EXCEPT ELECTRICAL (SIC 35)



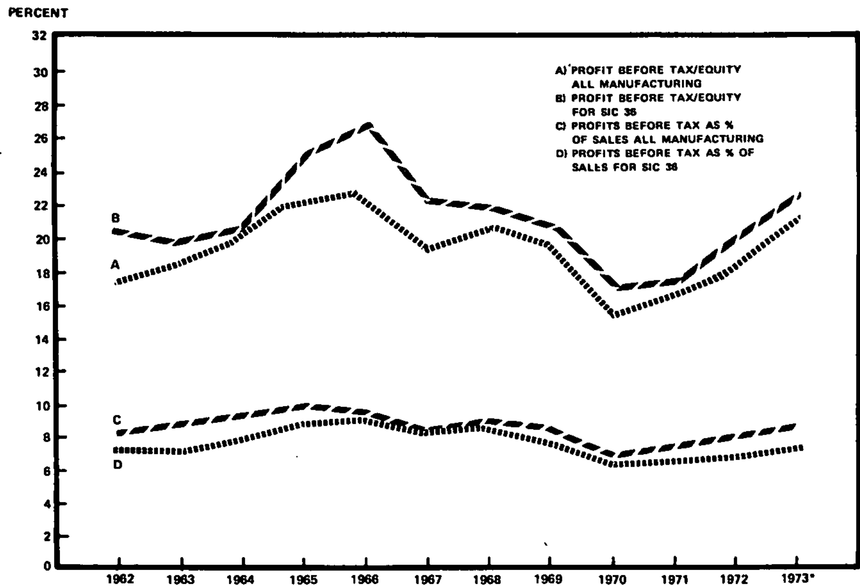
	MANUF	MACHINERY EXCEPT ELECTRICAL
1973 ESTIMATED PRE-TAX MARGIN	8.0	10.2
1970 THRU '72 AVERAGE MARGIN	7.0	8.8
1962 THRU '69 AVERAGE MARGIN	8.7	10.5

	MANUF	MACHINERY EXCEPT ELECTRICAL
1973 ESTIMATED PROFITS PRE TAX/EQUITY	21.6	24.3
1970 THRU '72 AVERAGE	16.8	18.8
1962 THRU '69 AVERAGE	20.0	23.4

* NOTE: 1973 IS THROUGH THIRD QUARTER ONLY
DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL
DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTURING CORPORATIONS" FEDERAL TRADE COMMISSION

PRE TAX PROFIT MARGINS & PROFIT BEFORE TAX/EQUITY FOR ALL MANUFACTURING AND ELECTRICAL EQUIPMENT AND SUPPLIES (SIC 36)



	MANUF	ELECTRICAL EQUIP. AND SUPPLIES
1973 ESTIMATED PRE-TAX MARGIN	8.0	7.7
1970 THRU '72 AVERAGE MARGIN	7.0	6.5
1962 THRU '69 AVERAGE MARGIN	8.7	8.0

	MANUF	ELECTRICAL EQUIP. AND SUPPLIES
1973 ESTIMATED PROFITS PRE TAX/EQUITY	21.6	22.9
1970 THRU '72 AVERAGE	16.8	17.9
1962 THRU '69 AVERAGE	20.0	22.7

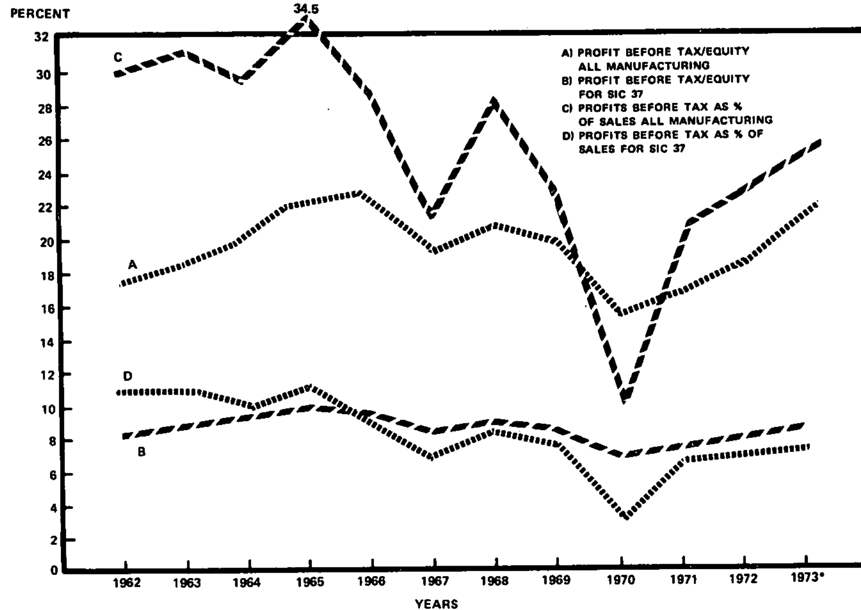
* NOTE: 1973 IS THROUGH THIRD QUARTER ONLY

DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL

DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTURING CORPORATIONS" FEDERAL TRADE COMMISSION

PRE TAX PROFIT MARGINS & PROFIT BEFORE TAX/EQUITY FOR ALL MANUFACTURING AND TRANSPORTATION EQUIPMENT (SIC 37)



	MANUF	TRANS. EQUIP.
1973 ESTIMATED PRE-TAX MARGIN	8.0	7.5
1970 THRU '72 AVERAGE MARGIN	7.0	6.0
1962 THRU '69 AVERAGE MARGIN	8.7	9.4

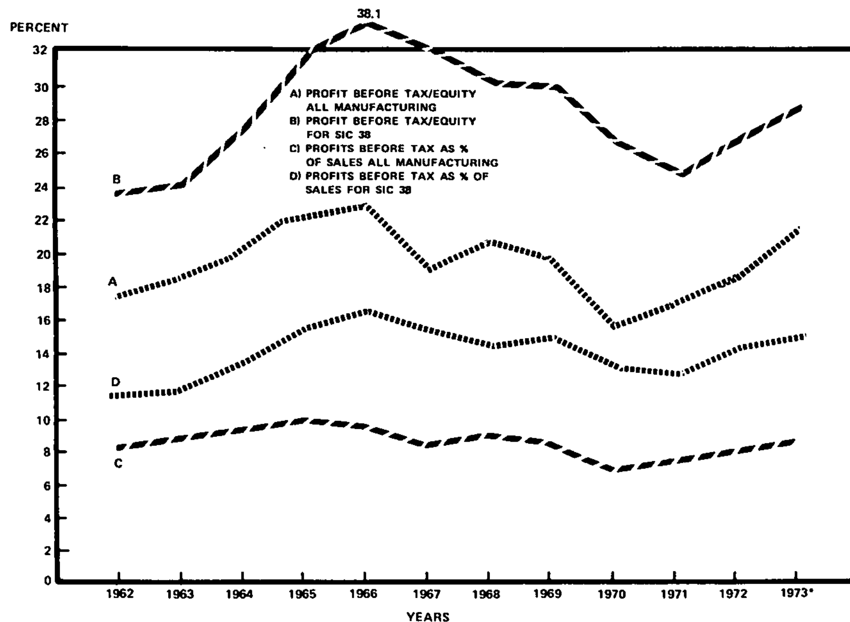
	MANUF	TRANS. EQUIP.
1973 ESTIMATED PROFITS PRE TAX/EQUITY	21.6	25.5
1970 THRU '72 AVERAGE	16.8	18.2
1962 THRU '69 AVERAGE	20.0	28.1

* NOTE: 1973 IS THROUGH THIRD QUARTER ONLY

DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL

DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTURING CORPORATIONS" FEDERAL TRADE COMMISSION



	MANUF	INSTRUMENTS
1973 ESTIMATED PRE-TAX MARGIN	8.0	15.3
1970 THRU '72 AVERAGE MARGIN	7.0	13.9
1962 THRU '69 AVERAGE MARGIN	8.7	14.5

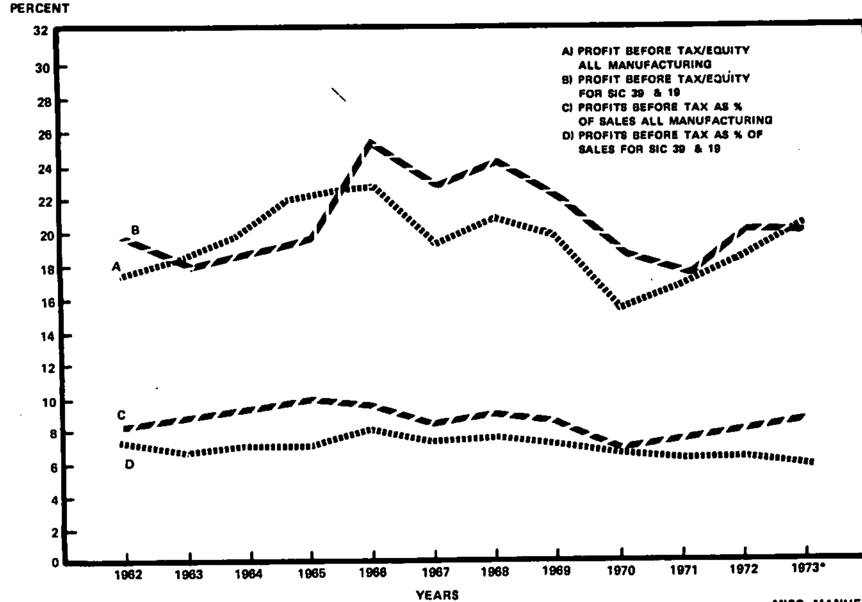
	MANUF	INSTRUMENTS
1973 ESTIMATED PROFITS PRE TAX/EQUITY	21.6	28.6
1970 THRU '72 AVERAGE	16.8	26.0
1962 THRU '69 AVERAGE	20.0	29.9

* NOTE: 1973 IS THROUGH THIRD QUARTER ONLY

DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL
DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTURING CORPORATIONS" FEDERAL TRADE COMMISSION

PRE TAX PROFIT MARGINS & PROFIT BEFORE TAX/EQUITY FOR ALL MANUFACTURING AND MISC. MANUF. & ORDNANCE (SIC 39 & 19)



	MANUF	MISC. MANUF. AND ORDINANCE
1973 ESTIMATED PRE-TAX MARGIN	8.0	6.0
1970 THRU '72 AVERAGE MARGIN	7.0	6.2
1962 THRU '69 AVERAGE MARGIN	8.7	7.2

	MANUF	MISC. MANUF. AND ORDINANCE
1973 ESTIMATED PROFITS PRE TAX/EQUITY	21.6	20.8
1970 THRU '72 AVERAGE	16.8	18.6
1962 THRU '69 AVERAGE	20.0	21.0

* NOTE: 1973 IS THROUGH THIRD-QUARTER ONLY
DATE: JANUARY 24, 1974

SOURCE: COST OF LIVING COUNCIL
DATA SOURCE: "QUARTERLY FINANCIAL REPORTS OF MANUFACTURING CORPORATIONS" FEDERAL TRADE COMMISSION

APPENDIX G

Statement of the Labor-Management Advisory Committee

1. The economic environment created by government decisions for the ensuing year is decisive to the operation and to the results of any economic stabilization program. The application of appropriate monetary and fiscal policy in a time of rising output and employment is essential to price and wage moderation. Price and wage controls that have been used in the past 18 months at some cost in efficiency and freedom to private decision making and to collective bargaining cannot substitute for responsible government policy on budgets and money supply in the economic climate of the year ahead.

2. The rapid and continuing rise in food prices at the wholesale level of agricultural products and at retail is a major problem to economic stabilization and to responsible collective bargaining in the year ahead. The prices of agricultural products are susceptible to various governmental decisions. Strong and effective measures to increase agricultural supplies and to contain and cut back prices are essential to responsible wage decisions in 1973.

3. Considering the economy as a whole, responsible wage behavior requires continuing stabilization in the average rate of wage and benefit increase (total compensation per manhour) in 1973 compared to 1972 so as to be consistent with the goal set by the President of getting the rate of inflation down to 2.5 percent or less by the end of the year.

4. The members of this Labor-Management Advisory Committee are prepared to use their good offices to create a climate favorable to the settlement of collective bargaining negotiations in major cases in 1973 within the framework of stabilization policies in cooperation with appropriate governmental officials. The settlement of negotiations over major agreements in 1973 without extended work stoppages or inventory dislocations can make a contribution to orderly economic expansion and stability this year.

5. The parties to collective bargaining agreements should address themselves both to short-term and longer run structural problems which they confront in their industries, localities and particular economic environments. Collective bargaining is pre-eminently a method of problem solving through negotiations. No single standard or wage settlement can be equally applicable at one time to all parties in an economy so large, decentralized and dynamic.

6. Economic and industrial relations stability is encouraged in 1973 by collective bargaining agreements of more than a year's duration, and in most situations the large first year catch-up that developed from rapid inflation in recent years may not be appropriate in 1973 negotiations.

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7. Responsible wage behavior for individual parties in 1973 requires that more attention be directed than in the recent past to issues of long term competitive conditions, productivity and working conditions, wage relationships, benefit costs, as well as to the achievement of moderate settlements.

This Labor-Management Advisory Committee is to advise the Cost of Living Council as to whether particular settlements are consistent with the goal (par. 3 above) for the rate of increase in wages and benefits for the economy as a whole or are unreasonably inconsistent with the goals of the Economic Stabilization Program. In this way parties will be better able to judge responsible wage and benefit behavior in addition to the general regulations.

8. If 1973 is to be a transitional year to a period without formal wage and price controls, with expanding employment and output, the moderate wage behavior described above, and correlate price behavior, is essential in the months ahead.

9. This is an initial statement of the Labor-Management Advisory Committee. The statement is advisory to the Cost of Living Council.

February 26, 1973

Members

Labor

I. W. Abel
Frank Fitzsimmons
Paul Hall
George Meany
Leonard Woodcock

Management

Stephen Bechtel, Jr.
Edward Carter
R. Heath Larry
James Roche
Walter Wriston

APPENDIX H

Policies to be Applied by the Construction Industry Stabilization Committee in 1973

The year 1973 is seen as a transition to a period without formal wage and price controls in the construction industry. The fundamental objective of policy for the 1973 collective bargaining season is to move toward viable long-run arrangements for dispute settlement in each branch of the industry and toward more effective collective bargaining in the public interest.

The period of controls, as envisaged in Executive Order 11588, should be used to make a major contribution to the resolution of some of the major longer-term problems of the industry through effective cooperation between labor, contractors and the government. Among the most significant of these long-run problems has been: (a) the need for procedures at the national level to facilitate the settlement of disputes over the terms of local or regional collective bargaining agreements, (b) broadening the geographical structure of negotiations in some localities and for some crafts, (c) development of special wage rates for some branches of the industry, (d) review of some managerial and labor practices and contract provisions in some localities as they affect costs, (e) greater co-ordination of collective bargaining negotiations among crafts and associations in some localities, and (f) improvement in the quality of information available for collective bargaining among local and national parties.

1. The Committee seeks to achieve a continuing stabilization of average rate of increases of collective bargaining settlements in 1973 compared to 1972.

2. The Committee may approve economic adjustments provided for in collective bargaining agreements on a case-by-case basis in the following circumstances:

   (a) Where the parties have made a careful review of the economic provisions of their collective bargaining agreement and have provided for an economic trade-off between increases in wage rates or benefits and other provisions of the agreement in view of the impact of the agreement on costs of construction.

   (b) A clear showing exists of inequity as measured by the relationship among crafts in a single locality and within the same craft in surrounding localities. Any substantial increase to provide restoration to appropriate intercraft or intercity differentials should be spread over a period of two years or

more. The Committee in considering wage relationships among crafts and localities will also give attention to clear evidence of changing historical relationships over the past decade and needs of the future.

(c) The Committee may continue to give special consideration to agreements which provide for significant changes in the geographical structure of bargaining, including the development of wage zones under one agreement, where such changes would promote the stabilization of collective bargaining and the effective utilization of manpower and management resources. The Committee may also be concerned with the geographical scope of fringe benefits plans.

(d) The Committee may-continue to approve adjustment necessary to maintain or provide reasonable fringe benefits. In the ordinary circumstances fringe benefits are to be considered a part of the package settlement. The Committee intends to explore more specific standards in this area.

(e) The Committee may continue to approve adjustments in agreements with low wages and fringes taking into account the area and branch of the industry.

3. No agreement is automatically entitled to an economic adjustment. The structure of wage and benefit rates in the locality and related areas and the consequences for effective stabilization and collective bargaining for the area are to be considered.

4. Attention should continue to be directed to questions of appropriate differentiation of rates by crafts among branches of the industry, such as heavy and highway, housing and commercial work, and local parties and craft boards may be urged to review or consider such differentiation.

5. Deferred increases will continue to be reviewed by the Committee, and those which would cause unstabilizing effects on other negotiations in the industry may be disallowed by the Committee as in the past. The Committee expects relatively few such cases in 1973.

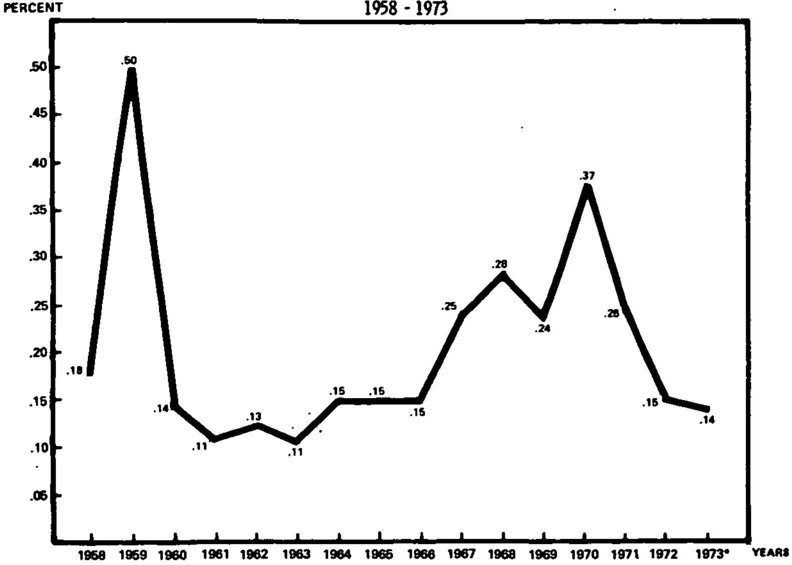
6. The Committee intends to delegate to the national craft boards authorization to act finally on certain cases. However, the Committee will retain authority to review any particular case before final action of the craft board is effective, or to review in advance cases in specified cities or types of cases, or cases of a particular craft.

February 26, 1973

APPENDIX I

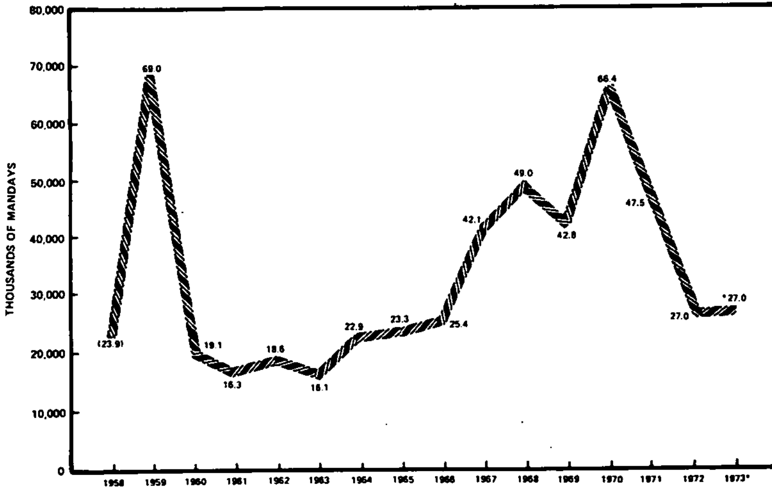
PERCENT OF IDLE-MAN DAYS COMPARED TO ESTIMATED WORK DAYS
1958 - 1973

A-72



* PRELIMINARY DATA
SOURCE: BUREAU OF LABOR STATISTICS
COST OF LIVING COUNCIL
JANUARY 1974

NUMBER OF IDLE MAN-DAYS DURING YEARS
1958 - 1973



* PRELIMINARY ESTIMATE
SOURCE BUREAU OF LABOR STATISTICS,
COST OF LIVING COUNCIL
JANUARY 1974

APPENDIX J

OPERATIONS SUMMARY

Since August 14, 1973, the date the primary Phase IV regulations became effective, 693 firms have filed prenotifications on 6,886 product lines representing 25.9 billions of price increases requested.

The Chemical Industry has been the single largest contributor with 1,064 product lines prenotified (15.0% of total product lines prenotified). That industry is followed by Electrical Equipment and Supplies with 636 prenotifications (9%), Machinery (Except Electrical) with 619 prenotifications (9%), Fabricated Metal Products (514 or 8%), Primary Metals (481 or 7%). These five industries account for 3,314 filings or 48% of the total filed since the beginning of Phase IV.

The weighted average percent price increase sought by the manufacturing and non-manufacturing sectors together is 7.4%. Major price increases have been prenotified by the following industries: lumber and wood products (10.0%);basic metals (11.1%); transportation equipment (7.4%),textile mill products (17.8%); apparel (11.2%); rubber and plastics (11.2%); and paper (8.6%).

In terms of magnitude of dollar requests, ten industries account for 86% of revenue increases requested with the Transportation Equipment Industry first with $4.8 billion--20% of the total dollar amount for all industries. Most of this amount is represented by automobile price increases. Primary metals rank second (15%) followed by Chemicals (11%), Textile Mill Products (7%), Food (7%), and the Postal Service (7%).

Decisions have been rendered on 5,520 or 80% of the filings. There has been a gradual increase in the weighted average increase granted rising by one or two-tenths of a percent each two-week period from 3.0% in early October to 3.9% in Mid-December to 4.8% by January 24. The Postal Service decision on December 21, which granted a $1.3 billion increase or 15.8% is the primary reason that the cumulative Phase IV weighted average granted rose to 4.8%.

For comparative purposes, the weighted average percent requested on all of the 6,477 decisions made during Phase II was 3.1%. The percent granted by the Price Commission was 2.6%.

The Economic Stabilization Program (CLC and IRS) has delayed implementation of $25.0 billion in price increases for 60 days or more and has denied $2.1 billion in prenotified price increases. (Decisions to date have been on price increases averaging 5.6%; 4.8% has been granted on the basis of cost justification.)

Source: Cost of Living Council, January 24, 1974

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PRENOTIFICATION AND DECISION SUMMARY

PHASE IV: AUGUST 12 THROUGH JANUARY 24, 1974

	PRENOTIFICATIONS						
	PRODUCT LINES		APPLICABLE SALES		INCREASE REQUESTED		
	NUMBER	SHARE	$ MILLIONS	SHARE	$ MILLIONS	SHARE	% OF SALES
CLC	1,165	16.9	$ 217,635	62.5%	$ 18,598	71.9%	8.5%
IRS	5,721	83.1	130,683	37.5%	7,259	28.1	5.6
TOTAL	6,886	100.0%	$ 348,318	100.0%	$ 25,857	100.0%	7.4%

	DECISIONS							
	PRODUCT LINES		SOUGHT		GRANTED		DENIED	
	NUMBER	SHARE	$ MILLIONS	% OF SALES	$ MILLIONS	% OF SALES	$ MILLIONS	% OF SALES
CLC	738	13.4%	$ 9,482	5.6%	$ 7,925	4.7%	$ 1,557	0.9%
IRS	4,782	86.6%	5,684	5.5	5,177	5.0	507	0.5
TOTAL	5,520	100.0%	$ 15,166	5.6%	$ 13,102	4.8%	$ 2,064	0.8%

NOTE: ABOVE DATA PERTAIN TO CURRENT INCREMENTAL INCREASES ONLY. THEY DO NOT INCLUDE ALL INCREASES FROM BASE PERIOD.

SOURCE: Cost of Living Council, January 24, 1974

FOOD PRENOTIFICATIONS AND DECISION SUMMARY *

Through January 24, 1974

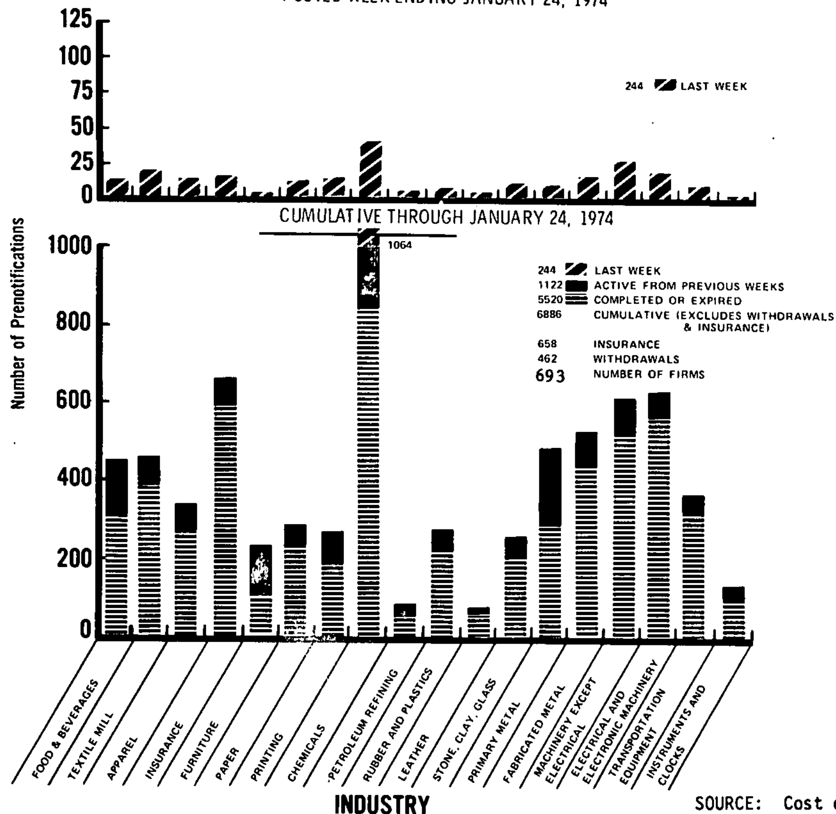
	PRENOTIFICATIONS						
	PRODUCT LINES		APPLICABLE SALES		INCREASE REQUESTED		
	NUMBER	SHARE	$ MILLIONS	SHARE	$ MILLIONS	SHARE	% OF SALES
CLC	163	39%	$27,947.21	$ 62%	$ 969.83	68%	3.5%
IRS	251	61%	16,822.97	38%	$ 461.86	32%	2.7%
TOTAL	414	100%	$44,770.18	100%	$ 1,431.69	100%	3.2%

	DECISIONS							
	PRODUCT LINES		SOUGHT		GRANTED		DENIED	
	NUMBER	SHARE	$ MILLIONS	% OF SALES	$ MILLIONS	% OF SALES	$ MILLIONS	% OF SALES
CLC	74	27%	$ 454.50	3.1%	$ 289.08	2.0%	$165.42	1.1%
IRS	204	73%	$ 340.23	2.7%	$ 305.28	2.4%	$ 34.95	0.3%
TOTAL	278	100%	$ 794.73	2.9%	$ 594.36	2.2%	$200.37	0.7%

* Excludes 47 CLC withdrawals and 18 IRS withdrawals.

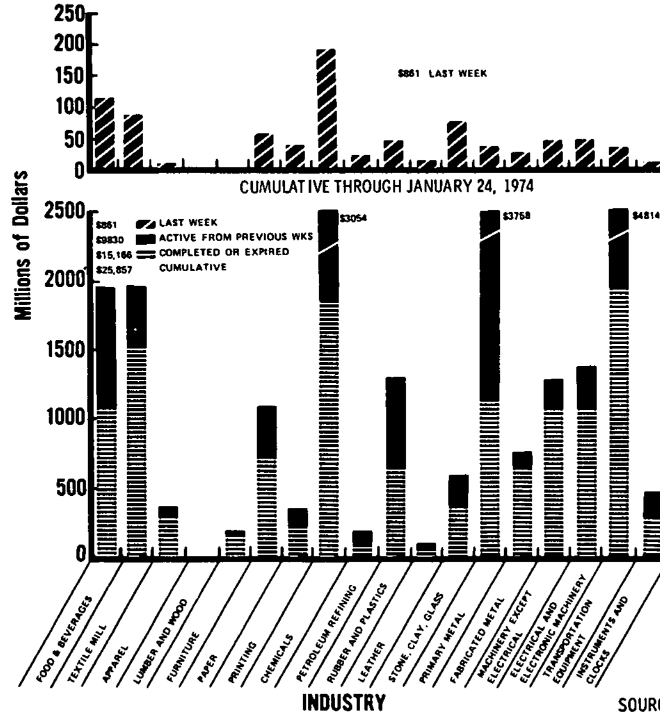
SOURCE: Cost of Living Council, January 24, 1974

PRENOTIFICATIONS CLASSIFIED BY INDUSTRY



SOURCE: Cost of Living Council, January 24, 1974

DOLLAR IMPACT OF PRENOTIFICATIONS CLASSIFIED BY INDUSTRY



SOURCE: Cost of Living Council, January 24, 1974

MAGNITUDE OF DOLLAR REQUESTS BY INDUSTRY

PHASE IV: AUGUST 12 THROUGH JANUARY 24, 1974

TWO DIGIT SIC INDUSTRIES	COST OF LIVING COUNCIL			INTERNAL REVENUE SERVICE			TOTAL		
	APPLICABLE SALES ($ MILLIONS)	% INCREASE WEIGHTED AVERAGE	$ INCREASE SOUGHT ($ MILLIONS)	APPLICABLE SALES ($ MILLIONS)	% INCREASE WEIGHTED AVERAGE	$ INCREASE SOUGHT ($ MILLIONS)	APPLICABLE SALES ($ MILLIONS)	% INCREASE WEIGHTED AVERAGE	$ INCREASE SOUGHT ($ MILLIONS)
MANUFACTURING:									
DURABLE GOODS									
24 LUMBER & WOOD PRODUCTS*	$ 319	8.8%	$ 28	$ 483	10.8%	$ 52	$ 802	10.0%	$ 80
25 FURNITURE & FIXTURES	818	7.2	59	1,684	6.5	109	2,502	6.7	168
32 GLASS, CERAMIC, CEMENT	2,573	9.4	243	6,424	4.9	317	8,997	6.2	560
33 BASIC METALS	27,074	11.7	3,169	6,860	8.6	589	33,934	11.1	3,758
34 FABRICATED METAL PROD	4,427	6.4	284	7,171	6.9	492	11,598	6.7	776
35 MACHINERY, EX ELEC.	14,509	4.3	630	14,230	4.3	614	28,734	4.3	1,244
36 ELEC EQUIP & SUPPLIES	12,605	5.2	652	12,249	5.5	677	24,854	5.3	1,329
37 TRANSPORTATION EQUIP	56,205	7.9	4,435	8,805	4.3	379	65,010	7.4	4,814
38 INSTRUMENTS	3,430	9.1	313	2,970	3.9	116	6,400	6.7	429
39 MISC MANUFACTURING	178	9.0	16	2,534	6.7	170	2,712	6.9	186
TOTAL DURABLE GOODS	$122,133	8.0%	$ 9,829	$ 63,410	5.5%	$ 3,515	$185,543	7.2%	$13,344
PERCENT OF TOTAL	(56.1%)		(52.8%)	(48.5%)		(48.4%)	(53.2%)		(51.6%)
NON DURABLE GOODS									
20 FOOD	$ 31,948	4.4%	$ 1,411	$ 17,031	3.0%	$ 507	$ 48,979	3.9%	$ 1,918
21 TOBACCO	4,195	2.1	87	185	7.0	13	4,380	2.3	100
22 TEXTILE MILL PRODUCTS	5,866	24.4	1,431	5,288	10.5	553	11,154	17.8	1,984
23 APPAREL, FINISHED FABRICS	708	15.1	107	2,360	10.0	236	3,068	11.2	343
26 PAPER	8,169	8.6	700	4,483	8.6	386	12,652	8.6	1,086
27 PRINTING & PUBLISHING	1,853	4.7	87	6,023	3.9	236	7,876	4.1	323
28 CHEMICALS	18,321	10.2	1,868	19,841	6.0	1,186	38,162	8.0	3,054
29 PETROLEUM REFINING*	1,010	8.5	86	1,293	7.7	100	2,303	8.1	186
30 RUBBER & PLASTICS	7,767	13.7	1,061	2,788	6.1	232	11,555	11.2	1,293
31 LEATHER & LEATHER PROD.	226	9.7	22	1,083	5.5	60	1,309	6.3	82
TOTAL NON-DURABLE GOODS	$ 80,063	8.6%	$ 6,860	$ 61,375	5.7	$ 3,509	$141,438	7.3%	$10,369
PERCENT OF TOTAL	(36.8%)		(36.9%)	(47.0%)		(48.3%)	(40.6%)		(40.1%)
MANUFACTURING	$202,196	8.3%	$ 16,689	$124,785	5.6%	$ 7,024	$326,981	7.3%	$23,713
PERCENT OF TOTAL	(92.9%)		(89.7%)	(95.5%)		(96.7%)	(93.8%)		(91.7%)
NON-MANUFACTURING	$ 15,439	12.4%	$ 1,909	$ 5,898	4.0%	$ 235	$ 21,337	10.0%	$2,144
PERCENT OF TOTAL	(7.1%)		(10.3%)	(4.5%)		(3.3%)	(6.2%)		(8.3%)
TOTAL	$217,635	8.5%	$ 18,598	$130,683	5.6%	$ 7,259	$348,318	7.4%	$25,857

NOTES: ABOVE DATA PERTAIN TO CURRENT INCREMENTAL INCREASES ONLY. THEY DO NOT REFLECT ALL INCREASES FROM THE BASE PERIOD.
* FIGURES FOR THESE INDUSTRY GROUPS DO NOT REFLECT DATA FOR PRODUCT LINES COVERED UNDER SPECIAL REGULATIONS (E G ENERGY, LUMBER).

SOURCE: Cost of Living Council, January 24, 1974

DECISIONS BY INDUSTRY
COST OF LIVING COUNCIL AND INTERNAL REVENUE SERVICE COMBINED

PHASE IV: AUGUST 12 THROUGH JANUARY 24, 1974

TWO-DIGIT SIC INDUSTRIES	NUMBER OF DECISIONS				INCREASES ($ MILLIONS)			APPLICABLE SALES ($ MILLIONS)	WEIGHTED AVERAGE PERCENT		
	TOTAL	FULL APPROVAL	PARTIAL APPROVAL	FULL DENIALS	SOUGHT	GRANTED	DENIED		SOUGHT	GRANTED	DENIED
MANUFACTURING:											
DURABLE GOODS											
24 LUMBER & WOOD PRODUCTS*	41	31	7	3	$ 65	$ 59	$ 6	$ 700	9.3%	8.4%	0.9%
25 FURNITURE & FIXTURES	103	70	28	5	144	134	10	2,174	6.6	6.2	0.4
32 GLASS, CERAMICS, CEMENT	191	109	79	3	395	342	53	7,544	5.2	4.5	0.7
33 BASIC METALS	291	174	103	14	1,125	899	226	19,591	5.7	4.6	1.1
34 FABRICATED METAL PRODUCTS	437	252	170	15	611	537	74	9,879	6.2	5.4	0.8
35 MACHINERY	508	332	164	12	1,100	1,028	72	26,777	4.1	3.8	0.3
36 ELECTRICAL EQUIPMENT	544	347	181	16	1,033	959	74	19,506	5.3	4.9	0.4
37 TRANSPORTATION EQUIPMENT	318	228	75	15	1,891	1,473	418	59,436	3.2	2.5	0.7
38 INSTRUMENTS, PHOTO, OPTICAL	112	80	31	1	297	260	37	6,249	4.8	4.2	0.6
39 MISCELLANEOUS MANUFACTURING	155	120	30	5	156	137	19	2,230	7.0	6.1	0.9
TOTAL DURABLE GOODS	2,700	1,743	868	89	$6,817	$ 5,828	$ 989	$ 154,086	4.4%	3.8%	0.6%
NON DURABLE GOODS											
20 FOOD	315	174	126	15	$ 1,055	$ 830	$ 225	$ 31,645	3.3%	2.6%	0.7%
21 TOBACCO	6	2	4	–	80	60	20	4,258	1.9	1.4	0.5
22 TEXTILE MILL PRODUCTS	380	205	164	11	1,406	1,239	167	8,126	17.3	15.2	2.1
23 APPAREL, FINISHED FABRICS	274	224	49	1	317	305	12	2,580	12.3	11.8	0.5
26 PAPER PRODUCTS	237	113	119	5	759	623	136	10,667	7.1	5.8	1.3
27 PRINTING & PUBLISHING	187	142	35	10	221	205	16	5,439	4.1	3.8	0.3
28 CHEMICALS, FIBERS, SOAPS	827	566	248	13	1,858	1,723	135	28,148	6.6	6.1	0.5
29 PETROLEUM REFINING*	54	37	15	2	78	71	7	1,285	6.1	5.5	0.6
30 RUBBER & PLASTICS	241	157	80	4	610	575	35	9,362	6.5	6.1	0.4
31 LEATHER PRODUCTS	57	46	11	–	65	60	5	1,158	5.6	5.2	0.4
TOTAL NON-DURABLE GOODS	2,578	1,666	851	61	$ 6,449	$ 5,691	$ 758	$ 102,668	6.3%	5.6%	0.7%
MANUFACTURING	5,278	3,409	1,719	150	$13,266	$11,519	$1,747	$ 256,754	5.2%	4.5%	0.7%
NON–MANUFACTURING	242	178	53	11	$ 1,900	$ 1,583	$ 317	$ 15,802	12.0%	10.0%	2.0%
TOTAL	5,520	3,587	1,772	161	$15,166	$13,102	$2,064	$ 272,556	5.6%	4.8%	0.8%

NOTES: *FIGURES FOR THESE INDUSTRY GROUPS DO NOT REFLECT DATA FOR PRODUCT LINES COVERED UNDER SPECIAL REGULATIONS (E.G., ENERGY, LUMBER).

SOURCE: Cost of Living Council, January 24, 1974

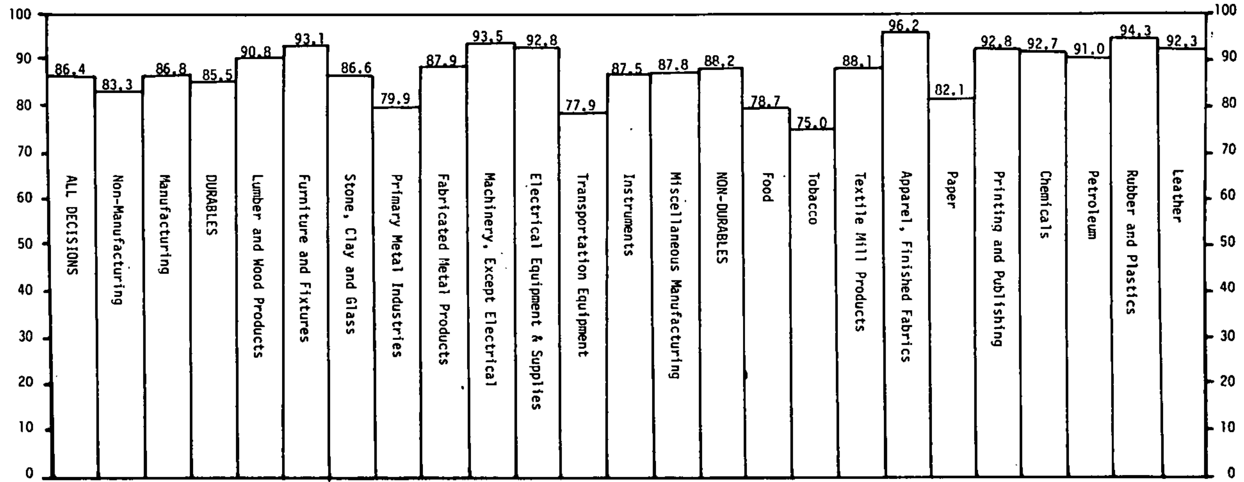
SUMMARY OF MAGNITUDE OF DOLLAR REQUESTS BY INDUSTRY

PHASE IV: AUGUST 12 THROUGH JANUARY 24, 1974

TWO - DIGIT SIC INDUSTRIES	MILLIONS OF DOLLARS		
	CLC	IRS	TOTAL
37 - TRANSPORTATION EQUIPMENT	$ 4,435	$ 379	$ 4,814
33 - PRIMARY METALS	3,169	589	3,758
28 - CHEMICALS	1,868	1,186	3,054
22 - TEXTILE MILL PRODUCTS	1,431	553	1,984
20 - FOOD	1,411	507	1,918
42 - POSTAL SERVICES	1,542	-	1,542
36 - ELECTRICAL EQUIPMENT & SUPPLIES	652	677	1,329
35 - MACHINERY, EXCEPT ELECTRICAL	630	614	1,244
30 - RUBBER & PLASTICS	1,061	232	1,293
26 - PAPER	700	386	1,086
SUB - TOTAL	$ 16,899	$ 5,123	$ 22,022
OTHER INDUSTRIES	1,699	2,136	3,835
TOTAL	$ 18,598	$ 7,259	$ 25,857

SOURCE: Cost of Living Council, January 24, 1974

INDUSTRY COMPARISON OF INCREASES GRANTED AS PERCENT OF INCREASES SOUGHT FOR PHASE IV DECISIONS THROUGH JANUARY 24, 1974



SOURCE: Cost of Living Council

DATE: January 25, 1974

SUMMARY OF PRODUCT LINES PRENOTIFIED BY INDUSTRY

PHASE IV: AUGUST 12 THROUGH JANUARY 24, 1974

TWO - DIGIT SIC INDUSTRIES	NUMBER OF PRODUCT LINES		
	CLC	IRS	TOTAL
28 - CHEMICALS	164	900	1,064
36 - ELECTRICAL EQUIPMENT & SUPPLIES	76	560	636
35 - MACHINERY, EXCEPT ELECTRICAL	58	561	619
34 - FABRICATED METAL PRODUCTS	50	464	514
33 - PRIMARY METALS	174	307	481
22 - TEXTILE MILL PRODUCTS	94	375	469
20 - FOOD	185	274	459
37 - TRANSPORTATION EQUIPMENT	78	284	362
23 - APPAREL, FINISHED PRODUCTS	8	318	326
30 - RUBBER & PLASTICS	102	192	294
SUB - TOTAL	989	4,235	5,224
OTHER INDUSTRIES	176	1,486	1,662
TOTAL VOLUME	1,165	5,721	6,886

SOURCE: Cost of Living Council, January 24, 1974

PHASE IV INVESTIGATIONS

Through January 24, 1974
DISPOSITION

TYPE INVESTIGATION	NUMBER COMMENCED SINCE 8-13-73	NOPV'S & REMEDIAL ORDERS	VOLUNTARY REFUNDS & ROLLBACKS	COMPROMISE SETTLEMENTS (PENALTIES)	CLOSED NO VIOLATION	INVESTIGATIONS IN PROCESS
CLC REQUESTED PAY	234	34*	0	0	126	74
LOCALLY INITIATED PAY	8	0	0	0	8	0
CLC REQUESTED PRICE	240	10	12	0	82	136
LOCALLY INITIATED PRICE	3,990	78	120	0	913	2,379
PRICE INVESTIGATED BY						
INDUSTRY:						
FOOD	5,318	87	802	0	4,429	0
PETROLEUM	58,046	545	342	-	57,159	0
TRUCK STOP	4,689	2	830	-	3,731	126
HEALTH	29	-	-	-	3	26
TOTAL	72,554	756	2,106	0	66,451	3,241

* Investigations Pending on 30

SOURCE: Cost of Living Council, January 24, 1974

WAGE CASES

For week ending January 24, 1974

Phases	Inventory at Beginning of Week	Receipts During the Week	Decisions Issued	Inventory at End of Week	Cumulative Receipts
Phase II					
Food	251	13	34	230	1,548
Health	53	3	3	53	592
Construction	6	-	4	2	194
Executive Compensation	-	-	-	-	37
Self Administered	13	1	-	14	791
State & Local Gov't.	4	-	-	4	35
TOTAL	327	17	41	303	3,197
Phase III					
Food	350	8	52	306	3,185
Health	15	-	1	14	144
Construction	17	-	6	11	199
Executive Compensation	11	1	1	11	633
Self-Administered	21	-	-	21	602
State & Local Gov't.	6	-	1	5	21
TOTAL	420	9	61	368	4,784
Phase IV					
Food	2,359	278	316	2,321	4,817
Health	348	17	31	334	423
Construction	83	2	8	77	165
Executive Compensation	215	14	12	217	339
Self-Administered	152	37	40	149	586
State & Local Gov't.	45	1	6	40	105
TOTAL	3,202	349	413	3,138	6,435
All Phases					
Food	2,960	299	402	2,857	9,550
Health	416	20	35	401	1,159
Construction	106	12	18	90	558
Executive Compensation	226	15	13	228	1,009
Self-Administered	186	38	40	184	1,979
State & Local Gov't.	55	1	7	49	161
TOTALS	3,949	375	515	3,809	14,416

SOURCE: Cost of Living Council, January 24, 1974

APPENDIX K

Stabilization in the Health Sector

Background

The serious inflationary history and continued inflationary potential of the health industry has required continuous mandatory control of this sector through the several Phases of Economic Stabilization. The unique characteristics of this sector, and particularly of the hospital industry, which is so susceptible to inflationary pressures, include:

- the nature of the reimbursement system, much of which is "cost plus" on a retrospective basis with little restraint on costs at the time services are provided;
- the demand for services which does not always correspond to need and, therefore, leads to excessive utilization of services;
- the manner in which consumers pay for service. Rarely do they pay the full cost at the time of utilization; often they pay only a small fraction of the cost directly;
- the relatively inelastic supply of health manpower, particularly physicians;
- the national excess of hospital beds which means that the hospitalized patient has to pay the fixed costs of the beds not occupied; frequently, facility and service expansion is not sufficiently evaluated in terms of market feasibility;
- the nature of the product and the lack of competitive pricing information which make informed consumer choice difficult;
- the role of the professional in making "purchasing decisions" for the patient; this is particularly true for such items as hospital care and laboratory services;

- the inadequacy of financial management systems with resultant inefficiencies passed routinely onto purchasers.

The cumulative impact of these characteristics - particularly the retrospective cost reimbursement system of financing - is to induce rather than restrain inflationary behavior. The various indices of health care inflation reflect this almost total lack of effective market constraints.

From 1960 to 1971, national health expenditures grew from $25.9 billion to $75.6 billion. Perhaps more significant, the percentage of GNP consumed by health expenditures increased 44 percent from 5.2 percent of GNP in 1960 to 7.5 percent of GNP in 1971. (Chart 1)

Medical care prices have consistently increased at rates far above that for the general economy. In 1960, the medical care services index of the CPI stood at 74.9. By 1971 it had risen to 133.3, an increase of 78 percent. During this same period, the CPI index for all items had risen only 37 percent. (Chart 2)

The most alarming increases have been measured in the hospital sector, particularly in the post Medicare period. Hospital semi-private room rates almost tripled from 1960 to 1971. Hospital expense per admission, the average price for a stay in the hospital, increased as dramatically from $244 per stay in 1960 to $743 in 1971.

Between 1969 and 1971, when consumer prices rose at an annual rate of 5.3 percent, medical care services, as measured by the CPI, rose 7.7 percent per year. Further, hospital prices by various measures rose over 13 percent each year. This particular aspect of the inflation in health costs was especially significant since 40 percent of all health expenditures are made in hospitals. Physicians' fees, which constitute about 20 percent of health expenditures, rose 7 percent during this same period.

The total expense of a day in the hospital increased at an annual rate in excess of 12 percent every year from 1967 to 1971. It reached a high point of 15.7 percent in

1970. The rate of increase in expense per admission was equally alarming, hitting an annual rate of over 17 percent in 1967. (Chart 3) Some of these cost increases reflected cost increases in the general economy, particularly wage increases in this sector. An equal share represented increases in the intensity of service - with views differing over how much of the service was medically necessary.

Thus, in the years leading up to the beginning of the Economic Stabilization Program, the health industry was the most inflationary sector in the American economy. For this reason, and for the unusual market characteristics which caused health care's inflationary performance to operate somewhat independent of the rest of the economy, the health industry has been treated as a special problem and subject to regulations somewhat different from those governing other sectors of the economy.

Impact of the Economic Stabilization Program

After two years of controls, the indices of inflation show significant improvement. The annualized rate of increase in medical care prices as measured by the CPI came down from 7.3 percent in the pre-Economic Stabilization Program period to 3.7 percent in 1972 and 4.4 percent in 1973.

Hospital semi-private room rates, increasing 12.9 percent per year prior to the program rose only 6.6 percent and 4.7 percent respectively in 1972 and 1973. (Chart 3)

The improvement in the cost per admission for hospitalization was less significant, though marked. Expense per admission came down to annual rates of 9.6 percent in fiscal year 1972 and 8.0 percent in fiscal year 1973 from a rate well over 13 percent in fiscal year 1970.

These results on hospital costs have also translated into decreasing rates of increase in health insurance premiums. A large sample of group experience rated accounts of commercial health carriers showed average premium increases down to 3.2% in 1973 from 7.8% in 1972 and 13% in 1971.

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By these measures there has been substantial improvement during this recent period and the health industry - private and public - is to be commended for it. While a number of smaller provider groups have been decontrolled, several important considerations led the Council to a continuation of controls in the key areas of the health sector as reflected in the recent publication of revised Phase IV regulations.

One factor is that the positive impact of the prospective annual budgeting approach taken with hospitals and nursing homes is just beginning to take effect with one-third of the hospitals only completing their first year under Economic Stabilization in June, 1973.

The primary reason, however, relates to the fact that the basic nature of the industry - and the methods for financing and reimbursement - remain essentially unchanged. The independent inflationary potential remains, if anything, greater than before as the industry faces the prospect of longer term cost controls beginning under expanded national health insurance legislation.

Cost of Living Council
January, 1974

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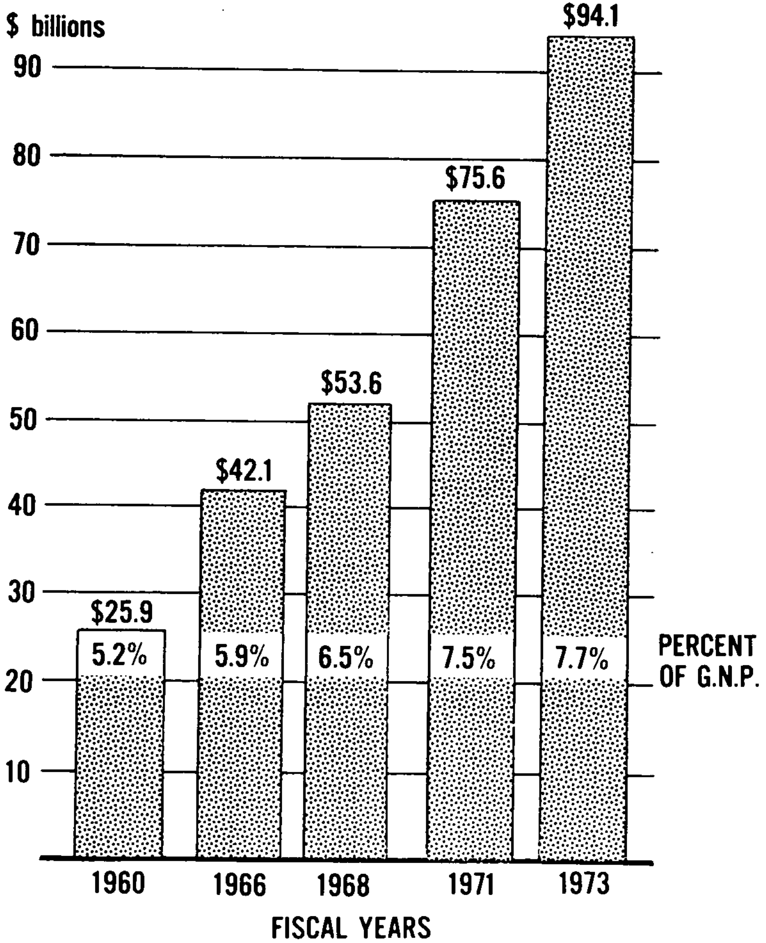
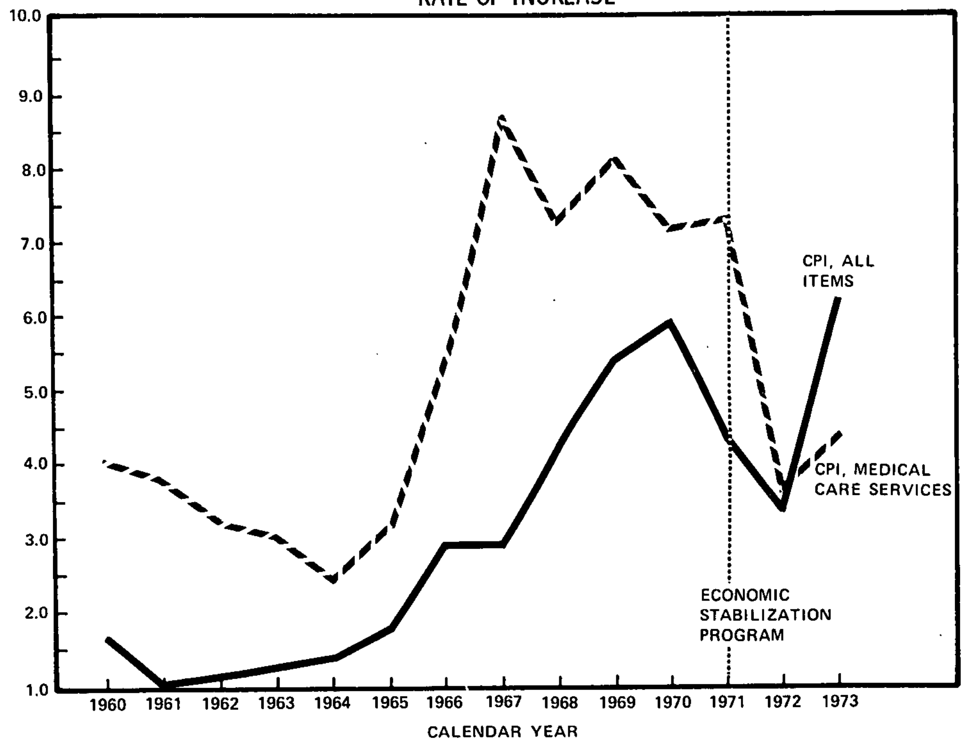
NATIONAL HEALTH EXPENDITURES AND PERCENT OF G.N.P. FOR SELECTED FISCAL YEARS



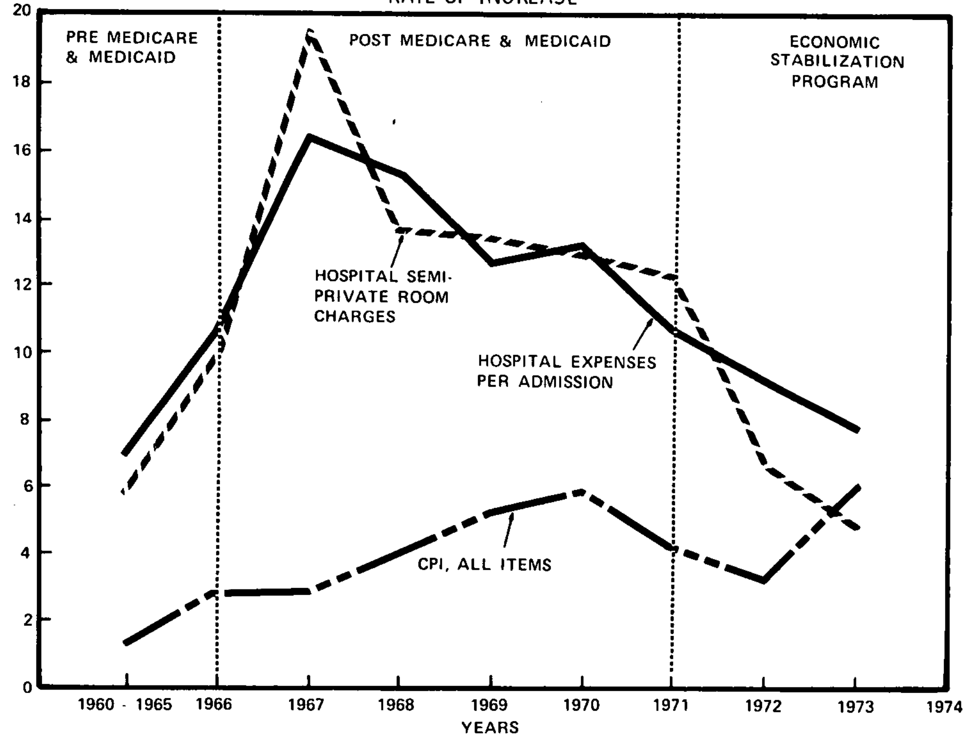
Source: Social Security Administration
January 1974

MEDICAL CARE SERVICES RATE OF INCREASE

ANNUAL PERCENT INCREASES



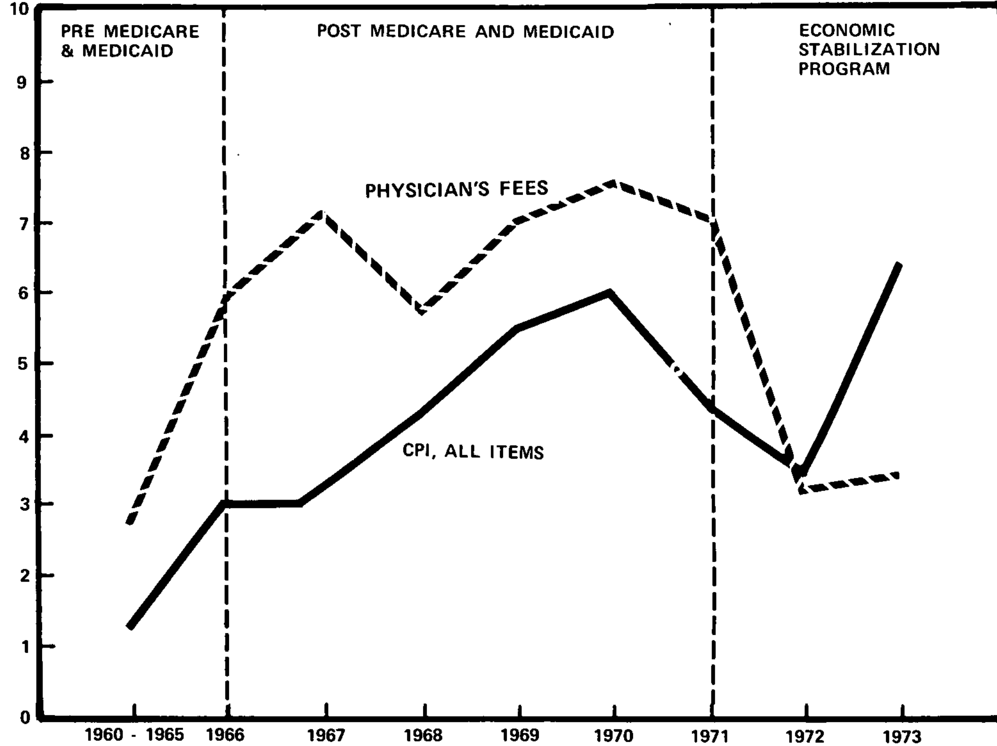
Source: U.S. Dept of Labor January 1973



Sources: U.S. Dept of Labor
American Hospital Association
January 1974

PHYSICIAN'S FEES
RATE OF INCREASE

ANNUAL PERCENT INCREASE



Source: U.S. Dept of Labor
January 1974

APPENDIX L

FARM AND MARKETING SHARE OF FOOD PRICES ✓

MARKETING SHARE OF RETAIL COST

FARM SHARE OF RETAIL COST

PERCENT OF RETAIL COST

65
60
55
50
45
40
35

1959 1960 1961 1962 1963 1964 1965 1966 1967 1968 1969 1970 1971 1972 1973 (PRELIM)

RETAIL VALUE OF MARKET BASKET CONTAINING AVERAGE QUANTITIES OF DOMESTIC FARM-ORIENTED FOOD PRODUCTS PURCHASED ANNUALLY BY URBAN HOUSEHOLDS.

SOURCE: U.S.D.A. 1973

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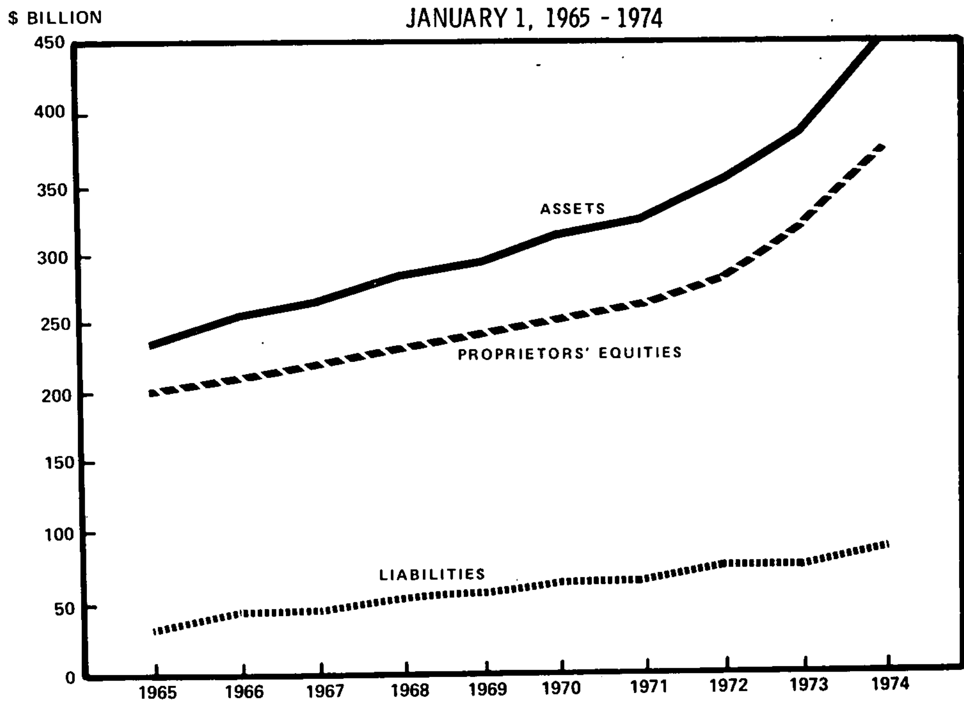


SOURCE: COST OF LIVING COUNCIL
JANUARY 1974

National Income by Type of Income, 1970 - 1973

	DOLLARS				PERCENT CHANGE FROM PREVIOUS YEAR				PERCENT OF TOTAL NATIONAL INCOME			
	1970	1971	1972	1973 p	1970	1971	1972	1973 p	1970	1971	1972	1973 p
	-----$ Billion-----				------------ Percent ------------							
Total National Income	800.5	859.4	941.8	1054.2	4.5	7.4	9.6	11.9	100.0	100.0	100.0	100.0
Compensation of Employees	603.8	644.1	707.1	785.3	6.7	6.7	9.8	11.1	75.4	75.0	75.1	74.5
Business & Professional Income	50.0	51.9	54.0	57.5	- 1.0	3.8	4.0	6.5	6.2	6.0	5.7	5.5
Income of Farm Proprietors	16.9	16.8	20.2	26.8	1.2	- .6	20.2	32.7	2.1	2.0	2.1	2.5
Rental Income of Persons	23.9	24.5	24.1	25.1	5.8	2.5	- 1.6	4.1	3.0	2.9	2.6	2.4
Corporate Profits and Inventory Valuation Adjustment	69.2	80.1	91.1	109.2	-13.3	15.8	13.7	19.9	8.6	9.3	9.7	10.4
Net Interest	36.5	42.0	45.2	50.4	19.7	15.0	7.6	11.5	4.6	4.9	4.8	4.8

p = preliminary data

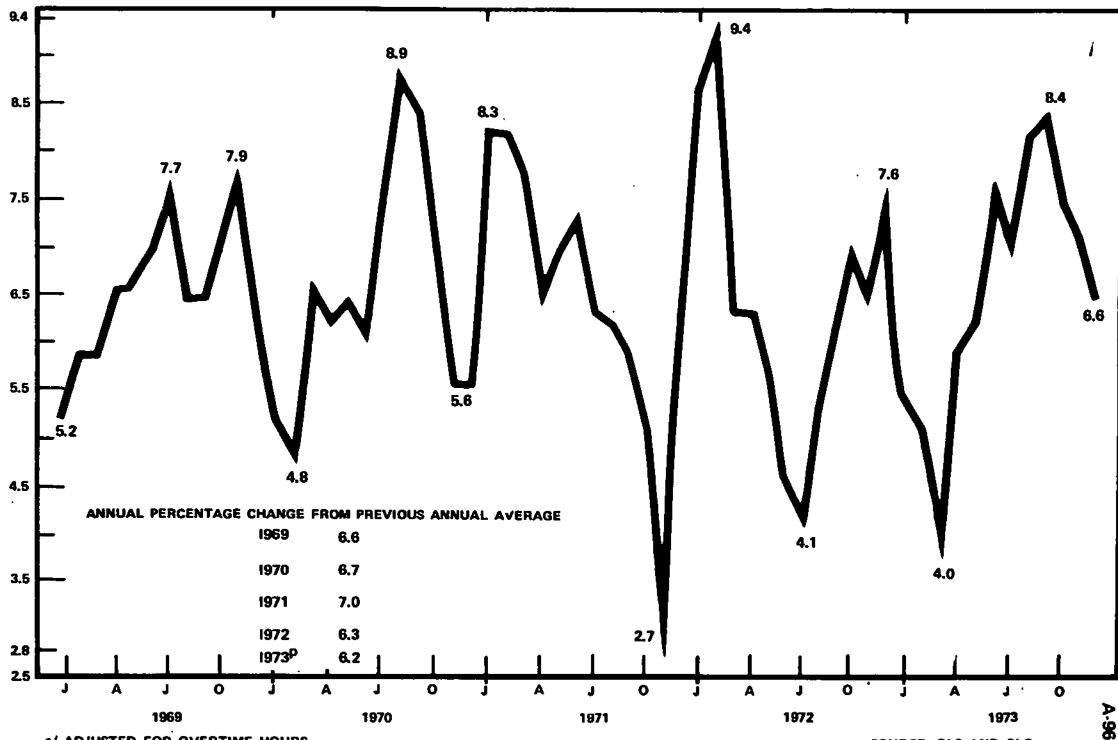
Source: Economic Report of the President, February 1974, Table C-15, and Department of Commerce, Bureau of Economic Analysis.

APPENDIX M

THREE MONTH CHANGES IN THE AVERAGE HOURLY EARNINGS INDEX 1/

FOR PRODUCTION WORKERS IN THE TOTAL PRIVATE NON FARM ECONOMY

(AT SEASONALLY ADJUSTED COMPOUND ANNUAL RATES)



1/ ADJUSTED FOR OVERTIME HOURS AND INTERINDUSTRY SHIFTS IN EMPLOYMENT

p/ preliminary

SOURCE: BLS AND CLC
JANUARY 1974

APPENDIX N

ECONOMETRIC EVALUATIONS OF THE IMPACT OF CONTROLS

In this section the impact of the Phase I through Phase IV controls program is evaluated in terms of its impact on reducing the rate of wage and price increase. The context within which this evaluation is conducted is through an analysis of wage and price equations in econometric models. This analysis is conducted in three stages. First, the results of researchers who have confined themselves to developing either a single wage or price equation or a two equation wage-price model are discussed. Secondly, the findings of the wage-price subsectors of the large econometric models are reported. Finally, a reference list is offered for more detailed information about the impact of controls. The intent of this report is to present the results reached by economists who have evaluated the controls program. Stress is placed on discussing a representative sample of studies.

SINGLE OR TWO EQUATION MODELS OF WAGES AND/OR PRICES

(1) Robert J. Gordon, "The Response of Wages and Prices to the First Two Years of Controls," Brookings Papers on Economic Activity (3:1973), forthcoming.

This is one of the more up-to-date studies on the effects of the controls program. It is the second paper presented by Gordon or this topic and it builds upon his earlier studies.

This paper presents a simulation study of wage and price behavior during the period beginning with Phase I and ending with the third quarter of 1973. Gordon's wage equation is more sophisticated than a simplistic Phillips equation, which basically depicts the short-run relationship between unemployment and increases in wages. It contains, as explanatory variables, the dispersion of unemployment, a measure of disguised unemployment, the unemployment rate of hours, the expected rate of change of prices, and a tax variable to take account of changes in social security taxes and personal income taxes. The price equation contains, as independent variables, standard unit labor cost, the change in the ratio of actual to potential productivity, the change in the ratio of compensation to a wage rate index, and the change in the ratio of unfilled orders to capacity. Parameter estimates are obtained by regressing these equations on quarterly data for the period 1954 through 1970.

Gordon runs a number of alternative simulations based on different assumptions about the following: the specification of the underlying wage equation and the impact of controls on other variables in the system. His overall findings are that Phases I through IV have had a very significant effect on prices and a smaller, but still a dampening, effect on wages.

In comparison with the basic simulation taken from an econometric model fitted to the pre-control period, he finds that actual nonfarm prices rose at an annual rate about 2.3 percent slower during Phases I and II than the simulated values indicated. None of this shortfall was shown to have been made up during Phases III and IV. Instead nonfarm prices fell another 0.6 percent behind their simulated values. Wages were shown to have risen less rapidly than in the no-controls simulation, at a rate of about 0.6 percent slower during Phases I and II and about 1.1 percent slower in 1973. Gordon's model attributes this entirely to the indirect impact of slow price growth on subsequent wage behavior. Given the actual behavior of prices, no direct effect of controls on wages was found.

Gordon suggests that his calculations regarding the effect of controls on prices may actually understate the impact of controls. In his basic calculations, he uses the nonfarm price deflator, which excludes farm and import prices. This is done on the assumption that farm and import prices are exogenous to the wage-price subsector and are not influenced by the controls. If this is not the case, the inclusion of either farm or import prices would raise the value of the price index in the no-controls equation and hence increase the apparent dampening effect of the program.

The simulations also assume that real output and unemployment would have been the same without the controls program. If, instead, it is assumed that nominal income is exogenous and followed its actual path, then real output would have been lower and unemployment higher over Phases I through IV. This would reduce the rate of inflation predicted by the simulation equation and thus reduce the impact of controls on prices. Gordon stresses, however, that the effect of this alternative assumption would not be large enough to reverse the general conclusions of the study.

(2) Pritchett Analysis

Employing one equation price models, David V. Pritchett found that controls did restrain price increases. Depending on the specification of the four alternative equations, he estimates from simulations through the fourth quarter of 1973 that prices, absent controls, would have been from 1.2% to 3.2% higher. Since no allowance is made for the depreciation of the dollar vis-a-vis other currencies, this range of estimates is likely to be understated. But final judgment on the effect of controls, he claims, rests on the period just after controls when a price bubble is possible. This bubble could offset any previously observed effect.

The price equations are based on the period from the first quarter of 1955 to the third quarter of 1971 using consumer prices for all items less food and mortgage interest costs. Unemployment rate variables are used as proxies for excess demand, and weighted price changes over the previous twelve quarters serve as an estimate of the expected inflation.

Two alternative proxies for generalized excess demand are investigated in the same basic equation. In one the official unemployment rate is used. In the other the variable is a function of the sum of weighted unemployment rates of various age-sex groups, where the weights are tied to the labor force composition of 1964. Usage of this variable permits more inflationary pressure in recent years due to a compositional shift. In 1973, for example, that unemployment measure was 0.4 percentage points lower than the official unemployment rate.

Both of these estimated equations are found to be consistent with the acceleration hypothesis, which implies both that the expected inflation rate tends to be realized in equilibrium and that unemployment rates lower than the equilibrium unemployment rate are associated with reductions in the unemployment rate. In other words, the evidence suggests that there may not be a long run tradeoff between inflation and unemployment. Instead, a definite and permanent change in the rate of inflation may be associated with each unemployment rate.

In any event, the final two equations used to test the effect of controls were based on specifications that were slightly altered to impose the acceleration hypothesis.

THE WAGE AND PRICE FORECASTS OF THE LARGE ECONOMETRIC MODELS

(1) F. Gerard Adams, George R. Green and David M. Rowe, "The Impact of Wage and Price Controls -- A Simulation Study," a study prepared for the Cost of Living Council by Wharton Econometric Forecasting Associates, Inc., January 1974.

This analysis is based on Wharton's large econometric model of the United States. The authors find that the controls program has had a significant effect on both prices and wages. In fact, contrary to the Gordon study, they find that Phases I through IV have had larger effects on wages than on prices. Their findings for 1973 and their predictions for the near term future of wage and price movements are the following:

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A simulation study which we completed for the year 1973 shows that if price and wage controls had been lifted early in the year wage rates would have been rising about 1.3 percent more rapidly (7.8 percent increase actual versus 9.1 percent in the simulation with control removed) while the overall GNP deflator would have been rising at a rate of 8.5 percent instead of the observed 7.9 percent -- a difference of one-half of one percent in the rate of increase. Consumer prices without the controls would have been increasing at a rate of about 1.0 percent higher than that actually observed. All of the above values refer to the performance of the economy during the last quarter of 1973.

Looking forward to 1974, the critical consideration appears to be wage increases. Later in 1974, price pressures are considerably moderated by the slow economic growth for the U.S. economy. On the other hand, efforts by labor unions to recoup the losses in real purchasing power from recent steep consumer price increases may add additional upward pressure in the absence of controls. If controls are continued, we expect that wage increases (private non-farm compensation per manhour) will be approximately at the rate of 8 percent during the year 1974. If controls were lifted immediately, then 9 percent, 10 percent, or even higher wage increases are not out of the question. If the lapse of the controls results in a 9 percent wage increase during the year, then the GNP deflator can be expected to increase at an annual rate of 7.7 percent during the fourth quarter of 1974 as against a 7.2 percent increase projected in our control solution. If wage increases as large as 10 percent occur, then the GNP deflator is projected to increase by 7.9 percent during the fourth quarter of this year. If controls are lifted, then consumer prices can be expected to increase by .3 of one percent (annual rate) above the control solution while a 10 percent wage increase would generate an increase in consumer prices of 0.5 percent more than the control solution.

TABLE 1

The Impact of Wage and Price Controls
The Wharton Model

	1973.1	1973.2	1973.3	1973.4
Deflator for Personal Consumption Expenditures				
Actual*	141.0	143.8	146.2	149.5
% Change (Annual Rate)	5.3%	8.2%	6.8%	9.3%
Simulated	141.1	144.4	147.2	150.8
% Change (Annual Rate)	5.6%	9.7%	8.0%	10.1%
Consumer Price Index**				
Actual*	148.7	152.0	155.3	159.0
% Change (Annual Rate)	5.7%	9.1%	9.1%	9.9%
Simulated	148.8	152.6	156.5	160.6
% Change (Annual Rate)	5.9%	10.6%	10.6%	10.9%
Gross National Product Deflator				
Actual*	149.81	152.46	155.06	158.04
% Change (Annual Rate)	6.04%	7.27%	7.00%	7.91%
Simulated	149.94	153.10	156.10	159.30
% Change (Annual Rate)	6.41%	8.70%	8.07%	8.46%
Private Nonfarm Compensation Per Manhour				
Actual*	5.037	5.102	5.206	5.31
% Change (Annual Rate)	11.66%	5.33%	8.44%	8.30%
Simulated	5.043	5.123	5.243	5.358
% Change (Annual Rate)	12.19%	6.51%	9.67%	9.09%
Wages as a Ratio to Current $ GNP				
Actual*				
Wages (Current $)	757.4	774.9	794.0	815.0
GNP (Current $)	1242.5	1272.0	1304.5	1334.0
W/GNP	.6096	.6092	.6087	.6109
Simulated				
Wages (Current $)	758.4	777.9	798.8	820.0
GNP (Current $)	1243.2	1276.7	1311.3	1344.2
W/GNP	.6100	.6093	.6092	.6100

* Actual data are preliminary ** 1958 base. 1967=115.56

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The results of the Wharton simulation study for 1973 are depicted in table 1.

(2) Federal Reserve Board - MIT - Penn Model

A simulation study of the Federal Reserve Board-MIT-Penn Econometric Model, was provided by Jared Enzler. It was based on both an estimation period ending in the second quarter of 1971 and an assumption that the independent variables in the price equation followed their actual time paths between then and the third quarter of 1973. This resulted in the following residuals (in percent that the actual price level is below what it would have been if no structural changes had taken place since the estimation period):

1971.III	- 0.4%	1972.I	- 0.9%	1973.I	- 2.3%
1971.IV	- 1.2	1972.II	- 1.7	1973.II	- 2.0
		1972.III	- 2.2	1973.III	- 2.1
		1972.IV	- 2.3		

Hence, the 1973: I figure, for example, menas that the price level (of the nonfarm business price deflator net of Federal excise taxes) is 2.3 percent below what it would have been given the parameters of the pre-controls equation and the actual value of the explanatory variables. In contrast to Gordon's work, which showed an enhanced effect of controls during 1973, he finds some evidence of a convergence of the controls and no-controls scenarios. According to the model, the maximum effect of controls in depressing price increases was reached by the last quarter in 1972 and that this effect has been maintained through 1973 with only minimal slippage.

(3) Paul H. Earl, "The Effect of Controls on the Economy," a study prepared for the Cost of Living Council under a contract with Data Resources Inc.

The Earl Study utilizes both the Data Resources quarterly econometric model and the stage of processing model of the United States economy to evaluate the impact of the controls program. His findings indicate that Phase I through IV have had almost no impact on the rate of wage and price inflation. These results are in contrast with those reported on by Gordon, Pritchett, the Wharton Model, and the FRB-MIT-Penn Model.

Earl's overall findings include the following:

With the exception of prices at the wholesale intermediate stage of processing, most prices were already exhibiting a slowdown in inflation rates prior to the imposition of price controls in the third quarter of 1971.

The Freeze was generally effective in dampening inflation rates. However, these slower rates were generally temporary.

A bulge in inflation rates is apparent during the first quarter of Phase II.

Goods at the intermediate wholesale stage of processing are presently displaying rapid inflation rates. Given the lags which exist before the intermediate materials are consumed at the higher stages of processing, these price increases should be reflected in early 1974 as higher prices at the finished wholesale and retail levels.

Processed food is continuing to exhibit high inflation rates at all stages of processing.

The relationships between the retail and finished wholesale prices has shifted during price controls within certain sectors, reflecting the uneven impacts of the controls.

The behavior of the compensation per manhour series is not significantly affected by the existence of controls.

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APPENDIX O

THE COST OF CONTROLS TO GOVERNMENT

ANNUALIZED COST

Exhibit 1 on the following page shows the annualized cost of Phases II, III, and IV of the Economic Stabilization Program. The costs have been calculated to show the comparative cost of each Phase as if it were in effect for a full year.

The government activities administering the program include:

- o Cost of Living Council (CLC)
- o Internal Revenue Service (IRS)
- o Support agencies including the Department of Justice, the Temporary Emergency Court of Appeals (TECA), and the Treasury Department

Phase	CLC	IRS	Other Agencies	Total
Phase II	$32,853,000	$73,344,000	$1,450,000	$107,647,000
Phase III	30,186,000	46,751,000	1,450,000	78,387,000
Phase IV	33,186,000	65,252,000	1,450,000	99,888,000

ACTUAL COSTS

The actual costs of the Economic Stabilization Program to government are:

Phase	Dates	Duration	Estimated Cost to Government
Phase I	August 15, 1971 - November 13, 1971	90 days	$ 1,260,000
Phase II	November 14, 1971 - January 11, 1973	14 mos.	87,245,000
Phase III	January 12, 1973 - June 12, 1973	5 mos.	29,527,000
Phase IV*	June 13, 1973 - April 30, 1974	10-1/2 mos.	79,677,000
		32.5 months	$197,709,000

*Includes "Freeze II" period June 13, 1973 thru August 13, 1973 (60 days)

Cost of Living Council
January, 1974

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ECONOMIC STABILIZATION ACTIVITIES

Comparative Annualized Costs of a Phase II, III and IV Program

(Based on Salary Rates as of January 1, 1974)

Items	Phase II		Phase III		Phase IV	
	Employees	Dollars ($000)	Employees	Dollars ($000)	Employees	Dollars ($000)
Cost of Living Council:						
Personnel Compensation	889	$ 18,225	800	$16,394	900	$18,452
Personnel Benefits		1,640		1,475		1,661
Travel		747		672		756
Rent, Communications & Utilities		3,240		3,045		3,266
Printing & Reproduction		879		791		890
Other Services		7,147		6,932		7,174
Supplies & Materials		560		504		567
Equipment		415		373		420
TOTAL - CLC		$ 32,853		$30,186		$33,186
Internal Revenue Service:						
Personnel Compensation	3,150	$ 56,535	2,000	$35,895	2,800	$50,253
Personnel Benefits		5,088		3,231		4,523
Travel		3,826		2,612		3,457
Rent, Communications & Utilities		4,487		2,849		3,989
Printing & Reproduction		1,134		720		1,008
Other Services		1,506		956		1,339
Supplies & Materials		406		258		361
Equipment		362		230		322
TOTAL - IRS		$ 73,344		$46,751		$65,252
Payments for Other Agency Support:						
Department of Justice		1,000		1,000		1,000
Temporary Emergency Court of Appeals		200		200		200
Treasury Administrative Support .		250		250		250
TOTAL - Other		$ 1,450		$ 1,450		$ 1,450
GRAND TOTAL	4,039	$107,647	2,800	$78,387	3,700	$99,888

Cost of Living Council
January 1974

APPENDIX P

THE COST OF CONTROLS TO BUSINESS

Several independent studies, two by the Battelle Columbus Laboratories (one of large Tier I industrials in the top 125 of the Fortune Double 500 and the other of smaller Tier I industrials in the 125-781 range of the Fortune ranking), one by the National Association of Manufacturers (NAM), and one by the IRS Industry Monitors have been made to ascertain the administrative costs to business of complying with the Economic Stabilization Program.

The results may be summarized as follows:

Annual Incremental Administrative Costs to Individual Businesses of Complying With the Economic Stabilization Program

	NAM	Battelle	IRS Industry Monitor Survey
Tier I	$174,876 (Ave. for Tiers I & II)	$669,700 (larger) Tier I	$271,950
		$189,000 (smaller) Tier I	
Tier II			$ 33,750
Tier III			$ 10,250

Cost to Company Per Type of Transaction (Battelle - smaller Tier I only)

Cost per Prenotification - $3,680 (Westinghouse has reported in a letter to the Cost of Living Council a per prenotification cost of $10,000)

Cost per Quarterly Report - $8,356

Cost per Exception Request - $7,711

The responses to the Battelle survey reflected a large range of estimated costs, and should, therefore, be quoted with caution.

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Economic Stabilization Program Cost As A Percentage of Annual Sales

	Battelle		IRS Industry Monitor Survey		
	Larger Tier I	Smaller Tier I	Tier I	Tier II	Tier III
Range	.006%-.095%	0%-.12%	.001%-1.162%	.011%-.052%	.018%-.081%
Mode	.035%	.035%	.024%	.048%	N.A.
Average	.032%	.053%	.023%-.024%	.037%	.049%

Estimated Total Annual Cost to Business*

Tier I & II	$.6860	to	$1.9380 billion
Tier III	.0354	to	.0864 billion
Total	$.7214	to	$2.0244 billion

*Obtained by multiplying Annual Incremental Cost figures by CLC records of the number of businesses in each category. The results should be viewed with caution because they are heavily weighted in favor of industrial firms.

Cost of Living Council
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APPENDIX Q

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ECONOMIC DISTORTIONS INDUCED BY PRICE CONTROLS

The Problem

Price controls, by their very nature, are intended to cause distortions in the normal price mechanism, by limiting the prices that vendors might otherwise charge for their goods and services. However, during the past several months there have been increasing allegations that price controls are inducing distortions into the economy that were not intended as part of the Economic Stabilization Program. In particular, it has been alleged that price controls have caused shortages and changed traditional business practices by:

- distorting import-export patterns,
- causing products to be withheld from the marketplace,
- discouraging corporate capital investment,
- forcing companies to alter product line mixes.

While it is clear that certain changes have taken place in these areas during the recent period of price controls, the actual impact of price controls is very difficult to measure. Many other economic forces have been at work simultaneously: an unprecedented surge in domestic and foreign demand, causing the economy to operate at full capacity, the energy crisis, shortages and changes in relative prices of raw materials, and devaluation of the dollar, to cite a few. Price controls have definitely contributed in some cases, but the problem is to sort out how much of an effect they have had in the larger economic context.

Summary of Conclusions

An analysis of the complaints of distortion in all industries except petroleum that have been received by the Cost of Living Council in 1973 from both private and public officials shows that:

- Some distortions were clearly due to controls, and their severity depended on the degree of price restraint imposed.
  - Exports of copper and copper scrap surged in June and July during the Freeze, and returned to normal levels after controls were relaxed.

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- Beef was withheld from market as a result of the ceiling on beef prices.

- A shift from light-weight to heavier-weight printing papers appears to be due in part to controls.

● Other alleged distortions do not appear to have been caused by controls.

- Corporate investment is increasing, and has followed the same pattern, with or without controls, regardless of program changes.

- Product mix changes in steel, textiles and newsprint have been due primarily to factors other than controls.

The examples cited below have been chosen because they are particularly illustrative.

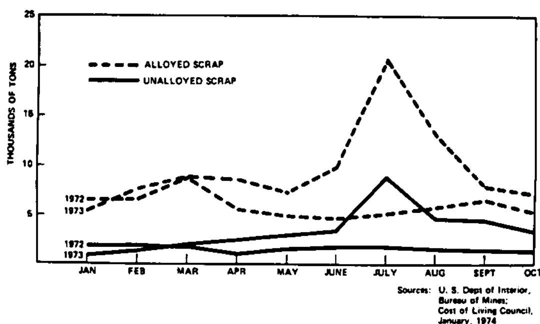
ALLEGED DISTORTIONS - PROVEN

Shift to Exports - Copper and Copper Scrap

Perhaps the best example of shifts in export patterns is refined copper and copper scrap. Chart 1 shows that in 1973 copper scrap exports were increasing at a fairly consistent rate until the Freeze was announced. The freeze of domestic prices, when world prices were soaring, caused a surge of exports in July. After copper scrap was exempted from controls (July 19th), domestic prices increased and the flow of exports slowed to roughly the pre-Freeze rate.

Chart I

COMPARISON OF 1972 - 1973 COPPER SCRAP EXPORTS

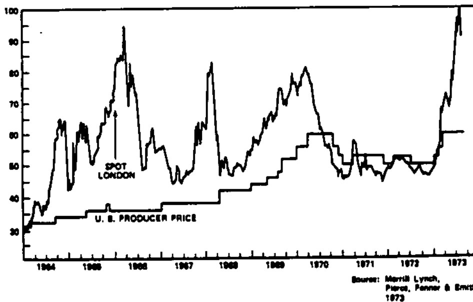


Sources: U. S. Dept of Interior, Bureau of Mines; Cost of Living Council, January, 1974

Chart 2 compares domestic producer prices of copper with world prices over the last decade. It can be seen that the differential between U.S. producer price and world prices was as wide in early 1966 and early 1968 as it was any time during 1973. During that period, the Administration was "jawboning" domestic producers to exercise price restraint, at the same time quota restrictions were imposed upon exports during the period from early 1966 to mid-1970. This "jawboning", along with 840 thousand tons of copper released from the stockpiles, effectively held domestic prices steady as international prices climbed and controls kept the copper in domestic markets. The 1967-68 widening of the price differential related to entirely different causes. A strike shut down the domestic industry from July, 1967 to April, 1968, and, of course, domestic producers could not be expected either to increase their prices when they were not producing or export copper in response to the high world price. In fact, the resultant decrease in supplies from U.S. sources resulted in the rise of international prices.

During 1969 and 1970 there was a greater willingness on the part of both government and the industry to allow the U.S. producers price to follow the world price more closely. This is demonstrated on Chart 2. In mid-1970, as world price dropped below U.S. levels, export controls were rescinded. Though world prices were then below U.S. prices, customers, having learned their lesson in previous periods of high demand, remained with their domestic suppliers, rather than lose "position" by switching to imports.

Chart 2
10 YEAR COMPARISON OF
INTERNATIONAL AND U.S. PRODUCER PRICES FOR COPPER



Source: Merrill Lynch, Pierce, Fenner & Smith 1973

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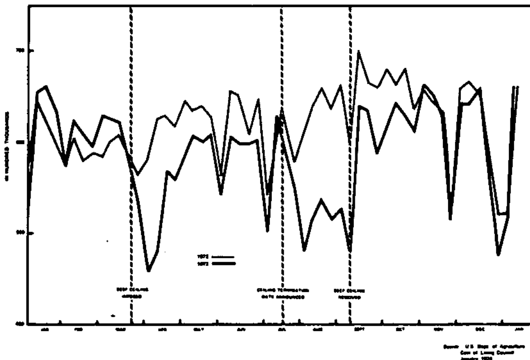
In 1973, U.S. prices initially attempted to reflect world figures, increasing from 50¢ to 60¢ , lb. Another price increase, of 10%, was announced for June 1973, but was wiped out by the imposition of the Freeze. Exports, responding to higher world prices, increased since there was no longer any impediment to exporting, and domestic prices were restrained. In short, the experience of the last decade shows that during periods of high world demand, if domestic prices are severely restrained without the imposition of export limitations, goods will tend to follow international prices and domestic shortages may develop.

Withholding of Product - Beef

Fluctuations in cattle slaughter rates in 1973 (Chart 3) broke from the 1972 pattern in both March, when the price freeze of meat was announced, and in July, when the announcement was made that the Freeze on beef prices would be continued until September 12. While the decline of the slaughter rate before the imposition of the ceiling suggests that high prices were reducing consumer demand (causinq fewer cattle to be slaughtered), the sharp spring and summer breaks with the 1972 pattern offer very strong evidence that stringent price restraint can induce producers to withhold goods from the market.

Chart 3
COMPARISON OF 1972-1973
DOMESTIC CATTLE SLAUGHTER RATES



Product Mix Change - Printing Papers

During 1970 the buyer's market in paper resulted in severe price wars in lighter weight printing papers, which buyers prefer, with almost no sales of heavier-weight papers. As a result, lighter weight paper margins were extremely low.

With the Phase II decision to allow price increases on a per ton basis, product mix shifts began to occur. While the manufacturing of heavier weight paper resulted in fewer sheets, it also resulted in greater tonnage. Thus, the price increase could be spread over greater units of production. Furthermore, the 6% "Cap" 1/ did not allow large enough price increases on lighter weight paper to make the margins competitive with heavier weights, and, as the industry moved toward capacity and supplies tightened, buyers willingly accepted heavier weights. This shift also caused a greater distortion than simply a change in weight because the reduced number of sheets resulted in lessened supply to buyers and because the heavier-weight paper consumed more woodpulp and wastepaper, further aggravating supply shortages to manufacturers.

ALLEGED DISTORTIONS - UNPROVEN

Investment Distortions Caused by Price Controls

The allegation that Phase IV price controls have seriously discouraged corporate capital investment by reducing profits and cash flows is difficult, if not impossible, to substantiate statistically. While it is hard to isolate the effect of price controls on investment, the most important fact to note is that spending by businesses for new plant and equipment accelerated in almost all industries in 1973 and is expected to be 12% higher in 1974.

The following factors are critical to an understanding of the effect of price controls on investment, and must be borne in mind when examining the statistics:

- Capital investments must necessarily be made on the basis of a long term market outlook. Larger Tier I companies which bear the brunt of price controls typically have good long-term borrowing power and are in capital-intensive industries with long investment lead times. On the other hand, most businessmen have been operating on the assumption that price controls are a short term aberration in normal business conditions.

1. "Cap" - limitation of how much the price of an item may be raised above the authorized average price increase for the product line as a whole.

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- Where there have been cutbacks in the level of capacity expansion, other factors probably have been far more significant than price controls: the energy crisis, shortages of building materials and product raw materials, heavy spending on environmental protection equipment, increased costs of money, as evidenced in high interest rates and a weak stock market, and general uncertainty about economic conditions.

- A few industries such as the steel industry, have been the subject of informal price controls (jawboning) for some years, making it harder to evaluate the effect of the present, formal controls.

- To the extent that corporate profits and cash flows have been inflated through inventory revaluation, many companies have had both the incentive and ability to invest.

- While profits may suffer slightly in 1974 as cheaper inventories are exhausted and reduced volume advantage is realized at high capacity, most economists expect heavy capital spending in response to a demand-pull inflation that remains unresponsive to price controls.

If price controls can be expected to discourage total investment, the experience of the U.S. economy during the past several years does not bear direct evidence that this in fact has been the case. As shown in the following table of changes in fixed investment by businesses, the advent of price controls in late 1971 was actually accompanied by a large boost in capital investment, reversing a two-year downward trend. This rise has been sustained and is projected to continue in 1974.

$ Changes In Fixed Investment By Businesses

	1968-9	1969-70	1970-1	1971-2	1972-3
Current $	10.9	2.1	3.8	13.2	15.3
Constant $	6.0	-3.6	-1.4	10.0	10.5
($ billions)					

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

The Commerce Department projects a 12% advance in expenditures for new plant and equipment in 1974, as shown on Chart 4. While this survey was made before the announcement of the Arab oil embargo, the industry figures that it cites are nevertheless very instructive.

Chart 4

Expenditures for New Plant and Equipment by U.S. Business, 1/ 1972-74

	(a) 1972	(b) 1973 P	(c) 1974 2/	(d) 1972-1973	(e) 1973-1974	(f) 73-74	(g) 73-74	(h) Percent of Investment for Pollution Control '73	(i) Factors affecting Investment in Certain Industries
	(Billions of Dollars)			Percent Change					
All industries	88.44	100.08	112.11	13.2	12.0	14	17.3 5/	5.9	
Manufacturing	31.35	38.00	44.40	21.2	16.8	24	*	10.1	
Durable goods 3/	15.64	19.39	22.61	24.0	16.6	26	*	8.3	
Primary metals 3/	2.75	3.48	4.34	26.6	24.6				
Blast furnace, steel works	1.24	1.41	1.71	13.1	21.7	52	43.7	13.6	Shortages of dollars available, materials, fuel, railroad cars
Nonferrous	1.18	1.68	2.16	41.7	28.4	45	41.0	22.5	Profitability should improve, but power shortage and environmental requirements hurt
Electrical machinery	2.39	2.90	3.18	21.3	9.8	13	12.2	3.2	Industry projects good growth
Machinery, except electrical	2.90	3.48	3.98	20.1	14.3	35	30.0	3.7	Sales of machine tools are strong
Transportation equipment	2.53	3.06	3.57	21.1	16.6	*	*		
Motor vehicles	1.83	2.24	2.68	22.8	19.5	20	28.7	7.3	Demand for more small cars requires new equipment
Aircraft	.43	.53	.58	23.2	9.2	13	*	8.7	Fuel crisis hurting airlines, and thus aircraft sales
Stone, clay and glass	1.20	1.50	1.68	24.9	12.0	43	23.3	7.7	Cement decontrolled in return for more capacity
Other durables 3/	3.87	4.97	5.87	28.4	18.1	1	*	9.5	
Nondurable goods 3/	15.72	18.61	21.79	18.4	17.1	22	*	12.2	
Food including beverage	2.55	3.05	3.28	19.4	7.5	17	11.5	6.7	Higher prices make demand uncertain; shortage of packaging materials; rising costs for raw foodstuffs
Textile	.73	.79	.77	8.1	-1.8	17	15.8	4.6	Shortages of manmade fibers and natural gas, higher price of cotton, labor problems
Paper	1.38	1.89	2.48	37.0	31.2	45	31.9	42.5	Large increase in investment expected, but nearly half for pollution control
Chemical	3.45	4.32	5.25	25.4	21.4	33	27.8	12.3	Demand high, but shortage of feedstocks
Petroleum	5.25	5.41	6.89	3.0	27.3	21	21.5	9.6	Record investments to meet fuel crisis, following year of record profits
Rubber	1.08	1.57	1.58	44.7	0.8	21	6.4	5.2	Large increase last year; petroleum shortage hurts industry; tire companies shifting to more radial tires
Other nondurables 3/	1.27	1.59	1.54	24.7	-2.7	-12	*	3.5	Printing and publishing, tobacco investment to decline; leather, apparel up
Nonmanufacturing	57.09	62.07	67.71	8.7	9.1	*	*	*	
Mining	2.42	2.76	3.14	14.2	13.9	30	*	5.3	If price of all fuels rise, new mines within 3 - 5 years
Railroad	1.80	1.94	2.27	7.8	17.2	10	*	2.6	Fuel crisis should stimulate investment in new equipment
Air transportation	2.46	2.41	2.16	-1.9	-10.5	-24	*	3.1	Airlines cutting back due to overcapacity and fuel crisis
Other transportation	1.46	1.60	1.62	10.2	0.7	8	*	1.7	Fuel crisis discourages transportation investment
Public utilities	17.00	19.09	22.16	12.3	16.1	*	*		Demand for energy is strong, although fuel costs are up
Electric	14.48	16.25	18.81	12.2	15.7	14	*	6.8	Investment slowed by environmental advocates and high interest rates
Gas and other	2.52	2.84	3.36	12.6	18.3	5	*	2.0	Price controls on natural gas have discouraged exploration since 1960's
Communication, commercial and other 4/	31.96	34.27	36.36	7.2	6.1	*	*	*	

Source - columns (a-e) U.S. Department of Commerce, Bureau of Economic Analysis 1-9-74
(f) McGraw-Hill, Preliminary Plans for Capital Spending in 1974-75 Nov. 9, 1973
(g) Data Resources Institute, Data Resources Review, January 1974
(h) 6th Annual McGraw-Hill Survey of Pollution Control Expenditures May, 1973
(i) Cost of Living Council, January, 1974

1. Data in columns a - c exclude expenditures of agricultural business and outlays charged to current account.
2. Estimates are based on expected capital expenditures reported by business in late November and December 1973. The estimates for 1974 have been adjusted when necessary for systematic biases in expectational data.
3. Includes industries not shown separately.
4. Includes trade, service, construction, finance, and insurance.
5. All industries except agriculture.
P. Preliminary
* not available

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Charts 5 and 6 compare trends in capital investment, as a percent of business, non-farm GNP. Chart 5 shows that while the percent of output committed to investment declined after 1970 before controls were imposed, it is now above the 1971 level, notwithstanding several phases of price controls.

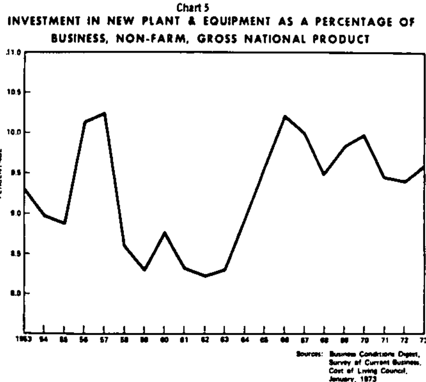
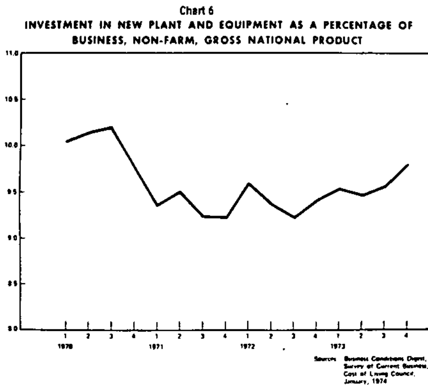


Chart 6 tells the same story as Chart 5, only in more detail, showing quarterly changes in investment as a percent of output for the years 1970-1973. No sharp changes can be attributed to the imposition of controls or changes in the program.



Finally, there has been a fear that price controls would place greater demands on the capital markets as firms sought money that they could not generate internally. However, much of the money for increased investment has in fact been generated internally and economist Henry Kaufman of Salomon Brothers predicts that total external sources of capital will actually drop in 1974 to $65 billion from $68.5 billion in 1973.

These general conclusions about the minimal effect of price controls on investment have been confirmed by three independent polls. When the National Association of Business Economists (NABE), the National Association of Purchasing Managers (NAPM), and the National Association of Manufacturers (NAM) asked their members in late 1973 if price controls have had any effects on capital spending, the results were remarkably similar.

Effects of Price Controls on Capital Spending

	NABE	NAPM	NAM
None	65.0%	66.7%	67.0%
Some	27.2%	19.4%	24.4%
Major	4.8%	13.9%	8.6%

The NAM survey further indicated that two-thirds of the companies felt that removal of controls would encourage increased capital spending. However, the amount of increase in capital spending that could be expected upon decontrol is open to question. Many companies have been making agreements to expand production in return for decontrol, but to the extent that decontrol is being used primarily as a bargaining tool, even these amounts probably give little indication of how investment has been affected by Phase IV price controls. Also generally unevaluated is the extent to which 1974 capital investment is designed to increase capacity as opposed to modernization or in response to stringent environmental regulations. Chart 4 also shows estimates of the proportion of 1973 investment due to environmental regulations. It can be noted that the paper (42.5%) and non-ferrous metals (22.5%) industries are the most significantly affected.

For these reasons it is difficult, if not impossible, to isolate the effects of price controls on investment. It is heartening to note though, that whatever the effect of controls, investment has held up well.

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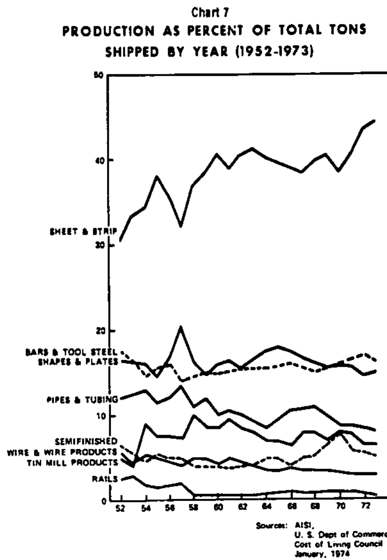
Product Mix Distortions Caused by Price Controls

It has also been alleged that controls cause changes in product mix by freezing the relationship of prices or margins between related items produced by the same industry. Thus, it is argued, firms decrease production of those items with low relative prices or margins. These allegations are examined with respect to certain steel items, textiles and paper products.

Steel

As Chart 7 shows, the long-term shift in the product mix of U.S. steel firms has been toward greater production of sheets and strip (flat-rolled items), at the expense primarily of railroad goods, shapes and plates, pipes and tubing, and to a lesser degree, tin mill products and wire products. This long trend may well have been accelerated by the over-valuation of the dollar that allowed significant market penetration by foreign producers in many of these products during the 1960's. The industry appears to have reacted to these changes by increasing strip and sheet capacity, where they were competitive, at the expense of expanding productive capacity of other lower profit items.

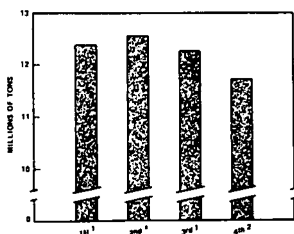


In light of these long term developments, it seems that the short run behavior during controls, and especially during Phase IV does not reflect a shift of product mix due to Special Rule #1, which allowed price increases only on sheets and strip. 2/ The relative increases allowed on various lines during controls has had almost no impact on mix. Rather the factors causing the shortages of certain goods can more easily be traced to the capacity operation (industry estimates currently at 100%) of an industry that previously reduced production of certain imported items with which it could not compete. As these imported items have become relatively more expensive and as voluntary import quotas have not been filled, it seems reasonable that users of short supply items are now paying the price for previously shifting to non-U.S. producers.

So while it could be argued that Special Rule #1, has not offered an incentive to shift to lower profit product lines, it is not clear from reviewing the long term trend that, absent controls, the steel industry would have reacted any differently than it has. In fact, potential shifts toward lower profit lines appear to have occurred in spite of controls since industry data submitted to the Council shows declining fourth quarter production of strip and sheet materials (See Chart 8 below). However, the Council believes actual fourth quarter production figures of those submitting forecasts will be 10% higher than industry estimates.

Chart 8

CARBON STRIP AND SHEET STEEL PRODUCTION
BY QUARTER 1973



Sources: 1. 1st, 2nd, 3rd quarters: AISI
2. 4th quarter: CLC data. 9,579,742 tons directly from corporate forecasts plus an estimated 2,000,000 tons from other steel companies
Cost of Living Council, January, 1974

2. 38 F.R. 25427 (September 13, 1973).

Textiles

Various representatives of the textile industry, including the American Textile Manufacturers' Institute (ATMI), have alleged that mills have been forced to drop low-profit lines due to the Phase IV controls. A survey of four firms chosen by the ATMI as representative of firms experiencing this distortion could not conclusively document either the extent to which changes in product mix have occurred or whether these changes could even be attributable to the controls program.

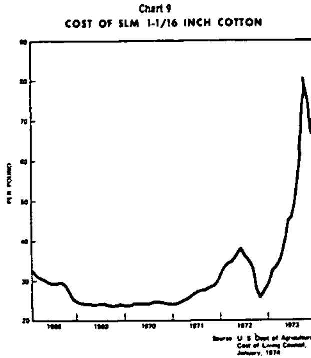
As part of normal business practice, low-profit product lines are always being dropped due to such factors as increased competition, style changes, raw material shortages, higher input prices, or increasing capacity utilization. Price controls are another variable, but the industry cannot single out controls as the main variable influencing the dropping of low profit product lines. But some firms contacted cited some specific characteristics of controls, such as choice of base period, as the main reason for dropping certain lines.

While neither the firms contacted nor the association could provide evidence to show where product lines had been dropped, it seems reasonable to assume that significant changes in raw material availability, a sudden increase in input prices or a higher percent of capacity utilization would individually, and certainly collectively, force a company into a position of dropping or reducing volume in the low-profit-margin lines. Statistical evidence from the fourth quarter of 1973 seems to indicate that the textile industry is experiencing these phenomena simultaneously.

Shortages in raw materials and pressures on capacity mean that profits can be increased only by allocating available material and capacity to those products with higher margins. Low margin items frequently represent high volume, and restricting production of such items has the effect of reducing pressure on supplies as well as increasing profits.

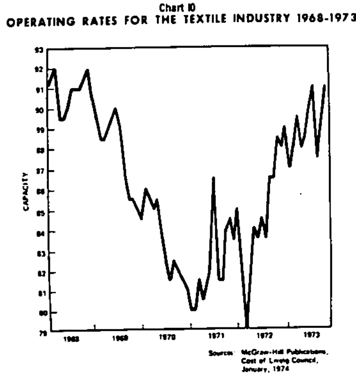
Sharply rising raw material costs provide an additional incentive to shift product mix toward higher margin items. These items have a higher margin from the outset and are more susceptible to pass-through of higher material costs.

Looking at the input cost for the textile industry, prices of cotton have risen appreciably in 1973, as Chart 9 shows. Meanwhile, lower margin cotton items faced strong competitive pressures from man-made substitutes. List prices for man-made fibers remained relatively constant until the fourth quarter, but since September petrochemical inputs for synthetic fibers have risen over 30 percent and synthetic fiber prices have begun to inch up.



Shortages in petrochemical feedstocks have caused production cut-backs of 15 to 18 percent in polyester, nylon and acetate. And with harvested cotton acreage down 4.4% and exports up 11.7% shortages in cotton are also being experienced. This understates the price pressure on cotton as it is the most widely used staple that is being exported. Supply shortages are not being eased by carryover as normal year-to-year carryover is down by 10%.

Chart 10 shows that the industry is operating at near capacity levels.



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With the shortages now being experienced due to the slight reduction in cotton yield, exports of cotton, problems with petrochemical feedstocks, high capacity utilization and price increases for natural and synthetic inputs, it is not at all surprising that some low profit lines might be dropped and that all productive efforts would be focused on higher profit items.

With these factors acting as they are, it is almost impossible to show a direct casual relationship between implementation of price controls and shifts in product lines. Although it may be possible that controls, when combined with other economic variables, would marginally contribute to the shift to higher margin lines, even the industry itself is reluctant to lay the blame on controls alone.

Newsprint

The product mix distortion has also been cited by numerous companies and associations as the cause of shortages of newsprint. Unlike other paper products, here the shortage does not appear to be related to controls.

As the graph below shows, newsprint's share of production in tons traditionally has been inversely proportional to capacity utilization. Thus, as capacity was being reached, production of newsprint, a less profitable product, decreased as a percentage of total paper production. However, newsprint making machines in the U.S. have been operating at rated capacity since 1970. Thus, any shortage would be due to a lack of capacity for newsprint making. This contrasts sharply with the situation in other paper products.

Further doubt about the causal relationship of controls is found in connection with the long strikes at some Canadian mills (source of approximately 70% of U. S. newsprint) and the fact that newsprint production declined as a percent of total paper production even during Phase III when the industry had considerable latitude to increase prices on any product.

Demand for virtually all paper products is still strong, and as in the textile and steel industries, with capacity reached, there is an incentive to shift to high profit margin lines. In the case of paper products other than newsprint and sanitary products (not analyzed here) controls may well have caused a distortion; but for the items mentioned here controls do not appear to have caused the shift or created the shortages.

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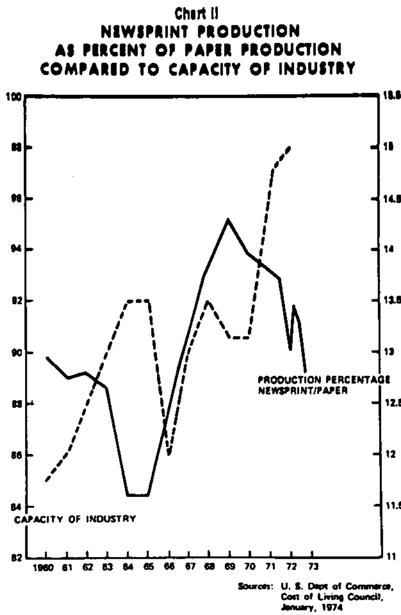

CONCLUSION

Some of the alleged distortions do in fact appear to have been caused by the controls program, but many more do not. It is easy to lay the blame for many changes on price controls, but the fact remains that many other even more powerful forces have been operating simultaneously in the economy. Where price controls do seem to have had distorting effects, the severity has depended on the degree of price restraint imposed. Where controls cannot be shown to have had distorting effects, the temporary nature of the program, in contrast to long term business considerations, may have prevented undesirable effects which might occur if controls were continued over a long period. Unintended distortions can be one of the most serious consequences of a controls program, and they must be constantly monitored in order that action may be taken to avoid even more serious problems.

Cost of Living Council
January, 1974

APPENDIX R

SUMMARY OF LEGISLATION IMPACTING
THE ECONOMIC STABILIZATION PROGRAM

Since President Nixon signed the extension of the Economic Stabilization Act (PL 93-28) on April 30, 1973, there have been over 70 bills and 35 amendments introduced in Congress which would extend, amend, repeal, or significantly affect the wage and price controls program.

Several bills seek a rollback and mandatory freeze on prices, rents, and interest rates. On the other hand, there are 10 bills and 2 amendments which attempt to repeal the wage and price control program.

Many legislative proposals exempt certain commodities from price controls. These commodities include food and agricultural products, petroleum and petroleum products, fertilizers and petrochemicals. Other bills provide a passthrough of cost on commodities, particularly, food, petroleum and petroleum products and material necessary for the mining of coal. Still other proposals mandate controls to stabilize the price of food, fuel and rents.

Legislation also has been introduced which significantly affects the administration of a wage and price control program. For example, Congress enacted a mandatory allocation program for petroleum and is considering export controls on shortage items. Specific legislation has been introduced to limit the export of raw agriculture products, petroleum and petroleum products, fertilizer and lumber.

Other proposals include an amendment to permit the cost increases incurred in compliance with a minimum wage bill to be passed through; a bill to stabilize the construction industry; an amendment to require the Administration to notify Congress 15 days prior to implementing any major change in the wage and price controls program; and a bill to provide for consumer relief from retail price violations.

This index of legislative proposals is testimony to a continuing interest of the Members of Congress in the administration of the Economic Stabilization Act of 1970.

Cost of Living Council
January 1974

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I. Legislation Mandate Controls

II. Legislation to Repeal the Economic Stabilization Act

III. Legislation Related to Controls on Food and Agriculture Products

IV. Legislation to Mandate Rent Controls

V. Legislation Related to Price Controls on Fertilizer

VI. Legislation Related to the Petroleum Industry

VII. Legislation Related to Petrochemicals

VIII. Legislation Related to Export Controls

IX. Miscellaneous Legislation Related to the Economic Stabilization Act

INDEX OF LEGISLATIVE ACTIVITY

May 1, 1973 to January 25, 1974

I. Legislation to Mandate Controls

House of Representatives

Bills

(1)	H.R. 8560 Representatives Rees June 8, 1973	A bill to amend the Economic Stabilization Act to rollback prices, interest rates and rents to January 11, 1973 levels and mandate a freeze for 90 days.
(2)	H.R. 8603 Representative Rees June 12, 1973	A bill to amend the Economic Stabilization Act to freeze prices, interest rates and rents at June 13, 1973 levels for 90 days and to extend the ESA until September 30, 1974.
(3)	H.R. 10160 Representative Harrington September 11, 1973	A bill to amend the Economic Stabilization Act to freeze prices and interest rates at September 12, 1973 levels and rents at August 12, 1973 levels.

Amendments

None

Senate

Bills

(1)	S. Res. 122 Senator Cranston May 31, 1973	A resolution stating that it is the sense of the Senate that Phase III of the President's economic stabilization program has failed and that the President should put firm controls on prices and wages.

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Amendments

(1)	Senator Jackson June 7, 1973	Amendment to S. 925, creating a federal financing bank, to mandate a 90 day freeze on prices, profits, rents, wages, salaries, and consumer interest rates. Withdrawn.
(2)	Senator Proxmire June 14, 1973	Amendment to S. 1248, the authorization bill of the State Department to impose a 90 day freeze. Withdrawn.

II. Legislation to Repeal the Economic Stabilization Act

House of Representatives

Bills

(1)	H.R. 10006 Representative Keating August 3, 1973	A bill to repeal the Economic Stabilization Act.
(2)	H.R. 10034 Representative Armstrong September 5, 1973	A bill to repeal the Economic Stabilization Act.
(3)	H.R. 10059 Representative Parris September 5, 1973	A bill to repeal the Economic Stabilization Act of 1970 and stimultaneously re-enact provisions relating to the authority of the President to allocate petroleum products.
(4)	H.R. 10166 Representative Keating September 11, 1973	A bill to repeal the Economic Stabilization Act.
(5)	H.R. 10230 Representative Keating September 12, 1973	A bill to repeal the Economic Stabilization Act.
(6)	H.R. 10384 Representative Symms September 19, 1973	A bill to repeal the Economic Stabilization Act.

(7)	H.R. 10791 Representative Burgener October 9, 1973	A bill to repeal the Economic Stabilization Act.
(8)	H.R. 10930 Representative Keating October 16, 1973	A bill to repeal the Economic Stabilization Act.
(9)	H.R. 11548 Representative Young (S.C.) November 15, 1973	A bill to repeal the Economic Stabilization Act.

Amendments

None

Senate

Bills

(1)	S. 2599 Senator Hatfield October 18, 1973	A bill to repeal the Economic Stabilization Act.

Amendments

(1)	Senator Buckley November 15, 1973	Amendment to S. 2589, the National Energy Emergency Act, to repeal the Economic Stabilization Act of 1970 on the effective date of S. 2589. Senator Johnston's motion to table passed 60-26.
(2)	Senator Buckley January 21, 1974	Amendment to H.R. 8547, the Export Administration Act, to repeal the Economic Stabilization Act on the effective date of H.R. 8547.

III. Legislation Related to Controls on Food and Agricultural Products

House of Representatives

Bills

(1)	H.R. 421 Representative Carney June 4, 1973	A resolution expressing the sense of the House that the President exercise his

authority under the ESA by freezing retail food prices and that the President establish a commission to investigate the cost and availability of food.

(2) H.R. 9134
Representative Price (Tex.)
June 29, 1973

A bill to amend the Economic Stabilization Act to exempt meat, poultry, eggs, dairy products, and feed ingredients from price controls.

(3) H.R. 10887
Representative Denholm
October 12, 1973

A bill to amend the Economic Stabilization Act to exempt agricultural commodities from price controls.

(4) H.R. 12085
Representative Rosenthal
December 20, 1973

A bill to amend the Economic Stabilization Act to stabilize the retail prices of meat for a period of 45 days at the November 1972 retail levels, and to require the President to submit to Congress a plan for insuring an adequate meat supply for U. S. consumers, reasonable meat prices, and a fair return on invested capital to farmers, food processors, and food retailers.

Amendments

(1) Representative Froehlich
July 16, 1973

Amendment to the Agriculture and Consumer Protection Act of 1973 which provided that price controls be lifted for any commodity if the Secretary of Agriculture determines that those controls will cause a food shortage. Adopted by voice vote.

Senate

Bills

(1)	S. 2094 Senator McGovern June 28, 1973	A bill to amend the Economic Stabilization Act to adjust freeze prices on agriculture commodities that the Secretary of Agriculture certifies are in short supply.
(2)	S. 2113 Senator Tower June 29, 1973	A bill to amend the Economic Stabilization Act to exempt meat, poultry, eggs, dairy products and feed ingredients of the commercial livestock feeding industry from price controls.
(3)	S.J. Res. 138 Senator Curtis July 23, 1973	A joint resolution to amend the Economic Stabilization Act to allow a dollar-for-dollar passthrough of costs in the production of beef since June 8, 1973, in a manner and to the same extent as that allowed other food products.

Amendments

(1)	Senator McGovern June 30, 1973	Amendment to H.R. 2261, a bill to extend the suspension of duties on imports of istle fibers, directing the President to increase the ceiling placed on the price of an agricultural product as of the June 13 price freeze if the Secretary of Agriculture determined that supplies of the product were being reduced to unacceptably low levels by the freeze and that supplies could not be increased by other means. Adopted 61-1.

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(2) Senator McGovern July 18, 1973	Amendment to S. 1861, the Minimum Wage bill, to amend the Economic Stabilization Act to permit the President to adjust prices of agricultural commodities if supplies of those commodities will be reduced to unacceptably low levels because of price controls. Adopted 90-4.
(3) Senator Tower August 2, 1973	Amendment to H.R. 5777, the Hobby Protection Act, to require the Cost of Living Council to allow the increased costs of raw agricultural products to be passed through and added to the price of beef. Adopted 84-5.

IV. Legislation to Mandate Rent Controls

House of Representatives

Bills

(1) H.R. 8512 Representative Barrett June 7, 1973	A bill to amend the Economic Stabilization Act to provide for a 90 day freeze on rents at levels prevailing on January 10, 1973.
(2) H.R. 8621 Representative Abzug June 13, 1973	A bill to amend the Economic Stabilization Act to provide for equitable rents.
(3) H.R. 4771 House Committee on the District of Columbia	District of Columbia Rent Stabilization Act to regulate the maximum rents to be charged by landlords. Passed House 210-144 on June 11, 1973.

Amendments

None

Senate

Bills

None

Amendments

(1)	Senator Kennedy June 27, 1973	Amendment to H.R. 8410, the Debt Limit Extension, to direct the President to place rents under the 60 day freeze instituted on June 13, 1973. Rejected 47-50.

V. Legislation Related to Price Controls on Fertilizer

House of Representatives

Bills

(1)	H.R. 10758 Representative Litton October 4, 1973	A bill to amend the Economic Stabilization Act to exempt from its provisions the stabilization of the price of fertilizer.
(2)	H.R. 10839 Representative Litton October 10, 1973	A bill to amend the Economic Stabilization Act to exempt from its provisions the stabilization of the price of fertilizer.
(3)	H.R. 10954 Representative Randall October 16, 1973	A bill to amend the Economic Stabilization Act to exempt from its provisions the stabilization of the price of fertilizer.
(4)	H.R. 10978 Representative Litton October 17, 1973	A bill to amend the Economic Stabilization Act to exempt from its provisions the stabilization of the price of fertilizer.
(5)	H.R. 11116 Representative Mathis October 25, 1973	A bill to amend the Economic Stabilization Act to exempt from its provisions the stabilization of the price of fertilizer.

(6) H.R. 11279
Representative Hungate
November 6, 1973

A bill to amend the Economic Stabilization Act to exempt from its provisions the stabilization of the price of fertilizer.

Amendments

None

Senate

Bills

(1) S. 2614
Senator Eagleton
October 26, 1973

A bill to amend the Economic Stabilization Act to require price controls on fertilizer exports as long as there are price controls on domestic fertilizer sales.

Amendments

None

VI. Legislation Related to the Petroleum Industry

House of Representatives

Bills

(1) H.R. 10087
Representative Findley
September 6, 1973

A bill to amend the Economic Stabilization Act to prohibit the Cost of Living Council from discriminating among petroleum marketers at all levels of distribution.

(2) H.R. 10425
Representative Hammerschmidt
September 20, 1973

A bill to amend the Economic Stabilization Act to prohibit the Cost of Living Council from discriminating among petroleum marketers at all levels of distribution.

(3)	H.R. 10426 Representative Hammerschmidt September 20, 1973	A bill to amend the Economic Stabilization Act to prohibit the Cost of Living Council from discriminating among petroleum marketers at all levels of distribution.
(4)	H.R. 10319 Representative Clancy September 18, 1973	A bill to amend the Economic Stabilization Act to permit passthrough of certain cost increases.
(5)	H.R. 10321 Representative Dulski September 18, 1973	A bill to amend the Economic Stabilization Act to adjust ceiling prices applicable to certain petroleum products and to permit retailers of such products to passthrough increased costs.
(6)	H.R. 10322 Representative Eilberg September 18, 1973	A bill to amend the Economic Stabilization Act to adjust ceiling prices applicable to certain petroleum products and to permit retailers of such products to passthrough increased costs.
(7)	H.R. 10349 Representative Wylie September 18, 1973	A bill to amend the Economic Stabilization Act to adjust ceiling prices applicable to certain petroleum products and to permit retailers of such products to passthrough increased costs.
(8)	H.R. 10354 Representative Cronin September 19, 1973	A bill to amend the Economic Stabilization Act to adjust ceiling prices applicable to certain petroleum products and to permit retailers of such products to passthrough increased costs.

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(9)	H.R. 10393 Representative de la Garza September 19, 1973	A bill to amend the Economic Stabilization Act to adjust ceiling prices applicable to certain petroleum products and to permit retailers of such products to passthrough increased costs.
(10)	H.R. 10398 Representative Eilberg September 19, 1973	A bill to amend the Economic Stabilization Act to adjust ceiling prices applicable to certain petroleum products and to permit retailers of such products to passthrough increased costs.
(11)	H.R. 10425 Representative Hammerschmidt September 20, 1973	A bill to amend the Economic Stabilization Act to adjust ceiling prices applicable to certain petroleum products and to permit retailers of such products to passthrough increased costs.
(12)	H.R. 10631 Representative Eilberg October 2, 1973	A bill to amend the Economic Stabilization Act to adjust ceiling prices applicable to certain petroleum products and to permit retailers of such products to passthrough increased costs.
(13)	H.R. 10391 Representative Wyatt September 19, 1973	A bill to amend the Economic Stabilization Act to exempt stabilization of the price of gasoline at the retail level from coverage under the Act.
(14)	H.R. 10422 Representative Frenzel September 20, 1973	A bill to amend the Economic Stabilization Act to require mandatory allocation of petroleum.

(15)	H.R. 10502 Representative Sikes September 25, 1973	A bill to amend the Economic Stabilization Act to permit dollar-for-dollar passthrough of cost increases at all levels of petroleum distribution.
(16)	H.R. 10677 Representative McKinney October 2, 1973	A bill to amend the Economic Stabilization Act to require mandatory allocation of petroleum.
(17)	H.R. 10643 Representative McKinney October 2, 1973	A bill to amend the Economic Stabilization Act to require mandatory allocation of petroleum.
(18)	H.R. 10871 Representative McKinney October 11, 1973	A bill to amend the Economic Stabilization Act to require mandatory allocation of petroleum.
(19)	H.R. 10617 Representative Rogers October 1, 1973	A bill to amend the Economic Stabilization Act to permit dollar-for-dollar passthrough of cost increases at all levels of petroleum distribution.
(20)	H.R. 10703 Representative Baker October 13, 1973	A bill to amend the Economic Stabilization Act to permit dollar-for-dollar passthrough of cost increases at all levels of petroleum distribution.
(21)	H.R. 10782 Representative Wyman October 4, 1973	A bill to amend the Economic Stabilization Act to permit dollar-for-dollar passthrough of cost increases at all levels of petroleum distribution.
(22)	H.R. 10845 Representative Brinkley October 10, 1973	A bill to amend the Economic Stabilization Act to permit dollar-for-dollar passthrough of cost increases at all levels of petroleum distribution.

(23)	H.R. 12132 Representative Denholm December 21, 1973	A bill to amend the Economic Stabilization Act to eliminate price controls of petroleum products.
(24)	H.R. 12214 Representative Reuss January 22, 1974	A bill to amend the Economic Stabilization Act to require a ceiling price on domestic crude petroleum not to exceed May 15, 1973, price adjusted for cost increases.

<u>Amendments</u>

(1)	Representative Saylor August 2, 1973	Amendment to S. 1081, Alaskan Pipeline Bill, to provide that no crude oil transported over rights-of-way granted under the Mineral Leasing Act of 1920 would be exported unless Congress adopted a concurrent resolution in agreement with a Presidential finding that such exports were in the national interest. Adopted by voice vote.
(2)	Representative McDonald August 2, 1973	Amendment to S. 1081, Alaskan Pipeline Bill, requiring the President within six months after enactment to develop a National Petroleum Contingency Plan to assure the equitable allocation of available crude oil and petroleum products among the states at nondiscriminatory prices during periods of disproportionate shortages. Rejected 179-233.

(3) Representative Findley
September 25, 1973

Amendment to H.J. Res. 727, continuing appropriations, to prohibit the Cost of Living Council from conducting a program which discriminated among petroleum marketers in the method of establishing gasoline and other petroleum product prices. Adopted 371-7.

(4) House Appropriations Committee
October 3, 1973

Committee amendment to H.J. Res. 727 to delete the Findley amendment. Rejected 6-90.

(5) Representative Symms
October 17, 1973

Amendment to H.R. 9681 (S. 1570), to set the expiration date for the allocation program at April 30, 1974, to coincide with the expiration of the Economic Stabilization Act, instead of February 28, 1975. Rejected by voice vote.

(6) Representative Hungate
October 17, 1973

Amendment to H.R. 9681, (S. 1570), to include anti-freeze within the mandatory allocation program. Rejected by voice vote.

(7) Representative Collins
October 17, 1973

Amendment to H.R. 9681 (S. 1570), to require Congress, rather than the administration, control the allocation program. Rejected by voice vote.

Senate

Bills

(1) S. 2415
Senator Curtis
September 13, 1973

A bill to amend the Economic Stabilization Act to permit the passthrough of cost increases of all goods sold or services performed.

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(2) S. 2420 Senator Bayh September 17, 1973	A bill to amend the Economic Stabilization Act to adjust price ceiling prices applicable to certain petroleum products and to permit retailers of such products to passthrough increased costs.
(3) S. 2453 Senator Stevenson September 20, 1973	A bill to amend the Economic Stabilization Act to permit dollar-for-dollar passthrough cost increases at all levels of petroleum distribution.
(4) S. 2480 Senator Cook September 24, 1973	A bill to amend the Economic Stabilization Act to allow passthrough of costs at all levels and to require the use of the same date for computing ceiling prices of petroleum products.
(5) S. 1570 Senate Committee on Interior November 14, 1973 cleared for President	Emergency Petroleum Allocation Act which provided (1) an additional 15 days for the President to put into effect regulations covering gasoline and products covered by the allocation program established by the President under the ESA; (2) retailers to pass on to their customers increases in the wholesale price of oil and oil products; (3) the same base period to be used to compute all price markups; (4) oil and oil product allocation to each user in an amount no less than that supplied to them during the corresponding period of 1972; (5) the same fines and injunctive relief as were authorized under the ESA; (6) export controls and (7) exemption of wells which produced 10 barrels or less daily (stripper wells) from the allocation program.

(6) S. 2892
Senator Mondale
January 24, 1974

A bill to amend the Economic Stabilization Act to establish a ceiling on prices of crude oil and petroleum immediately and to subsequently rollback those prices.

Amendments

(1) Senator Bartlett
June 5, 1973

Amendment to S. 1570, Emergency Petroleum Allocation Act of 1973 to remove oil company products from existing price controls set by the Cost of Living Council. Rejected 21-71.

(2) Senator McIntyre
June 5, 1973

Amendment to S. 1570, urging the President to take further action to effectively stabilize prices on crude oil and petroleum products. Passed on voice vote.

(3) Senator Jackson
July 12, 1973

Amendment to S. 1081, Alaskan Pipeline Bill, to prohibit the export of domestically produced oil unless the President found that such export would not diminish the total quantity or quality of petroleum available to the U. S. Adopted 92-2.

(4) Senator Mondale
July 12, 1973

Amendment to S. 1081, Alaskan Pipeline, to prohibit the export of domestically produced oil unless the President found that such a prohibition would endanger national security and to permit either House of Congres to disapprove any report within 90 days. Rejected 31-62.

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(5)	Senator Bartlett July 14, 1973	Amendment (as amended by Senator Jackson) to S. 1081, Alaskan Pipeline, to exempt certain oil sales from price controls, i.e., the first sale of crude oil and natural gas liquids produced from "stripper wells" from price controls under the ESA and from allocation programs. Adopted 67-1.
(6)	Senator Jackson July 16, 1973	Amendment to S. 1081, Alaskan Pipeline, which provided that the President should report to Congress his findings on the need to export Alaskan oil and that Congress was empowered to halt such exports within 60 days by joint resolution. Adopted 86-0.
(7)	Senator Bartlett July 31, 1973	Amendment to H.R. 5777, the Hobby Protection Act, to exempt from price control and allocation programs the first sale of crude oil and natural gas liquids produced from any lease whose average daily production did not exceed 10 barrels per well. Rejected 43-50.
(8)	Senator Bartlett August 1, 1973	Amendment to H.R. 5777, the Hobby Protection Act, to amend the Jackson amendment to allow the President to determine if mandatory fuel allocation was in the national interest and, if so, when to begin and terminate such a program. Rejected 20-70.

(9) Senator Jackson
August 1, 1973

Amendment to H.R. 5777, the Hobby Protection Act, to direct the President to initiate a mandatory allocation of crude oil and refined petroleum products 25 days after enactment of the bill. Adopted 80-9.

(10) Senator Mondale
December 19, 1973

Amendment to S. 2776, the Federal Energy Emergency Act, to limit price increases of crude and refined oil to the actual increases in the cost of producing them. Motion by Senator Long to table the amendment passed 47-44.

VII. Legislation Related to Petrochemicals

House of Representatives

Bills

(1) H.R. 11768
Representative Sarasin
December 4, 1973

A bill to amend the Economic Stabilization Act to exempt stabilization of the price of petrochemicals from coverage under the Act.

(2) H.R. 11939
Representative Huber
December 13, 1973

A bill to amend the Economic Stabilization Act to exempt stabilization of the price of petrochemicals from coverage under the Act.

(3) H.R. 12041
Representative O'Brien
December 19, 1973

A bill to amend the Economic Stabilization Act to exempt stabilization of the price of petrochemicals from coverage under the Act.

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Senate

Bills

None

Amendments

None

VIII. Legislation Related to Export Controls

House of Representatives

Bills

(1) H.R. 8547
House Committee on Banking and Currency

A bill to amend the Export Administration Act of 1969 to require the Secretary of Commerce in most instances to determine materials or commodities to be subject to export controls as a result of current or prospective domestic inflationary impact or short supply of such materials. Passed 220-133.

Amendments

(1) Representative Findley
September 6, 1973

Amendment to H.R. 8547, the Export Administration Extension Act, to provide that either the House or Senate could disapprove the Secretary's action. Rejected 154-211.

(2) Representative Ashley
September 6, 1973

Amendment to H.R. 8547, the Export Adiminstration Extension Act, to remove the limitation on the export of soft wood logs and lumber. Accepted by voice vote.

(3) Representative Heinz
September 6, 1973

Amendment to H.R. 8547, the Export Administration Extension Act, to impose tighter export controls on scrap iron and steel. Rejected by voice vote.

Senate

Bills

(1) S. 2002
Senator Tower
June 14, 1973

A bill to amend the Economic Stabilization Act to authorize the President to prohibit or curtail the exportation of articles, commodities or products from the U. S. when the need arises to do so to stabilize wages, rents and salaries and for other purposes.

Amendments

None

IX. Miscellaneous Legislation Related to the Economic Stabilization Act

House of Representatives

Bills

(1) H.R. 8298
Representative Anderson
May 31, 1973

A bill to promote economic stability in the construction industry to provide legislative authorization of the construction industry stabilization committee and its wage stabilization activities; and to mandate the construction industry stabilization committee to prepare a plan for construction industry bargaining reform within 12 months of date of enactment.

33-074 O - 74 - 16

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(2) H.R. 12039 Representative Froehlich December 19, 1973	A bill to amend the Economic Stabilization Act to exempt groundwood and chemical papermaking pulp from coverage under the Act.
(3) H.R. 12055 Representative Breaux December 20, 1973	A bill to amend the Economic Stabilization Act to exempt stabilization of the price of oil country goods from its provisions.

Amendments

None

Senate

Bills

(1) S. 2524 Senator Tunney October 3, 1973	A bill to amend the Economic Stabilization Act to provide effective consumer remedies for retail prices violations.

Amendments

(1) Senator McGovern June 22, 1973	Amendment to S. 1636, Council on International Economic Policy, to require the President to notify Congress 15 days before taking any major action under the ESA. Rejected 29-47.
(2) Senator Taft July 18, 1973	Amendment to S. 1861, Minimum Wage, to allow employers to increase the price of their products to compensate for increased labor costs caused by S. 1861. Rejected by voice vote.

(3) Senator Randolph October 9, 1973	Amendment to S. 425, the Strip Mining Act, to direct the President or the Cost of Living Council to grant automatic price increases for coal to reflect the increased costs of producing coal because of compliance with the Act. Passed on voice vote.
(4) Senator Randolph October 10, 1973	Amendment to S. 425, Strip Mining Act, to urge the Administration to take action, including permission to raise prices, to increase the supply of steel for coal mine roof bolts and plates for underground mining needs to assure adequate supplies of coal in the immediate future. Adopted by voice vote.
(5) Senate Appropriations Committee	The Committee recommended and the Senate voted $10 million for personnel increases for the Cost of Living Council for the Supplemental Appropriations Bill, $10.7 million less than the budget request. December 12, 1973
(6) Senator Buckley December 19, 1973	Amendment to S. 2776, the Federal Energy Emergency Administration Act, to include coal in the products for which price increases would be limited to the actual increase in the cost of producing the products. Rejected 30-60.

APPENDIX S

CONCENTRATION AND PRICE CHANGE
BY 2-DIGIT S.I.C. INDUSTRY
IN MANUFACTURING SECTOR
RANKED BY CONCENTRATION

S.I.C.	NAME	(1) Top 4 PCT Concen-tration	(2) Rate of Price Change 68-72	(2) Rate of Price Change 71-72	(3) WPI Change 72-73
21	Tobacco Manufacturers	78	3.9	2.8	4.7
37	Transportation Equipment	68	3.6	3.7	2.7
38	Instruments	53	1.6	1.1	2.1
36	Electrical Machinery and Equipment	48	1.9	0.1	3.1
33	Primary Metal Industries	44	4.8	3.0	18.8
28	Chemicals and Allied Products	42	0.5	1.4	10.3
32	Stone, Clay, Glass, and Concrete	37	4.8	3.3	4.1
22	Textile Mill Products	36	0.0	4.6	22.3
35	Machinery, Exc. Electrical	35	3.0	2.3	6.1
29	Petroleum Ref.and Related Inds.	33	2.3	1.9	125.0
20	Food and Kindred Products	33	4.2	5.2	20.3
30	Rubber and Misc.Plastics Products	32	0.0	-4.9	6.1
26	Paper and Allied Products	32	2.9	2.7	11.8
34	Fabricated Metals, Exc.Mach.	29	4.6	3.8	6.7
39	Misc. Manufacturing	29	2.9	3.1	7.2
31	Leather and Leather Products	28	4.9	9.7	-0.2
23	Apparel and Other	22	2.1	2.0	5.3
27	Printing and Publishing	20	4.0	4.6	N.A.
24	Lumber and Wood Prods., Exc. Furn.	19	6.0	12.8	24.2
25	Furniture and Fixtures	19	3.1	2.2	4.5

NOTES:

1. Concentration measure shown is the percent of shipments in the 2-Digit S.I.C. that is accounted for by the top 4 firms in each constituent 4-Digit S.I.C. The value shown is equal to or greater than the percent of shipments in the 2-Digit S.I.C. accounted for by the top 4 firms in the 2-Digit group, depending on whether the same 4 firms are largest in every constituent 4-Digit S.I.C. Concentration data is for 1970, and comes from the Bureau of the Census, Survey of Manufacturers.

2. Price changes are compounded annual percentage rates of change in the G.N.P. deflators.

3. Wholesale Price Index change from Dec. 72 to Dec. 73, concorded from commodity groupings to Standard Industrial Classification (SIC).

Cost of Living Council
February 1974

"OLIGOPOLISTIC" VS. "COMPETITIVE" INDUSTRIES

CHANGE IN W.P.I.

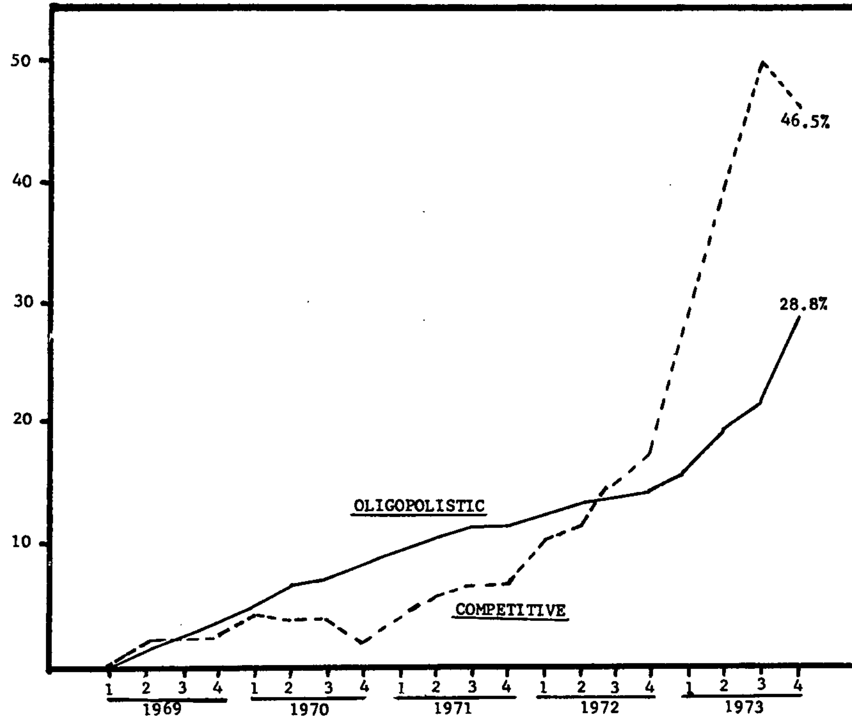
PERCENT

CHANGE IN

W.P.I.

SINCE

1969:1 = 0



NOTE Definition of oligopolistic and competitive W.P.I. groups based on Eichner, Alfred S., "A Theory of the Determination of the Mark-Up Under Oligopoly", The Economic Journal (Dec. 1973).

Cost of Living Council
February 1974

APPENDIX T

A-150

ECONOMETRIC PROJECTIONS OF THE GNP
DEFLATOR FOR 1974 AS OF DECEMBER 1973
(Quarterly Rates of Change Annualized)

Source	QI	QII	QIII	QIV
Chase Econometrics	6.7	5.6	6.0	5.9
Fair/Princeton	5.8	4.8	4.1	4.2
DRI	6.2	6.6	6.4	6.1
Wharton	7.1	7.2	7.2	7.2
Lintner/Harvard	7.8	7.2	6.5	6.0
Kidder-Peabody	6.5	5.8	5.3	4.7
ASA/NBER	6.0	5.1	5.3	4.5
Morgan Guaranty	6.6	6.5	5.2	5.0
IBM 1/	8.7	7.2	6.3	5.9

1/ January, 1974 Forecast: December data unobtainable

Cost of Living Council
February 1974

APPENDIX U

INDUSTRIES RANKED BY ENERGY COSTS AS

A PERCENTAGE (%) OF COST OF MATERIALS

SIC CODE	DESCRIPTION	VALUE OF SHIPMENTS (mill $)	COST OF MATERIALS (mill $)	PURCHASED FUELS AND ELECTRIC ENERGY (% of cost)
324	Cement, hydraulic	1,560.3	564.9	43.0
325	Structural clay products	1,115.2	386.6	21.2
266	Building paper & board mills	465.7	218.5	16.2
281	Industrial chemicals	16,524.3	7,545.1	14.8
322	Glass & glassware pressed or blown	3,052.0	1,009.3	14.5
321	Flat glass	811.1	240.3	14.4
263	Paperboard mills	3,536.4	1,885.5	13.6
303	Reclaimed rubber	32.1	14.5	13.1
261	Pulpmills	841.8	496.4	11.6
262	Papermills, except building paper	5,825.7	3,229.6	11.6
332	Iron and Steel foundries	4,977.5	1,956.8	10.6
326	Pottery and related products	717.8	217.7	8.9
347	Metal services, N.E.C	1,484.9	516.8	8.9
331	Blast furnace & basic steel products	25,790.4	14,677.7	8.5
333	Primary nonferrous metals	5,290.6	3,930.0	8.1
279	Printing trade services	684.4	98.7	7.9
339	Miscellaneous primary metal products	2,129.0	1,035.2	7.8
329	Miscellaneous non-metallic mineral products	3,314.5	1,409.2	7.7

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INDUSTRIES RANKED BY ENERGY COSTS AS

A PERCENTAGE (%) OF COST OF MATERIALS

SIC CODE	DESCRIPTION	VALUE OF SHIPMENTS (mill $)	COST OF MATERIALS (mill $)	PURCHASED FUELS AND ELECTRIC ENERGY (% of cost)
249	Miscellaneous wood products	2,039.0	1,028.2	6.9
191X	Guns, mortars ordnance and accessories, N.E.C.	562.2	150.4	6.5
282	Plastics materials and synthetics	9,345.6	4,569.4	6.3
328	Cut stone and stone products	261.4	97.2	5.9
226	Textile finishing, except wool	2,113.6	1,177.3	5.6
327	Concrete, gypsum, & plaster products	6,545.8	3,291.1	5.4
241	Logging camps & logging contractors	1,814.1	954.6	5.1
336	Nonferrous foundries	1,919.6	868.2	4.9
286	Gum & wood chemicals	279.4	144.7	4.6
242	Sawmills and planing mills	5,267.7	2,804.0	4.5
295	Paving and roofing materials.	1,683.5	972.7	4.5
221	Weaving mills, cotton	2,650.5	1,379.8	4.4
223	Weaving and finishing mills, wool	546.8	296.1	4.4
298	Miscellaneous chemical products	3,571.3	1,723.0	4.4
307	Miscellaneous plastics products	7,765.0	3,354.9	4.0
306	Fabricated rubber products, N.E.C.	3,495.0	1,475.0	3.8
222	Weaving mills, synthetic	3.129.6	1,711.8	3.7

INDUSTRIES RANKED BY ENERGY COSTS AS

A PERCENTAGE (%) OF COST OF MATERIALS

SIC CODE	DESCRIPTION	VALUE OF SHIPMENTS (mill $)	COST OF MATERIALS (mill $)	PURCHASED FUELS AND ELECTRIC ENERGY (% of cost)
359	Miscellaneous machinery, except electrical	3,884.1	1,222.9	3.7
283	Drugs	7,278.1	1,808.6	3.5
195	Small arms	379.7	129.1	3.4
278	Blankbooks and bookbinding	848.4	241.3	3.4
354	Metalworking machinery	6,555.8	2,169.3	3.4
287	Agricultural chemicals	2,751.3	1,607.7	3.3
362	Electrical industrial apparatus	4,929.7	2,006.4	3.2
311	Leather tanning and finishing	838.3	498.5	3.1
206	Sugar	2,857.0	2,015.4	3.0
345	Screw machine products bolts, etc.	2,620.1	1,065.3	3.0
385	Ophthalmic goods	565.2	176.6	3.0
291	Petroleum refining	24,583.7	20,091.9	2.9
301	Tires and inner tubes	5,231.9	2,468.4	2.9
228	Yarn and thread mills	3,604.8	2,262.0	2.7
367	Electronic components & accessories	7,296.4	2,917.2	2.7
342	Cutlery, hand-tools and hardware	4,485.3	1,709.5	2.6
224	Narrow fabric mills	531.2	247.5	2.6
386	Photographic equipment & supplies	4,709.2	1,233.6	2.5
229	Miscellaneous textile goods	2,438.5	1,489.1	2.5
252	Office furniture	857.3	340.1	2.5
275	Commercial printing	8,298.8	3,214.2	2.5

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INDUSTRIES RANKED BY ENERGY COSTS AS

A PERCENTAGE (%) OF COST OF MATERIALS

SIC CODE	DESCRIPTION	VALUE OF SHIPMENTS (mill $)	COST OF MATERIALS (mill $)	PURCHASED FUELS AND ELECTRIC ENERGY (% of cost)
349	Miscellaneous fabricated metal products	6,022.4	2,783.4	2.5
383	Optical instruments and lenses	385.6	120.8	2.5
196	Small arms ammunition	381.9	186.8	2.4
271	Newspapers	7,354.5	1,817.5	2.4
323	Products of purchased glass	1,156.6	600.0	2.4
348	Miscellaneous fabricated wire products	1,336.4	598.4	2.4
356	General industry machinery	7,422.6	3,102.8	2.4
381	Engineering & scientific instruments	1,105.0	408.6	2.3
382	Mechanical measuring and control devices	2,275.9	740.9	2.3
254	Partitions and fixtures	1,225.4	531.1	2.2
302	Rubber footwear	519.8	228.7	2.2
346	Metal stampings	7,095.7	3,407.6	2.2

INDUSTRIES RANKED BY ENERGY COSTS AS

A PERCENTAGE (%) OF COST OF MATERIALS

SIC CODE	DESCRIPTION	VALUE OF SHIPMENTS (mill $)	COST OF MATERIALS (mill $)	PURCHASED FUELS AND ELECTRIC ENERGY (% of cost)
395	Pens, pencils, office and art supplies	873.4	356.4	2.2
192	Ammunition, except for small arms	5,278.7	1,661.6	2.1
205	Bakery products	7,357.2	3,221.7	2.1
244	Wooden Containers	414.4	230.6	2.1
253	Public building furniture	471.8	218.5	2.1
259	Miscellaneous furniture and fixtures	576.4	261.0	2.1
317	Handbags and personal leather goods	509.2	209.5	2.1
335	Nonferrous rolling and drawing	11,316.2	8,062.9	2.1
355	Special industry machinery	5,186.4	2,168.5	2.1
364	Electric lighting and wiring equipment	4,832.2	2,030.5	2.1
343	Plumbing and heating, except electrical	2,207.0	1,109.3	2.0
373	Ship and boat building and repairing	3,503.4	1,564.0	2.0

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INDUSTRIES RANKED BY ENERGY COSTS AS

A PERCENTAGE (%) OF COST OF MATERIALS

SIC CODE	DESCRIPTION	VALUE OF SHIPMENTS (mill $)	COST OF MATERIALS (mill $)	PURCHASED FUELS AND ELECTRIC ENERGY (% of cost)
399	Miscellaneous manufactures	3,169.2	1,318.8	2.0
194	Sighting and fire control equipment	35.0	10.5	1.9
243	Millwork, plywood & related products	5,395.6	3,155.9	1.9
265	Paperboard containers and boxes	7,116.5	3,970.9	1.9
299	Miscellaneous petroleum and coal products	668.0	396.2	1.9
361	Electric test & distributing equipment	4,618.7	1,825.6	1.9
396	Costume jewelry & notions	1,227.6	507.7	1.9
225	Knitting mills	6,336.0	3,683.9	1.8
264	Miscellaneous converted paper products	7,672.0	4,039.2	1.8
313	Footwear cut stock	234.0	124.7	1.8
316	Luggage	283.3	125.0	1.8
369	Miscellaneous electrical equipment and supplies	3,900.3	1,733.6	1.8
203	Canned, cured and frozen foods	11,961.5	7,326.7	1.7
251	Household furniture	6,622.6	3,208.7	1.7
334	Secondary nonferrous metals	1,644.0	1,350.1	1.7
384	Medical instruments and supplies	2,327.5	833.6	1.8
394	Toys & sporting goods	2,785.5	1,229.6	1.7
208	Beverages	13,330.8	6,855.1	1.6

INDUSTRIES RANKED BY ENERGY COSTS AS

A PERCENTAGE (%) OF COST OF MATERIALS

SIC CODE	DESCRIPTION	VALUE OF SHIPMENTS (mill $)	COST OF MATERIALS (mill $)	PURCHASED FUELS AND ELECTRIC ENERGY (% of cost)
227	Floor covering mills	2,678.8	1,776.0	1.6
235	Hats, caps, & millinery	221.9	98.6	1.6
344	Fabricated structural metal products	12,615.2	6,432.1	1.6
353	Construction and related machinery	9,498.8	4,544.2	1.6
372	Aircraft and parts	18,432.8	7,820.6	1.6
204	Grain mill products	11,209.6	7,787.9	1.5
207	Confectionery & related products	3,442.3	1,827.1	1.5
276	Manifold business forms	1,277.7	550.3	1.5
284	Soap, cleaners & toilet goods	8,467.2	3,170.2	1.5
352	Farm machinery	4,456.4	2,457.3	1.5
363	Household appliances	6,061.6	2,911.6	1.5
366	Communication equipment	12,985.3	4,833.8	1.5
393	Musical instruments & parts	506.5	233.2	1.5
273	Books	3,681.9	1,220.6	1.4
341	Metals cans	4,159.4	2,429.4	1.4
351	Engines and turbines	5,024.9	2,500.9	1.4
213	Chewing and smoking tobacco	186.6	81.5	1.3
231	Men's & boy's suits & coats	1,892.1	858.7	1.3
357	Office and computing machines	6,909.7	2,811.9	1.3
358	Service industry machines	6,621.2	3,558.7	1.3

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INDUSTRIES RANKED BY ENERGY COSTS AS

A PERCENTAGE (%) OF COST OF MATERIALS

SIC CODE	DESCRIPTION	VALUE OF SHIPMENTS (mill $)	COST OF MATERIALS (mill $)	PURCHASED FUELS AND ELECTRIC ENERGY (% of cost)
212	Cigars	359.3	140.5	1.2
233	Women's and misses outerwear	7,698.5	3,882.2	1.2
285	Paints and allied products	3,655.9	1,921.1	1.2
314	Footwear, except rubber	3,068.5	1,342.6	1.2
315	Leather gloves and mittens	92.1	48.7	1.2
374	Railroad equipment	2,363.9	1,372.3	1.2
375	Motorcycles, bicycles, and parts	469.6	256.6	1.2
391	Jewelry, silverware & plated ware	1,559.8	824.5	1.2
202	Dairy Products	14,813.3	10,923.0	1.1
209	Miscellaneous food & kindred products	12,580.7	8,651.8	1.1
239	Misc. fabricated textile products	4,615.2	2,611.5	1.1
193	Tanks and tank components	345.2	193.8	1.0
319	Leather goods, N.E.C.	143.0	68.3	1.0
232	Men's & boy's furnishings	6,116.1	3,036.2	0.9
234	Women's and children's undergarments	1,913.4	885.2	0.9
238	Miscellaneous apparel and accessories	1,188.6	586.2	0.9
387	Watches, clocks, and watchcases	906.8	442.7	0.9
236	Children's outerwear	1,194.9	600.3	0.8

INDUSTRIES RANKED BY ENERGY COSTS AS

A PERCENTAGE (%) OF COST OF MATERIALS

SIC CODE	DESCRIPTION	VALUE OF SHIPMENTS (mill $)	COST OF MATERIALS (mill $)	PURCHASED FUELS AND ELECTRIC ENERGY (% of cost)
371	Motor vehicles and equipment	58,138.0	37,575.7	0.8
211	Cigarettes	3,573.3	1,464.3	0.7
201	Meat Products	26,078.5	21,168.8	0.6
272	Periodicals	3,238.6	1,239.3	0.6
365	Radio & TV receiving equipment	4,543.8	2,664.4	0.6
214	Tobacco stemming and redrying	1,408.7	1,286.7	0.5
379	Miscellaneous transportation equipment	4,012.8	2,662.6	0.5
274	Miscellaneous publishing	764.2	211.1	NA
277	Greeting card publishing	738.7	268.3	NA
312	Industrial leather belting & packing	50.0	20.1	NA

Cost of Living Council

January 1974

Senator PROXMIRE. Mr. Dunlop, I certainly did not mean to imply in my opening statement that there is not a concern with inflation and a very deep, strong feeling that the administration would like to do everything it possibly could do about it. But what I fail to see is an effective program.

You have introduced one element that certainly should be included, in all fairness, and it is a very, very important element—that is the effort to try to increase supply. And it is vital and central.

But, having said that, and of course we all recognize that to increase supply often takes years in many instances before we can increase it sufficiently to restrain price increases. I, frankly, do not see anything except advisory committees, review committees, and so forth, to cope with what seems to be a problem that is made up of two things.

No. 1, a terrific momentum going from last year, and No. 2, some very serious and severe inflationary problems that are going to come up this year, more real than they were last year.

I have particular reference to the area where you have the greatest expertise, and that is the likelihood that we are going to have wage-cost pressures. Am I too pessimistic when I say there does not seem to be any effective way to cope with this?

Again, I do not mean to challenge anybody's sincerity and their determination to do something about it. What I am saying is that there does not seem to be any apparatus, any program, any means of controlling what seems to be a very serious inflation in the coming year.

Mr. DUNLOP. May I comment on those remarks, Senator Proxmire?

First of all, I have been, and remain, one of the persons who feel it very important to be very candid about the extent of the inflationary pressure. And I do believe they are, at this moment, very, very strong.

Let me supplement that a little bit. In the period from now until the middle of the year, our agricultural situation is one which will yield, as we knew last fall, substantially higher prices in wheat. These prices of wheat which are referred to are bound to have their impact in areas where flour derivatives of feed grain are important.

We have just completed a study, Senator Proxmire, on the extent to which the high petroleum and energy costs have been working their way through the manufacturing sector. In the last exhibit, page A–151, in the prepared statement, Senator Proxmire, you will see a table showing the industries ranked by energy costs as a percentage of cost of materials. It is important to see how concentrated energy costs are in some industries.

There have been suggestions to us that we have barely begun to see the impact on manufacturing costs of these energy costs. It will be June or July before those costs come through. And so I share that concern.

While I would not want to minimize those inflationary pressures, professionally, on the other hand, the situation is, I do not think, all that bleak. That is the price side of it and I will, at the end of these remarks, comment on the wage side of the issue.

There is, for example, the fact that the economies of the world must be cooling. These energy developments and others suggest that these economies of Western Europe are, in fact, cooling. There is a lot of evidence that this is bound to happen and it will have very significant effects on primary prices which have been a central source of these inflationary pressures over the past year.

It seems to me that those primary prices have got to come down. The expenditure to support their present levels with the growth in supply, is very high.

Secondly, our agricultural output it seems to me as we argued before, is likely to increase appreciably. Last year being the first year of almost all-out agricultural production is bound to have impacts when the new crops come in, weather permitting, to effect these primary prices. So the agricultural picture is not all that bleak after midyear.

On the wage side, Mr. Vice Chairman, I would like if I may to go to the tables which I have prepared. The purpose of my comment is that very often people have compared the 8.8-percent rise in the cost of living from December 1972 to December 1973 with our 5.5 wage standard.

The 8.8-percent increase in the CPI is the December to December figure as table 1[1] shows. However, the CPI rose 4.2 percent year over year from 1972 to 1973. And average hourly earnings rose 6.2 percent year over year. The compensation per man-hour rose, as shown. Table 2[2] shows not only the CPI year over year, but also what those wage adjustments were, supplemented by the operation of cost-of-living escalators.

So I think that those tables suggest that while we do face higher wage pressures as I readily admitted, there are a couple of factors which are making for moderation. One, we do have a very soundly based internal wage structure in industry occupational areas. Secondly, we do enjoy a very constructive labor/management relationship atmosphere in the country at this time.

Never before in my experience have so many contracts in a year been settled earlier. Those are favorable factors. Against that, I grant you, the rise of living costs and the level of profits would operate the other way. But it seems to me that while we will have higher settlements, it seems to me that they, on the whole, will be responsible settlements while no doubt in excess of productivity.

Senator PROXMIRE. Mr. Dunlop, this presentation does not show, as I understand it—maybe I misread it—it does not seem to show the weekly earnings. It shows the average hourly earning. Furthermore, it shows that for the year. As you well know, what happened at the end of last year in the fourth quarter and what happened in January of 1974, was particularly serious for the worker because his number of hours worked declined and the actual money income in January, as I recall, for wage earners dropped. So that his real income, in view of the inflation in January, was seriously penalized.

This kind of developing trend as the year goes on in a big wage settlement year is likely to be very serious and would suggest to me

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[1] See table 1, p. 237.
[2] See table 2, p. 238.

that something on the order, if not guidelines, but some kind of a system to try and exercise greater control over a possible wage/price spiral, ought to be introduced.

We have no program for coping with it.

Let me just say one more thing. I know that you believe wage policy can best be carried on through informal discussion and negotiation with union leaders. You have had enormous success with this in the construction area as the chart here and other things indicate, but to do this with an entire economy is obviously beyond the power of any one man, no matter how skilled he is.

It would seem to me that some kind of a policy to try to relate wage increases in the cost of living and to try to keep it within reason would be helpful.

Mr. Dunlop. Table 1 [1], in front of you, does show the December to December changes. The 8.8 CPI, the 6.7, the 7.2, and the 8 percent are either the December to December or the fourth quarter to fourth quarter comparison.

I would also respectfully suggest to you that wages are not determined on the monthly basis or on a short-term consideration. Parties who are responsible for bargaining have longer run considerations. I do not want to give you the impression that I do not think there is a problem. I am trying to say that I agree with you, that there is a problem. On the other hand, I have not wanted to create the view that it is all that bleak and difficult. There are some mitigating factors working the other way.

Now let me say a word about the problem of wage policy in 1974. The first point I would say to you is to suggest that a wage policy is not worth the powder to blow it to hades unless it has the cooperation of labor and management. That is a prejudice of mine. I think the British experience currently is only one indication of that point of view.

I do not believe that it is possible at this time to secure that kind of cooperation with a continuation of the kind of wage guidelines and figure of the sort that you imply.

The second observation I would make is that I'm afraid that in the present circumstances, the only kind of wage guideline number you could try out which would seem to have equity to it would be a very large number, and I think that would be much more inflationary than not. One of my strong arguments against the notion of guidelines is that the number becomes the floor in the negotiations of various people. My responsible labor and management friends on both sides are unanimously of the view that it is doubtful that such guidelines are stabilizing. Guidelines tend to raise those expectations. Just for concluding these remarks, I have brought with me a piece of paper which I wrote over the New Year's holiday weekend seeking to put forward in a single memorandum my considered experience and judgment about wage stabilization, Mr. Vice Chairman, and I would be happy to give that to you and the members of the committee. In it, I took some time to lay out my views about wage stabilization with considerable care.

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[1] See table 1, p. 237.

Senator PROXMIRE. My time is up. I would like to conclude by saying that you are a mighty persuasive man, but it seems to me this comes down to one solid argument after another about why we can do almost nothing about it.

Senator Percy.

Senator PERCY. I would like to yield to Senator Javits.

Senator JAVITS. Thank you, Mr. Vice Chairman.

Mr. Dunlop, I generally would not accept Senator Percy's yielding to me, but I do this time because I wish to follow up precisely on the point which Senator Proxmire was making.

Do we understand that you recommend against any further guideline with respect to wage increases?

Mr. DUNLOP. Senator Javits, I have always been opposed to wage guidelines as a matter of public policy. That is not a new conviction of mine. It was a view which I took in the 1960's. It is a view which I have persistently held in my present job.

I would point out to you, as was said in the testimony, and I will give you the citation in a moment, that it is also the unanimous view of all of my labor and management advisory committees, and indeed, every labor and management representative I know, that they are opposed to it. You will find that on page A-67 of my prepared statement.

Perhaps I should state why. First, it is my view, in part, because a single number becomes the floor at which negotiations tend to start. Employees come to believe that they are entitled to that number by grant of the Government and union representatives who settle agreements at such a figure are seen by workers as not doing very effective work or doing a job very well. I think that is a very bad state of affairs in the economy.

Second, in my view, I am opposed to it because employers are tempted in the face of a strike, and too many succumb, to settle for a higher figure and then go around and argue before the stabilization agency that the agreement that they have signed should be reduced. I know of nothing that is more detrimental to the long-run future of responsible collective bargaining than such an approach.

Third, I take this view because no single number can be equally applicable for all circumstances in the economy. Indeed, I would argue that the very nature of inflation is that it distorts relationships, that it sets one rate higher than it ought to be, and if you go along and add a uniform rate on top of all that, it seems to me that it only makes the problem worse.

There are industries and occupations where wage rate relationships extend from Alaska to the rural South. Some employees have had frequent increases in the past while others have not had adjustments for a number of years.

I point out to you that in the public service area we have many elected officials who have not had increases since 1966 or 1967. Their wages are not set at the same kind of interval as under traditional collective-bargaining arrangements. I can only quote the judgment of a very high level of labor-management representatives when they say to me, "No single standard or wage settlement can be equally applicable at one time to all parties in an economy so large and decentralized and dynamic."

Finally, Mr. Vice Chairman, if I may be permitted another second on this response, there is no simple or uniform means of valuing complex fringe benefits such as pensions. One company has a lot of young workers. Another has a lot of old workers. One company has a lot of people whose health experience is different from another, and to try to compress all of those differences into a single number, Senator Javits, is something which I think is a great mistake.

And finally, as these guideline numbers continue in effect, the parties devote their energy to gaming the number, gaming the regulations, instead of spending their time constructively solving their own problems.

Senator JAVITS. Mr. Dunlop, thank you very much.

Now, if you would permit me to disagree with you 180 degrees, and I'll tell you why. Everything you have said relates to individual bargaining between the individual union or a group of employees and the employer. It had absolutely no relation to the total economy, which is the only reason for guidelines or controls. And incidentally, every argument that you have made tells us that we have been wrong in extending the Economic Stabilization Act.

Why do you people recommend it? You have no change in conditions. You had 8.8-percent inflation between December 1972 and December 1973. Your prediction for 1974 is not very much less than that. It may be higher.

Can you give me the reconciliation? Every argument you made was just as effective a year ago, and two years ago, if you are right, as it is today, yet you were in here urging us to revoice this power.

And one further point. I read from your own prepared statement, page 59, that you want this power, yet you are asking us to take it away from you. Here is what you say at the bottom of the page: "While there may be reasonable differences of opinion over the question of the need for authority for wage and price controls in other sectors after April 30, 1974, the health care area is the only one in which we favor authority for mandatory controls at this time. We shall continue to review other particular sectors as the Cost of Living Council proceeds with a program of gradual sectoral decontrol."

But, my dear friend, you are going to have no power for sectoral or any other kind of decontrol if we do not give you a law beyond the one you ask us for.

Mr. DUNLOP. A quick comment that I would make is this. In the health area, to which you specifically refer, where we have asked for controls to continue, although this is not a final judgment, it would not be my notion that it would be appropriate to continue the current wage regulations and the current wage guidelines in the one or two sectors including health that remain under control.

It seems to me a more appropriate solution that those wages should be reviewed, where appropriate, by a tripartite committee, and that some kind of general comparability standard or some kind of general equity notion should apply, and that is not a general guideline.

Senator JAVITS. Mr. Dunlop, how can it apply if you have no power whatever? All you have got is that you have a group that is going to advise. You ask us to take away even your standby authority. How will you have anything left? You would have no weapon in the closet whatever.

It seems to me that it would be the height of improvidence and folly for us to follow the administration's advice in this matter. They do not have to use the power. Having a franchise of being present is still worth an awful lot. Believe me, we are finding that out.

Nonetheless, it is our duty in my judgment, to give it to you, even if you do not use it, because I think to relinquish it is highly improper.

Mr. DUNLOP. On that latter point, I think what the testimony said, and what we are concerned about is that the existence of that authority itself tends to become an inflationary factor because what happens is that people suspect that it might be used, and then prices tend to rise in order to get in before anybody uses it. We have seen that at times in the past year, and it seems to us that the mere existence of that kind of authority may, under these circumstances, itself become an independent factor creating inflation.

Senator JAVITS. But, Mr. Dunlop, isn't it exactly the reverse of that proposition, what the administration has been advocating for the past few years, when it first went into this whole phase of income and wage and price control? Now not only is there no change in conditions, but situations look worse. What is the change that now dictates that we should go to another route?

Mr. DUNLOP. I think I would say this to you, Senator Javits, that the kind of inflationary conditions that we are now facing are such that the controls can do very little good in that picture. They run the risk of doing considerable harm in my judgment, and in that circumstance, we think it is better that the authority for them be removed.

The conditions that we are now in—I have tried this morning to state that there are a great many adjustments in many industries that have to be made. I think it is fair to say that the existence of price controls in those areas makes those realinements of auto, plastics, the cases I cited, the oil and steel industry very much more complicated, and for that reason we should eliminate them.

Senator JAVITS. Mr. Dunlop, my time is up but I would like, with the Chair's permission, to say this one thing. The issue today is not control or decontrol. The issue today is the power to control or decontrol, and I am very much for continuing to vest that power in the President.

Thank you.

Senator PROXMIRE. Congresswoman Griffiths.

Representative GRIFFITHS. Thank you very much.

I would say I believed that the price controls at the beginning was improper unless it was done with a very technical law, and that the power really rests with the Congress. The Congress should have done something about it.

In my estimate it should not have been given in the first place. I do not think you have exercised it very well, and I would like to ask you, if you take off all the controls, what about all the rest of the people? The prices of anything they purchase made by those big unions will be tremendously higher. What about the people?

Are you advocating everything be removed? What are you advocating?

Mr. DUNLOP. That consideration did not enter in my mind at all. First of all I think maybe I should respond by suggesting to you how little of the economy is today under control. The material in front of you shows, I believe, that only 28 percent of the economy as measured by the CPI, is under control. We propose in the recommendation for petroleum and health to keep 9 percent remaining at the end of April 30 under control, and so, we are talking about now decontrolling another 18 percent of the CPI. The figures are larger for the work force; about 38 percent are now under control, and we are proposing to retain 3 or 4 percent, which would mean about a 34 percent reduction.

The first point is therefore that only a relatively small part of the economy by those two measures, anyway, remains under control at the present time.

The second point is that I think the history of movements of wages, as I know them, between union and nonunion groups suggests that those wage relationships have been fairly well maintained in the past. I do not think that controls have very much to do with those relative wage changes. Lawyers in nonunion areas have adjusted their wages to go along with union rates, and the differences are more likely to exist in the benefit area.

Representative GRIFFITHS. Let me ask you then, in the health control, do you want to control the fees of doctors?

Mr. DUNLOP. Our regulations which are now in effect provide for limitations on the extent to which doctors may raise their fees or certain other medical groups may raise their fees. It also provides limitations on hospital charges.

The limitations on the hospitals are 7½ percent cap on revenues at the present time, with certain additions allowed for capital costs, oil and energy costs, and for patient mix. The description of this is found on page A–85 of my prepared statement.

Representative GRIFFITHS. Well, do you control the salary of an orderly in a hospital or just the price of the hospital care?

Mr. DUNLOP. It would be my view that there should be submitted to the Cost of Living Council applications, then as now, for wage cases in hospitals.

Representative GRIFFITHS. Have you had any objections from medical groups?

Mr. DUNLOP. A great many. I have never met anyone who enjoyed having their prices and fees controlled.

Representative GRIFFITHS. If you do enact the new health bill, do you assume that later you will set the fees of doctors?

Mr. DUNLOP. We have said that these economic stabilization controls should continue until the Congress can address the question of suitable cost contraints in a national health insurance bill. That is the administration's position, as I understand it.

I do not know what that will be when the Congress enacts it.

Representative GRIFFITHS. I have looked at your suggestions and I do not see any constraints on the fees of doctors or of anybody else.

Mr. DUNLOP. In what?

Representative GRIFFITHS. In the proposed health bill that you are suggesting.

So I think you are going to have a problem, but I am very interested. I was one of the introducers of a national health insurance bill, and I am glad to hear you point out that in your bill you are going to control the fees of doctors, but we are not. We do not do anything about it. We are not going to depend on the Government to set those fees.

So I think it's very interesting that this administration proposes setting fees for doctors.

Mr. DUNLOP. We propose to continue our present regulations on the health care and health insurance sector until the Congress can address that question in the future in a health insurance bill.

Representative GRIFFITHS. This committee has done a study of poverty in this country, and we have found that those families with two wage earners in a family, both the mother and father working, in the 1960's moved rapidly out of poverty. Only families where there is just the mother supporting the family remains a poor family.

At the present time women are losing their jobs all over the country.

What do you think that the inflationary, deflationary effect will be?

Mr. DUNLOP. I am not familiar with the particular study. I am quite familiar with labor force numbers. The proportion of women in our labor force is of course growing very rapidly and the current trend will no doubt continue.

I would say the principal problem is the matter of the level of employment rather than anything else. We find that in times of high employment, like during the last year, the labor market is relatively tight and we expand more rapidly the number of jobs for women.

Representative GRIFFITHS. Do you think that the effect will be deflationary on the economy or do you think that the effect will be that the one wage earner left in the family will demand a higher wage, thus creating an inflationary force?

Mr. DUNLOP. I would have thought that first of all, if the facts are as you say—and I do not know any to the contrary—then the decline is the result of deflationary factors in the economy already at work. There will be the wage pressures that you talk about, but I am not aware in my experience that those factors have been very large in the total wage-making force. I have not known them to be incisive in the past.

Representative GRIFFITHS. How effectively do you think you can control the price of oil?

I heard a Canadian minister talk the other day in which he pointed out that 50 percent of the oil used in Canada, is coming from Canada, 50 percent of it is imported. On the other hand, they were shipping out to the United States 50 percent of their oil. They have an export tax on that oil so that the oil that they ship out brings in money.

If we really control the prices of oil in this country, that is produced here, is it not true that it will simply be sold abroad?

Mr. DUNLOP. There are a number of different prices involved. That is no longer the area of my responsibility, but I will try to answer it this way.

The price of crude oil is now $5.25 a barrel, which I saw just before the first of the year. Is it possible to control that? Yes. And it is being controlled. If you mean the price of stripper well oil, no, that was released from control by an act of Congress, and Congress alone has the authority to act in that area, given the fact that it has mandated the stripper well exemption.

The price of what we call new oil, through a two-pricing system that the Cost of Living Council developed in August in order to stimulate new oil production, is also floating free, like the stripper well oil.

The price of imports I do not think it is possible to control, unless one wishes deliberately to affect adversely the amount of oil that we import into the United States, because crude oil outside the United States is a worldwide determined price.

So some prices you can control. Others you cannot.

Representative GRIFFITHS. Thank you.

Senator PROXMIRE. Senator Percy.

Senator PERCY. I would like to follow up, Mr. Dunlop, on Congresswoman Griffiths' comments on pricing.

As you know, we have a so-called emergency energy bill on the Floor of the Senate today, and a provision of this bill, section 110, specifically requires that the ceiling price for all crude oil should be the price for that grade of oil in that field on May 15, 1973, plus $1.35. This brings the average crude price to $5.25, and then the administration gets some leeway.

Do you feel this is a good practice in light of all you know about the intricacies of the market, the necessity for flexibility, the speed of movement, for us to try to just repeal the law of supply and demand and legislate into law a specific price on a specific product at this particular time?

Mr. DUNLOP. Senator Percy, I have too many problems to get into on that. It is outside of my jurisdiction, but I will try to comment on the last.

I have not been in favor of this kind of specific detailed legislation. I'm sorry. I may not entirely agree with Congresswoman Griffiths about the Congress acting in the details of the control business. As my prepared statement shows, we have about 139 bills that have been introduced, and many of them under consideration about specific details of our stabilization program.

My view is that if you either are going to have a stabilization program, you allow administrators to run it for a while. If you do not like it, get rid of it or get rid of them.

But the kind of detailed regulations of Congress in the controlling field while under my authority in the Cost of Living Council I did not think was very helpful.

On the more philosophical part of your question, I have a feeling that some restraint on the price of oil such as we now have is perhaps not unwarranted, because I have the view that prices will rise much higher than they are now, and that the effect of that sweeping through the American economy in a short period of time would be really very disruptive.

Moreover, it seems to me that since that high price is not the result of a sound, long-run economic determination but rather the result of certain temporary interferences with the market, it seems to me that that is a case where there may be a fair case made for some restraint on the price.

Senator PERCY. Your answer is no, that you feel we should not legislate prices in this particular bill.

Mr. DUNLOP. I do not want to be that specific. It is outside of my domain.

Senator PERCY. We are asked to vote on something specific. We cannot vote and put a law into action. Would you vote to roll back prices to $5.25 and build that into a law today?

Mr. DUNLOP. I would rather leave the authority with an administrator.

Senator PERCY. The answer is that you would vote against it. Is that right?

I intend to vote against it for that reason, too. I want to put you on the record to make sure I have expertise with me on this.

I would like to ask you about ways that we can go about increasing productivity and to not just concentration on controls which have been disastrous in their effect.

Do you strongly support the House in their bill denying the Productivity Commission $2 million? The Senate has long since passed that bill. The Commission is going out of business, going to lose all of its staff. Those people do not know what to do now.

Do you fully and strongly support, and do you think if the House denies this country a Productivity Commission at this stage that it would be a penny wise, pound foolish action that would certainly add to inflation and certainly would not help us control it at the level that we should with cooperation between labor and management?

Mr. DUNLOP. Senator Percy, there's scarcely a statement anyone could make which I could be more in agreement, and I wish to express my appreciation to Members of Congress here today, Mr. Vice Chairman, Senator Javits, and yourself, for their very strong support.

I do not thoroughly understand the actions. You should know that the Cost of Living Council has transferred to it a unit of not all but some of the main activities of the Productivity Commission group, particularly those people working in areas of health, transportation, food and state and local government pending the final resolution of this matter in Congress. We think its long-run activities on things like the unit train and other areas where we have had very fine results should be supported, and I appreciate the work of the Members of Congress here that has been done on that.

Senator PERCY. Thank you, Mr. Dunlop. I supported the April 15, 1971, decision. I did so reluctantly, not really feeling that we had the wisdom to tamper with the market system, but that something had to be dramatically done, and really what we needed was a cover for reevaluation. We were really being done under for a quarter of a century in our effort to have other nations export to us, and placing ourselves at a competitive disadvantage, and we could not just reeval-

uate our currencies and bring them more in line without showing that we intended to do some dramatic things, even though most of us felt they would not be particularly effective.

The end of what we have attempted to do has been demonstrated successively, I think, each year. I am so disillusioned with our ability to regulate and control the economy. We do a very lousy job of this. We do not know really how to do it, and under these conditions, I think you have done a remarkable job, a Herculean job, really, but I think increasingly it is going to be difficult, if not impossible, and I think you have been realizing it and decontrolling rapidly, and I admire what you have done and the strong, tough bargaining you have done to increase production, increase capacity and letting the market forces bring down prices with adequate supply. I am really wondering whether we should have a stand-by authority.

I would like to read to you a comment from the Wall Street Journal article, "Let's End Control Completely," by your distinguished predecessor, Jackson Grayson, in which Mr. Grayson says:

> The mere existence of such an agency would encourage price increases and discourage price decreases, an unfortunate lesson learned that you had better get wage-price increases while you can. Time and again the good guys got hurt by exercising restraint.
>
> Many businessmen have told me that they will not reduce prices for fear that a new freeze, a new rule or a new decontrol will catch them with their prices down.

If there is anything that I learned in business in the 25 or 30 years, it was just that every single businessman tends to cover himself, protect himself just as every consumer does. I even saw it in a survey on all hospital administrators on a 7½-percent price increase, 7½ to 9½ were allowed. Very few are not taking their full 7½, whether they can justify it or not. They are taking it because they do not want to get caught with their base down, because the next regulated price increase will be an increase on that base, and if they miss this one they are going to be at a disadvantage against the others.

There is a psychology that feeds this thing. You grab all you can get there, where in the free market you are bitten by the control mechanism of the market itself.

We are to vote today not only to end oil controls but even the standby authority. I would really want to discuss this in depth with my distinguished colleague from New York, whose judgment I have a high regard for, who works for the same sophisticated business community in the North that we have in the Midwest.

I feel the existence, the very existence, of it means that there is going to be pressure on prices to get them up, and wages, to get them up, because they may be controlled again. If you look at the past few years, that would probably hold true.

Do you have a comment on that at all, or do you disagree with Mr. Grayson?

Mr. DUNLOP. The recommendations we have made in the area of health and petroleum, and that Congress itself has legislated until February 28, 1975, in the case of petroleum, are entirely congruent with what you have said.

Senator PERCY. Thank you very much.

Senator PROXMIRE. Congressman Blackburn.

Representative BLACKBURN. Thank you, Mr. Vice Chairman.

I would like to voice my own amen to what Senator Percy has said about what I think would be a disastrous move, if we began legislating prices on specific commodities. I think it is appropriate to observe that the authority for the wage and price controls were put into the law primarily as a political gesture, not as an economically justifiable move.

I recall the debate on the floor when we enacted the authority for wage and price controls. We were being told by the White House that the White House would never use wage and price control authority, if we gave it to them. With that background, the Congress—that is, the House and the Senate together—enacted authority for wage and price controls by what I consider to be a political motivation. That is, if inflation continued to be a political problem, the party out of power could blame it on the White House for not using the power that the Congress had granted. If inflation did not continue to be a political problem, the party in power could ignore it as a political issue, and talk about something else.

I am firmly convinced that the imposition, the utilization of wage and price controls, was itself a result of political pressures, and not one of economic justification. As I look at the increase in consumer prices on all items, if from 1970 to 1971 there was an increase of 5 percent, that is from 116.3 up to 121.3, and under the wage and price controls, which always has a temporary stabilizing effect, we still had inflation at 4 percent from 1971 to 1972. And then, ultimately, the basic economic considerations will assert themselves, so that we see from 1972 to 1973, under wage and price controls, that we had a 7.8 percent increase in prices.

Even more dramatically, in 1971, when we imposed wage and price controls—again, I am convinced, as a result of political pressure, rather than economic justification—the wholesale price index only increased by 3.5 percent, and, oh! what a happy day that was! So we imposed wage and price controls, and we find that the wholesale price index went up from 1971 to 1972 by 5.2 percent. Even more dramatically, it has gone up since December of this last year through January, and it has gone up 3.5 percent in 1 month.

To me, there is a lesson to be learned from all this. Wage and price controls do not reduce the rate of inflation. I think there are worldwide market forces over which we have absolutely no control. While it may be very popular to talk about rolling back prices, whether it is in oil or any commodity, or what have you, there are still world market influences that we cannot insulate ourselves from.

We are seeing the spectacle of our paper being sold overseas because it is more attractive on the price side for the seller. We have seen the spectacle of fertilizer coming in in relatively short supply because, again, the price being attracted from abroad is almost double what we were allowing it to be sold for domestically. I believe that has been corrected, though.

All I am trying to say, Mr. Dunlop, is, the figures, that really no one can argue with because they are right here in black and white, do not substantiate a justification for continued wage and price controls.

I wonder if you would care to comment, or are you in a position to comment, on the degree to which domestic forces have resulted or created the 3½ percent wholesale price increase during the last 2 months, as opposed to international influences?

Mr. DUNLOP. Congressman Blackburn, let me say this. There is no doubt that the high level of activity during 1973 produced strong inflationary forces. And there is also no doubt that after a while, it becomes particularly difficult if not impossible to disentangle the impact of worldwide prices upon our own domestic ones.

For example, the price of ferrous scrap, because of worldwide demand for it, has increased and its prices get reflected in the higher price of steel, which gets reflected in the price of an automobile or the price of a refrigerator, and so on, down the line. And at some point it becomes impossible in a worldwide interdependent economy to disentangle that.

I do think in 1974, as I responded to the vice chairman, we are seeing in energy and in other primary products the spreading of those effects through the economy. And so we have a complicated interaction of both worldwide and domestic forces. These were the dominant forces in my view, in 1973, and we are now experiencing the impact of these forces floating through, or pushing through the domestic economy in the form of cost and price increases in 1974.

Now, I do have a little difficulty with some of the numbers you cite. I do agree—I happen to agree for different reasons—that now is the time to end mandatory controls and, as you indicated the authority for mandatory control. If in a period prices go up 3 percent and in another period 10 percent, and during both periods controls were in effect, it does not necessarily mean the controls were more effective in the 3-percent time than in the 10-percent time. The question really is, what would otherwise have happened?

It seems to me that the problem of appraising the consequences of controls is a very detailed matter, and the Cost of Living Council, I think, has tried and I have tried, and my associates have tried, not to be doctrinaire about this, but to look at each particular case to see whether it was the controls or whether it was more from the metal shortages, worldwide factors, the lack of capacity, the embargo, or something else. One must distinguish whether the controls themselves are the source of the problem or other forces.

But I do agree that now is the time to withdraw from mandatory controls. You might refer to pages A-13 and A-97 of my prepared statement for technical discussions of the points I have made.

Representative BLACKBURN. Let me make this observation. Suppose I go home and I speak to my constituents, who are very much upset about prices, and they ask this question: Why do we not stop exporting our scrap iron? Why do we not stop exporting our grain, or whatever other commodity we may have that there is a desire for on the world markets?

My general feeling is that if we attempted to build a wall around the country and became completely self-sufficient in all minerals—and that is what we would have to do if we are going to cut off part of our commodities from export—eventually you would have to look at it as though we were going to become a completely self-supporting nation.

What would that do to our standard of living?

Do you have any ideas on that?

Mr. DUNLOP. That is a very important and very difficult area. We do have restraints on the export of scrap. They have just been extended until June 30 of this year, and that, I think, is appropriate, because we are the only major industrial country that exports scrap, and otherwise our domestic economy would be very much distorted by large outflows and higher prices.

Now, again, I am not doctrinaire about that. I say it is very difficult, and I think in the main we should be very, very cautious about it, because we are at a stage where we are trying to develop more trade, more independence. If we are engaging in those kinds of restrictions at a time that we are trying to talk about free trade, we will have problems. I think that we should, as a matter of policy, expand trade. I think that is clear.

Representative BLACKBURN. When you say it is a matter of policy that we should expand trade, do you mean from a standpoint of good economics?

Mr. DUNLOP. Yes.

Representative BLACKBURN. We would benefit from trade, and it would be a mistake, if we want to continue to maintain our standard of living, if we attempted to alter that policy and went to a less-trade position?

Mr. DUNLOP. I agree with that as a policy. There are times when we need to watch the specific situations a little better than we have. As a matter of policy, that is correct, in my judgment.

Representative BLACKBURN. I thank you. My time has expired.

Senator PROXMIRE. Congressman Widnall.

Representative WIDNALL. Thank you, Mr. Vice Chairman.

I regret that I was unable to get here on time because of the gas shortage. I would like to tell a very short tale in connection with it.

On Saturday and Sunday in north New Jersey, where I live, it was impossible for me to get any gas. Monday gas was available but only on even numbers, and I had an odd number. I had half a tank of gas and a car that gulps it down. I started down the turnpike, thinking at least I could get $1 worth at the turnpike, and found out that the even number rule applied that day, so I could not even get a dollar's worth. Then we had to put up in a motel just across the bridge in Delaware, at a cost of $25, to wait for the gas stations to open today. And today I was able to get a dollar's worth of gas in one station, subsequently $2 worth, and then $2 worth more. So I ended up just getting a total of ten gallons of gas, which just got me to Washington.

For all the people in the United States who think that a Congressman gets all the gas that he wants and has no problems, I would just like to pose that as probably what is typically happening around the country.

I do not envy either one of you with your jobs. They are extremely important, and you are carrying them on under very difficult conditions.

Mr. Dunlop, do you plan to ask for mandatory prenotification of price increases for any or all sectors of the economy under the proposed new legislation?

Mr. DUNLOP. I am not sure that I heard that.

Do we advocate mandatory prenotification?

Representative WIDNALL. Of price increases to any or all sectors of the economy under the proposed legislation.

Mr. DUNLOP. We do recommend that the health care sector remain under control, but aside from that or any others that might be subsequently suggested and included in the legislation, it is our view that there should be an authority to require notice, perhaps, of price changes. But that is not the kind of meaning that is normally encompassed by the word "prenotification," so I think that the general answer to your question is negative.

Representative WIDNALL. There has been considerable talk about poor predictions being made by both private and governmental economists with regard to food price conditions and prospects. Have you commissioned a study by a professor which addresses itself to this matter?

Mr. DUNLOP. Yes. The Cost of Living Council took the initiative in asking the Council of Economic Advisers, which is the appropriate agency, I believe, in the Government, to review particularly our agricultural forecasts. Because those forecasts were used not only in the Government but in the private economy as well, they made quite a mark on that sector last year. We asked that a study be made, yes.

Representative WIDNALL. Could a copy of that study be made available to this committee?

Mr. DUNLOP. Yes, sir, if you request it, I will see that it be made available to the Committee.

Representative WIDNALL. Mr. Vice Chairman, could that be incorporated as part of the record?

Senator PROXMIRE. Yes, indeed.

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

AN APPRAISAL OF DEFICIENCIES IN FOOD PRICE FORECASTING FOR 1973, AND RECOMMENDATIONS FOR IMPROVEMENT

(By Karl A. Fox [1])

The objectives of this appraisal were stated as follows by Gary Seevers on October 5, 1973:

"Top policymakers need an independent review of deficiencies in food price forecasting, and to identify those that were unique to 1973 and those of a more permanent character. The review should cover weaknesses in the data (or economic intelligence) and weaknesses in the procedures by which the data are interpreted and used."

The percentage increases in prices of U.S. farm products from October 1972 to August 1973 were by far the largest experienced since 1945-48. The combination of causes and facilitating circumstances was essentially unprecedented. Some of these, like the opening up of trade with the People's Republic of China and the USSR, successive devaluations of the dollar, and a synchronization of business cycle upswings in most of the developed countries, were economy-wide in their potentials. Others were specific to agriculture, including an unusual pattern of droughts in several countries.

U.S. prices of farm products had been deceptively stable for nearly two decades, as large CCC stocks and excess productive capacity had held prices of major crops close to the government loan rates. CCC stocks had been worked down during the late 1960's and early 1970's to more moderate levels. As of mid-1972, they still looked adequate relative to the normal requirements of U.S.

[1] Distinguished Professor in Sciences and Humanities and Professor of Economics, Iowa State University.

consumers and our regular export customers; however, they constituted, as in earlier years, a large proportion of the world carryover of food and feed grains. As world grain production dropped sharply in 1972-73 and world demand surged upward, the last bit of slack was jerked out of the world grain economy. U.S. prices of wheat, corn and soybeans shot up the extremely inelastic world demand curves for food and feed. In some of the underdeveloped countries, poor people had less bread and rice; in the developed countries, livestock had less grain and protein meal, and consumers had less meat.

The magnitude of the increase in farm product and food prices in the U.S. surprised everyone, inside government and out. To those who were struggling to contain inflation in the administered-price sectors of the economy, the uprush of food prices was a bitter disappointment. For practical purposes, it appeared that the food price forecasting system had failed them.

I. THE BASIC PROBLEM AS I SEE IT

Therapists have noted that families in need of help usually bring one member forward as the Identified Patient. In most cases it turns out that the Identified Patient is no sicker than anyone else and that the malfunction inheres in the family as an interacting system. The cure comes about through improved communication, recognition of mutual needs, and a decision to work together toward common goals.

I see no evidence that any U.S. agency did an adequate job of forecasting economic developments during 1972-73. To the best of my knowledge, no U.S. agency has an adequate model of the world economy, or even an adequate conceptual framework within which to discuss interactions among the food, agricultural and other sectors of the world economy. In brief, I believe the whole Federal establishment is ill-prepared in terms of data, models, analytical procedures, and patterns of interagency communication for the tasks of forecasting and policy formation in the "open" economy of 1973.

Economists and agricultural economists have never communicated very well about domestic problems. Deans of Agriculture have discouraged farm boys from studying monetary and fiscal policy and city boys seem to feel that a knowledge of agriculture is arcane, or obscene, or both. Ignorance leads to arrogance. As a city boy who found high intellectual adventure in the U.S. Bureau of Agricultural Economics, I find the arrogance of other city boys toward people who work with agricultural data singularly ill-founded. My personal pantheon includes H. L. Moore, Henry Schultz, Mordecai Ezekiel and Frederick V. Waugh as "heroes of statistical demand analysis and econometrics" right along side of Frisch, Tinbergen, Leontief, Koopmans, Wold and Stone.

Economists and agricultural economists need each other now more than ever before. The problem is to communicate about agricultural and other developments on a world-wide basis. It is foolish to regard the problem of agricultural intelligence as separable from that of intelligence about the world economy as a whole, and it is foolish not to have, and use, models of the world economy which incorporate agriculture as one of a number of interacting sectors.

I see no evidence that the government has criteria of completeness, relevance, and accuracy by which to compare different components of the economic intelligence system. I am disturbed by charges that OMB does not know how to appraise an agency's budget requests for economic data and analysis independently of its requests for action programs. It seems to me that the Council of Economic Advisers should be responsible for exerting continuous pressure for improvements in data and analytical methods relevant to economic policy and for making vigorous representations within the Executive Branch and to Congress when portions of the system are deteriorating for lack of funds or attention or when gaps are left unfilled.

My impression is that our economic intelligence system generally is operating far below the level permitted by the state of the arts and far below the level needed if we are to show some degree of leadership in this field. In the 1920's, the U.S. Bureau of Agricultural Economics led the world in statistical demand and supply analysis for agricultural commodities. It did so again in the early 1950's. As of 1973, the openness of U.S. agriculture to demand and supply factors throughout the world presents a new hazard to domestic economic policy and a new challenge to U.S. economists.

Members of the guidance committee made a number of suggestions for improving the economic intelligence function in USDA. It seems to me that the overriding need is this: The economic intelligence function must be given increased salience in the organizational structure of the U.S. Department of Agriculture and in the attention and concern of the Secretary of Agriculture. One suggestion is that there should be an Assistant Secretary for economic intelligence function, and that he be responsible for the Statistical Reporting Service, the Economic Research Service, and the Foreign Agricultural Service. The Secretary of Agriculture should make it perfectly clear that he wants the best economic intelligence service in the world for monitoring and anticipating developments in food and agriculture and for relating them to U.S. intelligence needs for all other sectors of the world economy. The Council of Economic Advisers and OMB should support him in this objective.

Other suggestions would come into focus against this background:

a. The grade structures for economists in ERS and FAS must be made fully competitive with those in other agencies responsible for economic intelligence functions. The ERS grade structure contains far too few positions at the GS-14, GS-15 and GS-16 levels to justify promising young economists in making career commitments to the agency.

There is a myth current among agricultural administrators in the land grant universities (and quite possibly, among some in government) to the effect that a good agricultural economist can be hired and retained on a lower salary than a good general economist. The fact is that a low salary structure will produce a mediocre staff in either field. The salary structures, standards of excellence, and role models in the two fields converge in people like Ezekiel, Waugh, Schultz, Griliches and Nerlove. ERS needs some people with this kind of aspiration level regardless of whether their diplomas say "Economics" or "Agricultural Economics."

b. It has been suggested that the objectivity of USDA's internal forecasts of exports, disappearance, and stocks should be strengthened by designating ERS representatives as chairmen of the Supply Estimates Committees for the various major commodities. It has also been stated that the ERS economists, in writing their situation and outlook reports, should be free to depart from "official" export forecasts and supply estimates and from the estimates published by SRS or any other agency.

The basic principle, it seems to me, is that the integrity and objectivity of the economic intelligence work of ERS, FAS and SRS should be maintained *absolutely*, to the extent that human wisdom can perceive such a standard. Any sources of potential bias, conscious or unconscious, should be anticipated and avoided, or eliminated if they materialize. The "lockup" reports of SRS dramatize the importance of such integrity, and this example might be used to underscore the need for it in the other agencies if it is threatened in any way.

c. It has been suggested that ERS be insulated from involvement in politically sensitive kinds of analysis, and that a small staff of "political economists" be attached to the Secretary's office for that kind of work. Among other things, this should dramatize the increased salience of the economic intelligence function and the determination that it be free of all suspicion of political bias or censorship.

d. An adequate economic intelligence service will cost more money. I understand that USDA is requesting budget increases of $3,000,000 each for ERS, SRS, and FAS in Fiscal Year 1975. I have not seen these requests, except for one $500,000 item for ERS, and I would have insufficient knowledge to pass judgment on them in detail. If a scientist man-year (SMY), together with supporting staff, supplies and other services, cost $40,000, the $9,000,000 would cover 225 SMY's, or about 75 SMY's for each agency. I believe ERS has about 440 SMY's at present; if so, 75 SMY's should be within the capacity of ERS to recruit and absorb, particularly if some were borrowed from university faculties and graduate programs on a one or two year basis. SRS recruits statisticians and is not likely to compete for the same people as ERS. I don't know what kinds of people would be sought by FAS.

In brief, the magnitudes of the increases look reasonable if the economic intelligence function of USDA is to achieve the needed salience and capability.

Some more detailed comments about the food price forecasting system are presented in Sections II and III.

II. WHAT WENT WRONG WITH THE FOOD PRICE FORECASTS FOR 1973

1. Some objective features of the U.S. food and agricultural situation during the 1972-73 crop year were unique or nearly so:

(*a*) U.S. exports of wheat and corn exceeded previous records by very wide margins;

(*b*) U.S. exports of soybeans set a new record, leaving carryover stocks at the lowest level in seven years;

(*c*) the increases from October 1972 to August 1973 in prices received by U.S. farmers for crop and livestock aggregates and for some individual commodities were the largest experienced since 1945-48, and the same applies to retail food prices;

(*d*) actions taken by other U.S. government agencies after October 1972 (including devaluation of the dollar and imposition and removal of retail price ceilings on beef and other foods) changed some of the premises on which the food price forecasts made in October-November 1972 had been based; and

(*e*) huge purchases of U.S. grain by the Soviet Union beginning in July 1972 and smaller ones by the People's Republic of China injected new elements into the world demand picture for 1972-73 and subsequent years.

2. A forecasting system that works well for moderate fluctuations in demand and supply variables may not work well for extreme fluctuations even if the basic structure is unchanged. If the structure is changed suddenly, all bets are off until the new structure is identified.

An analysis of ERS forecasts made in the Quarterly Situation and Outlook Memorandum (for official use only) from 1966-I through 1973-III shows major structural breaks for wheat, corn, and soybeans in 1973. The maximum percentages of error in forecasting U.S. farm prices of each of these crops for 1973 were more than twice as large as the maximum percentage errors ever made during 1966-72 (Table 1, columns 5 through 12).

The phenomenal and unexpected increases in prices of wheat, corn, soybeans (and other grains and feeds) after October 1972 account for significant fractions of the unanticipated increases in prices of livestock and products in 1973. All species and products were affected in the same direction (production reduced and prices increased), with amounts and time lags varying according to the characteristics of the production processes involved. The increases in livestock prices relative to earlier forecasts would have been subsantial even if the demand and supply structures for livestock products had continued as in 1966–72.

As a matter of fact, these structures were disrupted by successive impositions and removals of controls on the retail prices of beef and other livestock products during 1973, by the availabiltiy of unprecedented and sure profits for farmers who sold their grain, and by great uncertainty concerning profits from feeding livestock. These disruptions were most pronounced during the third quarter of 1973. Table 1 shows the ERS record for forecasting farm prices of beef cattle, hogs, wholesale milk, eggs and turkeys from 1966-I through 1973-III. Only four of the 20 maximum percentage errors made for these commodities (columns 5 through 12) occurred during 1966-72; the other 16 occurred in 1973, two each in 1973-I and 1973-II and 12 in 1973-III (columns 13 through 16).

The forecasts of the index of prices received by farmers for all commodites and of its crop and livestock components (first three rows in Table 1) also show major structural breaks in 1973, with maximum percentage errors in 1973 averaging more than twice as large as the maxima ever experienced during 1962-72. Of the 44 maximum percentage errors made from 1966-I through 1973-III for the three index numbers and eight individual commodities in Table 1, 40 occurred in 1973; of these, 29 were bunched in the third quarter.

3. It takes a forecaster some time to be sure whether he has made a random error of larger-than-average size or is confronted with a structural change. During 1972-73, structural changes occurred very rapidly and affected many different commodities which were interrelated as alternative enterprises on farms, supplementary or competing feeds for livestock, and competing foods for people. Broad experience in coordinating price forecasts across commodity lines is essential for coping with these complexities.

TABLE 1.—ANALYSIS OF FORECASTING ERRORS FOR PRICES OF SELECTED FARM COMMODITIES, BY QUARTERS FROM 1966-I THROUGH 1973-III: BASED ON THE QUARTERLY SITUATION AND OUTLOOK MEMORANDUM (FOR OFFICIAL USE ONLY) PREPARED BY THE ECONOMIC RESEARCH SERVICE

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
					Maximum absolute percent error											
	Average absolute percent error, 1966–72, by forecast period				1966 through 1972, by forecast period				1973 (first 3 quarters) by forecast period				Number of maximum absolute percent errors occurring in			
Commodity or commodity groups	1	2	3	4	1	2	3	4	1	2	3	4	1966–72	1973 January to March	1973 April to June	1973 July to September
Number of quarters	22	28	28	28	22	28	28	28	2	3	3	3				
Prices received by farmers:																
All commodities	5.2	4.5	3.4	2.2	13.6	11.9	8.9	6.0	34.5	31.8	26.4	11.0			1	3
All crops	5.4	4.4	3.4	2.4	13.1	12.4	11.7	7.0	39.0	35.5	29.7	13.9			1	3
Livestock and products	6.5	6.0	4.5	2.8	13.7	15.7	12.0	7.3	31.4	29.4	24.3	10.6		1		3
Beef cattle	8.0	7.1	6.8	4.4	17.8	18.5	17.8	13.2	28.7	28.7	22.4	13.4		1		3
Hogs	15.5	13.2	10.0	6.4	48.8	42.6	19.8	14.7	44.8	41.6	38.4	15.9	2	1		1
Wholesale milk	4.4	3.7	2.4	1.3	15.0	14.0	8.6	4.2	14.9	12.1	10.0	6.5	2			2
Eggs	11.4	10.1	9.6	6.6	29.3	29.3	27.2	18.9	43.2	35.1	31.8	20.0			1	3
Turkeys	6.9	6.8	5.6	4.3	19.0	20.9	17.0	13.4	43.4	42.9	29.0	14.3			1	3
Wheat[1]	9.0	6.9	5.0	3.6	22.7	22.1	20.9	15.8	63.6	59.7	55.8	35.1				4
Corn	9.7	9.8	7.4	3.8	27.4	22.6	17.3	11.0	49.8	48.0	44.1	21.4				4
Soybean	9.5	7.2	5.9	3.2	28.4	23.8	19.2	12.6	61.3	60.1	53.9	29.4			4	
Totals													4	3	8	29
Averages, 5 livestock products	9.2	8.2	6.9	4.6	26.0	25.1	18.1	12.9	35.0	32.1	26.3	14.0				
Averages, 3 crops	9.4	8.0	6.1	3.5	26.2	22.8	19.1	13.1	58.2	55.9	51.3	28.6				

[1] Columns 9 through 12 include 1972–IV and columns 1 through 8 exclude 1972–IV, in the case of wheat.

Source: Compiled by Karl Fox from detailed computer printouts supplied by the Economic Research Service on Nov. 8, 1973. Selection of time periods and methods of presentation made by Karl Fox.

As of October 1972 the Economic and Statistical Analysis Division of ERS was uniquely vulnerable in this respect as a result of recent retirements and transfers, and one death. These removed the division director and both deputy directors, the heads of the two sections most relevant to the coordination of food price forecasts, and other key personnel, as follows:

Director: Transferred to Foreign Development Division, ERS, September 1972.

Deputy Director A: Retired, March 1972.

Deputy Director B: Heart attack, June 1972; died November 1972.

Head, Demand and Price Section: Detailed to Cost of Living Council, 1971. Transferred to Cost of Living Council, January 1972.

Acting Head, Demand and Price Section: Transferred to Treasury Department, October 1972.

Head, Food Consumption and Utilization Sections: Transferred to Cost of Living Council, March 1973.

Head, Feed Section: Retired, June 1972.

None of these individuals were replaced immediately; their duties were assigned on an acting basis to other members of the division in addition to their regular jobs, pending decisions on a major reorganization of ERS as a whole. A new ERS administrator had been designated in January 1972. He appointed a distinguished advisory committee in May 1972, which reported in November. The reorganization was implemented in July 1973.

The people responsible for coordinating price forecasts from October 1972 through June 1973 were capable and dedicated, but they were overextended. They would have done somewhat better with more experience and more manpower. Even so, the structural breaks would have led to large forecasting errors.

4. Other factors (the ban on DES as a feed additive, a severe winter, wet corn with lower than usual nutritive value, etc.) are said to have reduced the daily gains in weight of cattle on feed and delayed cattle marketings and slaughter in the first three quarters of 1973. Some analysts believe that SRS overestimated pig crops and numbers of cattle on feed in the early months of 1973; others do not. All the factors mentioned would have operated to raise prices of slaughter cattle in 1973 relative to the forecasts and intensify pressures against the retail price ceilings for beef. It is also probable that consumer demand for beef and other livestock products was underestimated.

5. So, a number of factors causing errors in the 1973 price forecasts were not present during 1966-72. The first four columns in Table 1 show the average absolute percentage errors of ERS price forecasts from 1966-I through 1972 IV. In each case, the average error is largest for forecasts made four quarters in advance and decreases quarter by quarter as the event approaches. This is certainly desirable behavior in a forecasting system. Percentage fluctuations in retail food prices are considerably smaller than those at the farm level, so the errors in forecasting farm prices during 1966-72 should not have posed serious threats to economic stabilization policies.

However.—During 1966-72, the prices of wheat, corn, other feed grains, and soybeans seldom rose very far above their respective government loan rates (support prices). The relative stability of feed grain prices and supplies contributed to the stability of livestock prices and production. The domestic livestock and feed economy was protected from disturbances originating in other parts of the world. As grain and soybean prices soared far above the loan rates in 1973, livestock prices were also exposed (directly and indirectly) to worldwide demand and supply factors.

The major structural break in 1973 was essentially this: To a 1966–72 forecasting model which included U.S. farmers, U.S. consumers and the Commodity Credit Corporation, it became necessary to add the rest of the world.

III. WHAT SHOULD BE DONE TO IMPROVE FORECASTS IN AND AFTER 1974?

1. The Economic Research Service was reorganized in July 1973. Responsibility for the economic intelligence and forecasting work has been assigned to the Deputy Administrator for Food and Fiber Economics. Under him are three divisions, National Economic Analysis, Commodity Economics, and Foreign Demand and Competition. The former Economic and Statistical Analysis Division has disappeared but its functions have been reorganized in a manner which should lead to major improvements, given time and resources.

The ERS Administrator and the Deputy Administrator for Food and Fiber Economics are giving top priority to improvements in the forecasting work. In

May 1973 the Deputy Administrator appointed a committee to review and evaluate ERS forecasts and forecasting procedures. This committee submitted a preliminary report on June 21, 1973, including (among other things) computations for 1971-I through 1973-I similar to those underlying Table 1.

The evaluation work was then broadened and deepened. The extensive computer printout underlying Table 1 was completed on October 10 for individual commodities and on November 7 for the price indexes. The scope of the review now underway is indicated by the attached outline dated October 1973 and the forecasting questionnaire. The review will have an impact on the thinking of all staff members involved and provide a basis for improved communication, data development, and analytical procedures.

A Status Report on Forecasts and Forecasting Methodology in the Economic Research Service With Recommendations for Improving the Program on Forecasting

I. INTRODUCTION

(1) The current interest in forecasting and forecasting methodology.
(2) Key considerations in the review and appraisal of forecasts and forecasting techniques.

II. THE ERS OUTLOOK INFORMATION PROGRAM

(1) Brief history.
(2) Current organization.
(3) Outlook publications.
(4) Clientele served.

III. DOCUMENTATION OF CURRENT FORECASTING PROCEDURES IN ERS

(1) General assembly procedures for compiling outlook intelligence.
(2) Specific procedures employed by commodity area.
(3) Procedures employed in units responsible for aggregate farm sector outlook.
(4) Procedures for compiling outlook intelligence on foreign markets.

IV. TECHNICAL CONSIDERATIONS IN THE APPRAISAL OF FORECASTS

V. HISTORICAL TRACK RECORD OF ERS FORECASTS

(1) Formulation of the track record.
(2) Some absolute performance measures for ERS forecasts.
(3) Historical source of largest errors in ERS forecasts.

VI. HISTORICAL TRACK RECORD OF SRS CROP AND LIVESTOCK PRODUCTION DATA FORECASTS BASED ON SURVEYS

(1) Some absolute performance measures for SRS forecasts based on surveys.
(2) Implication of errors in SRS estimates for ERS forecasts.

VII. AN EVALUATION OF FUTURE MARKET QUOTES AS A GUIDE TO CASH MARKET FORECASTS

VIII. A CAPSULE SUMMARY OF TECHNIQUES CURRENTLY EMPLOYED BY SRS IN THE COMPILATION OF KEY DATA SERIES ON PRODUCTION, STOCKS AND PRODUCERS INTENTIONS

IX. STATE OF THE ARTS WITH RESPECT TO ADP APPLICATIONS IN SUPPORT OF THE ERS-SRS OUTLOOK MISSION

X. THE INTERACTION BETWEEN FORECAST INTELLIGENCE AND NATIONAL POLICY IN THE FARM AND NONFARM SECTORS

XI. AN INVENTORY OF ANALYTICAL MODELS IN ERS

(1) Classification of models by type of major use.
(2) The current relationship of models to the ERS forecasting process.
(3) Validation and evaluation of models.

XII. RECOMMENDATIONS FOR IMPROVING SHORTRUN FORECASTS

(1) Technical functions.
(2) Organizational functions.
(3) Publication and dissemination of outlook information.

FORECASTING QUESTIONNAIRE

1. List regularly published reports on outlook and frequency of reports originating in your unit.
2. List outlook meetings and conferences in which you participate.
3. List interagency committees and conferences on outlook policy and projections in which you participate regularly.
4. List items for which forecasts are prepared on a regular basis.
5. Indicate briefly the general sequence of procedures used in formulation of forecasts for consumption and prices.
6. Review Illustration 1 itemizing techniques and methods for completeness. Add additional categories if needed and number beginning with 24.
7. Complete Illustration 2.
8. Complete Table 1 using Illustrations 1 and 2 as a reference.
9. Indicate briefly, a few key areas which might be investigated toward improving the unit's outlook mission. (Data, technique, publication, organization or other issues can be itemized.)
10. If estimated parameters are found to be useful in preparing forecasts, list and define parameters frequently utilized in the forecast process. (i.e. elasticities, regression equations, flexibilities, etc.)
11. (Optional). Explain in as much detail as possible, the procedures involved in forecasting each item cited in Table 2, emphasizing the association of data series with techniques, by forecast date and forecasted time period.

In his budget request for Fiscal Year 1975, the ERS Administrator has given top priority to a $500,000 increase for improvement of supply, demand and price forecasting procedures for major commodities. A copy of the request, justification and plan of work is attached.

In my judgment, the $500,000 increase is essential. It is part of a coordinated set of budget requests for ERS, SRS and FAS. As noted in Section I, I believe these requests are reasonable and should be strongly supported. I also believe that the status of the whole economic intelligence function with USDA should be sharply upgraded to cope with the new relationships of U.S. agriculture to the world economy and the rapid changes in the food and agricultural sectors at home and abroad.

2. Some commodity analysts believe that the Statistical Reporting Service's estimates of hog and cattle numbers, pig crops, and numbers of cattle on feed have been too high since December 1972. I understand that the SRS figures are subject to random sampling errors of perhaps two or three percent at the national level, so it is quite possible for a negative error of two or three percent to be followed by a positive error of two or three percent, and vice versa. In addition, nonsampling errors may occur as new producers move into cattle or hog production and others move out; the lists from which SRS draws its samples cannot be kept fully complete and up to date.

DEPARTMENT ESTIMATE—ECONOMIC RESEARCH SERVICE

Programs: Economic Analysis and Research to Improve Farm Income and Economic Analysis and Research to Expand Agricultural Exports

1. Title: Improvement of supply, demand and price forecasting procedures for major commodities ($500,000 increase in FY 1975)

OBJECTIVES

The broad objective is to improve short and intermediate term forecasts of foreign and domestic supply, demand, and prices for major commodities, especially grains, oilseeds, livestock, poultry and dairy products. Specific objectives are to improve the accuracy and timeliness of:

1. U.S. supply and demand forecasts for grains, oilseeds, beef, pork, poultry, eggs, and dairy products;

2. Current economic information and forecasts of foreign demand for and exports of major U.S. commodities; and

3. Domestic and foreign price forecasts for grains, oilseeds, livestock, poultry and dairy products.

JUSTIFICATION

The Economic Research Service has a major responsibility for developing economic forecasts of demand and prices for commodities produced by American farmers. These forecasts play a major role in both private and public sector decisions. The impact of these decisions on the welfare of all Americans has been clearly demonstrated by events during the past year.

Considerable criticism has been focused on the accuracy and reliability of certain recent ERS short-term forecasts, particularly those for domestic farm and retail prices of livestock, poultry, dairy, grains, oilseeds, and food in general.

ERS and others familiar with outlook and forecasting activities of the Department recognize the existence of forecast errors and the probable sources of error. In 1972 ERS established a committee composed of prominent representatives of government, industry, and universities to review its entire food and fiber economic research program. The committee noted certain deficiencies in the outlook, situation, and forecasting function of ERS and strongly recommended that the Agency take steps to alleviate these deficiencies.

But the problem has become particularly acute and visible at a time when the already increasing resources that ERS has allocated to this important function have been overtaxed to meet the needs for economic information of those charged with stabilizing food and agricultural prices. The need for such information to sustain economic stabilization programs and serve the increasingly strong market orientation of U.S. agriculture is likely to continue to overtax available ERS research.

A primary purpose of the recent reorganization of ERS was to increase the resource commitment to short-term forecasts of supply, demand and price. Despite these adjustments, resources remain insufficient to systematically isolate sources of error and develop alternative forecasting concepts and procedures to improve forecast accuracy and timeliness. The development of procedures for systematic evaluation of all forecasts and forecasting procedures is a key ingredient to continually improved forecasts. The additional resources would be directed toward these ends.

PLAN OF WORK

Specific activities included in the plan of work are to:

1. Analyze and evaluate currently used short-term forecasting methods and procedures and past forecasts to determine the amount and specific sources of error. This is expected to reveal strengths and weaknesses of existing forecasting procedures, documentation practices, data and their use, and implicit as well as explicit forecasting models.

2. Develop alternative forecasting concepts and procedures based on existing methods and techniques and test for improved performance over existing procedures.

3. Determine which new methods and techniques might be used. Continue development and evaluation of the relative accuracy of those which appear feasible.

4. Implement and evaluate on a continuing basis those procedures which are most promising in terms of accuracy, timeliness, simplicity, and economic rationale.

5. Develop an improved framework for procuring and compiling information on commodity supply and demand conditions in the U.S. and foreign countries and use this information to forecast supply, demand, price and exports and imports of crop and livestock commodities.

6. Adapt the latest automated technology for handling data and increasing the timeliness and availability of forecasts.

The analysis and research to achieve the stated objectives and to carry out the above activities will be performed in Washington, D.C. as a joint effort of the Commodity Economics, National Economic Analysis, and Foreign Demand and Competition Divisions of ERS. Approximately 7 SMY's will be assigned to implement steps 1 through 4, 4 SMY's for step 5, and 2 SMY's for step 6. The remaining funds will be used to acquire supply, demand and price data in the U.S. and abroad.

A multiple-frame sampling procedure for estimating livestock numbers has been introduced in some states to reduce errors of this sort.

SRS's estimates are rigorously protected from political influence. The dates for releasing estimates are announced a year in advance. If information accumulated during the twelve months following release of an estimate indicates that it must have been in error in a certain direction, SRS then issues a revised estimate. Further revisions may be made after the results of a new agricultural census have been analyzed.

On rare occasions, SRS has revised an estimate in something less than twelve months. However, since marketings and slaughter of cattle on feed (and pigs on farms) as of a given date extend over roughly a six month period and may be influenced by price expectations, weather, disease and other factors, it is not likely that an error will be conclusively demonstrated in less than six months at the soonest. SRS would not be justified in making frequent revisions.

The SRS reporting system involves cooperation with the 50 States and is designed to yield State estimates, as well as U.S. totals, for the major farm products. It is *possible* that errors in some of the U.S. totals could be reduced if State estimates were abandoned and sampling designs revised accordingly. As a general proposition, this seems undesirable. However, the SRS Administrator could be asked to present a plan for increasing the precision of estimates of U.S. totals for a few key series, such as the number of cattle on feed.

Some analysts maintain that estimates of numbers of cattle on feed made by the American National Cattlemen's Association are more accurate at present than those made by SRS. I do not know whether this is true, and in any event I see no reason why it should remain true. I see real dangers in a policy which would abandon or undermine portions of the SRS data system in favor of data collected by private organizations from their own members. If the private data are useful for some kinds of forecasting, they should be used *in addition to* the SRS estimates, which are designed to serve a broad public purpose. To do an adequate job of forecasting U.S. prices of foods and farm products in an open economy, we need comprehensive estimates of supplies of all farm products in all parts of the world—including our own country.

3. Some people have expressed concern about pressures that could bias ERS forecasts, with or without intent. For example, it has been suggested that USDA's supply estimates committees, which make forecasts of production, exports and other utilization of major crops as a basis for program planning, are dominated by representatives of action agencies. It is surmised that their forecasts may at times be influenced by agency concerns.

This is one of a number of problems that require action by the Secretary of Agriculture in the broader context described in Section I. I believe that the economic intelligence function must be given sharply increased status in the organizational structure of the U.S. Department of Agriculture and in the attention and concern of the Secretary. All real or potential threats to the objectivity of this function should be eliminated. The number of positions in ERS at grades GS-14 through GS-16 should be substantially increased, and filled by recruiting or promoting first-rate people. The whole function will gain in prestige to the extent that it recruits, develops, and retains people who justify that prestige through performance.

Representative WIDNALL. Your current proposal for graduated decontrols is it possible for some sectors to still be under control after April 30 when the Stabilization Act terminates thus ending your authority to control them?

Mr. DUNLOP. If I understand your question we have asked at this time only for the authority to continue mandatory controls in the health care sector. That is the only one. And aside from that—of course, the petroleum area is under a separate statute—we have not asked for such authority.

Representative WIDNALL. What will the status of the Construction Industry Stabilization Committee be after the proposed reorganization of the Cost of Living Council?

Mr. DUNLOP. That is an important question, and I do not know quite how to answer it. Under the formal proposal that was made to

the Congress through the Senate committee on February 6, which is reiterated in my testimony here this morning, there would be no controls, mandatory controls, applied to construction.

In response to questions, I have said that it is my understanding that the top labor and management fellows in that industry are currently having discussions with each other about their problems. Whether anything will come of that, or what will come of it, I am not able to predict at this time. But I would be hesitant to make a recommendaton on the matter, pending the outcome of those deliberations.

Representative WIDNALL. Mr. Dunlop, you have stated several times in testimony that the view of the American people towards controls has changed.

Are you referring mainly to labor or to all segments of the population, and how did you get this information, through consumer sentiment surveys, or what?

Mr. DUNLOP. I think the answer to that is, first of all, it is clear that many spokesmen for organizations including many people who are spokesmen for organized labor, prior to the middle of this year took the position that they were in favor of controls and supported their continuation.

I think since that time, as was exemplified in the statement of our Labor Management Advisory Committee, those views have shifted. The numerous representations that we have had from business people, producers of all kinds, I think supports that view, that shift.

As to the view of the general public, I think that is much more ambiguous. I think it is clear that we have seen, as others have, the polls that have been made public. I think those polls still show support for controls, although I think that there is a growing awareness of the limitations that direct controls can have in terms of their impacts on wages and prices.

Representative WIDNALL. Thank you, Mr. Vice Chairman.

Senator PROXMIRE. Senator Humphrey.

Senator HUMPHREY. It is a privilege to have your prepared statement, this voluminous product that you have here, and I have looked over at least the parts that were relevant, up to the appendix.

Let me ask you a few questions on the matter of the future not so much the past. In 1973, I think that we would agree that we sort of stumbled around for a while on this whole subject of inflation, control, moving from phase II to phase III and so forth.

Where are we now? Phase IV?

The administration apparently is going to ask Congress to drastically change our anti-inflation policies, particularly some of the tools to deal with it. And I assume that you and others in doing this were basing it on some analysis of the inflation outlook.

My questions, with that assumption, are these: What are you expecting as an increase of consumer prices in 1974?

I realize that prophecy is a gift and not a science, but you are a gifted man, so I am going to ask you to make a prediction here.

Mr. DUNLOP. A lead-in comment to what you said. I do not regard the recommendations as all that drastic. We have engaged since July, anyway, of last year in the process of gradual decontrol, and we are

going to continue that up until April 30. We have been phasing out controls since last July, so it is not all that precipitous.

Now, with respect to your specific question, I earlier in the day agreed with the vice chairman that the first half of the year is fraught with substantial inflationary pressures, because of the continuation of the worldwide price pressures, and growing out of the agricultural situation, wheat particularly, although not exclusively, and growing out of the fact that the high price of petroleum and energy has not yet swept through the manufacturing sector, and that we will not see its peak until June and July. That is what I said earlier in the day.

And then I also pointed out on page A-150 of my prepared statement that forecasters generally in the United States have predicted a very high rate of inflation in the first two quarters of 1974, with some retardation in that inflation rate in the second, third, and fourth quarters as the larger harvests come in, et cetera.

I think last year all of the forecasters were wrong, but they cannot be all wrong all the time. I suspect that that is as reasonable a forecast for the year ahead as anyone can make.

As to the precise numbers, I do not have any specialized knowledge in that area. I agree that the Department of Agriculture has forecast a continuing high increase.

Senator HUMPHREY. You are aware of the Department of Agriculture's record on forecasts?

Mr. DUNLOP. Nobody knows that record better than I.

As I responded to a question earlier, I initiated in the Government a critical study of the forecasts and the methods that have been used, and I think we will do better in the future.

Senator HUMPHREY. You have been pointing out you have been phasing out controls and coming down now to the April 30 deadline. But as you have been phasing out controls, Mr. Dunlop, is it not true, for whatever reason, and there are many reasons that you have already alluded, but as the controls have been phased out, prices have been going up. And I do not quite understand how that becomes an anti-inflationary policy.

Mr. DUNLOP. Well, I think the crux of the matter is the presumption that the continuation of controls would result in lower prices. I have very carefully tried to analyze their effects in 1973, and it is my considered judgment that in 1974, while there might be a few constraining effects on prices in some sectors, I think the net effect would be so adverse to production in various sectors that on balance they should be phased out.

I think also, it is quite dubious to presume that the increases in prices have been due to the phasing out of controls. That is true in an area like fertilizers, which we talked about before. We could have controls on fertilizer, but I think you would agree with me, they would very materially reduce further the amount of fertilizer in the United States in 1974, hence the amount of food produced in our country this year.

In other areas, I do not think the removal of controls will have that effect. I have some doubts about the view that we face a single further price bulge after these decontrols because we have been

decontrolling for the past 9 months. I think the big problem now is that we face still the passing through to the manufacturer and consumer of these high energy prices and raw material prices. Copper is an illustration.

Senator HUMPHREY. I know your feeling about controls, and I worked with you on the fertilizer and I felt that you made the right decision, and you know I encouraged you to do so.

The optimism of the forecasters about the third and fourth quarters, is this based upon faith, hope and charity, or is this based upon any kind of economic analysis?

The first two quarters I think we can understand why the increased pressures. I think you pointed out, to my satisfaction at least, that the full impact of the energy crisis has not been felt yet all the way through the manufacturing process.

Again I want to caution you, because I think you speak very bluntly within the administration—not caution you, but may I just say consult with you—that the Department of Agriculture looks more optimistically on production than I think they ought to. They have not quite related acerage to fertilizer. They would just like to believe that it is going to be a jolly good year. And I am the town's best optimist up until recently. I am now taking a very low rating as an optimist.

I am just wondering if you had any real scientifically economic analysis that would substantiate what you call the retardation rate for the third and fourth quarters, except that you hope that it will happen?

Mr. DUNLOP. That is a fair question. I may say that you need not doubt my skepticisms about projections, in or out of the Government.

I would say, first of all, that there are two fundamental points: That the economy of the United States, whether you like it or not, and the economies of Japan and Western Europe are cooling. The main impetus of this inflation has been in these primary prices; in zinc and copper, in cotton and so forth, and fibers and metals. We think those levels of prices cannot be maintained, and that the cooling of those economies should turn them around. That is the first point.

The second point, in my judgment, is that the agricultural output in the second half of the year, if weather prevails, not only here, but abroad, as well—should constitute another factor working on that side of holding prices down.

If you ask me can I guarantee it, I say of course not. And that is why in the agency which we are proposing for the future it is so crucial in our minds that every effort should be made to work on supply, because that, in the agricultural area, is the only way in which agricultural prices can in fact be affected.

Senator HUMPHREY. I just want to make a general comment.

I am worried a little bit about your reasoning on the third and fourth quarters, as far as lowering the inflationary pressures, that you are going to see a higher level of wage pressure which will be offsetting.

The second thing that I would just note for the record is that I believe a number of countries in Asia and Africa have discovered

what the Arabs have discovered; namely, that they have the commodities that we need in this industrial society, and they are not innocent spectators now; they are going through what you would call on-the-job training. And some of these products that we need in our industrial system are going to become surprisingly scarce and rather high priced.

I think these are factors that we have to keep in mind.

Also I would note that with these factors in mind, we were told a year ago pretty much the same thing, that we could expect the third and fourth quarters to be much better than the first and second quarters.

Now, I want to believe you, I really do, because I do not get any particular joy out of thinking that things are going to be any worse. What my concern is, if we do away with the Economic Stabilization Act and we do not have standby authority for example—I happen to support standby authority at least—and if we do not have a pretty precise outline of what the CLC is going to do under the new program—and I have looked over what you have described on pages 57 and 58 of your prepared statement—unless we have some precise idea of what this is all about, bad as the present system may be, it is better than none at all. And I just want to simply say that I hope that we may get from you—the man in this Government who I think speaks more plainly and clearly than most anyone I know—precisely what you have in mind with this new CLC operation. And if you do not have it now, it will come to us later on.

Because I think that before we legislate in April, we ought to have a better idea of what is going to happen.

That is about all the time that I have.

Senator PROXMIRE. Mr. Dunlop, thank you very, very much for your most able testimony. We most deeply appreciate it.

Our next witness is Mr. John Sawhill, who is sitting right on target in one of the hottest jobs, along with Mr. Simon, in Government. He is Deputy Administrator of the Federal Energy Office.

Mr. Sawhill, you have a very useful prepared statement. Let me just make a couple of remarks about it; we may save a little time in the questioning.

Number one, you indicate that total fuel consumption can be achieved without severe economic dislocations, in the automobile industry, the recreation industry and other areas.

I would hope you could come to grips with a couple of problems that you do not mention in your prepared statement; that one, the immensity of price increases for petroleum and the impact on the consumer—old oil going from $3.65 to $5.25, a 45 percent increase.

Also there is nothing on what to do about long lines and endless waiting, with not only the inconvenience, but the economic impact that that does have on the American people and the likelihood that that may continue for many, many months to come.

Also there is nothing that I could see in your prepared statement on the highly controversial area that does deserve some explanation about the reallocation of fuel.

In my State we have suffered a reduction in oil of a significant amount, and an increase in our neighboring State of Illinois, where

Wisconsin has been abiding by the conservation measures in cutting our speed limits sharply; Illinois did not. And also we feel badly about the fact that neither you nor anybody else in the Energy Office made any attempt to contact our Governor or Mr. York, who is handling energy problems in the State of Wisconsin; doing what we think is an outstanding job, also your office did not consult with any Wisconsin Senator or any member of the House delegation from Wisconsin. It was simply done, period. And we think that there was some useful suggestions and information that could have been provided you.

Having said that, we are happy to have you. Go ahead.

It has been suggested that if you can abbreviate your prepared statement to 10 minutes or so, then we can proceed with the questioning.

STATEMENT OF HON. JOHN C. SAWHILL, DEPUTY ADMINISTRATOR, FEDERAL ENERGY OFFICE

Mr. SAWHILL. I will summarize my prepared statement.

I appreciate the opportunity to appear before you today to comment on the economic report and other subjects which I know are concerning you in the energy area. In matters concerning the energy situation I would like to express this as short-term problems and long-term problems.

First, addressing the short-term problems. Because of the mild winter there will almost certainly be no shortages in home heating oil; and a relatively large stock of distillates should provide us with a great flexibility in dealing with these shortages in spring and summer.

Basic conservation efforts continue to be essential, however, particularly in the consumption of gasoline and residual fuels.

Our attention is now focused on increasing the supply of gasoline, aviation fuel, jet fuel and residual fuel, to prepare for the expected summer demand increases. We made the estimate of the overall shortage for the second quarter of about 16 percent, or 3.8 million barrels a day. This figure is based on what we call unrestrained demand, and does not give effect to price elasticity or embargo leakages.

We are still studying the impact of these factors and will publish a comprehensive estimate by the end of March.

But based on unrestrained demand, the individual shortages in the second quarter will be 12 percent for gasoline; 27 percent for aviation and jet fuel; 6 percent for metal distillates and 32 percent for residual fuel oil.

We have made some estimates to apply if the embargo were lifted. We concluded that, if the embargo were lifted and pre-embargo shipments were resumed beginning in April, the total shortfall, based again on this unrestrained demand, would be about 8 percent.

The individual shortages would be 4 percent for gasoline; 13 percent for jet fuel; 3 percent for metal distillates; and 16 percent for residual oil.

Managing a shortage of this magnitude will continue to require major conservation programs, by both business and consumers; as

well as a continuation of our oil and coal switching in utilities because of this residual short fall which I cited.

Our strategy in dealing with the shortage is to try to reduce as much as possible the impact on employment. Whether we have been able to achieve this so far without severe economic dislocations, I suspect, depends on how we define the word "severe." We certainly have had some economic dislocations, as you pointed out.

As far as prices are concerned, as the 1974 Economic Report of the President indicated, there was some possibility that the price might rise and clear the market to eliminate the shortage. While this might be appropriate in the long term, in the short term we do not intend to let prices alone ration fuel supply. We must protect the interests of the consumer at a time when world prices have risen to heights that do not reflect long-run demand supply relationships.

Therefore, we will continue to control the prices of old oil and consider price controls on new oil and stripper wells.

Turning to long-term problems, domestic energy supplies have increasingly fallen behind energy demands since 1949, the first year when the country went from an energy exporter to being an energy importer. In the last 15 years the rate of productivity and production has constantly decreased while the rate of growth of demand has constantly increased. Thus the gap, which has been met by imports, has been widening at an ever increasing rate in the last 3 years, 5 percent per year, while domestic production has increased only about 3 percent per year.

As a result, domestic sources, which provided 95 percent in 1960 and 88 percent in 1970, provided only 83 percent in 1973. More significantly, the percentage of petroleum imported doubled in the same period. In absolute terms, the quantity controlled, being the imported, almost quadrupled.

Forecasts, made prior to the embargo and subsequent crude oil price increases, predicted that the United States would import over 43 percent of its crude oil and petroleum products requirements in 1980, at costs exceeding $17 billion, based on the 1972 import prices.

Of course that figure would be doubled or tripled today.

We have found, because of the embargo, that we can no longer count on importing as much oil as we need, whatever the price. Thus for the twin reasons of national security and balance of payments, we must reduce our dependence on oil imports. This is why the President established in November a new national goal of energy self-sufficiency by the end of this decade.

We feel that the thrust of product independence is essential to both short and long-term solutions to the energy problem.

I would now like to briefly discuss Project Independence.

As you know, the thrust is to eliminate waste and to conserve energy resources. We cannot wait for the normal market forces to reduce demand as prices rise. We must adopt energy conservation and demand curtailment as a long-term policy decision, and not as a temporary expedient to be followed during this period of peak shortage. This would mean lighter and much less powerful automobiles, lower speeds on highways, reduction of heating costs in our homes, new demands on our public transportation, less waste in our indus-

trial processing power plants, and fewer throwaway containers. Hopefully with these measures we can reduce the rate of the demand or growth rate of 5 percent to somewhere in the range of 3 to 3.5 percent in 1980.

If we can, this would be the equivalent of saving as much as 6 million barrels of oil per day.

We plan to do a great deal of research to permanently reduce energy consumption. Additionally, we have measures to increase supply by developing our coal reserves more effectively, by increasing the production of oil from oil shale, and by pushing forward in the development of the utilization of nuclear power.

In this regard, I think one of the important things we have to do is convince Government policymakers and the public that nuclear reactors are safe, and that waste disposal problems can be solved. Considerable research must be directed to this.

Finally we have to work with the more distant energy sources such as geothermal and solar energy and fusion, which seems to be one of the ultimate answers to our energy situation.

As an interval contribution to the product independence objectives there must be a program designed to provide incentives for energy conservation.

Several such initiatives were presented in the Joint Economic Committee's staff study on the 1975 budget. The energy section of this study refers to four possible types of taxes to reduce energy consumption: Increase the excise tax on gasoline, crude oil, all energy sources, and place an excise tax on excessive residential energy uses. We are currently studying these propositions and other alternatives. Any of these taxes, or a combination of them, would undoubtedly have some effect and would induce conservation.

What is needed, at this point, is a quantitative insight into the effectiveness of such measures and their effects on the general economy. We are attempting to quantify these effects right now.

A further issue is how the revenue raised should be used.

Your staff study indicates that a 30 percent tax on gasoline would yield $16 billion, and suggested that this revenue might be applied to such programs as unemployment compensation, public service employment or aid in State and local governments.

I feel that if such a tax were enacted, in addition to these items, we should also consider using such revenues on energy initiates. For example, I think we should positively encourage energy resource development investment and research into alternative energy sources. By doing so, we could accelerate the rate of private investment.

In addition, funds raised in this way could be used to promote conservation practices, such as allowing tax incentives for homeowners for installing insulation, and subsidizing mass transit.

This concludes my summarized statement, Mr. Vice Chairman.

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

[The prepared statement of Mr. Sawhill follows:]

PREPARED STATEMENT OF HON. JOHN C. SAWHILL

Mr. Chairman and members of the committee, I appreciate the opportunity to appear before you today to comment on the Economic Report of the President. This report outlines a number of major objectives. I will confine my

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comments to those items which help structure a comprehensive energy program able to deal with the current shortages and also ré-establish our ability to be self-sufficient in energy. I would like to discuss some immediate short-term effects of the crisis, some longer-term effects and their relation to energy self-sufficiency and finally some comments on your Committe's study on the Budget.

Problems of inflation, unemployment and balance of payments have been our major economic concerns for many years. They have now been joined by another problem—shortage of energy—which will dramatically affect all the others if we permit it to. All of us are well aware of the energy shortages precipitated by the oil embargo. However, these are merely symptoms of long-term problems which have been building for many years and will not simply vanish when the embargo is lifted.

We have been rapidly depleting our non-renewable petroleum fuels while failing to develop any adequate alternative sources of energy. We have been operating under the assumption that cheap, abundant energy would always be available. This has contributed to wasteful patterns of energy consumption and insufficient incentives to develop adequate domestic resources. As recent events have shown, this has left us very vulnerable to any interruption of the imports we have come to rely upon.

SHORT-TERM PROBLEMS

Today, I want to discuss some of the short-term problems caused by the oil embargo and what our national policy should be to minimize its effects.

First, however, I will address the immediate short-term outlook for fuel supplies. Because of the mild winter there will almost certainly be no shortages of home heating oil and our relatively large stocks of distillates provide us with great flexibility in dealing with the changing shortages of the spring and summer. Major conservation efforts continue to be essential, particularly in the consumption of gasoline and residual fuel. Our attention is now focussed on increasing the supplies of gasoline, aviation jet fuel, and residual fuel oils to prepare for the expected summer demand increases. Presuming the embargo remains in effect, our current forecast of overall shortages for the second quarter of 1974 is about 16 percent or 2.8 million barrels per day. This figure is based on unrestrained demand and does not give effect of price elasticity or embargo leakages. We are still studying the impacts of these factors and will publish a comprehensive estimate by mid-March. But based on unrestrained demand, the individual shortages would be 12 percent for gasoline, 27 percent for aviation jet fuel, 6 percent for middle distillates, and 32 percent for residual fuel oil. This is the overall deficit between supply and unrestrained demand for the second quarter based on the usual expected demands during this quarter minus the estimated actual supplies including imports, plus the amount necessary to rebuild stocks in order to avert more serious gasoline and residual fuel shortages in the high-demand third quarter.

A recent study by FEO showed that if the embargo were lifted and pre-embargo shipments resumed beginning in April, the total shortfall—based on unrestrained demand—would be about 8%. The individual shortages would be 4% gasoline, 13% jet fuel, 3% middle distillate and 16% residual.

Our main concern is still to minimize impacts on industrial output and the employment situation. The past months have shown that reductions of 15 to 20% in total fuel consumption can be achieved without severe economic dislocations. We are continuing the development of conservation and allocation policies to deal with shortages of these magnitudes. What has not been determined is the longer term effects of this level of shortage on the general economy.

The 1974 Economic Report of the President indicates the possibility that prices might rise enough to clear the market and eliminate the shortage. While this may be appropriate for the long term, in the short term we do not intend to let prices alone ration fuel supplies. We must protect the interest of the consumer at a time when world prices have risen to heights which do not reflect long run demand-supply relationships. Therefore, we will continue to control the prices of "old" oil and are considering price controls on "new" oil and oil from stripper wells.

The short-term strategy of FEO has been to allocate our fuel resources as equitably and effectively as we can, and to respond decisively to exceptions not covered by our regulations as they arise. The 1974 Economic Report stresses the Administration's determination to manage the energy shortage so as to

keep loss of jobs and production to a minimum. To do this, it will be essential to provide, or permit, incentives to maximize imports, domestic exploration and production, as well as providing rapid fuel shifts to key industries. Different strategies, however, will be necessary to provide a longterm solution to the energy problem.

LONGER-TERM PROBLEMS

Domestic energy supplies have increasingly fallen behind energy demands since 1949, the first year that the United States moved from being a net energy exporter to being a net energy importer. More importantly, over the last 15 years, the rate of growth in energy production has constantly decreased while the rate of growth of demand has constantly increased. Thus, the gap, which has been met by imports, has been widening at an ever-increasing rate. Over the last three years, demand has grown by over 5 percent per year while domestic production has increased only about 3 percent per year.

As a result, domestic sources, which provided 95 percent of United States energy in 1960, and 88 percent in 1970, provided only 83 percent in 1973. More significantly, the percentage of petroleum imported doubled over the same period. In absolute terms, the quantity of petroleum imported nearly quadrupled. Forecasts, made prior to the embargo and subsequent crude oil price increases, predicted that the United States would import over 43 percent of its crude oil and petroleum products requirements in 1980 at costs exceeding 17 billion dollars, based on 1972 import oil prices.

Were we to import all the oil predicted by these forecasts at present prices, the total outlay would double or triple. This outflow of funds would have a staggering effect on our economy and our balance of payments, even if the oil-exporting nations were to invest a substantial portion of these revenues back in the U.S. economy. We do not intend to let this situation develop. We intend to find low-cost oil production methods or substitutes. National security considerations, indicate that using domestically-produced oil (or substitutes) that cost somewhat more than the equivalent imports, may be a better course than growing reliance on foreign imports.

We have also just found that we can no longer count on importing as much oil as we need, even at any price. Thus, for the twin reasons of national security and balance of payments, we must reduce our dependence on oil imports. This is why the President established in November a new national goal of energy self-sufficiency by the end of this decade. We feel that the thrust of Project Independence is essential to both short and long term solutions to the energy problem. I would now like to discuss Project Independence, what it means to us, its objectives and how they can be achieved.

PROJECT INDEPENDENCE

The first major thrust of Project Independence is to eliminate waste and conserve energy resources. We cannot wait for the normal market forces to reduce demand as prices rise. We must adopt energy conservation and demand curtailment as a long-term individual and collective ethic now, and not simply as a temporary expedient to be followed during this period of acute shortage. This will mean lighter and less powerful automobiles; lower speeds on our highways; reducing heat losses in our homes; fewer empty seats on our public transportation; less waste in our industrial processes and powerplants; fewer throwaway containers. These measures will enhance rather than detract from our economic well-being and standard of living. Our goal is to cut our annual energy consumption growth rate from the present 5 percent to 3 to 3.5 percent by 1980. This could save as much as 6 million barrels of oil equivalent per day. We also plan to do considerable research aimed at permanently reducing energy consumption. For example, better insulation of houses, more efficient automobile engines, and more efficient power cycles can save energy without causing economic or social dislocation.

The second major thrust to Project Independence is to stimulate the development of existing domestic energy resources as well as alternative new sources. Specifically, our program will include the following:

- We must develop our coal reserves more effectively. We have 1.5 trillion tons of identifiable coal reserves, one-third of which are economically recoverable now. We must utilize this abundant resource. We need to mount major research and development efforts in coal gasification and liquefaction. Simultaneously, we must develop and use techniques for mining coal that do not scar the landscape permanently or endanger the health and safety of miners.

• We have talked for years about the production of oil from our oil shale. There is an estimated 1.8 trillion barrels of oil in the U.S. shale resources which could satisfy our oil needs for over 100 years. We need an increased effort by both the Federal government and private industry to develop this potentially productive resource. Some have estimated the in-situ processes for extracting shale oil would make it possible to produce oil close to the current cost of Persian Gulf crude. In-situ extraction should also have minimal impact on the environment and its development must be expedited.

• We must also push forward in the development and utilization of nuclear power. Currently, nuclear power provides less than one percent of our energy needs after 30 years of development. It could easily provide 10 percent by 1985. We must take every step to expedite the licensing and construction of nuclear powerplants which are an essential part of our program for achieving energy self-sufficiency. We will also develop a broad nuclear program which looks toward liquid metal and other breeder reactors. In addition, top priority will continue to be given to assuring that nuclear power plants are built and operated safely with acceptable environmental impact. We must convince government policy makers and the public that nuclear reactors are safe and waste disposal problems can be solved.

• We have also talked for years about development of such relatively distant alternatives to fossil fuels as fusion, geothermal and solar energy. For the next decade these alternatives are still very much in the research and development stage of growth and they could not come into widespread use until after 1990. Nevertheless, although we will invest in the development of these alternatives, at the same time we must focus now on nearer-term measures for expanding energy supplies.

In summary, then our long-term policy must be to greatly accelerate these energy related research and development programs. This is where the major budget impact occurs. The President proposes spending over $1.8 billion in this area in 1975 compared to $700 million in 1973. This will be complemented by an even larger investment by the private sector.

JOINT ECONOMIC COMMITTEE STUDY

An integral contribution to Project Independence objectives must be a program of tax initiatives designed to provide incentives for energy conservation and domestic resource development. Several such initiatives were presented in the Joint Economic Committee's staff study "The 1975 Budget: An Advance Look." The energy section of this study refers to four possible types of taxes designed to reduce energy consumption: an increased excise tax on gasoline, an excise tax on crude oil, a tax on all energy sources, and an excise tax on excessive residential energy uses. We are currently studying these propositions and other alternatives. Any of these taxes, or combinations of them would undoubtedly have some effect on demand and would induce conservation. What is lacking at this point is a quantitative insight into the effectiveness of such measures and their effects on the general economy and we are attempting to quantify these effects. A further issue is how the revenue raised should be used. Your staff study indicates that a 30-cent tax on gasoline could yield $16 billion and suggested that this revenue might be applied to such programs as unemployment compensation, public service employment, or aid to State and local governments. I feel that if such a tax were enacted, we should also consider using such revenues on energy related initiatives. For example, I think we should positively encourage energy-resource development and investment and research into alternative energy sources. By doing so, we could accelerate the rate of private investment. In addition, funds raised in this way could be used to promote conservation practices such as allowing tax incentives to homeowners for installing insulation, and subsidizing mass transit.

This finishes my prepared statement. I will be happy to answer any questions the Committee may have.

Senator PROXMIRE. Let me get back to the questions that I began to raise when I introduced you.

We have had an increase from $3.60 a barrel to $5.25 a barrel in old oil. This, of course, has had a tremendous effect on the price of gasoline at the pump.

Old oil, as you know, constitutes 70 percent of the domestic production; and I think we have to recognize with old oil the cost would seem to be less likely to increase after all the facilities are in place.

Now, when that increase was made did you examine the books of the oil companies to determine what increase in price was justified on the basis of increased cost?

Mr. SAWHILL. I have to answer that question, Mr. Vice Chairman, by saying that it was the responsibility of the Cost of Living Council, before I took on my responsibilities at the Federal Energy Office, therefore I do not know. As to the effect of the increase, old oil while it constitutes 70 percent of domestic production because of the amount of oil we import constitutes roughly 45 percent, I think, for total petroleum consumption. Therefore, the 45 percent increase of $1.75—if my quick calculations are right—would amount to about 2 cents per gallon at the pump.

I do not mean to minimize that. Each cent per gallon increase that occurs at the gasoline pump means $1 billion to the American consumer.

One of the problems I had to wrestle with recently is the problem of gasoline station owners wanting greater margins.

Senator PROXMIRE. It seems to me there should have been a hard, clear justification for this increase.

There is obviously no incentive justification here in as much as new oil is treated separately and provided for in ever larger price increases. Is that not correct?

Mr. SAWHILL. New oil is treated separately, yes.

Senator PROXMIRE. What is the justification for this kind of enormous increase, and why should there not be a rollback?

Mr. SAWHILL. As I say, I was not involved in this increase. That does not mean that I should not be prepared to discuss it.

I think the justification——

Senator PROXMIRE. You have authority now to change that, do you not?

Mr. SAWHILL. That is correct.

Senator PROXMIRE. Have you given any consideration to doing so?

Mr. SAWHILL. Rolling back the old oil price?

Senator PROXMIRE. Yes.

Mr. SAWHILL. No.

Senator PROXMIRE. Why not?

Mr. SAWHILL. I agree with you that there should be cost justification. I believe there is cost justification.

Senator PROXMIRE. You believe there is, but you do not know? You have not seen it?

Mr. SAWHILL. I have not seen it, no.

Senator PROXMIRE. Do you not think, since you are the No. 2 man in FEO, that if you have not seen it, then nobody has seen it? That means that there has not been justification provided.

Mr. SAWHILL. I do not believe that is correct.

Senator PROXMIRE. Who has seen it?

Mr. SAWHILL. We have a section in the FEO which focuses on the whole price question. They are the ones who have worked out the cost

justification for this increase since they were the very people that were transferred over for that purpose.

Senator PROXMIRE. They were producing this oil profitably for $3.60—only a relatively few months—no indication that the costs have gone up. This does represent a tremendous windfall bonanza, does it not?

Mr. SAWHILL. Yes, it is a big increase.

Senator PROXMIRE. Since it is not going to result in additional production, I do not see that the impact can be justified. It results in a much higher profit for the oil companies, higher prices for the consumer. Where is the equity?

Mr. SAWHILL. Of course the windfall profits tax that was proposed was designed to tax away the windfall profit.

Senator PROXMIRE. That would not take effect until after the profit goes over $5.25, would it?

Mr. SAWHILL. That is correct.

Senator PROXMIRE. That would not do anything to this?

Mr. SAWHILL. It would not do anything to this.

Senator PROXMIRE. Does OMB have the data? Did you indicate that?

Mr. SAWHILL. I am sure the data is in the Federal Energy Office. We will be glad to supply it.

Senator PROXMIRE. Would you provide that data for us?

Mr. SAWHILL. Yes.[1]

Senator PROXMIRE. We would appreciate that very much. I would like to ask you about whether or not you have any plans to do anything effective about these long lines at filling stations—I am aware of your allocation program; I realize it is messy and difficult for you to handle—but you indicated that even if the embargo should be lifted, we would face an 8 percent short fall, a 4 percent shortage of gasoline, and I assume that would result in the continued lines. It would still result in a serious inconvenience for the American motorist, would it not?

Mr. SAWHILL. It would result in some inconvenience; certainly significantly less than we have now. It would be more on the order of the kind of inconvenience we had last summer.

Senator PROXMIRE. I am not sure it would be less; I will tell you why. Is it not true that in any of these efforts, when the President goes on national television and appeals for cooperation, he gets an immediate patriotic response?

Mr. SAWHILL. Yes.

Senator PROXMIRE. That tends to wear off as time goes on. It is very hard as time goes on to persuade people to adopt these conservation measures except in a war situation. So I am not so sure that it is going to be so easy to adjust in the future. Is that not your problem, too?

Mr. SAWHILL. As I say, with the shortage significantly reduced, I would think that the problem of lines would be reduced, once the embargo ends. But until the embargo ends, we do have a problem on our hands. There is no question about it.

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

Senator PROXMIRE. As you admitted very frankly and honestly—you told us that it is not over, that we still have a shortage.

Mr. SAWHILL. Clearly.

Senator PROXMIRE. Is this 8 percent figure on the basis of the long-term rise in demand that you posited in your prepared statement?

Mr. SAWHILL. That is correct.

Senator PROXMIRE. Do you have any estimate on what it is likely to be in 1975, if the embargo is lifted?

Mr. SAWHILL. I do not have any. We are working on those estimates; I do not have any estimates available at this time.

So much depends, as in any economic forecast, on assumptions, the form assumptions must take, and what we will import in crude oil and to our refineries.

Senator PROXMIRE. When you appeared on national television on Sunday, you seemed to indicate that the simplest answer, the most immediate answer to these very serious problems that we have for the consumer in buying gasoline and waiting for gasoline is reallocation.

Mr. SAWHILL. Yes.

Senator PROXMIRE. I am not against that. I think reallocation is good principle and I favor it, but I think it should be applied with considerably more information and so forth than your office seems to have.

Is it not true that you are taking oil from States such as Minnesota and Wisconsin and providing it to other States?

Mr. SAWHILL. Any time you do reallocation, clearly you have to take it from some State and give it to another.

Senator PROXMIRE. I am asking you whether or not that is the case. You did that?

Mr. SAWHILL. At the present time, based upon a draft we did two weeks ago, we have requested the major refineries in this country to do some reallocation.

Senator PROXMIRE. Did you take into consideration all the conservation measures that States such as Wisconsin put into effect, where we reduced our speed limit and so forth?

Mr. SAWHILL. No, we did not take that into consideration.

Senator PROXMIRE. Why did you not? Why should that not have been considered?

We reduced our speed limit. We lost our oil; you reallocated it away from us. Illinois did not reduce their speed limit, they continued it; and they were rewarded, they got an increase in their oil allocation. This is really burdening our people in our State, and I am sure in other States where they have lost oil, although they have abided by conservation measures, they feel that at least should that not be taken into consideration. You say it has not been.

Mr. SAWHILL. Honestly, I would have to tell you it was not.

What we took into consideration was the available supply going into these different States and the percentage of the requirements.

Senator PROXMIRE. How can you expect the people in State government and the citizens of a State to support conservation measures if their reward is going to be, is to suffer a diminution in the availability of oil?

Mr. SAWHILL. I do not think the conservation measures that Wisconsin undertook hurt them at all. I think it helped them, because if they felt that they undertook these conservation measures meant that they could get along much better with the supplies that were available.

Senator PROXMIRE. That was helpful for the whole Nation. If every State had done this, we would have been better off, obviously.

Mr. SAWHILL. No question about it.

Senator PROXMIRE. Do you not think it would be wise in the future to consider that as one element in reallocation?

Mr. SAWHILL. I am not sure how we could do that, Senator Proxmire. Every State in the Nation now presumably has a mandatory 55-mile per hour speed limit, just as we have a mandatory daylight savings plan. It is hard to estimate the kinds of local conservation that is going on.

Senator PROXMIRE. Well, let me ask you about something else.

We are very proud in our State about the work we have done in our conservation of petroleum. We have a very able person assigned by Governor Lucey, Mr. York. I am told that they had no opportunity to consult with your office, the people from your office did not talk to them, did not get their input, their knowledge about what the situation was at all. Nobody in my office was approached, nor was Senator Nelson or any member of our congressional delegation of Wisconsin. We were not told; it was just done.

Would it not be better to find out from us what information we have, particular the Governor and his conservation office?

Mr. SAWHILL. Yes, I think so. I think we were remiss in not working more closely with State officials prior to every allocation.

Senator PROXMIRE. Will that be done in the future in any future allocations?

Mr. SAWHILL. Yes.

Senator PROXMIRE. That would be most helpful if we are told about it. Our people are not selfish. They recognize that we all have to share this equally and fairly; but I think they felt that in this case, they were given a raw deal. It was not fair.

Mr. SAWHILL. Let me say this, I have been in touch with Governor Evans from Washington, which as you know has had the National Governors Conference, and invited him to bring his executive committee in to meet with us so we could review the whole process that we are trying to develop for reallocating supplies to bring everybody somewhere near an equal basis.

When you turn the clock back two years, as Congress has had us do, and reallocate supplies to what they were in the 1972 base period in a large and complex industry like the oil industry, it is bound to be difficult if you move in a program like this.

Senator PROXMIRE. I have great sympathy for you; you have an exceedingly difficult problem; I recognize that. As you have indicated this morning, it was an error on the part of your office not to at least inform us so we knew what was going on, so that we could be as helpful as we can.

Mr. SAWHILL. We have taken steps through the governors' conference to improve that situation, and we have taken steps with the State and local government liaison groups to work more closely.

Senator PROXMIRE. I would urge you to find a way of at least considering the cooperation that the State has with a voluntary conservation measure. They are likely to change. The one that I mentioned was the speed limit. I am sure there are others. And the extent to which the State puts these in effect would be a very effective way to gain national cooperation, to provide some consideration.

Mr. SAWHILL. Yes.

Senator PROXMIRE. Senator Javits.

Senator JAVITS. I would like to join with Senator Proxmire in our sympathy for you.

Mr. SAWHILL. Thank you.

Senator JAVITS. I would not want to have any questions that I ask to seem to you to be critical of what I know is a very trying assignment.

In that vein, sir, we hear very disquieting reports of a possible strike by gas station dealers. Now, you have sought to do something about that in giving them a one cent per gallon increase in order to deal with their overhead problems and the inequalities of allocation, determining their volumes of sales.

But what about actually sitting down with them and not compounding the mistake that was made with the independent truckers but actually holding regional conferences with the gas station dealers to see what their problems are and try to beat them?

Mr. SAWHILL. We have done that, sir. We formed in January a Retail Gasoline Dealers Committee, made up of 12—I believe—representatives that were nominated from a much larger group, that we invited to come to Washington to work with us on the problems that retail dealers face. They met with us last week, and one of the results of that meeting was the price increase that we announced on Saturday.

It seems to me, at least from my assessment of what the committee has told us, that there are three problems. First, the men running these regional gasoline stations are the guys on the front line, basically, and they are bearing a considerable amount of the brunt of this energy shortage. They are the people that have to in effect ration our gasoline supplies, and this is a difficult thing for them to do. They are concerned about the nondiscrimination rule that was required by Congress and we implemented in the Emergency Petroleum Allocation Act, so we tried to work with them to enable them to maintain some of their previous business by permitting them—and we put this in the confines of that act—not to discriminate on the customers, be it physicians or whatever.

Second, we gave them a one cent price increase. We gave 1 cent as of January 1, and we gave them a 1 cent price increase that will go into effect on March 1, for those stations that are particularly hurt by this situation and if those stations receive less than 85 percent of their 1972 base period allocation.

Finally, we will be announcing today some additional allocations in those States that have been particularly hurt by the shortage, and I think that would further alleviate the problem so we can supply additional supplies and additional mark-up, and some understanding in terms of the nondiscrimination rule.

Senator JAVITS. How do you estimate the chances of a strike by the gas station dealers or operators?

Mr. SAWHILL. That is always a difficult thing. The retail dealers group that we have been working with feel that as long as we are willing to continue listening to them, as long as we are willing to meet with them again, and we are on February 28 to consider further recommendations that they might make, then the gasoline station operators should be understanding of the actions we have taken.

There are other groups in the country like the independent truckers. There are a wide variety of groups representing the gasoline station owners. I am meeting tomorrow with a group from Oregon and Washington who have threatened to go on strike. They agreed to delay it after I talked to them on the phone for several hours Sunday night and pending a meeting in Washington to enable us to try to clarify what we have done.

I am meeting with some of the other trade associations tomorrow. So we are trying very hard to avoid any errors we may have made by dealing with the truckers by moving quickly, talking to them, and trying to understand the problems that these people face.

Senator JAVITS. Do you feel that we have a right to be reassured by what you are telling us now?

This would be the biggest catastrophe of all.

Mr. SAWHILL. It would be a problem. But on the other hand, we in government have to balance interests; to balance the interests of the consumer and to control prices at levels that do not require the consumer to pay that much more; in enforcing nondiscrimination rules that Congress has told us by law that are appropriate. I feel they are appropriate too, personally. So this balancing act is a very difficult act. I am not an experienced labor negotiator, so I hesitate to give you an opinion on whether you have the right to be reassured. I see some reassurances from some areas of the country, although in other parts of the country we still have problems.

I can assure you of this. I will be willing to meet and talk to any of these people and try to understand their problems.

Senator JAVITS. Have you enlisted the Small Business Administration, the Department of Commerce which deals with business, the Department of Labor that deals with labor, and other agencies of government, including the Mediation Service, that has more experience than you?

Mr. SAWHILL. Yes. we have enlisted the Mediation Service.

Senator JAVITS. You have enlisted every agency of government that would count here on an emergency basis?

Mr. SAWHILL. We are in the process of doing that.

Senator JAVITS. Do that. Do it. I strongly urge you to do that.

The other point that puzzles me is that you are against rationing. I personally toured many gas stations in my State. The situation is a shambles. Odd numbers, even numbers, half a tank, no half a tank, arbitrary figures of sales, gas held for reserve by the dealer himself who does not want to sell out in 1 or 2 days.

Every kind of scene. That is in addition complicated by the fact that counties have rationing systems, States have rationing systems, voluntary and mandatory. Cities are now having rationing systems.

Mayor Beame wants to put one in New York City. He is probably right.

How can you possibly resist the need for a national program that will be fair?

Mr. SAWHILL. I think you have characterized my position when you said I was against rationing. My position is hopeful that we can avoid rationing, as I think rationing is not going to solve many of the problems which you describe. We are still going to have long lines, even if we ration. We are still going to have a very large bureaucracy if we ration and will be spending a lot of taxpayers' money.

I think that we can manage the situation short of rationing. I am hopeful that we can. I do not know that we can. That is why we are spending the taxpayers' money for preparing a rationing plan. We have printed coupons and are getting prepared to put it in place if the need arises.

Senator JAVITS. I think the country has, rather, the feeling that not only are you against it, but you are so much against it—I am not speaking about you. I am talking about your office and the President—that you are going to overstay your mark.

It is true that you are not going to solve all the problems. Of course not. Maybe you will not even solve any of the problems. But our people—and it is reflected in what you said about the statute that we passed—have a literal obsession of laying on failing on all levels with all people. The only way you can do that is by some form of Federal regulation even if you do not apply it in given States. A Congressman just told me in his State they do not even know that there is a gasoline shortage. They are lucky.

Mr. SAWHILL. In parts of New York State they do not know there is a gasoline shortage.

Senator JAVITS. But take New York City. It is being penalized because New York City uses half of the gas per capita that is used comparably in any other part of the country because we have a subway and a rapid transit system. So we get hit. So we are very irritated by it and very resentful.

The problem is one of laying on fairly for the country with power. You do not have to put it in every State. I cannot for the life of me see how it can be avoided, with all these mushrooming control plans, including the individual gas station dealer. He is a government regulator and he does not like it. People will not look at a man's gas tank. You can make all the voluntary regulations you like about half the tank. They say most of the customers will hit him in the nose.

I really think it is an impossible situation, and anything that you could say about that would be critical to the Nation.

Mr. SAWHILL. It seems to me that we need to give it a month or maybe longer, maybe a month and a half, to see if our allocation program can smooth out some of these tremendous inequities that we are seeing between New York City and Rochester.

I went up to Rochester and I did not see any lines at all. The western part of New York State, I understand, is in pretty good shape. And then you can see some of the inequities between northern and southern Florida.

Senator JAVITS. And in the counties around New York there has been a tremendous bulge in population. In the counties there are 200,000 more new cars registered, and the historical basis of 1972 does not take that into consideration.

Mr. Sawhill, again, Americans like something definite. I am not trying to tie you down or sneak a question in on you. But in the planning of your Office, would you say that it is fair to State that the testing period which you people have in mind is a date of March 31?

That is 6 weeks.

Mr. SAWHILL. I think we should at the least give ourselves 6 weeks. We have to look and see how the program——

Senator PROXMIRE. You said when?

Mr. SAWHILL. The 15th of April.

Senator JAVITS. By April 15, on the outside, you will tell the American people you will have to ration, or if you do not, why?

Mr. SAWHILL. This will be a presidential position. The President will ultimately decide.

Senator JAVITS. This is how you feel now?

Mr. SAWHILL. Yes.

Let me say this, if I could—that we need some things from Congress to help work on this rationing problem. The three things we need are: First, some modification of the crude oil modification program, which is requiring us to take crude supplies from those refiners that can make gasoline better than anybody else in the country and give it to refiners that do not have that same capability of making gasoline. So we do need some modification in that. Sure, we have to protect the small refiners and make some redistribution of crude supplies. But the way the law requires us to operate now, we do not feel we have enough flexibility in that program.

Second, we need a bill establishing our agency, because right now we are operating under executive order. And if, in the New York region—I do not know the exact figures—but of the few hundred people in that office only ten of them are permanent employees. The rest are detailed in, including the regional administrator. So we have got to have a statutory base for us to operate. Otherwise we cannot do the job you want us to do.

Finally, we need authority to go to rationing in the event that we have to go to rationing. And along the way we have to have some appropriations so we can begin putting this rationing apparatus into place. Sure, we had enough money to print the coupons. But it is going to take a lot more than that to bring the people on board the FEO and give the States support so that they can begin putting a mechanism in place.

Senator JAVITS. Thank you, Mr. Sawhill.

Senator PROXMIRE. Senator Humphrey.

Senator HUMPHREY. Thank you. First, Mr. Sawhill, I want to associate myself with the general comment of the Senator from New York, Senator Javits, on the whole subject of rationing. I have done this before. I know it is not a popular issue. No one really wants to ration. We would like not to. The question is, What is the most equitable manner to deal with the problem that we have?

Certain areas of the country are going through a very painful experience. It is shameful. Total confusion. You mentioned some of the areas, northern and southern Florida, problems we see in metropolitan areas in certain parts of the country. They have no difficulty with their gasoline, to be sure. But other parts are in very severe shape. And the confusion is unbelievable. And what we are really doing is training up a whole population as to how to get by to avoid rules and regulations. We are getting violence, threats of violence.

I hope in your decisionmaking process that you keep every one of these matters in mind, and I know you will. The administration opposed an allocation system. Some of us have proposed an allocation system. Now, I know the fuel is in short supply. That was opposed. Finally it came around to that. Now, belatedly, and we said so repeatedly, that there was too much delay in getting the machinery set up for allocations. What worries me is the long delay in case we have to go into any kind of rationing.

Mr. Sawhill. That is why I say we need the bill and the appropriations, so we will not have these delays.

Senator Humphrey. You are saying this, and this is fine, and I support the idea of you having legislative authority for an agency such as yours. I happen to know, for example, that your original office on allocations was totally understaffed. They do not even answer the telephone. It is as phoney as a $3 bill. You have a regional office. You have somebody detailed from the Bureau of Mines, somebody detailed from this agency and that agency. They did not know any more about the problems of gasoline than if you had gone on in and got somebody behind Walgreen's soda fountain. That is no way to run an agency.

So I am prepared to help you in every way. But I have not noticed the administration pushing that.

Mr. Sawhill. You may take my comments as a push.

Senator Humphrey. Would you talk to a higher authority, maybe get it a little extra shove, because we will fight it out for you?

I do have a couple of questions relating to your allocation program. We have a little program out our way. I sent a telegram off to Mr. Simon on the 13th of February informing him that the FEO's own form 1000 showed that Minnesota received 88.8 percent of the 1972 base shipment rather than 97.4 announced in Washington. We were not informed that there were going to be any changes, not at all. The Governor was not informed. I was not informed. The Attorney General was not informed. Our Civil Defense Office was not informed. We were in the same situation as Wisconsin. We have been trying to do a good job. We do not want to be gluttons. All we want is our fair share, and when I speak of a fair share I want you to keep in mind that that fair share has to take into consideration the fact that spring planting season is coming with 20 percent more acreage being put into production at the request of the government. Also, because of wood prices we are going to need gasoline and diesel, and fuel and propane and other petroleum supply allocations are going to be necessary. You have got a new formula coming out, a new allocation plan. Can you tell me what percentage of 1972 base we will receive under the new allocation plan?

Mr. SAWHILL. We are going to be coming out with some emergency allocation for the month of February to help those areas that have been particularly hard hit by the energy situation. I cannot tell you the percentage right now.

Senator HUMPHREY. That is the one that is hurting us. You are reaching in, you are taking it out and passing it around and giving it to somebody else.

Mr. SAWHILL. That is the problem. You take it from someone and he does not like it because you took it. You give it to somebody else and he does not like it because he does not feel it is enough. You make no one happy.

Senator HUMPHREY. It would have been very helpful if we had at least had some consultation on it, because all hell broke loose.

Mr. SAWHILL. There is no question about that, and I will admit our mistake there. I will say this, though. We are under a lot of pressure because of the very conditions you described—the long lines and the people getting extremely concerned about this. So we have to make some decisions to move gasoline into areas before we have completely accurate data. In other words, we have to act on the best data we can to avoid the kind of panic that we are seeing in certain sections.

Senator HUMPHREY. I want to give a figure so you will not be misinformed. The 97.4 percent that you were working on as your base figure is not right. We had 88.4. That is what we have been getting, and we would like to have you to get your data straightened out so we get our fair share. That is all we are asking for, just our fair share.

Mr. SAWHILL. We have to look at other States that are down in the 60-percent area and recognize that we had to make some quick decisions to help those areas that are really in extremely short supply.

Senator HUMPHREY. The FEO has estimated that gasoline consumption declined from its forecasted rate some 90 percent in December. What are these estimates based on? Are you also monitoring heating fuel consumption, particularly in commercial and public buildings?

Mr. SAWHILL. Yes, we are monitoring heating fuel consumption, and there has been excellent conservation practices. As far as gasoline consumption is concerned we took last January's demand and added a general normal average growth factor to it, and then looked at the actual usage in January 1974 to determine the difference.

Senator HUMPHREY. I will yield to Senator Proxmire.

Senator PROXMIRE. I will take a minute to summarize. I understand Senator Humphrey may have a question or two more, but I will summarize now.

Unfortunately, it seems to me—you may want to respond to this—that we have the same sad song today that we have had day after day here. There is no evidence of effective, vigorous economic leadership today. We have been told that wage-price controls are out by Mr. Dunlop, that we cannot do anything about inflation. He made an eloquent justification, in my view, of no policy. Nevertheless, it was a no-policy situation.

Now we come to your position. I think that you and Mr. Simon are very able men. You know I have great respect for both of you. But there is no policy here in pricing. You have indicated that the enormous price increases were not based on cost increases, were not based on any considerations that were necessary to get more production. There was no policy to prevent the waiting in line for gas that seems to be something that is likely to go on for a long, long time. There is no policy to meet the effect of the energy shortage on the automobile industry, the recreation industry, the housing industry.

In other words, there just does not seem to me to be any effective economic leadership here at all. I cannot expect you to answer for the other people.

But you may want to make a response with respect to this. Because that is what comes through. And as I say, without any derogation of your ability, which I think is very great.

Mr. SAWHILL. I think we are showing leadership, because we have moved rapidly to build up an agency that had 200 people and today has 2,000 people. Adding 1,800 people to an agency in an 8-week period. Setting them up and organized, before Congress has given us the legislation to get this done. I think that does show good leadership and rapid movement.

To say that we have not made mistakes would be wrong. By the same token, I believe that we are moving quickly to overcome these mistakes, and I do think that we do have a policy for handling these long lines. Our policy is to try to get our reallocation program working so that we can redistribute supplies away from these areas that have sufficient supplies into the areas where we have shortages.

The long lines are really occurring in the major metropolitan areas. We just have to get more gasoline there, and we will.

On the other hand, we recognize that this may not be the whole answer.

Senator PROXMIRE. This is something that, as you say, is likely to change. It is not a static situation in which you reallocate supplies once and that is the end. You have to continue that.

Mr. SAWHILL. Every month. That is the only way that we are going to be able to operate the program.

Senator PROXMIRE. It is not the only way you can operate the program. You can operate the program also through rationing.

Mr. SAWHILL. If the program does not work as we have indicated all along, we would put a rationing program into preparation. We began printing coupons. However, we need the money and the authority to put that into effect. We hope that Congress will give us both.

I do not think it is a lack of policy. There are startup problems, I will admit, but I think we are overcoming them. I do think we have a policy for managing these long lines. We are working more effectively with the States, admittedly more than we have done in the past. I think we are beginning to see that things are catching hold and working much more effectively than before.

As far as rationing is concerned, we are not against rationing. However, we would like to avoid rationing. In my office, I see groups coming through every day; doctors, schoolteachers, traveling sales-

men, who all want special consideration in the rationing plan. This could end up as inequitable as the present system.

Senator PROXMIRE. Would you expect in the future to try to tie the pricing decision of whether there are increases permitted or rollbacks and forths to some kind of an assessment of what the costs are and what the evidence shows is necessary to produce additional production?

Mr. SAWHILL. Yes; we have got to have prices go up to a point where they pull out these additional supplies, because that is a part of the function.

Senator PROXMIRE. We ought to have some basis to know what that takes. We should not have to go to $10 or $12 on new oil, as we have in some cases, I understand.

Mr. SAWHILL. We should be in the position to justify whatever the level of the price is, to say this level should be sufficient to bring on the supply.

As I said in my testimony, we are not just going to let prices go at any level to ration supply.

Senator PROXMIRE. How long is it going to take you at this point where you are going to have a rational system that the public can understand and we can have some reliance on?

Mr. SAWHILL. I think within the next several weeks we should be able to provide the data.

Senator PROXMIRE. I do have a couple of quick questions that I would like to ask.

One of the serious problems here is that consumers feel that they are being asked to take the entire brunt of this. The oil companies are really benefiting from the shortage. Their profits are up fantastically. It is true that the service station people are suffering, but the suffering does not seem to be equalized.

Does the Federal Energy Office have a consumer council, or do you plan to hire one?

Mr. SAWHILL. We have a Consumer Advisory Group.

Senator PROXMIRE. How about that. I understand that is a fine group. But that committee has had one meeting that I know of.

Have there been any further meetings?

Mr. SAWHILL. That committee is a fine group. Their purpose is to review our data, make sure we are collecting the right data, and to help us analyze this data.

Senator PROXMIRE. You have not used that group very much.

Have they only had one meeting?

Mr. SAWHILL. Yes; they have only had one meeting. The consumer group I refer to is headed by Lee White and includes representatives——

Senator PROXMIRE. Lee White is the best. I am delighted you have him.

Mr. SAWHILL. He disagrees with a lot of things we do. We welcome that kind of disagreement. He publicly talks about it. This kind of interchange is good, and we have been working with the consumer group. We have scheduled another meeting for March 3 or 4.

Senator PROXMIRE. Did you say you hired a consumer council?

Mr. SAWHILL. No; we have this Consumer Advisory Group.

Senator PROXMIRE. How about a consumer council?

Mr. SAWHILL. We established—maybe this can suffice, I do not know—a sector to work with the poor people who are really hurt by this crisis, and the function of this group is to work with those disadvantaged groups to make sure that they have access to whatever Government assistance is available to them as they are hurt by this energy situation.

Senator PROXMIRE. Is that also staff?

Mr. SAWHILL. We are beginning to build a staff; yes.

Senator PROXMIRE. I understand the consumer people are very, very concerned about the absence of a consumer council.

Mr. SAWHILL. Maybe we ought to consider establishing one.

Senator PROXMIRE. I hope you will.

Let me just conclude by asking you again about the energy statistics office. Heller, Gordon, and MacIlvoy are a very fine committee and enormously able people. You have said they have only had one meeting, no further meeting.

Why have there not been further meetings?

Was not their first meeting useful?

Mr. SAWHILL. It was very useful. They laid out to us some of the problems they saw in our data, and we are moving to correct some of those problems.

It would be appropriate for us to get back together again in the next 4 to 6 weeks just to show them the progress we have made and report to them how we have adopted their recommendations.

Senator PROXMIRE. Has the administration sent up its promised legislation for improving energy statistics?

Mr. SAWHILL. I have seen the bill. Whether or not it has been transmitted I am not sure.

Senator PROXMIRE. The staff tells me it has not been sent up.

Senator HUMPHREY. May I ask you, Mr. Sawhill, how do you feel about the bill that is before the Senate today?

Mr. SAWHILL. I think we have some concern about it.

Senator HUMPHREY. Do you support it or oppose it?

Mr. SAWHILL. We probably oppose it in its present form because of the concern we have about the way in which it requires us to regulate prices.

Senator HUMPHREY. The rollback provision?

Mr. SAWHILL. It requires us to roll back prices back to $5.25. That does not give us much to switch or to raise prices in the event higher prices are needed to bring on the alternative sources of supply in this country.

Senator HUMPHREY. The reason for that—and I realize that is a very inflexible position——

Mr. SAWHILL. If you could make it more flexible, perhaps it could be more palatable.

Senator HUMPHREY. However, as Senator Proxmire just said here, there is no reliable data that you are basing these pricing prices on. New oil, so to speak, has gone up $10 a barrel. There is no reason. Ten dollars a barrel.

Why not make it $20 or $6?

Mr. SAWHILL. That is determined in the marketplace.

Senator HUMPHREY. The buyer beware, so to speak. And the Government has got something to do besides just let a few people run hog wild.

Mr. SAWHILL. In my testimony I feel this way strongly. The price does not really need to be any higher than a long run supply and demand price. Of course, it has gone higher because of the critical shortage we face because of the embargo. And we have got to be careful not to let that price go up to levels of $10 or $15 or $20. Clearly, that is above the long range supply price.

I have no problem admitting that. The studies I have seen indicate the price is somewhere between $6 and $8.

Senator HUMPHREY. Senator Jackson, yesterday in the Senate, pointed out how you could get so-called new oil by just drilling a new hole alongside of the old one and closing up the old one and open up the new one, and you have new oil and it is in a new price range.

Mr. SAWHILL. New oil is conditioned to the supply, so to the extent that new oil replaces old oil their other supplies would not be counted as new oil if they produced more.

Senator HUMPHREY. What is the figure, $7? I believe the price in the bill is $7.09.

Do you figure that is too low?

Mr. SAWHILL. It is hard to tell. At $7.09, $7.80, whatever.

Senator PROXMIRE. The bill provides a base, that it is $5.25 with 25 percent above it. So the present bill has flexibility.

Mr. SAWHILL. Our position would be that we need more discretion than that. As we discussed, we have not at this point been able to give you a well-documented presentation on what the price should be.

Senator HUMPHREY. What we are really hearing is, in other words, you are of the opinion that oil prices ought to go above $7.09?

Mr. SAWHILL. I do not have any more data to show that it should be $8 or it should be $6. But I think before we tie the hands of people that are going to be required to administer this program, we should have a little more dialogue.

Senator HUMPHREY. I recognize you are doing pretty well when the oil prices went up. They were not on the poverty program.

Mr. SAWHILL. They were not on the poverty program. There is no doubt about that. But there is some question about how the oil companies are doing on their return on investment. That is how we measure the profitability of an industry. It is not really much different from the rest of American business.

Senator HUMPHREY. My point is that if we are going to legislate a structural organization for the Federal Energy Office, given the appropriations and the things that you require, that we want some assurance that it is going to protect the public interest. And the public interest is obviously not being protected if these prices can be set by the producer just as he would like them to be set.

Mr. SAWHILL. I do not deny that legislation is needed, I indicated in my testimony that regulations are needed. I faced that very decision when I had to decide how much to let the retail price of gasoline go up. We had to balance out the interest of the consumers and the gasoline station, as you always have to do. There is no question about it.

What I am saying is, I would rather not have my hands tied by $7.09, or a rigid price like that. As I indicated in my testimony, we are considering a rollback of this new oil price and the stripper well price that Congress agreed on. The stripper well price went up $5.25 a barrel. Did we get any more oil from stripper wells?

I do not know.

Was there cost data done to support that?

I do not know.

Senator HUMPHREY. Let me be very frank with you. There are economists and there are specialists all through this Federal Government. And it seems to me, in light of the fact that the American public is being told that there is an energy crisis, that the Government ought to be organized on that basis. We ought to have this data. We ought to be able to pull the people out of the agency to get this data, and not going around here flying the ship of state by the seat of our pants.

Mr. SAWHILL. I agree with that, Senator Humphrey. But I think the point is that you readily criticize me for letting prices go up.

Senator HUMPHREY. Not you sir, but the Office.

Mr. SAWHILL. Or anyone. But remember that the Congress freed the price of stripper wells without cost justification, just as Senator Jackson has stated. Maybe we both acted too hastily. Maybe we have got to bring these prices under some control. I admit that.

Senator HUMPHREY. Some of us were not for that freeing the price of stripper wells. Besides that, that is a small percentage.

Mr. SAWHILL. It is about the same percentage as the new oil. The new oil and the stripper wells constitute the same percentage, although small, of our basic domestic production. They are both in the 12 to 13 percent range. It does constitute a large number of wells. We have 460,000 wells in this country, of which 350,000 are stripper wells.

Senator HUMPHREY. The President and almost every other national leader has asked the American people to do certain things—turn down the thermostats, and they have told the kids to shut off all the lights. I remember when President Johnson was turning off lights around town when we did not even have an energy crisis. And it takes all sorts of things.

The public, rightly so, is being asked to make these conservation measures. And in the main, I think people have been doing a pretty good job making that effort. But when this happens, we see the big utility companies one by one asking for per unit price increases to make up the revenue that they are supposedly losing because people are conserving on the use of electricity. If the increases are allowed, what will be the effect on our Nation's conservation effort? Will not people simply say, what the hell, why should I conserve? All they do is raise my price?

You know, you freeze, you turn off the lights, you scold the kids. You do a lot of different things, and the utilities come in and say, well, business is not as good as it used to be, so we raised the price.

Mr. SAWHILL. The problem of the utility situation is that they have heavy fixed costs and low variable costs. If they reduce their production and reduce their revenues, their fixed costs go on—the cost of their debt, operating a fixed plant, and so on.

I do not think that their price increases are fully matched by the demand decreases. So the average consumer pays less for his electric bill if he conserves, even if the price goes up.

Senator HUMPHREY. Again, I think the point the Vice Chairman was making, Senator Proxmire—a consumer council, representing the consumer interest in this——

Mr. SAWHILL. I agree with you. We have this consumer group. They are very active. They disagree with us a lot. Their meetings are open to the press and the public. Maybe we even need a greater representative for consumers. I do not disagree with that. I would like the consumer interest to be heard a little more sometimes, particularly when we go in with these negotiations with the gasoline operators.

Senator HUMPHREY. One more thing. I have written to the Office a number of times about hexane, which is a product which is needed for the drying of the oil seams. And we need an allocation of it, because the industry is suffering severely. I wonder if anything has been done about it.

Mr. SAWHILL. I do not think—I will correct myself if I am wrong—that we have the authority to allocate hexane. The only petrochemicals that we are allocating are benzene and kelodine. We do have the authority to allocate the crude oil that goes into the production of hexane and all the other petrochemicals. I do not believe the act gives us the authority. It would be an extremely complex industry to completely regulate and allocate if we did move into the petrochemical industry. I think we ought to consider that very carefully before we do that.

Senator HUMPHREY. I hope you look at it very carefully, because it is terribly important. That is all I have, Mr. Vice Chairman.

Senator PROXMIRE. Thank you very much. Finally, Mr. Sawhill, I want to express my admiration for your ability and your calm demeanor under difficult circumstances.

The committee will stand recessed until tomorrow morning at 10 o'clock in room 318 in the Russell Building.

[Whereupon, at 12:50 p.m., the committee recessed, to reconvene at 10 a.m., Wednesday, February 20, 1974.]

THE 1974 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 20, 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 318, Russell Senate Office Building, Hon. William Proxmire (vice chairman of the committee) presiding.

Present: Senator Proxmire.

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. During the first part of this committee's annual hearings, we have heard an almost dizzying succession of bad news. The Council of Economic Advisers has presented us with the most pessimistic forecast for the domestic economy of any year in a long, long time. The Secretary of the Treasury has presented a similarly gloomy assessment of the international outlook. Yesterday, the Cost of Living Council added to the doom and gloom by pointing out that we have "barely begun to see" the ultimate impact which fuel price increases must inevitably have on prices of manufactured goods.

I do not mean to imply that the bad tidings which administration witnesses have brought us is in any way exaggerated. If anything, the available facts suggest that the magnitude of the impending economic disaster has been understated. Just in the past week, we have learned that in January we experienced one of the largest wholesale price increases on record, that industrial production declined for the second consecutive month, and that personal income actually declined in money, current dollars, by $4 billion.

Back in 1971, many of us felt that the worst possible combination of inflation and unemployment had been achieved. Now we see that we were wrong. This year the inflation is far worse and the unemployment seems destined to be at least as bad. And for the longer term we must contemplate an extended period during which the shortage of fossil fuels will exercise a serious constraint on many of our traditional patterns of production and consumption.

This morning we are very lucky to have three of the outstanding experts in the country in these areas before us. I have just had a chance to glance at Mr. Ackley's excellent prepared statement, but I had a chance to read more carefully the prepared statements of Mr. Houthakker and Mr. Perry. It is interesting to see the sharp contrast, and I think that is welcome. That is exactly the kind of panel that I think is likely to be most productive and most interesting.

Mr. Houthakker makes no bones about it. He starts right off by saying, "We now have 2½ years of mandatory price-wage controls behind us, and the results can only be described as a complete failure." He goes on to say, "I have said enough to indicate I do not believe the extension of wage-price controls are in the public interest."

We have Mr. Perry, who on the other side said: "Paradoxically, all this is happening despite a rather successful experience with the wage-price programs we have had since 1971. Those dealt with the wage-price spiral that existed throughout most of the nonfarm economy, and that spiral slowed in the face of a rapid expansion in output and employment. That spells success."

He goes on to say, "But I find it a great mistake to abandon all wage and price programs."

And then we have Mr. Ackley taking a different view, but a view which I am not sure precisely what he proposes, something apparently in between.

Mr. Perry also suggests something that I think is fascinating, and something that is specific and definite and will be welcome for discussion. It may not be welcome for policymakers. That is a 30-cent per-gallon increase in the price of gasoline which is his suggestion to consider, not necessarily saying that he thinks it is right, but that is one of the options he suggests.

At any rate, this morning our panel of witnesses has been asked to do double duty by discussing both the overall outlook—especially with regard to prices—and the petroleum situation. Since the committee heard testimony yesterday from both Mr. John Dunlop, Director of the Cost of Living Council and Mr. John Sawhill, the Deputy Director of the Federal Energy Office, we have plenty of questions with regard to both areas of policy. Luckily our witnesses this morning are extraordinarily well qualified to advise us on both areas.

Our first witness will be Mr. Hendrik Houthakker, professor of economics at Harvard University. Mr. Houthakker served as a member of the Council of Economic Advisers from 1969 to 1971. It is always a pleasure to welcome him before the Joint Economic Committee because we know that we can depend on him for a refreshingly sensible and candid appraisal of whatever question he is discussing. This morning we have asked him to give us the results of his recent work on the demand for petroleum products and the outlook for petroleum prices, as well as his views on the general economic situation.

Our second witness will be Mr. George Perry, senior fellow at the Brookings Institution. The estimates of potential oil profits recently made by Mr. Perry and publicized in the Perry-Heller forecast of 1974 have startled us all and have awakened the country to the need

to take measures to reduce this enormous potential transfer of income from consumers to producers. We are eager to hear his suggestions for dealing with this problem as well as his views on the overall outlook.

Our final witness, Mr. Gardner Ackley, professor of economics at the University of Michigan, was a member of the Council of Economic Advisers from 1962 to 1964 and served as its Chairman from 1964 to 1968. While at the council he was largely responsible for developing and administering an incomes policy whose consistency of design and success in operation seem all the more remarkable now that we can compare it with the unhappy succession of phases and stages which we have endured over the last 3 years. The Joint Economic Committee has turned to Mr. Ackley for advice on many occasions, but surely never before with any more critical or urgent need to know what to do next about inflation.

Mr. Houthakker, you may begin.

STATEMENT OF HENDRIK S. HOUTHAKKER, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. Houthakker. Mr. Vice Chairman, I am grateful for the invitation to appear before this committee to give my views on the subject of inflation and related matters. Unfortunately, I am not really prepared to say much about the demand for petroleum, although it is a subject in which I have an interest; I did not know it was on the agenda. To the extent I can I will be glad to answer questions on the subject.

We now have 2½ years of mandatory price-wage controls behind us, and the result can only be described as a complete failure. While we cannot know for certain what would have happened in the absence of controls, it seems unlikely that the rate of inflation would have doubled from what it was before the first freeze in August 1971.

As this committee knows, I was not a supporter of controls when they were first adopted, but the actual experience with them has been much worse than even I expected. Nevertheless, we have to recognize that popular and congressional support for controls has not yet disappeared. There are still some who maintain that the obvious failure of the control program is the fault of its administrators, not of the program itself. Although mistakes were no doubt made, I do not believe this charge can be substantiated.

The administrators of wage-price controls, in particular Grayson Jackson and John Dunlop have made a sincere, indeed almost heroic, attempt to make controls work. Mr. Dunlop's statement before the Subcommittee on Production and Stabilization of the Senate Committee on Banking, Housing and Urban Affairs, dated February 6, leaves no doubt about his commitment to the success of the program, nor about the outstanding competence and unquestioned integrity with which he has approached his task. The fiasco of controls cannot be attributed to its administrators, nor to lack of cooperation from business, labor or the public at large.

The simple fact is that wage-price controls will not work in a free and open peacetime economy. They can be successful in wartime,

when a unique national goal is generally accepted and strict enforcement is thus made possible. In fact, during major wars we have been willing to dispense with a free and open economy. Quite properly we have not been willing to dispense with it in a time of relative peace. The vast bureaucracy that is necessary not only to control wages and prices, but also to make the allocation decisions that are normally made by the price mechanism, was not set up. Of course I am not suggesting that such a bureaucracy should have been established, for I do not believe that a Russian style economy would have been any more successful in the United States than it has been in Russia. Nevertheless the attempt to run price and wage controls with a relatively small administrative apparatus was almost certainly doomed from the start.

We are now faced with the aftermath of controls, even though they are still with us. It is most important that the correct lessons be drawn from this experience. Both the Council of Economic Advisers in chapter 3 of its report and Mr. Dunlop, in the statement I referred to earlier, have tried to do so. Although they do not come to identical conclusions, the difference between their positions is not large. Presumably the President had the final word when he wrote in his economic report that "the free market is, in general, our most efficient system of economic organization, and . . . sustained and comprehensive suppression of it will not solve the inflation problem." I would certainly subscribe to that conclusion.

As the Council of Economic Advisers points out, particularly in the penetrating discussion on pages 99–103 of its report, the effectiveness of controls can only be judged by their impact on aggregate supply and aggregate demand. It may well be true, as Mr. Dunlop emphasizes, that the control program has had a depressing effect on particular prices and wages, but inflation is a rise in the general price level; holding down particular prices and wages does not necessarily hold down the general price level.

Indeed, all too often attempts to hold down particular prices and wages only create market imbalances whose repercussions have adverse effects elsewhere. When such imbalances appeared in the agricultural sector the administration wisely relaxed its control and let the price mechanism sort out the problem, perhaps not to everybody's satisfaction, but nevertheless better than any other approach could have done. Unfortunately it has not yet adopted this solution to our most urgent current problem in the area of petroleum products.

Unlike most European countries we have so far been unwilling to let the free market operate; instead we are relying on regulations that change almost daily, and not merely because of changing circumstances. As a result we have long lines before our gasoline stations, where many consumers waste their time waiting for a few gallons of gasoline. Even if the free market price of gasoline were as high as 75 cents one would have to put a pretty low value on one's own time to prefer waiting half an hour for 5 gallons at 50 cents. If it were felt that high gasoline prices would put an undue burden on the poor, this could be overcome by a system of gasoline stamps, similar to food stamps.

Indeed, outright rationing would probably be better than the chaos now prevailing in large parts of the country. Here again we see the basic defect of the present approach to controls: Prices are held down but not nearly enough is done to allocate the available supplies in a rational manner. And yet most of the pressure appears to be for further price restraints, regardless of their effect on supply and demand. The reported plans to put a ceiling on the price of "new" crude are a disturbing example. The most promising way out of our present predicament is more domestic production, which a free market is most likely to bring about.

The next decision facing Congress in the area of controls is whether to extend the enabling legislation when it expires on April 30. I have said enough to indicate that I do not believe extension of the present law is in the public interest. The time has come to admit that inflation cannot be held down by passing laws against high prices. This does not mean, of course, that we should abandon the fight against inflation.

On the contrary, the problem of inflation is worse than ever, due in part to the distortions created by the controls themselves. It appears that our financial system can adjust without too much difficulty to inflation rates up to 5 or 6 percent. When the rate of inflation approaches 10 percent, as it does now, these adjustments appear to become more and more difficult.

According to the notion first put forward by Irving Fisher, nominal rates of interest tend to equal the sum of the real rate of interest and the expected rate of inflation. The real rate of interest appears to be somewhere around 3 or 4 percent; it is usually close to the dividend yield on equities. Thus an inflation rate of 4 percent would translate into a long-term bond rate of 7 or 8 percent.

At the moment the inflation rate is almost 9 percent and expected by most forecasters to remain at this level throughout 1974. Yet the long-term bond rate is only about 8 percent, which makes the real return on bonds negative. To offset the expected rate of inflation the long-term bond rate would have to be somewhere around 12.5 percent. Such imbalances in the capital market may be temporary, but if they persist for any length of time they cannot help but have a major impact on saving and investment. With a negative rate of interest it does not pay to save; it does pay to borrow and spend, which would further aggravate inflationary pressures. In fact, I wonder if recent developments do not provide support for the ancient but lately unfashionable view that inflation necessarily accelerates into hyperinflation unless drastic measures are taken.

In this context it is also significant that outside the United States the picture is generally even worse. In several countries inflation rates are higher than in the United States and the prevailing nominal rates of interest also leave only a negative real return. A worldwide acceleration of inflation is unmistakable. As is true here, it is associated with rising prices for basic commodities, but that is not a sufficient explanation.

No doubt crop failures lead to higher agricultural prices, just as an embargo by producers leads to higher petroleum prices. Strictly

speaking, however, these are only relative price changes; it is not equally obvious why they should lead to a rise in the general price level. Price stability is not a situation where all prices remain the same, but rather one where some prices rise and others fall, depending on changes in productivity and other market forces. This is probably also why wage-price controls and income policies, which are directed only at preventing certain prices from rising, are futile if at the same time they discourage other prices from falling.

And this brings me to a subject dear to my heart, competition. It is characteristic of competitive markets that prices are flexible both upward and downward. In markets where competition is weak, on the other hand, price reductions are rare. The original purpose of cartels, for instance, is usually to prevent price falls rather than to enforce price rises—OPEC is an exception. Monopolists and regulatory commissions rarely look kindly on price reductions, although they may also have inhibitions about price increases as large as occur sometimes in competitive markets.

The most common reason for a price reduction is a rise in supply. Therefore the only effective anti-inflationary policy is one that stimulates supply. This is what the so-called procompetitive strategy, which I have advocated before this committee on earlier occasions, amounts to. Since time is short, I may perhaps refer to the hearing of November 14, 1972, and my subsequent letter to you, Mr. Vice Chairman.

Now that the failure of controls is there for all to see, the administration and the Congress should turn to measures with greater promise of success. Reforms are most urgently needed in the regulated industries and in the antitrust area. I do not minimize the political difficulties there may be in the way of such reforms, but if we want to come to grips with inflation, some bitter medicine appears to be in order.

Measures to stimulate competition will not have much immediate effect, but then there do not appear to be any measures that do—certainly not controls. It will take time to overcome the present inflation, but if we do not lay the groundwork for better price performance now we risk further disintegration of our economic system in the not too distant future. We have had our fling with controls, let us now get back to serious business.

Thank you.

Senator PROXMIRE. Thank you, Mr. Houthakker.

Please proceed, Mr. Perry.

STATEMENT OF GEORGE L. PERRY, SENIOR FELLOW, THE BROOKINGS INSTITUTION [1]

Mr. PERRY. Thank you, Mr. Vice Chairman. This is a year when the parts of the economic scene are more striking than its whole. Accordingly, I would like to summarize my position on the major dimensions of the economic outlook for 1974, and then go into some particular problem areas more fully.

[1] The views expressed are my own and are not necessarily those of the officers, trustees, or other staff members of the Brookings Institution.

OUTPUT AND EMPLOYMENT

The President and his economic advisers are advertising, "No recession in 1974." This represents a semantic rather than a substantive difference with private forecasts, including my own. The Council's expectations of declining real activity during the first half of the year, followed by renewed expansion in the second half, with a year-over-year gain of one percent in real output, lies in the reasonable forecast range. However, even with this scenario, the unemployment rate will rise to around 6 percent by mid-year and will come down little, if at all, from that level by year's end. Also, while the first half recession is as near to a sure thing as anything in economic forecasting can be, the return to strong expansion in the second half is by no means assured.

Some notable features of the 1974 outlook that lead me to this judgment include the following:

1. Declining auto production—sales off 25 percent—and residential construction—starts off 45 percent—are the main weak spots in the first half outlook. Renewal expansion in the second half depends importantly on their recovery.

2. Business investment outlays are expected to be exceptionally strong for a recession year, with a 17 percent rise in manufacturing outlays projected by the latest commerce survey. A serious cutback in present spending plans by business would jeopardize the overall expansion expected for the second half.

3. Consumer purchases outside of the auto sector will be held back by rising prices that reduce real incomes. Rising prices that are not offset by wage increases have the same effect as a tax increase on consumers. During 1973, rising food prices took away about $15 billion in consumer purchasing power, with some of this offset through higher spending by farm families whose incomes rose. Now rising oil prices are adding another tax to consumers. A 50 percent rise in the average price of all the products of petroleum will cut consumer purchasing power by $18 to $20 billion more. And with the higher receipts going to foreign governments and oil industry profits, the only offset will come through gradually rising energy investments and whatever small rise in exports to oil producers occurs.

4. Other nations will suffer a real income loss even larger than ours as a result of skyrocketing oil prices. With the higher receipts going entirely to foreigners, their economies are threatened with substantial recessions and our own exports to them will not expand as we had been expecting before the oil crisis. It is hazardous to guess from now how strong this deflationary impact from abroad will be later this year.

In view of these prospects for 1974, policy should be moving to fight recession today on at least two counts. First, because even if the downturn lasts only through the first half, unemployment rates will still be high the rest of the year. Second, because the forecast of a recovery by mid-year is necessarily uncertain, and we should be taking steps to increase its likelihood. Short-term interest rates should be sharply reduced. And fiscal policy should be made deliberately expansionary, in part through a tax reduction for consumers.

We should not be misled into ignoring the 1974 recession because its origins include the unusual situation in world petroleum markets, or because we will have to wait a year before the National Bureau tells us it has occurred. Unemployment is rising rapidly. And a recession by any other name hurts just as much.

INFLATION

Despite rapidly increasing slack in both labor and product markets in the economy, inflation will not slow in 1974. I expect the GNP deflator will rise by at least the seven percent predicted by the Council of Economic Advisers. Consumer prices will rise even more. And in the first half of the year, the CPI is likely to rise even faster than the 8½ percent that it rose during the 12 months of 1973. Paradoxically, all this is happening despite a rather successful experience with the wage-price programs we have had since 1971. Those dealt with the wage-price spiral that existed throughout most of the nonfarm economy, and that spiral slowed in the face of a rapid expansion in output and employment. That spells success. The excessive inflations of 1973 and 1974 lay beyond the scope of the programs, though not necessarily beyond the scope of any government policy.

The essential difference in the two types of inflation—the one we did moderate and the one that got away—is that wages have not paralleled the recent and current acceleration of prices. Food and fuel have added between 4 and 5 percent to the average rise in consumer prices over the past year. By this summer, if food prices rise another 10 percent and fuel prices reach levels averaging 50 percent above 1973—not unreasonable assumptions—they will have added 10 percent to the average rise in consumer prices over an 18-month period. It is crucial to any longer run hope for slowing inflation that these increases not spill over into the main body of wages and prices throughout the nonfarm sector of the economy. Equity cannot be made an issue here. Workers have not fallen behind the prices of the products they produce. And wages cannot make up for ground lost to food and fuel between 1973 and 1974 without starting a chain of wage-price hikes that would raise prices an average of 25 percent economy-wide.

Thus, today we are faced with the need to contain wage increases while at the same time restoring some of the real income lost by wage earners over the period. Part of a social contract for wage moderation should include tax reductions that would restore some of the after-tax income loss of middle and lower-income wage earners—an attempt to raise incomes via the tax table rather than via the bargaining table. I have already indicated this is good fiscal policy. In the face of current food and fuel prices, it would also serve the cause of equity. And to the extent it can substitute for wage increases, it is a tax reduction that can fight inflation.

In this situation, I find it a great mistake to abandon all wage and price programs. We need all the insurance we can get against a stepup in wage increases. Rather than retire John Dunlop, I believe we should award him the Nation's highest civilian medal and keep him on the job.

PROFITS

Having gone through a complete cycle since the peak in the late sixties, we can now judge that profits, outside the petroleum industry, have not grown extravagantly. The profit share has not gotten ahead in the inflation of this period, and the inflation cannot be blamed on expanding profit margins. In 1974, with recession reducing output and a weak productivity performance raising unit labor costs, profits in most industries will be down substantially. By contrast, in the petroleum industry, price increases will be swelling profits—by some $12 billion before taxes if crude oil prices average $7 per barrel; by some $16 billion if petroleum product prices rise by 50 percent this year; and by much more than that if product prices rise to clear the market for fuel.

THE PETROLEUM PROBLEM

The present oil crisis raises two kinds of questions. What to do about the distribution of products to consumers, including their price. And what to do about encouraging exploration and development in order to expand the supply of oil products. Good answers to each of these questions need not be mutually exclusive.

DISTRIBUTION AND CONSUMER PRICES

The present long lines at gas stations and the uncertainty about the availability of gasoline that faces consumers today has to be the worst possible way to handle our gasoline shortage. Two avenues are open for replacing this chaos with some order: Formal rationing and substantial price increases. Neither of these is exactly popular in prospect. So we go on wasting fuel while looking and waiting for it—making the gasoline shortage about half again as bad as it really is. We call out the police to keep the peace at the pumps. And we pass rules such as the odd-even day system, which is billed as rationing, but which can do virtually nothing to reduce the present chaos. If the government screws up its courage and adopts one of the alternatives, it will prove a welcome relief to consumers from what we now have—rationing by harassment and inconvenience.

Everyone will weigh the bureaucratic costs of formal rationing differently. A formal system that allowed ration coupons to be traded would remove the black market risk and would provide a safety valve to let off the pressures that a fixed allocation system would entail. While the effective gasoline price under such a system—the pump price plus the price of coupons bought from others—would be as great as the price that would clear the gasoline market in the absence of rationing, consumers who chose to get by with less would be able to buy a reasonable allotment of gasoline at a fixed, lower price. And the extra dollars spent by consumers who bought extra coupons would go to other consumers who sold their coupons.

If formal rationing were unacceptable, allowing the price to rise so as to choke off some demand would still be preferable to the present system. Someone whose time is worth $4 an hour is already paying

$1.20 a gallon when he waits an hour in line. I hesitate to offer the calculation for time worth $10 an hour and a 2-hour line—hardly an unreal situation these days. Consumers are getting no more gasoline now than they would be with market-clearing prices; and many would be paying effectively less if the whole price appeared on the pump. We are using pain to clear markets today. Using either price or coupons would be better.

Letting price clear the market does not have to imply higher profits. We could do what the Europeans have done for years and put a large excise tax on gasoline for the duration of the shortage. At a guess, a tax of $0.30 a gallon on top of present prices would probably hold back demand enough to eliminate the lines and uncertain availability at gasoline stations. And it would yield about $25 billion in revenue.

Whatever solution is adopted, it need not provide an unacceptable windfall to profits. Formal rationing with a frozen price or the use of a stiff excise tax would not entail higher prices to producers. And if prices are simply allowed to rise to clear the market, new taxes can divert most of the windfall to the Treasury.

With any solution that does involve higher prices, a further tax reduction to consumers is called for, over and above that called for by present food and fuel prices. This would ease the further real income burden to individuals of still higher fuel prices. And it would maintain aggregate purchasing power in the face of the aggregate loss of real income that these higher prices entail. Since a $0.30 gasoline price rise would divert some $25 billion either to the Treasury—if accomplished by an excise tax—or to profits—to be taxed at that level—it should be offset by a corresponding $25 billion tax rebate or reduction to consumers.

PRODUCTION AND CRUDE OIL PRICES

The foregoing discussion has been in terms of product prices for gasoline. Many present policies and proposals are directed at crude oil prices. But the two are intimately linked; how we handle one will largely determine the other. And as I have indicated, good answers may involve huge profits, some of which the Government may want to tax away. While the whole subject of possible tax changes for the oil industry is well beyond the scope of my present remarks, I would like to offer just three general points relating our long-run supply needs to our handling of the present shortage situation at the crude oil level.

1. Both the level of crude oil prices and their profile through time will be important determinants of domestic oil supplies. While estimates cannot be considered terribly reliable in this area, a price of $6 to $7 per barrel—perhaps less—will probably prove ample to make us self-sufficient in oil in the longer run. But to maximize production in the near-term when we need it badly, producers must be convinced it is more profitable to produce and sell today than to keep oil in the ground waiting for a higher price. This is doubtless a factor causing the present inadequate supply of natural gas, since producers are likely to bet the price will be substantially higher in the future. It is

also a defect of the administration's windfall tax proposal which lowers the excise tax per barrel over time. On the other hand, if tax changes are contemplated for the domestic oil industry, such as reducing the depletion allowance, phasing them in over time would have the desired effect of maximizing present production.

2. New exploration and development will depend on the prospective profitability of new ventures rather than on the present level of profits in the industry. This means the price of "old" oil matters very little for future supplies. The recent proposal to roll back the price of new oil is picking on the wrong barrels. A high present price for new oil serves a useful purpose. And the requirement that products reflect a blended price of new and old oil is counterproductive.

3. New development, both of petroleum and of substitute energy sources such as shale oil and coal, would be encouraged by the assurance of protection from low-priced imports in the future. While such protection would be wasteful under most conditions, if we are committed to self-sufficiency, it makes sense. It also makes sense to build up reserves of petroleum against the possibility of another embargo or restriction of foreign supply. Such a reserve would allow us to be effectively self-sufficient while still importing at a modest level if the price were attractive. A proposal by Charles Schultze to require importers to put a fraction of their imports—say one-third—into permanent storage would serve this purpose.

That's all. Thank you.

Senator PROXMIRE. Thank you very much, and without objection your fine supplement on "Industrial Capacity" will be printed in full in the record at this point.

[The supplement referred to follows:]

INDUSTRIAL CAPACITY

(Supplement to statement of George L. Perry)

A lack of industrial capacity will not limit recovery from the 1974 recession and should not restrain the pursuit of expansionary policies that would otherwise be appropriate. On the contrary, in most industries, a quick recovery during 1974 and a strong expansion of output will be needed to validate investment plans now underway and to sustain a continued expansion of capacity. I exclude the automobile industry, which will not be able to convert facilities fast enough to meet the demand for smaller cars this year; and I exclude petroleum, which we may have to allocate for some time to insure industrial and commercial needs are met.

From early 1973, some observers were warning that we were short of manufacturing capacity and some measures of capacity utilization, such as the Wharton Index—which showed an average operating rate in manufacturing of 96.4 percent in the second quarter and 12 out of 19 manufacturing industries at 100 percent—were sending off signals that capacity limits had been reached or approached in a wide range of manufacturing activities. Other measures, such as the Federal Reserve Board Index of capacity utilization, showed ample spare capacity—an average operating rate of only 83.4 percent in manufacturing.

In a study I recently completed, I concluded, rather anti-climatically, that the situation lay somewhere in between. A few major industries, such as petroleum refining, steel and paper were fully utilizing their plant and equipment early in 1973. But overall growth in the economy was not limited by such restraints. Although total GNP growth slowed dramatically after the first quarter, the slowdown is traceable to output in two sectors: agriculture and automobiles. Output in the rest of the economy rose at a 6 percent rate in both the first and third quarters of the year and at a 4½ percent rate in the second quarter—still faster than the economy's long-term trend growth. Over

this same interval, manufacturers added over ¼ million workers to their payrolls and production expanded at an 8 percent annual rate in durable goods industries.

Thus, there is no evidence that a widespread shortage of plant and equipment capacity limited the expansion in 1973. There were isolated shortages, but primarily of raw materials, not industrial capacity. And the very strength of the expansion—which was rapid for several quarters in a row—led to growing order backlogs, lengthening delivery times, and low inventory-sales ratios. Output cannot expand instantly in response to sharp increases in demand; unfilled orders and inventories are buffers that expand and contract to make up the difference.

Nor can much of the acceleration of prices that took place during the year be explained by operating rates. The spectacular rise in world raw materials prices and the end of Phase II price controls explain most of it. Much of this industrial price increase we have experienced may have been justified by past and concurrent cost increases. And strong markets may have helped pass these costs through into prices. But little of the price increase of 1973 seems attributable to a shortage of plant and equipment.

While capacity shortages may have been rare, the average manufacturing operating rate was high relative to the unemployment rate in 1973. Most operating rates were higher in 1973 than in 1969, although the unemployment rate averaged nearly 5 percent last year compared with 3½ percent in 1969. While the expansion of the labor force was sufficient to generate a growth in potential output of 4 percent a year, manufacturing capacity grew an average of only 2.5 to 3.0 percent a year over this interval. Plant and equipment capacity grows in response to the need for it and its profitability. But manufacturing production declined from 1969 to 1971 and profit rates fell sharply, removing the incentive for capacity expansion. Starts of new investment projects declined substantially in 1970–1971 from previous levels.

Rapid expansion in 1972 and 1973 reversed this decline in starts. It generated the need for new capacity growth. Aided by depreciation changes and reinstatement of the investment credit, this expansion sharply raised profitability. And the value of new investment projects started climbing again.

Table A illustrates these developments for manufacturing as a whole and for a few basic materials industries that experienced relatively high operating rates in 1973. For all manufacturing, the value of starts that year was 20 percent above the 1965–1969 average and 48 percent above the depressed 1970–1971 levels. If industry can look beyond the present recession to a quick recovery and new expansion of output and profits, we should expect it will continue adding substantially to capacity. A prolonged recession or aborted expansion runs the serious risk of again curtailing new investment projects just as it did in 1970–1971.

TABLE A

	Change in output (percent at at annual rate)			Value of investment starts (billions of dollars in 1958 prices)			
	1964–69	1969–71	1971–73	1965–69	1970–71	1972	[2] 1973
All manufacturing	6.4	−2.4	9.1	26.1	21.4	25.0	31.6
Primary metals	3.6	−6.0	12.1	2.9	1.9	2.3	3.2
Stone, clay, glass	3.2	−1.1	8.6	.9	.7	1.0	.7
Paper	5.9	.7	7.9	1.3	1.0	1.1	1.5
Chemicals [1]	10.3	2.5	9.1	2.8	2.4	2.8	4.4
Petroleum	3.6	3.3	5.0	4.6	4.0	4.4	4.8

[1] "Chemicals" is a very heterogeneous industry category. High operating rates were experienced in limited parts of it. And only a part of it is involved in producing basic materials.
[2] 1973 data are the average of the 2d and 3d quarters of the year.

The wage-price programs of 1971–73 will be blamed by some for discouraging investment. An equitable program for slowing the inflationary merry-go-round of wages and prices should not be bad for investment plans. However, some aspects of recent programs may have had some discouraging effects. In particular, I believe profit margin restrictions run some such risks. And I believe it invites problems to control prices in clear shortage situations, such as in lumber during the recent housing boom. But whatever modest mistakes may have been made in these directions during the past two years, the surge in

investment starts that took place *after* 1971 suggests they were not great. The great slump in new investment projects took place *before* the controls, during the recession-weak growth years of 1970 and 1971.

Table A also shows the rather different behavior of petroleum compared with other industries. Petroleum output did not suffer the kind of decline that most of manufacturing did. Yet investment projects did decline noticeably. And despite a strong rise in output since 1971 that pushed refinery capacity to its limits, new investment projects started in 1973 were only a little above their 1965–1969 levels.

Mr. PERRY. Thank you. I just wanted to keep my verbal remarks short.

Senator PROXMIRE. Mr. Ackley, please proceed.

STATEMENT OF GARDNER ACKLEY, PROFESSOR OF ECONOMICS, UNIVERSITY OF MICHIGAN

Mr. ACKLEY. Mr. Vice Chairman, I very much regret the copies of my prepared statement were not available to you in advance of today's hearing. However, being out in the provinces, where I am, and given the time when I first received a copy of the economic report, which was last Wednesday, my other obligations, and the present status of the U.S. mail, it was just impossible to have it to you in advance. Indeed, I assume it was the inadequacy of the U.S. mail which prevented my having received until yesterday morning the letter from this committee asking me to testify today and inviting me to submit my prepared statement 24 hours in advance.

My prepared statement deals only with the problem of inflation and its control, not because I think I really know very much about that, or have any answers to that most complex and puzzling problem, but because I think it is the most interesting of our current policy questions. I am going to read only a portion of the prepared statement, and then add a few comments, if I may, Mr. Vice Chairman.

Senator PROXMIRE. Well, the entire prepared statement will be printed in full in the record at the end of your oral statement.

Mr. ACKLEY. After noting in the prepared statement that a number of special events and circumstances were responsible for much of our inflation problem in the last year and a half, and that these events were largely beyond the ability of this or any administration to deal with effectively, whether through wage and price controls or in any other way, I continued as follows:

Still, the fact that these events and their consequences were largely beyond the Government's control does not relieve it of blame for some of the impact of these events. There was obviously a serious failure of the Government's agricultural intelligence system, domestic and international, which delayed by at least a year the already long-overdue ending of crop restrictions and price supports, of subsidized food exports, and of food import quotas.

These failures of intelligence also led to silly predictions of farm and food prices which have discredited the entire anti-inflation effort. Repeal of the investment tax credit as "unjustified by the national priorities of the 1970's," as well as unnecessarily rigid environmental standards, have doubtless contributed to capacity shortages in several key industries. The failure to eliminate oil import controls, when

recommended by the administration's own study committee, contributed to the U.S. shortage of refining capacity; as did an obviously faulty analysis and forecast not only by the oil industry but by the Interior Department's oil staff.

Moreover, the administration's complete ideological rejection of any Government interest in or responsibility for attempting to influence particular wages and prices from January 1969 until August 1971, and its repeated by the description of each next phase of controls as phase out, has surely neither allayed inflationary expectations, nor contributed to the success of the subsequent controls.

Indeed, the continual flip-flop on controls has been quite disastrous: in 1971, there was the flip from no truck with incomes policy in any form to full-scale controls; in 1973 there was first the flop to the relaxed self-administration of phase III, followed by the flip to a new freeze—including the incredible adventure with meat ceilings; thereafter, almost immediately, there was widespread decontrol of items just brought under control. Export controls provide another example—imposed apparently with inadequate consideration for their effects abroad, then immediately watered down or removed under external pressure. The record is one of political expediency, of an absence of clear plan or firm intention, and of unresolved ideological tensions within the administration.

I agree with the Council's basic view that inflexible, widespread direct controls, long-continued, can do more harm than good, especially in the presence of excess demand. But I do not agree with the Council's curious implication that controls can thus be useful only in a slack economy. After all, wage and price controls were clearly highly effective both during World War II and the Korean war, when the economy was exceedingly taut. In any case, to argue that controls which might have been appropriate and useful in the economic conditions of 1972 were ineffective in 1973 attaches far too much importance to relatively small differences in the unemployment rates of the 2 years, in the rates of growth of real output, or in rates of capacity utilization. It is ridiculous to contend that there was a sharp qualitative difference between a cost-push inflation in 1972 and a demand-pull inflation in 1973. In both years, inflation was a complex mixture of cost-push and demand-pull elements, with a modest increase in the latter component in 1973. And to the extent that there was a little more demand-pull in 1973, that fact, by itself, would to me have a justified somewhat wider scope of mandatory controls in the latter year. But that is not the major consideration.

I have argued on many occasions—including before this committee—that widespread mandatory controls were inappropriate in either year. But I have also contended that if they were to be used, they could and should have been used far more effectively. Controls are a very powerful instrument; thus potentially very useful, but also dangerous. If they are to be used, it should be for purposes that cannot be achieved in any other way. And except when used in the form of a temporary freeze, for shock treatment, they need to be detailed, precise, the tool of a coherent strategy, skillfully administered by an adequate staff, and rigorously enforced. Instead, much of

the time they have been employed as a blunt instrument, not tailored to particular situations and problems, with insufficient knowledge of their economic effects, and with little or no attention to the extent of compliance.

My prepared statement then discusses the Council's analysis of the effectiveness of controls in 1973—found on pages 99 to 103 of its annual report—an analysis which I find quite unsatisfactory. The Council's conclusion is framed very hesitantly or even negatively: Including judgments such as "we cannot rule out the possibility that inflation would have been greater without controls," or "no one can disprove the thesis that controls had a significant effect, although the 1973 market makes it a hard thesis to believe." But it is clear that the Council believes the net effectiveness of controls in 1973 was close to zero.

My own conclusion, equally hesitant, is somewhat different. It is expressed as follows in my prepared statement:

My own hunch—and it is little more than that—is that controls have had some effect in slowing inflation, as well as some costs in terms of equity and of efficient resource allocation. I would also hold that they could have been more effective—or less costly—or both—if their purposes and strategy had been more clearly conceived, their scope more limited, their structure more detailed and flexible, and had more resources been available for their administration and enforcement.

I suppose that what I am saying is that I think the controls might have reduced the rate of inflation in 1973 by perhaps somewhere between 1½ to 3 percentage points.

Senator PROXMIRE. You mean for the whole period?

Mr. ACKLEY. I mean that price levels at the end of 1973 might have been 1.5 to 3 percentage points higher in the absence of the controls.

At the time I prepared my prepared statement I did not have the testimony of John Dunlop before the Subcommittee on Production and Stabilization of the Senate Committee on Banking, Housing and Urban Development, which I have now received. This testimony, rather than the Economic Report, presents the Administration's plans and proposals for the future control of inflation. And although I have not had time fully to digest it, let me make a few comments based on it.

It seems to me that Dunlop's review of the effectiveness of controls is far superior to that made in the council's report. I say this not only because it tends to support my own hunch, rather than the council's, but rather mainly because it attacks the question in what seems to me to be a far more sensible and factual way.

The Chairman's letter, which I received yesterday, suggested some specific questions on which I might comment, and let me take just two minutes more to do so. First, I was asked for my evaluation of the current price outlook. I have to precede my answer by repeating what I said in a speech last December about price forecasts; namely, "that anyone who wants to know about the prospects for inflation might better consult an astrologer than an economist." Unlike our forecasts of real activity and employment, which I think are reasona-

bly good and getting better, I think economists' forecasts of price level changes have been uniformally terrible and probably getting worse. I think the reason is that our economic theory of inflation is sadly deficient, and our econometric work on wages and prices is largely a pretentious cover-up of our ignorance.

The only claim I would make for myself, and it is a very modest one, is that I think maybe I have known this a little longer than some of my colleagues. But I do not think that makes my price forecasts any better than anybody else's. Recently I have been careful to call any forecast of prices a hunch rather than a forecast. Well, my hunches, for whatever they are worth, are, first, that the speculative bulge in food and raw material prices is about over, worldwide; that, on the average, raw commodity prices may very well be lower a year from now than they are today. However, obviously we are going to have a faster rise in wages in the year ahead, to reflect what has happened to the cost of living—unless something is done along the lines of George Perry's suggestion—and that this will be taking over as the primary factor driving the inflationary spiral.

My own GNP forecast for 1974 is very similar to the council's: 1.2 percent in real GNP, and about 7.2 percent increase in the GNP deflator. However, between the fourth quarter of 1973 to the fourth quarter of 1974, it seems to show something like 6.5 percent annual increase, compared to about 7.75 percent increase within the year 1973. And by the fourth quarter of 1974, the deflator would be rising at a rate of about 4.5 percent. I repeat that I think these hunches are probably worth very little.

Another thing the letter asked for was suggestions about future anti-inflation policies. Let me say just a word on that. Much as I dislike controls, and I would prefer to see them largely dismantled, I have held until very recently that it would be a mistake to allow the existing legislative authority for wage and price controls to expire on May 1. However, I am greatly influenced by Mr. Dunlop's testimony, which points out that some 69 bills have been introduced for amendment of the wage and price control legislation. And Mr. Dunlop believes it is likely that a number of these bills might very well be attached to any renewal of general control authority. Your judgment, of course, as to whether this is likely is far better than mine. But if Mr. Dunlop is correct, I think I would tend to agree with his recommendation that it would be better simply to let the general authority expire.

I find most of what Mr. Dunlop proposes in the way of continuing anti-inflation agency and authority, using mainly voluntary methods very much in line with what I have thought and said on this subject for some time, although his suggestions are deliberately rather vague. I apparently would differ with him on some details. However, since there is not time to present my own views, let me simply refer to a short article of mine which Professor Houthakker published in the journal he edits—Review of Economics and Statistics—in August 1972, entitled "An Incomes Policy for the 1970's."

Thank you, Mr. Chairman.

Senator PROXMIRE. Thank you, Mr. Ackley.

[The prepared statement of Mr. Ackley follows:]

PREPARED STATEMENT OF GARDNER ACKLEY

The topic of today's session is listed in the Committee's press release as "Prices, Profits, and Taxes". I shall devote this brief statement only to the first of these three.

The opening paragraph of the 1974 Annual Report of the Council of Economic Advisers recites the dreary facts about the "Hydra-headed monster" of inflation: a 45% rise in consumer prices in eight years; a rate of inflation about twice as great at the end of this period as at the beginning; a complete absence of "durable success" for any of the many programs launched to stop inflation; a problem worse in many other countries than here. I accept the council's description of the situation. But did it have to happen? What can be done about it?

In a few minutes I obviously can only summarize—without developing them—a few ideas about inflation and its control, and a few comments on the treatment of these topics in the 1974 Economic Report. But I will be glad to try to extend my argument during the question period if you should so desire.

First, let me quickly dispense with two wrong answers to the question why we have failed to control inflation—answers not given by the Council but by some of its critics.

One is the monetarist answer: the fault lies with the Federal Reserve System. I regard as errant and arrogant nonsense the statement that if only we had had a different monetary policy we could now be enjoying price stability along with high employment. While I might not agree with every twist and turn of Federal Reserve policy over these years, we cannot blame the Fed for our inflation. Nor is the other, and even more important, tool of demand management—i.e., fiscal policy—basically to blame for inflation. Again, I would criticize the policy of particular years: including the years 1966 through 1968, with which I had something to do. That period of over-stimulus to aggregate demand, with the unemployment rate reduced to an average of 3¾%, and at or below 3½% for extended periods, surely kicked off this 8-year period of rising prices. But it surely cannot be blamed for the last five years' continuation and acceleration of inflation. If management of aggregate demand alone could stop inflation—or even prevent it from accelerating—the four years 1970–73 should have done it: a period in which the unemployment rate averaged nearly 5½%, and included only *one month* (after February 1970) in which the rate was as low as 4.6%.

Of course, someone may respond that, since four years of 5½% unemployment didn't stop inflation, that only proves that we needed four years of unemployment averaging 6½% of 7%—or perhaps one or two years of 10% unemployment; and he might advocate demand-management policies to deal with inflation in this way. It may be correct—though I am far from sure of it—that there is at all times some rate of unemployment high enough to stop inflation, and some rate—a bit lower, perhaps—which would then prevent it from resuming. But I would assert that these rates are (a) unknown and unknowable, and thus not useful as guides to policy; (b) fluctuate widely over time, depending on a host of other factors; (c) are in no meaningful sense to be described as "natural"; and (d) much of the time are almost surely higher than our society would or should tolerate.

In fact, it should be clear by now that monetary and fiscal policy alone cannot prevent inflation. Indeed, there is no cheap, easy, or "natural" way of doing it. Which means that if we really want to avoid inflation we must depend on costly, difficult, or "unnatural" methods—and be sure that the remedy is not worse than the disease. One such alternative method is that of wage-price controls. Such controls have now been in effect 2½ years, and it is clear that they didn't stop inflation either. However, what we want to know is whether they reduced it, and by how much. This question is treated in a chapter of the Council's 1974 *Annual Report* entitled "Inflation Control Under the Economic Stabilization Act." This, and a similar chapter in the 1973 *Report*, not only describe the broad features of the U.S. price-wage control system, but attempt, as well, an analysis of the program's effectiveness.

The analysis, not unexpectedly, reveals a certain amount of schizophrenia. On the one hand, the controls program has represented a major Administration effort, and it is not easy to admit that it was a dismal failure. On the other hand, Council Members are not known to have been strong believers in the usefulness of any form of incomes policy. Indeed, the view has been attributed

to one of them—perhaps inaccurately—that the only benefit to be derived from the use of controls would be to discredit them as a policy instrument.

First of all, I think that all of us must recognize that a number of serious inflationary events have occurred in the past 2½ years which were quite beyond the capacity of this or any Administration to deal with effectively—whether through controls or in any other way. Numerous crop failures or political difficulties in a number of countries reduced supplies of food and industrial raw materials; the unusual coincidence of strong boom conditions in many countries raised the demand for these materials to unexpected levels; so far as the United States is concerned, the devaluation of the dollar, necessary and appropriate as it may have been, further raised some domestic prices; and the recent embargo and price increases on Arab oil, which have provided the latest in the series of inflationary shocks, was clearly nothing which could have been anticipated nor avoided.

Still, the fact that these events and their consequences were largely beyond the government's control does not relieve it of blame for some of the impact of these events. There was obviously a serious failure of the government's agricultural intelligence system, domestic and international, which delayed by at least a year the already long-overdue ending of crop restrictions and price supports, of subsidized food exports, and of food import quotas. These failures of intelligence also led to silly predictions of farm and food prices which have discredited the entire anti-inflation effort. Repeal of the investment tax credit as "unjustified by the national priorities of the 1970's," as well as unnecessarily rigid environmental standards, have doubtless contributed to capacity shortages in several key industries. The failure to eliminate oil import controls, when recommended by the Administration's own study committee, contributed to the U.S. shortage of refining capacity; as did an obviously faulty analysis and forecast not only by the oil industry but by the Interior Department's oil staff.

Moreover, the Administration's complete ideological rejection of any government interest in or responsibility for attempting to influence particular wages and prices from January 1969 until August 1971, and its repeated blythe description of each "next phase" of controls as "phase out," has surely neither allayed inflationary expectations, nor contributed to the success of the subsequent controls.

Indeed, the continual flip-flop on controls has been quite disastrous: in 1971, there was the flip from no truck with incomes policy in any form to full-scale controls; in 1973 there was first the flop to the relaxed "self-administration" of Phase III, followed by the flip to a new freeze—including the incredible adventure with meat ceilings; thereafter, almost immediately, there was widespread decontrol of items just brought under control. Export controls provide another example—imposed apparently with inadequate consideration for their effects abroad, then immediately watered down or removed under external pressure. The record is one of political expediency, of an absence of clear plan or firm intention, and of unresolved ideological tensions within the Administration.

I agree with the Council's basic view that *inflexible, wide-spread* direct controls, *long-continued*, can do more harm than good, especially in the presence of excess demand. But I do not agree with the Council's curious implication that controls can thus be useful only in a slack economy. After all, wage and price controls were clearly highly effective both during World War II and the Korean War, when the economy was exceedingly taut. In any case, to argue that controls which might have been appropriate and useful in the economic conditions of 1972 were ineffective in 1973 attaches far too much importance to relatively small differences in the unemployment rates of the two years, in the rates of growth of real output, or in rates of capacity utilization. It is ridiculous to contend that there was a sharp qualitative difference between a "cost-push" inflation in 1972 and a "demand-pull" inflation in 1973. In both years, inflation was a complex mixture of cost-push and demand-pull elements, with a modest increase in the latter component in 1973. And to the extent that there was a little more demand-pull in 1973, that fact, *by itself*, would to me have a justified somewhat wider scope for mandatory controls in the latter year. But that is not the major consideration.

I have argued on many occasions—including before this Committee—that wide-spread mandatory controls were inappropriate in either year. But I have also contended that if they were to be used, they could and should have been used far more effectively. Controls are a very powerful instrument: thus potentially very useful, but also dangerous. If they are to be used, it should be for purposes that cannot me achieved in any other way. And except when used

in the form of a temporary freeze, for shock treatment, they need to be detailed, precise, the tool of a coherent strategy, skillfully administered by an adequate staff, and rigorously enforced. Instead, much of the time they have been employed as a blunt instrument, not tailored to particular situations and problems, with insufficient knowledge of their economic effects, and with little or no attention to the extent of compliance.

In short, even if I were to agree with the Council's conclusion that *these controls* have done little good, and that they have had significant costs, I would not accept the implied conclusion that *no* feasible system of controls—or other form of incomes policy—could have done any good, either in 1972 or in 1973.

In any case, I do not regard the Council's analysis of whether and how controls might have slowed inflation as either correct or helpful. The argument of pages 100–103 is a curious and confusing one. It starts by observing that there have been few shortages—other than for temporary periods—at the consumer level. Thus, prices must have been high enough most of the time—that is, prices must have advanced fast enough—always to clear the market. Since no shortages are observed, the Council concludes that controls could have restrained inflation if and only if they had either reduced aggregate demand or increased aggregate production. Neither of these seems very plausible. Ergo, price controls had no effect.

In the first place, I do not understand why the Council limits its consideration only to the consumer component of total output: shortages of investment, government, or export goods would seem equally relevant. Although I am not sure how one recognizes or measures a shortage, many seem to think that steadily lengthening order backlogs, and widespread inability to acquire and maintain desired inventories are evidence of shortages. These were surely observed; in fact, the Council elsewhere pays considerable attention to these phenomena. And other observers have thought they found evidence of shortages of consumer goods, too. Indeed, many have argued that price controls have created widespread shortages—either stating or implying that this is precisely why they are bad. The Council, on the other hand, seems to be arguing that the controls were bad—or at least useless—because there were *no* shortages!

In any case, the whole argument about shortages seems relevant only to that part of any inflationary process that is most blatantly "demand-pull" in character; or, perhaps, only to those markets in which prices are normally market determined in the very short run. Does the Council mean to imply that demand-pull is the only source of rising prices? It doesn't explicitly say this, but it seems to be implied.

From consideration of price controls, attention turns to the possible effect of wage controls. These, the *Report* suggests, might have been effective in slowing the rise in prices if, through holding down wage rates, they had thereby encouraged larger employment, greater output, and thus produced lower prices. Once again, any possible "cost-push" effect of wage increases is ignored, and thus any benefit to the price level from a suppression of cost-push forces. This benefit, of course, would be quite independent of whether or not wage controls had led to increased production.

Here the discussion wanders off into the question of how fast wage rates did rise in 1973, and whether it was faster in 1973 than in 1972. This being somewhat unclear, the *Report* concludes that, in any case, nonfarm unit labor costs rose faster than nonfarm prices in 1973, whereas this was not the case in 1972. Which leads to this bold and definitive conclusion: "This suggests—but only suggests—that labor compensation was not being held down to an unusual degree." (No reference is made, incidentally, to the other side of this coin: namely, to the view of some analysts that the faster rise of nonfarm unit labor costs than nonfarm prices proves something about the effectiveness of *price controls!*)

Following the "suggests but only suggests" sentence, the *Report* continues: "Analysis of the probable behavior of wages in relation to a longer list of variables, including the condition of the labor markets, also makes it seem probable that wages rose as much as might have been expected without controls. If so, one might also conclude that the controls over wages did not raise employment and output and so restrain inflation in the demand conditions of 1973." And that is the end of the argument. The one thing that can be said in its favor is that it is not dogmatic.

I have indicated some of the things which seem wrong with the reasoning as I went along, and many other quarrels are possible. But the two funda-

mental deficiencies of the argument are, in my view, first, that it seems to ignore entirely the significance of cost-push elements in a year like 1973 (though apparently admitting their relevance in 1972). And second, it seems to analyze a macroeconomic phenomenon—inflation—in a framework appropriate only to an analysis of individual markets. That is, it fails entirely to recognize the elementary macroeconomic arithmetic of inflation, which is quite independent of whether one visualizes prices being pulled up by demand, or incomes being pushed up by market power, or some of both. The arithmetic merely recognizes that any rise of prices itself creates the higher incomes which permit higher prices to be paid: that any net rise in money incomes in excess of productivity gains must, by definition, have been reflected in higher prices. This arithmetic makes it exceedingly difficult to distinguish in practice between cost-push and demand-pull forces. But it also implies that, if controls slow down the increase *either* in prices, *or* in wages and profits, it slows down the increase in the other.

I do not know how anyone can prove whether controls have or have not slowed inflation. The question should be—and I hope will be—the subject of a great deal of detailed and sophisticated economic research for many years to come, although it will probably never be definitively resolved.

My own hunch—and it is little more than that—is that controls have had some effect in slowing inflation, as well as some costs, in terms of equity and of efficient resource allocation. I would also hold that they could have been more effective—or less costly—or both—if their purposes and strategy had been more clearly conceived, their scope more limited, their structure more detailed and flexible, and had more resources been available for their administration and enforcement.

I regret that the *Economic Report* did not include the Administration's plans and recommendations for dealing with inflation in the future—beyond presenting its fiscal-policy recommendations and counseling patience. I understand that some of these plans have been outlined by Administration witnesses before other Committees (or perhaps before this one); but I have not yet learned enough about them to be able to comment meaningfully.

Let me therefore conclude with this brief observation. The Council's *Report*—like almost all public discussion of inflation—has a strangely ritualistic character. It dances around the subject, repeats standard incantations, but never really comes to grip with it. Maybe it is not supposed to.

We all start out by deploring inflation as one of the major economic problems of our society. But we rarely attempt to define precisely the nature of that problem, and the costs of failing to resolve it. We only "konw" that they are serious.

Next, we list the various attempts that we have made—or might make—to prevent or reduce inflation. We find that every one of these also has costs: restrictive demand-management policies reduce output, employment, incomes, and probably the future rate of economic growth. Controls involve hardships, inequities, inefficiencies, and may reduce the future rate of economic growth. Structural changes to make markets more perfect and prices and wages more flexible downward involve political, social, and budgetary costs which we cannot contemplate. They, too, might reduce the future rate of economic growth.

And there it ends. Rarely if ever do we attempt to measure or assess how the costs of efforts to restrain inflation compare with the costs of inflation.

However, if we are patient, if we are "prepared to stay the long course," we can win the battle. Go away, inflation!

Senator PROXMIRE. I would like you, Mr. Ackley, to put on your astrologer cap for just a minute and tell us what difference it would make, if you can give us a range, and you gave us a range on the effect of the 1973 wage-price controls, and what difference it would make if we had wage-price controls continued after April 30, compared to what would happen if we simply permitted them to lapse? Let us make some assumptions here. Supposing we could simply renew the wage-price controls, and provide that there would be the opportunity to impose standby restraints, or restraints imposed by the President if he found that there were extraordinary inflationary increases in either wages or prices? Do you think that would have

any effect, any perceptive effect, any significant effect on inflation in 1974?

Mr. ACKLEY. I think that the key to any possible success for an income policy, whether mandatory or voluntary—in 1974 or indeed any other year—is what happens to wage rates. And clearly, as Mr. Perry's testimony points out, there is going to be strong pressure on the part of labor, which will appear justified to at least many segments of public opinion, for very large increases in wage rates. He suggested that letting "nature take its course" on wages might add up to 25 percent to the price level. So the key is wages, and his solution was a tax reduction to buy labor's consent for some kind of continued controls. I do not know whether that would work.

I do not know whether anything will work to secure the cooperation, or at least the tolerance, of labor for some system of continuing wage restraints. But that seems to me to be the key. And I would have thought it useful to have had some legal authority to maintain wage ceilings in the hope—

Senator PROXMIRE. What I am asking, Mr. Ackley, is for you to give me—you gave me your estimate of the effect of wage-price controls in 1973. I would like your estimate of the effect in 1974, if you can give me one. If you cannot give one, I will understand.

Mr. ACKLEY. You see, I have tried to talk around your question.

Senator PROXMIRE. I know you have. That is why I want to get an answer.

Mr. ACKLEY. I think if we had a program which could achieve reasonable wage restraint, it could make a considerable difference in the inflation rate in 1974, a difference of 3, 4, 5 percent in the rate of inflation during the year.

Senator PROXMIRE. Now, that is very, very interesting and very helpful.

You are obviously in a minority position this morning, Mr. Houthakker, a position which is a majority position expressed by witnesses before our banking committee in testifying on the law itself, and a position which certainly the overwhelming majority of businessmen and labor leaders seem to take. But how about the conclusion of Mr. Perry that controls have worked well in slowing the wage-price spiral, and how about that in light of the fact that Mr. Shultz submitted to us five econometric studies, three of which made an estimate of the effect of wage-price controls on wages and prices, and all of them found they were positive, and all of them found they were significant in slowing down inflation? How do you answer that?

Mr. HOUTHAKKER. Well, there may be some difference in approach here. It is a difference which has nothing to do with which administration is in power. I see more resemblance between the views of John Dunlop and Gardner Ackley than I do between John Dunlop and myself, even though we are in the same department at Harvard. The main difference is whether one regards prices as determined primarily by wages or primarily by other factors. As Gardner Ackley has rightly pointed out, we do not have a satisfactory theory of the general price level in economics. I do not claim to have one either. But for what it is worth, my thinking has been running more

along the lines of prices being primarily determined by monetary factors, which would make the wage-price relation of quite secondary importance. As far as I can see, the level of money GNP is determined primarily by preceding changes in the money supply.

Senator PROXMIRE. You do not believe there is such a thing as a wage-price spiral that has operated in the past, or do you think it is so dependent on monetary policy that it has been exaggerated in any impact?

Mr. HOUTHAKKER. Yes, sir. I think there would be no wage-price spiral unless monetary policy permitted it. And now this, of course, is not the full answer because one could say that monetary policy itself, to some extent, is dependent on other factors. But for what it is worth, though I have personally found more success—

Senator PROXMIRE. What is your answer to the apparent direct effect of high settlements of wages? For instance, you had the settlements in 1971 of 15 percent, 12 percent in some major industries, followed by a big increase in prices.

Mr. HOUTHAKKER. I have no doubt that if wages in a particular industry go up then prices in that industry will usually go up, too. But where we do part company is in the effect of these developments on the general price level, which includes farm prices, and fuel prices, and service prices and a great many other things. What we are concerned with here is not what happens in steel. Steel is an industry with a small percentage of the GNP; I do not know the exact figure, but it is sometimes held to be a pattern setter. That is the kind of view which I do not find compelling. In other words, if you want to explain the overall price levels then we have to look at two things. In the first place, what determines money GNP, and in the second place what determines real GNP, and then the price factor comes out by subtraction. If we approach it that way, then what happens to steel wages, or rubber wages or any other wage group is not all that important.

Now, I would be the first to admit that it is a very tentative view and again I agree we do not seem to have a satisfactory theory of inflation. I am trying to elaborate one at present, but in the meantime I just am not convinced by any arguments concerning particular prices as evidence that controls have succeeded, or particular wages for that matter.

Let me say one other thing in that connection, if I may. It is quite possible to argue that the present control program has held down wages in 1973, but I do not regard that as much of a success by itself. I do not see any reason for holding down wages if prices cannot be held down.

Senator PROXMIRE. Is it not pretty unfair though, and many of us have fallen in this trap, we look at it superficially, and it is true that we have the only peacetime wage-price controls in our history, and we have the worst price inflation in our peacetime history. The simple analysis, therefore, is that it has failed. On the other hand, you recognize that the shape of inflation was, No. 1, an explosion of food prices that were not controlled, and that was obviously the result of mistakes on our part, and also enormous foreign demand; and then second, this energy situation which was something that you

could not possibly attribute to controls. If you leave those two elements out, and then if you recognize what happens, what happened in phase III when we went into a more or less voluntary system, which most people who advocate wage-price controls think is not appropriate, when you put all of these together, does it not seem that it is perfectly possible that the wage-price control system did work when you are considering what it could do, and what its possibilities were?

Mr. HOUTHAKKER. Well, if you look at it this way, by looking at particular sectors you would, indeed, come to that conclusion. But I feel that basically this is not correct, that one cannot say well, something happened in farming and the controls had nothing to do with that. The performance in the nonfarm sector has not been all that spectacular either. But more generally——

Senator PROXMIRE. It has been pretty spectacular with respect to wages. The increase in wages, including fringe benefits, has been less than 7 percent at a time when the cost of living has gone up much more than that.

Mr. HOUTHAKKER. Well, let me deal with these questions in somewhat of a different order than you raised them. In the first place, I would say that the increase in food prices certainly has been a major element in the inflation of 1973. This should have led to a lesser increase in other prices if there had been the kind of offsetting that I am talking about. In other words, if you really talk about the general price level, and not about particular price levels, than an abnormal rise in food prices would lead to a somewhat lesser rise in nonfarm prices in that respect, and the same with respect to energy. This offsetting I think has not taken place to any great extent.

Senator PROXMIRE. That is based on such an unrealistic notion of the virility of the competitive forces in the economy. Apparently what you say is that people are going to have to spend more on food so they are going to spend less on other things and then demand declines, and the same with this other thing. But it works the other way. If people are having to spend more on food, then they are likely, absent controls, because of this to insist that they want wage increases and, of course, you have the effect in fuel particularly if that price goes up, it pushes up other prices because it enters into almost everything we buy. Almost everything you buy requires energy to produce, and you have to pay for that. And we have a cost accounting system in our business establishments that passes on costs in higher prices almost automatically.

Mr. HOUTHAKKER. Well, certainly the unions try to pass on the price of living increase, although they were not very adamant in 1973, just as business will try to pass on cost increases. They do not always succeed in that. The extent to which they succeed depends on market forces, and this gets us back again to the monetary situation.

However, I would like to make one other point, if I may, on the question of wages. I do not really know whether the relatively low rate of increase of wages in 1973 is due to the control program as such. I suspect that much of it was due to John Dunlop's personal intervention. Maybe he was armed with the power of——

Senator PROXMIRE. Well, without the control program how could he have moved in?

Mr. HOUTHAKKER. Well, I would say that we are dealing there with a situation where competition is not very strong, and there is always hope for some particular intervention, at which he is extremely good. The other thing is what we have seen; that there is no evidence——

Senator PROXMIRE. Yes; but it is good because he has been using this again and again. For example, even when he terminates the programs, as he did in the fertilizer area, he used his authority to continue the program to persuade the fertilizer companies to increase their production. When he terminated controls on automobiles he persuaded them to hold down their price increases, and they made a commitment to do so. Without that authority, and without the control apparatus, he would not have been able to negotiate.

Mr. HOUTHAKKER. I agree. I think this has been one welcome development. John Dunlop has been using the power of the Cost of Living Council for what I regard as a more worthwhile end, to increase supply, and this is something there should be more of. In fact, in his statement to this Senate subcommittee he also makes this point, that this is really the direction in which he would like to see the control program evolve, and I support that notion.

Senator PROXMIRE. Well, good. But then would you follow him when he says he does not want any standby authority, his legal authority would lapse except with respect to health? And, of course, you have a separate law with respect to energy after April 30. And I think he may be saying this because he is a member of the executive branch and he does what the President wants to do. But if we do that, if we simply allow the Wage-Price Stabilization Act to die, except that minor exception for health, that we would not have this bargaining power. Is that not correct?

Mr. HOUTHAKKER. It would be important to get from him a judgment as to how important his stick behind the door has been. I believe he was here yesterday, but I did not see any report of the meeting, so I do not know what he said. I think this is really the critical matter.

Senator PROXMIRE. He was asked about that in a couple of different ways, and he did not give me a very satisfactory answer. Not that he is not a frank and an honest man, it is just that I think he is in a position where he is asked to meet the constraints the administration imposes and has to impose to get unified action within the administration.

Let me ask you, Mr. Ackley, to spell out specifically what the options are. I take it you say that looking at the political as well as the economic situation, you might very well simply let the Wage Stabilization Act die on April 30. Did I misinterpret that?

Mr. ACKLEY. No; I do not think you misinterpreted it. It seems to me that Mr. Dunlop, at least by implication, says he hopes to have some new legislative authority. He refers to the possibility of legislative authority which would permit him to require advance notice of wage and price changes. He refers to the possibility of hearings and so on. I would add some further elements to that authority which might even permit some authority, in exceptional circumstances, for advance notice.

Senator PROXMIRE. Advanced notice? I am not so sure about that because this is the difference, it seems to me, between the proposal that Mr. Arthur Burns made to us, which would have required advance notice, and an opportunity for hearing, and a holdup on wage and price increases for 30 to 45 days in paysetting industries. This specifically, categorically was opposed by both Mr. Dunlop and Mr. Shultz when they appeared before the Senate Banking Committee. They said they were opposed to anything like that.

Mr. ACKLEY. Well, I am looking at pages 55 through 60 of Mr. Dunlop's prepared statement before this committee, and he lists his and the administration's recommendations. On page 57 he says that:

> There are a series of activities and measures which the Government can, and should, undertake to contribute to moderation of inflation * * *. Among the activities to be undertaken are the following, briefly stated, and without detailed elaboration: Have authority to require reports on prices, wages, imports, and exports and to compel attendance at public hearings to explain price and wage decisions.

Senator PROXMIRE. Exactly. Exactly. Well, that is nothing. He requires reports. They do not have to give an announcement that they are going to increase the price. They put it into effect and then they report as to why they did it, maybe. But there is no indication in advance of a price increase by the steel industry, for example, or the automobile industry, or in advance of a wage determination, that there has to be advance notice so that anything can be done about it. The reports, yes, and discussions and all——

Mr. ACKLEY. What I am saying, Mr. Vice Chairman——

Senator PROXMIRE. [continuing]. And debate and so forth. But no opportunity for any kind of influence on that decision by Government.

Mr. ACKLEY. All I am saying is that I would give that kind of authority—whether it is what Mr. Dunlop had in mind or not—to require advance notice, to suspend the effective date of proposed wage and price changes, to investigate, to compel testimony, and perhaps—as a last resort—authority in specific circumstances to impose temporary mandatory orders to control specific wages and prices.

Senator PROXMIRE. Now, that last, he did not ask for that, did he?

Mr. ACKLEY. No; he did not. You could be correct in saying he did not ask for any of this. He did, however, close his statement by saying that: "The administration looks forward to working with members of this committee and your colleagues in the Congress to develop specific legislation that will meet the needs for a continued and practical stabilization effort." It seems to me that Congress can well take up that challenge to work with the administration to attempt to evolve some kind of useful legislative authority. I refer, of course, to legislation which would permit the continuation of some significant effort to influence particular wages and prices.

Senator PROXMIRE. Well, then, let us take another specific area. Mr. Dunlop has vigorously opposed any economywide wage guideline of any kind, or price guideline of any kind, especially in 1974. And he says any realistic wage guidelines would be very high, and would become a floor. You were one of those, along with Mr. Heller, and a

very few others who were the principal architects of what I think was a very successful wage-price guideline program from 1962 until 1966 when it was blown out of the water partly by the Vietnam war and partly by the airline situation. At any rate, should we have a wage guideline in 1974? Is that practical? Is it possible?

Mr. ACKLEY. Mr. Dunlop has opposed specific guidelines for a great many years. He used to argue with us during the days of the guidepost that it was a mistake to have a specific standard, although he sympathized with the effort to influence wage decisions. I respect very much Mr. Dunlop's judgment in this matter because I know his long and distinguished experience in labor negotiations. Nevertheless, I continue to feel that some kind of standard, not necessarily as explicit or as detailed as the ones included in the "Guideposts" is necessary, at least to have in my mind, if not in black and white.

Senator PROXMIRE. Let me see if we can get at something specific now. Now you, when you were on the council, the guidepost, as I understand it, was for a 3 percent wage increase. The assumption was that you would have relative price stability. That worked extraordinarily well. We had very limited inflation during that period. Now, I take it that you would try to go along with Mr. Dunlop not to have a figure, a precise figure. But what could you do that would be effective absent a figure? Would that mean anything?

Mr. ACKLEY. Well, I would suggest, Mr. Vice Chairman, that the guidepost of 3.2 percent was a general standard, that the guideposts themselves provided for various kinds of exceptions. They were, of course, as you recall—

Senator PROXMIRE. Would you want to put that into effect again?

Mr. ACKLEY. Yes; I would; certainly that substantial exceptions would be required.

Senator PROXMIRE. What kind? What kind of guideline would be possible in a year when they predict a 7 percent inflation, and we have just had 8 percent, and it may be much more than that? What could you put into effect that would not give an inflationary bias to wage settlements?

Mr. ACKLEY. I think some kind of escalator clause obviously has to be provided in a situation in which inflation is already very much an established fact.

Senator PROXMIRE. Then perhaps what you would do is have a cost of living escalator. Would you permit the full increase in the cost of living to be translated into wage increases?

Mr. ACKLEY. I think trying to spell these things out in advance is rather difficult. There are all kinds of options. One would be to permit full escalation, but only if the wage increase—independent of the escalation—is lower than permitted otherwise. And there certainly ought to be room for exceptions and modifications to fit the circumstances.

Senator PROXMIRE. You see, here is what really bothers me. What I am concerned about is that we have had a far more reasonable and statesman-like and economically wise performance one way or another, for one reason or another on the part of labor than I think anybody had a right to expect in 1973. It was extraordinary, I think, and we would all have to agree to that. Now, we see what is happen-

ing in Europe, and we see in Germany some of the unions, where they have a fine record of controlling inflation under tough circumstances, you see in Germany you have a demand for a 15 percent increase on the part of the civil service workers. You have in Britain the whole economy closed down. They are asking for what, a 35 or 36 percent increase. Now, it seems to me it does not take much imagination to see that this kind of a nightmare might very well hit this country unless we are able to work something out, because I do not see how labor can stand still year after year if we are going to have the kind of inflation which seems to be coming up this year, and with the very frightening possibility that it might continue and might feed on itself. The notion that the last half of 1974 is going to be better than the first half might work out, but the inflation I have seen in the past tended to last longer than that, and with controls being abandoned that this could be a very, very tough and serious problem. And we may be making a critical decision in the next few weeks. Now, that general language about how we ought to try to have some kind of a vague escalator in there is not very helpful.

Mr. ACKLEY. Well, I did not come prepared, Mr. Vice Chairman, to suggest standards for a wage control or wage guidepost effort in 1974. And all I am suggesting is that authority of a general sort for some kind for continuation of government interference in the wage and price making processes seems to be important, although it will take a lot of skill and a lot of good luck to make it amount to much. But we ought not to pass up any opportunities, and it seems to me that simply allowing all authority to expire would be passing up an opportunity rather unnecessarily.

Senator PROXMIRE. Mr. Perry, you are the member of the panel who has indicated that you felt wage-price controls had worked well with respect to wages, and I think there is a lot of evidence that it has. What can we do with this, if anything, for 1974, in your view?

Mr. PERRY. The President did not want the authority to go into the control program once before, and Congress gave it to him, and it turned out that he used it. So I don't know why Congress should hesitate to keep that authority on the books. The President can impound that authority, but at least it is there.

As to what a program could hope to do at present, for starters the principle that there is no way—short of a ruinous general inflation—to raise wages to compensate for what has happened in food and fuel prices has to be recognized.

If wages were to escalate to make up for what food and fuel have done to living costs, the prices of the things those wages are paid to produce would go up correspondingly. That would require a further catch-up for wages, leading to further price rises and so on. Given the initial rise in food and fuel, the whole process does not stabilize until the entire average price level is 25 percent higher. We cannot really contemplate this. So we must recognize, in any program for wages, that the price increase that we have gotten in the food and fuel areas has to be borne in the form of a loss in the real wage.

Senator PROXMIRE. Just conceivably it might work, especially if your scenario of profits works out, if profits moderate and prices do not go up the full extent, that we might expect conceivably that

might work out. But I think that is very, very optimistic. I have spoken to a number of industry groups in the last week or so since we had our recess. They are all pleading, crying for wage-price controls to go off. Now, why? Well, they say they are going to have to push their prices up very, very sharply in all kinds of areas. Now, when that happens, of course it means that you are going to get higher prices, and also much higher profits. Every kind of inducement for labor unions to say, well, we cannot sit around here and accept a 7-percent increase when the inflation is going to be worse that that, and we are going to have to get 10, 12 percent. This is what concerns me, Mr. Perry.

Mr. PERRY. The possibility concerns me too, and I do not think that there is an easy answer, but it would not hurt to try something. This is why I put forward the proposition of a social contract under which the Government would use a tax reduction to restore the real income lost by wages in exchange for moderation in wage increases.

Senator PROXMIRE. How big a tax cut would that be?

Mr. PERRY. Well, it depends whether you are worried primarily about the lower and middle income wage earner, or whether you try to do it for all incomes throughout the economy. Total wage and salary payments come to about $700 billion, or about $600 billion after taxes. If you were to offset the real income loss represented by a 3-percent price increase, on that total it would come to $18 billion. By concentrating on middle and lower incomes, it would be substantially less.

Senator PROXMIRE. Do you think a temporary reduction for 12 or 18 months in the social security tax—that is the most regressive tax, it hits the payroll directly, it hits people with incomes of $13,000 and less—would you think this would be a practical way to meet this?

Mr. PERRY. Yes. That would be an excellent tax to work with. It would concentrate the benefits right in the middle and lower income wage earners group.

Senator PROXMIRE. Given the outlook for the economy overall, would all three of you gentlemen agree that that would not be inflationary.

Mr. ACKLEY. Mr. Vice Chairman, I need to enter a mild dissent on the question of tax reduction. I tend to believe my own forecasts of real income and employment; and in the kind of economy that seems to me most likely, it is not at all clear to me that additional fiscal stimulus is desirable. Now, it may work out that the economy is going to need fiscal stimulus, and I think it is reasonable to begin discussing possible tax reductions. But I have not yet reached the point where I am ready to say I think we need it. It seems to me that, for the long run, we will have a serious problem maintaining sufficient tax revenues to do the kinds of things we need to do on the expenditure side of the budget. Certainly any tax reduction ought to be temporary.

Senator PROXMIRE. Mr. Houthakker.

Mr. HOUTHAKKER. Well, I am rather more sympathetic to the idea of a tax reduction. I do not think there is a cast iron——

Senator PROXMIRE. You say you are sympathetic or are unsympathetic?

Mr. HOUTHAKKER. I am sympathetic. I do not think that there is a cast iron case for it, but I can well see the economy deteriorating further in the beginning of 1974 to make that case more convincing. So we are extrapolating right now. I would say that the outlook at the moment is for further increases in the unemployment rate, and given the long lead time which we know exists in tax reduction, it is not at all amiss to start talking about it now. There are undoubtedly people who feel more strongly about it than I do, and they might make a case. If it turns out that that case is wrong, then there is still time to back away from a tax reduction.

Senator PROXMIRE. How about doing two things at once, how about the kind of tax reduction I have talked about combined with the kind of a tax increase that Mr. Perry talks about, maybe not quite as big as he suggested. He suggested a 30-cents-a-gallon tax which he suggests would raise $25 billion. Now, it seems to me it is impossible to have any tax like that politically unless you combine it with some kind of a tax reduction. But that might do a couple of things. Number one, it might give relief to wage earners, and number two, it might discourage gasoline consumption and limit demand. And then, number three, in addition, of course, as Mr. Perry points out, it would reduce the enormous profits that otherwise the oil companies would get in the transfer of income from consumers to the oil companies.

Mr. HOUTHAKKER. Well, I am very sympathetic.

Senator PROXMIRE. Do you think that kind of combination might be appropriate?

Mr. HOUTHAKKER. I think it would work well. I have always been sympathetic to the idea of an excise tax on gasoline and perhaps other petroleum products.

Senator PROXMIRE. What bothers me about this position, and maybe Mr. Perry would like to answer it, too, is because both you gentlemen indicated that you thought if the price went up to 75 cents, I think you said, per gallon, it might reach an equilibrium price. And Mr. Perry said 80 cents, and that would be a 50-cent price and a 30-cent tax and that might do it. I have not seen any evidence of that at all. You recall what happened in England in World War II when the price of cigarettes tripled, went up from 25 cents to 75 cents a pack. The consumption dropped off about 5 percent for a little while, and then went right back up to where it was. I think people are hooked on travel and on gasoline maybe almost as much as they are on cigarettes. So I am not so sure. We have no studies that are definitive at all. We have no experience with this kind of thing. We just do not know what the elasticity of demand is. Is it not possible you might have this imposed and have the same lines that you have now, though even worse frustration with people paying so much for the gasoline they buy?

Mr. HOUTHAKKER. Well, Senator, I think we do have quite a bit of evidence by now on the elasticity of demand for gasoline, not only from econometric studies, but also from what has actually happened in a number of countries. In this country there is already an apparent fall in gasoline consumption.

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Senator PROXMIRE. Yes, but that fall in gasoline consumption is certainly, a great deal of it, maybe all of it, not as a result of increased prices, but of the enormous inconvenience, no stations open on Sunday, long lines any other day in all of our cities, big cities. Certainly that has been a principal element in reducing gasoline consumption, plus the people have wanted to cooperate with the government at all times, most people do, and they have been cutting down on their driving.

Mr. HOUTHAKKER. Well, Senator, I am not talking about the last 3 months now. I am talking about the first three-quarters of 1973 when there were no real shortages, perhaps a few local problems, but probably everybody did get gasoline without too much difficulty, even though not always at the first station he went to. There is evidence that consumption in that period was held down quite significantly, presumably by higher prices.

I may perhaps refer you to a paper done by my collaborator, Mr. Verleger, for the Council on Environmental Quality, which was released by CEQ last December. It reviewed the evidence in considerable detail, and comes to the kind of conclusion that George Perry and I have come to, that the equilibrium price would be somewhere around 75 to 80 cents. I do not think we can attach too much significance to the 5-cent difference between us.

Senator PROXMIRE. How high is it in foreign countries? Is it not as much as $1.25 in Italy and so forth, and people are still driving a great deal. And our affluence is so much greater, and our reliance on automobiles is so much greater than other countries.

Mr. HOUTHAKKER. I was visiting in Germany last month and had occasion to look at the gasoline consumption figures. Prices have gone up there quite sharply because there have been no price controls, and there is already a decline in consumption below the level of 1972. So it appears that through December of 1973, despite a very strong economy, the European countries too, or at least Germany, have provided evidence of higher prices restraining gasoline consumption significantly.

Senator PROXMIRE. Mr. Perry.

Mr. PERRY. I agree.

Senator PROXMIRE. Do you have any other evidence that you will reach an equilibrium at 80 cents a gollon?

Mr. PERCY. I do not think either Mr. Houthakker or I would stake his reputation on precisely what the necessary price level would be. With elasticity estimated at around 0.2, doubling the old price would bring it to about 80 cents, and would cut back demand by about 20 percent, which about matches the drop in our supply. There are a lot of things they can change in the supply situation, and if we have a little more gasoline by this summer we could have a little lower price.

Senator PROXMIRE. I take it Mr. Houthakker would be inclined to do this without a tax increase. An increase works both ways, No. 1, to reduce demand and, No. 2, to increase production and supply. Is that right?

Mr. HOUTHAKKER. Supply is always important. However, I would say there is a case for increasing the excise tax on gasoline anyway, and there would still be a large enough increase to stimulate domestic

production. Domestic production, of course, is a very important part of the long run solution. But, in the meantime, the excise tax would help, too.

Senator PROXMIRE. Here is the difference between your position and that of the Federal Energy Office as given to us yesterday. I think you have argued, both you gentlemen have argued now that worst of all we have a higher price, but we have long lines, so we have to wait in line for gasoline, and we have to pay a higher price too. You are saying why not let the price go up to a point where you would reduce or eliminate the lines, but they argue, and it makes some sense if it is workable, they argue that the price should not go any higher than the long-term level, that if it goes up above a level necessary to get an increase in production in the longer term that it is an unnecessary price and it is extracting funds from the consumer for the benefit of the oil company. Is it not true that it takes 2 to 3 years from the time the oil company gets their revenues until they can begin to invest them in greater exploration and production and so forth?

Mr. PERRY. I do not understand that at all. If there will be more food available in 1975, is that a reason for trying to hold today's food prices to a 1975 level?

Senator PROXMIRE. Could be. Why not? Why not?

Mr. PERRY. Well, we could have long lines at the meat counter, too.

Mr. HOUTHAKKER. I have the same feeling as Mr. Perry on that subject. I believe that in the long run the price will not be as high as it is now; it will not be anything like the $10 which we now have for new oil. However, I do not think we should try and second-guess this too much. Our record of second-guessing these things is very poor, and I myself have come up with lower estimates of long-run equilibrium prices, but we know the estimates are inaccurate and we should not put too much faith in them. There is no great harm at the moment in having higher gasoline prices. They will stimulate a restructuring of demand, which we need.

Senator PROXMIRE. But you see what the higher price does; it does not result in any increased production if the oil company or the farmer figures that the price is going to come down within a year or so, when any production plans he makes could begin to reach fruition, so that all it does is mean a higher price for the consumer and a higher profit for the oil company, without accomplishing any end in terms of increasing supply. That is the position that they take. You think that is wrong?

Mr. PERRY. I think to some extent it is backwards. Oil does not spoil, and if the producer thinks that the price of oil is going to go up—because this control system is going to break down or for whatever reason—he will reduce his present output in the hopes of selling at a higher price next year. I think that is a very important factor, and we could be doing ourselves a great deal of harm by ignoring it.

Senator PROXMIRE. I see, if you let the price go up now, and it is going to go down in the future, that means that he is going to reduce his inventories and sell whatever he can in the short range, because he fears the price will be lower?

Mr. PERRY. That is the way he is influenced in making today's supply decision and I am afraid we may be inducing him to make the socially wrong decision.

Mr. HOUTHAKKER. I agree with that.

Senator PROXMIRE. Let me ask you this, Mr. Perry. Do you believe any gains in domestic oil production can be obtained for prices of new oil above say $7 a barrel, and would any producer in his right mind invest to develop oil estimated to cost more than that amount, or even that much? Is there any reason why the price of old oil should be rolled back to say $4 or $4.25?

Mr. PERRY. Yes. I see no reason not to roll back the price of old oil to the extent that we worry about price at all. It produces a windfall that domestic producers are getting at the moment. It corresponds precisely to the increase in the national treasury of other oil producing nations, and it does not serve any purpose.

Senator PROXMIRE. Why does the price of new oil have to be above $7?

Mr. PERRY. One reason is the one I have just offered you; it is important for producers to look forward, not to a rising price but, if anything, to a falling price. We cannot assure that, we do not know what the future price is going to be. Guesses that one could make now suggest that $6 or $7 oil would make us self-sufficient. Those are guesses. I do not think we can rely on them terribly much and perhaps a lower price will do it. We have to let the system work and see what happens. However, I think that would be a fair guess.

However, between now and then the producers are going to be playing a game of deciding when to bring their oil out of the ground. If they think at the present there is an inequitably low price for new oil, or for some reason that prices are going to go no higher, they will restrain production. There is a greater deal of additional profit in waiting for higher prices. So I think that it just serves very little purpose to try to hold down the price.

Senator PROXMIRE. When you consider the price only about a year ago, in fact only about a year ago the price of oil in the ground was $3.60, and now the old oil is $5.25, and new oil, heaven knows how high that price is. And when you consider the fact that when you increase that price you not only increase the profits, but also the value of the reserves in the ground, which is not reflected as yet in their profits, and will not be for years, when you put all of that together you wonder how you can possibly justify an increase, further increase in price. Certainly that increase, that doubling from $3.0 to $7 is going to result in far more oil being produced, because if it is uneconomical to produce oil at $3.60, it is more economical to produce oil at $4, still more at $5, still more at $6, and still more at $7. How much do you need? We were producing 70 percent of what we needed at $3.60. It seems to me that without some hard facts, without some data, without some basis for this, it is just very wrong to permit this price to go up and let the oil companies really determine what kind of price they want to extract.

Should we not require them to make some kind of showing? You see, we are victimized in this government. All of the data comes from

the oil companies. The Interior Department testified to that and so did the other agencies that deal with oil. So it would seem to me that we ought to require, since they have all of the data, to require them to make a showing, a proof that their costs have gone up that much.

Mr. HOUTHAKKER. The only way in which we can get out of our present problem is to have more domestic supply, and I am quite willing to live with somewhat higher prices if that is what it takes. The important part is to maintain competition in the petroleum industry, and that will drive the price down if it is too high. I do not think anybody can be very certain about what the long-run price is going to be.

Senator PROXMIRE. I would sure like to know how you make competition effective in that industry. They have been successful in this period, when there is such enormous demand and need in knocking out a lot of their independent marketers, and the independent refiners have been suffering for years and years. They have a vertical integration and enormous power in the seven big oil companies. So they are able to greatly reduce competition, effective competition.

Let me ask you, Mr. Ackley, how would you feel about the controlling of oil prices, new and old?

Mr. ACKLEY. I guess I am more sympathetic with the administration's position on this than my colleagues are. It seems to me that a substantial increase in the price, if it occurs, certainly must be through a tax and not through simply letting the price seek its own level. In the first place, I do not think seeking its own level means very much in this industry. I do not think if you took those ceilings off the oil industry that prices would go up to a clear-the-market level. They do not know how to set clear-the-market prices. They have never done it. They never will. They would be ashamed of their profits. I think it is silly to assume that these firms behave like pure competitors, or they are all that rational about taking oil out of the ground today versus 2 years from now.

Remember also that there is a refinery shortage here, and that you cannot increase the supply very much in terms of refined products, even if you gave them the incentive to pump oil out of the ground faster. I think clearly we have got the worst of all possible worlds now with the controls but no rationing. I would like to avoid rationing if possible. I am not sure that it will be possible. But certainly I would not support a crude oil price level, and the attendant profits, which would produce the gasoline prices of $1 or $1.25 a gallon, on the ground that these were necessary to ration use of gasoline.

Mr. HOUTHAKKER. I would say that the correction of prices like $1 and $1.25 would come very quickly.

Senator PROXMIRE. I am sorry, I missed that. The correction what?

Mr. HOUTHAKKER. The correction of prices that Mr. Ackley mentioned at $1 or $1.25 would come very quickly, because at those prices it is very profitable to produce gasoline, and there are not that many barriers of entry. It is an industry where there are a great many small firms.

Senator PROXMIRE. What about the refinery shortage? Now, it takes years to build a refinery, and the fact is that we do have a serious refinery shortage. We have bought our refined products from

outside this country and, of course, we have great limits on what we can buy abroad, and we have very little control on the situation abroad, and the price abroad has been skyrocketing.

Mr. HOUTHAKKER. At present levels of demand, our refining industry can supply nearly all products, with the exception of residual fuel oil. Our refineries for years have found residual fuel oil an unprofitable operation and, therefore, have produced very little.

Senator PROXMIRE. You mean to say with an increase in demand of 5 percent a year, compounded, that our refinery capacity is adequate in view of the fact that we have had to import from abroad much of our refined oil?

Mr. HOUTHAKKER. We have not been importing that much of our gasoline and other refined products. We have been importing residual fuel oil. Also I do not believe that a 5 percent projection for the increase in consumption is realistic any more. This year, in 1974, we may well see an actual decline, not just a relative decline, an actual decline. In 1973 we probably had an actual decline in overall consumption.

Therefore, we should avoid the trap of just extrapolating blindly by some percentage figure. Consumption is responsive to price, and more so in the long run than in the short run. As a result we are not faced with the kind of figures that the National Petroleum Council has asked us to believe.

Our refining industry has expansion plans right now under way. They can refine at the moment probably between 13 and 14 million barrels a day. That is not enough for our overall consumption, but it is enough for everything except residual fuel oils.

Now, we probably will have to figure on importing residual fuel oil for some time to come, and this should not be a great problem because in other countries, in the Caribbean and in Western Europe, the refining industries do produce residual fuel oils, because there is less consumption of gasoline. Therefore in the next few years we can count on getting some supplies of residual fuel oil, for which we have always been a major market. The refining industry argument is not as compelling as you apparently believe it is.

Mr. PERRY. Senator, may I just add something?

Senator PROXMIRE. Yes.

Mr. PERRY. To the previous question, the question need not be whether profits are going to be extravagant. In the first place, a combination of a frozen $4 market price of old oil and $10 new oil represents about the same total revenues as $5 old oil and $7 new. The aim of trying to contain some of this total price and profit increase is not what is in question here. The question is should we be willing to roll back the price of old oil, which serves little useful purpose for inducing activity, and let the price of new oil go, which does. That is a trade off between the old oil and the new oil, and it need not change the total profits in any way.

Finally, if you do add another dollar to the price of new oil, that just is not adding very much. That is adding eight-tenths of a cent to the average price of gasoline, and I just do not think that is an issue over which we should take a lot of risk of messing up the supply situation.

Finally, we now have a requirement for blending these prices. You have to blend the crude oil price and sell a blended product. That is counterproductive.

It would be better to tell producers they are not allowed to blend. At least in that way we would be choking off the maximum amount of demand by selling, at the margin, a high priced product, that produced by imported and "new" oil. Those who want it can buy it, but they are going to have to pay the full price. When you take that and average it in with some cheaper oil, you lose a lot of the good effect of high price, basically because the consumer buys more than he should.

Senator PROXMIRE. I wonder how you can have that kind of a situation in a competitive situation?

Mr. PERRY. But at present it is not a competitive situation.

Senator PROXMIRE. There is one station that I bought gas a week ago for 60 cents a gallon because it is a foreign product, and I went into another station in my State and they have it for 45 cents. Now, you cannot have that. But what you are suggesting would continue the differential on a different basis. You would say you have a higher price for the new than the old.

Mr. PERRY. I am saying reverse the law, insist that you must charge the different price, rather than insisting that you may not and you must blend.

Senator PROXMIRE. You certainly will have longer lines.

Mr. PERRY. Some production will be sold at its true, high price, and that has the maximum effect of suppressing demand. The rest would require rationing or lines such as at present.

Senator PROXMIRE. Well, let me ask, getting to something else rather quickly——

Mr. HOUTHAKKER. Senator, may I just add one thing to what Mr. Perry said. If old oil is defined unambiguously, then I would agree with him that its price has no effect on the production, and we should roll back that price. But the distinction between old oil and new oil is a very temporary one. The danger of rolling back the old oil and letting the new oil free is that people will drill more wells, and those will be new oil supply, but they will let the production from the old wells decline. So I would hope we do not roll back the price of old oil because that would also have a serious impact on supply.

Senator PROXMIRE. Well, let me get back very briefly before we conclude to what really separated you gentlemen on wage-price controls. I think almost anybody could be happy with this panel or unhappy because whatever your viewpoint you have a champion here. You have Mr. Houthakker who said get rid of the whole thing. You have Mr. Perry who said it works well, we ought to find some way of continuing it. And you have Mr. Ackley who is in between. And I want to see if I can get from Mr. Ackley a somewhat more definite, once again, somewhat more definite description. You said that we need detailed, precise, coherent, adequately staffed, vigorously enforced controls if we are going to have controls. This is the kind of system that works if you have it. Do you think it is practical now to have detailed, precise, coherent, adequately staffed and vigor-

ously enforced controls? Can we do that now with the political attitude that we have, and with the experience that we have gone through for the last 2½ years?

Mr. ACKLEY. Mr. Vice Chairman, I think if you are going to have controls, then they ought to be that kind of controls. But I do not think that we needed to have, or ought to have had, or now ought to have such controls on a broad scale. I would prefer, if I could have my way, simply to extend the authority as it now exists, and permit the administration to do what it thinks it best can do. But I do not advocate extension of widescale controls.

Senator PROXMIRE. Where do you differ from the administration's recommendations, if anywhere? What they have advocated is continuation of energy controls separately, and the controls in the health area, period, except they would require reports, they would require information of various kinds, but no advance notice on prices, and no authority to act to either prevent price increases or rollback prices or wage increases. Now, where do you differ from that prescription that they have proposed?

Mr. ACKLEY. My real preference would be detailed legislation setting up an income policy authority which would provide very specific kinds of grants of authority to a new agency which would be setup in the law. Now, that probably is not possible in the present situation. There is no such proposal on the board.

Senator PROXMIRE. What would that agency do with respect to wages and prices? What would it do?

Mr. ACKLEY. It would have the authority to require advance reports, to delay, to hold hearings, to make recommendations.

Senator PROXMIRE. Good. Okay.

Mr. ACKLEY. And in exceptional cases to prohibit.

Senator PROXMIRE. You say to require advance notice?

Mr. ACKLEY. Right.

Senator PROXMIRE. Of wage and price increases of substantial significance to the economy?

Mr. ACKLEY. Right.

Senator PROXMIRE. You would pretty much go along with Mr. Arthur Burns' proposal?

Mr. ACKLEY. As I understand Mr. Burns' position, it is very similar to mine, yes.

Senator PROXMIRE. Mr. Perry, would you agree with that?

Mr. PERRY. What is important is that we somehow do something with wages. That we do not give up Mr. Dunlop's ability to do something in this area.

Senator PROXMIRE. Well, this would do it, this would provide the authority to hold up a wage increase until he could take a look at it, and then perhaps exert whatever influence they can.

Mr. PERRY. Okay.

Senator PROXMIRE. Mr. Burns' proposal, however, would not permit a rollback. It would simply permit hearings, and that is it. If Congress then decided it would like to act, or the President decided he wanted to ask Congress for the power, he could do so.

Mr. PERRY. I think it is very hard to define exactly what power is needed. Mr. Dunlop is kind of a one-man band, and he does it very well. I would just like to give him whatever he needs.

Mr. ACKLEY. I think the simplest way, Mr. Vice Chairman, would simply be to renew the present authority, inasmuch as there is no coherent alternative plan now spelled out, and no legislation drafted. That would permit, if the administration wanted to and were willing, to do any of these things that we have talked about.

Senator PROXMIRE. Of course, it gives the President of the United States a tremendous amount of power.

Mr. ACKLEY. I agree that it does.

Senator PROXMIRE. I can think of no economic power more severe in our society than the power to control prices and wages. That is the name of the game. But your answer is that you would give him that discretion. All right.

Let me ask, I think Mr. Houthakker, your position is very clear on this. Now, let me finally ask a question relating to interest rates. All of you apparently expect interest rates to remain at very high levels. I have here the economic indicators, and they show that the latest figure on FHA new home mortgage deals is 8.78 percent, 8.75 percent. Now, as we know, this level of interest rates is devastating to housing, small business and local government. What are your observations on what can and should be done?

Mr. Houthakker.

Mr. HOUTHAKKER. Well, I feel that interest rates will remain at this level and, indeed, at even higher levels as long as inflation remains at this level. I see no reason to think that these interest rates, in nominal terms, have a discouraging effect on housing. During most of 1973 when we had a real boom in housing, interest rates were approximately that level. The figure you quote is——

Senator PROXMIRE. Well, that is not quite true. Let me read you what the interest rates for mortgages in 1973 were: 7.56, 7.55, 7.56, 7.63, and it was not until the last quarter that they rose to above 8.2 percent. Now, after that housing just went into a fantastic nosedive, and we had a very bad fourth quarter, as you know. In December 1.4 million housing starts, a depression level, and it seemed that there was a clear sensitivity to interest rates at that level. And they are remaining very close to it, and ¾ percent is not that much lower.

Mr. HOUTHAKKER. I am not at all convinced that the decline in housing starts was a result of this small change in interest rates. Interest rates of 7.5 percent would have been regarded as extortionate 5 years ago, but they did not prevent an unprecedented boom in the early part of 1973. What happened, in my opinion, is that housing starts were too large in 1973, there was some overbuilding, and the vacancies rose, so as a result there was a correction, which in the housing market always tends to be a very sharp one. But I would give very little weight to interest rates in this.

Senator PROXMIRE. Our long-range housing goals are 2.6 million a year, and we just barely reached that finally last year; and we are still having very low vacancy rates, less than 2 percent now nationally. I do not see how you can say we seem to have a temporary glut last year, and also we had a badly skewed system in which we increased production in the high priced houses, and Government assisted housing gradually died because there were no new approvals.

Mr. HOUTHAKKER. I am sure there have been distortions. However, on the figure of 2.6 million, I would suggest that excludes mobile

homes, which are now between 600,000 and 700,000 a year and therefore a major factor in the total supply. In other words, the housing goal is being exceeded right now, if you include the mobile homes, as I think one should.

Senator PROXMIRE. Mr. Perry.

Mr. PERRY. I guess I subscribe to the old fashioned notion that the movement of funds in and out of thrift institutions is the main thing that governs short-run swings in housing starts. High, short-term interest rates take money away from thrift institutions and the mortgage market dries up. That is a bit too simplistic, but by and large I think it describes the situation.

My expectation is that short-term interest rates are going to decline sharply this year, and money will pour back into conventional mortgage lending channels.

Senator PROXMIRE. The rate of interest on mortgages drops much more slowly, as you know. It fluctuates all over the place on the 90-day stuff.

Mr. PERRY. I think the rate of interest on mortgages will stay relatively high, of course. In the kind of inflation we have, most people regard an 8 percent mortgage or an 8.5 percent mortgage as a rather promising kind of a debt to be involved in.

Senator PROXMIRE. You have a social problem here though, with mortgage rates as high as they are, and with the cost of houses as high as they are, more than one-half of the people in this country cannot afford to buy a new home. Sixty percent cannot. That would not be so bad if you had a Government assisted housing program that was moving, but since January of last year we have had a moratorium on Government assisted housing. The result is that you are getting houses for people who have money, and you are not getting houses for people who are at modest incomes.

Mr. PERRY. I think the question of Government assistance to housing is a separate one from the question of the money markets.

Senator PROXMIRE. Except I think you have to put it together. I would agree that they work separately, but if you had both high interest rates and no Government assisted housing you have got a very difficult problem. Here is one area where you could really stimulate the economy without inflationary consequences. You have better than 9 percent of the construction workers out of work on a seasonally adjusted basis, and for once you have an abundant supply of housing materials. And yet, we are not building the houses we need. So we should stimulate this, provide more jobs, and particularly in view of the fact that a relatively modest investment by the Federal Government brings forth a great deal of private money.

Mr. PERRY. I agree.

Mr. HOUTHAKKER. I think that as a part of the general effort to combat recession, increased Government assistance to housing would probably be effective. I would go along with that.

Senator PROXMIRE. Mr. Ackley.

Mr. ACKLEY. I think interest rates, short-term rates will fall considerably during this year. I think it is very likely that the bill rate may get down to 6 percent or below, the prime rate below 8 percent, and other short-term rates will fall comparably. The flow of funds into thrift institutions, which has already improved considerably, will continue, and the resulting greater mortgage availability should

lead to a substantial increase in housing starts. I think the mortgage rate is not going to fall a lot, but it could very well come down to 8 percent or even below. It has already fallen half a percent from its peak, and I think it is likely to continue down. And I think housing will recover, and will be an important factor in keeping the recession mild, and making the recovery fairly prompt.

Senator PROXMIRE. You come from the University of Michigan.

Mr. ACKLEY. Right.

Senator PROXMIRE. You are at the University of Michigan?

Mr. ACKLEY. Yes.

Senator PROXMIRE. They have the finest consumer survey of any that we have in our country, and it has been one of the best economic forecasting devices as far as consumer behavior is concerned for 25 years. They report the worst consumer outlook over the last couple of times they have had the survey that they have ever seen, especially with respect to major purchases like housing and automobiles. And yet, although you anticipate mortgage rates will stay as high as 8 percent, and you recognize the validity of this consumer survey, you still say that housing starts are going to once again recover at the end of 1974. Are you not being pretty optimistic?

Mr. ACKLEY. Perhaps. I nevertheless believe that to be the most probable outcome.

May I say that current consumer attitudes are dominated by the fact of inflation. The "index of consumer sentiment" is a conglomerate of answers to a number of questions; and, in this instance, its deterioration has been dominated by answers relating to inflation and inflationary expectations. Consumers do not like inflation.

Senator PROXMIRE. Well, they do not buy. It has a bearish effect. I always thought it had a bullish one, or I always thought so, but when people anticipate inflation they just pull in their horns. They do not know what to expect. Is that not right?

Mr. ACKLEY. That is not what happened in 1973 as consumer sentiment deteriorated, except for automobiles, and primarily in the fourth quarter. Consumer spending was very strong.

Senator PROXMIRE. Not in housing and automobiles. Housing and automobiles are two major areas that it was not strong.

Mr. ACKLEY. I treat that as investment, but all right. Consumers did not respond to their deteriorating sentiment, or did not reflect this deteriorated sentiment in the way in which they were spending on gas and services except for automobiles, and that mainly in the fourth quarter. I think that the savings rate is going to be somewhat higher this year than it has been, than it was on the average last year, but that it will come down again as the year goes by, as small automobiles become available for people to purchase.

Senator PROXMIRE. Well, gentlemen, thank you very, very much. This has been a most interesting and useful hearing, and I deeply appreciate your testimony and your responses.

The committee will stand in recess until tomorrow morning at 10 o'clock when we meet in this room to hear Saul Hymans, Arthur Okun, and Sally Ronk on monetary and fiscal policy.

Thank you.

[Whereupon, at 12 noon, the committee recessed, to reconvene at 10 a.m., Thursday, February 21, 1974.]

THE 1974 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 21, 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 318, Russell Senate Office Building, Hon. William Proxmire (vice chairman of the committee) presiding.

Present: Senator Proxmire.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; Lucy A. Falcone, John R. Karlik, L. Douglas Lee, and Courtenay M. Slater, professional staff members; Walter B. Laessig, minority counsel; and Michael J. Runde, administrative assistant.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. The committee will come to order. Yesterday the difficult question of developing a price-wage policy for 1974. This morning we have asked our witnesses to concentrate on the equally difficult area of fiscal and monetary policy.

We need a fiscal and monetary policy which will be supportive of the economy and help to halt the rise in unemployment, yet we cannot afford a fiscal or monetary policy which will be inflationary, and we must be especially careful not to return to any Government spending policies which will place increased demands on our limited energy supplies.

To develop the right policy package will require great ingenuity, and decisions need to be made quickly, because the time when the economy is expected to be weakest is right now in the first half of 1974.

As Mr. Hymans points out in his prepared statement, the President's budget already implies such a rapid increase in spending within the current year that it may be unachievable. Thus, it would seem neither possible nor desirable to fight recession through any further increase in total spending at least within the curent fiscal year.

Personally, I would hope that total spending can be cut substantially, although I would urge increases in certain specific areas, such as housing and public service employment. Thus, if fiscal policy is to be used in any major way to further strengthen the economy, the changes may have to be on the tax side. The possible need for a tax cut is one of the questions we want to explore this morning.

Monetary policy also faces difficulties. Lower interest rates and greater credit availability would certainly appear to be desirable,

particularly in the housing sector. Yet it is difficult to see how lower long-term interest rates can be achieved in the face of current and anticipated inflation.

Fortunately our witnesses this morning are eminently qualified to help us with these difficult questions. Our first witness is Mr. Saul Hymans, professor of economics at the University of Michigan where he is responsible for the very excellent economic forecasts prepared by the Research Seminar in Quantitative Economics. This morning he will present their most recent forecast.

Our second witness will be Mr. Arthur Okun, senior fellow at the Brookings Institution and former Chairman of the Council of Economic Advisers. Mr. Okun, you are always especially welcome as a witness before this committee because we can count on you for fresh and imaginative policy recommendations. You are frank and outspoken and I think that you have the unusual knack of being particularly clear and incisive in your comments.

As I indicated earlier, we sure need some fresh recommendations this year, and I am glad to see that your prepared statement is devoted to this purpose.

Our final witness will be Ms. Sally Ronk. Ms. Ronk has an extensive background as an economist in government and in the New York financial community. She was with Bankers Trust Co. for a number of years as economist and as vice president. More recently she has served as economist with Drexel Burnham Company.

Mr. Hymans, go right ahead, sir.

STATEMENT OF SAUL H. HYMANS,[1] PROFESSOR OF ECONOMICS, AND CODIRECTOR OF THE RESEARCH SEMINAR IN QUANTITATIVE ECONOMICS, UNIVERSITY OF MICHIGAN

Mr. HYMANS. Thank you. It is a pleasure to be here again.

Senator PROXMIRE. Let me interrupt to say to you and your colleagues if you do want to skip any part of your prepared statement the entire prepared statement will be printed in full in the record and I have read these prepared statements last night.

Mr. HYMANS. The view of the economic outlook which I shall present today is based on the quarterly econometric model of the Research Seminar in Quantitative Economics (RSQE) of the University of Michigan. This model is the subject of a continuing research effort under the joint direction of Prof. Harold T. Shapiro and myself. While our forecasting operation is organized around the econometric model, I am sure you all realize that the generation of an actual forecast requires considerable judgemental input. Before turning to the forecast itself, I would like to discuss seveeral of those factors which required judgemental handling before the econometric forecast could be produced.

It seems fairly obvious that the short-term economic outlook depends most crucialy on two factors: The energy crisis and the stance of governmental stabilization policies, both fiscal and monetary.

[1] I would like to acknowledge the assistance of Prof. Harold T. Shapiro and Ms. Gail Blattenberger in the preparation of this statement. The forecast presented here is based on the quarterly econometric model of the Research Seminar in Quantitative Economics (RSQE) of the University of Michigan. The RSQE research program is financed, in part, by a grant from the National Science Foundation.

Given the ranges of uncertainties involved, the energy crisis is probably the more critical of the two. First, we are still somewhat uncertain of the volume by which our oil imports will actually fall short of what would have been imported had there been no oil embargo and had prices remained on a track which seemed "normal" in mid-1973.

Second, we are even more uncertain about how long the embargo will last, how strenuously it will be applied to each of a large number of Western economies with widely varying degrees of dependence on imported oil, and how leakproof it will turn out to be with respect to our own country.

Third, there is substantial uncertainty regarding the size and impact of what may be called the economic shortfall resulting both from the embargo and the recent history of oil industry decisions regarding the growth of domestic capacity to recover and refine petroleum.

Finally, the rate at which new domestic oil capacity will come on line, the rate of further improvement in refining yields, and the rate at which alternative energy sources will become available are all subject to great uncertainty.

There are several important dimensions to this issue. The oil shortfall can be measured by the size of the excess demand for oil products which would exist at any specific price below that which would clear the market.

In this sense the shortfall is manifested in long lines of cars at service stations, inequities and/or favoritism in the distribution of meager supplies, and a probably misguided but growing fervor for rationing.

These aspects of the shortfall can be virtually eliminated by allowing prices to respond to the realities of the market. Which is not to imply that the solution would be painless, but the lines of cars would disappear and new bureaucratic waste would be avoided.

Another dimension to the shortfall is what it will cost the economy in total output and employment relative to what might have been. This is, of course, of extreme importance and is a relevant dimension of the problem no matter how we choose to deal with the market clearing aspects.

In its latest annual report the Council of Economic Advisers has expressed the expectation that real growth for 1974 will be only about 1 percent. Before last October, most forecasters had expected real growth for 1974 to be in the 2 to 3 percent range.

Using a 2½ percent average, the energy crisis can be viewed as in large measure responsible for an output loss which will amount to some $12.5 billion of real GNP—1958 prices—in 1974. If permanent, an output loss of this order of magnitude could be expected to reduce employment by about 1¼ million.

From what I can gather—and much of this is impressionistic—it appears that if the embargo continues our oil shortfall will be at the rate of about 2 million barrels per day in 1974, relative to what would have been available on the price track which was considered normal 6 months ago.

A 2-million-barrel shortfall in this sense amounts to about 13 percent of normal supply, yet the Council report—and most other forecasts as well—envision an output loss which is smaller than 13 percent by a factor of roughly 10.

I, too, am prepared to believe such a favorable possibility, but it must be clearly understood that very important assumptions are implicit in any such evaluation of the output loss.

Principal among these is the assumption that individuals as consumers will bear much of the initial burden of the oil shortfall in order to minimize the size of ultimate burden which will affect them as consumers and workers.

Under normal circumstances the consuming public purchases 35 to 40 percent of gross petroleum output in the form of fuel for automobiles, home heating, and other such final products. If consumers cut back their final product use of petroleum by 35 to 40 percent of the gross shortfall of 13 percent, most of the rest of the shortfall—well over 1 million barrels a day—would amount to a loss of intermediate inputs in the multitude of production processes throughout the economy.

The cutbacks in output which would follow would lead to very substantial losses in income and employment with the result that the ultimate loss of output would be far greater than 1 to 2 percent of GNP and the public as consumers would in the end be far worse off.

We have then the paradoxical result that by assuming a large share of the initial burden consumers can minimize their ultimate losses. This, in fact, is the underlying justification for the semivoluntary conservation measures being urged on the public by the Federal Government and many lower governmental units as well.

From what we can tell from statistics on power output, gas and oil sales, and so on, the final demand sectors are indeed economizing. Exhortation is an important temporary stimulus in this process, but increases are obviously playing a critically important role as well and have more permanent effect.

In the forecast which I shall present, we have assumed that as long as the shortfall remains at the 2-million-barrel-a-day level, final demand use of fuel and other energy by consumers and all levels of government will be reduced by 20 percent relative to normal total use.

In terms of real GNP this amounts to a direct $9 billion—1958 prices—reduction, just about 1 percent of the total. But the direct and indirect effects of this cutback in final demand will absorb more than 20 percent—or 300,000 to 400,000 barrels a day—as the loss in intermediate oil inputs. Much of this can surely be absorbed by marginal changes in production and distribution relations, including somewhat greater use of nonpetroleum fuels, without resulting in a sizeable additional loss of output.

Let me turn now to matters of fiscal and monetary policy. It is quite apparent that even under the best of available possibilities the first half of 1974 will be characterized by a measurably severe economic slowdown. Output growth will cease or turn temporarily negative and unemployment will be on a rising path.

It appears that, under the circumstances, the monetary authorities are disposed to be generally supportive and expectedly helpful to homebuilding activity which has dropped off sharply in recent months.

In our view it seems likely that the combination of supportive monetary policy and depressed economic activity will result in a fairly steady downward trend of short-term interest rates through most of the year.

We expect that the 90-day Treasury bill rate, which has recently slipped down to about 7 percent, will drop into the 5½ to 6 percent range by yearend before it begins to reverse direction. Longer term interest rates should not be expectd to rise from their current levels in the near term, but they are not likely to drop much either with prices rising at the rates now generally expected for 1974.

On the fiscal side, I would like to make two observations. First, I find it encouraging that the administration has so clearly accepted the responsibility to see to it that the economy does not slip into a prolonged cumulative downswing. The latest CEA report and numerous statements by administration spokesmen and the President himself force one to this understanding.

At an operational level, however, I find the "Budget Message" somewhat mystifying. The latest budget document estimates that Federal expenditures in the national income accounts will rise by about $28 billion between fiscal years 1974 and 1975. From what I can get out of the envisioned program increases, normal growth, and likely inflationary effect, such as increase seems to be a bit on the high side, but in the likely range.

I cannot, however, reconcile the estimated total for fiscal 1974 with the information already published for the first half of fiscal 1974; that is, the last half of calendar 1973.

The administration estimates an expenditure total in excess of $285 billion for fiscal 1974—NIA basis; I cannot quite reach $282 billion. such a discrepancy is quite meaningful because it implies an annual rate expenditure difference of $6 billion in the first two quarters of calendar 1974.

Further, it has important implications for the path of Government expenditures after midyear. If the official fiscal 1974 total is to be attained, Federal expenditures will have to rise at an extraordinarily rapid rate from now to midyear and then rise at an extraordinarily low rate during fiscal 1975 in order not to exceed the proposed total for that year.

This is reminiscent of the situation which I discussed before this committee exactly 2 years ago. At that time the administration had projected fiscal 1972 expenditures of nearly $238 billion and I stated that we simply could not get there from where we then were. I estimated at the time that the total would end up short of the official projection by more than $3 billion; in fact, it fell short by about $4.5 billion.

I am as incredulous of the administration's current projection as I was of the one 2 years ago. I also find it hard to understand the administration's estimate of the fiscal 1975 deficit. The official projection calls for a deficit of $8.5 billion—NIA basis; I would expect a deficit in the $12 to $15 billion range for fiscal 1975. Table 1 [1] contains budget summaries for the current fiscal year and for fiscal 1975 and contrasts the official projections with those which we have prepared—labeled "RSQE"—and which form the basic input to our econometric forecast.

I hope you will forgive me if I present two alternative forecasts for the coming year and a half and fail to tell you which one I myself would bet on. The simplest reason is that at this point I just do not know which one to select as the more likely.

[1] See table 1, p. 581.

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What distinguishes the two forecasts is the assumed length of time for which the 2-million-barrel-a-day oil shortfall persists. In what I have labeled "Forecast A"—table 2 [1]—the assumption is made that the oil embargo continues right through mid-1975 to impose a 2-million-barrel shortfall of which the final demand sectors continue to absorb about 80 percent as previously discussed.

The assumption in "Forecast B"—table 3 [2]—is that the flow of oil from the Mideast begins to increase by the middle of this year and the shortfall shrinks steadily from then on. In this case, however, we assume that oil supplies will remain tight enough to keep fuel-related prices from rolling back very far, though some price relief is assumed relative to peak levels of mid-1974.

We expect, for example, that under Forecast B conditions the price of gasoline at the service station will average 60 cents per gallon around midyear and then decline to about 50 cents per gallon by the end of this year. We see no chance in the foreseeable future of returning to fuel prices which were considerd normal only a short time ago.

I call your attention to the lower portions of table 2 [3] which provide a quick summary of "Forecast A." Real GNP is now estimated—that is no longer true as of the release of new data yesterday—by the Commerce Department to have totaled $844.1 billion—1958 prices—in the fourth quarter of 1973. We forecast that real GNP will decline to about $837 billion in the second quarter of 1974—a decline of about 1.5 percent at annual rate. In the same period:

The unemployment rate is forecast to rise to about 5¾ percent.

The overall rate of inflation, as measured by the GNP deflator, is forecast to be 7.5 percent—annual rate.

Corporate profits—plus IVA—will decline sharply from more than $112 billion to $98 billion.

Further:

Following a drop of nearly $8 billion in the second half of 1973, consumer expenditures on automobiles and parts are forecast to decline by another $3.5 billion in the first half of this year.

Expenditures on residential construction are forecast to decline by more than $7 billion over the same period.

The only expenditure sectors which are expected to provide real stimulus to the economy in the first half of 1974 are business capital spending and Government purchases. These areas of expansion, however, will be far outweighed by the extreme weakness of the automobile and housing markets, plus the final demand cutbacks resulting from the energy crisis.

Under the assumptions of "Forecast A"—table 2 [4]—we expect that the most depressing effects of the energy crisis and the recession in building activity will be over by midyear. By the end of this year total output—real GNP—is forecast to have recovered to the level of the fourth quarter of 1973 and to rise by nearly 4.5 percent—annual rate—in the first half of next year.

The unemployment rate is forecast to peak at about 6¼ percent in the beginning of 1975 and to be down to about 6 percent by midyear.

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[1] See table 2, p. 582.
[2] See table 3, p. 583.
[3] See table 2, p. 582.
[4] See table 2, p. 582.

Housing starts are forecast to head upward in the spring of this year and to recover to an average of 1.85 million—annual rate—in the second quarter of 1975.

The worst of the auto decline should be over by the third quarter of this year but no substantial recovery is forecast before next spring. The overall rate of inflation during the year ending in the second quarter of 1975 is forecast to moderate to about 5¼ percent.

The major contrast between "Forecast A"—table 2 [1]—and "Forecast B"—table 3 [2]—involves the pace of recovery after mid-1974. With the flow of oil beginning to return to a more normal rate by midyear, the level of output in the fourth quarter of this year should be well above the level of a year earlier and the rate of growth of real GNP in the first half of 1975 is forecast to accelerate to about 6¾ percent, instead of 4.5 percent as in Forecast A.

Such a path of expansion would contain a much sharper recovery in the auto market, substantially more inventory building, and an unemployment rate under 5.5 percent before mid-1975. The rate of inflation would be substantially less than under Forecast A.

However, the extent of the difference in the inflation rates under "Forecasts A and B" would be largely a temporary phenomenon, resulting from one-time rollbacks in fuel-related prices.

I will close by noting that neither of the forecasts which I have presented quite makes the 1 percent growth rate for 1974 as a whole which is contained in the latest CEA report, and the CEA's unemployment rate forecast is a bit lower than ours as well.

But I emphasize that the differences are well within the ranges of normal forecast error; they amount to essentially the same forecast. Indeed, I have made a forecast run using the official Federal budget as an input and that essentially reproduces the 1 percent growth, 5.5 percent unemployment path in the Council forecast for 1974. The discrepancy is then pushed into the first half of 1975 with the official budget input producing a slightly lower rate of growth as a result of a sharp cutback in the growth of Federal spending as fiscal 1975 progresses. Thank you, Mr. Vice Chairman.

Senator PROXMIRE. Thank you, Mr. Hymans.

[The tables referred to in Mr. Hymans' statement follow:]

TABLE 1.—FEDERAL GOVERNMENT EXPENDITURES IN THE NATIONAL INCOME ACCOUNTS

[Billions of dollars]

	Fiscal year 1973 [1]	Fiscal year 1974		Fiscal year 1975	
		OMB [1]	RSQE [2]	OMB [1]	RSQE [2]
Purchases of goods and services	104.5	111.5	110.4	121.6	122.0
Defense	73.9	75.3	76.0	82.0	82.6
Nondefense	30.6	36.2	34.4	39.6	39.4
Transfer payments	89.4	107.2	105.0	123.5	117.1
Grants-in-Aid	40.4	44.1	4.41	46.6	46.6
Net interest paid	14.4	18.2	18.2	19.6	21.0
Subsidies less current surplus of Government enterprises	6.4	4.2	4.2	2.1	2.1
Total expenditures, national income basis	255.1	285.1	281.9	313.4	308.8

[1] The Budget of the United States Government, Fiscal Year 1975, p. 329.
[2] Estimates by the Research Seminar in Quantitative Economics, The University of Michigan.

[1] See table 2, p. 582.
[2] See table 3, p. 583.

TABLE 2.—FORECAST A, OIL SHORTFALL OF 2 MILLION BARRELS PER DAY THROUGH MID-1975

[Except as noted, figures are in billions of dollars, seasonally adjusted at annual rates]

	1974				1975		Calendar years		Percent of changes	
	I	II	III	IV	I	II	1973	1974	1973–74	1974.2–1975.2
Gross national product	1,352.3	1,372.0	1,395.4	1,423.9	1,456.3	1,488.7	1,288.2	1,385.9	7.6	8.5
Personal consumption expenditures	846.2	862.8	879.6	897.1	917.9	939.2	805.0	871.4	8.2	8.9
Automobiles and parts	50.6	48.6	48.9	50.2	50.6	53.9	57.9	49.6	−14.3	10.9
Gross private domestic investment	205.6	199.2	198.6	201.9	204.4	210.0	201.5	201.3	−.1	5.4
Business fixed investment	145.3	147.8	148.6	149.1	149.2	149.8	136.0	147.7	8.6	1.4
Residential construction	48.4	46.9	49.8	52.2	55.1	58.2	58.0	49.3	−14.9	24.1
Inventory investment	11.8	4.5	.2	.7	0	1.9	7.4	4.3		
Net exports	5.4	7.0	6.7	7.2	7.5	7.3	4.6	6.6		
Government purchases of goods and services	295.2	303.0	310.6	317.8	326.6	332.3	277.2	306.6	10.6	9.7
Federal defense	77.2	78.7	80.0	81.4	84.2	84.9	74.2	79.3	6.9	7.9
Other Federal	35.0	36.2	37.4	38.6	40.2	41.4	32.7	36.8	12.5	14.4
State and local	183.0	188.1	193.2	197.7	202.2	206.0	170.3	190.5	11.9	9.5
Gross national product in constant dollars (1958 prices)	839.6	837.4	840.3	845.0	852.9	863.5	837.3	840.6	.4	3.1
Gross national product deflator (1958=100)	161.08	163.84	166.07	168.51	170.76	172.41	153.86	164.87	7.2	5.2
Unemployment rate (percent)	5.37	5.77	6.04	6.18	6.19	6.09	4.86	5.84		
Housing starts (millions)	1.24	1.41	1.57	1.69	1.74	1.85	2.06	1.48	−28.2	31.2
Corporate profits plus IVA	105.3	98.0	91.9	94.0	95.2	98.5	109.2	97.3	−10.9	0.5

TABLE 3.—FORECAST B, OIL FLOW RÉSUMÉS BY MID-1974

[Except as noted, figures are in billions of dollars, seasonally adjusted at annual rates]

	1974				1975		Calendar years		Percent of changes	
	I	II	III	IV	I	II	1973	1974	1973–74	1974.2–1975.2
Gross national product	1,352.3	1,371.3	1,395.7	1,422.0	1,460.1	1,495.2	1,288.2	1,385.3	7.5	9.0
Personal consumption expenditures	846.2	862.3	881.8	898.8	924.6	946.6	805.0	872.3	8.4	9.8
Automobiles and parts	50.6	48.6	49.3	51.4	52.8	57.0	57.9	50.0	−13.6	17.3
Gross private domestic investment	205.6	199.4	196.7	200.3	205.4	214.7	201.5	200.5	−.5	7.7
Business fixed investment	145.3	147.8	148.3	147.9	148.2	149.7	136.0	147.3	8.3	1.3
Residential construction	48.4	46.9	49.8	52.2	55.0	57.9	58.0	49.3	−14.9	23.5
Inventory investment	11.8	4.7	−1.4	.2	2.2	7.0	7.4	3.8		
Net exports	5.4	6.6	6.5	5.0	3.2	1.4	4.6	5.9		
Government purchases of goods and services	295.2	303.0	310.7	318.0	326.9	332.6	277.2	306.7	10.6	9.8
Federal defense	77.2	78.7	80.0	81.4	84.2	84.9	74.2	79.3	6.9	7.9
Other Federal	35.0	36.2	37.4	38.6	40.2	41.4	32.7	36.8	12.5	14.4
State and local	183.0	188.1	193.3	197.9	202.5	206.3	170.3	190.6	11.9	9.7
Gross national product in constant dollars (1958 prices)	839.6	836.9	842.2	852.2	865.9	880.9	837.3	842.7	.7	5.3
Gross national product deflator (1958=100)	161.08	163.86	165.72	166.87	168.63	169.73	153.86	164.38	6.8	3.6
Unemployment rate (percent)	5.37	5.77	6.00	5.98	5.76	5.42	4.86	5.78		
Housing starts (millions)	1.24	1.41	1.57	1.69	1.75	1.85	2.06	1.48	−28.2	31.2
Corporate profits plus IVA	105.3	97.7	91.7	91.9	97.3	102.8	109.2	96.7	−11.5	5.2

Senator PROXMIRE. Mr. Okun, please proceed.

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

Mr. OKUN. Because I favor substantial changes in economic policy, I shall focus primarily on a set of recommendations for action, omitting detailed diagnosis. My general diagnosis underlying these policy prescriptions is that the American economy is currently in its sixth postwar recession, and that antirecessionary policies can contain the damage in output and employment without jeopardizing relief from excess demand pressures.

INCREASED BUDGETARY SUPPORT

In my judgment, the net fiscal impact during calendar year 1974 should exceed that recommended by the administration by approximately $8 billion—or, more meaningfully, by between $6 and $10 billion.

The administration's fiscal program for calendar 1974 calls for a $6 billion full-employment surplus, matching that of 1973. If, as Professor Hymans suggested, expenditures do not meet the administration's targets, the fiscal impact will be even smaller than it was in 1973.

Maintaining an unchanged budgetary impact from 1973 to 1974 is inappropriate fiscal policy, in effect providing the same treatment for a case of the chills in 1974 that was used to fight a fever in 1973.

STRENGTHENED FEDERAL PROGRAMS

Some added contribution can be made on the expenditure side of the budget by (*a*) stepping up public service employment programs; (*b*) strengthening the unemployment insurance system both by enacting quickly the measures proposed by the administration and also by going somewhat beyond them; and (*c*) by renewing and invigorating Federal aid to the beleaguered area of housing. Only a few Federal expenditure efforts can be geared up rapidly enough to bolster private purchasing power within calendar year 1974.

Hence, the appropriate fiscal support to the economy must include promptly enacted tax reductions. I can suggest three alternative economically equivalent programs for tax reduction of $5 or $6 billion a year: (*a*) A reduction of payroll—social security—taxes on the working poor and near poor; (*b*) the introduction of an option in the individual income tax whereby the taxpayer could choose a $200 tax credit as a substitute for the $750 personal exemption that is now deducted from taxable income; or (*c*) a uniform rise in the personal exemption from $750 to $900.

RESTRUCTURE OF WITHHOLDING

When a personal tax cut is enacted, withholding taxes should be adjusted to reduce current overwithholding—as well as to incorporate the tax cut—thus permitting a larger immediate addition to consumer purchasing power.

TAX REFORM

In order to preserve the long-run power of the Federal tax system, the Congress should commit itself to developing a $5 billion program of revenue-raising tax reforms to be phased in during 1975 and succeeding years.

Monetary policy should support the economy in the months ahead by promoting a gradual and smooth reduction of short-term interest rates; with appropriate easing, the Federal funds rate and the Treasury bill rate might fall to the neighborhood of 5 percent by midyear.

The basic objective of prompt monetary easing is to promote the upturn in homebuilding that is critical to a general economic upturn late in 1974.

PRICE ROLLBACK ON OIL

The ceiling price of "old" crude oil should be rolled back to $4.25 per barrel, and a ceiling price should be imposed on "new" oil at about $8 per barrel.

The administration's two-tier pricing system is the right idea, distinguishing between production that was profitable when crude oil sold for $3 a barrel—old oil—and incremental production—new oil—that requires more extensive or more intensive extraction. It should be used to keep the windfall out of old oil and to promote adequate incentives for new oil.

A rollback in the ceiling price of old oil by $1 and a $2 saving on new oil would reduce the inflation rate for this year by half a point and increase real purchasing power by $5 billion—equivalent to the tax cuts I outlined above.

I do not comprehend why the pending energy legislation accepts the $5.25 prices for old oil; and I fear that the bill may be a bit too severe on the price of new oil. Most of the risks lie in being tough on new oil prices and most of the money lies in being tough on old oil prices.

PROPER—NOT PUNITIVE—TAXES ON PETROLEUM

The right pricing policy on petroleum should eliminate any need for punitive special taxes on the profits of the petroleum industry or on the production and sale of crude oil.

Any potentially excessive revenues of oil companies should stay in the consumer pocket rather than be allowed to flow into the corporate treasury and then be partially siphoned into the Federal Treasury.

Excess profits should be prevented, rather than taxed. Appropriate expansion of profits that accompanies an expanding path of U.S. oil production should be encouraged, not penalized. Consumers can be given a fair deal and investors a strong incentive by judicious reliance on the two-tier price system and by a prompt clarification that there will be no punitive taxation.

On long-range considerations, several changes in the taxation of the petroleum industry are desirable. The incentive to invest abroad —particularly in politically insecure areas—should be dramatically reduced; as should any incentive to divert capital into tax-haven activities.

On the domestic front, the tax provisions that permit depletion in excess of original cost and immediate writeoff of intangible drilling costs should be phased out over a period of several years.

STEPS ON THE EMBARGO

Congress should enact, effective until explicitly repealed, a prohibition against future imports of oil from any oil-producing nation that is currently banning shipments of its petroleum to the United States.

Bargaining and pleading for the end of the embargo makes no sense for the United States. Such a policy strengthens the oil producers' cartel, and the cartel—not the embargo—is the real economic problem.

If the overall production of the cartel is held down, an end of the embargo could turn out to be one of the great nonevents of modern times. Indeed, if we were offered all the foreign oil we wanted at, say, $12 a barrel, our real GNP could well be lower as a result of the extra drain on our incomes.

GASOLINE RATIONING

The Congress should promptly give the administration authority to ration gasoline by coupons and encourage the implementation of William Simon's contingency rationing plan. Rationing by coupons is no delight, but it can surely improve on the chaos of rationing by queues. In particular, it can provide the consumer with some basis for planning on decisions ranging from vacations to home buying.

PLANNING DOMESTIC FOOD REQUIREMENTS

Congress and the administration should develop a national food budget for the year ahead that will indicate the available margin of exports consistent with domestic requirements at stable prices. I stated before this committee last September:

> The one constructive measure that could provide insurance against continued food inflation would be the setting of export ceilings for key farm products, designed to moderate—not to reverse—the growth of foreign sales, and to distribute the products equitably to countries that have traditionally depended on the United States as a supplier.

My concern unfortunately was fully justified. Despite a bountiful harvest in 1973, prospects for food prices are bleak today, largely because of the mismanagement of our export policy for the second year in a row. This losing streak simply must not be continued for another year.

WAGE-PRICE POWERS

Congress should move swiftly to extend the Eeconomic Stabilization Act beyond its expiration date of April 30. The Congress clearly cannot run a controls program—and it must therefore delegate some price-wage control powers to the executive. I believe that the risks inherent in that delegation of power can be minimized by mandatory full reporting to the Congress by the administration at quarterly intervals on its decisions to use—and not to use—the powers provided by the act.

I apologize for seeming presumptious by listing so many recommendations. I believe that the Joint Economic Committee is the supreme forum for the airing of issues and alternatives in economic policy. I hope to contribute to informed discussion before this committee and to provide evidence that many alternatives are available for serious consideration. I don't claim to have all of the right answers. And my batting average is considerably less than a thousand. Some of my proposals might hurt more than they help, even though they all look sensible to me. I trust the committee to sort out the right from the wrong recommendations.

Thank you.

Senator PROXMIRE. Mighty modest.

[The prepared statement of Mr. Okun follows:]

PREPARED STATEMENT OF ARTHUR M. OKUN [1]

Because I believe that substantial changes in economic policy are needed, I shall devote this statement primarily to a set of recommendations for action. In order to save time, I shall omit detailed diagnosis and concentrate on specific prescriptions.

In general, the prescriptions reflect my diagnosis that the American economy is currently in its sixth postwar recession, and that anti-recessionary policies can contain the damage in output and employment without jeopardizing relief from excess demand pressures. The oil embargo and the ensuing escalation in petroleum prices produced the deterioration of the economic outlook from the moderate slowdown that seemed to be on the horizon some months ago. Hence, the current setback should not be blamed on inappropriately restrictive fiscal and monetary policies. Nonetheless, fiscal and monetary policies are part of the cure, as are measures to deal with the critical sectors of fuel and food.

1. *Increased Budgetary Support.*—In my judgment, the net fiscal impact during calendar year 1974 should exceed that recommended by the Administration by $8 billion (or, more meaningfully, by between $6 and $10 billion). As the Annual Report of the Council of Economic Advisers makes clear (Table 1, p. 31), the Administration's fiscal program for calendar 1974 calls for a $6 billion full employment surplus, matching that of 1973. While the budget is actually expected to shift from a tiny surplus to a modest deficit, that reveals that the sag in economic activity is hurting the budget—it does not mean the budget is doing more to help the economy. Maintaining an unchanged budgetary impact from 1973 to 1974 is inappropriate fiscal policy, in effect providing the same treatment for a case of the chills in 1974 that was used to fight a fever in 1973.

2. *Strengthened Federal Programs.*—Some added contribution can be made on the expenditure side of the budget by (*a*) stepping up public service employment programs; (*b*) strengthening the unemployment insurance system both by enacting quickly the measures proposed by the Administration and also by going somewhat beyond them; and (*c*) by renewing and invirogating federal aid to the beleaguered area of housing. Only a few federal expenditure efforts can be geared up rapidly enough to bolster private purchasing power within calendar year 1974; I would be pleasantly surprised to learn that the potential for such quick-acting programs exceeds $3 million.

3. *Broad-based Tax Cuts for Individuals.*—Hence, the appropriate fiscal support to the economy must include promptly enacted tax reductions. I can suggest three alternatives—and economically equivalent—tax reduction programs of $5 or $6 billion a year; (*a*) a reduction of payroll (social security) taxes on the working poor and near poor, with an offsetting transfer from general revenues into the social insurance trust fund; (*b*) the introduction of an option in the individual income tax whereby the taxpayer could choose a $200 tax credit as a substitute for the $750 personal exemption that is now deducted from taxable income; or (*c*) a uniform rise in the personal exemption from $750 to $900.

In terms of my personal social priorities, my preference among these measures follows the order in which I presented them—the lifting of payroll taxes

[1] The views expressed are my own and are not necessarily those of the officers, trustees, or other staff members of the Brookings Institution.

does most for the lowest income workers; the credit option is next most progressive, benefiting families in tax brackets of 26 percent or lower. On the other hand, the pragmatic desire to get prompt action my point to the reverse ranking; a restructuring of the payroll tax raises an issue of principle, while a rise in the exemption may pose the simplest legislative task.

4. *Restructure of Withholding.*—When a personal tax cut is enacted, withholding taxes should be adjusted to reduce current over-withholding (as well as to incorporate the tax cut), thus permitting a larger immediate addition to consumer purchasing power. The present extent of over-withholding is excessive, and the best time to correct it is a recession year. In order to avoid the possible confusion of two changes in withholding taxes within just a few months, the correction should be timed to coincide with the tax cut.

5. *Tax Reform.*—In order to preserve the long-run power of the federal tax system, the Congress should commit itself to develop a $5 billion program of revenue-raising tax reforms to be phased in during 1975 and succeeding years: This is a modest—really, an excessively modest—objective, and it could be achieved in large part by the tax reforms on petroleum that I shall outline below.

6. *Supportive Monetary Policy.*—Monetary policy should support the economy in the months ahead by promoting a gradual and smooth reduction of short-term interest rates; with appropriate easing, the federal funds rate and the Treasury bill rate might fall to the neighborhood of 5 percent by mid-year. I would not be concerned if such a flight path meant that the rate of growth of the money stock wiggled and jiggled from month to month. If, however, that growth rate was persisitently below 4 percent or above 10 percent, I would reconsider the target path of interest rates, as I would also in the event of any surprises in the strength of economic activity. The basic objective of prompt monetary easing is to promote the upturn in homebuilding that is critical to a general economic upturn late in 1974.

7. *Price Rollback on Oil.*—The ceiling price of "old" crude oil should be rolled back to $4.25 per barrel, and a ceiling price should be imposed on "new" oil at about $8.00 per barrel. The heavy burden of higher prices of petroleum products is reducing the consumer's spendable income over other commodities, much as a tax increase would. Proper use of price controls on oil is thus essential to bolster consumer purchasing power, as well as to limit inflation, promote equity in income-distribution, and to provide adequate incentives for increased U.S. production of petroleum. The Administration's two-tier pricing system is the right idea, distinguishing between production that was profitable when crude oil sold for $3.00 a barrel—old oil—and incremental production—new oil—that requires more extensive or more intensive extraction. It should be used to keep the windfall out of old oil and to promote adequate incentives for new oil.

A rollback in the ceiling price of old oil by $1.00 and a $2.00 saving on new oil would reduce the inflation rate for this year by half a point and increase real purchasing power by $5 billion—equivalent to the tax cuts I outlined above. I do not comprehend why the pending energy legislation accepts the $5.25 price for ol doil; and I fear that it may be a bit too severe on the price of new oil. Most of the risks lie in being tough on new oil prices and most of the money lies in being tough on old oil prices.

8. *Proper—Not Punitive—Taxes on Petroleum.*—The right pricing policy on petroleum should eliminate any need for punitive special taxes on the profits of the petroleum industry or on the production and sale of crude oil. Any potentially excessive revenues of oil companies ought to stay in the consumer pocket rather than be allowed to flow into the corporate treasury and then siphoned partially into the federal treasury. Excess profits should be prevented, rather than taxed. Appropriate expansion of profits that accompanies an expanding path of U.S. oil production should be encouraged, not penalized. Consumers can be given a fair deal and investors a strong incentive by judicious reliance on the two-tier price system and by a prompt clarification that there will be no punitive taxation.

On long-range considerations, several changes in the taxation of the petroleum industry are desirable. The incentive to invest abroad (particularly in politically insecure areas) should be dramatically reduced; so should any incentive to divert capital into tax-haven activities. Such a reform requires a thorough overhaul of the U.S. tax treatment of foreign royalty payments on oil, as well as depletion on foreign production.

On the domestic front, the tax provisions that permit depletion in excess of original cost and immediate writeoff of intangible drilling costs should be

phased out over a period of several years. Their elimination might perhaps be made concurrent with the end of price controls on oil.

9. *Steps on the Embargo.*—Congress should enact, effective until explicitly repealed, a prohibition against future imports of oil from any oil-producing nation that is currently banning shipments of its petroleum to the United States. Bargaining and pleading for the end of the embargo makes no sense for the United States. Such a policy strengthens the oil producers' cartel, and the cartel—not the embargo—is the real economic problem. If the overall production of the cartel is held down, an end of the embargo could turn out to be one of the great non-events of modern times. Indeed, if we were offered all the foreign oil we wanted at, say, $12 a barrel, our real GNP could well be lower as a result of the extra drain on our incomes. Competitive forces will ultimately lead to a collapse of the cartel that is now holding the world price of oil far above its long-run supply price. We should aid and abet those forces. Making clear that the United States is not a potential customer for those countries that have suspended shipments to us would help to prick the oil price balloon. Moreover, expressing our conviction about the rules of fair trade would give an unmistakable signal to any other nations now considering cartelization of their basic products.

10. *Gasoline Rationing.*—The Congress should promptly give the Administration authority to ration gasoline by coupons, and encourage the implementation of William Simon's contingency rationing plan. Rationing by coupons is no delight, but it can surely improve on the chaos of rationing by queues. In particular, it can provide the consumer with some basis for planning on decisions ranging from vacations to homebuying.

11. *Planning Domestic Food Requirements.*—Congress and the Administration should develop a national food budget for the year ahead that would indicate the available margin of exports consistent with domestic requirements at stables prices.

I stated before this committee last September:

"The one constructive measure that could provide insurance against continued food inflation would be the setting of export ceilings for key farm products, designed to moderate—not to reverse—the growth of foreign sales, and to distribute the products equitably to countries that have traditionally depended on the United States as a supplier."

My concern unfortunately was fully justified. Despite a bountiful harvest in 1973, prospects for food prices are bleak today, largely because of the mismanagement of our export policy for the second year in a row. This losing streak simply must not be continued for another year. And prompt steps to develop a sound export policy on farm products for the coming crop year would have an immediate favorable effect on food prices.

12. *Wage-price Powers.*—Congress should move swiftly to extend the Economic Stabilization Act beyond its expiration date of April 30. The Congress was wise in 1970 to provide the President with adequate power and authority to invoke wage and price controls; the use of that authority in 1971 and 1973 helped to provide the only respite from inflation experienced in the past seven years. The Congress clearly cannot run a controls program—and it must therefore delegate some price-wage control powers to the Executive. I believe that any risks of that delegation can be minimized by mandatory full reporting to the Congress by the Administration at quarterly intervals on its decisions to use—and not to use—the powers provided by the Act.

In my judgment, selective price-wage controls can play a limited constructive role this year, for example, in ensuring that 1974 collective bargaining settlements do not lead to unnecessary price hikes such as occurred in 1970–71. The indication that controls have had some role in the shortages of the past year does not lead to the conclusion that they have no appropriate uses in which their benefits exceed their costs. In some instances, I believe controls were used badly rather than that they were bad.

The Joint Economic Committee is the supreme forum for the airing of issues and alternatives in economic policy. I view my long list of proposals as an effort to contribute to informed discussion before this Committee and to provide evidence that many alternatives are available for serious consideration. My own guess is that perhaps one-third of my recommendations would be helpful; one-third could be amended into measures that would be helpful; and that one-third could be harmful. I trust the distinguished members of this Committee to sort them out.

Senator PROXMIRE. Please proceed, Ms. Ronk.

STATEMENT OF SALLY S. RONK, CONSULTANT

Ms. RONK. The outlook for the economy in 1974, presented in the annual report of the Council of Economic Advisers, is for a distinct slowdown in real output in the first half of 1974, to be followed by some pickup in the second half. Prices, as measured by the GNP deflator, are expected to rise by 7 percent over the year before. These projections yield a gross national product for 1974 of $1.390 billion, which would represent a rise of 8 percent over the 1973 figure.

In broad outline, the Council's scenario is almost precisely the same as the one I developed in late January. The assumptions underlying my outlook included an assessment that, while the Arab oil embargo will be ended within a month or two, the oil crisis has brought a permanent change toward less wasteful uses of energy.

Also, the oil price rise, to which the economy is currently adjusting, was considered as a one-shot affair, and, with farm prices hopefully declining later in the year, as the result of increased plantings, good weather and consequent bountiful harvests, the first half year's rate of price advance was expected to give way to more moderate price increases of under 6 percent in the latter part of the year.

Thus, I anticipated a 0.7 percent rate of real growth for 1974 as a whole and a 7.3 percent inflation rate. My tables 1 and 2 [1] give the details for the various components of output and income, annually and quarterly. While the Council's report does not present such detailed estimates, it does discuss the broad patterns expected for the major areas of spending.

As far as I can deduce, the Council anticipates somewhat higher Federal Government and plant and equipment expenditures, but the differences are, for the most part, minor, and, of course, offsetting. Thus, I have no major quarrel with the Council's economic outlook on the output side.

On the income side, I would suspect that the slowdown in GNP growth, plus wage-cost-push pressures, are likely to entail a somewhat larger decline in corporate profits than the Council's 1.5 percent. Also, the Council did not spell out a specific saving rate, but I expect a noticeable rise from 6.1 percent in 1973 to 6.9 percent in 1974.

This economic outlook would entail sharply reduced demands for short-term credit on the part of both business and consumers. The flows of funds associated with my outlook are shown in Table 3.[2] The short-term credit demands of both business and consumers exploded in the first quarter a year ago, as economic activity was surging at an 8-percent-plus annual rate for real growth. Automobile sales were averaging 12.5 million units, at annual rates, and sales of other consumer durable goods were also strong.

At this time, in contrast, real economic activity is probably declining, and auto sales have plummeted to a 9.5 million annual rate. Already a marked subsidence in business and consumer credit demands is observable and, if the economic outlook turns out as my figures suggest, both demands will slacken further, with only modest pickups toward the end of the year.

In the case of consumer installment credit, the volume extended peaked in July, but leveled off thereafter until December when it

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[1] See tables 1 and 2, p. 595 and pp. 596 and 597, respectively.
[2] See table 3, p. 598.

plunged. The annual rate of increase in consumer installment credit was only $4.9 billion in December compared with $24 billion at the peak in the first quarter and in July.

Not surprisingly, autos account for half of this drop, but the other half is shared equally by installment credit paper to finance big ticket items and by personal cash loans.

For 1974 as a whole I expect automobile credit to decline as the amount of repayments overtakes the lower level of new borrowings. Gross extensions of credit for other durable goods and for personal loans should increase somewhat, reflecting chiefly higher prices, but rising repayments will substantially cut the volume of net extensions from last year's level. For the year as a whole, my forecast of consumer credit growth is $12.1 billion, or only about half as much as the $23 billion expansion in 1973.

Business credit demands are likely to decline even more sharply than demands for consumer credit in 1974. Although inventories are currently being accumulated, on a GNP basis, at a faster clip than prevailed during most of 1973, some of the accumulation is undoubtedly involuntary and will be followed by efforts to cut back as sales decline or level off.

As can be seen from my GNP tables—tables 1 and 2 [1]—my projections incoporate such expectations.

Moreover, the volume of financing demands for inventories in 1974 will be moderated further by lower inventory profits. It is the book value of inventories that needs to be financed. Both inventory accumulation on a GNP basis and inventory profits are still running high, but, if the rate of inflation slackens, as my projections anticipate, the book value of inventories will advance by considerably less in 1974 than in 1973.

Also, as sales decline, the current heavy financing requirements stemming from inventory accumulation are being partially offset by a markedly lower rate of rise in receivables. With sales expected to perk up somewhat later in the year, this offset may be slightly reduced. Nevertheless, the combined requirements for inventories and receivables should continue to slacken with the declining growth of book value of inventories.

More importantly, however, short-term financing requirements in 1974 should be materially reduced by funding of short-term debt. In 1973 business financed overwhelmingly at short term. In fact, contrary to the experience prior to 1972, when the volume of short-term funds raised by nonfinancial corporations was only a small fraction of the volume of long-term funds raised, the two nearly matched in 1973.

Nonfinancial business corporations began concentrating on short-term credit in 1972, but in that year, the volume of short-term funds raised was only half as large as the volume of long-term funds raised.

This analysis leads to the conclusion that business short-term credit demands will fall back materially in 1974 from the unprecedented totals of 1972 and 1973. With demands for short-term credit off on the part of consumers as well as business, I am projecting that the volume of short-term funds raised in 1974 will total $40 billion, versus $62 billion in 1972 and $74 billion in 1973. These compare

[1] See tables 1 and 2, p. 595 and pp. 596 and 597, respectively.

with an average of $30 billion for the years 1965 to 1969, and $24 billion in the depressed years 1970 and 1971.

The credit markets, therefore, will be relieved from the extreme pressures of short-term credit demands which helped to push credit expansion and interest rates to historic highs in 1973. And the chief beneficiaries will be the commercial banks, where large portions of the extraordinarily heavy short-term credit demands of 1973 converged.

This means that, barring excessive surges in other demands for bank funds—long-term and government securities—the expansion of commercial bank credit will fall back substantially from the 12.8 percent rate of growth of 1973. It also implies that the Federal Reserve will no longer be under pressure to accommodate an undesirably large credit expansion and thus to underwrite the unacceptably high current rates of inflation.

This year's report of the Council of Economic Advisers points out that, in the second half of 1973, the annual rate of growth in the money supply—M1—was under 5 percent and in M2—the money supply plus time deposits other than large negotiable CDs—about 8 percent.

An implication was made that a policy of continuing growth of M2 at approximately that rate would be consistent with reaching the goal for 1974 of attaining a moderate expansion "which will bring a halt to the rise in unemployment and yet resist an upsurge of inflation."

The economic report also points to the danger that an overgenerous increase in the money supply would steepen inflationary expectations. With short-term credit demands likely to drop significantly in 1974, the probability of, if not attaining, at least approximating the Council's policy goal for monetary expansion is enhanced. In fact, rates of growth for the monetary aggregates which are not far above these targets are incorporated in my flow of funds projections.

In addition, no surges in bank credit expansion are anticipated from the side of government or long-term credit, thus rendering unnecessary the caveat which I expressed above. I am projecting bank credit expansion of 9.4 percent for 1974, which is well below the 1973 rate. In dollar volume, bank loans and investments are expected to increase by $64 billion in 1974 compared with $74 billion in 1973.

Federal Government borrowing requirements will probably be only moderately larger in 1974 than in 1973 and thus will not comprise anything like the weight on the credit markets of the huge borrowings of a few years ago.

Some factors argue that the deficits presented in the budget for the fiscal years 1974 and 1975 are overly optimistic. Both corporate profits and personal income may have been overestimated and receipts thereby overstated.

Of greater significance might be a larger step-up in spending than the budget visualizes to meet the exigencies of the economic downturn. Nevertheless, by substracting the known spending total for the first half of fiscal 1974, we can see that the budget itself has incorporated a surge in spending for the January-June 1974 period, the very time when the economy is likely to be weakest.

However, even after making allowance for the large scheduled increases in social security benefits and for some added antirecession

spending, this surge appears so large as to be unrealistic. Thus, the deficit for calendar 1974 as a whole does not appear likely to mount by significant proportions. I am estimating a $10.7 billion deficit for calendar 1974 versus $7.9 billion for 1973.

At the same time, Federal agency borrowings will decline dramatically in 1974. A large part of the huge buildup in Federal agency borrowings from $10 billion in 1972 to $22.5 billion in 1973 was attributable to housing, although the agriculture agencies also needed more money. Besides that in 1973, the market began to be tapped by the General Services Administration and borrowings were increased by the Washington Metropolitan Area Transit Authority.

In 1974, there will presumably be continued heavy borrowings by all except the housing agencies and the Federal Financing Bank should also enter the market for the first time. A significant offset, however, will be a substantial swing from net new issues to repayments of debt by the Federal home loan banks. In all, Federal agency borrowings are projected as totaling only $8.4 billion in 1974, which is even below the 1972 figure.

State and local governments have gradually reduced their draft on the credit markets since 1971, when total funds raised—both long and short term—peaked at $17.4 billion. Last year such borrowings totaled an estimated $9.8 billion.

Initially, the decline reflected a leveling in construction expenditures but such expenditures began to rise again last year. Last year's further decline was probably associated with the flush positions in which State and local governments found themselves as the result of current and retroactive revenue-sharing payments. Also, the effects of rising tax receipts, which were producing large surpluses even in the absence of revenue sharing were still being felt.

For 1974, State and local government surpluses are expected to disappear as the year progresses, because of the slowing of tax receipts and leveling in revenue sharing in the face of continued rising expenditures.

Thus, borrowings will rise materially from the reduced 1973 level. I am projecting total net borrowings of $15.7 billion for the year. Nevertheless, the decline in Federal agency issues will far overshadow the rises in Federal and State and local government borrowings so that the total raised by government, at $32 billion, would still be significantly smaller than the $40 billion estimated for last year.

While a slackening of credit demands in the short-term and governmental areas will be aiding the economic goals for 1974, this is not true of the long-term credit area. There, the almost certain decline in mortgage demands will probably be far offset by steeply higher net issues of corporate securities.

The strains in the mortgage market are only too evident. Housing starts plummeted from a peak of 2.5 million units early in 1973 to 1.35 million in December. Not only was the availability of funds clobbered when interest rates went through the roof in the summer, but a weakening in demand had already become noticeable prior thereto.

With deposit flows now improving, particularly at savings and loan associations—which essentially have no other place to go for investment—housing starts are probably bottoming out currently and should gradually rise throughout 1974.

Net new residential mortgages issued, however, lag starts and thus should remain depressed during the first half of 1974. I am projecting that, following the recovery in starts, net new residential mortgages issued will increase during the second half of the year.

The volume of commercial mortgages raised, on the other hand, while rising much less rapidly than in recent years, is not likely to decline in 1974. The total for residential, commercial, and farm mortgages is expected to drop from $68.3 billion in 1973 to $62.4 billion in 1974.

It has already been pointed out that corporate bond borrowings in 1974 will be boosted by some funding of short-term debt. In addition, with business spending on plant and equipment showing a continuing strong rise and with internal funds of corporations declining, the need to finance at long-term will be augmented.

A projection that the excess of plant and equipment spending of nonfinancial corporations over internal funds—retained profits, depreciation and tax liability—will grow from about $12 billion in 1973 to $26 billion in 1974 underlies my forecast of a huge step-up in bond borrowings by nonfinancial corporations.

Furthermore, commercial banks have already entered the bond markets in droves and will probably continue their heavy borrowings throughout the year.

In total, I am projecting net new issues of corporate bonds at $29 billion for 1974, compared with $15 billion for 1973. This would entail some $37 billion of gross corporate bond offerings. Also, the pressures for redressing debt-equity ratios should bring a substantial rise in net new issues of corporate stocks, particularly on the part of utilities, from the relatively depressed level of 1973.

Such a tremendous rise in corporate bond issues might reasonably suggest strong upward pressures on corporate bond yields. But the demand side is only half of the picture. The rapid recovery of savings flows, after only a short period of disintermediation last summer, has alreadly been alluded to.

The savings and loan associations and mutual savings banks should enjoy healthy net deposit increases in 1974, although there is not likely to be a replay of the massive inflows of 1971 and 1972 that followed the previous period of disintermediation.

In addition, the inflows of funds to insurance companies and pension funds should continue their steady increases of recent years. Thus, the funds available for investment by savings institutions should be noticeably larger in 1974 than in 1973, while demands for mortgages will be dipping.

The foregoing suggests that mutual savings banks will swing from net liquidators of corporate bonds in 1973 to fairly large net purchasers. In addition, pension funds and insurance companies are in the process of increasing their net purchases of corporate bonds at the expense of the proportion of their new funds invested in common stock.

Because the volume of institutional funds likely to be invested in corporate bonds will be ample to meet the huge increase in demand for corporate bonds, residual investors, or individuals and others, will not be called upon to absorb much overflow.

In the past, the need to attract these investors tended to force yields up. Thus, the upward pressures on corporate bonds yields, which would be expected from the greatly enlarge and supply of corporate bonds, will be mitigated. I am looking for an average level of new Aa utility issue yields of 8 percent for the first half of 1974 to be followed by a gradual decline to 7.5 percent.

The upward pressures on corporate bond yields will also be counteracted by the further drop in sight for short-term interest rates. The Federal Reserve has been gradually nudging rates down and, if the economic scenario under discussion proves valid, may be expected to continue to do so in its recent orderly, gingerly, and gradual manner.

However, in view of the anticipated persistence of a 5 to 6 percent inflation rate later in the year, short-term rates will probably not tumble to anywhere close to their previous recession lows. I see the prime rate, currently 9 percent, leveling off at 7.5 percent in the second half of the year and the 3-month Treasury bill rate—currently 7 percent—moving down to 6 percent around midyear and 5.5 percent by year end.

Thank you.

[The tables referred to in Ms. Ronk's statement follow:]

TABLE 1.—GROSS NATIONAL PRODUCT, ANNUALLY, SEASONALLY ADJUSTED ANNUAL RATES

[In billions of dollars]

	1971	1972	1973	1974 (project)	Percentage of change		
					1972	1973	1974
Gross national product	1,055.5	1,155.2	1,288.3	1,390.4	9.4	11.5	7.9
Consumer spending	667.2	726.5	805.0	872.3	8.9	10.8	8.4
Durable goods	103.6	117.4	131.2	129.9	13.3	11.8	−1.0
Autos and parts	46.6	52.8	57.9	53.0	13.3	9.7	−8.5
Furniture and household equipment	42.1	48.1	54.7	57.2	14.3	13.7	4.6
Other	14.9	16.5	18.5	19.7	10.7	12.1	6.5
Nondurable goods	278.7	299.9	336.3	373.3	7.6	12.1	11.0
Food and beverages	136.6	145.3	161.6	180.3	6.4	11.2	11.6
Clothing and shoes	57.1	62.3	69.7	74.5	9.1	11.9	6.9
Other	85.1	92.3	105.0	118.6	8.5	13.8	13.0
Services	284.9	309.2	337.6	369.1	8.5	9.2	9.3
Housing and household operation	138.2	149.3	162.5	175.7	8.0	8.8	8.1
Other	146.7	159.8	175.1	193.4	8.9	9.6	10.5
Business investment	153.2	178.3	201.5	211.3	16.4	13.0	4.9
Nonresidential	104.4	118.2	136.0	148.7	13.2	15.1	9.3
Structures	37.9	41.7	48.3	54.6	10.0	15.8	13.0
Equipment	66.6	76.5	87.8	94.1	14.9	14.6	7.2
Residential	42.7	54.0	58.0	54.1	26.5	7.4	6.7
Change in inventories	6.1	6.0	7.4	8.5			
Net exports	.8	−4.6	4.6	2.9			
Government spending (goods and services)	234.3	255.0	277.2	304.0	8.8	8.7	9.7
Federal	98.1	104.4	106.9	111.6	6.4	2.4	4.4
National defense	71.6	74.4	74.2	76.2	3.9	.3	2.7
Other	26.5	30.1	32.8	35.4	13.6	9.0	7.9
State and local	136.2	150.5	170.3	192.4	10.5	13.2	13.0
GNP (constant 1958)	745.4	790.7	837.3	843.5	6.1	5.9	.7
GNP price deflator (1958=100)	141.60	146.10	153.59	164.82	3.2	5.1	7.3
New auto sales (million of units)	10.3	10.9	11.6	9.8	5.8	6.4	−15.5
Private housing starts (million of units)	2.0	2.4	2.0	1.7	20.0	−16.7	−15.0
Single-family	1.1	1.3	1.2	1.0	18.2	−7.7	−16.7
Multifamily	.9	1.1	.9	.8	22.2	−18.2	−11.1
Industrial production (1967=100)	106.7	115.1	125.4	127.1	7.9	8.9	1.4
Unemployment rate	5.9	5.6	4.9	5.5			
Business spending on new plant and equipment	81.2	88.4	100.0	112.8	8.9	13.1	12.8
Corporate profits before tax	85.2	98.0	126.1	121.8	15.0	28.7	−3.4
Corporate profits after tax	47.4	55.4	70.1	67.9	16.1	26.5	−3.1
Personal income	863.5	939.4	1,035.5	1,124.1	8.8	10.2	8.6
Personal saving rate	8.1	6.2	6.1	6.9			

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TABLE 2.—GROSS NATIONAL PRODUCT, QUARTERLY, SEASONALLY ADJUSTED ANNUAL RATES

[In billions of dollars]

	1973 (prel.)				1974 (proj.)				4th quarter percent of change	
	1st quarter	2d quarter	3d quarter	4th quarter	1st quarter	2d quarter	3d quarter	4th quarter	1972–73	1973–74
Gross national product	1,242.5	1,272.0	1,304.5	1,334.0	1,354.2	1,376.7	1,400.8	1,429.7	11.2	7.2
Consumer spending	779.4	795.6	816.0	829.0	846.3	864.3	880.2	898.2	10.2	8.3
Durable goods	132.2	132.8	132.8	126.8	125.7	128.2	130.8	134.8	3.2	6.3
Autos and parts	60.5	59.7	59.2	52.1	50.5	52.5	53.5	55.5	−5.0	6.5
Furniture and household equipment	53.7	54.4	55.0	55.8	56.0	56.2	57.5	59.0	11.6	5.7
Other	18.0	18.6	18.6	18.9	19.2	19.5	19.8	20.3	9.9	7.4
Nondurable goods	322.2	330.3	341.6	351.1	361.2	369.7	377.2	385.2	13.0	9.7
Food and beverages	154.7	158.1	164.4	169.0	174.0	178.5	182.0	186.5	13.3	10.4
Clothing and shoes	68.3	69.3	70.1	71.2	72.6	73.8	74.9	76.5	9.4	7.4
Other	99.2	103.0	107.1	110.8	114.6	117.4	120.3	122.2	14.8	10.3
Services	325.0	332.6	341.6	351.2	359.4	366.4	372.2	378.2	10.1	7.7
Housing and household operation	157.1	160.4	164.5	186.1	170.9	173.9	177.2	180.7	9.4	7.5
Other	167.9	172.2	177.1	183.1	188.5	192.5	195.0	197.5	7.1	7.9
Business investment	194.5	198.2	202.0	211.2	209.2	208.4	211.5	216.0	6.7	2.3
Nonresidential	130.9	134.1	138.0	141.1	144.5	146.3	150.0	154.0	13.5	9.1
Structures	45.3	47.2	49.4	51.1	52.7	53.4	55.1	57.2	18.8	11.9
Equipment	85.5	86.9	88.6	90.0	91.8	92.9	94.9	96.8	10.8	7.6
Residential	59.0	59.6	59.2	54.2	52.7	53.2	54.5	56.0	−4.7	3.3
Change in inventories	4.6	4.5	4.7	15.9	12.0	8.9	7.0	6.0		

Net exports	0	2.8	7.6	8.0	4.0	3.0	2.5	2.0		
Government spending (goods and services)	268.6	275.3	279.0	285.8	294.7	301.0	306.6	313.5	9.6	9.7
Federal	105.5	107.3	106.8	107.8	109.9	111.5	111.9	113.0	5.0	4.8
National defense	74.3	74.2	74.1	74.0	74.9	76.3	76.4	77.2	2.2	4.3
Other	31.2	33.1	32.7	33.8	35.0	35.2	35.5	35.8	11.6	5.9
State and local	163.0	168.0	172.2	178.0	184.8	189.5	194.7	200.5	12.7	12.6
GNP (constant 1968 dollars)	829.3	834.3	841.3	844.1	840.3	841.3	843.6	848.7	3.9	.5
GNP price deflator (1958=100)	148.81	152.46	155.06	158.04	161.12	163.64	166.05	168.46	7.1	6.6
New auto sales (millions of units)	12.5	12.2	11.7	9.8	9.5	9.7	9.9	10.2	−13.3	4.1
Private housing starts (millions of units)	2.4	2.2	2.0	1.5	1.4	1.6	1.8	2.0		
Single-family	1.4	1.2	1.1	.9	.8	.9	1.0	1.1		
Multifamily	1.0	1.0	.9	.6	.6	.7	.8	.9		
Industrial production (1967=100)	123.1	124.8	126.8	127.0	126.5	126.7	127.2	127.9	5.7	.7
Unemployment rate	5.0	4.9	4.8	4.7	5.3	5.5	5.7	5.5		
Business spending on new plant and equipment	96.2	97.8	100.9	104.9	108.2	111.9	114.5	116.7	14.1	11.2
Corporate profits before tax	119.6	128.9	129.0	127.0	123.4	121.0	118.5	124.1	25.1	−2.3
Corporate profits after tax	66.9	71.6	71.5	70.5	68.4	67.5	66.1	69.4	23.3	−1.6
Personal income	996.6	1,019.0	1,047.1	1,079.2	1,098.0	1,116.0	1,131.8	1,150.5	10.7	6.6
Personal saving rate	5.9	5.9	5.7	6.9	7.3	7.0	6.8	6.3		
Annual rates of increase: [1]										
GNP (current dollars)	14.4	9.5	10.2	9.0	6.0	6.6	7.0	8.3	11.2	7.2
Consumer spending	14.2	8.3	10.2	6.4	8.3	8.5	7.4	8.2	10.2	8.3
Business investment	10.8	7.6	7.6	13.5	−3.8	−1.6	6.0	8.5	7.1	7.9
Government spending	12.1	10.0	5.4	9.7	12.4	8.5	7.4	9.0	9.6	9.7
GNP (constant 1958 dollars)	8.4	2.4	3.3	1.3	−1.7	.4	1.1	2.4	3.9	.4
GNP price deflator (1958=100)	5.9	7.0	6.8	7.7	7.8	6.3	5.9	5.8	7.1	6.6

[1] Not compounded.

TABLE 3.—TOTAL FUNDS RAISED AND SUPPLIED IN U.S. CREDIT MARKETS

[In billions of dollars]

	1972	1973 (est.)	1974 (proj.)	1973 1st half	1973 2d half (est.)	1974 1st half (proj.)	1974 2d half (proj.)
Funds raised:							
Long-term funds:							
Mortgages	65.5	68.3	62.4	35.0	33.3	28.5	33.9
Corporate bonds	20.1	15.1	29.2	7.4	7.7	16.7	12.5
Corporate stocks	11.0	9.0	13.2	5.3	3.7	5.3	7.9
Total	96.6	92.4	104.8	47.7	44.7	50.5	54.3
Government securities:							
U.S. Government	15.2	7.9	8.2	1.9	6.0	−3.3	11.5
Federal agencies	9.9	22.6	8.4	9.5	13.1	3.7	4.7
State and local governments	12.2	9.8	15.7	4.3	5.5	7.0	8.7
Total	37.3	40.3	32.3	15.7	24.6	7.4	24.9
Private short-term funds:							
Open market paper	1.6	7.9	5.1	1.3	6.6	1.3	3.8
Consumer credit	18.8	23.6	12.1	9.5	14.1	3.4	8.7
Business creidt	28.7	48.8	14.1	36.7	12.1	6.5	7.6
Security credit	8.8	−10.1	4.2	−7.9	−2.2	1.3	2.9
Other	3.9	4.6	4.5	2.2	2.4	2.5	2.0
Total	61.8	74.8	40.0	41.8	33.0	15.0	25.0
Total funds raised	195.7	207.5	177.1	105.2	102.3	72.9	104.2
Funds supplied:							
Savings institutions:							
Life insurance companies	13.6	15.0	16.0	8.2	6.8	8.5	7.5
Corporate pension funds	6.6	6.3	7.7	3.0	3.3	3.5	4.2
State and local retirement funds	7.3	8.6	9.9	4.9	3.7	4.8	5.1
Fire and casualty insurance companies	6.0	6.8	7.6	3.0	3.8	3.6	4.0
Savings and loan associations	36.5	26.1	25.7	18.9	7.2	9.8	15.9
Mutual savings banks	10.2	5.7	7.8	4.8	.9	3.2	4.6
Credit unions	2.8	3.3	2.0	1.6	1.7	1.0	1.0
Investment companies	−1.8	−2.3	−1.0	−1.8	−.5	−1.0	—
Real estate investment trusts	4.9	4.9	4.3	2.4	2.5	2.3	2.0
Total	86.1	74.4	80.0	45.0	29.4	35.7	44.3
Banking:							
Federal Reserve banks	0.3	8.3	7.0	5.3	3.0	2.0	5.0
Commercial banks	74.6	73.9	64.0	39.8	34.1	27.9	36.1
Total	74.9	82.2	71.0	45.1	37.1	29.9	41.1
Business:							
Nonfinancial corporations	3.5	9.4	11.0	2.8	6.6	3.0	8.0
Finance companies	10.7	8.6	.6	5.1	3.5	−.3	.9
Security brokers and dealers	4.2	−6.1	2.4	−5.3	−.8	.7	1.7
Total	18.4	11.9	14.0	2.6	9.3	3.4	10.6
Government:							
Federal Government	−.2	.3	1.0	−.9	1.2	.6	.4
Federal agencies	5.3	9.4	9.0	4.6	4.8	4.3	4.7
State and local governments	1.9	2.3	3.2	.2	2.1	1.6	1.6
Total	7.0	12.0	13.2	3.9	8.1	6.5	6.7
Foreign	10.6	5.5	−2.8	7.6	−2.1	−4.0	1.2
Residual	−1.3	21.5	1.7	1.0	20.5	1.4	.3
Total funds supplied	195.7	207.5	177.1	105.2	102.3	72.9	104.2

Senator PROXMIRE. I thank all of you very much for your most useful analysis.

Mr. Hymans and Ms. Ronk, you both made fine analysis and interesting and impressive forecasts but neither of you came down very hard on the side of specific recommendations for monetary and fiscal policy.

Would you like to do that for us, how you think monetary policy should shape up in 1974 and how fiscal policy might shape up for the 1975 budget?

Mr. HYMANS. The view I presented regarding the stance of monetary policy being supportive and especially helpful to homebuilding, and allowing short-term Treasury bill rates to get into the 5.5-percent range toward the end of the year is really a combination of what I would like to see and——

Senator PROXMIRE. What would you like to see?

Mr. HYMANS. Well, it is that as well. It turns out to be the same thing. I think that the appropriate policy would be to emphasize housing and to get interest rates down in that——

Senator PROXMIRE. Except that you say that you expect short-term rates to drop but you simply indicate you don't think mortgage rates will go higher.

Mr. HYMANS. No; I think that——

Senator PROXMIRE. They are 8¾ percent now.

Is it going to give housing much of a boost if they go down to 8.5 or 8? Is there a serious problem for housing in view of the moratorium on new approvals for Government-assisted housing which knocks out 600,000 housing starts, or a large part of that?

Mr. HYMANS. There are two aspects to that. One is that I do think mortgage rates will fall somewhat. I don't know how much. I would not be surprised to see three-fourths of a percentage point drop of the mortgage rate over the next 6 or 8 months but I think the other aspect, which is the flow of funds into mortgages is extremely important and I think the drop in the short-term rates will be of major importance in getting funds flowing into mortgage availability.

Senator PROXMIRE. I understand there is a law on the books which enables the administration to move without further legislation to provide for houses that cost less than $30,000, a subsidy to the interest rate to bring it down to 7 percent.

Now, it seems to me that would really give a substantial assistance for low-income housing.

As you know, in 1973 we had a drop in houses that cost less than $30,000 of 35 percent, a precipitous drop. We had an increase in housing costing more than that—36 percent. A lot of expensive houses were built but very few houses for moderate income people.

Mr. HYMANS. If such a law is on the books that is an appropriate time——

Senator PROXMIRE. It would be a relatively modest expenditure, it seems to me, to get a great deal more private spending and jobs, in view of the fact that you have 9.5 percent unemployment in the construction industry now. You would be putting idle resources to work.

Mr. HYMANS. I agree.

Senator PROXMIRE. How about your fiscal policy?

Mr. HYMANS. With respect to fiscal policy, I talk about the expenditure side where I don't think it is feasible either to make the administration target or to consider trying to expand spending even more rapidly than is in the administration target.

On the tax side, which I have not discussed at all, I was interested to hear Mr. Okun's ideas about the three possibilities for tax cuts, and I find altering the exemption system a very attractive way to do this.

Senator PROXMIRE. How about the practicality of reducing the payroll tax, social security tax?

Mr. HYMANS. I think that is quite practical.

Senator PROXMIRE. Wouldn't that be the most progressive action that could be taken?

Mr. HYMANS. Sure.

Senator PROXMIRE. Inasmuch as it is the most regressive tax?

Mr. HYMANS. Yes. I must say, as long as you force me to talk about tax cuts and of the kind I am in favor of, that I am concerned about tax cuts in combination, with the oil price rollbacks.

I am not sure I agree with the view that Mr. Okun has taken on that point.

Senator PROXMIRE. Well, as you know, there is another view that the Senate expresed when we passed by better than a 2-to-1 margin a proposal that would provide for a discretion on the part of the administration in which presumably the price of old oil would be $5.25 and the President could go up 35 percent; in other words $7.09 for new oil. That is, of course, not what Mr. Okun prescribed and I think from a logical standpoint it makes a lot of sense.

With old oil you don't need an incentive up from $3.60, which it was a year ago, to $5.25. If that price were to be rolled back, it doesn't seem logical that it would reduce available supplies. At the same time it is the new oil that we want to increase production.

Mr. HYMANS. Yes. I am not sure that the economic realities permit this kind of a two-tier markets where it is easy to determine who brought the new oil and old oil. We open up the possibility of evasion regarding which oil this is——

Senator PROXMIRE. If you don't have two-tier, though, you open up an enormous opportunity for exploitation by the oil companies of the consumers, if they can go up, and they will. It seems to me if they raise the price of old oil to what it takes to produce new oil, and now they are going to $10 and $11 a barrel for the new oil, so if they go to, say, $7 or $8 for all their oil, then the profits they had last year—and Profesors Perry and Heller projected for 1974—there would be $25 billion in transfer from the consumer to the oil companies.

Mr. HYMANS. Without effective separation of the market for old oil and the market for new oil it is extraordinarily difficult to have that system work effectively, and I would much prefer to see a system whereby we use the taxing power of the Government to remove excess profits if we don't like what is being done with the profits.

Senator PROXMIRE. That is awfully hard; that is so inefficient. Excess profit taxes have never worked very well. There are so many ways smart businessmen can beat it. There is an incentive on inefficiency, all kinds of ways to let your expenses go up. Government takes your profit anyway.

Mr. HYMANS. That is right, but it seems to me that what you are doing is choosing between two evils and I suspect that using the tax system will provide you with ways to choose the lesser of the evils by

giving tax credits to consumers based on income and by necessarily increasing the tax rates on oil profits, all of which I think would work better than a system which I believe is doomed to fail, the two-tier system, when you cannot effectively separate at the end, at the sales end, old oil and new oil.

Senator PROXMIRE. Let me ask Mr. Okun to comment before I go to Ms. Ronk.

Mr. OKUN. I think it is right choosing between evils. However, I would have a lot more sympathy for anyone who might be asked to administer a proper excess profits tax with an offset of tax credits that might have to be adjusted on a monthly basis than for anyone who is asked to administer a two-tier price system.

We ran two-tier price systems in World War II and we ran them in Korea. They don't require a complete separation of the prices but rather a blending of the price at some point along the line.

Crude oil is easy to trace. It goes into the approximately 200 refineries in this country. We are dealing with large corporations which probably would take great care from the top to the bottom to be law-abiding citizens, whether they like the law or not.

Certainly in a situation where the oil companies will turn out to be extremely profitable, even following the law that I am suggesting, there would be little reason for them to try to evade the law.

A two-tier price system is feasible although it isn't easy. It is a headache for the administrators.

But no one is proposing to eliminate the two-tier nature of the system. It is probably a little harder to maintain the two-tier system with a spread of $4 between old and new oil that with a spread of $2, but its not that much harder. The best strategy is probably to assure some blending of prices rather than maintain two separate tracks for the new and old oil price, as in the present system, from the barrel to the ultimate consumer.

When the oil crisis began, there was concern that it might impair our productive capability leading to plant shutdowns for lack of oil for processing or even for space heating.

That hasn't happened and I think that is to the credit of the FEO, and director Simon. They have prevented the oil crisis from turning into a major supply disruption. Instead it has become basically a disruption of demand for oil-related commodities with automobiles as the most outstanding example.

It has also become a major drain on consumer income.

My colleague, George Perry, outlined that yesterday. We are getting the equivalent of a $15 to $20 billion tax imposed on the consumer with very major outpayment to foreigners who are essentially collecting the tax. Those are the friendly oil countries that are shipping us oil. They are collecting these extra revenues and that means a reduction in the purchasing power of the United States.

Senator PROXMIRE. Let me follow up at this point.

We had before us a couple days ago John Sawhill and Mr. Dunlop and we questioned them pretty closely as to how the Cost of Living Council ever arrived at $5.25 for old oil. They couldn't give us any basis. The Cost of Living Council didn't make an objective study of the oil companies' books, didn't make an analysis to determine wheth-

er the cost had gone up; $5.25 was just a figure they apparently picked out without objective data to suport it. Now you suggest $4.25. I am just wondering whether you select that on any kind of basis or was that a seat-of-the-pants guess?

Mr. OKUN. That comes from the seat of the pants; that is where it was in December.

Senator PROXMIRE. Don't you think we ought to do our very best to get what facts and figures we can and arrive at a price, whether it is more or less than $4.25, that would provide a full and complete cost passthrough plus and a fully fair return on their investment and then provide, if you have a two-tier system, then provide something based on some kind of data that elicits the kind of oil in the reasonably short run that you have to have.

Mr. OKUN. That certainly is a better approach. I suspect that you will come out with an answer that is in the range of say $3.80 to $4.50.

As you pointed out, a year ago, crude was selling for $3.50 a barrel. Cost increases on wells that were already drilled and in operation can't be very significant. The extraction cost on a barrel of oil is well under a dollar a barrel. So the $3.50 might be escalated by cost increases of another 10 or 20 cents at most.

If you want to ensure enough profitability, then make it more profitable than it was a year ago, even for the old oil producers. Even so, I think that the answer will be close to $4.25-plus or minus 30 or 40 cents.

Senator PROXMIRE. It seems to me you settle a lot of argument, you could have some basis for settling arguments. You could contend that you were trying to be as fair as you could to the consumer and producer.

Ms. Ronk, suppose you give us your recommendations on monetary and fiscal policy. You made a fine analysis and a very interesting forecast. We would like to have recommendations.

What do you think we should do up here?

Ms. RONK. Well, as far as mortgage rates are concerned, I think the turnaround in savings flows to savings and loan associations will result in a declining level of mortgage rates because the savings and loan associations, aside from their liquidity requirements, have nowhere else to go than to invest in mortgages, and, therefore, I believe that housing starts, which have bogged down, will gradually rise.

However, in the housing area, there was a weakening of demand even before the disintermediation of last summer, so I don't think we will see the type of surge in housing which would be a great economic booster.

Senator PROXMIRE. You don't think it would require any change in the kind of monetary policy that Mr. Burns—we don't know what he is going to do but the indications are that they may have a policy that will be fairly neutral; that is, increase the money supply at the rate of long term growth of the economy plus 2 or 3 or 4 percent.

Ms. RONK. Yes; I think I implied that such a policy would be valid in the current situation where an easy policy by providing excessive monetary growth can only step up inflationary expectations.

Senator PROXMIRE. Mr. Okun went farther than that. He went between six and ten. Did I misread that?

Mr. OKUN. I said that I would focus on a path of interest rates rather than a path of M-1 and would not be much concerned if the narrowly defined money supply wiggled and jiggled from month to month. I would set some tolerance level, a fairly wide one, at which point I might be deterred from pursuing an interest rate path if there was evidence that money growth was persistently exceeding 10 percent or persistently falling short 4 percent.

Senator PROXMIRE. If it is 8 and 9 and 10 percent, wouldn't that be, if not unprecedented, an unusually sharp increase in the money supply in many years?

As I recall, I remember when we had the 1972 increase of 8 percent. I tried to check back to see when we had that much of a percentage increase in our history. Maybe if we have a situation now with inflation that we need something like that.

Mr. OKUN. I wasn't opting for 10 percent and I am not expecting 10 percent. If the economic outlook did not improve and if interest rates were pursuing the path that I suggested, then a few months of high money growth rate would probably indicate that people had a great deal of preference for liquidity in a time when they were feeling very anxious and panicky.

I think that it is very important to try to distinguish, although one can't do so immediately, between changes in the demand for money that reflect changes in the demand for spending and changes in demand for money that reflect people's desire to be liquid in a situation where they are very uncertain about the future. Therefore, its conceivable that you could have a couple of months, in which money growth would be unusually high or unusually low, without causing any reason for concern.

Senator PROXMIRE. I agree with that, we have had very few periods when the money supply, one that is currently plus demand deposits, has increased at an annual rate of 12 percent.

What specific recomendations do you have with respect to spending and taxing?

Ms. RONK. May I address myself to the money supply again?

The only trouble with running 10 percent monetary growth for two months in a row is that the credit markets are very sensitive to large increases in the money supply and thus might react in a way that might force interest rates up temporarily.

Senator PROXMIRE. You mean force them down, let them drop?

Ms. RONK. No; no I would be worried about the inflationary expectations.

Senator PROXMIRE. Ten percent for two months in a row, wouldn't you have that increase supply availability of credit, wouldn't interest rates be inclined to drop rather sharply?

Ms. RONK. The markets would be expecting inflation to rise and demand a larger inflation premium.

Senator PROXMIRE. Well, on that assumption it seems to me you might as well forget it. Do you others agree?

Mr. OKUN. I agree with your statement. How markets respond to the evidence or the release of data on money growth depends on what they think the Fed is trying to do and how the Federal Reserve views the news. There has been a pattern recently in which the Federal Reserve policy has reversed direction after getting a month or two of

very high or very low money growth. Consequently, people came to expect these rapid turnabouts in policy stance. But if the Federal Reserve were willing to make the maintenance of a smooth and reasonable path of interest rates its primary goal, in the absence of apparent changes in economic activity, I think that the markets would respond differently. I believe in Euclidean economics: Buying bonds or bills raises their price and selling bonds or bills lower their price, regardless of whether the seller is the Federal Reserve or a financial institution in the private sector.

Ms. Ronk. You asked me about fiscal policy.

Senator Proxmire. Yes.

Ms. Ronk. The budget message proposes, as has been pointed out, a bulge in spending for the January-June 1974 period but at the same time receipts will still be reflecting the explosion in income and in corporate profits last year. As a result, the budget would be running a seasonal surplus for the January-June period and not be very stimulative even if the increase in spending were achieved.

But what I am anticipating is that the large first-half increase in spending will be postponed, and that, with the spending increases stretched out, we will not have a sharp decline in the rate of increase in spending in the second half of the year which would make the budget turn from neutral to restrictive.

Senator Proxmire. I take it what you are suggesting to us is that what we should do is try to provide as much stimulus as we can now; is that right?

Ms. Ronk. That is right.

Senator Proxmire. That means in the fiscal 1974, in this calendar, early calendar 1974?

Ms. Ronk. Yes.

Senator Proxmire. Of course I was asking really about what we should do about the 1975 budget. That is what we are working on now. We really can't do a great deal. Maybe the administration could do something. But there is not much Congress can do about fine tuning it to the extent we have to look forward, rightly or wrongly.

The only other option is with regard to what is out 3 or 4 or 5 months away.

Ms. Ronk. I think the 1975 budget deficit in the budget was underestimated, as I mentioned. The council overestimated corporate profits and personal income so receipts will decline more.

Senator Proxmire. So you think there will be a bigger deficit in the 1975 budget than estimated?

Ms. Ronk. Yes.

Senator Proxmire. You estimated that is how big?

Ms. Ronk. For the fiscal year I don't have the figures here but it would be $12 to $15 billion.

Senator Proxmire. How about the full employment budget?

Ms. Ronk. Well, it would be in slight deficit, too.

Senator Proxmire. In deficit? You estimate that will be in deficit?

Ms. Ronk. Yes, sir.

Senator Proxmire. You are the first economist who has estimated that. Everybody else has estimated it will be in surplus. In fact, our staff people argue it will be in surplus under almost any circumstances.

Their estimate is even if you recalculate the full employment at 4.6 or 4.7 instead of 4 percent, you are likely to have a surplus.

How about you, Mr. Hymans.

Mr. HYMANS. I don't find the full-employment surplus interesting enough or important enough to make calculation on the full-employment surplus.

Senator PROXMIRE. You are certainly a maverick in the fraternity, aren't you. That is unusual. You say it is not interesting enough even to make a calculation?

Mr. HYMANS. No; because it doesn't tell you unless you happen to be——

Senator PROXMIRE. Don't you believe in the fiscal drag concept that if you have a surplus, say, let us take a more extreme case, you have 7 or 8 percent unemployment, and you have a slight deficit, obviously with 5 percent unemployment, you would have a big surplus. Don't you consider that would slow down your recovery or not?

Mr. HYMANS. Yes, but that is not a matter in the change in the full-employment surplus telling me anything. What I want to know is what the current change in the budget is going to do.

Senator PROXMIRE. That is an important factor. What does that tell you?

Mr. HYMANS. How much stimulus is being provided by whatever budget changes are going to take place, not how much stimulus is provided if you are where you are not and haven't been. That is what the full-employment surplus tells you. I just regret the popularity of that concept.

Could I return for just a moment to the earlier question about the oil prices, the two-tier sytem, and tax changes?

Just to point out that when you compare tax changes which the Government can institute, either a tax increase on gasoline, tax rebates to the consumers on income taxes, and excess profits taxes, and compare that with governmental setting of prices in place of the market, whatever competence has ever been demonstrated by the Federal Government seems to me to be wholly on the side of not tinkering with market prices and instead using the tax system.

It seems to me recently we have demonstrated amply that the Federal Government just doesn't make out right when it goes and tinkers with market prices, when it replaces the market pricing mechanism, and that seems to me to be a very important lesson to remember at a time when we have to set policy that is of importance in the short run. It is almost certain that we are going to mess up oil prices.

Senator PROXMIRE. Give me a specific excess profit tax that would work. I haven't seen one. It would be very discouraging of efficiency and so forth.

Mr. HYMANS. One way to do it is not to use an excess profit tax but instead put a tax on retail sales of gasoline and then the money does not flow to the oil companies in the first place.

Senator PROXMIRE. Well, sure, a kind of sellers market. If you put any kind of tax on the retail price of gasoline it is just a sales tax.

Mr. HYMANS. That is right.

Senator PROXMIRE. Consumer pays more, that is all.

Mr. HYMANS. Yes.

Senator PROXMIRE. It discourages demand, it has that effect.

Mr. HYMANS. That is exactly what you want to do at this point.

Senator PROXMIRE. There we are groping in the dark, we have no experience here, we just don't know what is going to happen, how elastic the demand is for gasoline. How do you know?

Mr. HYMANS. Estimates.

Senator PROXMIRE. There is a very bad experience with some products.

I mentioned the other day the price of cigarettes in Britain. In World War II, they tripled the price and the sales went down about 5 percent for a few months and then went right back to where they were, and I am inclined to think something like that could apply to gasoline. You could have a 25 to 30 cents a gallon tax and I am not convinced it would reduce your consumption enough to take the excess demand out of the market.

Mr. HYMANS. Well, if that is the case it seems to me what you have to do is treat oil not piecemeal in this way but treat it as a public commodity in the first place and you can't do it in——

Senator PROXMIRE. What do you mean treat it as a public commodity?

Mr. HYMANS. Treat it as a public commodity in the sense that we say there is a vested interest in the country in providing a certain flow of oil and we don't want private industry to handle that.

I am not necessarily advocating this position.

Senator PROXMIRE. That is not a practical suggestion, really, is it? Nobody is going to do that. We are not going to nationalize the oil companies.

Mr. OKUN. That is hardly an area where the Federal Government has shown great competence.

Mr. HYMANS. I am not advocating that position and I am saying we are trying to do that piecemeal by regulating the prices, by establishing a two-tier system, by assuring there aren't excess profits generated in the first place, and I am saying we are building more and more bureaucracy and inefficiency into the system by this kind of scheme.

Senator PROXMIRE. Well, all right, let me get back, away from that.

We have had a lot of testimony in this area that has been exciting and interesting. We would like to get as much information on monetary and fiscal policy as we can.

One thing I would like to challenge in your also very persuasive presentation is the great emphasis which you seem to have on Government spending and increasing the budget, which is the biggest budget and biggest increase in the budget we ever had in peacetime.

This is a $30 billion incrase over last year. This is an increase of 10 percent over last year. In percentage terms it is very great, an increase in real terms. But this is a very sterile budget. It dosn't do anything. It provides 80 percent of an increase in military spending or social transfer payments and Medicare and Medicaid and other things like that. There is very little increase; in fact there is a real decrease in education spending, manpower training, housing, the areas that would provide either economic goods or real muscle and strength for the economy.

You do suggest very briefly, in your statement, that you might want to change the priorities somewhat and give housing a help in

providing unemployment compensation increases. Don't you think that fiscal policy really ought to take a look at the makeup of the spending situation we have and recognize how enormously inflationary that high military spending is and how desirable it is to provide the things we really need in our society?

Mr. Okun. I made no effort to survey the issue of priorities and perhaps I accepted them too passively in only suggesting Government spending to add on to the President's budget. There is another department at Brookings that deals with the composition of the budget; that hasn't been my area of expertise. However I agree that, if we can determine that adequate national security can be purchased at a lower price tag than what is recommended in the budget, then tht would be all to the good. The present budget does not reflect my social priorities, but it is somewhat closer than last year's. Last year's budget I said was economically impeccable but socially intolerable. I find this year's budget socially tolerable—although not ideal—but economically peccable and I guess I concentrated on the latter.

Senator Proxmire. Economically peccable. By that you mean it is subject to criticism?

Mr. Okun. Yes, I am joking. That isn't really a word.

Senator Proxmire. Well maybe it ought to be anyway.

Mr. Okun: I wanted to emphasize that, if one is looking for additional fiscal stimulus, the bulk of that has to come from tax reduction in terms of any criteria of efficiency, promptness, and priority.

It can come from the tax side, if by cutting defense expenditures, room can be made for some of the additions in housing and unemployment benefits and job creating programs, which I think are inherently desirable.

Senator Proxmire. This is one of the most perplexing and puzzling and difficult kind of situations we have had that I can recall in the years I have been here, because we do face a recession. We had a very sharp dropoff in, I should say an increase in unemployment in the last 3 months. We have had a dropoff in industrial production. At the same time we do have raging inflation. It is really raging and the momentum is building up.

And if you try to cope with one you aggravate the other. So it seems to me to be an extremely difficult time in which to recommend policy that you have confidence in.

Let me start with Mr. Hymans and go across the panel.

The administration has indicated it will develop contingency anti-recession plans if needed. The other day Senator Javits, a member of this committee, introduced legislation providing for 500,000 public service jobs to be put into effect when the President felt he could, but presumably if unemployment increased.

The cost of the program is $4 billion. He wanted to put it through right away so the President could act within the next few weeks, if necessary.

Mr. Perry said yesterday that action was needed today both because unemployment is already rising and recovery in the second half is far from a sure thing.

So, Mr. Hymans, how about it, do you think that kind of program or some other program would be desirable or would have such in-

flationary implication it would not be worth it? What would you recommend?

Mr. HYMANS. I am agreeing with what you said a few minutes ago, this is a more difficult situation than the kind of recessionary situation we have faced in the past.

For the most part, in recent history we faced a recessionary situation in which we knew there was plenty of excess capacity and if we increased employment, increased the flow of income payments and so on, we knew that production could expand under the stimulus of the increased demand that would result and we would benefit economically by getting an increased flow of output and incomes without very much impact on inflation.

Here we are in a situation, particularly as long as we are constrained in the available quantity of important resources, in this case oil, that if we go into, if we generate incomes, additional incomes through public service employment or anything else, without the additional capacity to produce what is going to be demanded as the result of the increased payment, we could generate substantial inflation in the process of doing this.

A great deal depends on what kind of public service the employment would be used for and so on.

Senator PROXMIRE. Isn't public service employment by and large less demanding of energy than other kinds?

Mr. HYMANS. It is not demanding of energy I am worried about. It is the demand for goods and services in general that will be generated by the increased income that would result and this general demand for increased goods and services, perhaps greater demand, for example, for gasoline by people with higher incomes, perhaps demand for more plastic products, anything that is in any way constrained by the shortfall in petroleum and——

Senator PROXMIRE. If you take that position then you are pretty much paralyzed in fighting recession.

Mr. HYMANS. You are not paralyzed. I am saying a great deal depends on what the public services employment is used to produce.

Senator PROXMIRE. You just said what you are concerned about is the increased demand flowing from the fact you are going to spend $4 billion that is going to go into the pockets of people who aren't going to save it, they are going to spend it.

Under those circumstances if they are not engaged in activities that would consume energy they are going to buy gasoline, they are going to heat their homes a little better.

Mr. HYMANS. Take a very stark contrast. You could, for example, do it by increased defense spending, and that is about the worst thing you could do. If you do it by increased defense expendtiure you are not going to produce anything that the private market wants to buy and all I am saying is what we want to do is increase employment in the areas in which the production is most nearly what the private market wants to buy so that we get increased flow of goods and services along with the increased income payments resulting from the increased employment. I think that is extremely important.

Senator PROXMIRE. It sounds very logical to me, very attractive. Housing is one area. Can you think of anything else?

Mr. HYMANS. Well, I suppose housing, medical facility areas, things of that sort.

Senator PROXMIRE. What facilities?

Mr. HYMANS. Medical facilities.

Senator PROXMIRE. That is a point.

Mr. HYMANS. In other words it is in an area where things are tight now.

Senator PROXMIRE. The administration is calling for a health program, Congress is calling for a massive health program, both of which will require a great increase in personnel and they are reducing the funds available for training doctors, nurses and paramedical personnel.

We have 15,000 qualified young people who want to go to medical school and we are not letting them go; they are being turned down. Here is an area where it would seem to me you could provide employment that would be constructive.

Mr. HYMANS. Absolutely.

Senator PROXMIRE. At the same time we are hiring 30,000 new people to work as civilians for the Pentagon?

Mr. HYMANS. Yes, sir, that is of course the wrong way to do it.

Senator PROXMIRE. Mr. Okun.

Mr. OKUN. I think that shortages of products other than petroleum are going to be a distant memory in just a few months. Operating rates are falling very sharply in industry. I think one has to go back and remember——

Senator PROXMIRE. What did you just say, you think petroleum shortages——

Mr. OKUN. Shortages other than petroleum.

The long list of shortages we have had in various metal products, paper, various types of chemicals, other than petrochemicals, will shrink very rapidly.

These shortages arose very rapidly. We didn't have a shortage list of any size in November 1972. Lumber and cement was the full extent of the shortage list and those problem areas were associated with the housing boom. The other shortages all developed in the next 6 months, as a result of an enormous spurt in output.

I don't think we should be planning ahead for a pattern of purchasing power that is going to be strong at mid-year, nor a pattern of industry wracked by widespread shortages. The petroleum shortage is unique, *sui generis*, it is enormous, and that is why I think it has to be handled basically by nonprice mechanisms.

I think that the price system is just as unsuited to handle the petroleum shortage as it is to allocate seats on a lifeboat. This is an emergency. It has to be managed in a way that guarantees that extra demand that might go to buy more gasoline doesn't get translated into inflation, that the available supplies continue to flow into the industrial uses that determine our basic supply capability. In that case, then the economy will be capable of absorbing more demand and turning it into extra output and employment and not extra inflation. The indices of economic output are going to indicate a recession in every respect, but petroleum within a few months; the anomaly will be that the price indices will continue to rise.

However, the current situation must be treated as a recession and the appropriate treatment for that illness should be undertaken.

Senator PROXMIRE. I thake it you would favor the Javits proposal?

Mr. OKUN. I would favor going as fast as one can on public service employment programs. I would be very surprised, however, if anything like a $4 billion public service program could be put into effect within the period in which we will need it. The history of the last couple of years has been that that program can be effective but that it moves slowly.

The maximum number of jobs under the public service employment program in 1973 was approximately 140,000. And that was 2 years after the program had been put into effect.

Senator PROXMIRE. Even if we passed an emergency bill in the next couple of weeks, somehow, and it passed the House and Senate and was signed by the President, the likelihood of putting that into effect in the next 4 or 5 months would be, you think, practically nil?

Mr. OKUN. I would like to be convinced that I am wrong on that score. But history makes me very cautious about launching antirecessionary expenditure programs, I remember the accelerated public works program of 1962 which had more expenditures in fiscal 1966, when we didn't need them, than in 1963.

Senator PROXMIRE. In 1966 when we had an inflation really taking off, beginning to——

Ms. RONK. Well I agree with Mr. Okun that we are in a period now where we have rampant inflation at a time when recession is approaching and when we want to be careful not to accelerate the inflation, but I think that as output declines the inflationary pressures will relax.

We have been through a period recently of what I would call a "one-shot affair" adjustment to higher farm prices and higher food prices. We have been living on cheap energy and cheap food for years. As we go into the second half of the year, these adjustments will have been about completed and the upward price pressures will be of a cost-push nature from the wage side, as wages try to catch up. As we enter 1975 we hopefully will be looking toward even lower inflation rates because we will not be facing heated economic conditions, while farm and food prices might even be declining and an adjustment to higher wage rates will have been accomplished.

Senator PROXMIRE. Doesn't that depend on just exactly what you mentioned, the wage push factor? In other countries their principal inflation problem now is that in England, for example, and Germany, they are facing enormous demand for huge increases in wages, and in fact it happened here, too, in light of what happened last year, with real wages falling.

Ms. RONK. Yes, that is why I see the rate of price increases remaining 5 to 6 percent in the second half of the year.

Senator PROXMIRE. Mr. Okun, you feel events justified your earlier recommendations, specific policies were needed to moderate the growth of agricultural exports. Could I get you to elaborate a little on what you mean by national food budget, what kind of export controls you feel are needed now? I like that idea very much. I think

the overwhelming majority of the American people approve the idea. I think you are such a sensitive economist—I know how careful we have to be with it—it could be construed as a very selfish policy that we take care of the best-fed nation in the world, the biggest nation and other nations of the world would suffer more serious inflation inasmuch as we are a big exporting nation.

At the same time I think it is wise to discuss this and I think the idea of a national food budget—I am not sure what you mean—I would like to have you spell it out.

Mr. OKUN. It seems to me——

Senator PROXMIRE. Let me say one more thing. We want to put that in the perspective, the fact that the guts of the inflation in 1973 was not energy but was food; it was about a 20 percent food inflation and that is what hurt.

Mr. OKUN. And that really has been the most acute disappointment in the last few months. We were hoping to get some relief from food inflation when we got our harvest in 1973. That hope completely vanished and now we face renewed food inflation, on top of the new fuel inflation. I am not an authority in this area. I don't understand fully how agricultural exports are managed today. It seems to me amazing we seem to have an open order book and take orders without even being sure that we have the supplies to meet them. It's inconceivable that we may actually have to import wheat in order to honor export commitments. That seems incredible to me.

Whatever puts the American consumer at the back of the queue needs to be eliminated. We ought to ask what is a reasonable amount of wheat, soybeans, corn, and other major grain products for the American market in the year ahead and then reserve this allotment for domestic purposes. A national food budget means planning ahead to ensure domestic supplies consistent with price stability.

Senator PROXMIRE. I am delighted to get that recommendation from somebody of your stature, because I tried to press that idea on Secretary Shultz. I tried to get some kind of notion that we would at least have an early warning system, information so we would know what effect our exports are having on our food prices here.

Last year we had an enormous export of wheat and feed grain. The price went up $2, $3, $4, and $5 a bushel for wheat and, of course, it pulled up soybeans and corn and meat and the substitutes along with it.

When I suggested this they seemed to feel that it was a very shortsighted, almost beggar-thy-neighbor notion, if we realized what was happening to our exports we might be persuaded to act, and if we did it might tend to hurt other nations, and I could understand how we can be sensitive to that, but I can't, for the life of me, understand why we shouldn't know what we are doing.

If you are going to have a wage-price, wage explosion that is inflationary, the most likely element to kick it off would be a continuing rise in food prices and people are sensitive to that.

Mr. OKUN. I think there is an equity issue here. As I see the equity issue, a situation where the United States increases its real volume of food exports by 40 percent and permits a 5 or 10 percent decline in the real food supply to the American market, is inequitable to the American consumer.

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The framework of equity can be maintained at this point by planning ahead for the 1974 crop year. The problem could be discussed on a multilateral basis with our trading partners to devise a fair sharing arrangement. We might ask them to consider using some restraint, to make sure their demand for our goods is kept within reasonable bounds, and we could assure them that they will get some reasonable sharing of the limited supplies.

A large increase in exports combined with a decline in the domestic availability does not meet my standard of equity. In some cases this reflects the action of some countries which have in normal years made great efforts to keep out American food and now in a year of shortage, are glad to get all they can get.

The question of food policies for the long run also ought to be raised in such a multilateral discussion.

If we are supplying countries now, we ought to have some assurance they don't slam the door on American food exports in times when food supplies come back in line with demand.

Senator PROXMIRE. Mr. Hymans or Ms. Ronk, would you like to comment on that?

Ms. RONK. That is a matter I haven't given much thought to but it sounds very reasonable to me.

Senator PROXMIRE. Let me ask about one other area before we are through, and I so much appreciate your patience and contributions this morning.

Mr. Okun is the only one of the three of you who expresses an opinion on the continuation of the Wage Price Stabilization Act that expires on April 30. The Administration recommended that it be allowed to die with the exception of health.

We already have energy prices separate that won't expire until February next year. It would expire on everything else, including the power to put into effect at any subsequent time by Executive action any wage or price control.

This position is supported by organized labor, supported by the business community. Mr. Okun was joined by Mr. Ackley yesterday. He said he thought we ought to continue the Wage Price Stabilization Act with the authority of the President to move in, if necessary.

The opposition argues it hasn't worked; we have had the worst inflation ever when we have had peacetime controls.

On the other side you can argue what happened to prices has nothing to do with wage-price controls, it has been foreign demand and the energy crisis and so forth.

What would be your recommendation, Mr. Hymans; should we continue the Wage Price Stabilization Act?

Mr. HYMANS. I read a news report a week or two ago which had some tantalizing but incomplete information about an alternative scheme which Mr. Dunlop seems to be favoring regarding essentially a guidelines office.

Senator PROXMIRE. Well, no guidelines, he is very careful on guidelines, he is very much against guidelines.

Mr. HYMANS. It is an information kind of scheme.

Senator PROXMIRE. He would ask for reports but not the kind—there is a difference—let me take a minute to point out Mr. Burns

has proposed that ad hoc boards be given the authority to hold up any wage or price increases in what he calls the pace-setting industries, for 30 to 45 days while we have hearings.

After the hearings are held, industries would be free to go ahead and increase prices or wages if they want to, but at least there would be a chance for Congress to act or for the President to ask Congress to act.

That is not what Mr. Dunlop proposes. All he proposes, as I understand it, is that there be reports, there be information at the same time, but wage and price increases could be put into effect and without any kind of waiting period, without any kind of hearings on those specific increases.

Mr. HYMANS. I guess the Mr. Burns kind of proposal is the one that attracts me. And whatever enabling legislation would be required to permit that, I would be in favor of. That seems to me to be exactly the right way to pursue the matter.

Senator PROXMIRE. Ms. Ronk.

Ms. RONK. I would think under the present circumstances, where industrial production is declining and unemployment is rising, that it would be good to eliminate the wage-price controls as the administration proposes and get through our post control flurry of price increases, which may not hold, in any case, if our economic pattern proves correct.

Senator PROXMIRE. Ms. Ronk, let me challenge you a little bit on that.

I think that what you say has certainly been the conventional wisdom, as I understood it, up until our experience in 1970. You know what happened then. We had an increase in unemployment that was quite serious and we had one of the biggest wage increases, inflationary wage increases, we have had, and it came at a time, of course, when there was a recession. You had a drop in productivity. The result was that skyrocketing wage costs pushed up prices and we had a worse inflation in 1970 than we had during the height of the Vietnam war.

So we could have that again, isn't that likely, you could have a slowdown in employment, you would have a recession, that would be at least to the point of maybe 6, 6.5 percent unemployment and falling productivity and with labor determined to catch up, and with considerable justification for that.

This is the nightmare that bothers some of us.

Ms. RONK. Well, I would say that some of that is inevitable because it is only equitable for labor to catch up somewhat as the year progresses but then I would agree that after that flurry that we should have something like the Burns proposal, a standby authority to hold down wage and price increases.

Senator PROXMIRE. So you would advocate we allow the law to expire and then maybe early in 1975 we put into effect something like the Burns proposal?

Ms. RONK. Well, I am not sure of the time period. The Burns proposal might be put into effect as the law expires so as to permit policing the increases. The beauty of phase II I felt was that the bureaucratic process did help to slow down the rate of increases and we had good experience under phase II.

Mr. OKUN. It seems to me that Mr. Dunlop now is using his powers in very ingenious ways which show that the powers are worth a good deal.

He exempts industries and gets treaties with them on how they are going to behave and I don't think that he could get those treaties unless he had the power to control them if they didn't behave. His enforcement technique has capitalized on the use of these latent powers.

Senator PROXMIRE. I couldn't agree with you more but you know Mr. Dunlop came before the Senate Banking Committee and the Joint Economic Committee and he told us that very clearly and emphatically he thought it would be a mistake to continue the Wage Price Stabilization Act. He thought the overhanging power would have an inflationary effect, pernicious effect, that he thought it would be better to let it expire.

It seems to me he is asking to be disarmed when he has still got a war to fight.

Mr. OKUN. Unilaterally.

Senator PROXMIRE. Yes.

I want to thank all of you for your most useful and helpful comments, as I say, at one of the most perplexing times and difficult times we ever had. I think your advice is very, very useful.

The committee will stand in recess until tomorrow morning at 10 o'clock when we meet in room 1202 in the Dirksen Senate Office Building and hear Mr. Cooper, Mr. Modigliani, and Mr. Steele.

[Whereupon, at 11:45 a.m., the committee recessed, to reconvene at 10 a.m., Friday, February 22, 1974.]

THE 1974 ECONOMIC REPORT OF THE PRESIDENT

FRIDAY, FEBRUARY 22, 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 1202, Dirksen Senate Office Building, Hon. Henry S. Reuss (member of the committee) presiding.

Present: Representative Reuss and Senator Proxmire.

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; and George D. Krumbhaar, Jr., 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.

Today we have set aside to hear the views of private witnesses on the international economic outlook. The committee is interested chiefly in four problem areas: The short-term outlook for our balance of payments in the face of sharply increased prices of petroleum imports; prospects for international monetary reform; reducing trade barriers; and the appropriate U.S. level of contributions for economic development assistance to poor countries.

The price increases announced by petroleum exporters last year have shifted the outlook for the U.S. trade balance in 1974 from a respectable surplus to a deficit of from one to several billion dollars.

Is this a prospect that should disturb us, or are inflows of excess oil earnings from producer countries for investment in the United States likely to maintain the strength of the dollar?

Given these new circumstances, what structural pattern of international payments is likely to emerge among the United States, the other industrial countries, developing nations, and the oil producers?

In this light, should we accept depreciation of the French franc and the Japanese yen this year with equanimity, or should we seek to prevent any further drop in the value of currencies issued by other industrialized countries?

We are observing the energy crisis by heating everything to 80 degrees, for which I apologize. I will try to change it. Apparently the fan is broken.

The effort to reform the international monetary system seems to have been overtaken by events. Virtually all major parties, including those previously most vigorously opposed to floating rates, now seem to accept the idea that market forces must be permitted to determine the relative value of various currencies for at least the foreseeable future. However, a number of pressing issues remain unresolved.

The nations of the EEC recently announced their intention to study ways of increasing the official monetary value of gold. Given the huge discrepancy between the official and the free market prices of gold, we cannot be blind to pressures for eliminating this differential.

But what is the most appropriate role for gold in the future and how should the question of its price be resolved?

In addition, there are as yet no generally agreed rules governing central bank intervention in exchange markets. At the moment, we are dependent upon ad hoc coordination among monetary authorities to avoid intervention at cross purposes.

One cannot be overly confident that these arrangements will continue to bear up under the strains of the future as well as they have in the past. We need some rules on what central banks can and cannot do in exchange markets, as well as guidelines regulating other government policies that can affect exchange rates.

What sort of rules should be instituted?

While the House passed a comprehensive trade bill during last year's session, the Senate Finance Committee will not begin hearings on this bill until next month. Initially, when the need was perceived to grant the President new authority to negotiate the reduction of impediments to trade, tariff and nontariff barriers to imports were the primary concerns.

But last year the United States embargoed exports of soybeans and high protein animal feed substitutes on the one hand, and Arab oil producers embargoed petroleum shipments to this country on the other. Potential scarcities of food and critical raw materials resulting from export controls are now even more pressing issues than access to the markets of industrialized countries.

Can cooperative arrangements be formulated and enforced to assure supplies of basic commodities to all customers on an equitable basis?

Turning to the developing countries, we are concerned especially about how the increase in oil prices will affect their growth prospects. Prospective fertilizer shortages raise the specter of widespread starvation, in addition to the adverse impact higher petroleum prices and reduced supplies will have on industrialization.

Wealthy nations will be able to adjust to the altered global petroleum situation, but for developing countries these changes may prove catastrophic. Oil producers with excess revenues should certainly be expected to increase their participation in the multilateral development banks and their bilateral assistance to countries especially hard hit by high oil prices and shortages.

But what amount of increased funding from oil producers should we expect if the United States and other industrial nations are going to continue their aid contributions at previously planned levels?

Underlying all the above questions is the fundamental query of how both rich and poor nations are going to adjust to the dramatic changes of the last year in international economic conditions and what cooperative measures can be implemented to ease the adjustment burdens.

We are fortunate to have with us this morning Richard N. Cooper of Yale University, Henry Steele of the University of Houston, and Franco Modigliani of MIT.

All of you gentlemen have provided us with very comprehensive prepared statements, which under the rule we will receive in full in the record, and now I would like to ask you to proceed orally, starting with Mr. Cooper.

STATEMENT OF RICHARD N. COOPER, PROVOST, YALE UNIVERSITY

Mr. COOPER. Thank you, Mr. Reuss. I am pleased to be able to appear before the committee to offer some observations on the international economic scene.

The year 1973 was an extraordinarily eventful one for the international ecenomy. At the official level, the Committee of Twenty reported at Nairobi on reform of the international monetary system, and adherents to GATT met in Tokyo to launch a new round of trade negotiations.

At the market level, the year opened with large speculative outflows from the United States, resulting in a 10 percent devaluation of the dollar, turmoil in financial markets, and a more general switch to floating exchange rates, with several European Community countries tying their currencies together in a joint float. Despite attempts by the Committee of Twenty to keep it alive, these developments marked an end to the Bretton Woods system of financial relations among countries, an end that had already been foreshadowed in 1971 with abandonment by the United States of the gold convertibility of the dollar.

Now, this would have been a full year by any standards. But these developments turned out to be only the beginning. Astonishingly, the dollar, which had been devalued twice in the previous 15 months, depreciated a further 10 to 12 percent until July before leveling out and then appreciating toward the year end.

Appreciation of the dollar occurred under the impetus of the more than doubling of crude oil prices, which shocked the world out of its complacent reliance on rapidly growing supplies of cheap energy. The joint float of European currencies broke down with France's withdrawal in early 1974.

Despite all of this turmoil, the world economy enjoyed an unprecedented bom in economic activity, pulling up the prices of all primary products, including those other than oil, against a background of general inflation. But at year end, there was widespread concern that the boom would become world recession. A slowdown from the hectic pace of 1973 was necessary, and this in itself carried the risk of overshooting. Overshooting was made even more probable by a reduction in supplies of crude oil and sharp price increases.

Now, Mr. Reuss, I have written a prepared statement which is too long to read, and I would like it to be included in the record and to

devote my oral comments on the current situation to just a few items picked out from among the many that might be discussed at the present time.

Let me direct my comments toward four issues. The first is that I think the Committee of Twenty in its discussions of international monetary reform, is on quite the wrong track at the present time. It began its deliberations against a background of some financial turmoil in 1972 and started out with an attempt to restore, as I perceive it, something like the Bretton Woods system, patched up to make it work better. Events have moved too rapidly for it, and it has not kept up with the fact that far from moving back towards a system of fixed exchange rates, as many participants in the Committee of Twenty would seem to wish, we have had floating rates now for nearly a year.

I believe that the Committee of Twenty should drastically realign its efforts toward two issues which are of crucial importance to the international economy today. The first concerns not how to restore a system of fixed rates, but rather how to restore a high degree of cooperation among countries in the system in which exchange rates are floating—in short, how to achieve a system of managed floating, floating which nonetheless excludes the possibilities of competitive either devaluation or revaluation for domestic economic purposes.

The second issue which the Committee of Twenty should devote much more attention to is the creation at the global level of a lender of last resort. I put forward a specific proposal to this committee just a year ago on how that might be accomplished. The underlying idea is that the leading central banks of the world through the IMF would, if necessary, lend to one another in periods of financial crisis very large amounts, and then tidy up afterward.

I will not go into the details of that proposal again this morning. But I continue to feel even more now, in light of what has happened in the international economy, than I did a year ago that this should be an essential feature of a reformed international monetary system. A lender of last resort is, of course, especially important in a system of fixed rates. But in the system of managed floating that I envisage some kind of lender of last resort is also a necessary feature.

I have given to the staff an article, which I would appreciate being inserted in the record as part of my testimony, concerning the reasons for the breakdown of the Bretton Woods system.

[The article referred to follows:]

[Article from Saturday Review/World, Jan. 26, 1974]

THE "SYSTEM" IN DISARRAY

EFFORTS TO ACHIEVE A NEW MONETARY ORDER REMAIN STALLED ON ONE KEY PROBLEM—HOW TO CORRECT IMBALANCES IN PAYMENTS

(By Richard N. Cooper[1])

International monetary affairs have been in disarray for six years, since the gold crisis of early 1968. The formal rules of the international monetary "system" are now in abeyence, and some observers contend that international monetary order has been completely shattered. The current circumstances are sharpened by the fact that the international monetary system apparently functioned marvelously throughout the 1950s and most of the 1960s.

[1] Richard N. Cooper is provost of Yale University and Frank Altschul Professor of International Economics there.

How did we get into the present state? How bad is it? What is likely to emerge from the present disarray? Answering these questions requires an excursion into interpretive history.

Before we launch on this excursion, two common explanations should be set aside. The recent disarray cannot be attributed either to the presence or to the passing of any individual—President de Gaulle is often cast in that role. Nor is it due to the admittedly dramatic decline that has taken place during the past two decades in the relative position of the United States on the world economic scene. Its share of gross world output dropped from 39 percent in 1950 to "only" 29 percent in 1972, and its share of international reserves dropped from 50 percent to 8 percent during the same period. European nations and Japan grew rapidly following the devastation of war, and the former have coalesced into a community that now exceeds the United States in the relative importance of its trade.

These factors have played a contributing role in evolving monetary developments, but they have not been central. The main considerations, alas, have been more technical. But that is only superficially a cause for regret. While it makes the problem more difficult to explain, it also makes a solution easier to grasp—once nations recognize the technical nature of the problem. Disagreements on fundamentals may remain, but at least the non-solutions that have so far dominated discussions can be set to one side.

The key problem of financial relations among nations is how to keep countries from getting into a balance-of-payments deficit (or surplus) and how to eliminate an imbalance once it arises. There are two broad approaches to the task of correcting imbalances: Financial conservatives favor reducing total domestic demand, even it that causes hgher unemployment. The other approach is to rely on measures acting directly on foreign trade and capital flows. Import taxes or quotas do that, and so do changes in the price of the country's currency with respect to foreign currencies—its exchange rate, in the language of financial markets.

The nineteenth-century gold standard had relied on the first approach; it was rejected by leading nations in the 1940s in favor of ultimate reliance on the exchange rate for balance-of-payments adjustment.

The Bretton Woods System—named after the New Hampshire village where the final conference was held in 1944—was bold in conception and ideal on paper. It was constructed on the ashes of the economic nationalism of the depression-ridden 1930s. The architects of this system laid down four points:

First, international financial questions impinged on many nations, hence called for international accountability by nations to the community of nations.

Second, it was thought that the best way to carry out this responsibility, yet still allow for the required adjustment, was for each nation to declare a *parity* for its currency, determining its exchange rate with respect to other currencies. That parity was to be changed when necessary to correct a "fundamental disequilibrium" in the country's balance of payments, but only with international approval. That approval was designed to prevent exchange rates from being changed in a predatory fashion, as they had been in the 1930s.

Third, each country was to maintain convertibility of its currency into other currencies for all trade and service transactions. The use by the Nazi regime in Germany of restrictions on international trade and travel made these devices odious as a restraint on freedom. Each country was also to maintain the convertibility of its currency in quite a different sense—namely, convertibility into gold or into a currency convertible into gold for any foreign *official* balances of its currency acquired through trade.

Fourth, a new institution, the International Monetary Fund (IMF), was created to police the new rules of behavior and to lend to nations in difficulty while they were still trying to determine whether or not they had a "fundamental disequilibrium" or to tide them over the period during which corrective steps were taking effect.

Most observers credit the Bretton Woods System with great work. World trade has grown at a truly fantastic rate—from $55 billion in 1950 to over $450 billion in 1973—nearly 10 percent a year over nearly a quarter-century, a record that must exceed all previous ones. Most of this growth was real; inflation accounted for a substantial part of it only in the last several years. World output has grown at a rate that looks small only by comparison with trade; and depressions have become "recessions," mild in comparison with pre-war strains of that malady.

But imputing this high performance to the Bretton Woods System has little validity. Indeed, the Bretton Woods System was actually tried for the first

time in the late 1960s, and it collapsed in the process. It was out of tune from the start, for it neglected the important role of international capital movements and the difficulty—the virtual impossibility, without Draconian measures inconsistent with other dimensions of economic freedom—of controlling them. This iconoclastic assessment requires justification.

In 1947, when the IMF was created, the overwhelming dominance of the U.S. economy contrasted sharply with the juridical parity among countries called for in the Bretton Woods Agreement—and indeed in most international agreements. (The one concession to actual asymmetries was a system of weighted voting, with the United States having the largest vote.) The countries of Europe and Asia had been devastated by war, and their dependence on the United States for food, materials, and capital equipment was heavy. For most countries, the key financial problem was the "dollar problem"—how to earn enough dollars to pay for needed goods.

The Bretton Woods System was postponed from the start of the IMF in 1947 for a "transition" period that lasted nearly fifteen years. After extensive currency devaluations in 1949, only France among major countries changed the value of its currency in the 1950s (a fact that, in combination with the turbulence surrounding a modest revaluation of the German mark in 1961, led many financial pundits to the view that changes in exchange rates were neither necessary nor desirable). How then did countries correct payments imbalances? By deflation of domestic demand? Occasionally, but that was not the important method of adjustment. Rather, it was first the introduction, then the gradual and variable relaxation, of controls on transactions with the United States and other "strong currency" countries. The devaluations of 1949 gave many countries a competitive edge against American goods, and as their exports expanded, they gradually relaxed their restrictions on imports—a process that lasted until 1961.

By the 1960s that process of differential trade liberalization had virtually run out. The time to introduce the Bretton Woods System might seem to have come, and indeed it was formally accepted by many countries in 1961. But now a new factor emerged that prolonged its true introduction for another six years: the emergence, in 1958, of a large U.S. balance-of-payments deficit, which was to remain large throughout the 1960s. The causes of that deficit were varied, including a short burst of inflation in the United States from 1956 until 1958, the recovery of Europe and the formation of the European Common Market (which stimulated American investment there on a massive scale), and even the advent of intercontinental strategic missiles, which reduced the physical security of the United States relative to business locations overseas.

Because of the large U.S. deficit, virtually all other industrial countries ran balance-of-payments surpluses throughout the 1960s. They were thus spared the need for making hard decisions to correct payments imbalances. While they would have found it impossible to run deficits indefinitely, surpluses did not carry the same compulsion to take corrective action.

The United States was an apparent exception to the rule regarding deficits. During the dollar-shortage days of the 1950s, countries had formed the habit of building up their balances in dollars. Habits based on convenience are hard to break; so they continued in the 1960s. But so long as other countries willingly held dolars, there was no need for the United States to eliminate its deficit—it could simply issue more IOUs (in practice, the same Treasury bills that are issued in the domestic market—that was one of the sources of convenience). France made an abortive attempt to discipline the United States in the mid-1960s by cashing all its dollars into gold at the U.S. Treasury. But that move was correctly interpreted as a political act designed to humble the United States. Other countries did not share that purpose, and they perceived that large-scale encashment of dollars into gold would bring an end the system they thought they were operating under; so they more or less voluntarily refrained.

The United States was of course concerned about its payments deficit, and the government took a number of foolish moves to correct it (such as imposing what amounted to a 50 percent tariff on all U.S. government purchases abroad, thus raising the tax burden), but it did not devalue the dollar, as a "fundamental disequilibrium" under the Bretton Woods System would have required.

The Vietnam war—induced inflation strained to the breaking point the willingness of other countries to accumulate dollars. First Germany (in 1969) and then Canada (in 1970) revalued their currencies upward to stem the inflationary

impulses from the United States. The U.S. deficit grew enormously in 1971; and when the United Kingdom (a country that ironically had been in chronic deficit until 1969) allegedly raised the prospect of converting some of its dollars into gold, the result was necessarily a formal suspension of gold convertibility by President Nixon in his new economic policy of August 1971. But that suspension would have come sooner or later, for the sharp growth in foreign-held dollars relative to the U.S. gold stock was making convertibility increasingly hypothetical.

It has become fashionable to blame recent financial difficulties on "speculators," on the Eurodollar market, or on multinational corporations. These groups are blameworthy only in the sense that financial crises would be less dramatic without them. Speculators, which for these purposes include many of the multinational corporations, often acting through the Eurodollar market, anticipate changes that they believe more fundamental economic developments would require sooner or later in any case. Speculation is a symptom of difficulty, not the cause of it. Of course, speculators may be wrong in their judgment, and their fallibility creates a source of disturbance that otherwise might have been avoided. The dollar undoubtedly depreciated too much last year. But by and large, the "disequilibria" arise from underlying cost, income, and price trends, not from speculation.

Until the late 1960s, exchange-rate changes among major currencies were rare. Differential trade liberalization in the 1950s and large (but grudgingly acceptable) U.S. deficits in the early and mid-1960s had reduced the need for such changes. And even when the need arose, governments were reluctant to act because of the speculative turbulence, before and after, created by highly mobile capital, in effect nullifying the Bretton Woods stipulation for thorough international consultation and agreement on proposed exchange-rate changes.

It is thus not too much of an exaggeration to say that the Bretton Woods System broke down just when it was actually first put into operation, that is, in the late 1960s, when major countries began to use large changes in exchange rates to correct fundamental imbalances. The inflationary pressures of the late 1960s put exceptional strain on the system, but payments imbalances are *bound* to arise from time to time because of divergent economic developments among countries governed by democratic majorities. A large machine with parts changing speed at different rates requires clutches and gears to keep the parts in harmonious alignment. Completely fixed exchange rates require all the parts to move at the same speed all the time, accelerating or decelerating together; abrupt changes in exchange rates, a la Bretton Woods, run the risk of stripping the gears.

The weakness of an international monetary system that relied for new reserves on the dollar—or on any other national currency—was recognized many years ago and has been potentially remedied through the creation of the new Special Drawing Rights at the IMF. Now the weakness in the adjustment process is perceived as well, but there is still a strong, if misguided, nostalgia—especially in Europe—for the Bretton Woods Systems. That system did serve the exceedingly useful purpose of establishing an international accountability for nations in the financial domain. But its basic *modus operandi* did not work and cannot work. Large-step changes in exchange rates are not compatible with the high mobility of funds prevalent today. We will not achieve a real reform of the international monetary system until this point is recognized by all the major parties.

The multinational Committee of Twenty, charged with laying down the principles of reform, is stalled on the key problem posed at the outset: how to correct imbalances in payments. Many participants would like to rely mainly on domestic economic adjustment. Indeed, they would like to see the new monetary rules impose much tighter discipline on domestic economic policies, especially in the present inflationary environment. Others, more realistically, perceive that the solution to inflation must be found domestically, not through international rules that cannot ultimately be enforced. Exchange rates must be changed more frequently and by smaller amounts (to discourage speculation) than in the past to provide the smooth adjustments among economies that are governed primarily by domestic concerns and considerations.

Since it takes twenty to agree, and the disagreements run deep, disagreement will prolong the status quo of floating exchange rates. This *ad hoc* system has weathered its difficulties far better than many had initially feared, and—who knows?—further favorable experience with it may provide the basis for agreement to institutionalize it. A worse fate could befall us.

Mr. Cooper. My second observation concerns the move taken last month by the United States to eliminate all impediments to capital outflow from the United States. I believe this move was a wise one at the present time. We can anticipate as a result of the large increase in oil prices substantial inflows of short-term capital to the United States, and in view of the presures that are likely to be exerted on many other economies it is important that the U.S. financial sytem be permitted to lend freely to the rest of the world. So I have no objection to the move as a short-term measure.

The administration, however, couched the move in terms of accomplishing its longer term objective of eliminating controls on capital outflows altogether, and I believe that as a long-term measure that was most unwise until we see what the outlines of the reformed monetary system will look like.

I have always viewed the interest equalization tax and the restrictions on lending abroad by banks and by large corporations not as a balance of payments measures, although they are widely considered to be balance of payments measures, but rather as devices essential to protect domestic economic policy as we have come to use that in the United States, in particular with its heavy reliance on monetary policy as the flexible short-run stabilizer.

So long as we rely as much as we do on monetary policy for short-run stabilization, we must at least have a possibility of inhibiting outflows of capital from the United States. Otherwise anytime we shift to easy monetary policy we will simply provoke large outflows of funds from the United States. These outflows will tend to undermine the impact of easy monetary policy on domestic investment and consumption, which the policy is designed to stimulate.

My point in simple terms is that until we know more clearly what the shape of the international monetary system will be, what it is going to settle down to, we should not deny ourselves the possible use of this instrument. I would therefore urge that the interest equalization tax not be allowed to lapse as legislation, and that the control system that we have established not be dismantled, even though I approve setting an interest equalization tax at the present time of zero and setting limitation on capital outflows by banks and firms sufficiently large so that at the present time it is not in practice an impediment to such flows.

My third set of observations concerns the macro-economic impact of the very substantial increase in oil prices that we have had. I feel that the Economic Reports of the President is wholly inadequate on two counts on this subject.

The first is that it neglects to specify the very substantial magnitude of what I would call the fiscal impact of the increase in oil prices. Analytically, the rise in oil prices from something around $2 a barrel. FOB Persian Gulf, of just 6 months ago to around $9 a barrel. FOB Persian Gulf, at the present time, and the correspondingly higher prices for oil supplies landed in the United States—analytically, that is similar to the imposition of a tax by the oil producing countries on all of the world's oil consumers.

The tax will generate huge "revenues" at 1973 consumption levels. The additional flow to the oil countries can be estimated at something

like $75 billion. Some part of those revenues will be spent for goods and services, but the rest will be channeled back into financial markets.

It is very much as though the U.S. Government were to impose an excise tax and use the proceeds to retire the public debt. We therefore have a combination of restrictive fiscal action arising from this increase of oil prices, combined with somewhat easy monetary debt management action. The net effect of these two things will be substantially deflationary.

To give you some idea of the magnitudes, the increase in expenditures on oil imports is likely, at 1973 levels of consumption, to be on the order of $15 billion for the United States alone, or about 10 percent of the personal income tax. Recall the extensive public debate in 1967 and 1968 over the proposed 10 percent surcharge on the income tax and whether that was wise from a fiscal point of view. Here in effect such a tax has been decreed by the world's oil producers. The U.S. Government, it seems to me, has not taken adequate notice of the overall macro-economic effects of that change.

The second aspect to which there has been inadequate official attention concerns the temptation by everyone in the United States—one tends to focus on labor unions because their demands are visible and represent large numbers, but one can see it also in professional people, in salaried employees and so forth—to maintain his real living standard in the face of rising prices, i.e. to recoup in higher wages and salaries any increases in the consumer price index.

The central point here is that when the impetus to higher prices comes from abroad, as it has done in the case of the increase in oil prices, there is no way collectively for the United States as a whole to recoup the real incomes. A tax has been imposed on us from outside the country, and other things being equal that will result in a loss of real income.

The magnitudes are not huge. For the United States they run something between 1 and 2 percent, which is well below 1 year's normal growth in real income per capita. But to the man in the street it shows up as a substantial increase in the cost of living, which with normal institutional practices he is going to try to recoup through higher wages and salaries.

The Government should make very clear that there is no way for the country as a whole to recoup that part of the increase in the cost of living due to higher prices for foreign oil. This is an external event of a type that used to hit us frequently when we were a nation of farmers, through the vagaries of weather and foreign prices. It is especially inadvisable at the present time to eliminate the guidelines on wages and salary increases. In its understandable drive towards elimination of controls, for which I have strong sympathy, the administration has not paid sufficient attention to the subtleties of the present situation. This is an especially inopportune time to move completely away from guidelines on wage increases; they should be combined with a clear, straightforward, even though unpleasant explanation of the economic facts of life as they now confront this country.

My final observation, also on oil, is to agree essentially with what is rapidly becoming the conventional wisdom on the problems associated with financing the huge payments that must be made to the net exporters of oil. It is absolutely vital that the consuming countries act together, that they avoid taking a catch-as-catch-can approach to the subjects. There is no way collectively in the short-run for the consuming nations to pay for their oil through exports of goods an dservices, although individual countries will be tempted to do so. Cooperation among these countries is therefore of vital importance to prevent a series of competitive devaluations or trade restrictions in other guises designed to generate the trade surpluses thought to be necessary to pay the greatly enlarged bill for imported oil.

A complementary part of that cooperative posture must therefore be some arangement for financing the balance-of-payments costs of oil payments by many countries that will run large balance-of-payments deficits. I am confident that a substantial part of this problem can be handled, at least for the year 1974 and into 1975, through two mechanisms.

The first is a draw-down on reserves. It is worth recalling that international reserves at the present time are at an exceptionally high level. Indeed, it is one of the ironies of the present circumstances that only 6 months ago many countries were complaining of a surplus of reserves in the world. Note that world reserves grew by a total of $100 billion between October of 1970 and October of 1973. Those reserves are now most welcome, and countries can and should be encouraged to draw on them to finance oil imports.

The second source about which I am optimistic concerns the prospect for recycling earnings of the oil countries back to credit worthy buyers of oil through the great financial markets of the world. That means mainly the New York money market and the Euro-currency market. It should be noted that in the last 2 years a long list of countries has borrowed in the Euro-currency market. Less developed countries as a group have borowed perhaps more than 10 billion dollars in that market during the year 1973. It is a market that is accessible to many countries.

Looked at in this way, the problem of financing oil payments reduces to one of a relatively small group of countries whose reserves are inadequate and whose access to the Euro-currency market or to the New York market is limited by virtue of very low credit worthiness. I have in mind such countries as India, Bangladesh, perhaps the Philippines and a number of very poor countries in Africa.

In the immediate future, therefore, the financing problem is one of assuring that these countries do not have to go through economic devastation as a result of the increase in oil prices. Strong pressure should be exerted on the oil-exporting countries themselves to help out through loans. But I would also urge that the World Bank be encouraged to use its high credit standing to borrow in markets for the purpose of making, not long-term development loans, but short-term program loans. It can worry later about the tidying up process.

Thank you, Mr. Reuss.

Representative REUSS. Thank you, Mr. Cooper.

[The prepared statement of Mr. Cooper follows:]

PREPARED STATEMENT OF RICHARD N. COOOPER

OBSERVATIONS ON THE INTERNATIONAL ECONOMIC SCENE

The year 1973 was an extraordinarily eventful one for the international economy. At the official level, the Committee of Twenty reported at Nairobi on reform of the international monetary system, and adherents to GATT met in Tokyo to launch a new round of trade negotiations. At the market level, the year opened with large speculative outflows from the United States, followed by a 10 percent devaluation of the dollar, turmoil in financial markets, and a more general switch to "floating" exchange rates, with several (but not all) European Community countries committing themselves to hold their currencies together in a "joint float." Despite attempts by the Committee of Twenty to keep it alive, these developments marked an end to the Bretton Woods system of financial relations among currencies, an end that had already been fore-shadowed in 1971 with abondonment by the United States of gold convertibility of the dollar.

But these developments turned out to be only the beginning. Astonishingly, the dollar, devalued twice in the previous 15 months, depreciated substantially further until July, then began an appreciation that accelerated sharply at year-end. The appreciation occurred under the impetus of a more-than-doubling of crude oil prices, which shocked the world out of its complacent reliance on rapidly growing supplies of cheap energy. The "joint float" of the European Community broke down with France's withdrawal in early 1974.

Notwithstanding all this financial turmoil, the world economy enjoyed an unprecedented boom in economic activity, pushing up the prices of all primary products, against a background of general inflation. At year-end, however, there was great concern with the possibility of world recession. A slowdown from the hectic pace of 1973 was necessary and this in itself carried the risk of over-shooting. That was made even more probable by a reduction in supplies and sharp increases in price of crude oil.

The fact of global economic interdependence was strongly dramatized by the Arab embargo and announcement of price increases for crude oil. The Bretton Wood framework for international monetary cooperation broke down just at the point when the need for cooperation became most compelling. As I have shown in a recent article (appended), the breakdown in that system was inevitable. From a substantive point of view it was probably even desirable in face of the events of last year, for the looser system of floating exchange rates was more capable of absorbing the strong shocks to which it was subjected than a system of fixed exchange rates would have been. But the fact of break-down strained the spirit and practice of cooperation among major nations that had built up over the years. The working out of a new framework is itself a formidable task, and now the biggest economic disturbance that the world has seen since the Second World War is superimposed on it.

In the remarks that follow, I propose to comment on only four features of the present international economic condition, chosen from among the many features deserving of comment.

I. PROGRESS ON MONETARY REFORM

First, contrary to the optimistic statements eminating from official sources, the Committee of Twenty, charged with reforming the international monetary system, is making little progress. Disagreements among the participating countries run deep, especially on the extent to which the monetary system may be expected to "discipline" the domestic economic policies of individual nations and on the role that the U.S. dollar should play in a reformed monetary system.

The view is held by certain European officials or rather the hope is entertained, that the international monetary system can provide a vehicle for reining in excessively expansionist domestic economic policies in individual countries, including in particular the United States. By re-instituting a system of fixed exchange rates with only loose requirements for changing them, they hope that countries running into payments deficits will have to deflate domestically, thereby putting a damper on world inflation. This view no doubt has merit as applied to relatively small countries that wish to maintain close financial ties with larger neighbors; but it is wishful thinking as applied to larger countries, for these coustries will more readily institute controls over international transactions or otherwise violate the rules of the system than squeeze the domestic economy too hard. Canada, Britain, France, Germany, and the United States have all illustrated in recent years that they will not be bound by a set of rules

that imposes too great burdens on the domestic economy. The U.S. administration is correct in insisting on a system that calls on countries—those in surplus as well as those in deficit—to eliminate their imbalances promptly, allowing exceptions to be made only by international agreement; and if necessary to do it by changing their exchange rates before large disequilibria are allowed to build up, inevitably requiring painful readjustment later. Prompt adjustment will minimize disturbances to the domestic economy.

Other countries want to curb the official international role of the dollar substantially, partly with the aim of imposing some balance-of-payments discipline on the United States. The United States should not resist this development, as it has so far, if it can get the Committee of Twenty to agree to its position on the adjustment process. The pieces of a bargain may be present, but so far there has been little disposition to put them together.

In the meantime, external events have moved rapidly. Far from being fixed. exchange rates are now generally floating, and working arrangements must be established to assure that official intervention in exchange markets does not occur at cross-purposes. In establishing a modus operandi in exchange markets, we may well find ourselves having worked out arrangements that are more durable, and having thus laid the basis for a reformed monetary system. If this happens, the new international monetary constitution will have evolved in the fashion of English common law rather than being laid down by a constitutional convention, American fashion.

While the Committee of Twenty has been deliberating, a group of private citizens from Europe, Japan, and North America has met under the auspices of the Trilateral Commission to array their ideas on international monetary reform. Events have moved so rapidly that the resulting report, *Towards a Renovated World Monetary System*, which appeared last October, is itself somewhat out of date. But it contains two suggestions, not yet considered in detail by the Committee of Twenty, that are highly pertinent to the present situation. The first is that nations work out rules of exchange market intervention to guide their behavior in a system without parities, such as we have at present. I understand that this question is now, after ten months of floating, finally under study. The second urges vastly greater short-term credit facilities for the international monetary system, drawing on a proposal I put before the Joint Economic Committee a year ago. This facility is especially important in view of the large build-up of short-term balances that the oil-producing nations are likely to have in the next several years, the possibilities for shifting those balances from currency to currency, and the exceptional uncertainties that several countries now face in their international payments. The facility would not, however, provide automatically for covering the large deficits in prospect due to larger payments for oil. I return to this topic below.

II. EVALUATION OF FLOATING EXCHANGE RATES

The second general point I would like to make is closely related to my pessimism concerning progress in the Committee of Twenty. It is that we should *not* judge the merits of a system of floating exchange rates, or of managed floating, by the experience of 1973. In many ways that experience was far better than was expected. In general, banks and business firms adapted quickly to the new situation, and markets survived the transition. Payments positions began to adjust in the desired directions. But the actual movement of exchange rates was distressingly high—a maximum swing of 20 percent for the pond and the German mark against the dollar, and 25 percent for the French franc. These moves are excessive, even with the oil shock. They reflected uncertainty not only about particular currencies, but about the nature of the financial system itself; the normally stable background rules and conventions against which business decisions must be made were themselves shaky. A well-established system of lightly managed floating rates should display much less erratic behavior than exchange markets did in 1973.

III. CAPITAL CONTROLS

My third general observation concerns the removal, in January of this year, of all limitations on outflows of capital from the United States. The timing of the move was impeccable in two respects. The dollar was strong in exchange markets, and European governments, the principal critics of capital outflows from the United States, were worrying about how to finance their large oil bills in 1974. The ability to draw readily on U.S. funds may prove a welcome change.

Despite the auspicious circumstances, I have reservations about dismantling the entire control system and allowing the interest equalization tax to lapse. Although these measures have been perceived as balance-of-payments measures sinc the IET was first introduced in 1963, I have always viewed them rather as measures designed to protect and facilitate *domestic* economic policy, especially as we have come to use it in the United States, with monetary policy bearing the main responsibility for quick response to changing economic conditions. Without some restraint on capital outflows, easy monetary conditions in the United States will induce large capital outflows, leading at a minimum to anxiety abroad and under a reformed monetary system based on fixed rates perhaps inhibiting appropriate domestic policies. With floating exchange rates, easy money induces a depreciation of the currency, which as we have seen last year leads to price inflation at home and, worse, results in an exportation of unemployment to other countries. With an open economy and high mobility of capital, monetary policy is not really suitable for stabilizing the domestic economy. For the long run, much heavier reliance on fiscal policy, less on monetary policy, is the appropriate direction in which to alter U.S. economic policy. In the meantime, while free capital movements are appropriate at the present time, I would recommend retaining statutory authority for an interest equalization tax and retaining a skeleton of administrative control machinery until we are clearer about what the future international monetary system will look like.

IV. CONSEQUENCES OF THE INCREASE IN CRUDE OIL PRICES

My fourth and final topic concerns the impact of recent increases in oil prices on the world economy. This is a vast, complex subject, with many ramifications going well beyond economics. But I will focus on several economic effects, especially the short-run problem of financing.

It is useful to recall the magnitudes involved: Persian Gulf crude oil prices (f.o.b.) rose from about $2.12 a barrel in January 1973 to $3.68 a barrel in November 1973 to $7.61 a barrel in January 1974. Crude oil from other foreign sources experienced similar price increases. At last year's volume, the price increases since last October will *raise* payments for imported oil by nearly $70 billion, to $120 billion c.i.f. at ports of importation. With total world trade running around $500 billion, this represents a tremendous jolt to the world system of international payments and to living standards in all oil-consuming economies. For analysis, it is useful to divide the problem into five separate but obviously related components: hort-term financing, short-term economic stabilization, terms-of-trade effects on real income, long-term substitution away from oil, and long-term investment by the oil producers.

1. I will dwell most extensively on the problem of short-term financing since that is the most immediate problem for the world economy and it is also where the issue of petroleum prices bears most directly on the international monetary system. The problem arises because for the next year or two virtually all net oil-importing nations will be in balance-of-payments deficit on conventional definitions. Indeed, in 1974 the cumulative deficit (with its corresponding surplus in the oil-exporting nations) will be staggering: it will *worsen* by the $70 billion mentioned above, less 1) an allowance for reductions in consumption of oil and 2) an allowance for increased purchases of goods, services, and long-term investment (including repayment of debt) by the oil-producing nations. At best these two factors together are not likely to amount to more than $30 billion in 1974, so unless oil prices fall (which they may) there will be a deficit-financing problem of something over $40 billion.[1]

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[1] The arithmetic of oil payments is somewhat confusing, even after allowing for uncertainties in the amount by which consumption will decline in response to such large price increases. Because of costs of production, costs of transport, and profits of the international oil companies, there is a substantial discrepancy between the gross payments for oil by importing nations and the net receipts for oil by exporting nations. The staff of the Council on International Economic Policy, for instance, reckons the cost per barrel of Persian Gulf crude c.i.f. U.S. gulf ports at $9.09 after January 1, of which an estimated $7.01 accrues as revenues to the exporting country. The remainder goes to shippers and the oil firms. But the *increase* in prices, $5.49 since a year ago, goes wholly as revenues to the exporting countries. It is this increased revenue, amounting to around $70 billion on last year's volume, that poses the financing problem. Some of the price increase will of course affect payments in late 1973, so the increase from calendar year 1973 to 1974 will not be this large, even if volume does not drop.

A 50 percent increase in imports by the oil-exporting countries would amount to about $10 billion. A 15 percent drop in world consumption of oil, implying a short-run price elasticity of demand for imports of .075, would cut the revenues of oil-exporting countries by around $15 billion. A drop in oil prices, such as many now anticipate, would of course reduce the revenues further.

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The first point to note is that in the aggregate these large purchases of oil will be self-financing: if the oil countries sell the oil at all, they will automatically use the proceeds for *something*, if only to build up interest-bearing deposits in the euro-currency market, which is where much of the money is likely to go. The question is not therefore whether the oil-exporting nations will invest their surplus funds, but rather where and in what form. My guess is that most of the investment will be in highly liquid dollar assets, mainly in the New York and euro-dollar money markets. These two markets are the only places large enough to absorb on short notice the volume of funds involved without acute disruption. In the absence of offsetting central bank action, these two markets should be flush with funds.

What about the nations that need the funds to pay for the enlarged import bill? They cannot hope collectively to pay in 1974 with goods and services, so they must either borrow or draw on their accumulated reserves. It is worth recalling that only six months ago many countries deplored the surfeit of reserves, and indeed the Managing Director of the International Monetary Fund was unable to get approval for an additional issue of the Special Drawing Rights. The last issue was in January 1972. World reserves stood at $187 billion at the end of September, 1973, having risen by exactly $100 billion (measured in dollars) from three years earlier. Many countries can comfortably finance their oil payments out of reserves during the next year or two, and by the standards of just a few years ago still have ample reserves. This is precisely the kind of occasion that reserves are meant to be used for: to smooth the transition to a markedly different condition.

But most countries do not have such a large cushion; the ability to draw down reserves is substantial, but they will dwindle quickly against the equally substantial additional payments for oil. These countries will have to borrow. As noted above, the funds will be globally available, from the oil countries themselves. But they will not be equally available to all countries that need them. Many countries will have no difficulty raising the necessary funds through short and medium term borrowing from the banks that are the depositaries of the funds; the euro-currency market has grown apace in recent years, and a rapidly growing list of countries has had access to it. Thus in the short run the financial markets will channel funds to where they are needed, provided countries are willing to borrow.

But some countries have neither adequate reserves nor adequate creditworthiness to borrow extensively through commercial channels. Most of these countries are less developed countries, and some may be able to borrow directly from the Arabs, on commercial terms. The sums required for these countries—India, Bangladesh, the Philippines, Uruguay are examples—are not large in comparison with the total problem, probably under $2 billion in 1974.

Two lines of approach are possible, and both may be necessary. The first is to lower the price of oil to these countries, either directly through discriminatory pricing by the oil-producing countries, under the rubric of solidarity within the Third World, or indirectly through loans on concessional terms by the Arab countries. The second is by financial intermediation on behalf of those countries, most expeditiously handled by the World Bank. The Bank can borrow readily in financial markets, on its own high credit standing, backed as it is by all member countries, and then it can re-lend in the form of program loans to the needy countries. The Bank could not give concessional interest rates on such loans—some outside source of funding would be necessary for that[2]—and it would not run any exchange risk, since the borrower would borrow dollars to pay its oil bill in dollars. But obviously the Bank could not avoid the intrinsic credit risk involved in such lending, and ultimately it might be called upon to reschedule the loans and in other ways to convert non-concessional loans to concessional ones. The problem here is to provide financing to get through 1974 and 1974 without inviting utter collapse of some economies through inability to pay for oil and oil-based products, such as fertilizers.

2. A second problem created by the sharp increase in oil prices concerns economic stabilization. In its economic effect, the large increase in oil prices

[2] One possible source of such funding, advocated in a more general context in *Towards a Renovated World Monetary System* (Trilateral Commission, 1973), would be the capital gains on sales into the private market of official monetary gold, since the gold is carried in reserves at $42.22 an ounce and recently has sold in private markets at over three times that amount. Official sales would depress the price, but not so much as to wipe out the gain, which could then be appropriated to the World Bank, without any book losses to the central banks or treasuries involved.

acts like an excise tax imposed on all consumers of oil, with the proceeds of the tax returned to the money market. In the context of the United States alone, where the incremental bill for imported oil will be an estimated $15 billion on the assumptions stated above, this excise tax would be equivalent in its effects to a 10 percent increase in personal income taxes (or, equivalently, a 1.5 percent income tax surcharge on all personal income), with the proceeds returned to the financial markets, e.g. to reduce the short-term public debt. Such a tax/investment combination would have a substantial deflationary impact on the American economy, and would require expansionist monetary and fiscal actions to offset it.

Reality is more complicated, not least because the increase in oil prices is global, yet some of the "tax" proceeds from other countries will undoubtedly be invested in the United States, reducing the net deflationary impact here but increasing it elsewhere (where, because of the higher dependence on imported oil, the deflationary impact will be proportionately stronger in the first place). Opening the American short-term money market to unrestricted foreign borrowing will tend to cut the other way, reducing the deflationary impact abroad and increasing it here. But the general point is, at the global level the increase in oil prices, resulting in revenues that will be placed in liquid assets rather than spent, will exert a short-run deflationary pressure on the world economy. Some deflation from the exuberant 1973 was desirable in any case. But forecasters already last fall foresaw a slowdown in 1974, and the oil price rise may result in over-shooting the mark; here is an area for close coordination of national economic policies, most logically at the OECD, to assure that the national actions are consistent and mutually supporting.

3. In addition to requiring actions for financing and stabilization, the increase in oil prices will also require action, or at least exhortation, to prevent a fruitless, inflationary attempt by many group in society to preserve their real income. A sharp shift in the terms of trade, with the price of imports rising relative to the price of exports, is a new experience for Americans. It leads to a real loss of income, and there is nothing Americans can do internally to recoup it. We are faced with having to pay out roughly $15 billion more in exports than we had counted on to buy the imports we want. (We can, of course, borrow the $15 billion and make the real payments later.) This lowers per capita real income in the United States by about 1.5 percent. The corresponding figure for other industrial countries is closer to 4 percent. Even the larger magnitude should be manageable in view of the rapid growth that all industrial economies have enjoyed in recent years—it is not much more than one to two year's growth in real income per capita. But the man-in-the-street simply experiences a rise in the prices he must pay for gasoline, fuel oil, electricity, and so on, and he is going to want higher wages to compensate for that. Because the "tax" comes from outside the country, however, there is no way that collectively we can compensate for it; it requires a reduction in real income relative to what we would otherwise enjoy.

For this reason, I regret very much the virtual abandonment of the government guidelines on wage settlements after April 1. In these of all circumstances we need guidelines on wages, combined with a forceful explanation of the fact that in this case the increase in price is external to the country, and thus cannot be recouped through higher money wages here (on the assumption that the OPEC countries will continue to raise oil prices in line with any inflation in the prices that they have to pay for imported goods). It is of course unfortunate that the increase in oil prices followed so rapidly on the heels of a sharp increase in food prices. (That conjunction may be more than a coincidence, since several Middle Eastern countries complained bitterly of the higher import prices they were having to pay, and they import food.) That was primarily an internal transfer, with American farmers benefiting at the expense of urban wage earners, although in that instance the United States also charged more to foreigners. But when such a large price increase comes from outside the country, average real incomes must fall, relative to what they would otherwise be. This is an important point that has received too little attention, for it is not widely understood it could set off a further wage-price spiral which can be quelled only by generating substantial unemployment.

Living standards can of course be maintained for awhile in the face of a decline in real income to the extent that consumers are willing to borrow, directly or indirectly, the funds that the oil exporting nations will inevitably be ready to lend to financial markets. Or they can be maintained through a

reduction in domestic taxes. The real cost to the economy as a whole will come only when the United States is called upon to increase its exports of goods and services to pay for the oil, and as noted above it is likely to take some time before the oil-exporting countries will be able to import that much. But the borrowed funds should probably be directed toward investment rather than consumption.

4. Over the longer term, the higher oil prices will discourage consumption and will stimulate the search for substitutes. Our modern industrial economies are remarkably resilient, and while they cannot survive without energy, they can survive without Middle Eastern oil—given enough time to adjust to the new situation. We cannot escape the cost entirely, however, for the substitutes will be more expensive than foreign oil was last summer, at least in the absence of technological break-throughs that are now difficult to foresee. In the short run, in other words, we must pay King Faisal's tax. In the longer run, we can limit the monopoly profits of the owners of oil by encouraging the entry of substitutes. But even after reducing our dependence on one source of supply we still will be left with higher energy costs than we have been accustomed to until these last few months.

5. The long-run developments described in the preceding paragraph, along with steady increases in consumption in the Middle East, will assure that Arab oil producers will not go on adding without limit to their financial claims on the rest of the world. But in the rather long meantime, they will be increasing those claims, and they will seek modes of investment other than short-term deposits and other liquid claims. In effect, the oil producers are exchanging one kind of asset—oil in the ground—for another, the more conventional financial assets. The possible problems associated with extensive Arab investment vary with the form of investment, and this is not the occasion to provide a lengthy analysis. Let it suffice to say that, broadly speaking, the Arabs can put their assets into a) deposits and other liquid claims, b) long-term bonds, c) equity shares without controlling interest, d) direct investment in productive assets or real estate abroad, e) real investment in productive assets at home (some of which would be imported), and f) commodity stock-piles, such as gold. All of these alternatives, with the magnitudes under consideration (e.g. initially $45 billion a year declining steadily to zero after, say, six years, plus accrued interest, amounting to around $200 billion in 1980, all concentrated in relatively few hands), could have noticeable effects on the world economy; but none of them would be really alarming, if properly handled. Liquid assets can be shifted from one claim to another, possibly disrupting money and currency markets. But it is precisely this kind of disturbance that an international lender-of-last-resort, such as I proposed to the Joint Economic Committee last year, would be designed for; it would promptly and smoothly "recycle" any untoward movement of funds of this sort. The present central bank swap arrangements represent a primitive form of such a facility, but they are now too small for the potential disturbances. A multilateral facility should be established in the International Monetary Fund.

Bond and equity markets can always be manipulated for gain by any transactor large enough to influence the expectations and actions of others through price manipulation. But if such manipulation were discovered it could readily lead to punitive response by the regulating authorities of the exchanges, and that would inhibit further manipulation. Direct investment abroad has certain problems associated with it, aired extensively in recent years in discussion of the multinational corporation. Some of those problems would be aggravated when the investor is a foreign government. But direct investments abroad by the Arabs will be slow in coming. And as has been said in connection with all multinational corporations, they represent hostages to the host government, which fact augurs in favor of conventional business behavior. So we should be thoroughly relaxed about this prospect until events prove the contrary.

Finally, purchases of gold seem the least troublesome of all. Beyond relatively small amounts, purchases seem bound to drive the price up to a point at which future selling of any magnitude would impose capital losses on the seller. Hence unless they can play successfully on the psychology of other gold hoarders, oil-exporting nations should be wary of putting too much of their wealth into this form.

Representative REUSS. Please proceed, Mr. Steele.

STATEMENT OF HENRY STEELE, PROFESSOR OF ECONOMICS, UNIVERSITY OF HOUSTON

Mr. STEELE. I very greatly appreciate the opportunity of being invited to present this statement before the Joint Economic Committee, and I hope that it may be of some use to the committee in its deliberations regarding the highly important economic issues arising out of the current context of United States energy imports and the international petroleum market. I am an academic economist with major research interests in industrial organization and the regulation of industry, and in presenting this statement I represent no one but myself.

My area of comparative expertise is petroleum economics, and I appear today as someone who is familiar with petroleum economics and the world oil market, rather than as a specialist in international trade or finance.

In accordance with your request, I will attempt to provide relatively brief answers to the questions to which you have asked me to devote my remarks: One, in regard to the world energy situation and its relationship to U.S. energy needs, what will be the likely supply and demand relationships for oil, and how will they impact on world prices?

Two, what comments seem appropriate in regard to the likelihood of finding a cooperative solution to oil payments problems?

In recent years I have undertaken several research projects related to these matters, and my views can be summarized rather concisely. First, since world oil prices are currently controlled by the actions of the cartel of oil exporting countries and not by producing companies or consumers, supply and demand relationships for oil do not determine price levels. In the case of a competitive industry, it would be necessary to present detailed data concerning production costs and the relationship between prices and demand, in order to analyze the impact of supply and demand upon prices.

But when a cartel is in a position to set prices at arbitrary levels, disregarding production costs—which are so low relative even to pre-1970 prices that they can be virtually ignored—and without any real knowledge of the state of demand, then it is obviously not productive to spend a great deal of time analyzing statistics on costs, reserves, productive capacity, consumption, and past prices.

Second, can a cooperative solution be found to the oil payments problem?

From the point of view of the importing nations, the only solution to the oil payments problem is to act in concert so as to reduce oil prices to manageable levels—say to 10 or 20 times production cost, rather than the immediately current levels amounting to 50 to 100 times as much as production costs. If such a solution is to be achieved it is obvious that the highest degree of cooperation among the importing countries will be required.

In past years, domestic oil prices have been higher than world prices, and there has been some concern that energy-intensive commodities produced in the United States would not be able to compete

well in world markets with products produced in countries enjoying lower oil costs. The situation is now reversed, with world prices higher than U.S. prices for oil.

Whether our trade balance gains or loses from the present extremely high level of world oil prices depends to a large extent upon the relative costs of oil to the industrialized countries, and the impact of oil costs on the production costs and prices of manufactured goods entering world trade.

Naturally, those countries whose energy costs rise most rapidly, and whose products are produced by the most energy-intensive production processes, will be at an increasing disadvantage in making export sales, and will tend to increase their imports. A preliminary ranking of industrialized countries with respect to their long-run vulnerability to high oil import prices would assign Japan to the most vulnerable category, and the United States to the least vulnerable category.

If very high world oil prices prevail, then in the long run—perhaps 15 or more years—the United States can produce adequate volumes of synthetic liquid fuels from coal and from oil shale, although only at costs probably appreciably higher than have been experienced in past decades. Canada is also very fortunate in this regard.

Of the European nations, Norway and England are the most fortunate in terms of their access to North Sea petroleum, and Holland has some energy advantage in view of its relatively vast natural gas resources. Other European countries are significantly more vulnerable to high oil import costs, while Japan is in the most exposed position of all the industrialized countries.

And of course, those countries currently making progress toward industrialization will be the most profoundly affected, since they will find it impossible to absorb oil import costs at currently high price levels.

Why are world oil prices currently at such high levels, and how will they behave in the future?

One must distinguish between the U.S. energy crisis, which is very real, and the world oil crisis, which is artificially contrived. In the U.S., oil production costs in recent years have been sufficiently high relative to prices that investment in new productive capacity has been inadequate. In the world market, production costs in the oil exporting countries have been so low relative to world prices that a several-fold increase in total production would still not raise costs to levels within sight of prices.

The domestic price level has of course been protected from foreign competition for a number of years through import and other controls, but even so it now appears that it was not protected at a sufficiently high level to maintain adequate domestic productive capacity in view of increasing cost trends. Hence the increasing reliance upon imports, which, when arbitrarily interrupted or prohibitively overpriced, give rise to at least a short-run supply crisis.

And this reduction in imports acts to compound the difficulties already faced by a domestic industry characterized by pervasive underinvestment, not only in exploration and production, but also in refining, storage capacity, transportation, and other sectors.

Such under investment furthermore characterizes not only oil and gas, but also the other energy industries, and has been caused by other factors in addition to prices below long run supply costs, such as inability to anticipate the nature of environmental controls on energy use, and to react adequately to their impact on costs and demand for the various energy sources.

What is the probable future course of world oil prices?

A wide range of possibilities exists. Today's high prices were inconceivable a year ago, but then prices in early 1973 were hardly foreseen in early 1970. Realistically, we should not feel confident in ruling out almost any price forecast as impossible.

There have been attempts, innocently motivated and otherwise, to portray increasing world oil prices as the inevitable result of the pressure of tremendously increasing world demand on a relatively limited productive capacity in the exporting countries, such that for physical reasons of reserves limitations, increases in supply cannot keep pace with rising demand. Nothing could be further from the truth.

The main mistake is in not realizing that Persian Gulf proved oil reserves alone are sufficient to supply an increasing rate of world consumption at constant prices of less than $1 a barrel through at least 1985 even if no new discoveries are ever made in these countries.

Furthermore, if one includes probable as well as proved reserves in the computation, oil supplies in Eastern Hemisphere exporting countries should be adequate to meet world demand until at least the year 2000. There is thus no element of natural scarcity of supply, and if prices are to be maintained above the freely competitive level of production costs including return on investment—perhaps 10 to 20 cents per barrel at the wellhead, including a 20 percent rate of return —monopoly power must be continually exerted to maintain the contrived scarcity of supply imposed with increasing severity by the exporting country cartel.

This is not to say that the companies have no stake in restricting supply. Any major increase in output during a short period of time would create great pressure on prices. But the international nature of the companies and their subjection to consumer country pressures would lead them to produce more and sell at lower prices, relative to the present cartel situation. Furthermore, competitive pressures among companies in the world oil market are too great to permit stable monopoly pricing. An effective exporting country cartel is a necessity for monopoly pricing of oil, and since 1970 the exporter cartel has been increasingly effective in the pursuit of that goal.

But the imposition of a cartel upon a highly diverse market structure which is potentially competitive makes for a very unstable situation, with many possible outcomes in the long run. Let us first consider two extreme possibilities, and then try to speculate upon a most probable cartel future.

At the one extreme, the cartel might further consolidate and strengthen its monopoly power. To be effective, any cartel must strive for a spirit of cooperation such that the potentially most productive members have to exercise the greatest degree of self-restraint in order to keep prices high for all members. This self-restraint is clearly in their own interest, since the largest sellers have the most to

lose if prices fall. On the other hand, the smaller producers need exercise relatively less self-restraint.

They can produce closer to full capacity since their smaller output contributes less to total supply, and hence poses less of a threat to price stability. And a certain lack of self-restraint often seems to be in the best interest of the smaller members. They can cheat on the cartel with relative impunity, since a 50 percent overproduction on their part might bring about less pressure on prices than a 5 percent overproduction by the largest members.

If many smaller members overproduce, the few large members must cut their output back in order to avoid price reductions. Cartels generally break up when overproduction by smaller members, plus new production by nonmembers, puts such a pressure on prices that major members abandon the arrangement rather than continue to reduce their own outputs enough to offset the expansion of uncooperative sellers.

The cartel's current strength is probably due more to political considerations—union to punish what is perceived as a common enemy —than to economic solidarity. If and when this politically inspired unity wanes, the latent divergence of interests among the members will become manifest. Only a few countries have so much oil income per year relative to spending opportunities that they would be interested in stabilizing exports at relatively low levels.

On the contrary, most of the cartel members have considerable need to expand export revenues in order to finance internal development. Hence friction will be assured. The latter group of countries will be likely to press for greater increases in output than the cartel as a whole desires. As this policy conflict intensifies, the members with desires for greater output will increasingly covet the oil resources of the more conservative members, and armed conflict may ensue.

The most favorable outcome for cartel solidarity would be a victory for the conservative members, following which they could raise prices even above current levels through further output curtailment. They would preferably act through the making of special deals with individual consuming countries, which would maximize their own bargaining advantage.

The impact on the importing countries would of course be extremely adverse. Growth rates would become negative, and the outputs of energy-intensive industries would contract disproportionately. The cartel's disposition of its foreign exchange receipts is likely at best to be amateurish, and this would render crippling disruption of the world monetary mechanism increasingly likely.

What are the prospects if the cartel thus increases its power over prices in the future?

Aside from a great deal of unavoidable uncertainty, panic and confusion, there will be an acceleration of the current trend to find oil and other energy sources not under cartel control. At $20 or more per barrel, the simple fact is that cartel oil prices are already above the longrun profit-maximizing level, even for a tight monopoly.

The cartel monopolizes present world oil export capacity to an extreme degree, but it does not monopolize all energy sources, or even total world petroleum supplies. A wellhead price of $20 per barrel in the Persian Gulf did not make sources of synthetic liquid fuels

look particularly attractive, and even a price of $5 might leave investors with some reluctance to risk the vast sums involved. But $15 or $20 or more per barrel would make synthetics a bonanza. Apart from synthetics, coal and atomic power are also increasingly attractive energy sources as oil prices rise above the longrun monopoly level.

But the biggest question, perhaps, is just how much more petroleum can be found in noncartel areas at current prices?

Oil in Arctic and offshore areas becomes more prospective at current price levels, and although it seems unlikely that new reserves can be found equal in magnitude to those of the Persian Gulf fields, the cartel strategy of limiting output relative to reserves means that noncartel oil can compete effectively against cartel oil on only a fraction of the reserve base. The current ratio of production to reserves in the Persian Gulf area is less than 2 percent, compared with rates elsewhere in the world of more than 10 percent.

The uneconomically low rate of inventory turnover is imposed by the necessity to keep production low to sustain monopoly prices. But noncartel oil production would be under no such constraint, and hence 20 billion barrels of noncartel oil reserves could sustain a production rate equal to that of 100 billion barrels of cartel reserves.

A strengthened cartel which progressively overreaches itself will therefore stimulate the rapid development of energy supplies from noncartel sources. This process, however, is a very lengthy one, and on one should underestimate the time required. Even in the United States, where the potential for elimination of cartel imports is better than in almost any other country currently importing from the cartel, the process will probably take about 15 years, even under the most favorable assumptions in regard to investment rates, technological advances, and reduction in the rate of consumption. For other countries, much longer time periods may be required.

At the other extreme, it is at least possible that the cartel's potential instability might bring about its collapse. As above, one can envision a scenario in which those cartel members anxious to increase output employ military force against those otherwise inclined.

Military advantage seems currently to be on the side of the former group, and the outcome of such a conflict might well be to place the resources of the largest Persian Gulf oil fields in the hands of those who are most anxious to increase production. The desire to increase output will be a powerful factor working toward lower prices. Since productive capacity could probably be increased two or three fold in two or three years, merely by the more intensive development of existing fields, the potential for rapid price decrease is definitely present.

Militating against this possibility, however, is the likelihood that the result of the conflict would be a reduction in the number of countries producing the oil. If one country conquers all the others, the cartel becomes a true monopoly and its power over price becomes even more absolute.

But if as few as three major countries remain, each of which is intent upon increasing its output, the prospect for cartel deterioration is still present. And if the producing companies are expelled during or after the war, and are not replaced by different companies—i.e., if the exporting countries choose the complete nationalization of the

oil—then the chances for considerable price declines are greatly enhanced.

It is very difficult to foresee what course, between these two extremes, the future path of world oil prices is likely to follow. Prices have already retreated somewhat from the highs reached in December 1973, but this may be due to short run factors which could readily be reversed. In the long run, prices are more likely to fall than to increase, but how far they might fall is anyone's guess.

Cartel members appear to be jubilantly confident, while representatives from the consumer countries appear by contrast to be dismayed, confused and disunited. But appearances may be deceptive. The bellicose tone of pronouncements in the Arab press regarding the February 1974 meeting of the consuming countries may be overcompensation for a certain anxiety regarding future developments. And even the consuming countries may be able to get together on a common approach when approximately $100 billion per year is at stake.

While it is hard to draw parallels with previous experience since the oil cartel presently possesses monopoly power in an essential commodity on a worldwide scale unsurpassed in economic history, it is nevertheless not without significance that no past cartel has ever succeeded in permanently avoiding the temptation to overreach itself by pricing above the long run monopoly level.

It will probably take the governments of the consuming countries quite some time yet before they can bring themselves to take effective joint action. During that time downward pressures on prices may be only intermittent, and increases may outweigh decreases.

Delays in forming an effective buyer cartel will be occasioned by many factors—the distrust abroad of the so-called Anglo-Saxon oil monopoly which in fact takes its orders from the exporting countries; the illusory hope that by virtue of superior skill in negotiation, an individual importing country can make a special deal at better terms than the group could obtain by acting in concert, and so on.

The closest sort of international cooperation among the consuming countries is necessary to reduce prices to manageable levels. Maximum buying prices should be determined, with no buyer being permitted to offer a higher price. There should also be prohibitions against individual oil buyers entering into long run contracts with particular exporting countries. By this means, active price competition among exporters will be kept alive through the device of frequent recontracting for sales. Cooperative agreements among the importing countris to share technical knowledge and available oil supplies, as currently being discussed, will be beneficial. But the first priority must be upon effective group action to reduce oil prices.

The obstacles in the way of such cooperation among the importing countries are very difficult to overcome, but the prospect of saving some $80 billion per year in oil import payments may eventually be sufficient incentive to elicit the necessary cooperation. The show of unity at the February 1974 Washington meeting of the consuming countries was encouraging, indicating a closer approach to unanimity of views than might have been expected.

Thank you, Mr. Reuss.

Representative REUSS. Thank you, Mr. Steele.

[The prepared statement of Mr. Steele follows:]

PREPARED STATEMENT OF HENRY STEELE

INTRODUCTION

I very greatly appreciate the opportunity of being invited to present this statement before the Joint Economic Committee, and I hope that it may be of some use to the Committee in its deliberations regarding the highly important economic issues arising out of the current context of United States energy imports and the international petroleum market. I am an academic economist with major research interests in industrial organization and the regulation of industry, and in presenting this statement I represent no one but myself.

My area of comparative expertise is petroleum economics, and I appear today as someone who is familiar with petroleum economics and the world oil market, rather than as a specialist in international trade or finance. I received my Ph.D. in industrial economics from M.I.T. in 1957, and since then have been engaged in teaching and research. My acquaintance with the petroleum industry is due to a continuing interest in its operations, developed not only through academic research but also through a variety of consulting activities for companies in the petroleum and oil field equipment industries, research foundations, law firms, oil industry trade associations, United States government agencies, and other western hemisphere governments. At present I am Professor of Economics at the University of Houston. My published research includes books, monographs, and journal articles on petroleum industry economics.

In accordance with your request, I will attempt to provide relatively brief anwsers to the questions to which you have asked me to devote my remarks: (1) In regard to the world energy situation and its relationship to U.S. energy needs, what will be the likely supply and demand relationships for oil, and how will they impoct on world prices? (2) What comments seem appropriate in regard to the likelihood of finding a cooperative solution to oil payments problems?

In recent years I have undertaken several research projects related to these matters, and my views can be summarized rather concisely. First, since world oil prices are currently controlled by the actions of the cartel of oil exporting countries, and not by producing companies or consumers, supply and demand relationships for oil do not determine price levels. In the case of a competitive industry, it would be necessary to present detailed data concerning production costs and the relationship between prices and demand, in order to analyze the impact of supply and demand upon prices. But when a cartel is in a position to set prices at arbitrary levels, disregarding production costs (which are so low relative even to pre-1970 prices that they can be virtually ignored), and without any real knowledge of the state of demand, then it is obviously not productive to spend a great deal of time analyzing statistics on costs, reserves, productive capacity, consumption, and past prices.[1] Second, can a cooperative solution be found to the oil payments problem? From the point of view of the

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[1] The temptation to do so is very great, since all manner of statistics abound, ranging from long historical series on costs and discoveries, to detailed projections of future market patterns beyond the year 2000. But a mere handful of important estimates will serve to orient current discussions. (1) Oil production costs in the Persian Gulf are around 10 cents per barrel at the wellhead. (2) The productive capacity of the cartel of the oil-producing countries is currently about 28 million barrels per day, and could be increased by a factor of two or three within a reasonable time without appreciably raising production costs. (3) Total oil imports from the cartel in 1973 were about 25 million barrels per day, and even if demand grew at 10 percent per year through the end of this century, current cartel proved oil reserves of over 350 billion barrels, plus probable reserves of another 300 to 500 billion barrels, would be more than sufficient to supply this demand. (4) The current competitive price of Persian Gulf oil is about ten to twenty cents per barrel. (5) The actual price paid on spot transactions has recently been close to $20. The short term monopoly price may be still higher, but the long run monopoly price is certainly lower. Such a price, which would be low enough to prevent the development of adequate competing energy supplies from non-controlled areas, is still anyone's guess. My guess is that Persian Gulf prices much above $5 would provide adequate incentive to develop the necessary alternative energy sources in the long run.

The most valuable studies of the world oil market have indeed relied heavily upon statistics, but still more heavily upon extensive observation and experience, close reading of the trade press, logical analysis, and the ability to distinguish between the often irrational rhetoric of industry controversy and the usually highly rational decisions made by actual market participants. On oil in the political arena, J. E. Hartshorn's *Politics and World Oil Economics* is a valuable reference. On oil economics, M. A. Adelman's *The World Petrolum Industry* is an indispensable guide to clear thinking, and my own heavy indebtedness to Adelman is obvious. On the other hand, recent analyses based primarily upon a political and cultural approach have been overly one-sided and misleading.

importing nations, the only solution to the oil payments problem is to act in concert so as to reduce oil prices to manageable levels—say, to 10 or 20 times production costs, rather than immediately current levels amounting to 50 to 100 times as much as production cost. If such a solution is to be achieved it is obvious that the highest degree of cooperation among the importing countries will be required. The following sections will discuss the two questions in more detail and enlarge upon the conclusions which have been merely suggested in this brief introduction.

I. WORLD OIL PRICES: SUPPLY, DEMAND, AND IMPACT ON UNITED STATES AND OTHER OIL IMPORTERS

In past years, domestic oil prices have been higher than world prices, and there has been some concern that energy-intensive commodities produced in the United States would not be able to compete well in world markets with products produced in countries enjoying lower oil costs. The situation is now reversed, with world prices higher than U.S. prices for oil. Whether our trade balance (defined here simply as exports minus imports) gains or loses from the present extremely high level of world oil prices depends to a large extent upon the relative costs of oil to the industrialized countries, and the impact of oil costs on the production costs and prices of manufactured goods entering world trade.

Naturally, those countries whose energy costs rise most rapidly, and whose products are produced by the most energy-intensive production processes, will be at an increasing disadvantage in making export sales, and will tend to increase their imports. A preliminary ranking of industrialized countries with respect to their long run vulnerability to high oil import prices would assign Japan to the most vulnerable category, and the United States to the least vulnerable category. If very high world oil prices prevail, then in the long run (perhaps 15 or more years) the United States can produce adequate volumes of synthetic liquid fuels from coal and from oil shale, although only at costs probably appreciably higher than have been experienced in past decades. Canada is also very fortunate in this regard, with its large reserves of oil and gas, and even larger endowment of tar sands. Of the European nations, Norway and England are the most fortunate in terms of their access to North Sea petroleum, and Holland has some energy advantage in view of its relatively vast natural gas resources. Other European countries are significantly more vulnerable to high oil import costs, while Japan is in the most exposed position of all the industrialized countries, with extreme import dependence and little chance of developing adequate indigenous energy resources. And of course those countries currently making progress towardindustrialization, at different rates, will be the most profoundly affected, since they will find it impossible to absorb oil import costs at currently high price levels.

Why are world oil prices currently at such high levels, and how will they behave in the future? One must distinguish between the U.S. energy crisis, which is very real, and the world oil crisis, which is artificially contrived by the exporting country cartel. In the U.S., oil production costs in recent years have been sufficiently high relative to prices that investment in new productive capacity has been inadequate. In the world market, production costs in the oil exporting countries have been so low relative to world prices that a several-fold increase in total production would still not raise costs to levels within sight of prices. The domestic price level has of course been protected from foreign competition for a number of years through import and other controls, but even so it now appears that it was not protected at a sufficiently high level to maintain adequate domestic productive capacity in view of increasing cost trends. Hence the increasing reliance upon imports, which, when arbitrarily interrupted or prohibitively overpriced, give rise to at least a short run supply crisis. And this reduction in imports acts to compound the difficulties already faced by a domestic industry characterized by pervasive underinvestment, not only in exploration and production, but also in refining, storage capacity, transportation, and other sectors. Such underinvestment furthermore characterizes not only oil and gas, but also the other energy industries, and has been caused by other factors in addition to prices below long run supply costs, such as inability to anticipate the nature of environmental controls on energy use, and to react adequately to their impact on costs and demand for the various energy sources.

What is the probable future course of world oil prices? A wide range of possibilities exists. Today's high prices were inconceivable a year ago, but then prices in early 1973 were hardly foreseen in early 1970. Realistically, we should not feel confident in ruling out almost *any* price forecast as impossible. There have been attempts, innocently motivated and otherwise, to portray increasing world oil prices as the inevitable result of the pressure of tremendously increasing world demand (since, say, 1969) on a relatively limited productive capacity in the oil exporting countries, such that for physical reasons of reserves limitations, increases in supply cannot keep pace with rising demand. Nothing could be further from the truth. That the rate of increase in world demand since 1969 has been somewhat below the average annual rate of the last two decades is only a minor point; the main mistake is in not realizing that Persian Gulg proved oil reserves alone are sufficient to supply an increasing rate of world consumption at constant prices of less than a dollar a barrel through at least 1985 even if no new discoveries are ever made in these countries. Furthermore, if one includes probable as well as proved reserves in the computation, oil supplies in Eastern Hemisphere exporting countries should be adequate to meet world demand until at least the year 2000. There is thus no element of natural scarcity of supply, and if prices are to be maintained above the freely competitive level of production costs including return on investment (perhaps 10 to 20 cents per barrel at the wellhead, including a 20 per cent rate of return on investment), monopoly power must be continually exerted to maintain the contrived scarcity of supply imposed with increasing severity by the exporting country cartel. Such contrived scarcity of supply is merely illustrated in its most dramatic form by export embargoes; more generally, the taxes imposed tend to curtail production rates by raising the costs to the producing companies far above the necessary level of business expenses. Furthermore, constant fear of confiscation of properties certainly reduces capacity expansion by the companies to minimal levels.

This is not to say that the companies have no stake in restricting supply. Any major increase in output during a short period of time would create great pressure on prices. But the international nature of the companies and their subjection to consumer country pressures would lead them to produce more and sell at lower prices, relative to the present cartel situation. Furthermore, competitive pressures among companies in the world oil market are too great to permit stable monopoly pricing. An effective exporting country cartel is a necessity for monopoly pricing of oil, and since 1970 the exporter cartel has been increasingly effective in the pursuit of that goal. But the imposition of a cartel upon a highly diverse market structure which is potentially competitive makes for a very unstable situation, with many possible outcomes in the long run. Let us first consider two extreme possibilities, and then try to speculate upon a "most probable" cartel future.

At the one extreme, the cartel might further consolidate and strengthen its monopoly power. To be effective, any cartel must strive for a spirit of cooperation, such that the potentially most productive members have to exercise the greatest degree of self-restraint in order to keep prices high for all members. This self-restraint is clearly in their own interest, since the largest sellers have the most to lose if prices fall. On the other hand, the smaller producers need exercise relatively less self-restraint. They can produce closer to full capacity since their smaller output contributes less to total supply, and hence poses less of a threat to price stability. And a certain lack of self-restraint often seems to be in the best interest of the smaller members. They can cheat on the cartel with relative impunity, since a 50 per cent overproduction on their part might bring about less pressure on prices than a 5 per cent overproduction by the largest members. If many smaller members overproduce, the few large members must cut their output back in order to avoid price reductions. Cartels generally break up when overproduction by smaller members, plus new production by non-members, puts such a pressure on prices that major members abandon the arrangement rather than continue to reduce their own outputs enough to offset the expansion of uncooperative sellers.

The cartel's current strength is probably due more to political considerations —union to punish what is perceived as a common enemy—than to economic soldarity. If and when the politically-inspired unity (never very monolithic) wanes, the latent divergence of interests among the members will become manifest. Only a few countries have so much oil income per year relative to spending opportunities that they would be interested in stabilizing exports at rela-

tively low levels. On the contrary, most of the cartel members have considerable need to expand export revenues in order to finance internal development (Iran, Venezuela, Iraq, Nigeria, Indonesia, Algeria). Hence friction will be assured. The latter group of countries will be likely to press for greater increases in output than the cartel as a whole desires. As this policy conflict intensifies, the members with desires for greater output will increasingly covet the oil resources of the more conservative members, and armed conflict may ensue.[2] The most favorable outcome for cartel solidarity would be a victory for the conservative members, following which they could raise prices even above current levels through further output curtailment. They would preferably act through the making of special deals with individual countries, which would maximize their own bargaining advantage.

The impact on the importing countries would of course be extremely adverse. Growth rates would become negative, and the outputs of energy-intensive industries would contract disproportionately. The cartel's disposition of its foreign exchange receipts is likely at best to be amateurish, and this would render crippling disruption of the world monetary mechanism increasingly likely.

What are the prospects if the cartel thus increases its power over prices in the future? Aside from a great deal of unavoidable uncertainty, panic, and confusion, there will be an acceleration of the current trend to find oil and other energy sources not under cartel control. At $20 or more per barrel, the simple fact is that the current level of cartel oil prices is already above the long run profit-maximizing level, even for a tight monopoly. The cartel monopolizes present world oil export capacity to an extreme degree, but it does not monopolize all energy sources, or even world petroleum supplies. A wellhead price of $2 per barrel in the Persian Gulf did not make sources of synthetic liquid fuels from coal, oil shales, and tar sands look particularly attractive, and even a price of $5 might leave investors with some relative reluctance to risk the vast sums involved. But $15 to $20 or more per barrel would make synthetics a bonanza. Apart from synthetics, coal and atomic power are also increasingly attractive energy sources as oil prices rise above the long run monopoly level. But the biggest question, perhaps, is just how much more petroleum can be found in non-cartel areas at current prices? Oil in Arctic and offshore areas rapidly becomes more prospective at current price levels, and although it seems unlikely that new reserves can be found equal in magnitude to those of the Persian Gulf fields, the cartel strategy of limiting output relative to reserves means that non-cartel oil can compete effectively against cartel oil on only a fraction of the reserve base. The current ratio of production to reserves in the Persian Gulf area is less than two per cent, compared with rates elsewhere in the world of more than ten per cent. The uneconomically low rate of inventory turnover is imposed by the necessity to keep production low to sustain monopoly prices. But non-cartel oil production would be under no such constraint, and hence 20 billion barrels of non-cartel oil reserves could sustain a production rate equal to that of 100 billion barrels of cartel reserves.

A strengthened cartel which progressively overreaches itself will therefore stimulate the rapid development of energy supplies from non-cartel sources. This process, however, is a very lengthy one, and no one should underestimate the time required. Even in the United States, where the potential for elimination of cartel imports is better than in almost any other country currently importing from the cartel, the process will probably take about 15 years, even under the most favorable assumptions in regard to investment rates, technological advances, and reduction in the rte of consumption. For other countries, much longer time periods may be required. As more reasonably-priced energy becomes available from non-cartel sources, cartel oil prices may fall. Importing countries can prevent a relapse into reliance upon the cartel, however, by imposing tariffs on imports from the cartel, and if necessary by using

[2] As this is being written, a news story in the Washington Post (February 11, 1974) informs us that Qaddafi of Libya is offering to train guerilla fighters to overthrow the leaders in Tunisia, Egypt, and Algeria in the name of "Arab unity." The Libyan leader is quoted as threatening that "if unity cannot be brought about by normal means, then it must be imposed by the people" and he offers Libya's services as "a school, where we will teach how a people can take up arms to stage a true revolution." Although Qadaffi appears uniquely idiosyncratic to non-Arabs, he is probably rather typical of the extreme sort of ideologue who appeals strongly to the Arab public. Hence if the ruler of an oil-rich state thinks it worthwhile to obtain "unity" with countries much less favorably endowed with petroleum resources, the temptation to extend this "unity" to areas much more richly endowed may eventually prove irresistible.

any tariff revenues to subsidize domestic energy industries. Such policies, which would be anathema if imposed upon otherwise free trade in the products of a competitive industry, may be required to neutralize a highly aggressive cartel.

At the other extreme, it is at least possible that the cartel's potential instability might bring about its collapse. As above, one can envision a scenario in which those cartel members anxious to increase output employ military force against those otherwise inclined. Military advantage seems currently to be on the side of the former group, and the outcome of such a conflict might well be to place the resources of the largest Persian Gulf oil fields in the hands of those who are most anxious to increase production. The desire to increase output will be a powerful factor working toward lower prices. Since productive capacity could probably be increased two or three fold in two or three years, merely by the more intensive development of existing fields, the potential for rapid price decrease is definitely present. Militating against this possibility, however, is the likelihood that the result of the conflict would be a reduction in the number of countries producing the oil. If one country conquers all the others, the cartel becomes a true monopoly and its power over price becomes even more absolute. But if as few as three major countries remain, each of which is intent upon increasing its output, the prospect for cartel deterioration is still present. And if the producing companies are expelled during or after the war, and are not replaced by different companies,—i.e., if the exporting countries choose the complete "nationalization" of the oil—then the chances for considerable price declines are greatly enhanced.

At present, the producing companies are integrated producer-refiner-marketers of the exported oil, and the governments of the exporting countries, having no "downstream" investment in tankers, refineries, or marketing organizations, must sell the oil to the international companies. Under existing tax laws, the companies were motivated to take much of the total profit of the entire integrated operation at the producing level, thus paying relatively high prices for the crude oil exported by the producing affiliate and imported by the refining affiliate of an integrated company. As long as the companies are permitted to operate "their concessions", they are captives of the exporting countries and since they must recoup in higher refined products prices the high tax costs of producing oil in the exporting country, they function (as an official of British Petroleum has expressed it) as "tax collectors" for the exporting country governments, in effect collecting taxes from consumers in the importing countries through the charging of prices high enough to cover the taxes imposed by the exporting country.

The producing companies would very likely be better off as a whole at present if, one and all, they voluntarily relinquished their "concessions", ceasing to function as captive integrated producers, and instead confronting the exporting countries as freely competitive buyers. With no interest in the profits from field production, they would therefore be motivated to buy as cheaply as possible, and prices could ultimately drop to the level of production costs. There are of course a number of reasons why the companies do not do this, the most valid of which is that if they left, it would under present conditions probably be easy for the exporting country to induce another company to replace them—particularly a company associated with a major importing country other than the U.S. or England. In effect, the exporting country would then obtain another "captive" integrated operation, so that its oil would be assured a long-term market in a particular country and would not be subject to arms-length bargaining over prices in a competitive market. It is very likely that the government of a major consuming country would be anxious to make such a special deal to "insure" itself of its "own" oil supplies—at a price perhaps well above market levels.

In summary then, the most favorable scenario for the oil importing countries would require a collapse of the cartel through internal dissension, hastened by the permanent withdrawal of the producing companies as concession operators. Under such circumstances prices could in theory drop to the level of production costs.

It is very difficult to foresee what course, between these two extremes, the future path of world oil prices is likely to follow. Prices have already retreated somewhat from the highs reached in December 1973, but this may be due to short run factors which could readily be reversed. In the long run, prices are more likely to fall than to increase, but how far they might fall is anyone's

guess. Cartel members appear to be jubilantly confident, while representatives from the consumer countries apear by contrast to be dismayed, confused, and disunited. But appearances may be deceptive. The bellicose tone of pronouncements in the Arab press regarding the February 1974 meeting of the consuming countries may be overcompensation for a certain anxiety regarding future developments. And even the consuming countries may be able to get together on a common approach when approximately $100 billion per year is at stake. Overconfidence on the part of the cartel members may play a part. With prices at unprecendented levels, why should they worry about a little price shading? Earlier this month Iran allowed a discount of more than $4 per barrel on sales to Pakistan, and commercial buyers promptly sought similar discounts from the Iranians. This is reminiscent of the actions of several cartel member governments on past occasions by way of shading prices to obtain incremental production and revenues. And as for cartel solidarity on production limitations, as recently as June 1972, it was flagrantly violated. At that time Iraq confiscated certain producing company properties in the Kirkuk field and production was reduced for some time. The cartel passed a formal resolution pledging its members not to increase their output in order to replace the Iraqi cutback, but other Persian Gulf producers swiftly increased production rates so as to accomplish precisely that goal. Such bits of evidence certainly do not justify any forecasts of the imminent collapse of the cartel, but they do indicate sources of weakness. And while it is hard to draw parallels with previous experience since the oil cartel presently possesses monopoly power in an essential commodity on a world-wide scale unsurpassed in economic history, it is nevertheless not without significance that no past cartel has ever succeeded in permanently avoiding the temptation to overreach itself by pricing above the long run monopoly level.

It will probably take the governments of the consuming countries quite some time yet before they can bring themselves to take effective joint action. During that time downward pressures on prices may be only intermittent, and increases may outweigh decreases. Delays in forming an effective buyer cartel will be occasioned by many factors—the distrust abroad of the "Anglo-Saxon oil monopoly" which in fact takes its orders from the exporting countries; the illusory hope that by virtue of superior skill in negotiation, an individual importing country can make a special deal at better terms than the group could obtain by acting in concert, and so on. Not until the importing countries take their common plight seriously can any relief from producer cartel exploitation be expected.

II. PROSPECTS FOR A COOPERATIVE SOLUTION TO THE OIL PAYMENTS PROBLEM

There are no prospects for a workable solution to the underlying cause of the oil payments problem (i.e., the existence of prohibitively high prices) without close cooperation among the consuming countries. Just as producer cartels are organized to maximize the seller's price, consumer cartels must logically seek to minimize buying prices. The allocation of resources under competitive buying and selling is in general more efficient, and considerably more certain, than under bilateral monopoly. But an equilibrium will never be achieved by allowing a powerful cartel to deal with producing companies and consuming countries one by one in special deals, or to do business on the basis of announcing unilaterally determined conditions which admit of no negotiation.

Consequently the closest sort of international cooperation among the consuming countries is necessary to reduce prices to manageable levels. Maximum buying prices should be determined, with no buyer being permitted to offer a higher price. There should also be prohibitions against individual oil buyers entering into long run contracts with particular exporting countries. By this means, active price competition among exporters will be kept alive through the device of frequent re-contracting for sales. Cooperative agreements among the importing countries to share technical knowledge and available oil supplies, as currently being discussed, will be beneficial. But the first priority must be upon effective group action to reduce oil prices.

It would no doubt expedite the attainment of a solution if the consuming countries would forbid any of their companies or citizens to operate as integrated producers in the exporting countries. Such unilateral relinquishment of concessions would greatly increase the incentive of the companies to drive hard bargains for purchased oil. The immediate losses to the companies would prob-

ably be more apparent than real, since higher earnings might be made by buying cheaply from the country rather than by producing subject to high tax payments. The obstacles in the way of such cooperation among the importing countries are very difficult to overcome, but the prospect of saving some $80 billion per year in oil import payments may eventually be sufficient incentive to elicit the necessary cooperation. The show of unity at the February 1972 Washington meeting of the consuming countries was encouraging, indicating a closer approach to unanimity of views than might have been expected.

Representative REUSS. Please proceed, Mr. Modigliani.

STATEMENT OF FRANCO MODIGLIANI, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. MODIGLIANI. Mr. Reuss, I am indeed pleased to be before this committee again. My last appearance was in July 1971. I have taken some time to look over what I said then, and I must say, if I may be slightly immodest, that I am pleased with the record since I hope that looking back at that record might increase the credibility of what I am about to say.

I know that this session is devoted primarily to international problems. However, I have turned over a prepared statement dealing with this problem, and therefore I would like, if I may be permitted, to devote some time to the domestic issues, being of course, very happy to come back to the international issues during your questioning.

Before turning to the domestic issues, I would like, however, to indicate, that on the international area, once more I am surprised and amazed at the extent to which Professor Cooper and myself seem to agree, almost 100 percent.

I would say that the agreement with what he said in this case is 99 percent. The only point of slight disagreement is on his view that we may have to retain price controls. To be sure, he did not mention explicitly, price controls; he mentioned wage controls. It seems a little hard to believe that one can maintain wage controls, without some appearance of price controls.

And on that issue, I believe that on the whole, the weight of evidence argues against price controls, even if that means very much reducing controls on wages.

But except on this point, I am in total agreement with what he said; and in fact, the prepared statement that I have turned over, insofar as it covers the same ground, says exactly the same things that he has said.

Perhaps, just as a slight point of emphasis, however, I think Mr. Cooper has perhaps not, at least in his oral testimony, put enough stress on the one point that was brought up by Mr. Steele, and that he also, in my opinion, did not quite stress enough; namely, the fact that the balance of payments crisis, insofar as the industrial countries are concerned, at least the major ones which met in Washington, is in my view a very transient problem. It is big, indeed; it amounts to many tens of millions in 1974. But I think it should be emphasized that it is destined to shrink rapidly and the reason for this, has been mentioned by Mr. Steele. But let me point out some implications of what he said with respect to the balance of payments. Namely, he has pointed out, as I have in my prepared statement, that there is a very

good chance that the cartel cannot hold. That is the first thing. If the cartel does not hold, and prices come down, the problem is reduced.

But suppose the cartel were to hold. There is only one way the cartel can hold: If some member of the cartel holds up the umbrella for others, and who can that be? Presumably the Arabs, the Persian Gulf States. But the Persian Gulf States are the only ones that are really causing problems in the balance of payments if by that, one means current account balance, because these are the States that at this point do not know how to spend, on goods and services, the large increase of revenue which they are getting.

Now if they hold the umbrella for the cartel, then their share is going to decrease and decrease rapidly for two reasons. First of all because there will be more supplies outside of the cartel. Secondly because all the members of the cartel outside of the Persian Gulf area will be very eager to take advantage of these huge prices to expand output while the going is good, as long as the Arabs are holding up the umbrella, which they may not do for a very long time.

But under those conditions, the share of the Persian Gulf States, the troublemakers, is going to shrink quite rapidly, and it is my view that by next year, the problem will be no more than half of what it is in 1974; and by 1976 it will be of an order of magnitude which is negligible compared with the many new things which will be hitting us by that time.

In fact, at the end of December, in one of the articles in the Corriere della Sera, parts of which I have included in my prepared statement, ventured to say that I would not be surprised, if in a couple of years the great problem of the day would be something entirely different. We will have forgotten the oil crisis and we will be talking about God knows what.

Of course the fact that the problem is transient emphasizes again the need for concerted action.

As I pointed out in my prepared statement, it would be absurd for the rest of the world to try to pass on us a large amount of their current deficit, because among other things, this would be only required during the transient phase. How it would be absurd for us to run into a deficit of $30 or $40 billions which would mean large-scale reshuffling of resources from internationally traded commodities to domestic commodities. To be sure, we could in principle offset the deflationary effect of reducing net exports to accommodate the rest of the world. We could offset that by domestic fiscal and monetary policy, but that would still require a massive shifting of resources from internationally-traded commodities to domestic commodities for us, and a corresponding opposite movement for the rest of the world.

Such a move might make sense if done slowly and if it would last many years, but it is absurd for a short time.

This then emphasizes the need for cooperative action in which the countries which now have a current account payments deficit will accept the deficit and will find appropriate ways of financing.

I have given some suggestions as to the way that should be done, and they seem to be very close to those proposed by Mr. Cooper.

Let me then turn to the domestic side.

My testimony in July of 1971 was largely devoted to explaining why the Nixon administration, the first Nixon administration, deserved a very poor grade, for the way it had managed the economy up to July 1971.

I furthermore suggested that the prospects for the balance of the term were equally dismal. I did not go beyond that because I had hoped then that there would not be a second term.

The reason for the mismanagement up to July 1971, was simply that the policy of the Administration had consisted in gradually squeezing the economy and raising unemployment, from a slightly too-low level below 4 percent in 1969, to a way-excessive level of over 6 percent by the time I was appearing before this committee. Then it was 6 percent. And I pointed out that the policies followed then were not sufficiently expansive, given that unemployment.

In particular, I tried to dissuade the commitee from being so much concerned with the fact that the money supply was rising at the incredible rate of 12 percent. Everybody seemed to be up in arms about that. I told the committee: do not worry about this. First of all the indicators we were using for the money supply were not reliable. And that view has finally sunk in.

I am pleased to remind you that the Federal Reserve Board has now finally appointed a committee to look into the measurement of money aggregates. I am a member of the committee so I will have an opportunity perhaps to carry out some of the suggestions that I made before this committee at that time.

I argued that neither monetary nor fiscal policy were expansive enough, and I think the fact that I was right was established by the fact that, despite the 12-percent increase in money supply, unemployment stayed at 6 percent for nearly a year. It was not until May that we finally got loose from the 6 percent. So that expansion of money supply at 12 percent was just not enough. Please remember this. There is no such thing as a magic number for the rate of growth of money. Do not let Mr. Friedman bamboozle you. There is no such thing—even if we have accurate measurement, and above all, if we do not have accurate measurement. So do not pay too much attention to the vagaries of that series. What is important are interest rates—especially, real interest rates, which is a complication—that is what matters. Forget the money supply except as a side indication of whether you might be wrong in your forecast of the strength of demand.

The other reason I was concerned, looking at the prospects for the future, was that I was afraid, if I may quote myself, (I am quoting from page 123)—"that if we have a slow recovery in 1971 as we seem to have, and if we are approaching election time, there will be all kinds of measures taken to stimulate the economy quickly at that time to be sure we get through the election time with a reasonable level of employment. And then we will be picking up speed. We will be picking exactly the wrong tactic; namely, going slowly when we are far away from the full employment goal, and running quickly when we get close to the goal, with a large chance of over-shooting it."

Mr. Reuss, I submit that this is exactly what happened. That was exactly the administration's game. They kept the economy saddled

with high unemployment hoping to get prices down, till they got close to election. Then they put on a full throttle, and we got close to election time, as the employment was getting close to a critical level, they were still injecting fuel, and that is the fundamental basis of the disorder which has characterized this economy in 1973.

The other reason for the disorder in 1973 is that you fell for the easy lure of price and wage controls. I warned you at that time that there was no hope in that direction, and again I could quote myself on this point. But I think it is unnecessary, because by now everybody agrees that price controls have been a most disruptive influence in this country, particularly, of course in phase III, and yet more in phase III-and-a-half and in phase IV. They have given rise to all kinds of shortages.

I was just today amazed to read, for instance, in the Wall Street Journal, a list of the items that are short today—with respect to one single line, the bakery products—the list included half a dozen items. Let me just read. Within the bakery industry, they say that what is short is "plastic baking trays, bread wrappings, oils, greases, food colors, and flavorings." Why are they short? Because of the disruptive effect of price controls, which simply does not help consumers, but leads things to disappear through exports, leads to misallocation of resources, and the like.

And what is incredible is that since Mr. Shultz himself has been prepared to admit the failure of the whole scheme, he nonetheless resented violently as I read it in the newspaper, Mr. Proxmire's suggestion that he and the administration were mismanaging the economy. Yet Mr. Shultz had the following thing to say in an interview in the Boston Globe: he said about price controls—let me quote him—"It was a disaster from an economic view, though a great thing from an educational point of view."

Well, my reaction to this is: Mr. Secretary, you were not brought in to use us as guinea pigs; you should have learned economics before you became Secretary of the Treasury, and you are not to use this country to make your educational experiments; you can do those in Chicago, but not on us. And it seems to me at least he should have the decency of not getting upset when somebody points out mistakes which he himself was willing to admit when he talked to somebody else.

Now there were other mistakes in 1973, and again Mr. Cooper has not stressed that, but I know he agrees with me. Among the mistakes that were made in 1973 was the fact that we let the dollar devalue quite unreasonably.

I had some misgivings about the devaluation of 10 percent at the beginning of the year. I thought it might be on the excessive side. But there certainly was no justification for the huge devaluation that occurred after the official devaluation, as the dollar floated, which reached its peak in July. By then the devaluation was on the order of 11 or 12 percent, over and above the 10-percent devaluation in the beginning of the year, a total of over 20 percent. That contributed a great deal, in my view, to the inflationary pressure in this country and contributed both directly by essentially raising import prices and, indirectly, by pushing our net exports very fast at the time

when the economy was already at capacity. I felt that a further devaluation of the dollar was unjustified; and evidently what has happened since fully supports my view.

And I am again pleased to say that I am on record for this; perhaps Mr. Reuss can remember it. At the end of February, I was in Spain, consulting for the Bank of Spain. I had the naive idea of thinking it might help to send a telegram to Mr. Burns, Mr. Schultz, and Representative Reuss urging that we should intervene to support the dollar, as necessary to prevent further devaluation. That was not done, and we have been paying the fees for that in the large devaluation in mid-1973.

I might add, to give further evidence of my beliefs, that I did make a little money by betting on the dollar at that time. That shows the depth of my conviction. Most of the time you say, if you are so smart, why ain't you rich. Well, I may not be rich because you cannot get very rich, even if you make a high percent on your capital, if you have a small capital. But I did my best.

Let us now look at what is in store for 1974.

Well, I said the score for the first year of the Nixon administration was below zero, if you can imagine that. I think the score for the plan that is on now for 1974 is equally low.

Of course we start out under terrible conditions, with galloping inflation at a rate never seen before, with an economy that is thoroughly demoralized, as evidenced by the stock market, where the ratio of price to earnings is the lowest, mind you, the lowest since the early 1950's, a time at which the depressed level reflected the memories of the great depression. In other words, the administration has been able to create an atmosphere analogous to that of the latter part of the great depression.

Now the plan for 1974 is the following: We open the year with nearly 5 million unemployed, with a rate of unemployment of 5.2 percent. That rate is already on the high side, even if you allow for changes in composition of the labor force. We should actually be aiming at reducing that rate slowly, not running like mad as we did in 1972, when we got running fastest as we hit 5 percent. No; we should be trying slowly to bring that back toward the 4.5 percent level, and you should focus on unemployment. That is the relevant factor in the economy; that is the one thing that has social consequences. Do not worry so much about other things.

Inflation in 1974 is unavoidable, but the administration plan is to try to reduce that by squeezing the economy again, by leading to a contraction in the first two quarters. Of course the President, in his speech, told Congress that there was going to be no recession in 1974. But the printed statement from the council acknowledges that there will be a contraction—at best, a leveling, probably a contraction—in the first two quarters of the year.

In my view, with current policy, there will be a contraction in the first two quarters. Then the turn about comes around the middle of the year. By that time, of course, unemployment will have reached 6 percent. And then the great plan is that from that point on we shall let the economy grow at its longrun growth rate. And that means we shall be sure to maintain unemployment at that level, or just about 6, a little below 6, but around 6 percent.

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Now I submit that there is no rationale that would justify this approach, unless the administration really believes that the people who are unemployed will reduce the pressure on food prices because they will not eat bread, and they will reduce the pressure on gasoline prices because they will not drive cars.

Well, all I can say is that that view is simplistic, to say the least. Prices will continue to rise for a number of reasons; because of lags, because the effect of higher oil prices is not completely worked out. What can be gained on the price front by increasing unemployment from the appropriate 4½ or 4¾ to 6, I think is peanuts, as compared with the social cost of that level of unemployment.

The administration justifies this plan, saying that in the first half of the year, the unemployment is almost unavoidable. It is almost unavoidable because of the consequence of the oil shortages. And they are pleased that the unemployment will be 6 percnt focusing on the price front.

Well, I have already indicated that I do not believe the statement about the price front or that a small gain on the price front would warrant the social cost paid for it. And I do not believe that there is nothing we can do now to improve the economy, even in the second quarter—for the first quarter, it is too late now—even in the second quarter; and certainly thereafter.

In the short run, we can certainly use a good bit of help, but not so much, I think, by use of fiscal policy, since what I think needs to be revived at this point is housing, which is faring badly. And housing can be revived and should be revived by an easier monetary policy. That, I think, is an immediate action.

Second, you should and can revive the economy by increasing the confidence of both consumers and business by impeaching the President. The day that happens, the stock market will take a big leap forward, and I wish you would tell me in advance so I can be sure to buy to the hilt.

That is—I would like to stress that even from an economic point of view—the impeachment of the President is a matter of importance and of great urgency.

The third thing we need to do is to disband those horrible price controls which are doing a great deal of damage, and which by now are really helping nothing. There may be a case for some very, very selective price controls; perhaps in the health care areas, perhaps there is a case for that. But in general they are doing nothing but harm, and the quicker we get rid of them, the better off we are.

Again, and fourth, let us not get again into a situation in the foreign exchange market where the dollar gets undervalued.

And let me comment briefly, now, on the international situation, since we have reached that point.

The advocates of floating rates have seemed to tell us that they are very pleased with the way floating rates have worked. Mr. Shultz himself, in the same interview in the Globe, of February 4, indicated that floating rates have worked very well.

Well, I beg to disagree with that. I think floating rates have worked miserably in that the large depreciation of the dollar after February 1973 was totally unjustified. And of course by January 1974

we were galloping toward an overshoot in the opposite direction. The speculators have given plenty of evidence that they do not know their business. I hope that they have lost a lot of money. But they certainly showed that they way overshot in 1973; and lately they were on their way to overshoot on the other side. Well, let us not let them do that. Let us essentially establish a system not of fixed parity, but of crawling parities; that is a system in which official parities exist, but can gradually adjust in time. But if we do so, the only condition under which such a system can work, as Profesor Cooper has correctly pointed out, is that there be a commitment and a willingness on the part of all central banks to support each other against speculative runs *without limits.* That is the key word. In the past, every attempt at establishing any kind of official parities even with broad margin, has been greeted by speculative attacks. And once speculative flows have reached the first billion or the first few billion, we have given up and the speculators, for a short while at least, have made money. Well, there is only one way to stop that and that is to make it clear that the central banks are no more stupid than speculators in setting exchange rates—I think the recent record shows that—and that they have a lot more power. By making it clear that we can print dollars ad infinitum, the Germans can print marks, and they can print them ad infinitum, and so on, we should convince speculators that Central Banks can afford to support each other without any limit. The moment this is done, and if nonetheless the speculators will test us, and for the first time after we have absorbed the first $50 billion, they will realize that we are still ready to absorb 50 more, then they will give up. And thereby we shall have regained some order in international exchanges.

In the longer run, of course, we still have a number of domestic problems to take care of. In particular, I think that we need to go through a much more careful analysis of what to do about financial intermediaries, and the housing markets. I think that the proposals of the administration now are poor proposals from the point of view of the restructuring of the financial intermediary sector. What they say is: every intermediary should be alike. But then, I ask, why do you want to have five different types of instructions if they all are going to be alike?

And what they proposed to do about housing is again some tax gimmicks, destined to encourage housing by making the rich people richer. I am against that. I may take advantage of any loophole there is, but I am against loopholes.

I am presently working on a proposal to revamp the financial structure and the housing market, relying on so-called "indexed" mortgages and "indexed" deposits, which I shall be glad to talk about on some other occasion. Let me just say that we are working on this, and I think there are indeed rational solutions to the problems.

At the level of international monetary reforms, again, I do not have much to add to what Professor Cooper said. He speaks of managed, internationally agreed, managed float. I speak of crawling parities with agreed intervention. I think the difference between us is semantic. We are talking fundamentally about the same thing, and I think that is the direction in which we should go.

In particular, it is time for the United States to stop playing the hypocritical game of saying, that, we are all in favor of complete symmetry, we are in favor of moving back to convertibility when in fact we are not ready to, and it is most questionable whether we should. So let us face the issue squarely, and let us talk about what is a non-convertible system that makes sense. And again, I have made concrete proposals to this effect. I have summarized them in the prepared statement you have before you, and I shall be glad to talk further about this in the questioning.

Thank you.

Representative REUSS. Thank you, Mr. Modigliani, and I thank all three of you gentlemen.

[The prepared statement of Mr. Modigliani follows:]

PREPARED STATEMENT OF FRANCO MODIGLIANI

BALANCE OF PAYMENTS IMPLICATIONS OF THE OIL CRISIS AND HOW TO HANDLE THEM THROUGH INTERNATIONAL COOPERATION [1]

Despite the bland and tranquilizing reaction of U.S. officials such as Secretary Schultz and Representative Reuss, Sunday's (Jan. 20) decision of the French government to float the franc strikes me as potentially very destructive as well as terribly irksome. It is irksome in that it mirrors the narrow egotism as well as incredible myopia that has been the trademark of foreign policy of the Pompidou regime for some time and especially in recent months, as well as the hypocrisy of the pious recommendations that France never ceases to address to others about the duty of sacrifice in the superior interest of the European community or of the international community (whenever that interest happens to coincide with France's own). Examples of similar actions abound in recent months: for instance, the French decision to explode nuclear devices in the Pacific; the leading role that France (unfortunately with the support of England) has taken in rejecting a common policy toward the energy crisis for the economic community of Europe with respect to supporting Holland; the unilateral French dealings with the Arab countries in order to insure her oil needs.

As for her double standard, it might be sufficient to recall the outrage with which France has condemned the decision of Italy to remain outside of the European snake, and also the fact that France was among the signers of the communique of the group of twenty, released in Rome the previous Friday, which explicitly recognized the desirability for close *collaboration* and the need to avoid *unilateral* actions and competitive *devaluations*. Two days after this communique, France unilaterally let the franc float with the obvious intention to let it devalue and in this way unload on others a part of the difficulties in her balance of payment.

The immediate and ostensible purpose of the French move is obvious enough: to avert the danger that, in order to support the franc in the face of a sizable deficit on current account and a possible capital flight, she might have to encroach on her foreign reserves (even though still sizable), and above all the danger of having to liquidate even a single ounce of gold. One may well say that, with this latest move, France has confirmed what many have suspected for a long time: namely that for the France of Pompidou and of the "Grand Patrie" to lose its gold is incomparably worse than to lose its soul.

One may well suspect that the true final purpose of the move was that of letting the franc devalue, as has actually happened in the first days of the float, during which the franc lost some 5%, in the hope that this devaluation would help improve her balance on current account. It is more difficult to foresee the intended effect on capital of movement since France has already for some time established a double exchange system with two separate markets, one for the commercial and the other for the financial franc. Since in any event the float of the franc, both of the financial and of the commercial one, will

[1] This article is a fairly liberal translation of two articles of mine which have appeared in the column "Osservatorio" of the *Corriere della Sera* on Jan. 24 and 26, 1974.

certainly be a "dirty" float, that is, one in which the French monetary authorities will intervene in the market, it is hard to tell whether France will endeavor to maneuver the value of the franc on the two markets toward encouraging or discouraging capital imports.

In any event, through the devaluation of the commercial franc, France intended clearly to reduce, or perhaps even to eliminate, the deficit on current account resulting from the increased cost of oil. But obviously this improvement could only be obtained at the cost of increasing correspondingly the deficit of other countries producing goods competing with the French ones; this means, in the last analysis, the deficit of the other industrial countries, whose current account balance are already in serious difficulties, frequently in fact more serious than those of France itself. It is in this sense that the French initiative may be labelled as narrowly egotistic. The reason for characterizing it also as incredibly myopic is that it is naive to think that the other countries, will passively accept a further deterioration resulting from a French devaluation. It is much more likely that these countries would have an irresistible temptation to imitate the French behavior responding to the French devaluation with a devaluation of their currencies. Indeed, this is precisely what has happened in the case of Italy, whose currency has followed closely the French franc. Should other currencies follow this lead, where would it all end?

If all the industrialized countries endeavor to eliminate or reduce markedly their deficit through devaluations relative to the dollar, one has to raise first the question as to whether the United States would be ready to accept passively this behavior and its implications. Let us suppose for a moment that the U.S. were to accept it. In this case one could certainly count on three outcomes. First, a large part of the potential gain that France or Italy expected from their devaluation would be lost in as much as the franc would not have lost value relative to the lira or relative to any other currency which had followed the French devaluation. Consequently, a sizable improvement would require repeated and huge devaluations. In the last analysis, the only country whose imports would increase and exports decrease would be the United States and the countries which would maintain their exchange rate with the dollar, such as, presumably, Canada. Second, the countries which devalue would be subject to further inflationary pressures as a result of the increased cost of oil and of other raw materials and goods coming from the countries which had not devalued. Third, the oil producing countries would really welcome this rush to devalue relative to the dollar, since a barrel of oil whose price had been fixed at, let us say, $7, would end up by acquiring even more of the goods produced by France, or Italy, or any other devaluing countries, than they had hoped to acquire when they increased their price to $7. In other words, devaluation would only deteriorate further to terms of trade between the industrial countries and the oil producing countries.

But while these devaluations would clearly increase the purchasing power of the oil producing countries, it is extremely unlikely that these countries, at least those of the Persian Gulf, would be induced to increase significantly their net imports since already in the current situation their revenue are larger than they know how to use for the acquisition of goods and services, at least for some time to come. Consequently, their dollar revenue would remain largely unchanged, except for a possible modest reduction in the quantity of oil sold, modest because the demand for oil, at least in the short run, is notoriously very inelastic. It follows that their largely unchanged surplus would have to be mainly compensated, in the last analysis, by an increase in the deficit of the American block, partly through on increase in their imports from the countries devaluing, and in part through a decrease in their exports both to the devaluing countries and to the other countries. It has been estimated, even if with a large margin of error, that the increase in the deficit of the industrialized countries outside of North America resulting from the increase in the price of oil might reach 40-60 billion dollars. Even if we suppose that this figure might be somewhat reduced because of the decrease in demand, and supposing that the countries which devalue aimed at shifting to the United States 2/3 of their increased deficit resulting from the increase in the price of oil, we would have to conclude that the final result of the general rush to devaluation, even if accepted by the United States, would be a worsening in the current account balance of the United States in the order of 30-40 billion dollars. In other words, the current account balance of the United States would have to shift

from the current rate of around 8 billion surplus to a deficit in the order of 25-30 billion. To appreciate the magnitude of these figures, it will suffice to note that the U.S. deficit at its peak in 1972 was around 6 billion, a figure which caused deep concern on the part of the entire financial world. It should be recognized, however, that at least initially this deficit would not create a balance of payment problem for the United States since it would be automatically financed by the acquisition of dollars on the part of the Arab countries.

At this point we need to raise two questions. First, is it possible that the United States would accept such a deficit passively? Secondly, even if this were the case, would this provide a sensible and rational solution to the oil crisis?

The answer to the first question seems to me to be a decided no. In the first place, an increase in the deficit of the order of 30 billion would have extremely serious deflationary effect in the United States and would threaten unemployment on large scale. These effects could of course, in principle, be compensated by careful expansionary fiscal and monetary policies leading to a corresponding increase in the domestic demand for consumption and investment, both private and public. But, even supposing that the government were capable of instituting promptly such a policy, this solution would still require massive shifts of internal resources from the production of internationally traded goods to other commodities. This would unavoidably lead to huge losses and widespread bankruptcies for many enterprises and massive lay-offs even if accompanied by a demand for labor in other activities. Such developments would unavoidably lead U.S. public opinion to demand effective countermeasures. One can readily visualize at this point quite a variety scenarios, such as massive interventions by the U.S. monetary authority in the foreign exchange market colliding frontally with the intervention of other countries, or the enactment of huge custom duties and import quotas. In other words, the unavoidable result would be international chaos and a new wave of nationalism and xenophobia on a world wide scale. All this may be to the liking of the Pompidous of this world, but it is doubtful that it would please anybody else. One must therefore conclude that unilateral actions and competitive devaluations are but a blind alley, moving the world to the brink of disaster.

The answer to the second question seems to be equally negative. That is, even if the United States were ready to absorb in an orderly fashion the increase in its deficit, offsetting it with refined anticyclical policies, the solution would not be a desirable one. This conclusion rests on the consideration that the transfer of internal resources from internationally traded commodities to other activities, both inside the United States and inside the devaluing countries, is an operation which is economically very costly and socially very painful. Such a massive shift might perhaps be justified if it could occur slowly, and if, once it had occurred, it promised to have some permanence. But a gradual transfer could not satisfy the immediate necessities of the balance of payments of the industrial countries. In addition, and this is the main point, there is no reason to suppose that the transfer would be a permanent or even a lasting one. In my view, in fact, the huge deficit which is confronting at this time the industrial countries outside of North America is certainly of a transitory nature. It is destined to shrink very rapidly even in the absence of competitive devaluations. In the first place, the majority of the producing countries, outside of those of the Persian Gulf, such as Iran, Indonesia, Venezuela, will tend rapidly, if not immediately, to use their increased revenues to increase their acquisition of goods and services, thus compensating their increased exports with larger imports which automatically would tend to eliminate the imbalance in current accounts. In addition, as I have indicated in previous articles in this column as early as late December, I regard it as highly improbable that oil prices can be maintained at the current level (in real terms) for any appreciable length of time. Some reductions may well come in the near future as seems to be suggested by recent reports of price behavior in some markets. But even if the price could initially be maintained I suggest that, as time goes by, the demand for oil will tend to diminish, both through techniques aiming at reducing oil consumption, and through substitutions with other sources of energy. There are also convincing reasons to suppose that the increase in price will soon give rise to a significant increase in production outside the cartel and that this in turn will reduce the demand for oil directed to the members of the oil cartel. At this point it would become very difficult to hold up the cartel price, or if the price could be maintained, this could probably happen only if the Persian Gulf countries were ready to reduce their

market share, by absorbing both the reduction in the total demand directed toward the cartel and the probable increases in production on the part of other members of the cartel.

The willingness of the Gulf oil states to reduce their share is certainly credible, since at the moment they end up by using a good share of their receipts for financial investment; they might well decide that the best investment they can make is in oil underground. But, even in this case, one has to conclude that with high probability, the revenues of these states—who are the source of problems because they do not automatically use their larger revenues to buy commodities—would diminish rapidly. If so, the problem of the deficit for the industrial countries would rapidly shrink from the current 40 billion dollars (which is probably already an overestimate) down to relatively modest figures.

If this analysis of mine is valid, as I hope for the peace of the world, and consequently the problem of the balance of payments of the industrial countries is only a tranchent one, the rational solution is not that of competitive devaluation. What is called for instead is a tranchent remedy, which can only consist, fundamentally, in the acquiescence on the part of the industrial countries to a deficit, initially of large proportions, but rapidly shrinking in time. If the relevant countries are ready to move toward this rational solution, then the only problem is the technical one of finding a way by which the producing countries can be induced to finance the deficit of the deficit countries either directly or through a variety of indirect ways. For instance, it is entirely conceivable that the Arab countries might wish to employ their surplus in financial or real investment in the U.S.A., and that in turn the U.S.A. might provide through private, public or semi--public channels financing for the other countries, in part perhaps through the Eurodollar market. It would be particularly desirable to find a way to provide financing for the countries of the third world, either directly from the Arabs or indirectly, for instance through loans by the Arab countries to the International Bank and by the International Bank to the underdeveloped countries. In so far as this solution is adopted, one could largely eliminate the very deficit since the less developed countries would be rapidly acquiring goods produced in the industrial countries. It is not necessary to enter here in the details of how financing of the investment of certain countries and of the deficit of others could be arranged. Any international financial expert would be able to put together in a short time a reasonable plan. In fact it is my understanding that the International Monetary Fund has already been working on just such a plan (See the report on the Rome mid January meeting of the Committee of Twenty in the Economist of Jan. 26). Chances of success could be greatly enhanced if the would-be borrowers were prepared to guarantee the lenders a reasonable "real" rate of return by devices of the type outlined below. What is essential however is that the industrialized country accept the principle and immediately put an end to the trend toward competitive devaluations.

It should be noted that this suggestion does not mean that no country should be allowed to modify its exchange rate. It is conceivable for instance that certain countries like Italy, which already had large deficit in their balance of payment before the oil crisis, should be allowed to devalue moderately relative to the majority of other currencies, or that most of the European currencies should be allowed to devalue modestly with respect to the dollar in order to shift part of the deficit to the United Sttaes. But what is implied is that such changes should occur only through international consultation and agreement. These agreements should establish a reasonable initial set of parities values, subject to gradual change in time [but with limitations to the maximum permissible rate of change] and a reasonable band of permissible fluctuations around the parity established at any point of time. Finally, the commitment to maintain the market rate within the limits allowed by the agreement should be guaranteed and made credible through a solid understanding among central banks committing them, in case of speculative attacks, to support each other *essentially without limits,* either directly or through appropriate devices developed in the international monetary fund. Only the certainty on the part of international speculators that we have brought to an end the era in which every speculative attack, provided it was pressed hard enough, would reap large profits for the speculators, can put an end to the chaos which has greeted every attempt at reestablishing official parities, even if with broad band.

The conclusion then is that we have to start out with a moratorium on unilateral devaluations initiated by France, and promptly convene at international conference of the interested states, including the producing countries, in order to replace the threatening chaos with an orderly and rational system. Italy could substantially contribute to reestablishing order and calm by offering immediately to the countries which have remained in the snake, and have not followed the French devaluation, to enter the common market snake. In so doing she could demand appropriate guarantees of mutual assistance of the type which she had justifiably requested since the inception of the snake as a condition for entering it (and which the Germans were prepared to offer to France). I certainly do share the views expressed by many Italian leaders that the Werner plan and the common market snake, as initially designed under the inspiration of France, was not a viable creature. Before attempting to establish and maintain rigid parities, it is necessary to unify the institution of the various countries: taxation, the regulation of financial market and financial intermediaries, the policies of trade unions, and so on. But at this point, Italy, having had the satisfaction of demonstrating to France that she was right in not entering the snake, could take a step which would help to reestablish confidence, by moving against the tide. At the same time, if Italy takes this step, would it not perhaps be appropriate to suspend temporarily France from the economic community until such time as French political forces, more farsighted than the current regime, forces which we all know exist and flourish in France, are ready to take over in that country?

Some considerations may finally be appropriate concerning the implications of the current oil crisis for the long-term reform of the international payment system. Over the last two years, the major emphasis in any scheme to revamp the international monetary mechanism has been on the notion of *perfect symmetry*. In the system of the future, every country should have exactly the same rights and obligations, notably with respect to convertibility. As has been pointed out repeatedly, this implies among other things the symmetric right for the United States to control its rate of exchange with other currencies.

The latest move initiated by France toward unilateral devaluation vis a vis the dollar suggests however that the time may have come for second thoughts about the desirability of perfect symmetry, and that it may be advantageous for the rest of the world to preserve its right to fix its exchange rate with respect to the dollar, and thus control the U.S. balance on current account. But, under this condition, as was pointed out in the joint essay with Hossein Askari ["The Reform of the International Payment System" (Essays in International Finance, No. 89, September 1971)] it is no longer reasonable for the rest of the world to expect the United States to accept the responsibility of conversion. If, for instance, under the present circumstances, the United States should accept a certain amount of deficit in order to accommodate the rest of the world, it cannot then be expected to convert into some other asset the dollar balances which will have been accumulated in the process by other countries.

All this suggests that it may be time for those responsible for revamping the international monetary system to take a fresh look at the proposal set forth in the above mentioned essay. Under this proposal, the rest of the world would be responsible for setting up and managing, by market intervention, a system of crawling parities with the dollar. Since the rest of the world would thus have the responsibility and power to set the exchange rate with the dollar, and hence control the U.S. balance of payments, the United States would not be required to convert dollar reserves accumulated by other countries into the other international reserve asset, which would consist of an international intangible medium of exchange created by the International Monetary Fund, similar in nature to the present SDR.

Under the plan the United States monetary authority would hold no international reserves having no use for them, while the monetary authorities of other countries would hold two kinds of international reserves, namely SDR's and inconvertible dollars balances. The parity of the SDR with the dollar (and hence with every other currency in the system), would be periodically adjusted on the basis of an index of prices, expressed in dollars, of a suitable basket of internationally traded commodities and services. Specifically, any change in this price index would give rise to an equal percent change in the price of the SDR in terms of dollars. Through this device, the SDR would have *a constant purchasing power in terms of the stated basket of internationally*

traded commodities. Foreign countries holding inconvertible dollar balances would be given an opportunity to secure protection against changes of the parity between the dollar and the SDR by turning any portion of their reserves over to the U.S. monetary authority, obtaining in exchange a claim against the U.S. denominated in SDR's and earning a moderate interest rate commensurate to that paid by the International Monetary Fund on SDR balances. By this device, all the rest of the world would have the opportunity to shed the risk associated with holding inconvertible dollar balances.

The fact that the SDR would, under this scheme, have a guaranteed constant purchasing power would make it a suitable numeraire for denominating international loans. In particular, the surplus oil producing countries, by making loans denominated in SDR to the deficit countries (directly or through an IMF facility) could shed not only the risk of exchange rate variations but also the risk of price level changes. Note also that with loans denominated in SDR's, there would be no danger, even in the case of direct lending, of creditor countries making massive shifts from one currency to another.

It would appear that this type of scheme could contribute substantially to the solution of a good many of the problems that have been created by the current oil crisis. Furthermore it could be put into effect quite rapidly even under the present unsettled conditions, a claim that no one could seriously make for any alternative system involving effective unconditional convertibility of the dollar.

Representative REUSS. Mr. Cooper, let me start with you. In your prepared statement, you talk about the domestic inflationary impact of tightened oil prices, and you point out quite correctly that those higher oil prices are, in effect, a tax on everyone, particularly working people who use most of it. And your prescription, then, is the continuation of some sort of guidelines or controls on wages.

My difficulty with that is not only the point that Mr. Modigliani made, that just to control wages without doing anything about prices is, as a poliical matter, not going to be accepted at all by wage earners, and would not work. I have the additional difficulty with it in that it seems to me that there is a far better way of asking wage-earners to remain within reasonable bounds in their wage increase requests than to try to continue a unilateral form of wage control, and that far better way is to give an immediate tax reduction to the wage earner making below, say, $13,000 a year.

You can do that very readily by cutting back on the payroll tax on which he now pays 5.85 percent on every penny he makes, and by adjustments on the income tax, distributing the benefits to under $15,000 a year people.

It seems to me—and I would like your reaction to it—that unless you are prepared to do that, as I certainly am prepared to do it, you cannot ask, in any equitable sense, labor to sit still for wage moderation.

Mr. COOPER. Yes, I am happy to comment on that because I think both you and Professor Modigliani misunderstood my remarks.

Representative REUSS. Perhaps so.

Mr. COOPER. I deliberately say that I regret the abandonment of Government guidelines on wage settlements. I draw a sharp distinction between guidelines and controls. I am one of those who believes that exhortation has some value. Indeed, the hearings and the other work of the Joint Economic Committee itself are predicated on the assumption that discussion and information have some social value, can influence decisions through the force of argument, since it does get translated directly into legislation by the committee.

It is in that spirit that I suggest that the point must be made that we cannot in 1974, at existing oil prices—I do associate myself both with what Professor Steele and Professor Modigliani say in not expecting the cartel to hold—maintain our real incomes inclusive of taxes. That point must be made very strongly, because I believe that —and here is where I think there is a distinction between wage guidelines and price controls—we must allow prices to go up more than wages and other income before taxes go up. That is what has happened and that is what must happen.

The price increase has been imposed on us externally, and if Americans do not accept that fact, it is going to lead to strikes, it is going to lead to a great deal of senseless social strife in this country. People will not succeed in preserving their real incomes at the end of it all, but in the process of trying to succeed, an enormous amount of social cost will be incurred by all parties concerned.

I speak in part these days as an employer of 7,000 employees, as provost of Yale, and there is simply no way our employees can recoup in wages from Yale University the full increase in the cost of living. We cannot do it as an institution. We too have had a huge increase in our fuel bill. I dare say there are many other middle-sized firms across the country that are in a similar position. So while I associate myself with Professor Modigliani not only on the offensiveness but also the disastrous consequences associated with an elaborate but not very well conceived system of price controls in this country, I distinguish that from the educational importance of separating prices from wages and other incomes and explaining the unusual relationship between the two in the present circumstances.

Now, let me comment specifically on your suggestion. I would, of course, approve that. It is consistent with my view that the economy needs some economic stimulus at the present time, and an effective way of providing that is to reduce taxes and, in particular, to reduce the payroll tax, which is the one that has the strongest impact on low-income groups. That would be desirable on macro-economic grounds as well as helping on the wage front.

I would go on to say, however, that if you are going to have the effect on wages that you suggest, some exhortation is going to be required, because officials and members of labor unions look at the negotiated wage, which is, of course, before taxes, perhaps even more than at their take-home pay, which is after taxes. So I think you have to combine any tax adjustment you want with a full explanation of what is going on, or you will not avoid the strife.

Representative REUSS. Well, I fully agree that you need full explanation. I am delighted that you go along with my tax cut for the moderate income worker proposal.

I would, however, stress a little more than you do that if you are going to, if you are not going to have a tax cut—you said you would, so we are not really talking about your position. But if you are not going to have one and you are just going to say to the worker, look, it has been determined by economists that you cannot really, by bidding up the price of a finite commodity, oil, you cannot really make yourself any richer, your chances of satisfying either workers or their leaders in the wage negotiation through that argument, I think, are very small.

I think your chances of satisfying them by unfolding a social contract in which the kind of worker we are talking about is redressed to the extent of, say, $10 billion a year, which he can then use to buy many things, not oil, that will make him happier. Some of those things will come about and will come into being through operating closer to full production and full employment than would otherwise be the case. Others will come about through a modest, quite modest, redistribution of income.

So I guess my point is that, do you not need the kind of tax reduction for the groups we are talking about in order to enable you to be listened to at all in your exhortation that wage increases, as such, do not really help the person to whom the increase is given?

Mr. COOPER. I would not be so pessimistic as you are. I do not disagree with your policy proposal at all, and I believe it would help substantially in dealing with this problem. But if for some reason we are told that such a tax reduction is not possible, I would not let it go at that. I would not despair.

I would make the effort at persuasion. The costs of failure are very high. We are likely to have a rash of strikes over wage demands that cannot be met in a situation in which collectively there is no way to increase real wages.

Representative REUSS. Let me call attention another——

Mr. MODIGLIANI. Could I comment on this?

Representative REUSS. Yes, Mr. Modigliani.

Mr. MODIGLIANI. Because I completely agree with the basic idea you have that you would like to replace wage increases with tax cuts, but I think you should push this one step further and say that we do not necessarily want overall additional stimulus in consumption, since I would like to see more investment in housing, that we should cover that tax reduction by a tax on those who are profiting from the current shortage.

Now, it just happens that we are, luckily enough not only large consumers of oil but also large producers. It seems to me that a rational solution of the problem is to put a nice, heavy excise tax on crude oil, on domestic crude oil, which can be graduated, so that you do not remove incentive at the margin. You put it on old oil, take the revenue of that tax, and use that to actually, explicitly reduce social security contributions; in other words, make it an explicit deal in which that money is used to reduce the withholding for social security. Then you really have a social compact in which you accomplish a fair distribution of income. You prevent some people gaining from the situation of shortage and you have distributed that effect evenly. Total consumption is still reduced, but it is reduced across the board, some of it falling on producers of oil, some of it falling on the consumers. So I think this is the kind of plan that needs to be pursued, that should be considered carefully.

I am aware of the fact that when you talk about practicalities, it is hard to get excise taxes through the appropriate committees. But if you re talking about rational solutions, if for a while at least you want to contemplate them, I think you should give real consideration to this possibility.

Representative REUSS. I agree you have to find, at least in part, the revenues that you have just lost by your tax reduction. If there

is something wrong on the plus or the minus side with the overall budget, surplus, deficit, whatever it is, that is another matter. But I quite agree that you ought, within this tax system itself, to repair whatever revenue losses you incur as a result of tax reductions to the moderate income worker that we are talking about.

My time for questions is up.

Senator Proxmire.

Senator PROXMIRE. Well, we have at least two very interesting and brandnew suggestions this morning on economic policy and economic analysis, new to me, and I have been at almost all of these hearings and have held other hearings in the Senate Banking Committee related to this.

Mr. Modigliani, you are the first witness who has suggested that the impeachment if the President would constitute—and you seem to do this seriously—a substantial economic benefit for our country. And you base this primarily on the effect it would have on consumer confidence.

Mr. MODIGLIANI. And investors confidence.

Senator PROXMIRE. Let me ask you to address yourself to what seems a contrary view that many might have. No. 1, the feeling on the part of many people is that President Nixon, for all his faults, has done a good job in some respects, with respect to foreign policy, the Middle East, with the Chinese detente, perhaps Russian detente.

No. 2, he would be replaced by Vice President Ford, who would be an economic carbon copy, and probably less flexible than President Nixon, who has been one of the most flexible Presidents we have had, and that relative inflexibility on the part of President Ford might be perverse, in the view of many economists—people who have espoused the views that you usually espouse.

No. 3, the impeachment process itself would be a wrenching experience for the country. It would take maybe all of a year. We would be in doubt, and right now it seems it would probably fail.

Under these circumstances, what is your response to the notion that this is something we should pursue, recognizing its economic implications as well as, of course, its political implications?

Mr. MODIGLIANI. Well, let me first of all comment on the fact that I quite agree with you the flexibility of the President. In fact, as far as I can tell he has managed to change his position on every single thing he has ever said, except one; namely, that he will not withdraw, and I hope that he will soon change his position on that one, to make his record perfect.

Now, the reason I feel impeachment is critical is that it is my belief that if he is impeached he will resign, and I am convinced that the President does not want to go through a trial; at a trial in the Senate there is no cloak of privacy or privileged communication.

Senator PROXMIRE. Now, let me see if I understand clearly. What you are saying is if he is impeached by the House of Representatives, he will not go to a trial in the Senate? You feel he will resign and that will serve the country?

Mr. MODIGLIANI. He will make a deal so he can keep some of his houses, and I think we would all be willing to let him keep at least

one, and he will be very glad to get out, staying out of the melee, which, I think, is perhaps what he really aspires to. I mean, this is my view, and thank God, as a citizen I can express my views about that freely.

Of course, he is innocent until proven guilty even if he is impeached, but it is my feeling that he would not want to stand trial by the Senate.

Now, the chances of impeachment seem to me to have been incredibly increased by the Michigan election. I think the Republicans are beginning to understand that it is just an incredibly myopic policy, that of insisting on protecting and supporting the President, a President who has clearly lost the support of the country.

Senator PROXMIRE. Mr. Modigliani, let me ask you about the economic implications here.

The point I made is there would not be a change in the economic policy in all likelihood. You would have, I agree, a different attitude, and whether President Nixon is impeached or not, I think once this is out of the way, you may get a greater feeling of stability. At any rate, say he is impeached and Vice President Ford becomes President and adopts economic policies that he seems to espouse, which are conservative Republican, the classical approach.

Mr. MODIGLIANI. Well, I would say, first of all, that the President is now so much involved in just keeping his associates out of jail that he does not have any time available to really think about the problems of the country, and I think he is making impulsive decisions, decisions that do not make much sense.

By the way, I would like to point out there is one decision of the administration that I support. I agree with Mr. Cooper, that the disbanding of the various restrictions on capital movements as a short-run policy was a very good one, so there are things, some good things, that have been done.

Senator PROXMIRE. Well, you also support the notion of eliminating all controls except those over health which the administration has proposed?

Mr. MODIGLIANI. Yes, that is right. That is my view. By the way, you know, that is the view that such a "radical" as McGovern advocated. You well know that McGovern was against price controls, the "great radical" of our time! In fact, his program looks very conservative compared with some of the things the administration has been doing.

Now, it seems to me that in the first place there would be just a sense of relief from the uncertainty of today. It is not good to wake up every morning wondering what the next thing will be that will make the stock market go up 20 points or go down 25 points, most likely go down 25 points. And, you know, just getting the suspense out of the way would be extremely helpful even if Mr. Ford was no better intrinsically than Mr. Nixon. But I do also feel that Mr. Ford would need more of the support on the Democratic side of Congress, and I feel that he might very well understand politics.

Let me point out here that one of the great dangers of 1974 is a repetition of 1972. I believe that if Mr. Nixon is still President as we approach elections, there will be an enormous pressure on him

to take some dramatic economic measures to bring down unemployment, because I do not think the Republicans can afford to go to the elections with 6 percent unemployment, or nearly as large, and galloping inflation. I think it is too much. And so there is a danger again of an irresponsible attempt at sudden stimulation of the economy.

Something one has to remember is that the economy must be treated with care. If you want to expand, you must generally not do it too fast. There is nothing wrong with having unemployment as low as 5 percent. In 1972 what was wrong was that we reached it in a period of 5 months; from May to November we went from 6 percent to 5.1 and we were still running at full speed at that time, and interest rates were the lowest around December of 1972.

The contrary should have been done. We should have had low interest rates in 1971, when there was 6 percent unemployment, but we should have had higher interest rates around the end of 1972. So, again, having a man like Mr. Ford, I think we would have a man who has less of a need to take irresponsible actions to save himself, to try to stay in office.

Senator PROXMIRE. Let me ask—the other point that you made, Mr. Cooper, that was new to me and very, very helpful, is the notion that our living standard simply must fall, and that we have to accept that, and that there is no way we can provide for an improvement in real income.

As I understand it, one of the outstanding labor leaders of the country called just this morning for a 12 percent wage guideline. He felt that kind of an increase was what labor deserved and needed and ought to have, and in view of the inflation we have had and so forth, look, this is it.

I think that perhaps underlines what you have been telling us, that if we try to restore the living standards by wage increases, they are going to be so inflationary we are going to have an irresistable wage-price spiral.

But let me ask if it is true that we must resign ourselves to this.

Now, many people argue that we did not have to have the kind of inflation we had last year if we had adopted these sensible policies, that we did not have to have the Russian wheat sale, that we did not have to have the enormously rapid using up of our reserves and surpluses in the food area, that if we had not had that we would not have had wheat going to $5 and corn and soybeans going so high, meat going sky high, and all of the food products following them up; that if we had some kind of early warning system, that if we at least have the protection of the American consumer against these drastic, radical export developments, that we can do something about the deteriorating living standard.

Do you think that is so heartless as far as the rest of the world is concerned that we should not consider it, or do you think it is something we can do?

Mr. COOPER. In the context in which we are now speaking, I draw a sharp distinction between the oil price increases and the food price increases. I think that the long-run supply price, if I can use the technical expression, of food in this country is nothing like the present $5-plus per bushel of wheat.

Senator PROXMIRE. Let me just interrupt to say, you see, the problem I have is that food is so central and such an enormous proportion of the consumer budget; gasoline, while important, is far less. It seems to me that it should be manageable in one way or another, rationing, some way of reaching this without a significant deterioration in our standards. Just the 3 percent increase we normally average in production annually over the years on a per capita basis should be able to take care of that quite easily.

Mr. COOPER. I am glad you mentioned that. When I talk about reducing living standards, I am talking about relative to what they would otherwise be. The total net impact of the increase in oil prices on the economy will amount to about 1½ percent at current prices, and prices may come down. But at current prices, it amounts to about 1½ percent of total personal income. Well, that is well within the normal growth per year, so if the normal growth in per capita income is something like 2½ to 3 percent a year, it means taking 1 year in which you cut that in half. It is not an absolute reduction that is called for so much as an adjustment of expectations for 1 year, or even for several years, if you want to spread it out by in effect borrowing from the oil exporters, increases that are lower than normal. But the difference——

Senator PROXMIRE. Well, let me ask you, then, the question that has really bothered me very, very much, and that I think is something that we just have not gotten answers to at all. We had an 8 percent plus inflation last year. The administration predicts a 7 percent inflation this coming year, and it will probably be more than that, because they have underestimated things in the past.

Now, if we have a 7 or 8 or 9 percent inflation, I cannot see any way, frankly, that we can adjust to that without a very high wage guideline. If we follow the guidelines, the pattern that you have suggested to us, that might very well be inflationary.

What is the answer?

Mr. COOPER. Well, I am trying to separate from what starts as a very complex situation the background inflation generated within the country, a superimposition on that from abroad. My remarks were really addressed to the external injection, not to the underlying domestic trend of rising inflation.

To put it in the terms in which you have now posed it, if we are going to have, let us say, 8 percent inflation in 1974, then, a "noninflationary" wage guideline, as far as the external impact is concerned, would be 9 percent; "noninflationary" in the sense that it would keep the increase in prices imposed on us from abroad from accelerating the domestic inflation by feeding an unending wage-price spiral.

Senator PROXMIRE. Could you do it by a far more widespread adaptation of a cost of living escalator in wage contracts?

Mr. COOPER. No. This is precisely the kind of situation in which you do not want a cost of living escalator. When the inflation is generated internally, wage going on price and price going on wage and so forth, that is a domestic problem to which no major industrial country has found an adequate solution. Some have tried income policies, some have tried deflation, and so forth.

The problem here is that the price increase is imposed on us externally, and if wages are automatically escalated to that, it will set

off a wage-price spiral, even if there was not one to begin with, or it will accelerate a wage-price spiral if, as in the actual situation today, we started out with one. So that——

Senator PROXMIRE. You see, we have, in fact, transferred real income to the farm sector as well as abroad.

Mr. COOPER. That is correct.

Senator PROXMIRE. Now, is it not possible for us to cope at least with the first part of that in the interest of equity?

Mr. COOPER. In the interest of equity, one might tax the farmers and use the proceeds to go even further than Congressman Reuss would go in reducing taxes on the urban wage earner. Last year there was a huge transfer of income from urban America to rural America. That was entirely within the country and affected greatly the distribution of income within the country.

An important question will face the Congress when agricultural prices begin to fall, as I believe they will, because I think that $5 a bushel plus is well above the equilibrium price of wheat. There will be very strong political pressures coming from rural sectors to put a floor on agricultural prices well above the actual market prices of just a few years ago, and I would hope that this body would resist that temptation.

Senator PROXMIRE. Let me get to the point that Mr. Okun made yesterday, and Mr. Shultz just moved right away from it, Secretary Shultz. I tried to argue that what we need is far more information about the impact of our exports on our prices here, an early warning system, and so forth. Secretary Shultz resisted that very strongly.

Now, Mr. Okun said he thought we ought to have it. He thought it was right. We ought to know what we are doing; we ought to have some notion of the effect that it has on our own standard of living here.

As one who has been principally interested in international economics, do you think we could make that effective and do that without a beggar-thy-neighbor or without a selfish policy?

Mr. COOPER. Your proposal is for an early warning system. It is hard to object to the formation——

Senator PROXMIRE. That is right. The Secretary of the Treasury seemed to do that when I suggested it to him. He said, "When you get that information then what? Why are you getting it?"

Mr. COOPER. He fears that you are likely to misuse it, and I would share that concern. I am all in favor of information, provided one uses it intelligently.

I would certainly be strongly opposed to a system which, whenever prices begin to rise in this country, imposes export controls on the product in question in order to keep prices from rising. In a wide variety of ways, we increasingly live in a one world economy. We are now experiencing what is in effect the reverse of that situation, in which the oil-exporting countries have restricted their supply of exports to us.

To be sure, the motivations are different, when a country like Canada which has been our traditional supplier, imposes a tax on its exports of petroleum to this country, we yell like hell, as we should. I would have thought that when the shoe was on the other

foot, and we are the exporter, we should accept the fact that if there is a drought in a large part of the world, the right thing to do in today's world is to share the real consequences of the drought by exporting food. We, of all people, are in the best position to help alleviate that distress by tightening our own belts just a little.

Senator PROXMIRE. My time is up. I agree with that, but I think at the same time, from a realistic standpoint, we ought to provide some clear responsibility to the American consumer. He, after all, has to be taken care of in at least a rudimentary way with respect to food. And industry, with respect to steel scrap and hides and lumber and a number of other things for export policies that have really caused enormous difficulties.

Mr. COOPER. The appropriate way to deal with food, I think, to distinguish that from some of the other products, is the way we dealt with it for many years, although not necessarily by conscious design; namely, through large buffer stocks.

Senator PROXMIRE. What?

Mr. COOPER. Large buffer stocks, to stabilize prices in both upward and downward movement for the world, not just the United States, through the maintenance of a large enough carryover so that we can absorb in any given year what might be a substantial world shortfall, without a big increase in prices. That is the appropriate way to deal with staple foods, and indeed, there will be a world food conference held later this year in which a leading proposal is along those lines, and I would strongly support that.

Let me just add one further comment, in the international context, to this. A large part of our difficulties during the past year, in items other than food—that is, you mentioned scrap iron and hides and paper—arose from two factors, both of which represented mistakes.

One was the excessive depreciation of the dollar. I agree completely with Franco Modigliani. I suggested to this Committee last year, just ten days after the February devaluation, that I thought it was a mistake. The sharp depreciation of the dollar in the markets following that devaluation was a mistake. We should not neglect that devaluation has not only demand stimulating effects, which is what we sought with the Smithsonian Agreement, but also price effects, and we felt them in spades during 1973. Devaluation and depreciation drove up our prices unnecessarily.

The second mistake, if you like, less easy to know what to do about, was the fact that in 1973 the world economy experienced what was probably the greatest peacetime boom year that has ever existed. There was a conjunction of economic expansion in this country, in Europe, and in Japan, such that real output grew during the year 1973 at well above long-term trend. When that happens, it pulls up all world commodity prices disproportionately.

It is a spill-out from excessively expansionist policy in this country in 1972 and early 1973, and it happened to be in conjunction with strong expansions in Europe and also Japan.

Those two things together, the excessive devaluation of the dollar plus the unsustainably strong growth in the world economy in 1973, more than explains the tremendous increase in quite a number of raw

materials prices. As world demand falls, many of those prices will drop.

I do not think the answer is export controls. The answer to that is better demand management.

Senator PROXMIRE. My time is up. Mr. Reuss, Mr. Modigliani did want to comment.

Mr. MODIGLIANI. I would like to comment on just one more thing. Since I was going to agree only 99 percent with Mr. Cooper, let me say that I do slightly disagree with him and agree with Senator Proxmire on the impact on real output of the United States of oil prices.

Mr. Cooper talks as though the United States was Italy, all of whose oil is imported, and in that case, he is absolutely right. The Italians are poorer to the full extent to which they use oil, but in this country most of the oil is domestically produced.

The imports of oil at the old prices was only in the order of 15 percent, and at the new prices, it is likely to be much less and; in fact, I can see the day when we will be net exporters. Under these circumstances, most of the effect of the higher imported price is to redistribute income from consumers of oil, to the producers of crude oil, and that is why I feel that much of the problem is one of distribution that can be handled by the kind of proposal which I put before Mr. Reuss before; namely, put an excise tax on crude oil which means that given the world price, the sellers will receive less.

The entire tax will not be borne by consumers because the price of oil is determined in the world market, so a barrel of oil will still cost $8 or $9. If you put an excise tax, that is borne by the producers, he will not be able to sell his oil at a higher price if you put a $4 tax.

The receipt from the tax can then be used to reduce the taxes of other people, and I think by using these taxes to reduce something like social security for instance, you can make an explicit bargain—I give you that, but you reduce your wage demands.

So it seems to me that Mr. Cooper is exaggerating the impact on our standard of living. I think it is really not too large. After all, our imports are a modest amount.

Senator PROXMIRE. Thank you, Mr. Reuss.

Mr. COOPER. The figure I used was 1½ percent of personal income and that comes from net imports. The gross effect is much larger, as Mr. Modigliani implies, but much of that is internal redistribution. The net effect is 1½ percent.

Mr. MODIGLIANI. That is—the net effect of 15 percent imports?

Mr. COOPER. That is the net effect on personal income in the United States, 1½ percent. It is, of course, much higher in Italy, close to 5 percent.

Mr. MODIGLIANI. That is right.

Representative REUSS. Mr. Steele, you indicated that you expect that with the loosening of the producer's cartels, oil controlled world prices will fall.

If and when that happens, would you favor that the United States return to an import quota system to protect its new domestic production capacity?

Mr. STEELE. Yes, I would favor that.

Representative REUSS. Mr. Cooper, in discussing controls on capital outflows from the United States, you commended the administration for having lifted them within recent weeks, but said that you would much prefer that they keep at least a skeleton administrative control machinery so they could put them back on again, if in the future a sensible United States domestic monetary policy of reasonably adequate money and reasonably low interest rates should produce an exodus from this country.

Is that a fair statement of your reasoning?

Mr. COOPER. Yes.

Representative REUSS. I certainly recognize the problem.

One alternative to all this cooperation in monetary policies of the industrialized countries is something everybody repeats, but it certainly has not come to pass so far. Obviously if it did come to pass they you would not ask for the continuation of capital controls would you?

I do not think it will come to pass very soon.

Mr. COOPER. No, I think the problem is somewhat more complicated than that. If all economies move together cyclically, of course, then a common coordinated monetary policy among the leading countries would be appropriate for dealing with that as a cyclical phenomenon.

But so long as the thickness of economic relationships is much greater within national economies than it is between economies, there will be divergences in cyclical movements from one economy to another. There will therefore be occasions in which, for example, we want to ease up on monetary policy in the United States at a time in which the Europeans do not want to, or may even want to tighten up. The economies will not be in perfect coordination.

Then, if the world does have a common, coordinated monetary policy, the world, if you like, finds itself in a dilemma. The Europeans would like it to tighten; the Americans would like it to ease.

That was very much the kind of situation we had in the early 1960's, in which there was a conflict between their economic objectives and ours.

Under those circumstances it may be necessary to break the monetary ties between the two areas in some way. Floating exchange rates have been suggested as one mechanism for doing that, but I think that is not a wholly satisfactory way of doing it.

Some kind of controls have been suggested as a way of doing it. That is not wholly satisfactory either. Ideally one would not have those controls.

The ideal world would be one with a common monetary policy and no controls. To deal we would have a flexible fiscal policy.

I strongly favor giving the administration bounded discretion over fiscal policy, the capability of moving personal income tax rates up or down by a few percentage points, for example, for fiscal policy reasons.

That is not a popular kind of suggestion at the moment, given what is widely felt to be the frequent abuse of Executive authority by the present encumbent, but I think that as a long-run matter we must have more flexible fiscal policy.

It is only through that route that we can diminish our reliance for internal purposes on monetary policy, coordinate our monetary policy with other countries, and allow funds to cross national borders freely.

Representative REUSS. Can it not be said, against keeping standby capital controls as you advocate, that it might make foreigners leary of bringing capital to this country in the first place because they think it might get stuck here?

Mr. COOPER. That is a risk that they have to entertain in any case. Our control system has not been applied to foreign-owned capital even in recent years. Foreign-owned capital could be withdrawn freely. There is always the possibility that the situation would be changed, but that possibility would exist in the future anyway, even if we did not have the control system.

So while I know that has been used by the Treasury Department as an argument for eliminating the controls, I do not believe others will perceive the United States to be either more or less creditable as a place for investment by virtue of having eliminated the control system.

Representative REUSS. Did you want to add to that Mr. Modigliani?

Mr. MODIGLIANI. Yes, I would like to add two points.

First of all, Mr. Steele was asked if he would be in favor of quotas, if the prices came down again. He said, "Yes" and there was no further comment. I would like to indicate that I am absolutely dead-set against quotas. I think they are destructive. Again they are arbitrary, they have had a very bad effect on our production, on our refining capacity. A very good case has been made that the real reason why refining capacity has not been provided in this country, was the uncertainty about the availability of oil, of crude oil, under the quota system.

I think there is a good case that if we have had people to develop high-cost supply sources, we ought to protect them. But that should not be done with quotas, it should be done with subsidies. We should let free exports and imports and simply pay the difference between some guaranteed price and the free market oil price, much as we have done in agriculture. Under this system, we would preserve equity and you have complete freedom of movement.

Second, I would like to make a somewhat similar comment with respect to Mr. Cooper's suggestion about maintaining certain provisions, he called them capital movement controls. I do not like to use that word because the word "controls" sounds like administrative controls.

Again, I am completely in favor of the spirit of his suggestion; that is, that you want sometime to make it unprofitable for people to move capital out or in, it can go either way. But again, that can be accomplished by tax incentives. The interest equalization tax is a perfect example of an incentive tax in which you do not have an agency that says you, Bank A can lend so much, and you, Bank B can lend so much.

It seems to me that here again we have a vast arsenal of tax incentive measures which can be used to accomplish almost anything you

want, and I wish we could keep away from price controls and quotas and always rely on such incentives.

I think Mr. Cooper agrees with me.

Mr. COOPER. I agree entirely with that. In fact, I favored switching the direct investment control system from administrative controls to a tax system, which I think would not have been nearly as difficult to administer as the Treasury and the Commerce Department then argued.

Mr. STEELE. May I make a comment?

Representative REUSS. Mr. Steele, you want to come back at Mr. Modigliani?

Mr. STEELE. I am glad that Mr. Modigliani made that statement. My answer would have been yes, with reservations, about import quotas. My assumption was that quotas are practically the only politically acceptable way to prevent excessive reliance upon imports, but I would prefer—and I did not enlarge upon that because I am not as articulate as Professor Modigliani—I would prefer subsidies.

But I do think the President's Economic Report, on page 123, lists one danger of subsidies, and that is that more and more of the energy producers will become reliant upon subsidies since the producers of new high-cost substitutes perhaps will have a profitability guarantee or at least a price guarantee which producers of regular supplies will not.

Representative REUSS. Thank you.

Senator Proxmire.

Senator PROXMIRE. I would like to ask both Mr. Cooper and Mr. Steele to comment on Mr. Modigliani's interesting bombshell that he thinks that one action that Congress could take that would greatly help the economy was the impeachment of the President of the United States.

I do not want to put you gentlemen on the spot, but I am going to ask you that question because you are distinguished economists and your comments would be most helpful.

Mr. COOPER. I find great difficulty in answering the question. One difficulty is in dealing with matters of this type, with questions of psychology rather than economics. It is no doubt true that waves of pessimism or optimism can sweep through the business community and can in turn influence investment plans and thus have profound influence on the economy.

Professor Modigliani mentioned the stock market. I also believe that movements in the stock market themselves can influence real investment.

On the other hand, that is not the question we are being asked to address. We are being asked to forecast whether the impeachment of President Nixon would result in a wave of optimism or a wave of pessimism, and I think you, in your response, Senator Proxmire, to Professor Modigliani's comment, set up the other side of the case very cogently.

I really do not have a judgment about it.

Senator PROXMIRE. How about the emphasis that Mr. Modigliani put, I thought, primarily on consumer problems, the effect on the consumer? That it would mean that the pessimism which the Uni-

versity of Michigan survey, for example, discloses is the worst they have had in 25 years in the closing months of 1973.

Is it possible that the impeachment of the President might correct that?

Mr. COOPER. It certainly is possible.

Senator PROXMIRE. Maybe you will be running for the Senate from Connecticut, you are a real diplomat.

Mr. STEELE. I tend to agree with Mr. Modigliani that it would be a plus, it would improve expectations. It would be a boost.

Senator PROXMIRE. You say it would improve expectations?

Mr. STEELE. Impeachment would improve expectations. I think what the market has done now is to try to discount the uncertainty of impeachment and if this event occurs, I think the result would be a relief.

And as far as the political impact is concerned, I think the point that it will be a great strain on the country has been overstressed. The country really deserves punishment.

Senator PROXMIRE. The country what?

Mr. STEELE. The country deserves punishment for the sort of political campaign that was permitted in 1972, the choice of candidates. I think this would be a very desirable lesson.

Senator PROXMIRE. Well you have to be a non-politician to make a statement like that. [Laughter.]

Do you agree, Mr. Steele, you are an expert in the oil area, you understand this, you have studied this most of your life intensively, do you agree with Mr. Modigliani that the excise tax on oil that he described can be used to prevent producers from receiving excessive and unjustified increases in income at the expense of consumers?

Especially if that tax is used to moderate other taxes?

An alternative to that that the Ways and Means Committee is considering right now, and that many of us like, is simply to repeal the depletion allowance, the repeal perhaps, or at least change the intangible drilling and these other incentives that we feel distort the market.

And this is an excellent time to either reduce them completely or eliminate them.

Mr. STEELE. I do not believe really that Professor Modigliani's proposal to, say, put a $4 per barrel excise tax on crude would result in the reduction of net prices to the producers in this country by the same amount.

That would be true, I think, if the domestic producers had the same monopoly power as producing countries, to the extent that there actually was a surplus of this much or more in the domestic market, but the production costs over here are much higher than in the foreign countries.

And I think if you want to reduce oil prices, what you ought to do is find some way to reduce royalties, to reduce bonuses, to reduce production taxes, to reduce excise taxes, to reduce dividends.

And I think what you ought not to do is to reduce the amount of new investment available to the industry. I think it would be a good idea to impose a tax upon excess earnings with tax credits for the amounts invested immediately, in new domestic exploration and development.

As far as removing depletion is concerned, I think the impact would probably be to increase oil prices because some of the effect per barrel of the depletion allowance has been compted away by companies, domestically, in some reduction of prices.

When the depletion allowance was reduced to 22 percent several years ago, the industry response was to increase prices by about 25 cents per barrel.

Senator PROXMIRE. I think you are absolutely right.

The effect alone of the elimination of the depletion allowance would increase oil prices but lots of economists argue that is exactly the point.

That we have had an artifically low price of petroleum. We have used up a finite limited resource extravagantly and wastefully. We are terrific gas guzzlers in this country and one of the reasons is we have these laws that put a premium on this kind of wasteful behavior.

And if you are going to move to the market place as the oil people want to do it them we ought to start with some of the things you mentioned, and the protection against imported oil that we have had for so many years.

And, also, these artificially, what seems to me inequitable taxes that provide, do provide incentives certainly for production, and do tend to keep the price down, but do it artificially.

Mr. STEELE. Well I would agree that it might be a good idea to increase the price in certain fields, to discourage excessive consumption. You asked me what ways could be used to reduce the price of oil?

Senator PROXMIRE. No, my idea was, what could you do to try to transfer, or prevent the transfer, of income that we are suffering now from the consumer to the oil industries, is has been massive.

It may be—some people estimate $13 billion, some people estimate it to be a lot more than that. What can we do about that?

Mr. STEELE. Well we need some way to exercise leverage over the rulers of the countries from which the oil is exported.

Senator PROXMIRE. As Mr. Modigliani pointed out, most of the production is domestic. Most of the consumption, I should say, is of domestically produced oil. The transfer is within this country except for maybe 15 to 20 percent.

Mr. STEELE. But production over here at current prices is steadily declining; that is, new oil production.

Senator PROXMIRE. It is declining, but the fact is you still have that inequity that we have some control over. You cannot do anything about it, or relatively very little about the policies followed by the Arab oil countries.

We can negotiate with them and we can work with the other consuming nations constructively, but we are a sovereign country. We can do something about the transfer within our own nation.

Mr. STEELE. I do not think that that transfer is on the same order of magnitude, however.

Senator PROXMIRE. My gosh, we had old oil—it went from $3.60 to $5.25, old oil. You have got new oil, domestically produced new oil going sky high.

Mr. STEELE. But the new oil is about 10 percent of the total consumption.

Senator PROXMIRE. The old oil is 70 percent. Together they constitute most of it, or the great lion's share.

Mr. STEELE. Well, the old oil, I would say is more like 85 percent. Somebody computed recently that the average price for all oil being sold now is about $5.95. New oil is about $9.50, and old oil is about $5.30.

Mr. MODIGLIANI. Could I comment on this? I think there is a slight misunderstanding of my position on this.

I would like to see us not having any protection of any kind, either export or import quotas of any sort. I would like to leave the price of oil completely free so that the domestic price of oil will be the same as the price of imported oil.

Indeed, at this point, that would mean that the old price of old oil would be somewhat larger. And then I would like to avoid the resulting enrichment of the domestic producers by putting a tax on them so that their net received price is no higher than now.

I said you can graduate this tax so that the tax is different on old oil and on new oil, and I can imagine a variety of incentives you may want to give to new oil producers.

It seems to me that the oil depletion happens to be a very poor way of subsidizing anything. Again, it is a kind of device that is destined to make richer people richer and I think the whole thing can be handled by subsidies and by excise taxes much better, so I would very much hope that you would get around to abolishing the oil depletion which is a very unreasonable and unfair windfall that is given to the producers of oil.

And, if necessary, we can certainly subsidize new discoveries. There are ways in which we can simply offer subsidies for newly discovered oil.

Senator PROXMIRE. I agree with so much of what you have said, Mr. Modigliani, but I just cannot understand how this excess tax that you talk about in the kind of sellers market we have, will not simply be imposed on the consumer?

The real bargaining power is on the side of the oil company. It is not on the side of the consuming public. Maybe we will have a different ball game in two or three or four or five years from now, but for the near future, the next two or three years at least, it would seem that the oil companies would get pretty much what they asked.

And we have had a policy of enabling them to pass through every cost, plus a great deal more.

Mr. MODIGLIANI. Senator Proxmire, let me make this clear. Look at New England, and let me here make perhaps a short side remark if I may.

I have been bemused by one of the Nixon administration's exponents, Mr. Simon, who recently has been telling various States: Look, if you have problems you better put in your own rationing. Why should I bother the rest of the country where there is plenty of oil just because you people have some problems? If you have problems, fix them on your own. I wrote a letter to our newspaper, which has not appeared yet, I hope it will soon appear, in which I said: "Splendid, Mr. Simon, I completely agree, if New England is

also free to set its own import policy, and if New England is free to decide how much taxes we pay to the Federal Government." Then I think he is absolutely right, we should take care of our problems.

Again, look at New England. If you have a perfectly free import policy, no importer, no oil user in New England is going to pay more than he can pay on the international market.

A domestic producer cannot get a higher price than the price prevailing on the international market. That is the price ceiling. They cannot do any better than that as long as everybody is——

Senator PROXMIRE. Well the price on the international market is so high.

Mr. MODIGLIANI. Okay, say the international market price is $9, put a $4 tax——

Senator PROXMIRE. They could go much higher.

Mr. MODIGLIANI. That is right. But still the excise tax can be as much as is necessary to bring down the net revenue to the producers to whatever level you think is sensible, and we can argue here whether it should be $5 or $4 or $6, we can argue about that, but essentially you ought to put a tax which takes the difference between the price you want to assure them.

Senator PROXMIRE. What you are saying then, Mr. Modigliani is that the consumer in this country is going to have to pay the world price and the world price is so high now it is likely to remain high for a long time?

Mr. MODIGLIANI. Correct.

Senator PROXMIRE. That is going to mean $1.50 a gallon.

You might argue, economically, that that is not a bad idea, but politically, forget it. It is just impossible.

Mr. MODIGLIANI. Perhaps the expert can tell us here, what would be the world export price of oil?

What do you think that the retail price of gasoline would be if the domestic price of crude was the same as the world price now? Could you give us an estimate of that?

Senator PROXMIRE. Mr. Steele.

Mr. STEELE. I have heard that gasoline sellers in this part of the country, who use their own imports at high prices, are charging, or have charged, prices as high as 68 to 70 cents a gallon, but of course their sales fell off rapidly because there were supplies available from producers that could continue to reach at much lower prices.

Senator PROXMIRE. Lower prices?

Mr. STEELE. Yes.

Senator PROXMIRE. We have no experience. We do not know what the elasticity demand is for gasoline. The price per gallon could go to $1.00, $1.50, it could be enormously high. It could be fantastic transfer of income.

Mr. MODIGLIANI. Of course, now, at the present time—it is hard to judge the elasticity of demand for oil because of widespread hoarding. But at present, if we are talking about gasoline at 70 cents a gallon, so be it, I'm paying 53 cents a gallon by now, and heating oil is as high as 42 cents a gallon for some of my neighbors—though others were paying much less. As you know that's one of the crazy Nixon administration schemes——

Senator PROXMIRE. Mr. Modigliani, you have an income of probably $40,000, $50,000, or more, but the income, if you take a typical constituent whose incomes are $10,000 and lower, in many cases. They have to drive to work, they have to use gasoline. Your pricing policy would mean they cannot get to work.

Mr. MODIGLIANI. Right. And I am saying you compensate them for the higher price of gasoline by reducing their income tax or by reducing their social security. So they pay, for 10 gallons, they pay now $2 more a week, because instead of 50 cents, they pay 70 cents, and you reduce their taxes by $2.

And under that condition, they are as well off but they can switch away from the expensive product. That is the essence of a sensible way to handle shortages. In fact, I proposed this scheme in 1947 for the first time, and again, if you are interested, I can provide you with a copy of a plan of this kind which, instead of rationing, uses the following principle: You establish how many gallons every person is entitled to, then you pay them the difference between the market price and the price you would have fixed, times number of gallons he is entitled to. But at the same time you let the market price free.

Senator PROXMIRE. We have literally tens of thousands of people in Wisconsin who drive 40, 50 miles to work everyday, whose incomes are so low, and whose income taxes are so low, there is no way you can reduce their income taxes, or even their social security taxes, to give them enough to compensate for this increase.

Mr. MODIGLIANI. Well, Senator Proxmire, at the present time these people are probably paying around 50 cents a gallon. At least in Massachusetts, 52 is a minimum, 62 is a very common price. I do not know what happens in Wisconsin.

Senator PROXMIRE. If the price goes to $1.50 then they are unemployed.

Mr. MODIGLIANI. There is no chance of this, Mr. Steele said 70 cents a gallon.

Senator PROXMIRE. No, he said 70 cents a gallon because they can get gas from other sources at a lower price now. Is not that right?

Mr. MODIGLIANI. No; I asked him, if we had to buy all of the crude oil at the world market price, how much would gas cost? And his answer was—he may think it over—70 cents a gallon.

Now, that is not very different than what we have now and now we do not get gas. At 62 cents, I have to wait an hour in line. I would much rather pay 70 cents and not wait in line, not waste my time and everybody else's time, and everybody's temper, and I would rather have a compensation for the high price in the form of lower income tax, particularly one that is made very visible by saying, "We are reducing your social security tax because you are paying more for oil."

Senator PROXMIRE. Let me ask Mr. Cooper to comment.

Mr. COOPER. I think Professor Modigliani put his finger on an issue here which should be underlined, and it really goes to the heart of our Federal system. Are we one country, or not?

The problem is that with the split price system that we now have, New England, in particular, and the Middle Atlantic States, in gen-

eral, are paying $12 to $15 per barrel for imported residual fuel oil, which is a major source of energy for manufacturing firms, for utilities and so forth. The same product is going for $5 or $6 a barrel in other parts of the country, the product of the old crude produced in the United States.

Now, the question is, can this situation persist for a long period of time? The long-term adjustment that that would require would be deep depression in those parts of the country that for quite artificial reasons are asked to pay for a major industrial input a price that is two to three times higher than that obtaining in the rest of the country, because the oil companies are asked, in effect, to allocate in a split market.

That is the problem with the present policy of distinguishing between old U.S. oil, new U.S. oil, and imported oil. Mr. Modigliani's strategy, essentially, is to go back and say, look, we really are one market and we do not want to impose artificial, arbitrary, competitive advantages or disadvantages on one part of the country or another as a matter of national policy.

The right way to do it is to have one price throughout the country, after allowance for transport costs, and if then you are concerned, as I am, about excessive profits or royalties that would go to the owners of a domestic resource, the thing to do is to tax those royalties.

Indeed, I think it is important to grapple directly with the problem of how to provide incentives for new sources of energy, and at the same time not have big redistributions of income from urban workers, or commuters, to the owners of oil and gas. We must distinguish three things. The first royalties on oil that is pumped out now at low cost. A second is the high marginal cost of getting some oil out of the ground. The third is stimulus to new exploration.

The way we have operated in this country is to provide stimulus to new exploration by giving large subsidies, in effect, through the depletion allowance, to the production of old oil. That is really a very inefficient way to do it.

What we ought to do, as Professor Steele suggests, is give direct subsidy to exploration, to new activities. That is the activity that we want to encourage. That is therefore the activity that should be subsidized, and, at the same time, we should impose sufficiently heavy taxes to prevent large windfalls on existing oil production.

Senator PROXMIRE. Pardon me for interrupting, but I think we have only two out of three of the economists favoring eliminating oil depletion allowance. I understood Mr. Steele to oppose it. Maybe I misunderstood him.

Mr. COOPER. I was not focusing on that part of his remarks, I was focusing on another part of his remarks which says we should stimulate new exploration and subsidies are an appropriate way to do that.

Senator PROXMIRE. And the oil depletion allowance is an inappropriate way.

Mr. COOPER. It is very inefficient way for accomplishing that objective.

Mr. MODIGLIANI. Very costly for what you get.

Senator PROXMIRE. It is my understanding—I have seen studies that suggest that for about 10 percent of the loss to the treasury or the present oil depreciation allowance with a direct subsidy, you can get about the same amount of exploration, so that we are taking 10 percent of a loss on revenue in applying it directly.

Mr. STEELE. I would agree that it has been an inefficient subsidy. It rewards production rather than discovery and I think different methods of subsidizing exploration could readily be devised.

Senator PROXMIRE. Let me ask just one more question. I apologize to Congressman Reuss for taking so long, but I think this is something that was in the paper this morning that concerned me. In fact, there were two stories. Let me ask you about both of them.

One of them was the argument that the big oil companies are absolutely refusing to go along with the allocation of oil that the Congress passed and that the administration does not like either. They say this allocation is a nightmare, it does not work, and I take it that the purpose of the allocation is trying to contest what you were talking about, Mr. Cooper, a treatment of all States in the country—equally, and a price that is equal.

Now, are the oil companies wrong? Is there some other way we can do this?

The apparent situation is that these oil companies have different facilities in various parts of the country and there are economic reasons why, with the shortage we have, they have to discriminate.

Mr. COOPER. I am not as conversant with the details of the scheme as I should be, perhaps, but on my understanding of it, it would go only a small part of the way toward dealing with the problem. That is, the key to the relocation scheme, as I understand it, is the relationship between owned crude oil production within the country and refinery capacity within the country.

Senator PROXMIRE. Can you do that overnight?

Can you provide a situation where you would have one price and fairly equal availability of oil? In a short period, can this be done?

Mr. MODIGLIANI. Absolutely. All you do is let the price free. Remove all controls, and you will see that in a very short time you, in Wisconsin and us in New England will be paying pretty much the same price except for transportation costs. You will see the——

Senator PROXMIRE. If you remove all the controls, under the present circumstances, with the shortages of—variously estimated up to 15 percent, does not the price go right through the roof?

Do not the oil companies then enjoy an enormous enrichment?

Mr. MODIGLIANI. I suggest that you make this up by taxing the crude oil.

Mr. COOPER. Let me cite one example.

Senator PROXMIRE. Then you redistribute what you get?

Mr. MODIGLIANI. That is right.

Mr. COOPER. Let me cite one example. You have to make due allowance for the fact that Modigliani and I are from New England and you are from Wisconsin.

Mr. MODIGLIANI. That is right.

Mr. COOPER. Of how the——

Senator PROXMIRE. The man in the middle is from Texas.

Mr. COOPER. Right. I will illustrate how the control system has a perverse affect in the present market. The control system limits the charge that can be put on old crude, coming from the United States. It also limits the wholesale price which the major oil companies can charge for number two fuel oil and gasoline.

However, it does not limit prices that can be charged for other products, nor does it limit the price that can be charged to import products. In order to maintain their profits, companies have readjusted their pricing structure so as to charge what the market will bear, if you like, for those products which are free of controls.

As a result, when we experienced an increase in New England in the price of bunker-C fuel oil, the justification that the distributor used for half of the price increase—which was way above what happened to world price increases, by the way—is that he had to make up for the refinery losses on the gasoline that he was refining from imported crude and selling it at controlled prices. The way he could do that was by raising enormously the uncontrolled price of residual fuel oil. So prices went up twice what they would otherwise do.

Now, this is a capricious, arbitrary consequence of the control system.

Senator PROXMIRE. Let me ask one final question.

The newspapers also reported a most heartening development, apparently, and I think it was Iran. The Shah announced that he would pledge a billion dollars to the World Bank, and he was hopeful that additional sums, in proportion to their production, would come from other oil-producing companies.

And Mr. McNamara—President McNamara—the President of the World Bank, said this is one of the most exciting happenings of his life. That is how it was reported in the newspaper this morning. This is something I know that they have been looking forward to.

Now, is it possible that if as much as $10 billion to $20 billion might be diverted to the World Bank in this way, is that realistic, and how useful would that be in bringing about a balance in this perplexing situation that we have?

As I understand it, the World Bank, in turn, would be expected to make the money available to the countries—the poor countries—that have suffered from the enormous increase in oil price and the unavailability of oil.

Mr. COOPER. If I might start out the answer to that question, I think the key is on what terms are these funds to be made available to the World Bank, and who bears the risk?

A number of countries, as I suggested earlier, do have access to commercial markets, so they need not resort to the World Bank for their funding.

Some countries, however, do not have the credit worthiness for access to private financial markets and, therefore, and support that can be given to the World Bank will assuredly be a help to those countries. But the World Bank, in its normal practices, would charge commercial interest rates and then the already heavy debt service load on the Indias of the world, if I can use that as illustrative of a couple of dozen countries, will reach such proportions in a few years time, at present oil prices, that they just cannot bear them.

Then we will be faced with the problem of rescheduling that debt, if not default—we usually try to avoid default by rescheduling debts —and the question thus arises, who is to bear the full risk of what amounts to a bad loan?

Senator PROXMIRE. Well, as an alternative, is it possible then to have some kind of a lower interest rate?

Mr. COOPER. That is right. One way of mitigating this problem would be if Iran and the other oil countries would agree, not merely to lend to the World Bank, but to lend to the World Bank at the concessional interest rates, rates which could, in turn, be passed on to the poor consuming nations. But I have not detected that in the Shah's remarks.

Mr. MODIGLIANI. Could I say that, in defense of the Shah, a man for whom I have little sympathy, that I do not think it would be particularly fair to say that Iran, which is still a poor country, should make loans at a low-interest rate.

It seems to me, very sensible, that the rest of the world should contribute to making loans at low-interest rates. They will provide the funds and all the rest of the world should equally contribute to making loans at low cost. I think we can afford to do that very well. And perhaps we should not let this session go by without pleading with you, and I am sure Mr. Cooper agrees, to restore foreign aid, which funds Congress has voted down, which I think is a really——

Senator PROXMIRE. Particularly the World Bank.

Mr. MODIGLIANI. Precisely, I think it is a shame. We are still the richest country in the world, whatever you might say, and we certainly can afford that small amount, that small contribution which I think is vital to such a large part of humanity. I hope that Congress would see fit to restore that appropriation.

Senator PROXMIRE. Thank you, Congressman Reuss.

Representative REUSS. I would just comment on this final point, that Mr. McNamara is going to have to have several jolly afternoons with Persian Gulf potentates, because I am afraid that Congress is not going to vote for the IDA replenishment, until, and unless, the nouveau oil rich countries make an important contribution to IDA themselves, which they are not now doing. Kuwait threw in a little bit, but none of the others threw in a nickel.

So for a whole variety of reasons, I wish Mr. McNamara well.

Well, gentlemen, you have been very forthcoming, outgoing, full of ideas and we are very grateful. We do have a printed record of our hearings and I hope you will all be able to take comfort in later years from what you said today.

We will now stand in recess until 10 o'clock Monday morning in this room.

I apologize on behalf of the energy wasting U.S. Congress, not only for the fact that this place was heated up like a sauna, but the architect of the building neglected to provide a method of opening the windows. So we stand recessed.

[Whereupon, at 12:30 p.m., the committee recessed, to reconvene at 10 a.m., Monday, February 25, 1974.]

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