663

[JOINT COMMITTEE PRINT]

Union Calendar No. 000

93d Congress, 2d Session - - - - - - - - House Report No. 93-0000

ACHIEVING PRICE STABILITY THROUGH ECONOMIC GROWTH

REPORT

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

TOGETHER WITH

SUPPLEMENTARY AND MINORITY VIEWS

DECEMBER 23, 1974

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

43-168 O WASHINGTON : 1974

JOINT ECONOMIC COMMITTEE

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

WRIGHT PATMAN, Texas, *Chairman*
WILLIAM PROXMIRE, Wisconsin, *Vice Chairman*

HOUSE OF REPRESENTATIVES

RICHARD BOLLING, Missouri
HENRY S. REUSS, Wisconsin
MARTHA W. GRIFFITHS, Michigan
WILLIAM S. MOORHEAD, Pennsylvania
HUGH L. CAREY, New York
WILLIAM B. WIDNALL, New Jersey
BARBER B. CONABLE, Jr., New York
CLARENCE J. BROWN, Ohio
BEN B. BLACKBURN, Georgia

SENATE

JOHN SPARKMAN, Alabama
J. W. FULBRIGHT, Arkansas
ABRAHAM RIBICOFF, Connecticut
HUBERT H. HUMPHREY, Minnesota
LLOYD M. BENTSEN, Jr., Texas
JACOB K. JAVITS, New York
CHARLES H. PERCY, Illinois
JAMES B. PEARSON, Kansas
RICHARD S. SCHWEIKER, Pennsylvania

JOHN R. STARK, *Executive Director*
JOHN R. KARLIK, *Senior Economist*
LOUGHLIN F. MCHUGH, *Senior Economist*
COURTENAY M. SLATER, *Senior Economist*
RICHARD F. KAUFMAN, *General Counsel*

ECONOMISTS

WILLIAM A. COX
SARAH JACKSON
CARL V. SEARS
LUCY A. FALCONE
JERRY J. JASINOWSKI
GEORGE R. TYLER
ROBERT D. HAMRIN
L. DOUGLAS LEE
LARRY YUSPEH

MINORITY

LESLIE J. BANDER
GEORGE D. KRUMBHAAR, Jr. (Counsel)
WALTER B. LAESSIG (Counsel)

CONTENTS

	Page
Prefatory Note	1
I. Overview	3
A. Economic Situation and Outlook	6
B. A Time Path for Restoring Full Employment	12
II. Sources of Inflation	20
A. Price Patterns, 1966–74	20
B. International Aspects of Inflation	25
C. Administered Pricing	29
D. An Evaluation of U.S. Experience With Incomes Policies	31
E. The Economic Impact of Environmental Regulations	36
III. The Impact of Inflation	43
A. On Individuals and Families	43
B. On Financial Markets	56
C. On State and Local Governments	63
IV. Policies To Deal With Inflation and Rising Unemployment	68
A. Fiscal Policy	68
B. Monetary Policy	74
C. Price-Incomes Policies	77
D. Policies To Strengthen Competition	85
E. Investment	93
F. Agriculture	99
G. Energy	104
Supplementary Views of Chairman Patman	120
Supplementary Views of Representative Bolling	122
Supplementary Views of Representative Reuss	123
Supplementary Views of Senator Humphrey	127
Supplementary Views of Senator Bentsen	125
Minority Views	139
Supplementary Views of Senator Javits	131
Dissenting Views of Representative Blackburn	136

APPENDIXES

A. S. Con. Res. 93	139
B. Committee Activities Pursuant to S. Con. Res. 93	141

Union Calendar No. ____

93D CONGRESS, 2d Session } HOUSE OF REPRESENTATIVES { REPORT No. ——

ACHIEVING PRICE STABILITY THROUGH ECONOMIC GROWTH

DECEMBER 23, 1974.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed with illustrations

---

Mr. PATMAN, from the Joint Economic Committee, submitted the following

REPORT

together with

SUPPLEMENTARY AND MINORITY VIEWS

[Pursuant to sec. 3 of S. Con. Res. 93; 93d Cong., second session]

PREFATORY NOTE

Senate Concurrent Resolution 93, adopted on August 7, 1974, instructed the Joint Economic Committee to undertake "an emergency study of the economy . . . with special reference to inflation," and to "provide the Congress with specific recommendations for legislation to improve the performance of the economy." The Committee was instructed to report its findings no later than December 31, 1974. This report is filed herewith pursuant to that mandate.

Immediately subsequent to the enactment of this resolution a new President assumed office. In his first address to Congress on August 12, 1974, President Ford expressed the hope that the Joint Economic Committee could present recommendations on economic policy in 6 weeks rather than 6 months. In response to this request, the Committee prepared an interim report under S. Con. Res. 93 which was presented to the Congress and the President on September 21, 1974. Copies of that report, entitled "An Action Program To Reduce Inflation and Restore Economic Growth," were distributed by the President to all participants in the White House Conference on the Economy on September 27 and 28, 1974.

In other activities conducted under S. Con. Res. 93, the Committee has held 30 days of hearings, has had its staff conduct detailed investigations of specific aspects of the problem of inflation, and has sponsored a number of special studies which will be published by the Committee over the course of the next few months. The text of S. Con. Res. 93 and a detailed description of the Committee's activities pursuant to that resolution appear at the end of this report.

At the time S. Con. Res. 93 was enacted it was already apparent that the Nation confronted a severe problem of declining output and rising unemployment, as well as a continuing and perhaps worsening problem of inflation. In the months since August, the problem of recession and unemployment has grown increasingly serious and the need for action increasingly urgent. This report, therefore, attempts to deal not just with the question of inflation in isolation from other economic problems but with the interactions between economic growth, inflation and unemployment. Our recommendations to the Congress are intended as a balanced package to deal with the very severe complex of economic problems which face the Nation at this time.

Within the next few weeks Congress will also be receiving the President's recommendations on economic policy as well as recommendations from many other sources. It is our hope that the extensive analytical material included in this report will be of value to the Congress in analyzing these other recommendations, as well as the recommendations of the Committee, so that the crucial decisions which Congress must make on economic policy within the next few months can be based on a full understanding of the implications of various policy alternatives.

NOTE.—Senator Fulbright states: "Because of the pressure of other responsibilities, I was not able to participate fully in the hearings and discussions underlying this report. Accordingly, I do not believe it would be appropriate for me to identify myself with all of the recommendations contained in it. However, I am pleased to join with my colleagues on the Committee in presenting this report to the Congress as a valuable study of the economic problems that afflict the United States and the world."

I. OVERVIEW [1]

In the closing months of 1974 the U.S. economy has not only continued to be plagued by an extraordinarily high rate of inflation but has also slipped rapidly into what, unless new policies are introduced quickly, could well turn out to be the most severe recession in over 35 years. How has this extremely unsatisfactory economic situation arisen? What must be done to halt the deterioration in the economy and regain a healthy noninflationary growth path? How can individuals and families—especially the poorest and most severely affected—be protected from the ravages of inflation and unemployment? These are the questions to which this report is addressed. We do not have all the answers. Further study and investigation by this Committee and by others is urgently required. Nonetheless the causes of the present crisis are sufficiently well understood and the immediate policy needs are sufficiently obvious that no time should be lost in adopting the policies necessary to arrest the present recession and restore a positive rate of growth of real output.

Fortunately, in 1975 the same policies which are needed to overcome recession and reduce unemployment will also help to restrain inflation. In contrast to some past periods, there is for the immediate future no "trade-off" between inflation and unemployment. Because of the effects of declining productivity on production costs, inflation as well as unemployment will be made worse if the recession is allowed to deepen.

The Need To Restore Economic Growth.—Productivity in the private, nonfarm sector has already fallen 3.5 percent during the past 18 months. As a consequence, the most recent data show unit labor costs rising at the highest rate in the history of these statistics. So long as real output continues to decline productivity is likely to continue to drop—or at best to remain unchanged. By contrast, productivity gains typically are unusually large in the early stages of recovery from a recession. Since wage increases will inevitably be large in 1975 as workers strive to keep pace with the price increases which have already taken place, productivity gains are urgently needed to offset part of this wage gain and thus slow the rise in unit labor costs.

---

[1] Representative Brown states: "I am struck by the contrast between the size of this Report and the small amount of time available to the Members of the Committee for review of the staff draft prior to final printing and distribution. I realize that there has been considerable time pressure on the Committee to hold hearings, do research, write the report and submit it to the Congress in conformity with Senate Concurrent Resolution 93, which authorized the JEC Report on Inflation. Nonetheless, with a Report as lengthy and as heavily laden with recommendations, some of them quite controversial, as this one, a period of less than one week is hardly an adequate time for the Committee Members to review the Report, confer with one another and reach conclusions regarding it in a reasoned and deliberative manner."

With nonfood commodity prices expected to be stable or falling, good progress against inflation should be possible in 1975, but only if productivity gains are achieved.

The productivity gains associated with rising output are essential to the control of inflation in 1975. Fiscal and monetary policies must be directed toward arresting the recession and restoring a healthy rate of growth of real output.

Restoration of healthy economic growth is also essential to the success of a longer run program to combine full employment and relative price stability. Because of the enormous gap which now has been allowed to develop between actual and potential levels of resource utilization, several years will be required to regain full employment. During this period it is essential that businesses proceed with the investments which will be required to bring the capital stock into balance with the full employment labor supply and enable the consumption demands of a full employment economy to be met in a noninflationary manner. Only if businessmen see evidence that the Government is committed to a quick beginning on a policy of steady progress back to full employment will they have the incentive to undertake the necessary investment.

A more detailed analysis of outlook for costs, prices, and productivity will be found on pp. 9–12; a proposed time path for restoring full employment on pp. 12–19; and specific fiscal and monetary policy recommendations on pp. 68–77.

The Need for a Price-Incomes Policy.—Even when the volume of unutilized resources is very large, as it certainly will be in 1975, some industries retain the power to command excessive price or wage increases in the face of falling demand for their product or service. This phenomenon is illustrated by the large increase in automobile prices at the beginning of the 1975 model year and by extremely large wage gains obtained by some construction unions in the face of a high and rising unemployment among construction workers. An even more dramatic example of market power is found in the case of international oil prices, which are being maintained far above any reasonable estimate of a competitive price. In none of these situations can the forces of competition be relied upon to set appropriate prices. Unless and until competition can be established in sectors such as these, the Government must play an active role in price and wage determination. Large steel price increases announced within the past week provide further evidence of the persistence of price increases in concentrated industries even at a time of rapidly weakening demand. It is precisely this type of situation in which the Government must act firmly to prevent or roll back unjustified price increases.

An active price-incomes policy focused primarily on those industries and unions with substantial market power must be a continuing element of our economic policy for the foreseeable future. For most sectors of the economy, such a policy should consist of an active effort to achieve voluntary wage and price restraint backed up by a

range of enforcement powers, including the authority to delay wage and price increases and, if necessary, to institute selective controls in situations that threaten overall progress toward price stability. In the special case of mineral fuels (oil, gas and coal) mandatory price controls are needed.

Our specific recommendations for an adequate price and incomes policy are found on pp. 77–85.

The Need To Strengthen Competition.—The necessity for a price-incomes policy arises from the fact that the degree of competition in our society is far from adequate. Over time, the reliance placed on price-incomes policy can be greatly lessened through measures to achieve a greater degree of competition.

Legislation requiring divestiture and reorganization in any industry where the possession of monopoly power prevents efficient resource development or effective price competition should be enacted. In addition, a commission should be appointed jointly by Congress and the President to recommend comprehensive legislation to eliminate both public and private barriers to competition.

Legislation to establish such a commission has been introduced by Members of this Committee. We plan to reintroduce this legislation in the new Congress and hope that it will be given timely consideration. A fuller discussion of these issues is found on pp. 85–93.

The Need To Help Those Hurt Most by Inflation and Unemployment.—Both inflation and unemployment are highly uneven in their impact upon families and individuals. In the case of unemployment, the individuals and families most hurt are fairly readily identifiable, and the costs are measurable. It is the responsibility of the Federal Government to undertake the programs necessary to spread these enormous costs equitably rather than allowing them to fall exclusively on the particular individuals who lose their jobs. Programs such as public service employment, unemployment compensation, and other forms of income support offer the means for achieving this objective.

Much less is known about the distributional impact of inflation. The evidence developed by this Committee during the course of this study strongly suggests, however, that, especially at a time when food prices are among those rising most rapidly, inflation bears most cruelly on the poor. In addition to strengthening income support programs, structural changes in the tax system offer an important means for more equitably distributing the costs of inflation.

Tax relief of $10 to $12 billion for low and moderate income persons should be enacted immediately. This relief should be financed by other revenue-raising tax changes to take effect primarily in fiscal 1977 and 1978. In addition, improved unemployment compensation and an adequate program of emergency public service employment are essential both to distribute equitably the costs of unemployment and inflation and to sustain the level of

consumer spending needed to prevent a worsening of the recession.

Our specific recommendations in this area are found on pp. 43–56.

A. Economic Situation and Outlook

The year 1974 has been a year of recession. Real output has fallen steadily throughout the year and unemployment has risen sharply, reaching 6.5 percent in November. At the same time prices have risen at a rate unparalleled in this century except during wartime periods. This chapter attempts to assess the current situation and outline the dimensions of the task of restoring noninflationary full employment. The possible explanations for the extraordinary price rise of 1973 and 1974 are discussed in Chapter II. The impact of inflation and unemployment on various segments of society is discussed in Chapter III. Chapter IV analyzes the policies needed to control inflation and achieve full employment.

The Outlook

Real output will almost surely continue to decline in the first half of 1975, or at best to stagnate, with unemployment continuing to rise rapidly. Economic events in the second half of next year will depend crucially on policy decisions taken in the first months of 1975. Our assessment of the outlook for the second half of the year assumes that the Government will respond quickly to the needs of the economy. We assume that monetary policy will accommodate a sustained drop in interest rates, especially short-term rates, so that funds will return to thrift institutions and again become available for housing and other depressed sectors. We assume that fiscal policy will depart from its present restrictive course and become supportive of an economic recovery. Under these assumptions, recovery could begin in the third quarter. By the fourth quarter real output could be growing at a rate sufficient to halt the rise in unemployment. Even so, the unemployment rate—which lags behind changes in real output—appears likely to average about 7½ percent or even higher during the second half of the year.

Assuming that the policies necessary to initiate recovery are adopted, the productivity gains associated with rising real output will reduce inflationary pressures in the second half of 1975. If 1975 harvests are good and if there are no new unanticipated external price shocks, the rate of price increase could drop to about 7 percent in the second half of the year.

Naturally, economic developments in 1976 are even more difficult to foresee than those of 1975. However, if Federal policies continue to be appropriately supportive, there is no reason why 1976 should not be a year of rapidly growing real output, diminishing unemployment, strong productivity gains, and a further reduction in inflation. Even so, as discussed in detail below (pp. 17–19), the economy will still remain far below its potential at the end of 1976, with unemployment still likely to be above 6 percent.

We assume that Federal policies will respond to the present critical need to support economic recovery. Nonetheless, it may help to demonstrate the importance of policy changes by asking what might happen if policies continue on a restrictive course. Were this to be the case, there would be little recovery in housing, consumer spending would be further dampened by declining real incomes, and there would undoubtedly be further sharp curtailments of business investment plans. Under these circumstances, real output would continue to drop in the second half of 1975. Unemployment could be above 8 percent and still rising at the end of 1975. With productivity stagnant, the inflation rate would be no lower than we have estimated above, and could well be higher.

Any effort to predict the future is subject to considerable uncertainties. The numbers used above and in the more detailed analysis which follows represent probabilities rather than precise forecasts. Nonetheless, these estimates are based on extensive consultation with experts and thorough analysis by the staff of this Committee. While our numbers are approximate, the general dimensions of the decline into which the economy is plunging are clear. Immediate policy efforts to interrupt this decline are imperative.

Gross National Product

1974.—Real gross national product (GNP) declined during the first three quarters of 1974. Although full statistics are not yet available, it is apparent that this decline has continued in the fourth quarter. For 1974 as a whole, real output will average about 2 percent below 1973, the largest year over year decline in real output since the late 1940s.

This decline has been centered in residential construction and in reduced consumer purchases of automobiles and other durables. Sharp drops in these components of GNP have not been offset by growth in other sectors. As shown in Table 1, net exports were the only component of GNP to rise significantly in 1974. The remaining components of final sales remained essentially flat, and a slower pace of business inventory accumulation added to the decline in total GNP.

TABLE 1.—REAL NATIONAL GROSS PRODUCT 1973 AND 1974

[Billions of 1958 dollars]

	1973 actual	1974 estimate [1]
Personal consumption expenditure	552.1	542.0
Durables	113.6	105.0
Other	438.5	437.0
Business fixed investment	94.4	95.0
Residential construction	32.9	24.4
Net exports	4.6	8.4
Government purchases	144.4	146.0
equals: Final sales	828.4	816.0
plus: Change in business inventories	10.8	6.0
equals: Gross National Product	839.2	822.0
Addenda:		
Unemploynent rate (percent)	4.9	5.5
Housing starts (millions)	2.0	1.4
Retail sales of domestically produced automobiles (millions)	9.7	7.6
Inflation rate (percent change in GNP deflator)	5.6	10.3

[1] Based on 3 quarters of official data plus Joint Economic Committee staff estimates for the 4th quarter.

Sources: Department of Commerce, Bureau of Labor Statistics, and Joint Economic Committee.

Important factors in explaining the decline in real GNP in 1974 are (1) An unprecedented drop in real disposable incomes due in part to the transfer of income abroad through higher oil prices; (2) consumer reluctance to purchase new automobiles; (3) an increasingly restrictive Federal budget due to the role of inflation in increasing tax receipts; and (4) an excessively tight monetary policy which had a severe impact on residential construction. Each of these factors is discussed in greater detail later in this report.

1975.—Every indicator presently available points to the continuation of a declining trend in real output during the first half of 1975. Housing starts have continued to decline, falling to a 1 million annual rate in November. Building permits have fallen to an annual rate of 720,000, the lowest level since this statistical series was initiated in 1960. Actual construction lags behind starts and permits, hence a further drop in real residential construction spending in the first quarter of 1975 is inevitable. The sharp fourth quarter drop in auto sales has caused inventories to accumulate despite reduced production schedules. Thus auto production will remain at depressed levels for some months. Recent sharp drops in new orders for various industrial goods point to reduced operating levels in many types of manufacturing once existing order backlogs are worked off. The latest Commerce Department survey of business investment plans indicates that plant and equipment spending in real terms will be falling in the current quarter and during the first half of 1975.

Output in the first quarter may be buoyed somewhat by the resumption of normal production following the coal strike. Apart from this temporary, strike-induced phenomenon, there seems little prospect that output can be restored to a rising trend prior to the third quarter.

As stated above, we assume that the Administration, the Congress, and the Federal Reserve will respond to the needs of an economy in which unemployment is rapidly heading toward 7 percent. The Committee therefore instructed its staff to prepare a forecast for 1975 based on the assumption that fiscal and monetary policies will be supportive of a recovery and that an active price-incomes policy will help to prevent excessive price increases in noncompetitive areas of the economy. Based on these assumptions, real output would continue to fall in the first half of the year but would rise at between a 3- and 4-percent rate in the second. Unemployment would rise to around 7½ percent in the third quarter and remain at that level through the end of the year, then begin to decline in early 1976.

It must be stressed that forecasting is a risky business. Furthermore, some magnitudes are harder to forecast than others. Even if estimates for real output and employment are correct, estimates of the unemployment rate could be inaccurate because of the difficulty of estimating changes in the size of the labor force. The forecast above assumes that the labor force will grow very little in 1975 as individuals are discouraged from even seeking jobs in such a slack market. Should the labor force continue to grow at its trend rate of about 1.8 percent per year, however, the measured unemployment rate—using the same assumptions about output and employment—would be close to 8½ percent in the second half of 1975. In other words, the outlook for real output and employment implies an enormous volume of idled labor resources, only part of which will show up as measured unemployment.

Prices

Price movements are even more difficult to forecast than changes in real output and employment. This difficulty stems in part from the fact that there is no previous historical period in which prices followed the pattern shown in 1973 and 1974 and in part from the fact that prices are strongly influenced by events which are by their nature unforeseeable, such as the weather or international political developments. Thus, although every effort has been made to appraise the price outlook carefully, any numerical estimates of the likely rate of price increase represent a high degree of approximation.

Several elements in the outlook suggest a considerable relaxation of inflationary pressures in 1975. Especially important are the following:

(1) The major European countries as well as the United States anticipate recession or stagnation and sharply rising unemployment. Because of slack demand, world prices of industrial raw materials should remain stable or decline. This development is already apparent in the wholesale price index for nonfood crude materials, which has declined for the past 2 months. Slack world demand will also stabilize or reduce the prices of manufactured goods which move in world trade. The wholesale price index for textile products and apparel, for example, has declined for the past 3 months.

(2) A number of basic industries have already increased their prices by extremely large amounts within the past year. Iron and steel prices have risen at a 45-percent rate since April, industrial chemicals at an 89-percent rate, and machinery and equipment at a 25-percent rate. Any needed post-control "catch-up" or adjustment to higher world prices has now been completed. Profits in these industries are high. Any further price rise would quite properly provoke public outrage. As discussed in Chapter IV (pp. 77–85) it is the responsibility of Government to see that unnecessary price increases in these concentrated industries do not occur.

The above factors should contribute to a marked reduction in the rate of inflation in 1975. Table 2 presents more detailed information on wholesale prices by commodity groups and by stage of processing and shows a far greater degree of industrial price stability in September, October, and November 1974 than in the previous 6 months.

Two other factors, however, will be working to make the price outlook less favorable than the above analysis would suggest. One is rising unit labor costs. The second is the probability of large food price increases.

Unit Labor Costs.—Changes in the labor cost of a unit of output are the sum of two components: Changes in hourly compensation and changes in output per manhour (productivity). As shown in Table 3, which summarizes the available data on changes in wage rates in 1973 and 1974, wages rose considerably more rapidly in the second and third quarters of 1974 than in 1973 and early 1974. Even so, wage gains have not kept pace with price increases. Real hourly earnings continued to decline in the second and third quarters.

TABLE 2.—WHOLESALE INDUSTRIAL PRICES

[Percent change, seasonally adjusted[1] annual rates]

	February–August 1974	August–November 1974
All industrials	36.9	12.7
By stage of processing:		
Crude materials, excluding foods and feeds	32.7	—2.7
Intermediate materials, excluding foods and feeds	45.4	11.1
Producer finished goods	27.4	26.5
Consumer nonfood finished goods	24.3	14.1
Textile products and apparel	10.5	—6.3
Fuels related products and power	64.2	4.1
Chemicals and allied products	72.6	43.3
Lumber and wood products	—2.3	—26.7
Pulp, paper and allied products	50.9	11.0
Machinery and equipment	29.3	26.4
Metals and metal products	58.1	3.0
Transportation equipment (NSA)	13.6	29.3
Other industrial products[2] (NSA)	21.6	15.5

[1] Except where otherwise noted.
[2] Includes: Hides, skins, leather, rubber and plastic products, furniture and household durables, nonmetallic mineral products and miscellaneous.
NSA—Not seasonally adjusted.

Source: Bureau of Labor Statistics.

TABLE 3.—CHANGES IN WAGE INDICATORS. BY QUARTER, 1973–74

	Seasonally adjusted percent change over previous quarter at annual rate						
	1973				1974		
	I	II	III	IV	I	II	III
Average hourly compensation:							
All employees, private nonfarm economy:							
Current dollars	11.8	5.9	7.0	8.1	8.3	10.6	11.0
1967 dollars	5.6	—2.7	—2.0	—1.6	—2.9	—1.7	—1.9
Average hourly earnings, private nonfarm economy	5.5	7.2	8.2	7.0	4.8	9.9	11.4
Hourly Earnings Index, private nonfarm economy adjusted for overtime (in manufacturing only) and inter-industry employment shifts:							
Current dollars	5.0	6.7	7.9	7.1	6.0	10.4	11.4
1967 dollars	—1.1	—1.5	—.9	—2.8	—5.6	—1.0	—1.3
Major collective bargaining situations:[1]							
Wage and benefit changes:							
1st-yr adjustment	7.1	7.8	7.2	6.1	6.9	9.0	11.9
Over life of contract	5.6	6.7	6.3	5.6	5.9	7.5	7.9
Wage-rate changes:							
All industries:							
1st-yr adjustment	5.5	6.2	5.8	5.5	6.2	9.2	11.1
Over life of contract	4.8	5.7	5.3	4.5	5.3	7.4	7.3
Manufacturing:							
1st-yr adjustment	6.6	6.2	5.9	5.5	6.1	8.5	10.1
Over life of contract	5.8	5.4	5.1	4.1	4.9	6.0	6.5
Nonmanufacturing:							
1st-yr adjustment	4.8	6.2	5.8	5.6	6.3	10.6	11.2
Over life of contract	4.2	5.9	5.5	5.5	5.5	8.8	7.5
Construction:							
1st-yr adjustment	4.8	5.4	4.6	4.9	5.2	9.4	15.9
Over life of contract	4.9	5.4	4.7	5.0	4.8	8.8	11.7

[1] Limited to private industry settlements affecting 1,000 workers or more (5,000 for wages and benefits combined), average annual change for settlements negotiated during quarter.

Source: Bureau of Labor Statistics.

With consumer prices still rising at a 13-percent annual rate in the most recent 2 months for which data are available, large wage demands must be expected in 1975 despite the slack economy. If the tax changes recommended elsewhere in this report (pp. 43–46) are enacted, these will help support the real value of workers' take home pay and should help hold wage increases within the 9- to 10-percent range. Without these tax changes, wage settlements could go even higher.

In a period of slack demand, some part of this wage increase will be absorbed by employers rather than passed on in higher prices. However, this process creates a squeeze on profits which obviously cannot continue indefinitely. Thus it is of the utmost importance that productivity again resume a rising trend. As shown in Table 4, in recent quarters a combination of a high rate of wage increase and a steady *decline* in productivity has caused unit labor costs to rise at an alarming 14-percent rate. If by the fourth quarter of 1975 wages are rising at a 9-percent rate and productivity at a 3-percent rate, then the rise in unit labor costs will have been slowed to about a 6-percent rate. This would still be high by historical standards, but would represent a dramatic improvement over the present situation.

Shortrun changes in productivity are a function of changes in output and in the number of hours worked. The recent fall in productivity is attributable to a drop in output unaccompanied by a reduction in employment. Similarly, gains in productivity in 1975 will be achieved only if output grows more rapidly than employment. This is why we put such stress throughout this report on the importance of restoring output growth if inflation is to be contained.

TABLE 4.—PRODUCTIVITY AND UNIT LABOR COST—PRIVATE NONFARM ECONOMY, 1973–74

[Percent changes; seasonally adjusted annual rate]

	1973				1974		
	I	II	III	IV	I	II	III
Output	9.4	2.5	2.5	1.1	−7.5	−2.9	−3.1
Man-hours	4.0	4.8	2.5	1.9	−2.4	.4	−.6
Output per man-hour	5.2	−2.2	0	−.8	−5.2	−3.3	−2.4
Compensation per man-hour	11.7	5.4	6.6	8.8	8.4	10.7	11.1
Unit labor costs	6.2	7.8	6.6	9.7	14.4	14.4	13.9
Addendum: Real compensation per man-hour	5.5	−3.2	−2.3	−.9	−2.7	−1.6	−1.8

Source: Bureau of Labor Statistics.

Food Prices.—Meat prices in 1975 and even in 1976 will be strongly influenced by the poor 1974 feed grain crop. High prices of feed grains are presently causing widespread liquidation of herds by meat producers. Thus, at the moment, meat supplies are ample and prices are falling. Once this liquidation is completed, however, meat and poultry may be in extremely short supply and prices could very well rise substantially. Because of the time required to establish new herds, an imbalance between meat supply and demand is likely to persist throughout the next 2 years. The timing of price fluctuations is, of course, difficult to predict, but many observers anticipate sharp rises in meat and poultry prices during the spring and summer of 1975. Other food prices will be influenced by Southern Hemisphere crops, soon to be harvested, and by our own harvests next fall. These prices are extremely difficult to predict at this time.

Overall Price Outlook.—Because of the unusual situation in the agicultural sector, it is important to analyze the farm and nonfarm sectors separately. Normally, prices rise more slowly in the private nonfarm sector than in the economy as a whole. However, during the first three quarters of 1974, prices in the private nonfarm sector (as measured by the deflator for nonfarm business product) have risen at an extraordinary rate of about 13 percent, while the inflation rate for the economy as a whole has been about 11 percent. With appropriate policies, it should be possible to reduce the inflation rate in the private nonfarm sector by more than one-half by the end of 1975. Because of the uncertain outlook for farm prices and because large wage increases must be anticipated in the public sector, the overall inflation rate for the entire economy may not drop by quite so much.

It should be a goal of public policy to reduce the rate of inflation in the private nonfarm sector of the U.S. economy from its recent 13-percent rate to below 6 percent during the second half of 1975. Achievement of this goal will require:

(1) Monetary and fiscal policies designed to restore healthy economic growth so that productivity gains will be realized.

(2) An active price-incomes policy which will discourage both administered price increases not justified by market conditions and excessive wage increases demanded by powerful unions.

B. A Time Path for Restoring Full Employment

The extraordinary price increases of 1973 and 1974 have focused attention on the problem of inflation and may have created the impression that controlling inflation is the Nation's most difficult longer run economic problem. This is not necessarily the case. As discussed in the preceding section, a large reduction in the inflation rate should be possible in 1975, and with appropriate policies further progress will be possible in 1976 and in subsequent years. The struggle to restore reasonably full employment may well prove to be the greater challenge for economic policy.

For 1975 and 1976 there will be no "trade-off" between the goal of reducing unemployment and the goal of containing inflation. The rapid growth necessary to reduce unemployment is also essential to achieve the productivity gains needed to hold down costs and prices. In subsequent years, however, as the volume of idle resources is reduced, shortages may emerge in particular sectors and create inflationary pressures long before overall full employment is reached. Sectoral pressures should not divert attention from the goal of full employment. However, as the economy approaches full employment, it is important that policies be directed to avoiding both excessively rapid rates of overall economic growth and sudden large increases in demands on particular sectors.

ACTUAL AND POTENTIAL GROSS NATIONAL PRODUCT

Since the early 1960s, the concept of potential GNP has been utilized to define a full employment growth path for the economy. Potential GNP is defined as the volume of real output which would be produced if the unemployment rate remained consistently at 4 percent. A 4 percent unemployment rate was chosen because this was thought to represent a level of resource utilization consistent with reasonable price stability, given the structure of the economy existing in the early 1960s. The goal of 4 percent unemployment was not intended to be immutable for all time. As this Committee has repeatedly stressed, structural improvements in the economy could, over time, make possible a reduction in the unemployment rate to 3 percent or less.

The rate at which potential GNP grows from one year to the next is a function of the growth of the labor force, the trend growth of productivity, and the decline in hours worked. The potential growth rate is estimated to be about 4 percent per year at present but, with changing demographic factors, will drop to about 3.2 percent by the early 1980s.

A vigorous debate over the continued appropriateness of 4 percent as an interim unemployment target emerged in the early 1970s. Continued examination of this question is most desirable, and the point is well taken that goals must be adjusted to fit changing circumstances. However, the evidence presently available does not support the conclusion that 4 percent is no longer an appropriate interim unemployment target.

Why then did inflation become so troublesome in 1973 when unemployment still remained above 4½ percent and why has inflation grown still worse while unemployment was rising again to 5 percent and more? It should be understood that, because of erratic short-run changes in employment and in labor force participation, the official monthly unemployment statistics can fluctuate rather widely around the trend rate of unemployment. A rule of thumb used by economists to estimate the trend rate of unemployment is that the unemployment rate is equal to 4 percent plus or minus 1 percentage point for each 3 percent difference between actual and potential GNP.[2] Chart 1 compares the trend rate of unemployment, so computed, with the published monthly unemployment rate statistics. Over time the two series are very close, but short-run deviations are considerable. In general, the measured rate tends to lag somewhat behind the computed trend so that the computed trend gives a more timely indication of the intensity of resource utilization.

---

[2] This concept, known as Okun's law, was first developed in Arthur M. Okun, "Potential GNP: Its Measurement and Significance," American Statistical Association, *Proceedings of the Business and Economic Statistics Section* (1962), pp. 98–104, reprinted in Okun, *The Political Economy of Prosperity* (Brookings, 1970). See also Arthur M. Okun, "Unemployment and Output in 1974," in *Brookings Papers on Economic Activity*, 1974:2, pp. 495–505.

Sources: Department of Commerce, Council of Economic Advisers, Joint Economic Committee.

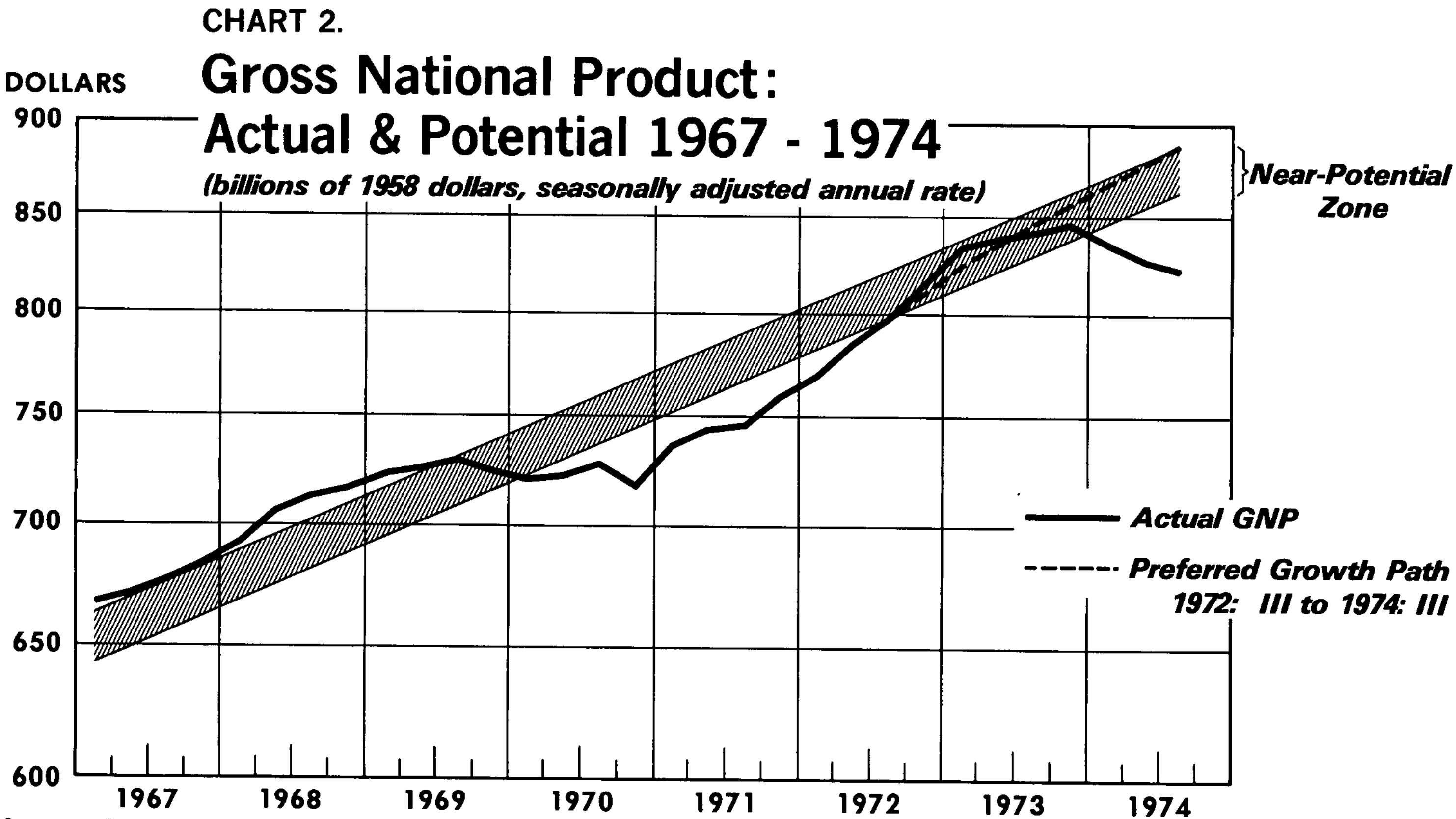
In the first quarter of 1973 the trend unemployment rate was about 4.3 percent, or very close to the interim target. As discussed in Chapter II, a substantial part of the inflation which has gripped the economy since the beginning of 1973 can be explained by two special factors, the extraordinarily rapid rise in food prices which began in late 1972 and the increase in the price of mineral fuels which began about the same time. In addition, the timing of this price rise which began in early 1973 is in part a product of the lifting of the Phase II control program at that time. However, these special factors do not explain all of the extraordinary 1973 price rise. Of fundamental importance in explaining the remainder is the excessive speed with which a relatively full degree of resource utilization was being approached in late 1972 and 1973.

The economy had experienced a prolonged period of stagnation throughout 1970 and the first three quarters of 1971. In the fourth quarter of 1971, the economy began to grow again at a rapid rate. From the third quarter of 1971 to the third quarter of 1972, real output rose about 7 percent. This gain was desirable, narrowing the gap between actual and potential output from 5½ percent of potential in the third quarter of 1971 to 3 percent in the third quarter of 1972.

Thus, in the fourth quarter of 1972 the economy, while it had not reached full resource utilization, had reached the point at which it would have been appropriate to gradually reduce the growth of real output toward the 4 percent potential growth rate. That is, a growth rate dropping from 7 to 6 to 5 to 4 percent would have been desirable. Instead, real output was permitted to grow at an annual rate of nearly 9 percent during the fourth quarter of 1972 and the first quarter of 1973. Exports rose at an annual rate exceeding 30 percent in real terms during this period and business fixed investment increased at a rate exceeding 20 percent. Even in an economy still operating below capacity overall, this extraordinarily rapid growth in certain key sectors created price pressures and inflationary bottlenecks. Furthermore, the overly rapid approach to potential was followed by an abrupt slowing of the growth rate in the second quarter of 1973 (before full employment had been achieved), and then by the present severe recession.

Chart 2 compares the actual growth path with a more desirable hypothetical approach to potential. The shaded area of the chart identifies the zone of near-potential operation in which sectoral price pressures are apt to emerge. The lesson to be learned from this experience is that chances of reaching a sustainable, noninflationary full employment growth path will be increased if excessively rapid rates of real growth are avoided once the economy reaches this zone of near-potential output. At the same time, growth must remain sufficiently rapid to permit the gradual attainment of full potential operation.

A 4-percent unemployment rate remains an appropriate interim policy goal. The concept of potential gross national product is a valid analytic measure for comparing the actual performance of the economy with this interim goal. When the gap between actual and potential performance is very large, as it will be in 1975 and 1976,



Sources: Department of Commerce, Council of Economic Advisers, Joint Economic Committee

very rapid rates of economic growth are desirable. As the gap between actual and potential is narrowed, the growth rate should be reduced so that full employment can be approached gradually to minimize inflationary pressures.

Chart 3 illustrates three alternative time paths for regaining the potential level of real output. These time paths are illustrative of three general types of policy which might conceivably be followed. They are certainly not intended as predictions of the actual time at which full employment will in fact be regained, but they do serve to illustrate vividly the general magnitude of the problem with which the Nation is confronted. In each case it is assumed that the trough of the present recession occurs in mid-1975 and that the gap between actual and potential GNP at the trough is about 12 percent. Time Path A, which assumes a steady 5 percent growth of real output, would not close the gap until 1986. Time Path B, which assumes an accelerating rate of growth, overshoots potential in 1980 with the economy growing at a 10 percent rate at that time.

Obviously neither of these hypothetical growth paths represents either a likely or a desirable pattern. They are presented in this admittedly mechanistic fashion to illustrate the weaknesses of two common prescriptions for economic policy. The "slow but steady" prescription illustrated by Time Path A would require 11 years to reach an "interim" target of 4 percent unemployment. The cumulative loss of output would approach $1,800 billion (measured in 1974 prices). Such a policy is far too slow and costly.

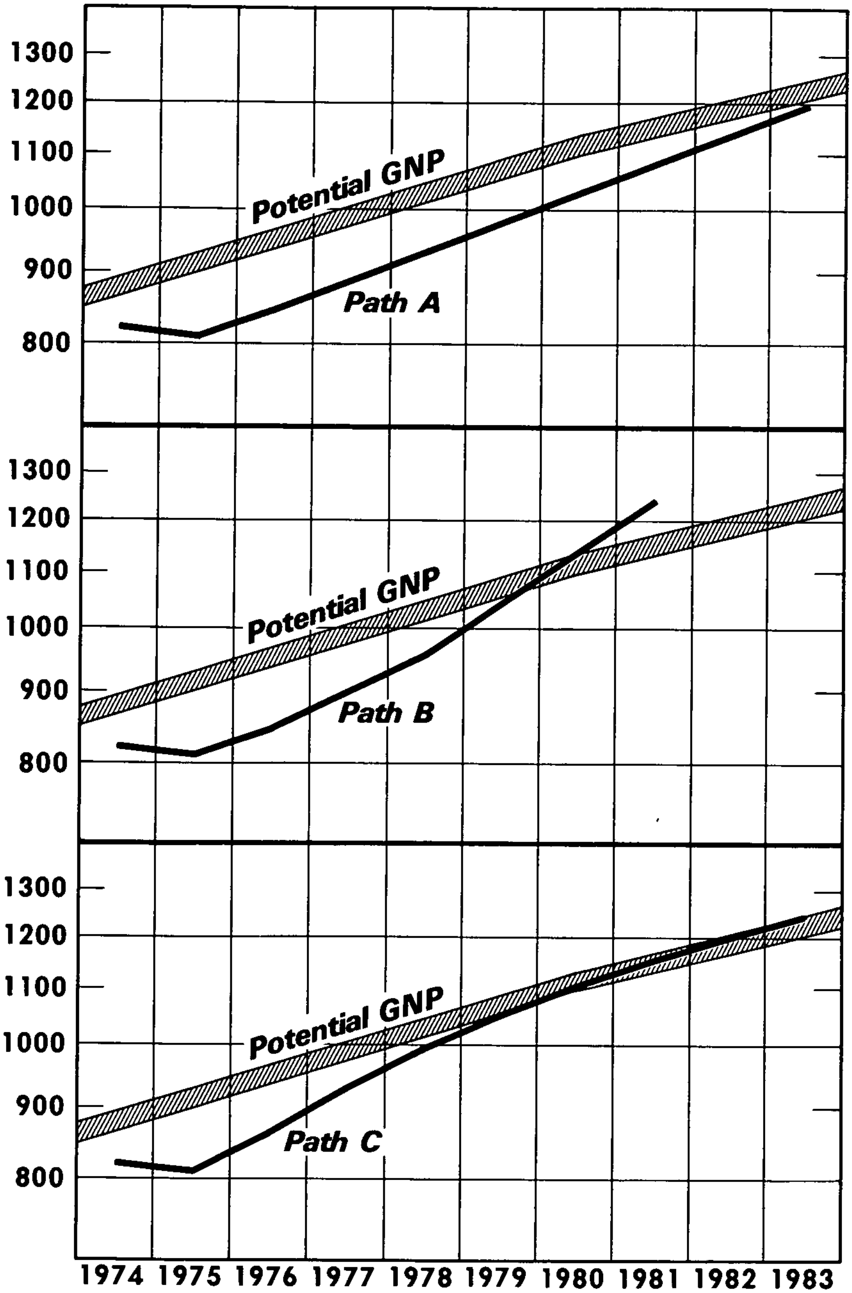
The "caution now; stimulus later" prescription illustrated in Time Path B would require 6 years to restore full employment, but the economy would be growing so rapidly at the time that potential was approached that enormous inflationary pressures would be unleashed. This would in all likelihood lead to restrictive policies and a new recession. In short, this would be a repetition of the mistakes of late 1972 and early 1973.

Time Path C, which assumes an 8-percent real growth rate in 1976 and 1977, followed by a gradual diminution of the growth rate, represents the more desirable approach to full employment. By 1979 the gap is reduced to about 3 percent of potential (the approximate equivalent of a 5 percent unemployment rate). The remaining gap is then closed gradually in a way which should avoid new inflationary pressures.

Even assuming that a growth path something like line C on the chart can be achieved, the cumulative loss of output through 1980 will approach $500 billion—a tragic and enormous loss. We would like to think that full employment could be restored more quickly. Perhaps it can, but the evidence of the past 30 years does not lead us to be hopeful. The growth path illustrated by line C on the chart implies an average annual growth rate of 6.5 percent from 1975 to 1980. This would exceed the growth achieved during either the 1961–66 or 1949–53 periods, the strongest periods of U.S. economic growth in the post World War II period.

CHART 3.

Alternative Approaches to Potential, 1974 - 1983



Sources: Department of Labor, Joint Economic Committee

The recession must be halted and growth of real output restored in 1975. Policies for future years must, of course, be reassessed at later dates. It presently appears, however, that in 1976 and 1977 policies should be directed toward sustaining the growth of real output at an annual rate of about 8 percent. Even so, unemployment may average about 7 percent in 1976 and slightly above 6 percent in 1977. Growth rates of 5 to 6 percent would be needed in 1978 and 1979 even to bring the unemployment rate under 5 percent by 1980.

There appears to have been little public recognition so far of the underutilization of labor resources which seems destined to dominate the remainder of this decade. The following points should be recognized:

(1) The recent debate surrounding the precise definition of full employment is irrelevant for the present. Not until 1979 or 1980 are we apt to be faced with the question of whether 5 or 4 or 3 percent unemployment is the appropriate target. Nonetheless, analysis of this question should continue and the Government should make its policy targets clear well in advance of their likely achievement. Only if this is done will businessmen proceed with the capital investment required to meet the future consumption demands of a high employment economy.

It is of the utmost importance that the Government make clear its determination to restore full employment and state clearly the time period over which this is likely to be achieved.

(2) High unemployment is accompanied by increased poverty and human suffering. The Government has a grave responsibility to assist those who are directly affected and to spread the costs of high unemployment as equitably as possible among all citizens.

Because of the high levels of unemployment and poverty apt to persist during the remainder of this decade, special urgency attaches to the enactment of an adequate program of income maintenance.

II. SOURCES OF INFLATION

S. Con. Res. 93, under which this study has been conducted, instructed the Committee to direct its analysis particularly toward the causes of and possible cures for inflation. This chapter analyzes the various apparent sources of inflation over the past 9 years. Section A of this chapter contains an overall summary of price developments from 1966 through 1974. Section B analyzes international aspects of inflation. Section C examines the role of administered prices. Section D assesses the role played by the various types of price-wage policies employed during the period. Section E examines the price impact of environmental regulations and concludes that, contrary to a frequently heard contention, these regulations are not a significant cause of either past or prospective inflation.

A. Price Patterns, 1966–74

In contrast to the early 1960s, which were a period of relative price stability, the past 9 years have been marked by a troublesome and accelerating rate of inflation. Table 1 shows the average annual rate of increase of the major price and wage indices during three periods: 1960–1965; 1966–1972; and 1973–74. The two periods, 1966–72 and 1973–74, are separable not only by the difference in the actual rate of price increase but also by a marked difference in the sources of the inflation.

TABLE 1.—MAJOR INDICATORS OF PRICE AND WAGE CHANGES

[Average annual percentage change per year]

	1960 to 1965	1965 to 1972	1972 to 1974 [1]
Deflator for gross national product	1.4	4.0	7.9
Deflator for gross private product	1.2	3.6	8.1
Consumer Price Index:			
All items	1.3	4.1	8.7
Food	1.4	3.9	14.6
All items less food	1.3	4.2	7.0
Wholesale Price Index:			
All items	.4	3.0	16.2
Industrial commodities	.2	2.9	14.2
Hourly earnings index (adjusted) [2]	3.2	6.0	9.4
Average weekly earnings	3.3	5.2	6.6

[1] 4th quarter 1974 estimated.
[2] Adjusted for overtime (in manufacturing only) and for interindustry employment shifts.

1966–72

The initial source of inflation in the period 1966–72 was the highly expansive fiscal policy of the 1966–68 period. The direct demands placed on the economy by the Federal Government—especially on the defense production sector—and the consumer demands resulting from rapidly rising incomes strained productive capacity in many sectors of the economy and caused year to year price increases (as measured by the GNP deflator) of 2.8 percent from 1965 to 1966, 3.2 percent from 1966 to 1967 and 4.0 percent from 1967 to 1968. Rising prices and a relatively strong demand for labor touched off an acceleration in the rate of wage increase. Compensation per man-hour rose about 6.5 percent over the previous year in both 1966 and 1967 and about 7.5 percent per year from 1968 through 1971.

Under the best of circumstances, these wage increases would have led to further price increases. The severity of the price increases was made worse by two factors. One was the total abandonment in early 1969 of any active price-incomes policy. The second was the recession which resulted from the restrictive fiscal and monetary policies introduced in 1969. The recession served to eliminate the productivity gains which otherwise would have partially offset the rise in hourly compensation. Prices rose 4.8 percent from 1968 to 1969, 5.5 percent from 1969 to 1970, and at an annual rate of 5.6 percent from the second half of 1970 to the first half of 1971. Comprehensive price-wage controls were placed in effect beginning in August 1971. Even so, prices rose at an annual rate of 2.9 percent from the first to the second half on 1971 and 3.2 percent from 1971 to 1972.

The economic problems and policies of the 1966–72 period have been analyzed extensively in past reports of this Committee and elsewhere. It is not necessary to repeat that analysis in detail in this report. Several points, however, are worth stressing.

(1) Economic growth during the 1965–68 period was unbalanced and excessively rapid. The rapidity of the approach to full employment rather than the actual level of resource utilization ultimately reached, accounted for much of the price pressure. GNP never went very far above its potential growth path. A level of resource utilization paralleling that of 1968 should be attainable, but whenever output is close to its potential, further expansion must be pursued gradually and in a manner which spreads the growth of demand broadly among the various sections of the economy.

(2) A reduction in the rate of GNP growth was certainly required in 1969. However, the recession and subsequent stagnation of 1969–71 went far beyond the necessary slowdown and doubtless beyond what was intended by policymakers. The loss of productivity occasioned by the recession only intensified the cost-push inflation. Furthermore, reduction in business investment during this period may explain in large part the subsequent inability of many industries to respond adequately to the higher demand levels of 1973 and early 1974.

(3) As discussed in Section B, the falling value of the dollar in international markets from mid-1971 on served to put some additional upward pressure on domestic prices. However, this was far from the major source of U.S. inflation prior to 1973.

(4) As discussed in Section D, the failure to conduct an active price-incomes policy in early 1969 represents a lost opportunity to deal with cost-push causes of inflation before they became deeply embedded. This failure led to the subsequent necessity to turn to comprehensive controls in late 1971. The controls, once invoked, played a useful role in helping to unwind the remaining cost-push elements of inflation.

(5) The unsatisfactory price behavior of 1966–72 is explainable in terms of the policy mistakes of that period. There is nothing in the price record of that period to indicate that the structure of the economy has changed in some basically inflationary manner or that, given proper policies, a combination of relatively full employment and reasonable price stability would have been unobtainable.

1973–74

The inflation of 1973–74 has been quite different in nature from that of 1966–72. The cost-push spiral which began in 1968 and 1969 had probably about worked its way through the economy in late 1972. The much higher rates of inflation which began in 1973 must be explained in terms of a new set of causes, some of them external factors outside the control of U.S. policymakers and some of them policy actions (or inactions) which served to make a difficult situation worse.

As discussed in more detail in Section B, rising agricultural prices and sharply higher international oil prices were major factors in the 1973 inflation. The direct effect of these price rises is fairly easily identifiable. Table 2 shows the Consumer Price Index in total and excluding food and fuel and the Wholesale Price Index for industrials, food, and fuel. These computations do not, of course, show the full impact of rising food and fuel costs. An important part of the rise in nonfood, nonfuel prices from mid-1973 on represents the passing on of the higher cost of fuel used in the production process. The pass-on of wage increases, which in turn were made necessary by rising food and fuel prices, explains a further part of the 1974 price increase.

TABLE 2.—SELECTED MEASURES OF PRICE CHANGE, 1972–74

[Percent change during period, seasonally adjusted annual rate]

	1972				1973				1974		
	I	II	III	IV	I	II	III	IV	I	II	III
Consumer Price Index:											
All items	3.1	2.6	4.4	3.5	8.4	7.5	10.2	9.2	14.2	10.9	14.2
Food	5.1	1.0	6.7	6.2	26.7	16.8	26.7	11.0	19.4	3.1	12.3
Fuel [1]	−.4	1.4	7.6	2.4	10.0	14.9	−1.3	48.7	70.7	22.3	3.7
All items less food	2.9	3.2	3.5	1.9	3.8	5.4	5.3	8.1	12.4	14.3	14.7
All items less food and fuel	2.9	3.5	2.9	2.5	3.8	3.8	5.5	5.5	8.6	12.8	15.2
Wholesale Price Index:											
All Items	3.2	4.9	6.9	11.3	19.5	20.9	13.2	8.7	24.5	12.2	35.2
Farm products processed foodsand feeds	3.1	5.9	18.5	32.1	46.8	44.8	33.5	−8.7	10.8	−29.3	59.2
Industrials	3.6	4.4	4.0	2.4	10.1	11.1	6.0	16.0	32.3	35.7	28.3
Fuels, related products and power	3.9	4.5	8.8	7.2	17.4	18.8	13.3	52.3	136.2	52.2	31.6

[1] Gasoline, motor oil, fuel cil, coal, gas and electricity.

Source: Bureau of Labor Statistics, U.S. Department of Labor.

Nonfood, nonfuel prices began to advance at a somewhat more rapid rate early in 1973, however, before these passthrough effects became important. This phenomenon requires some further explanation. Part of the explanation lies in the price effects of the devaluation of the dollar. These are discussed in Section B. A further part of the explanation lies in the untimely removal of the Phase II price controls in early 1973. These factors, however, probably do not account fully for the new spurt of inflation. The remainder of the explanation would appear to lie in the speed with which full employment was being approached in late 1972 and early 1973.

As discussed earlier (pp. 13–15), real output grew at an annual rate of nearly 9 percent during the fourth quarter of 1972 and the first quarter of 1973. This rate was inappropriately rapid since the gap between actual and potential output had been reduced to less than 3 percent by the third quarter of 1972.

Export demand was a big factor in producing this rapid growth of output. Stimulated both by the devaluations and by strong demand conditions in Europe and Japan, exports grew at an annual rate exceeding 30 percent in volume terms during the fourth quarter of 1972 and the first quarter of 1973. This export growth was in itself highly desirable. Indeed, it was the hoped-for result of the devaluations. However, accommodation of this export demand in a noninflationary manner would have required that monetary and fiscal policy exert sufficient restraint on domestic demand to release the resources needed for export production.

During the same period that exports were growing so rapidly, business fixed investment was growing at an annual rate of over 20 percent in real terms. Again, this in itself may have been desirable—certainly there are areas of the economy which have been shown in 1973 and 1974 to have had inadequate plant capacity. However, for business investment to rise at this pace, other areas of the economy needed to be restrained.

In sum, in late 1972 monetary and fiscal policy should have turned slightly in the direction of restraint so that full employment could have been approached in a steady and gradual fashion. Instead, both fiscal and monetary policy became more expansive. The deficit in the Federal budget, measured in full employment terms, rose from $5.3 billion in the first half of 1972 to $9.5 billion in the second half.[1] The growth of the money supply rose from a 7.7 percent annual rate in the first half of the year to a 9.4 percent rate in the second half. Table 3 shows changes in the prinicipal fiscal and monetary aggregates by half years and also the quarterly changes in real output growth.

It is true that fiscal policy turned significantly more restrictive in early 1973, but the change was late in coming and was probably too abrupt when it did come. Thus the growth of real output fell sharply after the first quarter of 1973. A temporary slowing of output growth may well have been desirable in mid-1973. However, policy turned even more restrictive in late 1973 and in 1974, carrying the downturn far beyond the point at which any commensurate benefits in terms of reduced inflation could be expected. Indeed, as stressed earlier, the recession is now making inflation worse by eliminating the productivity gains needed to offset large wage increases.

Unlike 1973, the inflation of 1974 has not been heavily concentrated in food prices. As shown in Table 2, consumer nonfood prices rose more

[1] These numbers are based on full employment budget estimates prepared by the Federal Reserve Bank of St. Louis. Estimates from other sources in some cases differ by several billion dollars. However, the direction of change from one-half year to the next is the same.

TABLE 3.—FISCAL AND MONETARY AGGREGATES AND REAL OUTPUT GROWTH, 1972–74

[Seasonally adjusted annual rates]

	Federal surplus or deficit (in billions of dollars)		Percent change in money supply	Change in real GNP (by quarters)	
	Actual budget	Full employment budget[1]		Quarter	Percent
1972:					
1st half	−17.3	−5.3	7.7	1	4.9
				2	9.5
2d half	−17.7	−9.5	9.4	3	5.8
				4	8.1
1973:					
1st half	−9.3	−2.7	7.7	1	8.7
				2	2.2
2d half	−2.0	+7.9	3.7	3	1.6
				4	2.3
1974: 1st half	−2.9	+12.5	6.5	1	−7.0
				2	−1.6

[1] Estimates of the hypothetical surplus of deficit which would have resulted at a constant 4-percent rate of unemployment.

Sources: Department of Commerce, Federal Reserve Board of Governors, Federal Reserve Bank of St. Louis

rapidly in the second and third quarters than did food prices. Fuel price increases continued to be a major factor in the first half of the year but not in the third quarter. Other nonfood commodity prices also continued to rise rapidly early in the 1974. The wholesale price index for non-food crude materials rose at an annual rate exceeding 40 percent in the first 7 months of 1974. In more recent months this index has begun to decline.

It is still too early to provide a complete explanation of the extraordinary price rise of the first three quarters of 1974, but the following factors surely enter into the explanation:

(1) Dramatic increases in fuel and raw material prices were still being passed through at the wholesale and consumer level.

(2) Rising food and fuel prices led to the need for large wage increases. Rapidly rising wages and a decline in output per man-hour combined to produce the largest unit labor cost increases on record. These had to be passed through into prices.

(3) The devaluations of 1971 through 1973 continued to have an impact on export demand. Exports were the only sector of the economy to grow significantly in real terms in 1974. Even though the economy as a whole was not at full utilization, this export demand may have placed additional upward price pressure on some sectors.

(4) Once price controls were removed in the early months of 1974, prices in many industries were raised far more than appears justified by cost increases. Motivations underlying these price increases may have included the desire to raise profit margins, to obtain cash flow for investment purposes, to bring domestic prices to the higher world market level, and to establish a higher base in case controls were reimposed. From a social point of view, price increases for these reasons were for the most part highly undesirable. This problem of administered prices is discussed in greater detail in Section C of this chapter.

These four factors probably explain most of the extraordinary price rise of 1974. Further study of the 1974 experience should be urgently pursued. So far, we find no evidence that the economy has undergone any basic structural change which makes full employment and reasonable price stability fundamentally incompatible.

The price increases of 1966–73 and probably of 1974 can be explained partly in terms of external factors beyond the control of macroeconomic policy and partly in terms of policy errors throughout the period. There appears to be no fundamental reason why, if proper policies are followed, the United States cannot in the future combine rates of price increase of 3 percent or less with rates of unemployment of 4 percent or less. To do so will require that:

(1) Monetary and fiscal policies be managed so that full resource utilization is approached in a steady, gradual, and balanced manner.

(2) Price-incomes policies actively discourage administered price increases which are not justified in terms of either of costs or of market conditions.

(3) The industrialized nations utilize the Organization for Economic Cooperation and Development as well as other multinational institutions to coordinate their economic policies so as to avoid either excessive or inadequate rates of economic growth in the OECD area as a whole.

(4) Improved mechanisms be developed for anticipating and dealing with the supply problems which can lead to sudden sharp price increases for basic commodities such as grains or fuels.

B. International Aspects of Inflation

The inflation that has occurred in the United States in recent years, which accelerated in 1973 and remained at a high rate throughout 1974, reflected several different economic forces at work. Among the most visible of these forces were international sources of inflation—the fall in the exchange value of the dollar from 1971 to 1973, the fourfold increase in the price of imported oil, and dramatic hikes in other commodity prices, including metals and grains. The following discussion places these international sources of inflation within a quantitative context. What porton of the inflation we have experienced recently can be attributed to international sources? Are external events in the foreseeable future likely to exacerbate inflation or aid in decelerating the rate of price increases?

The Relative Significance of International Sources of Inflation

Past international sources of inflation can be conveniently divided into two classes: First, the impact of the series of exchange rate changes that began in 1971, and second, the effects of increases in commodity prices, including the price of oil. The following discussion of the extent to which economic forces operating internationally have produced inflation in the United States is based primarily on a study prepared for the Joint Economic Committee by the Board of Governors of the Federal Reserve System.[2]

This study separates exchange rate changes from other international sources of inflation. The division is a sensible one if one considers the degree of policy influence the United States had over these different types of international economic events. Although the external value of several European currencies began to move in May 1971, before dollar-gold convertibility was terminated in August of that year, the decision to realign dollar exchange rates was largely one taken by American policymakers. Of course, the establishment of any exchange rate requires the consent of at least two parties, and the changes that occurred as well as the system that has evolved today reflects compromises adopted by policymakers from virtually all countries with market economies. Nonetheless, the initiative to restructure dollar exchange rates largely came from the United States.

On the other hand, increases in commodity prices, even the price of wheat, have largely been out of the hands of U.S. policymakers. The quadrupling in the price of oil reflected the decision of the producing countries. The rise in the price of basic agricultural commodities resulted from strong world demand coupled with crop failures in the Soviet Union and other producing areas and the disappearance of the anchovies off Peru. Metals prices were driven up by the simultaneous peaking in the business cycles of most of the major industrial countries. Therefore, the impact of exchange rate changes can be logically distinguished—on the basis of the degree of U.S. policy control—from other international sources of inflation.

The Impact of Exchange Rate Changes

A decline in the external value of a nation's currency, whether the result of a devaluation by a stated amount or gradual depreciation in exchange markets, immediately has the effect of raising the domestic currency price of imports. While this is the most direct and immediate inflationary impact of such an exchange rate change, devaluation or depreciation has a number of indirect effects which also tend to raise prices. For example, increased costs of imported raw materials and semimanufactures contribute toward raising the full cost of final products. In addition, as a result of the increased domestic prices of imports, residents will tend to shift some of their purchasing from imports to locally produced substitutes. If the industries producing these substitutes are already operating at near capacity levels, or if sufficient domestic competition is lacking, the prices of domestic substitutes will rise, perhaps by an amount comparable to the increase in the price of imports.

A fall in the external value of a nation's currency also affects exports. The foreign currency price of exports declines, and therefore

[2] Richard Berner, Peter Clark, Jared Enzler, and Barbara Lowrey, "International Sources of Domestic Inflation." Typescript to be published by the Joint Economic Committee.

foreigners will hopefully purchase more of the nation's products. Again, if industries producing exportable goods are initially operating at capacity levels, the domestic currency prices of these items may also increase somewhat. Increased domestic prices for import-competing and export industries allows producers of these goods to bid labor, land, factories, and equipment away from producers of nontraded items. The ability to pay higher wages, rents, and equipment prices is essential to the expansion of import-competing and export industries.

Finally, both the shift in domestic demand from imports to locally produced substitutes and the shift in foreign demand toward the products of the devaluing (or depreciating) country have an expansionary impact on domestic activity, since total spending on that nation's goods will grow. If the nation is operating at full employment when the impact of the exchange rate change takes hold, this increase in total spending will also tend to drive prices up.

Several attempts have been made to estimate the domestic inflationary consequences of dollar devaluation and depreciation in recent years. While these estimates differ in methodology and in the time period examined, the conclusions derived fall within a limited range and tend to support one another. For example, the study done for the Joint Economic Committee by the Federal Reserve Board of Governors estimated that 15 percent of total inflation from the middle of 1971 through mid-1974 could be attributed to the decline in the external value of the dollar.[3] An economist employed by the Federal Reserve Board but not a contributor to the study done for the Joint Economic Committee, Sung Y. Kwack, has made two independent estimates of the price consequences of exchange rate changes. By one method he calculated that a 10 percentage point devaluation or depreciation of the dollar would on the average raise U.S. prices by 2 percentage points.[4] In the second analysis, he noted that the dollar had been effectively depreciated by about 5 percent per year from 1971 through 1973 and estimated that as a result of this decline, an average annual increase in domestic prices of about 1.4 percent had occurred.[5] Since the Consumer Price Index from 1971 through 1973 rose at about 4.6 percent annually, Kwack's estimates would attribute approximately 30 percent of the total increase in consumer prices to the decline in the external value of the dollar. In another study of the period from November 1972 through August 1973, economists William Nordhaus and John Shoven estimated that the decline in the external value of the dollar was responsible for 17 to 20 percent of the rise in wholesale prices that occurred during this period.[6]

These estimates of the inflationary impact of exchange rate changes,

---

[3] Berner, *et al.*, *ibid.*, p. 31.

[4] Sung Y. Kwack, "The Effect of Foreign Inflation on Domestic Prices and the Relative Import Prices of Exchange Rate Changes," to be published in *The Effect of Exchange Rate Adjustments*, edited by P. Clark, D. Logue, and R. Sweeny, p. 15.

[5] Sung Y. Kwack, "Price Linkage in An Interdependent World Economy: Price Responses to Exchange Rate and Activity Changes," Paper prepared for the National Bureau of Economic Research Conference on Research in Income and Wealth, "Price Behavior: 1965–1974," Washington, D.C., November 1974, p. 28.

[6] William Nordhaus and John Shoven, "Inflation 1973: The Year of Infamy," *Challenge*, May–June 1974, p. 18.

which differ in the time periods covered and are consequently not wholly comparable, indicate that from approximately 15 to 30 percent of the price increases that have occurred in recent years can be attributed to the fall in the external value of the dollar. While currency devaluation or depreciation always tends to have the inflationary consequences described above, such exchange rate adjustments are essential to eliminate persistent balance-of-payments deficits. A trade deficit, which the United States ran in 1971 and 1972, means that a country is consuming goods produced abroad in excess of its own sales of goods to foreigners. Unless a trade deficit is financed by earnings from previous foreign investments or by capital inflows, conditions must change to eliminate the deficit. Since the United States has typically been a capital exporter, the payments situation of the United States in the early 1970s was not sustainable. Our utilization of goods and services had to be reduced in order to permit export growth and curtail imports. Dollar devaluation and depreciation brought about the price changes necessary to effect a shift in the U.S. balance of payments from deficit to surplus. The inflationary and expansionary impact of these price changes could have been offset, at least in part, by a shift to less expansive monetary or fiscal policies than actually were followed, especially in late 1972. To end U.S. payments deficits, a reallocation of productive resources and a shift in domestic spending patterns was necessary. The only market mechanism for bringing about these changes was to alter exchange rates.

World Commodity Price Movements

The analysis of external sources of inflation done for the Joint Economic Committee by the Federal Reserve Board also included an estimate of the inflationary consequences in the United States of increases in the cost of petroleum, agricultural products, metals, and other basic commodities. This study estimated that 24 percent of the rise in the personal consumption deflator that occurred between mid-1971 and the second quarter of 1974 could be attributed to the impact of higher world commodity prices.[7] This estimate cannot simply be added to the 15 percent rise in prices attributed in the same study to dollar devaluation and depreciation because the economic conditions which led to the commodity price changes were themselves in part the result of the exchange rate changes. One can conclude from the Federal Reserve Board's study, however, that no more than approximately 40 percent of the increase in the personal consumption deflator from mid-1971 to mid-1974 was the result of the fall in the external value of the dollar and exceptional commodity price increases.

Any attempt to estimate what would have happened to the economy under different circumstances must be accepted with caution. However, the general conclusion that emerges from the estimates discussed above is that something less than one-half of the inflation that has occurred in the United States from mid-1971 to mid-1974 can be attributed to external origins. The remainder must have been caused by sources originating in the United States, either excess demand, cost-

---

[7] Berner, *et al.*, *op. cit.*, p. 32.

push forces or administered price increases resulting from concentrations of market power in the hand of producers or suppliers of inputs essential to production.

Prospective External Factors Affecting Inflation

No prospective international economic developments loom on the horizon that could produce the kind of rise in prices that the United States has experienced since 1971. Exchange rates are far closer to an equilibrium level than they were. No substantial further increase in oil prices is expected. The cost of most metals is headed downward. Although sugar prices have recently hit new peaks, any further sizable increase is unlikely. The outlook for grain and oil seed prices will be largely dependent upon the size of crops in the United States and the Soviet Union next year. Food prices may well continue to rise further, but these gains are likely to be offset in large part by decreases in the cost of other commodities. Thus, the most immediate source of inflation in the United States and other industrial countries is likely to be cost-push pressure from workers trying to recoup the loss of real income experienced in recent years.

C. Administered Pricing

It has long been recognized that the pricing and wage-setting power of certain producers and unions comprises an inflationary force largely independent of market conditions and macroeconomic policy.

Leaders of the large corporations in the concentrated national industries usually can count on other firms in the sector to respond cooperatively to initiatives increasing prices. Joint price boosts are usually in the short-term commercial interest of all, because the demand for any major sector's output is relatively inelastic. In concentrated industries, unlike industries with more competitors, no major producer can successfully expand his market share by underpricing the rest, because an attempt to do so would promptly bring everybody's prices back down. For the same reasons, firms in concentrated industries show great resistance to downward price adjustments during weak markets.

Some unions, likewise, can force wages out of line with the rest of the economy through tight control over the supply of workers. For example, this power seems especially strong in the construction trades.

The exercise of private market power was held in check to a large extent during the period of price and wage controls. Since the expiration of controls, however, exceptionally large price increases have been imposed in several concentrated industries, even though the controls system allowed the pass-through of most increases in production costs. Automobiles, steel, aluminum and chemicals—all sectors dominated by three or four firms—have raised prices by 25 percent or more during 1974.[8]

[8] Not all of the increase in automobile prices is reflected in the consumer or wholesale price index, both of which are adjusted to reflect automobile quality changes.

These actions have given a powerful new thrust to inflation. Construction wage settlements concluded during the third quarter of 1974 provide for an average first year wage increase of 16 percent, giving an unwelcome new lift to the structure of costs and prices in that industry.

There follows a brief discussion of the actions of the automobile and steel industries—two concentrated sectors with the largest price boosts in 1974. The construction industry is treated in considerable detail in Chapter IV.

The automobile sector has experienced the worst sales record in model years 1974 and 1975 of any time in well over a decade, yet during this period it has raised prices faster than ever before. With demand down, price controls were lifted in early 1974 under an agreement supposed to limit any increases and to see that they were not levied disproportionately on the popular, compact cars. The removal of controls, however, gave the industry its first opportunity to adjust to the 20 to 30 percent rise in the U.S. prices of competing foreign cars resulting from the dollar devaluations. Despite sluggish sales, heavy inventories and production cutbacks, therefore, prices were marked up sharply in several jumps, including the extraordinary boost in prices for new models introduced in September 1974. List price increases since a year ago average about $800 per car. These boosts included the passthrough of sizable labor and materials cost increases and some charges for government-mandated equipment. However, they also included charges for accessories made "standard" for the first time and sizably increased mark-ups.

Instead of competing prices down during this slump, therefore, the auto companies seem to have competed them up. Apparently industry leaders concluded that purchases deferred in 1973 and early 1974 would have to be made shortly, and they moved in concert to reap high profits on these sales. But the widely publicized price move, combined with a sharp decline in general consumer confidence, seems to have alienated many car buyers. The dropoff in sales is in fact so persistent and severe that it has become a major factor in deepening the current recession.

The radical price action taken by U.S. automakers has closed the price advantage over foreign cars gained through the large dollar devaluations. The result is shown in recent increases in sales of imported cars, which again are enlarging their share of today's price and energy-sensitive market.

Including the increases just announced, steel prices have now been boosted by 50 percent in the past year; aluminum has gone up equally fast. The big surge came in May and June after the expiration of price controls. Industry representatives contend that these increases were imposed mainly to cover cost increases incurred since price controls were instituted in 1971, but also partly to increase retained earnings needed for investment purposes. In any event, combined with record sales, these prices have carried profits to unprecedented levels of return on investment.

Recent increases have brought U.S. steel prices up to the level of foreign prices, despite the two dollar devaluations of the past 3½ years. This in itself is not surprising. If the past is any guide, however, these new high prices will be very sticky under the downward pressures of the recession. The international steel industry, on the contrary, engages in aggressive price competition for the export customers on which each firm depends for existence. It is therefore more competitive in nature than its U.S. counterpart, which confines itself largely to its relatively insulated home market. International prices already are falling sharply due to slumping demand, and imports have risen markedly in the past few months.

Steel profits are very sensitive to the industry's utilization of capacity as well as to its prices. It might be hoped that the U.S. steel industry would capitalize on the correction of the dollar exchange rate to move energetically into export markets. This would offer it an opportunity to maintain higher capacity utilization and profitability, especially during recessions. Unless the industry is willing to reduce its prices during recessions, however, it will be no better able than in the past to compete in these markets and again will face persistent pressure from imports. Present signs in this regard are not especally hopeful. On the contrary, the industry already is seeking to protect its prices through new forms of barriers to lower-priced imports.

Autos and steel are merely two concentrated sectors which offer conspicuous recent examples of private pricing power. This power also exists in various other industries. The exercise of market power in ways not proscribed by existing antitrust laws has aggravated the inflation process markedly in 1974. Furthermore, excessive price and wage claims make action against recession harder to mount so long as their after-effects continue to pass through the economy.

Without greater restraint in 1975, either voluntary or compulsory, a wage-price spiral could ensue for several years, forcing austere economic policies accompanied by increasing social conflict, with no real gains for anyone.

D. An Evaluation of U.S. Experience With Income Policies

Prior to 1971, the United States had had no experience with the use of wage and price controls in peacetime. The price and wage guideposts employed during the early 1960s had provided one period of experience with the use of a fairly systematic and comprehensive voluntary incomes policy. This experience of the early 1960s plus the various types of controls employed between late 1971 and early 1974 provide only a limited base of experience from which to evaluate the future potential for price-incomes policies. Nonetheless, it is important that this experience be examined and that principles be formulated to guide future policy. This section summarizes the results of evaluations which have become available to date. Additional studies by a number of researchers are currently in process, and it is important that this type of evaluation continue to be pursued. In undertaking assessments of the impact of guideposts or controls it is, of course, essential to look not only at the rate of inflation that occurred while the policies were in force, but also at what the rate of inflation might have been without the incomes policies, given underlying economic circumstances and how these were being affected by other economic policies. In other words, what actually happened must be compared with an estimate of what might have happened during the same time period in the absence of the incomes policy.

Wage-Price Guideposts, 1962–66

Wage-price guideposts, first introduced in the 1962 Economic Report of the President, were intended to improve price stability by establishing voluntary standards for noninflationary wage and price behavior. Such standards were necessary, it was argued, because there were major segments of the economy where firms or employees had sufficient market power to influence wage and price decisions regardless of market forces of supply and demand. The guideposts were intended to prevent the abuse of such market power by mobilizing public opinion to bring such wage and price decisions more in line with what could be expected in competitive markets.

The guideposts used longrun trends of productivity as a rough guide to how wages and prices would behave in a smoothly functioning competitive economy. The general guide for noninflationary wage behavior was a rate of wage increase, including fringe benefits, equal to the trend rate of overall productivity. Noninflationary price behavior, on the other hand, called for a price reduction if industry's rate of productivity increase exceeded the trend for the economy as a whole, a price increase if an industry's productivity gains were below this trend, and stable prices if industry and economy-wide productivity increases were equal. These general rules were supplemented by modifications to allow for special circumstances in specific industries.

The introduction of guideposts in 1962 appears to have dampened developing inflationary forces in subsequent years. The Government announced a policy which sounded practical, indicated a concern about price stability, and subsequently acted to implement this policy with vigorous and well-publicized efforts to secure voluntary compliance.

The statistical evidence available on the impact of the guideposts on wage and price movements during the 1961–65 period provides some evidence that they slowed the rate of inflation. Wholesale industrial prices are estimated to have been dampened from 0.6 to 1.6 percentage points per year for the period from 1961 through 1965. Manufacturing wages for the same period were deflected downward about 0.8 percentage points per year. Thus, the combined wage and price effects of guideposts suggests that the overall inflation rate was substantially reduced.[9]

1966–71

It is important to note that the guideposts were employed during a period when the economy was operating far below its potential level of resource utilization. At the beginning of 1961, the economy was operating about 9 percent below its potential. Not until 1965 did output reach even the 97 percent of potential which has been referred to in an earlier section of this report as the lower limit of the "near-potential" zone in which sectoral price pressures are apt to emerge. In the judgment of this Committee, the guideposts were well designed to deal with the type of price increase which stems from lack of sufficient competi-

---

[9] For a thorough review of the evidence on the impact of guideposts see John Sheahan, *The Wage Price Guideposts*, Washington, D.C.: The Brookings Institution, 1967. (Chapter VII).

tion in concentrated industries even in periods of slack demand. As the experience of 1966–68 illustrates, they were less well suited for coping with the sectoral price pressures which emerge when the economy is pushed to further rapid expansion at a time when it is already near full employment.

As discussed in an earlier section, overly expansive fiscal policy was a basic source of inflation in the 1966–68 period. Voluntary guideposts could not contain price increases which stemmed from large new demands placed on industries unprepared to expand production quickly nor the wage pressures stemming from rising prices and tight labor markets. The guidepost policy was abandoned in 1967 in favor of a less systematic policy of attempted voluntary persuasion frequently referred to as "jawboning." This policy may have had some salutary effect in particular situations but was far from an adequate tool to deal comprehensively with growing inflationary pressures.

Faced with the type of demand pressures which emerged in 1966, there were two policy choices for dealing successfully with inflation. One would have been a significantly more restrictive fiscal policy, achieved either through a tax increase or sharply reduced Federal spending. The other would have been a comprehensive program of wage-price controls accompanied by rationing of goods or services in short supply. It is widely agreed that neither of these policies would have been politically acceptable at that time because of a basic division of sentiment within the country concerning the Administration's foreign policy. Those who disapproved fundamentally of U.S. involvement in Vietnam were quite naturally unwilling to support the policies which would have made it possible to finance this involvement in a noninflationary fashion. In this basic sense, the economic policy mistakes of the 1966–68 period stemmed from political division within the country rather than from any lack of technical understanding of the steps which must be taken to avoid inflation at a time when government spending is rising sharply.

By 1969 the nature of the inflationary problem was changing. Agreement was widespread both that U.S. involvement in Southeast Asia should be reduced and that the overall growth rate of output should be slowed. This was a situation in which a skillfully conducted voluntary incomes policy in conjunction with moderately restrictive fiscal and monetary policy might very well have been useful in containing the cost-push spiral which was emerging. Such a policy was, however, philosophically unacceptable to the new Administration, which instead chose to pursue quite restrictive fiscal and monetary policies over an extended period. While these policies were indeed effective in reducing real output—doubtless going beyond the intent of policymakers in this regard—the impact on prices was disappointing. The failure to achieve the hoped-for reduction in the rate of price increases was in fact judged by policymakers to be so serious as to necessitate the complete reversal of policy which was embodied in the price-wage freeze of August 1971 and the subsequent period of controls.

Wage and Price Controls

A program of direct wage and price controls was a component of the New Economic Policy launched in August 1971. The stated purpose of the controls was to avoid the inflationary consequences which it was feared would otherwise be associated with the expansionary policies also introduced at that time. It is not easy to evaluate the degree of success in this objective because it is not possible to know with certainty what course inflation would have followed in the absence of controls. As a result, controversy continues over whether controls reduced the rate of inflation, whether the reduction was permanent and what economic costs accompanied these controls.

Notwithstanding the continuing controversy, the preponderance of available evidence suggests that Phase II of the control program, which was in effect from November 1971 through the end of 1972, may on the average have reduced the rate of price and wage increase by somewhere between 1 and 2 percentage points per year. This evidence is taken from econometric studies that compare the actual rate of inflation with the controls to an estimated rate of inflation without the controls. The question of whether the various phases of controls were equally successful on the wage and the price side has also been a source of controversy. Several careful studies suggest that during Phase II the impact on prices was greater than the impact on wages, but that during Phase III, in effect from January to June 1973 wages were controlled considerably more effectively than prices. Few studies are as yet available of the Phase IV control program, which was in effect through last April.

Against the estimated benefits one must consider the direct and indirect costs of the controls program. The direct costs consist of the administration necessary for the Government and private sector to operate controls. The outlays of the Federal Government for implementing controls were $108 million for Phase II and $78 million for Phase III.[10] Estimates on the administrative costs to business for complying with the controls regulation cover a range of from $0.7 to $2 billion, with the more realistic estimates at the lower end of the scale.[11]

The indirect costs of the control program in the form of decreased economic efficiency are much more difficult to estimate. It has been vigorously alleged that controls caused widespread shortages and distorted resource allocation by perverting import-export patterns, causing products to be withheld from the markets, and discouraging capital investment. The National Association of Manufacturers is perhaps typical of this point of view, concluding that "controls have caused tremendous disruptions and dislocations; controls have not only failed to contain inflation, they helped to fuel its fires." [12]

Many of the distortions which appeared in 1972 and subsequently can be explained by factors other than the controls, however. Because of extraordinary domestic and foreign demand pressures, the lumber industry did show some evidence of product alteration to evade controls, curtailed production, and diversion of supplies to export markets. There were also some shortages of cattle hides during the initial freeze, as base prices were set unrealistically low in

[10] Statement of John Dunlop, Executive Director, Cost of Living Council, before the Senate Committee on Banking, Housing and Urban Affairs, Feb. 6, 1974, app. O.

[11] Ibid., app. P.

[12] National Association of Manufacturers Survey of Wage and Price Controls, Dec. 21, 1973, p. 37.

view of the Argentine embargo of hides. Apart from these special situations, it does not appear that controls in the first year interfered seriously with the price adjustments necessary to maintain efficiency and avoid shortages.[13] Nor is there any convincing evidence that controls seriously discouraged capital investment by reducing profit and income flows. There are two reasons why one would not even expect this to be the case. In the first place, capital expenditures are made on the basis of a comprehensive look at the long-term market outlook. Secondly, corporate profits improved substantially in the controls period, rising in absolute terms at a 15 percent annual rate, and as a share of national income from 11.8 percent in 1970 to 13.6 percent in 1973. Looking directly at the pattern of business fixed investment over this same period, in fact, one can see it paralleled profit performance by rising 10 percent in both 1972 and 1973, following 2 years of decline.

It is true that shortages and economic distortions accelerated in 1973, as the control program shifted to Phase III. An especially disruptive set of control actions was the imposition of a price ceiling on red meats on March 29, 1973, and a continuation of a ceiling on beef prices after the second price freeze was removed for other food items. Tho meat ceiling created substantial shortages as meat producers curtailed marketings sharply. Meat processors also cut back their operations, and in some cases closed, as the unrealistically low ceilings reduced their profit margins. Prices rose to artificial levels as a result of decreased supplies. After the ceiling was removed in September 1973 meat supplies expanded and prices dropped sharply. Meat prices did not remain low, however, in considerable part because of the disruptions and instability introduced into the meat industry by the control actions taken in 1973.[14]

In addition to the problems in the meat area, shortages or distortions in other areas may have been caused by controls. Perhaps the best illustration of controls causing a shift in export patterns is the copper scrap market where alloyed copper scrap imports more than doubled between May and July of 1973.[15] Similar difficulties were encountered in the fertilizer industry as firms found it more profitable to sell fertilizer abroad. Shortages also occurred because cost passthrough rules for controlling price increases tended to discourage production of those items which had unfavorable profit margins. Steel shortages of reinforcing bars, mining roof bolts, and baling wire are examples, while additional examples can be found in the petrochemical area.

While some shortages and inefficiencies were obviously due to controls, controls do not appear to have been the underlying cause of shortages in most cases.[16] Food shortages were primarily the result of a combination of mistakes in U.S. agricultural policies and a decrease in the world production of grain. The acceleration of world economic growth in 1973 also placed demands on the U.S. economy that aggravated shortages in particular areas. In short, most of the shortages experi-

[13] Marvin Kosters and Dawson Ahalt, "Controls and Inflation: An Overview." Paper prepared for the National Bureau of Economic Research Conference on Research in Income and Wealth, Washington, D.C. November 1974, pp. 56-62.

[14] For a similar view see Norman Kosters and Dawson Ahalt, op. cit.

[15] Statement of John Dunlop before the Senate Committee on Banking, Housing, and Urban Affairs, Feb. 6, 1974, app. Q.

[16] Koster et al., op. cit., pp. 62–66.

enced during the controls period were due to underlying supply and demand conditions in particular markets.

Although there were some costs and economic inefficiencies associated with the price and wage controls, the benefits in the form of reduced inflation and increased economic growth more than offset the costs. This was more true of Phase II than Phase III, which was not very successful on the price side.

E. The Economic Impact of Environmental Regulations

In the past year, there have been many statements by top Administration officials and leading business executives which suggest that environmental regulations should be relaxed. These individuals maintain that existing environmental standards have a significant adverse impact on economic or energy supply objectives. Others have countered that the adverse effect of present environmental regulations is vastly overstated. In order to evaluate this question, the Joint Economic Committee conducted three days of hearings on November 19, 21 and 22, 1974, and requested extensive staff work on the economic impact of environmental regulations. The most recent data on costs and benefits of environmental regulations' compliance and other information needed to evaluate the economic impact of present environmental standards was collected and analyzed.

In these hearings the most significant conclusion about the price impact of environmental regulations was submitted by the Council on Environmental Quality (CEQ). They reported on four independent estimates of the impact of environmentally related expenditures on the rate of inflation. One estimate was prepared by the CEQ staff and three by outside consultants using large scale macroeconomic models. Each of the estimates yielded essentially the same conclusion, expressed as follows in the CEQ statement submitted for the hearing: "Pollution abatement expenditures are not having and will not have a significant impact upon the rate of inflation." The actual estimate by CEQ was that the sum total of all environmental expenditures has contributed approximately 0.50 percent of the nearly 20 percent annual Wholesale Price Index increase over the past year. As for the near future, such expenditures are expected to add about 0.30 percent annually to the Consumer Price Index from 1973 to 1978. Over the entire decade (1973–82) there will be no discernible effect on the average price level.

It is important to note the negligible price effect over the decade since the actual dollar amount of expected environmental expenditures appears tremendous. The most recent estimate is that the incremental capital and operating costs ("incremental" refers to those expenditures specifically mandated by Federal standards) over the decade will be approximately $195 billion (in 1973 dollars). However, this number represents only about 0.7 percent of the expected total gross national product. The percentage of GNP that is devoted to expenditures for environmental control is expected to peak at approximately 1.7 percent in 1976 and decline thereafter.

Considerable concern has also been expressed that large investments in pollution control equipment may displace investments in other productive capacity. Private pollution control investments in 1974 will be about 3 percent of gross private domestic investment and 6 percent of all plant and equipment investments. These percentages are expected to remain approximately constant through 1976 and fall thereafter. Although these percentages represent a total of $6 billion a year to meet the 1976 air and water standards, an analysis by Chase Econometrics has concluded that the displacement of private investment would occur predominantly in areas other than plant and equipment expenditures.[17] This conclusion was supported by a recent Department of Commerce survey.[18] This study concluded that only 2 percent of the firms surveyed had reduced their plant and equipment expenditures as a result of the burden imposed by pollution control measures. A representative of the oil industry further confirmed this general conclusion at the environmental hearings by stating that "No capital project has been abandoned exclusively because of specific environmental regulations." [19]

It must be emphasized at this point, however, that these relatively small aggregate figures do imply much larger effects for certain industries. Total pollution abatement expenditures and these expenditures as a percentage of total capital expenditures are quite high in certain industries (Table 1).

Large expenditures and percentage figures, particularly in such capacity-constrained industries as steel, paper and chemicals, indicate that some industries are significantly affected. In these cases, where high pollution expenditures are combined with high capital expenditures for productive capacity, a careful analysis should be done of the costs and benefits on a case-by-case basis.

While the aggregate inflationary implications of environmental regulations may not be that serious, it is equally important to consider their effect on employment and real output, particularly in a recessionary period. Recent studies have examined the extent to which expenditures for pollution control discourage expenditures for new plant and equipment, cause construction delays or necessitate plant closings and layoffs. These studies suggest that although certain industries have been significantly affected by large outlays for pollution control, aggregate output is expected to be stimulated in the next few years by environmental expenditures.

Before examining these future stimulative effects, past experience should be carefully examined. Since January 1971, there have been 69 industrial plant closings associated with environmental regulations, involving about 12,000 jobs. However, Federal Government enforcement action was responsible for only 14 of the 69 closings. As an example, a representative of the oil industry testified at the Committee's recent hearings [20] that there have been no plant closings in that industry that were caused by the enforcement of environmental regulations.

---

[17] Chase Econometric Associates, Inc., prepared for EPA and CEQ, to be published in early 1975; made available through CEQ.

[18] John Cremeans, "Capital Expenditures by Business for Air and Water Pollution Abatement, 1973 and Planned 1974," *Survey of Current Business*, Vol. 59, July 1974, pp. 58–64.

[19] Statement of P. N. Gammelgard, vice president, American Petroleum Institute, "Economic Impact of Environmental Regulations," Hearings, Joint Economic Committee, Congress of the United States, Nov. 21, 1974.

[20] Ibid.

TABLE 1.—POLLUTION CONTROL EXPENDITURES OF INDUSTRIES

[Dollar amounts and as a percent of capital spending]

Industry	Actual, 1973		Planned 1977	
	Dollar amount (millions)	Percent of capital spending	Dollar amount (millions)	Percent of capital spending
Iron and steel	$206	11.7	$488	20.1
Nonferrous metals	301	18.0	213	7.9
Electricity machinery	105	3.7	111	3.1
Machinery	145	4.2	251	5.1
Autos, trucks, and parts	233	11.2	244	10.0
Aerospace	23	10.2	19	2.7
Other transportation equipment	9	4.3	20	6.1
Fabricated metals	136	7.2	171	7.3
Instruments	31	2.9	96	5.4
Stone, clay, and glass	134	9.0	163	8.8
Other durables	131	6.5	176	8.5
Total durables	1,454	7.6	1,952	7.8
Chemicals	455	10.2	609	9.8
Paper	424	22.8	373	15.8
Rubber	97	6.2	72	4.2
Petroleum	692	12.7	852	11.2
Food and beverages	194	6.3	269	6.9
Textiles	27	3.5	76	8.7
Other nondurables	48	3.1	64	4.8
Total nondurables	1,937	10.3	2,315	9.6
All manufacturing	3,391	8.9	4,267	8.7
Mining	207	7.6	165	4.3
Railroads	44	2.2	93	3.0
Airlines	224	9.3	121	16.4
Other transportation	34	2.0	66	3.5
Communications	256	2.0	506	3.0
Electric utilities	1,212	7.6	3,841	13.2
Gas utilities	41	1.5	92	2.3
Commercial [1]	278	1.3	168	.7
All business	5,687	5.7	9,319	7.0

Source: McGraw-Hill, 7th annual McGraw-Hill Survey of Pollution Control Expenditures, May 1974.

[1] Figures based on large chain, mail order, and department stores, insurance companies, banks, and other commercial businesses.

The aggregate impact of these plant closings will be counterbalanced by the stimulative effect of environmental expenditures. A recent Chase Econometrics study showed that GNP will be somewhat higher in each year up to 1977 due to pollution abatement expenditures. (Table 2) This stimulative effect will be countered by a slightly depressive effect after 1977, so that the net effect on GNP for the remainder of the decade is minimal.

In the short run, however, expenditures for pollution abatement are likely to contribute much-needed stimulus to the declining economy. The Bureau of Labor Statistics has estimated that more than 50,000 workers are presently employed in federally financed sewage treatment projects. Chase Econometrics has estimated that the unemployment rate for 1975 would be 0.4 percent higher if pollution abatement expenditures were discontinued. Because of the present recession, human and physical capital are and will continue for some time to be underutilized. Expenditures for pollution control are a productive and sensible use of these idle resources.

TABLE 2.—ESTIMATED IMPACT OF POLLUTION CONTROL EXPENDITURES ON NEW ECONOMIC VARIABLES, 1974–75

	1974	1975	1976	1977	1978	1979	1980	1981	1982
Gross national product, current dollars:									
Baseline projection	1,405.1	1,557.9	1,738.9	1,931.2	2,149.6	2,354.0	2,555.8	2,762.7	3,008.9
With pollution control costs	1,413.8	1,586.8	1,779.1	1,962.0	2,157.7	2,344.5	2,550.7	2,775.8	3,030.9
Percent difference	.62	1.86	2.51	1.59	.38	−.40	−.20	.47	.73
Gross national product, 1973 dollars:									
Baseline projection	1,279.5	1,303.1	1,364.0	1,455.2	1,514.0	1,570.6	1,619.1	1,664.3	1,726.2
With pollution control costs	1,286.9	1,323.4	1,379.0	1,432.5	1,491.8	1,539.3	1,594.9	1,654.7	1,723.4
Percent difference	.58	1.56	1.10	−.19	−1.47	−1.99	−1.49	−.58	−.16
Implicit GNP deflator, 1973 = 100:									
Baseline projection	109.8	119.5	127.5	134.5	141.9	149.8	157.8	166.0	174.3
With pollution control costs	109.8	119.9	129.0	136.9	144.6	152.3	159.9	167.7	175.8
Percent difference	0	.33	1.18	1.78	1.90	1.67	1.33	1.02	.86
Consumer Price Index, 1973 = 100:									
Baseline projection	110.9	120.5	128.6	136.4	144.6	152.9	161.3	169.4	178.68
With pollution control costs	111.0	121.0	129.4	138.0	146.4	154.6	162.5	170.6	179.22
Percent difference	.09	.41	.62	1.17	1.24	1.11	.74	.41	.0
Wholesale Price Index, 1973 = 100:									
Baseline projection	121.0	135.5	142.2	148.7	155.8	162.7	169.1	175.2	181.5
With pollution control costs	121.1	136.8	146.2	153.5	160.5	167.0	173.2	179.4	185.8
Percent difference	.08	.96	2.91	3.23	3.02	2.64	2.42	2.40	2.37
Unemployment rate, percent:									
Baseline projection	5.2	5.5	5.3	4.8	4.4	4.4	4.5	4.7	4.6
With pollution control costs	5.1	5.1	5.0	4.8	4.6	4.8	4.8	4.8	4.7
Percent difference	−1.92	−7.27	−5.66	.60	4.55	9.09	6.67	2.13	2.17
Fixed investment in producers durable equipment, constant dollars:									
Baseline projection	91.4	95.7	102.8	109.3	116.7	121.8	126.4	130.4	135.6
With pollution control costs	93.8	102.4	107.4	110.2	114.4	117.7	123.0	129.0	135.4
Percent difference	2.63	7.00	4.47	.82	−1.97	−3.37	−2.69	−1.07	−.3

Source: Chase Econometric Associates, Inc., as presented in Joint Economic Committee Hearings, Nov. 22, 1974.

A final impact which must be examined is the extent to which compliance with environmental regulations decreases domestic energy supplies. The interaction of environmental regulations and the development and use of domestic energy resources is extremely complex and cannot be discussed in full in this report. Sizable capital investments for pollution control have been made in the energy field (particularly by the electric utility and petroleum refining industries) and environmental requirements have clearly increased the demand for certain fuels and decreased the potential supply of others. However, testimony presented by the Environmental Protection Agency and the Federal Energy Administration suggested that there had been no serious delays in energy projects directly attributable to environmental regulations. Rather these delays have been attributable to numerous court suits (often brought by private organizations) and local opposition. The Project Independence report supports this conclusion by pointing out that equipment shortages (particularly draglines and oil drilling rigs) limit expansion in the near term much more significantly than do environmental considerations.

The National Environmental Protection Act should be amended to require the Environmental Protection Agency to undertake a detailed economic impact analysis for each major new environmental regulation. The analysis should assess the regulation's short-run and long-run price, output and employment effects. The results of this analysis should be thoroughly reviewed during EPA's consideration of the new regulation and should be made available to the public prior to consideration. Such analyses should also be submitted to Congress whenever major pieces of environmental policy legislation are being considered.

Expenditures for environmental protection also contribute to more efficient utilization of resources. Producers should incorporate costs associated with environmental protection into the price of their products. Until recently, companies have used the air, water and surrounding land as free goods, dumping wastes at no cost to the company. However, there was a cost borne by society, which became increasingly severe. Finally environmental regulations had to be promulgated to force industries to account for the social costs they were inflicting. However, these costs to clean up the environment are really a cost of producing the product and therefore should be "internalized" into the product price and ultimately borne by the consumers of the product.

All pollution control costs should be internalized so that the price of the product to the consumer fully reflects the social costs of its production.

Environmental investment will directly affect the cost of some products. However, the argument that pollution control costs are more inflationary than other demands on scarce resources, such as expenditures for defense or space exploration, is not correct. Excess demand may require a general, economy-wide reduction in expenditures but there is no substantive reason that environmental expenditures should be the first ones cut, particularly in light of the convincing evidence that what they achieve (a cleaner environment) is worth a great deal more, even in purely monetary terms, than the cost of achieving it. Environmental investments are certainly not non-productive unless one feels that improvement of the quality of life is nonproductive.

Estimates of overall costs and benefits of environmental protection are admittedly rough. The fundamental type of cost-benefit estimate, which compares the direct pollution control costs and the direct benefits (reduced damages) gained from the expenditures, clearly indicates that expenditures for environmental protection are justified. Costs, which were $6.3 billion in 1973, are estimated to average $19.4 billion annually over the next ten years. Environmental Protection Agency estimates for 1970 show annual benefits from controlling air pollution of $12 billion and from controlling water pollution of $13 billion. A more recent study completed in 1974 by the National Academy of Sciences and the National Academy of Engineering[21] concluded that the tangible benefits from cleaner air alone are $15–$20 billion per year; a figure which did not even take into account intangible aesthetic and ecological values and risk reduction. Furthermore, research done by EPA showed that measurable damages from particulates and sulfur oxide ($11.2 billion annually) are more than twice the necessary annual control expenditures. Thus, if these three estimates are at all accurate, the benefits from controlling pollution have exceeded and clearly will continue to exceed the costs. Even if the price impact of these expenditures were far greater than it is, the public benefits stemming from these expenditures would still make them a good investment.

A more sophisticated analysis should take into account the output, price and employment effects of environmental expenditures. Unfortunately, it would be an extremely difficult task to quantify these effects in dollars terms so that they could be added to the previous analysis. However, the results in Table 2 allow us to assess the general dimensions and directions of these other effects. The effect on total output, over the 1973–82 decade is minimal. The addition to inflationary pressures, which should legitimately be added to the resource costs, has been and will continue to be quite small, as the cumulative 1982 GNP deflator and Consumer Price indices indicate. On the other hand, the effect on employment should be added as a benefit because additional employment will be generated in the next few years. Thus, the simple dollar-for-dollar benefit-cost comparison becomes even more favorable when these broader price and employment effects are considered.

Based on a review of all of the above evidence, the Committee supports the following recommendation:

There should be no general relaxation of environmental standards for the sake of reducing inflationary pressures

[21] "Air Quality and Automobile Emission Control," prepared by National Academy of Sciences and the National Academy of Engineering for Senate Committee on Public Works, U.S. Congress, September 1974.

because: (1) The benefits of this investment clearly exceed the costs, (2) their contribution to inflation has been and will continue to be minimal, (3) delays will only increase the ultimate cost of environmental cleanup, and (4) the stimulative effect of these expenditures on employment in the near future will be beneficial to the economy.

Relaxation of any individual standard should occur only when economic analysis has clearly indicated an unfavorable cost-benefit ratio or severely adverse economic consequences.

III. THE IMPACT OF INFLATION

A. On Individuals and Families

Aggregate Changes in Real Income.—By every measure of real income, that is, money income adjusted for inflation, Americans have suffered a decline in their purchasing power during the past year. Table 1 indicates that from third quarter 1973 to third quarter 1974, most measures of real income declined more than 3 percent. Real hourly earnings, the best measure of the average production worker's wage rate, declined 3.1 percent. Real weekly earnings, which also reflect the decline in hours worked, fell even more, by 4.3 percent.

Accompanying the high rate of inflation this past year has been a steady rise in dollar incomes. As a result, taxpayers have been pushed into higher tax brackets. The increase in effective tax rates further reduced real income. For example, a family of four earning $4,300 in 1970 would have paid no taxes but would now pay $159 in taxes just from receiving cost of living increases. This means that only 86 percent of the income increase would remain with the family after taxes.

After adjusting inflated dollar incomes for rising prices and for higher tax burdens, disposable income has fallen sharply. As Table 2 shows, the decline in real disposable income during the current recession is larger, in fact almost twice as large, as in any other postwar recession. This sharp decline in purchasing power may portend an even greater than normal drag on the economy and may well dampen a recovery expected now to begin toward the end of 1975.

TABLE 1.—ANNUAL RATES OF CHANGE FOR SELECTED MEASURES OF INCOME AND EARNINGS [1]

	1965–69	1970	1971	1972	1973
Disposable income—1958 prices	4.0	3.1	4.5	6.9	3.8
Per capita disposable income—1958 prices	2.8	2.0	3.5	6.0	3.1
Real adjusted hourly earnings—private non-farm	1.5	.9	2.4	3.6	−1.6
Real gross weekly earnings—private non-farm	.7	−1.8	3.5	3.4	−1.7
Real spendable weekly earnings [3]	−.4	−1.3	3.5	4.1	−3.1
Real compensation per manhour, total private	2.9	1.1	2.8	3.5	−.2
	1974 [2]	**1973: IV**	**1974: I**	**1974: II**	**1974: III**
Disposable income—1958 prices	−3.0	0.7	−7.9	−4.4	−0.4
Per capita disposable income—1958 prices	−3.7	0	−8.5	−5.0	−1.1
Real adjusted hourly earnings—private non-farm	−3.1	−2.7	−6.7	−1.4	−1.4
Real gross weekly earnings—private non-farm	−4.3	−4.0	−8.6	−2.8	−.6
Real spendable weekly earnings [3]	−5.0	−4.6	−8.9	−3.7	−2.9
Real compensation per manhour, total private	−1.7	−1.3	−4.5	1.6	−2.5

[1] Percent changes for annual data are based on 4 quarter changes, from 4th quarter to 4th quarter; percent changes for quarterly data are based on quarterly averages expressed at compound annual rates.
[2] Percent changes from 3d quarter, 1973 to 3d quarter, 1974, the most recent quarter for which data were available at press time.
[3] After-tax earnings expressed in 1967 dollars for a worker with 3 dependents.

Source: Bureau of Labor Statistics, Department of Labor, and Bureau of Economic Analysis, Department of Commerce.

TABLE 2.—CHANGES IN INCOME AND TAX BURDENS DURING POSTWAR RECESSIONS[1]

Recesssion years	Percent decline in real disposal income[1]	Taxes as a percent of personal income: Including Government transfer payments		Excluding Government transfer payments	
		Peak	Trough	Peak	Trough
1948-49	−1.9	10.4	9.5	11.0	10.1
1953-54	−.7	14.2	13.2	14.9	14.0
1957-58	−1.3	13.8	13.4	14.7	14.4
1960-61	−.7	14.6	14.5	15.7	15.8
1969-70	−.8	18.1	16.9	19.8	18.8
1973-74	−3.1	17.8	18.4	19.9	20.8

[1] Percent changes based on those quarters during which peak and trough months occurred, as defined by the National Bureau of Economic Research.

Source: Bureau of Economic Analysis, Department of Commerce.

Why has real disposable income fallen so severely in the last year, compared to other recession years? First, taxes as a percent of total personal income have risen during this recession, while in every other recession the tax burden was reduced, either through tax cuts or because taxpayers moved into lower tax brackets as their incomes fell. In three of the past five postwar recessions, the tax burden fell by almost a full percentage point (taxes as a percent of personal income excluding government transfers), thereby providing stimulus to the economy. During the current period, however, the exact opposite has happened. In the third quarter of 1974, the tax burden was almost a percentage point higher than it was at the economy's peak, a year ago. This increase reinforces the decline in real income which we are now experiencing, rather than cushioning it.

Critics of this argument might suggest that although the tax burden is increasing on some persons, government transfer payments, including aid for families with dependent children, food stamps and supplemental security income, are increasing sharply enough to offset higher tax rates. Table 2 shows, however, that this is not true. Even when taxes are taken as a percent of personal income including transfers, the tax burden is increasing.

The Need for Tax Relief.—The impact of sharp declines in real disposable income during the past year has been particularly severe on low and lower middle income families. In addition to higher personal income taxes, the regressive social security tax places a greater burden on lower income families because it is levied only on the first $13,200 of income. These families have seen the prices of goods which constitute a large share of their budgets rise more sharply than other goods. They have less discretionary income, fewer savings, and are therefore less able to maintain their standard of living in the face of rapid inflation and higher taxes.

A tax cut aimed at lower income taxpayers would offset partially the drag on the economy from rapidly rising tax collections and could limit further declines in real output. In order to preserve the tax base in the long run, such a tax cut should be followed at an appropriate later date by tax increases such as elimination of the oil depletion allowance, a stronger minimum tax, abolition of the Domestic International Sales Corporation (DISC) provisions of the tax code, and some form of energy conservation tax. However, to redress part of the income loss suffered by lower income taxpayers, to limit further declines in real output, and to introduce progressivity into the tax system, tax relief to low and middle income Americans on the order of $10 billion is appropriate now. A tax reduction of this magnitude would maintain the personal tax burden at the level that prevailed at the start of the recession at the end of 1973, rather than allowing it to increase, as has been the case thus far in 1974.

This tax relief could be achieved in several ways: Two of these measures, the optional substitution of a tax credit for the personal exemption and an increase in the low income allowance would be generally preferable to the others, since the tax relief would be concentrated on those families with incomes approximately at or below the median. Possible means for achieving tax relief are:

(1) Taxpayers could be allowed, at their option, to substitute a credit of between $200 and $225 for each $750 personal exemption. The amount of the credit would depend on whether this form of tax relief were combined with others or whether it were the only measure. A $200 credit would reduce Federal revenues by approximately $6.5 billion (based on 1974 income levels), and would result in a net tax reduction for families with incomes up to $20,000. A $225 credit would reduce revenues by about $10 billion, and would provide tax relief for families with incomes up to $26,000. In either case, the adoption of an optional credit would not affect families with incomes below $5,000 who presently pay no tax. The only means of providing some relief from inflation for these families through the tax system would be a rebatable tax credit or a reduction in the social security tax rate. The income range within which families would benefit would vary somewhat with family size. Small families would benefit at levels below $5,000 and large families would benefit at income levels above $20,000 or $26,000, depending on the size of the credit.

Recent studies demonstrate that the personal tax burden—the personal income tax combined with the payroll tax—is roughly proportional, claiming about 25 percent of income for most income groups. Tax relief in the form of an optional credit would increase the progressivity of our tax system.

(2) The low-income allowance and the standard deduction could be increased. For illustrative purposes, an increase in the low-income allowance from $1,300 to $1,800, an increase in the standard deduction ceiling from $2,000 to $2,200 and an increase in the standard deduction rate from 15 to 20 percent would reduce revenues by about $3 billion. An increase in the low-income allowance would reduce or eliminate taxes for those individuals and families who are actually below the poverty line but whose inflated dollar incomes now subject them to the income tax.

(3) The personal exemption could be increased from $750 to $800 or $850. The revenue loss incurred from such an increase is approximately $1.8 billion at an $800-exemption level and $3.4 billion at an $850-exemption level. Although this form of tax relief has more broad based appeal and can be justified on the grounds that all taxpayers have moved into higher tax brackets as a result of inflation, it would benefit the higher income taxpayers the most. An increase in the

43-168 O - 74 - 4

exemption to $850, for example, would be less objectionable if it were combined with the introduction of an optional $200 credit. Otherwise, it would lessen rather than increase the progressivity of the tax system.

(4) The payroll tax rate (FICA) could be reduced for an 18-month period beginning January 1, 1975, from 5.85 percent on both employer and employee to 5.2 percent, the rate in effect in 1972. The main advantage of this proposal is that it would reduce the overall tax burden on those workers who pay little income tax because of their low income status, but who are nevertheless subject to the social security tax. Of all the tax changes being considered, it is the only one which would aid those families with incomes below $5,000. This measure would reduce revenues by $4 billion in fiscal 1975 if made effective as of January 1, 1975, and by $8 billion in fiscal 1976. While the tax reductions were in effect, fundamental reform of the social security system should be undertaken.

(5) Another tax credit option would be to substitute a personal tax credit for the present personal deductions. The credit, equal to 25 percent of the amount which under current law would be the total amount of personal deductions, would be subtracted from the final tax bill. With such a credit, every dollar of allowable personal deductions would be worth the same to every taxpayer regardless of his tax bracket, a definite improvement over the present situation in which a deduction of $100 is worth $70 to the wealthiest taxpayer but only $14 to the lowest bracket taxpayer. This tax credit would reduce taxes for all single taxpayers earning less than $18,000 and married couples filing joint returns with income under $27,000.

In order to reduce the drag on the economy from inflation-swollen tax collections and to restore purchasing power to lower income families and individuals, personal taxes should be reduced by $10 to $12 billion annually.

The Impact of Rising Unemployment Levels.—The fall in real income described above is causing distress and hardship for a great many Americans. Consumption of food, fuel, and shelter, has been severely curtailed for lower income individuals and families. These problems, serious though they may be, do not compare with the extreme hardships that individuals suffer when they (or their family heads) become unemployed and remain so for an extended period.

In the past year, the unemployment rate has increased by 1.9 percentage points, from 4.6 to 6.5 percent. An additional 1.9 million persons have joined the unemployment ranks since October of last year, 71 percent of them through loss of their jobs. The remainder were new entrants or reentrants into the labor force. The steady upward drift of unemployment and its distribution among different groups since the middle of 1973 is shown in Table 3.

One subgroup that the BLS does not report on in its unemployment statistics is the poor, but it is common knowledge that in recession, as in inflation, the poor are the hardest hit. A brief discussion follows of the specific impacts that recession has on the poor.

The combined impact of increased unemployment and decreased labor force participation and number of hours of work falls dis-

TABLE 3.—UNEMPLOYMENT RATES AMONG MAJOR POPULATION GROUPS

	Quarterly averages					Monthly data	
	1973		1974				
	III	IV	I	II	III	October 1974	November 1974
Unemployment rates:							
All workers	4.7	4.7	5.2	5.1	5.5	6.0	6.5
Adult men	3.1	3.0	3.5	3.5	3.7	4.3	4.6
Adult women	4.8	4.7	5.1	5.0	5.4	5.6	6.6
Teenagers	14.3	14.3	15.3	15.1	16.1	16.9	17.3
White	4.2	4.2	4.7	4.7	5.0	5.4	5.8
Negro and other races	9.0	8.6	9.4	9.0	9.5	10.9	11.7
Household heads	2.7	2.8	3.0	3.1	3.2	3.7	3.9

Source: BLS, Employment Situation, November 1974 Bulletin.

proportionately on lower income groups. In recent years the percent of income loss suffered by poor, male-headed families due to economic contraction has been double that of higher income families. Statistics show that a white male head of a poor family is one and a half times as likely to become unemployed as a similar person whose family income is three times the poverty level.

Besides the immediate effect of unemployment—reduced income—there are other more subtle longer-term effects that are quite difficult to measure. Based on evidence that lifetime earnings depend on work experience and on-the-job training, it can be said that the current reductions in labor demand are reducing the opportunities for low-income workers to advance, which in turn are reducing their potential for lifetime income gains.

An additional concern is that other families which suffer unemployment in the current recession, though perhaps temporarily, will join the ranks of the poor. An estimate made in a recent Brookings Institution study was that a 1 percentage point increase in the unemployment rate could add as many as 900,000 people to the poverty population.[1]

Unemployment Assistance

Unemployment Compensation Benefits.—Although approximately 86 percent of all experienced nonfarm workers are covered by the Federal-State unemployment compensation system, in Nov. 1974, about 2.5 million unemployed persons were not covered by the unemployment insurance system or were not entitled to benefits under its provisions. These persons include new entrants to the labor force, domestics and agricultural laborers, and long-term unemployed whose benefits have been exhausted.

Benefits.—There are no Federal standards for benefits, as to qualifying requirements, benefit amounts, or regular benefit duration. Hence benefit formulas differ considerably among the states—maximum weeks of benefits vary from 20 to 36 weeks, most frequently 26 weeks. Only eight of the States entitle all claimants to the maximum; the rest vary the maximum duration with the amount of past earnings or employment. These varying provisions have resulted in approximately

[1] Edward Gramlich, "The Distributional Effects of Higher Unemployment," *The Brookings Papers on Economic Activity*, Washington, D.C., Sept. 1974.

50 percent of all claimants exhausting benefits before receipt of 26 weeks of unemployment compensation.

Although many States have statutory provisions which provide that the worker will receive 50 percent of his average weekly wage, this provision is qualified by a maximum level of benefits which is often set so low that it effectively undercuts the 50-percent guarantee. In fact, more than two-fifths of all workers now covered by the unemployment insurance system find their benefits limited by State ceilings at a level below the half-pay standard.

The Federal-State extended benefit program, established by Public Law 91–373, is a second tier of protection for the unemployed. It pays up to 13 weeks of extended benefits to workers who have exhausted their regular benefits during periods of high unemployment. Extended benefits are generally payable at the same rate as the claimant's weekly benefit amount under the State law, and eligibility for extended benefits is determined in accordance with State law. There is an overall limitation of 39 weeks on combined regular and extended benefits.

Status of Unemployment Trust Funds.—Because of recent increases in unemployment, interest has risen in the status of unemployment insurance (UI) funds, including State reserves and the special UI trust fund that makes interest-free loans available to States temporarily falling below acceptable minimum levels for funds. Since 1972, three States (Washington, Vermont, and Connecticut) have borrowed from the special UI fund operated by the Department of Labor. Most of the other States appear to be in a relatively healthy condition with an acceptable balance in their accounts.

As of September 30, 1974, the balance of reserves in the unemployment trust fund for all States totaled $11.2 billion. Even in the sharp 1961 recession when the national unemployment rate was 6.7 percent for the year, the aggregate reserves in the trust fund remained at $5.8 billion, albeit their lowest level since 1943. At present, the Unemployment Insurance funds are considered sufficient to weather any foreseeable rate of unemployment.

In recent weeks both Houses of Congress have moved to extend additional unemployment compensation to those workers previously ineligible and to those workers who have exhausted all of their benefit rights. The Committee believes that these initiatives are essential to cushion the shock of unemployment on individuals and on the national economy. With regard to duration, benefit amount, and coverage of unemployment compensation, we recommend:

(1) A uniform, Federal unemployment compensation standard providing for a maximum duration of 39 weeks in all States should be established. The additional 13 weeks which will be added to the average 26 weeks now prevailing in most States could be financed through Federal-State cost sharing without reference to a "trigger" mechanism.

(2) The maximum weekly unemployment benefit should be raised to two-thirds the average wage in each State, and each individual recipient should receive at least 50 percent of his previous weekly wage, up to the maximum.

(3) At least 26 weeks of coverage under the unemployment insurance system should be extended to the three broad categories of workers presently excluded: agricultural workers, domestics, and employees of State and local governments. This would encompass an approximate 12 million workers who are not now covered by the unemployment insurance system or who are ineligible for benefits under its provisions.

(4) Additional emergency federally funded benefits up to 13 weeks should be authorized to be activated when, if and for so long as the national unemployment rate averages 6.5 percent or above over a three month period. These would include a continuation of benefits for those whose coverage has been exhausted and special benefits for persons with demonstrated past labor force attachment but not covered by present programs. Eligibility for these benefits would be limited to persons for whom neither regular public or private employment or special public service employment can be provided.

Public Service Jobs.—Under present legislation there is already available to State and local governments for public employment programs: $250 million under a continuing resolution extending the Emergency Employment Act; $370 million from the 1974 fiscal year appropriation for Title II of the Comprehensive Employment and Training Act (CETA); and $350 million under the fiscal 1975 CETA Title II appropriation—for a total of $970 million. In addition, another $63 million is being utilized for public employment by prime sponsors under CETA Title I. This aggregates to slightly more than $1 billion which will provide for an estimated 170,000 jobs at an average annual wage of about $6,000 available to local areas whose unemployment rate has averaged 6.5 percent or more for 3 consecutive months.

A second part of CETA provides for 380,000 man years of training and employment at a cost of about $2 billion. However, it is estimated that around 95 percent of these monies will be used for training and support purposes rather than work experience, so that the program will provide very few public service job slots. This is of necessity an estimate because the decision as to how the money is spent—either for training or for jobs—is left to the discretion of the eligible localities.

In recent weeks, Congress has acted to expand public service employment opportunities for those individuals who have become unemployed due to deteriorating economic conditions. On December 10, the Congress passed a House-Senate Conference Report authorizing $2.5 billion for the creation of approximately 330,000 one-year slots—at an average $7,800 per year per job—in transitional public service employment. The bill also extends unemployment compensation coverage to approximately 12 million workers not now covered by the existing unemployment insurance system with a projected cost of $2.5 billion at present unemployment rates; and authorizes up to $500 million for a job opportunities program under the Public Works and Development Act for a one-year program of emergency financial assistance to stimulate, maintain, and expand job-creating activities.

Assuming that the President signs this legislation before the end of the year, these new public service jobs, job opportunities, and benefits will be available to the unemployed early in 1975. The new Congress will have to consider such revision or expansion of the programs as may be necessary in light of employment conditions in the coming year. It should be noted that the number of persons unemployed in November reached nearly 6 million, up 460,000 from the previous month. It is important that the size of the public service employment program be designed to adjust to the level of unemployment.

An expanded public employment progam sufficient to create a total of 750,000 jobs is needed at once. The program should be expanded by an additional 250,000 for each additional ½ percentage point rise in the unemployment rate, above the current level of 6.5 percent. When unemployment begins to decline the size of the program should be gradually reduced in similar stages.

The full-year cost of this program would be about $6 billion at 6.5 percent unemployment, rising by $1.8 to $2 billion for each further 0.5 percentage point rise in the unemployment rate. These totals seem large, but if expenditures are not used this way to provide jobs, additional income support will be necessary for the unemployed. There is plenty of useful work to be done in the public sector. The importance of this initiative is that it provides a degree of productive employment, income, and self-esteem for individuals who would otherwise be without jobs.

Relief Measures for the Poor and the Elderly

The Poor.—The poor have been the hardest hit by changing economic conditions in 1974. The combination of inflation, recession, and rising unemployment has been catastrophic for the poor and near-poor. While the poor may not suffer a proportionately greater decline in dollar incomes than other groups, the decline in their purchasing power is from a level that is at best marginally adequate. Price increases in recent years have caused a greater loss of purchasing power for the poor than for higher income groups.

In all of the previous inflationary periods since World War II, the poor benefited because of accompanying tighter labor markets. But the economy is now in the midst of a serious recession. Also contributing to the poor's loss of purchasing power is the general tendency for the wages of low-skilled workers to adjust less to inflation than average wage rates, primarily because they lack the bargaining power of better-paid and more highly unionized workers. Prices of the basic purchases made by the poor have been rising faster than the Consumer Price Index. For example, food price inflation of the past 18 months has added twice as much to the cost of living of the poor as to the average urban worker's cost of living.[2] The poor cannot "substitute down" as the more affluent can to less expensive foods.

---

[2] Loraine Donaldson. "The Poor Pay More—of the Food Inflation Tax," unpublished paper. Georgia State University, 1974. Food costs, which according to the Bureau of Labor Statistics have risen about three times as fast as other major budget components, generally account for a higher proportion of the poor's expenditures than of higher income groups.

Dried beans and rice, which are common items in the diets of the poor, increased in price from December 1970 to March 1974 by 256 percent and 124.3 percent, respectively.

What can be done to reduce the burdens imposed on the poor by the present combination of recession and inflation? Most public assistance is channeled to the poor through the many income support programs which have been established in the United States since the depression more than 45 years ago. These programs, established at different times and with varying objectives, have combined to produce an overall income transfer system riddled with conflicts and inequities, operated at huge cost, and delivering inadequate benefits to millions of needy persons.

A comprehensive program for reform of our income maintenance program was presented earlier this month in a report issued by the Subcommittee on Fiscal Policy of this Committee, under the leadership of Congresswoman Martha Griffiths. The recommended program consists of two parts: Tax relief for low- and moderate-income workers and modest cash grants related to income for the poorest in our society. Tax relief would occur through the substitution of rebatable tax credits, which are deducted from tax liability, for the personal exemptions now in effect. Excess credits would be paid to the individual(s) filing the tax return.

This comprehensive system of credits and allowances is more efficient and equitable than the food stamp and AFDC programs which it would replace. This program breaks sharply with the traditional welfare structure in that it avoids the penalties on work, marriage and family responsibility that the old programs perpetuate. We commend the full 260 page report to anyone seriously interested in the Federal income transfer system, the problems under which it currently operates and some of the possibilities of reform.

We recommend that the program for income maintenance reform contained in the report of the Subcommittee on Fiscal Policy and the legislation that would enact this program be given the most immediate consideration.

While endorsing this welfare reform package and agreeing fully with the points it raises concerning the serious deficiencies in the current welfare programs, we also recognize that some immediate improvements are needed in the income support programs to help compensate the many poorer Americans who have suffered greatly from this year's severe inflation and developing recession. The Subcommittee on Fiscal Policy realizes, and states in its report, that its recommended program could not be in effect until 1977. In the light of this time lag, extension under existing statutes of the food stamp and Aid for Dependent Children (AFDC) programs is required to provide immediate relief to the poor.

The food stamp program should be emphasized since it is the income support program reaching the greatest number of people, it focuses on the necessity which has risen most rapidly in price, and is a program that can be made more effective with a few simple administrative changes. Currently, there are 14.3 million recipients of food stamps out of a total eligible population estimated to be between 30 to 35 million.

The cost has escalated in the past three years from $1.6 billion to $4.0 billion. Many economists view this expansion of the program as a healthy development in that they see many advantages to food stamps as an income support program. More people benefit at a far lower per capita cost than in the government's two other major welfare programs, Medicare and AFDC. Also, the Food Stamp Program is mandatory, is nation-wide, is based on minimum food needs tied to national standards and most important, is designed to help all the needy. Thus, it includes the working poor, who are usually not covered by other income support measures.

Despite these laudable advantages, the program as it is currently operating suffers from some serious shortcomings. Perhaps the most significant is that the amount of food stamp allotments (currently $150 per month for a family of four) is simply not enough to provide for a nutritionally balanced diet. In many cases, this deficient payment affects the health of prenatal infants, nursing mothers, the elderly, and the unemployed. As things now stand, a family with a low income receiving food stamps may have to spend more than 40 percent of its income to obtain a minimum required diet.

The monthly bonus amount is based on the Economy Food Plan of the USDA, which currently provides allotments allowing less than 40 cents per person per meal. According to a food consumption survey by the USDA, less than 10 percent of those who eat at the cost level of the Economy Food Plan obtain the full recommended dietary allowances. For this reason, the USDA's Low Cost Food Plan should become the basis for food stamp allotments.

An equally significant defect of the present program is that the maximum purchase price, 30 percent of net household income, is too high. In fact, this ties in with the low level of participation in the program, since the high cost of purchasing food stamps is the most important reason for non-participation by many households. Thus, the maximum purchase price should be set at 25 percent of net household income, which would not only increase the value of the stamps for those currently using them (particularly benefitting the elderly poor), but would also attract many more people into the program, especially those poor people who felt they simply could not afford the current purchase price. These changes would raise the annual cost of the program by approximately $420 million.

It should be noted that this 25 percent maximum and preservation of the existing sliding scale up to that maximum, is in conflict with the President's recent amendment to the food stamp regulations. This amendment would require, as of March 1, 1975 *all* food stamp recipients to pay a flat 30 percent of net income for their food stamp allotment. This is a most ill-advised administrative change; it would increase the already severe burden that the poor and near-poor are bearing. Specifically, households with one or two persons would be hurt the most. Of these 50 percent are over 60 years of age. An elderly individual receiving the current Supplemental Security Income (SSI) payment of $146.00 a month now pays $30 to receive $46 in food stamps, a $16 bonus. The President's amendment would increase the purchase price to $43.80, reducing the bonus to $2.20, a virtually negligible amount. Among food stamp recipients of all ages, those with the lowest incomes will experience the greatest percentage increases in purchase prices. The ultimate effect, therefore, will be a strong inducement for many to drop from the program.

The participation problem is already a serious one. Only 40 to 48 percent of those eligible actually use food stamps. Even this low rate overstates the participation of the elderly, blind, and disabled, which is currently 28 percent. Legislation to alleviate much of this problem has already been passed by Congress in July specifying that the Federal Government should cover 50 percent of administrative costs, as compared to the present level of 28 percent. Additional funds to cover administrative costs should enable states to hire more certification workers.

Another major problem is that the semi-annual increase in the food stamp allotment lags four to twelve months behind the increases in cost of the Economy Food Plan. For example, the Food Stamp allotment during this month (December 1974) is based on the Economy Food Plan established in February. Costs are probably 10 to 15 percent higher now.

> **To increase the value of the food stamps, for current participants, the President's administrative decision earlier this year should be reversed and the maximum purchase price should be reduced from 30 percent to 25 percent of net household income. The present sliding payment scale up to the maximum should be retained. Furthermore, the U.S. Department of Agriculture should expand participation in the program, particularly by implementing the provisions of P.L. 93–347 that enable the Federal Government to provide 50 percent of the administrative costs of the program. The payment scales of the Food Stamp Program should be adjusted every four instead of every six months.**

The Elderly.—The elderly poor are in especially difficult circumstances for they have no hope of changing to a better job, getting a promising job if unemployed, or of increasing their income in any manner (other than automatic social security increases) as they face escalating prices. Food price increases have been harsh for most elderly, but absolutely devastating for some. A retired couple simply cannot spend 30 to 40 percent of their budget for food when rent or a mortgage may consume another 40 to 50 percent of their income.

The income support programs for the elderly are quite few in number, the principal ones being social security, supplemental security income, and medicare. Although social security benefits are received by most elderly people, they are insufficient as a sole source of income. For example, extrapolating the 1973 Bureau of Labor Statistics Autumn Budget for a Retired Couple to July 1974 gives incomes of $5,702 for the intermediate budget and $3,951 for the lower budget. Yet the average social security payment for a retired couple in July 1974, after the 11 percent increase was in effect, was $310 per month ($3,720 annually).

A related problem with present social security benefits is the extent to which they are decreased by the retirement test provision. Beyond the first $2,100 of earned income for an individual age 65 to 72, the social security payment is decreased by $1 for every $2 of earned income. The combination of this benefit reduction and the social security taxes they must pay on all earned income discourages most older persons into permanent retirement at age 65. Many of the elderly also receive private pensions. These, however, do not usually contain any cost-of-living adjustment, so that their real value decreases drastically in an inflation such as we have been experiencing. The lack of coordination between the private pension system, the social security system, and welfare programs is responsible for the existence of substantial pockets of poverty among the aged.

In January 1974, the Social Security Administration put into effect a new program, the supplemental security income (SSI) program to help relieve the burden of poverty among the elderly. This program (which replaced the Old Age Assistance Program among others) was quite bold in that it was the first major welfare program to specify a federally guaranteed income floor conditioned only upon need for a broad group of the population. But the program currently includes only about 1 million of the estimated 4.2 million persons newly eligible. In order to make the program a truly effective one of assistance to the elderly, there must be a massive effort to locate and enroll as many as possible of the 2.5 million elderly who could be receiving benefits.

Another problem with the program concerns the federally administered State supplements, which are currently received by approximately 41 percent of all SSI participants. The States are not required to grant automatic cost-of-living increases as is true for Federal benefits, nor are they even required to pass along the Federal automatic increase. Thus, even though social security payments have increased 11 percent, and SSI payments by 12 percent, some recipients have received no increase in their benefits because their State supplemental payments were correspondingly reduced.

An even more fundamental defect is that the benefit levels of many SSI participants, even of those who receive state supplemental payments in addition to the Federal benefit, have decreased in real income terms from what they were in January 1972. In other words, many SSI recipients have a lower real income than they did 3 years ago when there was no national income floor, just individual State programs. For elderly individuals this real decrease in the standard of basic support has occurred in 19 States, with the maximum decrease being 24.8 percent in Vermont, while elderly couples have experienced a decrease in 21 States, the maximum being 20.2 percent in Florida.

Although this program is the first to have a federally mandated income floor, it allows many elderly people who have virtually no other alternative means of obtaining an income to spend the latter years of their lives below poverty level incomes. Even when State supplementary payments are included, the elderly couples in 37 States and the elderly individuals in 41 States receive incomes that fall below the poverty line. Even with the SSI program, from 3½ to 4 million elderly live in poverty. The SSI benefit level should be linked to the poverty line. The total cost of this linkage, which would, of course, lift the blind and disabled recipients out of poverty also, would be $1.4 billion for the first 6 months of 1975. The additional cost in fiscal year 1976 of eliminating poverty among SSI recipients would be $3.0 billion.

To provide assistance to the elderly poor, the Supplemental Security Income program should be amended to bring the recipient's total income up to the poverty threshold level. In addition, the Social Security Administration should provide the necessary funding and initiatives to increase participation in the program to a target figure of 90 percent among those who are eligible. Finally, the SSI program should incorporate a "maintenance of effort" provision requiring the States to pass through all of any Federal benefit increase.

Housing Assistance.—In 1949 the Congress established "the goal of a decent home and a suitable living environment for every American family." In 1968 the Congress reaffirmed this national housing goal and determined that it could be substantially achieved within the next decade, or by July 1, 1978.

In pursuit of this objective, the Congress has fashioned various kinds of Federal assistance to augment the supply of funds for residential mortgage loans. But availability of mortgage loans at moderate interest rates are of no great help to low and moderate income families who cannot afford to pay for standard quality housing without undue hardship. To bring the cost of adequate housing within the means of low and moderate income families, the Government has had to provide some form of subsidy.

The subsidy mechanism can work in one of two ways—it can reduce the cost of housing units to bring them within the reach of poor families, or it can augment family incomes (across-the-board or specifically for housing) to the point where they can afford units of at least standard quality.

Until recently, the Federal subsidy programs have been of the first type. Through interest subsidies, annual contributions, and rent supplements, they have reduced the cost of housing units and made those units available to low and moderate income families. The Administration was dissatisfied with the way these programs worked. In January 1973 it suspended the two principal vehicles—the section 235 and the section 236 programs. Since then it has impounded the funds appropriated by Congress for these programs, except to fulfill outstanding commitments.

Critics of the Federal assistance programs that involve subsidies tied to the housing unit, particularly those critics in the Executive Branch, have proposed that such subsidies be replaced by some kind of housing allowance program. Under such a program, a low-income family would receive a monthly assistance payment equal to the difference between a "fair market rent" for a rental dwelling and a specified portion (ranging between 15 and 25 percent) of the low-income family's monthly income. The chief advantage of this housing allowance approach is that it gives the low-income family a "freedom of choice" to select its place of residence, instead of being forced to live in a designated house in a designated neighborhood.

At the behest of the Executive Branch, the Congress authorized a new housing assistance program for lower income families in the Housing and Community Development Act of 1974 that has all the earmarks of housing allowances. However, the act also permits subsidies to be tied to newly constructed units. Since the administrative regulations for this program are still being developed, no assistance is being furnished under this new authority. Meanwhile, suspension of the older programs continues, except to fulfill outstanding commitments and to accommodate completion of some urban renewal projects.

The net effect of the suspensions and the new legislation is that Federal subsidies for low-income housing have slowed to a trickle. Federal housing subsidies for middle-income families through the Government National Mortgage Association tandem plan are moving full steam ahead, propelled by the additional authority provided by the Emergency Home Purchase Assistance Act of 1974.

The Executive Branch should accelerate the establishment and funding of housing assistance program newly authorized under the Housing and Community Development Act of 1974 so that Federal housing assistance can again be channeled to those who need it most—the poor, the elderly, and the physically handicapped.

B. Financial Markets

Serious distortions of normal credit flows occurred in 1974 with devastating consequences for many sectors of the economy. Small savers were faced with the choice of watching their time deposits shrink in real value, of searching for new and often less liquid or less secure forms of saving, or of simply abandoning the effort to maintain a cushion of savings. The withdrawal of deposits from savings institutions dried up the flow of funds into mortgages and plunged the residential construction industry into the worst depression of the entire postwar period.

It is difficult to determine to what extent these distortions were the result of the inflation itself and to what extent they were the result of the highly restrictive monetary policies adopted in the hope of controlling inflation. What is clear is that the resultant condition of tight money and high interest rates has intensified and prolonged the recession while at present only beginning to reduce the rate of inflation. The effectiveness of these policies in combating inflation remains to be seen.

This section discusses two particularly severe financial impacts of inflation and tight money: (*a*) The depression in housing, and (*b*) the difficulties in the municipal bond market.

Steps To Revitalize the Housing Industry.—Over the past two and one-half decades, housing construction has experienced sharp fluctuations reflecting the cyclical availability of mortgage credit. Housing has been the residual borrower in the capital market, to be accommodated after all other credit demands are met. When business and government borrowers' demands for credit have risen, commercial banks, life insurance companies, and most recently mutual savings banks have shifted from mortgage lending into higher yielding business loans, corporate bonds, and municipal securities. At the same time, individual savers, especially those with large accounts, have withdrawn funds from their savings deposits and invested them instead in market securities with greater returns.

When the economy overheats, credit restraints are imposed. Funds for construction loans and long-term residential mortgage loans become increasingly scarce, accompanied by higher interest rates for the builders and homebuyers who do obtain loans. Credit lines to mortgage companies are cut back.

The sharp declines in housing starts that have been associated with each credit crunch during the past 25 years meant that the housing industry, together with mortgage lenders and homebuyers, bore the brunt of fluctuating business and government credit demands. The Congress has sought to tap the security markets in order to channel more funds into the mortgage market. The vehicles established include: The Federal Home Loan Bank (FHLB) advances to savings and loan associations, secondary market purchases by the Federal National Mortgage Association (FNMA), and most recently the Federal Home Loan Mortgage Corporation (FHLMC), mortgage-backed securities guaranteed by the Government National Mortgage Association, GNMA special assistance programs, and construction lending by real estate investment trusts (REIT's).

Each of these innovations has worked well when credit was in plentiful supply. But when tight money occurs, either they do not work well or they are inadequate to offset massive disintermediation. Clearly, if housing production is to be revived and thereafter maintained, a "rainy weather" strategy has to be fashioned to assure that housing gets a "fair share" of the credit available during periods of tight money. Such a strategy might include (1) additional funds for construction loans and financing on an interim basis an inventory of mortgage loans pending sale to institutional investors; (2) supporting the market for securities issued by the housing credit agencies; (3) instituting a countercyclical reserve for the housing credit agencies.

To revive a moribund housing construction industry, serious consideration should be given to establishing a new government credit program to provide funds to private mortgage loan originators whose lines of credit are cut back due to tight credit. These private lenders would use the funds to make construction loans to homebuilders and to finance on an interim basis an inventory of mortgage loans to homebuyers pending their sale and delivery to institutional investors. Funds for these credits would be borrowed from the Federal Financing Bank.

The current financial situation for mortgage companies and other loan originators is analogous to the situation faced by savings and loan associations prior to the establishment of the Federal Home Loan Bank System, or to the situation faced by commercial banks prior to the establishment of the Federal Reserve System. With the onset of credit restraints, their lines of credit from commercial bank sources are cut back, interest costs on loan renewals increase, and their ability to dispose of unsold inventory is greatly impaired, unless they are willing to sell at rising discounts. Confronted with such a credit squeeze, they sharply curtail new mortgage loans.

Since the bulk of mortgage company originations are Federal Housing Administration (FHA) or Veterans' Administration (VA) residential mortgage loans, this cutback hits federally underwritten residential loans the hardest.

In view of the demonstrated workability of FHLB advances as a means of overcoming the vulnerability of savings and loan associations to fluctuations in credit availability, it might now be appropriate to establish a comparable system of Federal credits for mortgage companies and other loan originators. Under such a system, all mortgage companies and any other FHA-approved mortgage lenders would be invited to become members of a federally supervised credit system whose members would be eligible to borrow from a new Federal credit agency. The credits would be used to finance residential construction loans and interim long-term loans for residential properties, to be held in inventory by the borrower pending sale or delivery to permanent investors.

This new Federal construction and interim loan agency would be authorized to borrow from the Federal Financing Bank such sums as are needed to finance its loan operations. Interest rates on loans made by this new agency would be subject to the following ceilings. On construction loans, the prevailing prime loan rate charged by commercial banks for small businesses would apply. The private mortgage loan originator, in turn, would charge homebuilders the prevailing prime rate for small business loans. On interim mortgage loans, the prevailing maximum interest rate for FHA-insured and VA-guaranteed loans, with no allowance for loan servicing would apply. Homebuyers would be charged the prevailing FHA-VA maximum interest rate, with no points allowed. The private originator would receive a fee to cover "out of pocket" costs for construction supervision, loan closing and disbursement, and other explicit costs.

Appropriate safeguards would have to be adopted to assure that the Government credit support would not displace loans by commercial banks or other private lenders, and that Federal loan funds were not used to finance substandard housing.

Interest rates on these inventory loans would be equal to the interest rates on the mortgage loans, with no allowance for loan servicing, so that private loan originators would have little incentive to make use of this Federal credit program during periods of credit ease. They would probably find it more advantageous to continue mortgage loan warehousing with commercial bank credits, which generally are available at interest rates lower than prevailing mortgage interest rates.

However, the availability of separate credit assistance to help mortgage loan originators hold an unsold inventory of federally underwritten mortgages would provide an assured source of credit during periods of tight money. Thus, when the original lenders experience increasing difficulty in selling mortgages to permanent investors who for various reasons have to curtail loan purchases, the mortgage originators would be able to hold the loans until the market improved. Since the interest rate charged on the inventory loan would be equal to the mortgage interest rate, they would not achieve any financial gain in holding the inventory. Equally important, they would not suffer any significant losses either, so that they would not be forced to sell the mortgage loans at discounts in order to cut their losses.

The U.S. investment accounts and the Federal Reserve Banks should support the market for securities issued by the Government-sponsored housing and farm credit agen-

cies and the Federal Financing Bank. The Government-sponsored agencies should be permitted to borrow from the Federal Financing Bank.

Each of the Government-sponsored housing credit agencies (Federal Home Loan Banks, Federal National Mortgage Association, and Federal Home Loan Mortgage Corporation) and each of the Government-sponsored farm credit agencies (Federal Land Banks, Federal Intermediate Credit Banks, and Banks for Cooperatives) was created to provide a supplementary source of credit for housing and farm loans to augment the resources of private financial institutions. They do so by borrowing in the securities market and lending the proceeds directly or indirectly to homeowners and farmers. Since they are outside the U.S. budget, they are not subject to budget constraints.

When the Government-sponsored agencies were established, it was contemplated that they would always be able to borrow funds at almost any time because of their resemblance to Treasury securities. However, in periods of credit tightness, investors differentiate these agency securities from Treasury securities to the extent that the agencies have to pay as much as 1 percentage point more in interest charges than the Treasury. To cover these higher interest costs, federally sponsored agencies have to raise the interest rates they charge or lower the price at which they purchase loans. The resultant higher interest rates have contributed to the slowdown in housing starts.

Over the years the U.S. Investment Accounts (such as the Social Security Fund and the Civil Service Retirement Fund) purchased substantial amounts of these Federal agency securities so that by the end of 1968 they held $4.2 billion, or 11.3 percent of the $37.7 billion of agency securities outstanding. Since then, the Federal agency debt has increased to about $84.7 billion. Meanwhile, the U.S. Investment Account holdings dropped to $2.0 billion, or only 2.4 percent on the total outstanding. In contrast, their holdings of Treasury securities increased from $76.6 billion at the end of 1968 to $140.3 billion at the end of September 1974.

It is difficult to understand why the U.S. Investment Accounts are forgoing the higher yielding securities issued by the government-sponsored agencies in favor of the lower yielding Treasury securities. Surely, in his fiduciary capacity in administering these accounts, the Secretary of the Treasury should seek the highest yields obtainable at minimal risk. It is recognized that if the Investment Accounts purchased more agency securities, they could hold fewer Treasury securities, necessitating more Treasury borrowing from the private capital market. But the Treasury can borrow at lower interest rates than those obtainable by the Federal agencies, particularly at times when tight money leads to wide rate differentials.

Several years ago, members of this Committee urged, to the point of introducing legislation, that the Federal Reserve Banks should purchase Federal agency securities as part of their open market operations. At the time, the Federal Reserve showed a great deal of reluctance in carrying out this recommendation. Since then, however, the Federal Reserve Banks have been acquiring Federal agency securities so that at the end of September 1974 they held $4.0 billion, or 5 percent of the total outstanding. Significantly, about $2.6 billion of these holdings were added by the Federal Reserve Banks in the last 15 months, representing about 30 percent of their net portfolio increase of Treasury and agency securities. The Federal Reserve should continue this degree of support for agency securities and the net additions to the resources of the U.S. Investment Accounts should be invested in agency securities in similar proportions.

In late 1973 the Congress established a Federal Financing Bank "to assure coordination of the Federal and federally assisted borrowing programs with the overall economic and fiscal policies of the Government, to reduce the costs of Federal and federally assisted borrowings from the public, and to assure that such borrowings are financed in a manner least disruptive of private financial markets and institutions." However, under the present statute, the Bank is not permitted to purchase the securities of any of the six government-sponsored agencies listed above.

Inasmuch as a key purpose of this bank is to lower the borrowing costs for Federal agencies, it should serve government-sponsored agencies functioning outside the Federal budget as well as those included in the budget. These sponsored agencies are carrying out public purposes as described in their enabling legislation. Hence their borrowing costs should also be reduced so that they can acquire housing and farm loans at the lowest possible interest rates, particularly in periods of severe credit restraint. Amendatory legislation should be enacted as soon as possible to correct this omission.

The Federally sponsored housing finance agencies have to date generally confined their borrowing to the amounts needed to repay maturing obligations and to finance loan purchases and advances covering recently made commitments and applications. Since the commitments to purchase and applications for advances rise rapidly as credit grows increasingly tight, the housing agencies are forced to borrow when funds are scarce in the security markets and interest rates for agency securities are comparatively high.

Agency borrowing under such conditions frequently results in very attractive yields to individual investors, causing them to withdraw savings funds from savings and loan associations, mutual savings banks, and commercial banks, a process termed "disintermediation." Loss of savings deposits through such disintermediation, in turn, further reduces the availability of funds for residential mortgage loans, exacerbating the shortage of mortgage funds and increasing the need for Federal agency support.

These disruptive effects could largely be avoided if the government-sponsored agencies did not borrow during periods of tight credit, except to repay maturing obligations. They could, instead, raise substantial sums by borrowing long-term funds when credit is easy and market interest rates are relatively low, and then invest the proceeds in Treasury special issue securities. Then, when credit again becomes tight, they could request the Treasury to redeem the securities and use the proceeds to purchase new mortgage loans or to make advances.

To replace the funds lost by these redemptions, the Treasury would have to borrow in the capital market. But because of its financial strength, the Treasury could borrow on more advantageous terms than those obtainable by the Federal agencies. Furthermore, this change would have the desirable effect of contributing to a centralization of Federal borrowing from the public, increasing the Government's ability to keep the volume of borrowing consistent with the needs of the economy. At times when the Government is faced with the need to restrict spending and borrowing, the burdens would be distributed throughout the Federal budget instead of being concentrated in the housing sector.

When credit ease reoccurrs, the Federal agencies could recover most of the funds they loaned out during the tight money period by selling the acquired loans to private investors and by encouraging savings and loan associations to repay the advances they received. The Federal agencies could then reinvest the proceeds from these loan sales and repayments in Treasury special issue securities; and if there is any shortfall below the targeted level, they could borrow the necessary funds in the private capital market.

During periods of credit ease, the yield differential between the rates of interest on long-term securities issued by the government-sponsored agencies and the rates on Treasury securities of comparable maturity is likely to be a small fraction of 1 percent per year. Assuming a 0.25 percent differential, a $10 billion contracylical reserve program for housing and farm credits would cost $25 million per year. If the reserve had to be used every third or fourth year to offset tight money, such a program would cost $75–100 million for each credit cycle, which is far less expensive than the GNMA Tandem Plans now being used. In any case, the disruptive effects of heavy agency borrowing in periods of tight money and high mortgage interest rate levels underwritten by the GNMA Tandem Plans would largely be avoided.

The federally sponsored housing finance agencies should issue long-term securities, with provision for advance refunding, during periods of credit ease and invest the proceeds in special Treasury securities of comparable maturities. These Treasury securities should be redeemable upon demand when credit becomes tight in order to provide the housing finance agencies with a supplementary source of funds at moderate interest rates at a time when money is scarce and interest rates are high.

In 1966 this Committee issued a two volume report on "State and Local Government Public Facility Needs and Financing,"[3] which found that the tax-exempt municipal securities market is relatively narrow, particularly vulnerable to tight credit, and that the loss of tax revenues to the U.S. Treasury on account of tax exemption of the interest greatly exceeds the savings in interest cost to the borrowing State and local governments. To deal with these problems, members of this Committee proposed legislation that would authorize Government guarantees of taxable municipal bonds, coupled with a 33 percent interest reduction subsidy.

Introduction of taxable municipal bonds broadens the options available to State and local governments in that they can now borrow in the much larger taxable securities market in addition to the tax-

[3] Joint Economic Committee, State and local *Public Facility Needs and Financing* (December 1966), vol. 2.

exempt market. Provision of a government guarantee entails little risk in view of the extremely low default rate for municipal bonds in the past 30 years. Since the average tax bracket of those who buy tax-exempt securities is, according to a staff study, about 44 percent, the U.S. Treasury stands to gain by reducing the subsidy for municipal bond financing from 44 percent to 33 percent.

The borrowing municipality also stands to gain because its net interest cost by virtue of the government guarantee and the 33 percent interest reduction subsidy is bound to be appreciably lower than the net interest cost at which it can borrow in the tax-exempt market. To judge for themselves as to whether this is in fact true, the State housing finance agencies should simultaneously solicit bids for both tax-exempt and taxable bonds, with the latter to be guaranteed by the Government pursuant to the Housing and Community Development Act of 1974 which was signed by the President on August 22. They could then choose the means of financing resulting in the lowest net borrowing cost.

Once taxable bond financing by State housing finance agencies is found to be both practical and economical, consideration should be given to utilizing this kind of financing for water and sewer facilities and for school buildings. The resultant lower interest costs would benefit the borrowing local governments and also stretch the value of the Federal and State payments for education and other local public services.

The State housing finance agencies should be encouraged to utilize the Federal program of government guarantees of their taxable bond issues combined with a 33 percent interest subsidy. Following this practice would both reduce credit demands in the tight tax-exempt municipal securities market, and channel additional funds into the residential mortgages.

Of the $24.7 billion of short-term notes sold by State and local governments in 1973, $11 billion or 45 percent were public housing and urban renewal notes, backed by a Federal guarantee of payment. If these notes were instead financed through the Federal Financing Bank, there would be considerably less pressure in the short-term, tax-exempt municipal securities market, helping to lower the interest costs for those State and local governments that need to borrow in this tax-exempt market.

In recent years, sales of federally backed public housing bond issues have accounted for about 4 percent of total muinicipal bond sales. While they are not as important as federally backed short-term financing, shifting of the means of long-term financing for public housing from the tax-exempt market to the Federal Financing Bank would, nonetheless, ease the pressures in the municipal bond market.

In calling for such possible extensive use of the Federal Financing Bank as the means of overcoming the scarcity in residential mortgage, farm credit, and municipal security sectors of the capital market, we recognize that this Bank is not a bottomless well and that it will have to raise the needed funds by borrowing in the private capital market or from the U.S. Treasury. But, in view of its towering strength based on its close identification with the U.S. Treasury, this Bank should be able to borrow on terms more favorable than those obtainable by municipalities, homebuilders, homebuyers, and farmers.

Most importantly, this Bank would help to assure that housing, agriculture, and State and local governments obtain a fair share of the Nation's credit resources in a period of tight money. The Federal Reserve authorities that determine monetary policy and the managers of Federal credit assistance programs should be working toward the same common objective of assuring a fair share of credit resources to the economic groups least able to fend for themselves in a period of tight credit.

To help bring about lower interest rates for State and local government public facilities construction, consideration should be given to sales of all public housing and urban renewal bonds or notes, secured by an indirect Federal guarantee, directly to the Federal Financing Bank instead of to investors in the tax-exempt municipal securities market. Withdrawal of these government guaranteed securities from the municipal securities market could lead to more favorable bids for new tax-exempt issues sold by State and local government borrowers and correspondingly lower interest rates.

C. On State and Local Governments

The State and local government sector has expanded to play an increasingly important role in the national economy. Since 1967 purchases of goods and services by State and local governments have grown significantly as a percentage of gross national product and as a percentage of total government purchases of goods and services (Table 1).

TABLE 1.—PURCHASES OF GOODS AND SERVICES BY STATE AND LOCAL GOVERNMENTS AS A PERCENTAGE OF GNP AND TOTAL GOVERNMENT PURCHASES OF GOODS AND SERVICES (CURRENT DOLLARS)

	1967	1968	1969	1970	1971	1972	1973	[1] 1974
As a percentage of GNP	11.3	11.6	11.9	12.5	12.9	13.0	13.1	13.7
As a percentage of total Government purchases of goods and Services	49.6	50.3	53.0	56.2	58.1	59.0	61.4	62.5

[1] Average of the 1st 3 quarters.

Source: Bureau of Economic Analysis, Department of Commerce.

Similarly, total employment by State and local governments has grown 28 percent from 1967 through 1974 (average of the first three quarters), while total nonagricultural employment, excluding the State and local sector, has expanded by 14.8 percent. In fact by almost any measure, State and local governments have expanded at a faster rate than the remainder of the economy.

Despite this increasingly important role as employer and provider of goods and services, State and local governments have very little control over national economic developments that significantly affect their revenues and expenditures. Constitutional requirements for balanced budgets preclude State and local governments from initiating discretionary fiscal policies designed to significantly expand or deflate the national or local economy. As a result, State and local governments often are significant victims of recession and inflation, experiencing shortfalls in revenues and intergovernmental transfers and increases in the demand for and cost of goods and services.

The State and local governments experienced a significant deterioration in their fiscal position in the past year. State and local governments maintained large surpluses in total accounts (National Income Accounts (NIA)) basis in 1972 and 1973 (Table 2, line 1) despite unemployment rates in excess of full employment. This surplus in total accounts includes surpluses in the social insurance trust funds, which are unavailable for operating expenditures. Nevertheless, even when these surpluses in the social insurance trust funds are removed (Table 2, line 3), State and local governments enjoyed surpluses in funds available for operation in 1972 and 1973.

TABLE 2.—SURPLUS OR DEFICIT, NATIONAL INCOME AND PRODUCT ACCOUNTS, ANNUAL BASIS

[Billions of dollars]

					1973				1974		
	1970	1971	1972	1973	I	II	III	IV	I	II	III
Surplus or deficit	1.8	4.0	12.3	9.2	13.2	10.4	8.4	4.6	3.2	2.0	2.1
Surplus or deficit, social insurance funds	6.5	7.5	8.4	9.1	8.8	9.0	9.2	9.4	9.6	9.7	9.8
Surplus or deficit, all other State and local funds	−4.8	−3.4	4.0	.1	4.5	1.3	−.8	−4.7	−6.4	−7.7	−7.7

Source: Bureau of Economic Analysis, Department of Commerce.

This surplus fiscal position resulted primarily from a bulge in revenues and intergovernmental transfers following the 1970 recession. During this recession, many State and local governments were forced to enact major tax increases to keep their budgets within balance. When the economy recovered in 1972–73, these tax increases began to yield surplus revenues in excess of those required to finance the constant level of service provided. At the same time, the 1970 State and local government fiscal crunch precipitated a significant bulge in Federal Government grants-in-aid to State and local governments, primarily as a result of the enactment of the general revenue sharing program (Table 3). Thus the revenue gains associated with economic recovery and tax and grant-in-aid increases combined to create a surplus.

TABLE 3.—PERCENTAGE ANNUAL INCREASE IN FEDERAL GRANTS-IN-AID

	1967 to 1968	1968 to 1969	1969 to 1970	1970 to 1971	1971 to 1972	1972 to 1973	1973 to 1974
Current dollars	15.7	10.3	20.7	18.8	28.5	8.3	5.9
Constant 1958 dollars [2]	9.5	3.9	12.1	12.2	22.9	2.0	−2.4

[1] First half of 1973 to 1st half of 1974.
[2] Deflated by implicit GNP deflator for State and local governments.

Source: Bureau of Economic Analysis, Department of Commerce.

Beginning in the third quarter of 1973, however, the surplus in total accounts (NIA basis) declined considerably. When the surplus in total accounts is adjusted by removing the surplus in social insurance funds, the combined State and local sector shows a large deficit in funds available for operation.

The weakening economic situation is primarily responsible for their return to deficits. Whenever the economy operates at levels below full employment, State and local governments experience large shortfalls in revenues. Income and sales tax receipts are affected by the shortfall in personal income and retail sales which accompany a downturn. If it is assumed that State and local revenues have an elasticity of 1.0 (a 1 percent shortfall in GNP will precipitate a 1 percent shortfall in State and local revenues) and that tax rates remain constant, the revenue shortfall in the fourth quarter of 1974 will be as much as $20 billion at an annual rate. While this is certainly a huge gap, the size of this revenue shortfall can be expected to increase to as much as $25 billion as the economy weakens through 1975. The revenue shortfall problem has recently intensified as State and local governments become more dependent on elastic revenue sources such as income and sales taxes, a development which certainly should be encouraged.

High levels of unemployment also tend to create additional demands for certain State and local government expenditures, particularly for unemployment compensation and public assistance. Three States and the District of Columbia are already borrowing from the special unemployment insurance trust fund operated by the Department of Labor to finance unemployment compensation expenditures, and several others may be forced into this position as unemployment rates continue to rise.

While recession has affected both aggregate revenues and expenditures adversely, inflation affects revenues favorably and expenditures adversely. In fact until recently the impact of recession on agregate State and local revenues and expenditures has been partially cushioned by the impact of high rates of inflation. In much the same manner that it affects the Federal budget, inflation increases aggregate State and local government revenues before it significantly raises expenditures. However, State and local governments will be subjected to serious expenditure inflation in the upcoming year as public employees and public assistance recipients rightfully attempt to regain some of their lost purchasing power. In addition the large increases in construction costs will have a major impact on State and local governments, since they are responsible for approximately 85 percent of all public construction activity.

The combination of inflation-affected expenditures and recession-induced revenue shortfalls will make it very difficult for many State and local governments to make it through the upcoming year without tax increases, employee layoffs, and cuts in levels of service.

While it is desirable to cushion the impact of inflation and recession on aggregate State and local receipts and expenditures, it is equally important that this economic assistance be targeted toward those States and municipalities that suffer the greatest revenue shortfalls and expenditure increases. Inflation, and particularly recession, have differing impacts on States and localities depending upon the local economic base, the government revenue base, and the services provided by the Government. Inflation, for instance, will have a significant impact on local governments. Expenditures for employee compensation, which will expand in the move to regain purchasing power, constitute a much larger share of local government expenditures than do State government expenditures. On the revenue side, inflation will have a lesser impact on those States that are dependent on income and sales taxes, which tend to rise automatically with the rate of inflation, than on States that derive a major share of their revenues from taxes which are levied by volume (gasoline, cigarettes, liquor, etc.). Local governments, on the other hand, will experience insufficient revenue gains because they are more dependent on the property tax as a major source of revenue. Lags in reassessment and resistance to reassessment as a result of declining real incomes is likely to cause a shortfall in the rate of increase of property tax revenues. In light of the forecasts for significant inflation in the next few years. State and local governments should probably move toward greater dependence on inflation-responsive sources of revenue.

Cyclical downturns tend to have a far more varied and significant effect on State and local governments than inflation. While most States will experience large revenue shortfalls and expenditure increases as a result of high unemployment rates, those States that have large energy and other natural resource deposits will benefit from the more intensive development of these resources. Similarly, local labor markets that are dependent upon durable goods manufacturing as a primary source of employment will suffer greater hardship than labor markets that derive a larger percentage of their income from the Government sector.

The elasticity of the State or local tax base will also have an important impact upon the size of the revenue shortfall. Those States and local governments that derive a significant portion of their revenues from elastic taxes, such as the income and sales tax, will suffer relatively larger shortfalls in revenues. Since States and large urban areas are most dependent on these sources of revenue, it is these areas that will experience the greatest recession-induced revenue shortfall.

While it is unrealistic to expect the Federal Government to completely compensate State and local governments for the fiscal crunch in the upcoming year, the Federal Government should partially indemnify State and local governments for hardships imposed upon them by macroeconomic developments. The degree of assistance provided to specific State and local governments should be dependent upon the differential impact of recession and inflation on specific States and localities.

A countercyclical revenue assistance grant should be enacted to compensate State and local governments for revenue shortfalls associated with significant cyclical downturns. Countercyclical revenue assistance funds should be allocated whenever the national rate of unemployment exceeds some predetermined level and should be targeted toward those areas that experience the greatest revenue shortfalls based on unemployment rate and tax base elasticity.

In addition to cushioning the impact of recession on State and local government revenues, the countercyclical revenue assistance grants would produce two further benefits. First, State and local governments would be encouraged to become dependent on more elastic and, in the case of the income tax, more progressive tax bases. Greater reliance on elastic tax bases would further insulate State and local governments from situations in which inflation has a greater impact on expenditures than on revenues. Second, the countercyclical revenue assistance grants could operate as an automatic stabilizer, moving the economy toward full employment by increasing government spending in periods of high unemployment.

We realize, however, that it will be difficult to enact a major countercyclical revenue assistance program in time to assist State and local governments in the upcoming fiscal squeeze. For this reason, a major public service employment program of the type recommended above is the most effective method for providing immediate fiscal assistance to already hard-pressed State and local governments.

A major public service employment program should be enacted to provide immediate countercyclical fiscal assistance to State and local governments.

IV. POLICIES TO DEAL WITH INFLATION AND RISING UNEMPLOYMENT

The earlier chapters of this report have described the economic situation and outlook, analyzed the causes of recent inflation, and assessed the impact of inflation and unemployment on various aspects of our national life. This final chapter identifies the policies which can contribute to economic stabilization and presents our recommendations for employing these policies at the present time.

The outlook for real growth and employment has deteriorated rapidly in recent weeks. Our recommendations have been prepared in light of this changed situation. Taken together, we believe our recommendations represent a well-balanced and responsible program for meeting the urgent needs of the present moment. When the economic situation is changing as rapidly as at present, however, policy must be prepared to respond in a flexible way. We shall not hesitate to present additional or revised recommendations in the months ahead if the economic situation deteriorates beyond what is presently foreseen.

A. Fiscal Policy

As part of its background review for preparing this report, the Joint Economic Committee has undertaken an extensive review of fiscal policy. Witnesses before this Committee, both private and government, have generally agreed that over the past year and a half fiscal policy has not contributed to the high levels of inflation that we have experienced. In spite of this consensus the Administration, until recently, continued to express the desire to balance the Federal budget. This Committee has long felt that the appropriate level of surplus or deficit was dependent upon economic conditions and should not be arbitrarily set at zero.

The Effects of a "Balanced Budget"

Budget projections are intended to go into effect approximately six months after they are presented to Congress and extend over a period of one year thereafter. This means that budget projections are based on a forecast at least 18 months long. Following any consistent policy—surplus, balance, or deficit—requires therefore the ability to make accurate forecasts. As an interesting exercise the Committee reviewed the original budget projections for receipts and expenditures contained in the President's budget for each fiscal year since 1963 and compared them with actual figures. These figures are presented in Table 1.

Table 1 shows that over the period 1967–1972 the surplus or deficit originally projected was very small. In fact, from 1967 to 1971 the budget was *projected* to be essentially in balance. The cumulative deficit which *actually* occurred over this period exceeded $50 billion.

TABLE 1.—FEDERAL RECEIPTS AND EXPENDITURES (NATIONAL INCOME ACCOUNT BASIS) FISCAL YEARS 1963–74

	Original budget projections	Actual	Difference
Fiscal year 1963:			
Receipts	116.3	110.2	—6.1
Expenditures	111.9	111.4	—.5
Surplus (+), Deficit (—)	+4.4	—1.2	—5.6
Fiscal year 1964:			
Receipts	111.4	115.5	4.1
Expenditures	119.0	116.9	—2.1
Surplus (+), deficit (—)	—7.6	—1.4	6.2
Fiscal year 1965:			
Receipts	118.8	120.5	1.7
Expenditures	121.5	118.5	—2.4
Surplus (+), deficit (—)	—2.7	+2.0	4.7
Fiscal year 1966:			
Receipts	121.0	132.8	11.8
Expenditures	127.0	131.9	4.9
Surplus (+), deficit (—)	—6.0	+.9	6.9
Fiscal year 1967:			
Receipts	142.2	147.2	5.0
Expenditures	142.7	154.5	11.8
Surplus (+), deficit (—)	—.5	—7.3	—6.8
Fiscal year 1968:			
Receipts	167.1	160.6	—6.5
Expenditures	169.2	172.5	3.3
Surplus (+), deficit (—)	—2.1	—11.9	—9.8
Fiscal year 1969:			
Receipts	182.5	190.4	7.9
Expenditures	185.0	185.7	.7
Surplus (+), deficit (—)	—2.5	+4.7	7.2
Fiscal year 1970:			
Receipts	202.3	195.2	—7.1
Expenditures	199.6	195.9	—3.7
Surplus (+), deficit (—)	+2.7	—.7	—3.4
Fiscal year 1971:			
Receipts	205.4	192.5	—12.9
Expenditures	203.8	212.4	8.6
Surplus (+), deficit (—)	+1.6	—19.8	—21.4
Fiscal year 1972:			
Receipts	225.9	213.2	—12.7
Expenditures	230.1	232.9	2.8
Surplus (+), deficit (—)	—4.2	—19.7	—15.5
Fiscal year 1973:			
Receipts	227.9	240.4	12.5
Expenditures	255.9	255.4	—.5
Surplus (+), deficit (—)	—28.0	—15.0	13.0
Fiscal year 1974:			
Receipts	263.0	274.9	11.9
Expenditures	275.5	276.6	1.1
Surplus (+), deficit (—)	—12.5	1.7	10.8

Sources: Office of Management and Budget, Department of Commerce, Joint Economic Committee.

A careful examination of Table 1 shows that expenditures on the whole have been projected far more accurately than revenues. If policymakers had in fact attempted to balance the actual budget as the year progressed, they would have had to alter expenditures or tax rates to compensate for the faulty projection of budget receipts. In a situation where an unexpected decline in real economic activity caused tax collections to fall, a reduction in expenditures or an increase in tax rates would have been necessary to keep the budget balanced. Such a policy would have further aggravated the decline in real output and in general would not have been desirable.

In studies prepared at the request of this Committee, the Wharton and Federal Reserve Board econometric models have been used to simulate a policy of balancing the budget over the period late 1969 to mid-1972.[1] Depending on the specific changes made to achieve balance, losses in real output by the end of the period ranging from $28 billion to $44 billion per year were estimated using the Wharton model. Losses of approximately $74 billion per year were estimated using the Federal Reserve's model. Unemployment rates ranged from 1½ percent to 5 percent higher under the balanced budget assumptions than under the policy which was actually followed. The rate of inflation showed little response to the changed budget policy. This result was not surprising since the type of price equations used in the models is far more sensitive to changes in monetary policy than to changes in the Federal budget.

The Full-Employment Budget as an Analytic Tool

Another fiscal policy that often has been suggested is to balance or maintain a consistent surplus in the full employment budget.[2] Recently the concept of the full employment budget has been seriously questioned because inflation increases revenues faster than expenditures, making the balance easier to achieve and less meaningful. When the full-employment budget concept was originally developed, two factors which caused changes in budget receipts and expenditures were considered—fluctuations in real output and discretionary decisions made by the President and Congress. By assuming a constant rate of growth in real output, the full-employment budget allows separate examination of the impact of discretionary decisions. No separate analysis is made of the impact of accelerating inflation on tax receipts, a factor which has assumed key importance only in the past two years. In a period of accelerating inflation, full-employment receipts as well as actual receipts tend to be increased more rapidly than expenditures. Therefore, examining the full-employment budget does not show the impact of discretionary decisions alone but shows a combination of discretionary decisions and inflation. An increasing surplus in the full-employment budget does not necessarily indicate that policymakers intended fiscal policy to become more restrictive. It does, how-

---

[1] The Committee plans to publish a detailed account of these studies within the next few months.

[2] The full-employment budget is a calculation to determine what tax receipts and Federal expenditures would be if the economy were operating at a constant rate of resource utilization. The rate of utilization most often used is consistent with having 96 percent of the civilian labor force employed.

ever, indicate that the combination of discretionary fiscal policy and the effects of inflation is in fact producing a more restrictive budget.

The full-employment budget has also been criticized because it has normally assumed an unemployment rate of four percent. Some have argued that "full employment" should be redefined to be 4½ percent or 5 percent unemployment. A higher unemployment rate would lower potential gross national product and therefore lower revenues significantly, while having much less effect on expenditures. However, for the purpose of determining whether fiscal policy is more or less restrictive relative to some past period, the change in the surplus—not the level of surplus—should be considered. An increase in the surplus indicates a move toward more fiscal restraint and vice versa. Since changes in the surplus are affected very little by changing the level of receipts and expenditures, the analysis would not be affected by using an unemployment rate different from 4 percent.

As an analytic tool, we find that the full employment budget is a useful device. Changes in the surplus from one period to the next provide a good indication of the direction in which fiscal policy is moving. It would also be helpful to be able to separate changes caused by inflation from those caused by policy decisions. Within the next few months, the Committee plans to publish a study suggesting how this separation can be made.

Ultimately fiscal policy must be considered in the context of monetary policy and other governmental impacts on the economy. The combination of all government actions should result in the overall economy being stimulated or restrained as necessary. It is, after all, the economy rather than the budget which is most important. Accordingly, no single rule for fiscal policy will serve the economy well in all situations. We can, for example, think of several different policy packages which would achieve the same macroeconomic goals but would have very different impacts on the distribution of income.

Budget Policy in Fiscal 1975 and 1976

As recently as last September, most economic forecasters were predicting a mild recession for 1974 and very sluggish, if any, economic recovery in 1975. Since September the economic outlook has deteriorated substantially. As pointed out in chapter I of this Report, we expect real output to continue to decline for the remainder of this year and throughout the first half of 1975, with unemployment rising above 7 percent.

Evaluation of the Federal budget at the present time indicates that receipts in fiscal 1975 may be substantially below the most recent official estimate of $293 billion. The worsening economic situation combined with the switch by many corporations from first in, first out (FIFO) to last in, first out (LIFO) inventory accounting methods and the unlikelihood that the Administration's surtax proposal will be adopted have combined to lower the probable level of receipts.[3]

[3] In an inflationary period, material held in inventory increases in value as prices rise. These inventory profits are subject to Federal income tax. Changes from FIFO (first in, first out) accounting method to the LIFO (last in, first out) method reduces the inventory profits and thus reduces Federal tax collections.

Total revenues could easily be $291 billion or less. Without any of the Administration's expenditure reduction proposals, expenditures are officially projected to be $306.8 billion. Because of the greater than anticipated rate of inflation, this $306.8 billion will buy fewer goods and services than was originally planned in the $304.5 billion spending proposal made in February. Any attempt to reduce spending further threatens to disrupt public services, create hardships, and intensify the recession without offering benefits in the form of reduced inflation.

Looking only at the unified budget confuses the impact of declining real output and discretionary fiscal policy. The full-employment budget which separates these two forces shows an estimated surplus at an annual rate of approximately $17 billion for the first half of fiscal 1975. In the second half of the fiscal year this surplus is estimated to grow by more than $10 billion, approaching an annual rate of $30 billion. This represents a significant shift toward economic restraint at a time of worsening recession. A staff analysis of this increase in the full employment surplus indicates that approximately half can be attributed to discretionary fiscal policy and the remainder to inflation.

In view of the deteriorating economic outlook and our expectation that real growth will decline throughout the first half of 1975, the surplus in the full-employment budget should not be allowed to rise during the remainder of this fiscal year.

In order to mantain the full employment budget surplus at the current level, full-employment expenditures should continue at their present rate and taxes should be reduced.[4] Elsewhere in this report we outline structural tax changes which would have a long-run net revenue impact of approximately zero. However, due to the timing we have recommended the tax cuts would precede the increases and thus provide support to the economy in early 1975 when it will be most needed. Net tax relief of $10–$12 billion (annual rate) in the second half of fiscal 1975 would prevent the full employment surplus from rising. As discussed in Chapter III (p. 45), permitting the substitution, at the option of the taxpayer, of a $225 tax credit for each personal exemption would provide approximately this amount of tax relief and do so in a progressive fashion.

Fiscal year 1976 begins six months from now and ends in about one and one-half years. Therefore any forecast of the economic conditions that will prevail during the year must be highly tentative, and the Congress and the Administration must stand ready to revise their planned actions in view of unanticipated changes in economic activity. At the present time the outlook is for a high unemployment economy in fiscal 1976. The first half of the year should show the beginnings of a recovery from the current recession and the second half hopefully a more vigorous rate of real growth. For the fiscal year as a whole the economy is expected to be operating at less than 90 percent of its potential. This forecast (presented in greater detail on pp. 6–12) assumes the Government will adopt a supportive fiscal policy. For the foreseeable future the economy will be so far from its potential growth

---

[4] Expenditures on unemployment compensation and related programs in excess of what would be spent at a 4 percent unemployment rate do not enter into the full-employment budget.

path that such a supportive policy will be required to spur it more rapidly in the direction of its potential and will not represent a significant inflationary threat. In the absence of supportive policies, recovery from the present recession is likely to be anemic, with unemployment continuing to rise. Anemic recoveries are all too typical of recent U.S. economic history. Unemployment rose in the "recovery" year of 1963, for example, and remained stuck at 5.9 percent throughout most of the "recovery" year of 1971. In both cases, additional fiscal stimulus was eventually required to keep the economy on a recovery path. Far better that fiscal policy steadily support recovery from the beginning, rather than be too restrictive at first and run the risk of being overly stimulative later on.

The surplus in the full-employment budget in fiscal year 1976 should not be allowed to increase over the level calculated for the first half of fiscal 1975. If the recession is as deep as presently anticipated, a modest decline in the surplus would be helpful in moving the economy more rapidly back toward its long-term potential growth path.

Credit Agencies

The number of "off-budget" agencies has grown tremendously in recent years. They include such agencies as the Federal Land Banks, the Federal Intermediate Credit Banks, the Rural Telephone Bank, the Rural Electrification Administration, the Student Loan Marketing Association, the Federal National Mortgage Association, the Environmental Financing Agency, the Federal Home Loan Bank, and the Federal Home Loan Mortgage Corporation. The 1975 budget estimated that the total credit advanced under the auspices of the Federal Government would be almost $17 billion. Slightly more than $2 billion of this total was included in normal budget consideration. Because of the rapid growth of these "off-budget" agencies, the Congressional Budget Act of 1974 provides that their lending activity should be considered with other Government spending.

The impact of these off-budget credit agencies has become a matter of some dispute and merits a thorough investigation by the Congress. This Committee has received conflicting testimony about the manner in which these programs should be considered in the budget. We are in substantial agreement with the recommendation made in the 1967 report of the President's Commission on Budget Concepts that a distinction should be made between loans and expenditures. The impact of Federally sponsored credit on overall economic activity will vary with economic conditions. Under some conditions the major function of this credit activity is probably to reallocate the total amount of credit that is available. Under other conditions this activity may add to the net credit available although the amount added is substantially less than the total amount of credit advanced under government auspices. Regardless of whether these agencies change the net amount of credit available or merely redistribute part of it, the economic impact of this activity should be considered separately from normal government taxing and spending when determining the overall impact of fiscal policy on the economy. In a situation where government credit activities do not provide a net stimulus to the economy, inclusion of loans in Federal expenditures would certainly overstate the amount of fiscal stimulus provided. In a situation where credit activities provide some stimulus to the economy, they are more appropriately considered in the overall context of monetary policy.

Table 2 is an illustration of how loans could be separated from expenditures in the budget presentation. A corresponding table showing the amount of debt issued by these "off-budget" agencies would also be useful.

While it is desirable for Congress to exert control over those Federal agencies which are not now included in the Federal budget, the lending activity of these agencies should not be considered as Federal expenditures for the purpose of determining the impact of fiscal policy on the economy. Federal credit activities should be presented in such a fashion that they are clearly identifiable and readily separable from regular government expenditures.

TABLE 2.—FEDERAL RECEIPTS, EXPENDITURES, AND NET LENDING—FISCAL YEAR 1975

[In millions of dollars]

Expenditure account:		
Receipts	$295,000	
Expenditures	302,104	
Expenditure account deficit		$7,104
Loan account:		
Disbursements	13,577	
Repayments	11,236	
Net lending		2,341
Federally owned enterprises excluded from Budget: [1]		
Disbursements	3,586	
Repayments	1,486	
Net		2,100
Additional net lending of agencies outside the Budget [2]		1,384
Total net credit (direct loans)		5,825
Net change in guaranteed and insured loans	13,284	
Less portfolio holdings	2,300	
Net change (guaranteed and insured loans)		10,984
Net credit advanced under the auspices of the Federal Government		16,809

[1] Export-Import Bank, Rural Electrification Administration, Rural Telephone Bank.

[2] Student Loan Marketing Association, Federal National Mortgage Association, National Rail Association, Environmental Financing Authority, Federal Home Loan Banks, Federal Home Loan Mortgage Corporation, Federal Land Banks, Federal Intermediate Credit Banks, and Banks for Cooperatives.

B. Monetary Policy

Monetary policy is a very powerful tool for controlling the total growth of gross national product measured in current dollars. Its value as a policy instrument is enhanced by the fact that unlike fiscal policy, adjustments in monetary policy can be made quickly and on a continuing basis. Nonetheless, in evaluating monetary policy as a tool of economic stabilization, two important considerations must be kept in mind:

(1) The economic effects of monetary policy changes appear only with a time lag of at least several months. Current policy

must be formulated in terms not only of current conditions but of conditions as they are expected to be six to twelve months and even longer into the future.

(2) Monetary policy influences the total growth of current dollar GNP. The division of this total growth into price change and real output change is influenced by many factors. As the experience of 1974 has demonstrated, the use of monetary policy to control GNP growth often has its first effect on real output, while price increases continue unabated. Current dollar GNP will rise about 8 percent for 1974 as a whole, but prices will be up about 10 percent and real output down about 2 percent.

Month to month fluctuations in money supply growth have little economic meaning. Over periods of six months to a year, however, rates of growth of the money supply, if carefully interpreted, can provide a useful guide to the thrust of monetary policy. Over shorter periods, the movement of short term interest rates, especially the Federal Funds Rate, may provide a better guide to the intent of monetary policy.

In interpreting changes in both the money supply and interest rates, it must be remembered that these aggregates are influenced by changes in the *demand* for credit as well as changes in monetary policy—which acts on the *supply* side.

In recent weeks the Federal Funds Rate—the rate at which bankers may daily borrow unused reserves from other banks to meet temporary requirements—has declined from a peak of over 13 percent to less than 9 percent. Other short-term borrowing rates have also shown a recent downturn, although not of equal proportion. In part, this may be attributable to some easing of monetary policy. A more important factor would appear to be that business firms—overloaded with short term debt which has drastically reduced their liquidity—have decided to restrain their total demand for funds in the light of the deteriorating state of general demand. Therefore, the decline in short term rates is primarily a signal of recession rather than of Fedeal Reserve policy aimed at getting the economy moving ahead again.

Whatever interpretation one places on the interest rate movements of the past few months, it seems clear that for much of 1974, monetary policy was highly restrictive. Over the six month period from April to October, the money supply rose at an annual rate of only 3.4 percent, and during the last half of this period the rate was only 2 percent. At a time when large price changes from sources outside the control of domestic macroeconomic policy were still working their way through the economy, it was inevitable that failure of monetary policy at least to partially accommodate these external price factors would have a severe impact on real output and employment. Just how severe is only now becoming fully apparent.

Excessively rapid reduction in the rate of growth of the money supply during mid-1974 has intensified and prolonged the present recession.

While there has apparently been some relaxation of monetary policy in the past two months, there has not yet been an adequate response to the needs of an economy which is already operating 10 percent below its potential and still sliding down.

The immediate task of monetary policy must be to help halt the drop in real output. The provision of adequate credit for residential construction is of key importance in this regard. Beyond this immediate need, monetary policy must be directed toward supporting the 7 to 8 percent rate of growth of real output which will be needed in late 1975, throughout 1976 and probably 1977 in order to partially close the gap between actual and potential levels of resource utilization.

The exact rate of monetary growth which will be required will depend on several factors. Assuming average velocity changes and no dramatic shifts in the level of world commodity prices, money supply growth in the range of 6 to 7 percent may be adequate. However, should the economy be subjected to new external price shocks comparable to the food or oil price increases of 1973, monetary policy must be adjusted accordingly.

The Joint Economic Committee's interim report issued last September discussed the need to develop a mechanism to channel available supplies of credit into the highest priority areas. We continue to believe that such a mechanism [5] is required. In light of the disastrous slump in housing construction, which is so clearly the direct result of the unavailability of mortgage credit, this channeling mechanism should give a very high priority to the housing sector. In our interim report last September we noted:

> The Credit Control Act of 1969 provides that the President can authorize the Federal Reserve "to regulate and control any or all extensions of credit" whenever he determines "such action is necessary or appropriate for the purpose of preventing or controlling inflation generated by the extension of credit in excessive volumes." Implementation of the Credit Control Act could lower the pressure on interest rates while reducing the inequities in the ability of various sectors to obtain funds by channeling credit away from speculative endeavors which are inflationary into productive investments. It is important to recognize that even a moderate easing of monetary policy will not entirely relieve the uneven competition for loanable funds. For the longer run, financial reforms are required to enable different types of borrowers to compete more equally for credit, and we will discuss this further in our December report. For the present, some form of credit channeling would allow the Federal Reserve to maintain a moderate restraint on the money supply while aiding the sectors most strapped by monetary restraint.
>
> Without endorsing any particular approach, there are several measures which the Federal Reserve could consider as a means for channeling credit:
>
> A capital markets committee could be created to advise the Federal Reserve on the selective extension of credit.

[5] Representative Brown states: "Such a mechanism may be desirable, but the implementation of it by Federal Agency may be even less efficient than the present competitive market system."

> To assure that the needs of various economic sectors are given an adequate hearing, this advisory committee should be composed of representatives of the Federal Reserve, other appropriate government agencies, the financial community, business, labor and consumer groups. Such a committee could have a strong impact on lending practices even without any authority to require changes in these practices.
>
> Under specific criteria established by Congress, the Federal Reserve could pursue a policy of variable reserve requirements. In order to make funds available for housing, for example, the Federal Reserve could lower the reserve requirements for those banks which increased construction or mortgage loans over and above the amount during some base period. A similar reduction in reserve requirements could also be made if bank loans were increased for public utility investment, for small business or other high priority uses determined by Congress.[6]

In this connection, it is noted that on September 16, 1974, the Federal Reserve Board released a statement on bank lending policies during periods of credit restraint which was developed by the Federal Advisory Council, a statutory body established under the Federal Reserve Act. This Council identified certain types of loans which would be inappropriate uses of the limited supply of bank funds, including loans for speculative purposes, loans for purely financial activities and loans to foreigners which divert funds from U.S. customers. The Council also listed categories where credit should be expanded.

In early October this Committee sent a letter to the 300 largest commercial banks asking for staitistics which would show the extent to which they held loans in the restricted and expansion categories as of September 1, 1974, and their targets for next year. Through December 3, only 166 of the 300 banks had responded, of which 86 replied that they could not furnish the requested information from their records. This poor response indicates that most large commercial banks either do not know very much about the loans they make or that they do not want to admit to a congressional inquiry that they make loans for speculative and purely financial purposes at a time when credit is scarce for housing and other productive purposes.

C. Price-Incomes Policies

As discussed in Chapter II, some part of recent inflation has been due to deficiencies in the Federal Government's wage-price policies, or what should broadly be considered incomes policies. Frequent changes in the type of policy employed have made these policies seem erratic, capricious and inequitable. The design and administration of incomes policies requires an extraordinary degree of political leadership, and that leadership has not always been forthcoming from either

[6] "An Action Program To Reduce Inflation and Restore Economic Growth." Interim report of the Joint Economic Committee pursuant to S. Con. Res. 93, Sept. 21, 1974, p. 18.

43-168 O - 74 - 6

the Executive or Congress. In fact, the vacillation between extremes—no policy to complete controls—has in itself had a destabilizing effect.

THE ROLE OF PRICE-INCOMES POLICIES

This gap in the Nation's economic policies must be closed to insure a comprehensive attack on inflation. At the present time the economy is far from any situation of excess demand. It is the responsibility of monetary and fiscal policy to bring the economy back to its potential growth path in a way which prevents the re-emergence of inflationary pressures due to excess aggregate demand. Price-incomes policies, on the other hand, are designed to cope with inflationary pressures that exist even when there is underutilization of the economy, or in the transition to full employment.

One reason prices rise in the absence of excess demand is that noncompetitive conditions in many sectors allow unions and firms to have significant discretion over wage and price decisions. When the economy is expanding, but long before it has reached full capacity, producers with substantial market power expand profit margins by raising prices, while unions with similar power seek wage increases in excess of productivity gains and larger than competitive labor markets would permit. Given the lack of downward flexibility of wages and prices in other industries, the net effect is a general rise in the price level. These price increases of course have secondary effects on costs through increases in the cost of materials and through the impact of the rising cost-of-living on wage demands.

A second potential cause of inflation is supply shortages or industry bottlenecks. These supply shortages can result from unforeseen market failures, as was the case in 1972 when world grain production fell 4 percent, or from artificial supply constraints imposed by government regulation. Such supply shortfalls can cause the bidding up of prices even though the economy as a whole is not at full resource utilization.

Finally, inflation can be caused by a psychology or public attitude that may not be supported by developments in the real economy. Although the process is certainly not well understood, consumers, producers, and workers apparently believe that once an inflation starts, it will continue and even accelerate. Workers consequently demand higher wage rates to offset the anticipated rise in the cost of living, producers raise prices to protect profit margins that are expected to erode due to higher material and labor costs, and consumers may temporarily aggravate the situation by increasing their purchases of goods and services before prices go higher. Taken together, these defensive actions reflect a psychology about inflation that tends to generate an inflationary spiral.

Fiscal and monetary policies are not well suited to deal with inflation stemming from the above causes, while properly designed and executed price-incomes policies can be of significant benefit. Traditionally incomes policies have focused on government efforts to persuade—or to compel—businesses and workers to avoid, reduce, or delay increases which they might otherwise have made in prices, wages, rents, dividends, or other forms of factor income. More recently in the United States, the concept of price-incomes policies has often included efforts to reform government activities that contribute to inflation, such as outmoded regulation, or more generally, government efforts to identify and eliminate supply bottlenecks. In the U.S., price-incomes policy can be defined as any systematic and continuing government effort to encourage or compel wage and price stability in particular markets, as well as direct government intervention in the price and wage setting process on a broader scale.

There is a wide variety of techniques that can be used in the fashioning of any particular incomes policy. There is no single model for an appropriate policy. Nevertheless, the Committee's review of U.S. experience with incomes policy indicates that there are some general principles that must be followed if incomes policies are to be successful.

(1) In order to anticipate inflationary developments, the Federal Government should develop a permanent and comprehensive system to monitor and analyze inflationary trends in individual economic sectors, including information on the international sector.

(2) Because the character of inflation can change rapidly, incomes policies should be flexible. Incomes policies in general, and mandatory wage and price controls in particular, will not be very effective when there is excess aggregate demand. Incomes policies will be most effective when there is some slack in the economy and inflation is primarily the result of cost-push forces.

(3) Incomes policies must be carefully coordinated with other government economic actions, particularly monetary and fiscal policies, which remain the primary tools for demand management.

(4) A successful incomes policy requires broad political support. A special effort should therefore be made to promote maximum participation of business labor, farmers, consumers, and other groups in the formulation and implementation of incomes policies. Political support for incomes policies can be strengthened by improved cooperation between Congress and the Executive, with Congress assuming more responsibility for the development and monitoring of incomes policies than in the past.

Future Use of Incomes Policies

Fundamental to the formulation of an effective incomes policy is an accurate diagnosis of the character of inflation. As we have indicated above, the current and prospective inflation is in large measure due to administered price increases in uncompetitive markets. In addition, inflationary cost pressures result from a combination of falling productivity, previous raw material price increases that continue to work their way through the stages of production, and large wage increases stemming from the legitimate desire of workers to overcome earlier declines in real incomes. The problem has been made more difficult because during the past year there has been a shrinkage in the economic pie to be shared by the Nation. In proposing price and wage adjustments, business, labor and government must recognize this circumstance and understand that no one can realistically expect to recoup immediately all the income losses suffered in the last 18 months.

Current and prospective inflation is not due to excess aggregate demand but primarily to the productivity decline associated with the recession, administered price increases in uncomparative markets, and a variety of other cost-push factors. Good progress in reducing inflation is possible in 1975, but only if:

(1) The recession is halted and productivity gains are restored; (2) the Government, labor, and business cooperate to avoid price or wage increases significantly in excess of those which could be achieved in competitive markets; and (3) the take-home pay of low and middle income workers is increased through tax reductions that cut the size of money wage increases needed to sustain real after-tax income levels.

Although the Committee has concluded that the recent experiment with direct wage and price controls yielded benefits in excess of its costs, there are several reasons that a comprehensive system of controls seems inappropriate at present. In the first place, comprehensive controls over all sectors of the economy are not administratively feasible because some markets, notably commodity markets, experience fluctuations in supply and demand that change prices daily, if not hourly. Second, comprehensive controls are not needed because inflationary problems do not exist in all sectors. As discussed earlier, the international supply and demand situation will work in favor of price stability in the more open and competitive sectors of the U.S. economy in 1975. Third, a system of direct controls makes the Federal Government responsible for far more than just regulating wages and prices, including investment plans, the extent of expenditures for social purposes, the extent of advertising expenditures allowed, and even financial solvency. Such involvement represents a degree of interference in private business decisions which should be undertaken only as the last available alternative. Finally, direct wage controls would essentially mean the abolition of the right to strike, a situation that would be in extreme conflict with the tradition of collective bargaining in this country.

Nor is the current political climate conducive to reestablishment of comprehensive wage and price controls. For an incomes policy to be successful in a democratic society, it must have the support of the major economic interests and the political backing of both the President and the Congress. Neither of these conditions appears likely to be met with respect to comprehensive wage and price controls in the near future.

Comprehensive wage and price controls are economically inappropriate and politically unrealistic at the present time. More selective techniques for carrying out a tough voluntary incomes policy should be utilized.

Strengthening the Council on Wage and Price Stability.—The Council on Wage and Price Stability was created in August of this year to serve as the principal institutional focus for U.S. incomes policy. Since then, the Council has appointed a Director, Dr. Albert Rees, and hired approximately 18 professional staff members. This limited staff has conducted hearings on inventory repricing and the sugar industry, published two staff studies, and testified before Congress twice. The Council itself, which is composed primarily of key Cabinet officers and chaired by Treasury Secretary William Simon, has met only once to discuss organizational matters, and on a second occasion to review an inventory repricing study.

The activities undertaken by the Council so far respond to many of the recommendations made in this Committee's Interim Inflation Report.[7] These activities should be continued and encouraged. The Council should continue its review of all government practices which contribute to inflation. It should enlarge its regular consultations with business, labor, and consumser groups. Finally, the Council should continue to hold public hearings on particular private or government actions that could damage the national effort to restore price stability.

Despite the activities cited above, present Council efforts are inadequate in several ways. In the first place, the Council lacks enough resources and authority to monitor inflationary trends, anticipate and analyze problems, and hold public hearings. The surest way for the present incomes policy to fail is to neglect to provide adequate resources to administer the program.

In order to be able to carry out its mandate, the Council on Wage and Price Stability should be given authority to subpoena pertinent information on wages, prices, sales, costs, and profits. The appropriation of the Council should be increased substantially to permit expansion of its staff and activities.

Goals.—Establishing appropriate goals against which to measure satisfactory performance in reducing inflation is difficult in the present circumstances. Historically, real wages have risen roughly in line with long-run productivity increases of about 3 percent per year. With prices expected to average some 9 percent higher in 1975 than 1974, this would imply a 12 percent increase in wages. Such a standard would contribute little to the slowing of inflation.

The establishment of wage and price goals in the current environment should begin from a different perspective. As we indicated earlier, high oil and food prices have reduced total income within the nonfarm segment of the economy. This loss of potential income has been further aggravated by the recession and the decline in productivity accompanying it. As a result there is no way in which everyone can receive an immediate and complete catch-up with inflation. If the more powerful and better organized groups in society do successfully demand a full "catch-up," it will be achieved at the expense of other groups within the United States, quite likely those who are poorer, weaker and less well-organized.

---

[7] Op. cit., ch. III.

Goals should be set to reflect the improved state of the economy which would result from the implementation of the policies recommended in this report. As stated above, it should be possible to reduce the rate of inflation reflected in the GNP deflator to within the neighborhood of 7 percent in the second half of next year. This assessment assumes that average hourly wage increases will be around 9 percent next year and that a 3 percent rate of productivity growth can be restored by the fourth quarter, thus reducing the rate of increase in unit labor costs to about 6 percent. Given the increasing slack in labor markets, and the opportunities for productivity gains in an economic recovery, these price and productivity goals are attainable.

Taxes.—In conjunction with these goals, a tax reduction for low and moderate income taxpayers should be enacted early next year. Low income workers should not be asked to risk any further reduction in their real incomes. A tax cut of $10 to $12 billion could reduce cost-push inflationary pressures by stimulating an economic recovery that would increase productivity, reduce labor costs, and yet still raise real incomes. At the same time, such a tax cut would replace some of the real income lost last year and protect workers against the possibility of future income losses due to higher food prices.

Tying such a tax cut to an incomes policy is unconventional in the United States, although not uncommon in other countries. U.S. workers and their union representatives are accustomed to bargaining for money wages that keep up with the cost of living. However, it should be possible for the President, Members of Congress and other public leaders to explain to workers the advantages of moderating their money wage demands while maintaining their real incomes through a tax cut. Various specific alternatives for achieving a tax cut of this magnitude have already been discussed in Chapter III of this report.

> **As an integral component of a fair and realistic incomes policy, the real incomes of low and moderate income workers should be supplemented by a tax reduction of $10 to $12 billion in 1975. The Government should work actively to persuade workers to moderate their money-wage demands by an amount roughly equivalent to the benefits of the tax cut.**

Compliance.—A successful voluntary incomes policy must be based on compliance. In the most basic sense, the willingness of the President and Congress to support the program will encourage people to take it seriously. Vigorous efforts by the President to enlist business and labor cooperation are essential. In special cases which threaten progress toward price stability more direct and tougher ways to back up the program may be necessary. The kind of flexible incomes policy needed now should have a variety of enforcement techniques at its disposal.

One useful enforcement technique is the imposition of a 30 to 90 day delay on wage or price increases. Such a delay would be imposed only if there were a high probability that a particular wage or price would seriously undermine progress toward price stability. The delay would provide time to analyze the situation carefully, hold public hearings if necessary, and generally alert the public to the merits of the case. Yet it would avoid direct control over wages and prices.

In view of the persistent tendency for prices to rise in some industries despite weak demand, it is possible that direct wage and price controls may be needed on a highly selective basis. As discussed earlier, controls have many disadvantages. Nevertheless, if voluntary compliance cannot be achieved situations may arise in which there is no acceptable alternative to the use of selective controls.

In order to ensure compliance with a price incomes policy:

(1) Congress should provide the President with the power to delay for a limited period wage or price actions which threaten to undermine progress toward price stability. During this period, hearings should be held to determine the facts and, if necessary, efforts should be made to bring about a non-inflationary adjustment;

(2) Congress should also provide the President with limited standby authority to reimpose price and wage controls on particular sectors of the economy. Such authority should be invoked only in conjunction with a Presidential determination that the benefits from such controls outweigh any adverse consequences. The authority should also provide that controls imposed by the President may, within 60 days, be modified or rejected by concurrent resolution of Congress.[7a]

Construction.—The construction industry presents price and cost problems which require special attention. The rate of price increase for nonresidential structures is primarily due to rising materials costs and steep wage increases over the last few years. Wages paid in the construction area are among the highest in industry, with average annual earnings exceeding those in all manufacturing industries except petroleum and coal. The annual rate of wage increase was 5.5 percent from 1965–68 but jumped to 10.5 percent from 1968–71. It then moderated during the 1971 to mid-1974 period to a rate of 5.6 percent. The slowing in the rate of increase was largely due to the efforts of the Construction Industry Stabilization Committee (CISC), a part of the economic controls program.

It is unlikely that the push for higher wages today is over. Wage agreements negotiated in the first half of 1974, many of which were concluded under CISC (which was dissolved in April), averaged between 8.0 and 8.5 percent. First-year wage increases under construction agreements negotiated during the second and third quarters of 1974 show increases of 9.4 and 15.9 percent respectively. This compares to an all industries average of 9.2 and 11.1 percent for the same periods. The large number of work stoppages in 1974 also points to higher wage demands.

Rising wages have been only part of the problem that has beset the construction industry. Since 1968, the rise in the cost of construction materials has outpaced the average increase for all industrial commodities. The Wholesale Price Index for All Construction Materials (ACMI) increased at an annual average rate of 4.7 percent from

[7a] Senator Proxmire states: "I am not convinced that it is necessary to provide the President with blanket authority to impose selective price or wage controls. If the President is given authority to delay wage or price increases, he can, if necessary, utilize the delay period to come to Congress for any additional authority which may be needed to handle a specific situation."

1965–73; the Industrial Commodities Index rose at a rate of 3.4 percent for the same period. The first nine months of 1974 show an annual rate of price increase of 20.5 percent for industrial commodities, and a 15.6 percent in the construction index. The leap in the Industrial Commodities Index is partly attributable to the increase in the price of oil; the virtual collapse of the housing sector of the construction industry may have constrained construction materials prices.

The rise in the All Construction Materials Index is the result of many factors, but shortages in key materials appear to be a major cause. Strong world demand, environmental controls, wage/price controls, and the energy crisis have each contributed to these shortages. The shortage in cement, a basic element of non-residential-construction, was in part a direct result of Environmental Protection Agency regulations which forced some companies to close down old plants which were economically infeasible to outfit with appropriate environmental controls. As a result, the industry was left with an inadequate capacity to meet existing demand. Recently, with the completion of newer plants and refurbishing of some others, this shortage has abated.

The wage-price controls created shortages in some materials which producers found uneconomical to manufacture under controls. Controls also led some producers, notably steel producers, to cut back on the diversity of products. Thus, contractors found themselves forced to buy heavier grade steel reenforcing bars than were needed. The economic controls may have also dampened incentives to expand capacity in construction materials.

The energy crisis also had an impact on the price of construction materials, though it was not as pronounced as in other sectors of the economy. During the energy crisis, petroleum derivative products such as asphalt, plastic pipes, and roofing materials, were in short supply. The shortage, plus the higher price of petroleum, has maintained the high prices on those goods. The price of prepared asphalt roofing, for example, has increased by 46 percent from August 1973 to August 1974. Other materials with high energy production costs, such as brick, also increased, albeit to a lesser extent.

Though information on productivity is sketchy, it does not appear that increases in productivity have matched the wage increases over the past few years. If the inflation in the construction industry is enough to push up costs of nonresidential fixed investment at a rate that is significantly faster than the rest of the economy, then the task of curbing inflation will prove to be difficult, since those costs set a price threshold for the production of other goods and services.

Costs of expanding industrial capacity play a central role in the economy because of their direct effect on the prices that must be obtained for outputs to warrant investment in new capacity to produce them. For several years construction costs have been rising at exceptional rates, and costs of machinery and equipment have recently begun to soar. Therefore, the Federal Government must take a forceful lead in formulating and advocating programs to enhance productivity and eliminate barriers to efficiency in this sector. The Construction Industry

Stabilization Committee should be reestablished to moderate construction costs and to propose legislative and institutional changes.

Consumer Action.—Pressures of inflation affect all consumers. On the one hand, the consumer is faced with continuing increased costs of food, energy, clothing, and almost all of the items which he consumes. He feels helplessly frustrated by rapidly rising prices and shortages of some commodities.

In the past, consumers and consumer groups have demonstrated that under suitable leadership they could exercise considerable muscle in the marketplace. During the energy shortage of 1973–74, consumers cooperated in the national effort to curtail wasteful consumption by turning down thermostats, extinguishing extra lighting, and driving less and at slower speeds. Consumers also cooperated in reporting violations of price ceilings on gasoline and diesel fuel during the embargo period. Recent cutbacks in purchases of both automobiles and sugar show that the consumers are capable of making their resistance to high prices felt in the market place.

Until now, however, consumers have not been mobilized systematically against excessive price increases. A proper appeal and organization would give individual consumers a sense of being able to participate personally in a meaningful way in the public interest.

Consumer groups should adopt a watchdog function on the wage-price front. Their influence should be brought to bear selectively against price increases based on scarcity or monopoly power and those imposed by cartels.

The Director of the Council on Wage and Price Stability should establish a Consumer Affairs Advisory Committee with representatives from consumer groups and a chairman selected by the Committee itself. The purpose of the Committee shall be to advise the Council of the effects of price increases on the consumer and to enlist the support of consumer groups to help combat inflation.

D. Policies to Strengthen Competition

The essence of the free market system is competition. Yet large areas of the economy—from food production, distribution and marketing, to manufacturing and banking—are highly concentrated and dominated by a few large firms. By definition, effective competition does not exist under monopoly and is hampered in its effectiveness under oligopoly. These are the conditions that prevail in large sectors of the economy.

But the American economy cannot remain both free and non-competitive. Consumers are entitled to the benefits of individual enterprise whereby businesses engage in price competition with reasonable regard to supply and demand. If they are denied these benefits because of monopolistic or oligopolistic practices, these practices should be controlled.

Some forms of economic activity lend themselves to monopoly control. The provision of water, electric power, natural gas, and sewerage are a few examples. In such cases monopoly control has been legitimized in exchange for public utility and other forms of government regulation. The public is protected from exorbitant rates and degraded services through the exercise of governmental control.

Of course, government regulations can become outmoded. They can also be distorted through poor administration or corrupt practices. Abuses of regulatory authority, often resulting in the imposition of unnecessary costs on the consumer, have led to the current demand for reform.

Typically, the dominant firms in concentrated industries have been able to use their market power to insulate their price levels from fluctuations in demand. When demand is high the tendency is to increase prices, sometimes at a lesser rate than in the more competitive industries. However, when demand declines prices tend to remain fixed at high levels or to rise further in the concentrated industries. The long-term trend in the concentrated industries has been steadily rising prices.

As discussed in Chapter II, the months since controls were removed last spring have been marked by an explosion of prices in the concentrated industries.[8] Many economists conclude that the huge price hikes in the past year in such industries as auto, chemicals, fuels, metals, machinery, paper and transportation equipment, have been brought about through abuses of market power and despite the fact that demand began to sag in the latter half of the year. For this reason, the current inflation has been referred to in part as an "administered" inflation, arising from the power of the concentrated industries to administer or impose price increases on the public regardless of market forces.

Traditionally in the United States, the industrial sector has been relatively free of Government controls. One way to respond to administered prices would be to establish comprehensive price and wage controls over the concentrated industries. The controls would be a substitute for competition. They would be designed to balance costs and profits in reasonable relation to supply and demand. For reasons explained earlier in this report, the Committee does not favor comprehensive controls at this time. As discussed in the previous section, we strongly advocate an active voluntary price-wage policy. The longer run solution, however, lies in steps to strengthen competition. Whether or not industry exercises self-restraint, the government needs to act now to strengthen price competition. It should be emphasized that it is vitally important to strengthen competition not only to curtail inflation, but also to preserve the free market system itself.

The Government as Buyer, Seller, and Producer.—The Government plays a major part in the market economy today. It is a purchaser of goods and services, a seller and trader of assets, a producer of goods, a conductor of research and development, and a manager of resources. In all of those capacities the Government needs to improve its performance by eliminating waste and mismanagement and increasing competition. In some areas, waste, mismanagement, and the absence of competition are noticeably interrelated. As a result, the Government's costs of doing business are excessive and the taxpayer is not getting full value for his tax dollars.

---

[8] See Table 2, p. 10, for wholesale price changes by industry.

Defense procurement is a case in point. Experts, including former Defense Secretary Robert S. MacNamara, estimate that on the average procurement costs are reduced by 25 percent or more when defense contracts are awarded competitively. These estimates have been borne out by recent studies.

The staff of this Committee analyzed a number of cases where the Defense Department switched from sole-source (non-competitive) to competitive procurement of weapon systems. In each case the introduction of competition brought about dramatic reductions in prices paid by the Government. A review of 20 cases involving missiles and sophisticated electronic equipment showed an average price reduction of more than 50 percent. Greater use of competition would substantially lower procurement costs.

Studies conducted by the General Accounting Office contain similar findings. A recent study done by a Defense Department task force found a strong tendency for the Government to become "locked in" to a single supplier. The loss of government freedom of action, the study concluded, permits suppliers to force prices up by various devices.

Nevertheless, the long-term trend in defense procurement has been away from competition. In the past several years only about 10 percent of prime contracts were awarded through advertised bids; about two-thirds of all contracts were awarded on the basis of negotiations with a single supplier. This means that only one-third of all prime contract awards are made competitively through advertised bidding or other practices. Defense officials have failed to act on the many recommendations from this Committee and others to increase competition through greater use of advertised bidding, parallel competition in design, development and production, and breakout of subsystem and components for competitive awards.

The President should direct the Department of Defense to increase competition substantially in defense procurement. Guidelines should be established for increasing the percentage of defense contracts awarded competitively by at least 50 percent over the next 2 years.

Opportunities exist for making greater use of competition in government purchases by other agencies, particularly the General Services Administration (GSA) and also in the sale and exchange of government assets. In one recent case, GSA sold an Air Force plant declared excess to the Government's needs to an aerospace firm despite repeated objections to the sale by the Department of Justice on antitrust grounds. The sale was made on the basis of negotiations with a single purchaser. No other firms were allowed to submit bids for the property. In another instance GSA conveyed a valuable government facility to a corporation in exchange for a building described as a "white elephant." The Government has not yet been able to find a suitable use for the building it acquired.

The Government has been especially unwise in the way it deposits public funds in commercial banks. A study done by the House Banking and Currency Committee in 1972 (updating a 1963 study) showed a heavy concentration of deposits of public funds in a few banks. The banks do not compete in any way for the deposits and do not pay the government interest on them because the law prohibits interest payments on demand deposits. More than $5 billion in Treasury tax and loan account balances are being held, in effect, as interest free loans by the banks. Over $2 billion were in the 50 largest banks. The banks are free to invest the public money they hold for their own private profit.

The President should direct the Department of the Treasury to terminate the practice of depositing large amounts of public funds in commercial banks without fair compensation. The Department of the Treasury should explore the alternatives of requiring the banks to submit competitive bids for the privilege of using public funds or of changing the law to permit interest payments on public deposits of this type.

Government policy regarding the use of disposition of energy resources is extremely wasteful. More than half of the fossil fuel energy resources in the United States are in the public domain. The full extent of the public holdings are not known because the Government has not developed an adequate information system. It is estimated that about one-third of all remaining domestic oil and gas resources are in the Outer Continental Shelf (OCS) and that half the known domestic coal reserves, half the geothermal resources, and about 80 percent of the high grade oil shale are on Federal lands or under Federal control.

The practice has been for the Interior Department to sell mineral rights in response to pressures from the private sector. The Government has not developed a rational plan for the development and production of energy from resources in the public domain in accordance with national needs. The present energy crisis is in no small measure a consequence of this lack of planning.

Competition for mineral rights has been nonexistent, partial, or ineffective. A hodge-podge of rules and practices govern the issuance of permits and leases for exploration and development depending upon the type of energy resources involved. Permits are issued on an ad hoc basis for exploration of the OCS, usually to joint ventures of major oil companies. Onshore oil and gas leases are often sold on a first-come, first-served basis or by lottery. Persons who obtain permits to look for coal get preference rights entitling them to free, noncompetitive leases for the lands included in the permit. The Government gets a royalty on any coal produced. But, as in the case of offshore or onshore oil and gas, there is no requirement to produce. In addition, there has been no requirement that those exploring for energy resources on public lands supply the data gathered to the Government. Private firms seeking development rights generally know more about the Government's resources than the Government.

The sale of nearly all coal and onshore oil and gas rights is through noncompetitive procedures. While offshore leases are sold by competitive bids, the Government's relative ignorance about the potential deposits puts it in a poor position to evaluate the reasonableness of the bids or to integrate planned development with other energy resources. The proposed acceleration of offshore leases, from about 1 million acres annually in 1973 to 10 million acres by 1975, is likely to intensify the Government's energy resource management problems. There is some likelihood that the number of bidders per offering will decline as the market is flooded and that Government revenues from the sales will drop.

It is also likely that if such a massive sale of offshore tracts occurs, actual production will be deferred for years in many instances. When the sale of oil shale leases was recently stepped up, competition declined until the fifth sale when there were no bidders. The massive sale of coal rights over the years has not served the public interest. Of the roughly 22 billion tons of coal in the public domain leased or committed to the private sector as of 1972, only 10 million tons were produced, less than 2 percent of coal production in the U.S. that year. Much of the remainder is being held for speculative purposes.

The President should direct the Department of the Interior to develop the capability for adequately gathering and analyzing information about the location, extent, and value of energy resources on Federal lands and the Outer Continental Shelf.

The President should issue orders prohibiting all noncompetitive issuance of permits and leases for exploration or development of energy resources in the public domain. Persons holding permits or leases should be required to supply all raw exploratory data to the Government and to begin production within a reasonable time.

The Government can also help improve the performance of the economy by producing goods and services in areas where it is practical and reasonable to do so and where competition in the private sector is absent or inadequate. Two major areas where this approach needs to be given immediate consideration are defense and energy.

There is a long history of direct government participation in defense production. Government arsenals have been in the business of arms and ammunition manufacturing since the founding of the Nation. Government shipyards, laboratories and research centers have also been in operation for many decades. In recent times a number of arsenals and Navy shipyards have been closed for reasons of economy. However, changes in military requirements, the structure of the defense and aerospace industries, and the costs of weapons systems make it necessary to re-examine government policy.

Aircraft and shipbuilding costs have steadily risen to the point where serious questions have been raised as to whether the Nation can afford to buy the types and numbers of weapons necessary for defense. Many experts attribute part of the increases to the procurement system which does not seem to provide incentives for producing high quality weapons at the least possible cost. The high degree of concentration in the aircraft and shipbuilding industries and the absence of effective price competition is also significant.

The present and threatened energy shortages are well known. These shortages might have been avoided or mitigated had there been better utilization of resources in the public domain. It is not too late for the government to adopt a plan for the intelligent use of these resources. Moreover, the energy crisis makes it imperative that the government exercise a greater role with respect to its own holdings.

As this Committee stated in its March 1974 report, *A Reappraisal of U.S. Energy Policy*, a Federal corporation could make an important contribution to the development and production of energy resources in the public domain. Such a Federal corporation, possibly modeled after the Tennessee Valley Authority, could be established to supplement and not replace private exploitation of public resources. If properly managed it could help stimulate competition and serve as a source of information on the economics of energy production which could then be used to measure industry performance.

The Office of Technology Assessment should make a study of the feasibility of improving and enlarging the utilization of Government owned defense research and production facilities to reduce the costs of major weapons and provide yardsticks to measure the performance of private corporations. A report and recommendations for action should be provided by the Office of Technology Assessment to the Joint Economic Committee at the earliest possible time.

A Federal Corporation should be created to develop and produce energy resources in the public domain. Among other purposes, this corporation could provide a yardstick with which to measure the costs of private corporations and stimulate competition. The Federal corporation should supplement and not replace the present system of development of publicly owned energy resources.

The Government as Regulator & Monitor.—The Federal Government exerts a major influence on the economy in its role as regulator and monitor of certain aspects of the private market. This role ranges from protecting the public from safety and environmental hazards to protecting small businesses from predatory practices of big business. A large part of the government role is intended to encourage competition and discourage unfair practices. Because government actions have sometimes stifled or prevented competition, regulatory policies have been subjected to increasing criticism.

In our Interim Report on Inflation this Committee discussed regulatory reform as one way to remove structural barriers that prevent the free market economy from working smoothly. Structural barriers exist in both the government sector and the private sector. They prevent the private economy from operating in accordance with supply and demand, inhibit competition, impose extra costs on the consumer, and thus contribute to inflation.

A recent study conducted for the National Commission on Productivity and the Council of Economic Advisers concluded that unjustified transportation regulations create huge amounts of waste, totaling more than $4 billion annually. Other structural problems in the public sector are created by equally unjustified government subsidies, import quotas, tariffs, and price supports. Of course, not all of these programs are wasteful. Some serve the public interest, some do not.

In the private sector industrial concentration is a fountainhead of structural problems. Administered prices, price fixing, price leadership, antitrust violations, unfair trade practices and other forms of private anticompetitive behavior have the same effects on the consumer and the economy as unjustified government regulations and subsidies.

In our interim report we recommended establishment of a commission to recommend comprehensive legislation to eliminate both governmental and private barriers to an efficient market economy. Bills to establish such a Commission have been introduced in the House (H.R. 17283) and Senate (S. 4118) and are now pending in the respective Banking Committees. The President subsequently proposed a commission to deal exclusively with regulatory reform, and hearings on this proposal (S. 4145) have been begun by the Senate Committee on Government Operations. We urge speedy action on both proposals and anticipate that the differences between them and other similar legislative proposals will be resolved so that there is no unnecessary duplication of effort in the event that more than one commission is created.

Steps to remove specific structural barriers can and should be taken in the meantime. Unfortunately, some of the regulatory commissions have confronted inflation with decisions to raise the frequently excessive prices in the regulated industries. For example, the Civil Aeronautics Board is trying to force international charter carriers to charge travelers more than the carriers want to charge.

New enactments such as the Energy Transportation Security Act, requiring that up to 30 percent of oil imports be carried on U.S. ships could be a setback to those hoping to curtail special interest legislation. As inflation and recession continue there will be additional pressures to protect those threatened with loss of income and jobs. Demands will undoubtedly be made for new or higher import restrictions, subsidies and other kinds of direct and indirect government assistance. Wherever possible decisions should be made which will not give rise to new restraints on trade and competition. For example, if imports endanger domestic jobs it would be preferable to give temporary aid directly to workers, through adjustment assistance, than to erect new barriers to international trade.

Regulatory agencies should restrain price increases and take steps to eliminate wasteful practices. All government agencies and Congress should resist pressures for new subsidies, import quotas, special interest legislation, price supports and other restraints on trade.

The antitrust laws and their administration need to be strengthened in order to prevent extreme abuses of market power. However, it should be recognized that the traditional antitrust approach has not produced the results intended when the laws were enacted. It has been more than 90 years since the Sherman Act and 60 years since the Federal Trade Commission Act and the Clayton Act empowered the Executive branch to break up monopolies, combinations, and conspiracies in restraint of trade; to stop unfair methods of competition and unfair or deceptive acts; and to prevent corporations from reducing competition by taking over other corporations. Efforts to implement these laws have been notably ineffective.

As part of our inflation study this Committee has held hearings on industrial concentration and abuses of market power. During the hearings the Chairman of the Federal Trade Commission was asked to cite the most recent examples of successful FTC enforcement of the antitrust laws. The only two cases produced dated back to 1964. One case was brought against the bakers in the Seattle area; the other concerned production of the drug, tetracycline. Without detracting from the hard work put into these cases and their importance, it must be observed that this record is hardly indicative of an effecive program to strengthen competition in the industrial sector of the economy.

At least three basic problems seem to be inherent in the traditional antitrust approach. One is the lack of resources available to enforcement agencies, making it difficult for them to manage several major cases concurrently. A second problem has been the lack of resolve to enforce the antitrust laws and sometimes the active hostility of high government officials and the President toward enforcement. A third problem is the time it takes to conclude a major case. It is not rare for an antitrust case to take 10 years to complete. It has been estimated that it might take that long for the depositions to be completed in a major case involving the oil industry, filed a year ago by the Federal Trade Commission. This approach does not appear to offer the prospect of restoring competition in areas of industrial concentration within a reasonable time.

An alternative approach would be for Congress to legislate directly to eliminate or lessen specific known abuses of market power.

An existing legislative proposal, the Industrial Reorganization Act, would permit antitrust enforcement outside of the criminal courts. A rebuttable presumption would be created that monopoly power is possessed wherever (1) a corporation earns profits in excess of 15 percent annually for five out of the past seven years, or (2) wherever there has been no substantial price competition among two or more corporations in any line of commerce in three of the past five years, or (3) if four or fewer corporations account for 50 percent or more of any line of commerce in any section of the country. Once a presumption of monopoly power is established, the corporation may be sued in a civil proceeding and subjected to appropriate remedies. As a finding of criminal intent to violate the antitrust laws would not be necessary, this approach could considerably shorten the time it now takes for an antitrust suit to be completed.

In our earlier energy report, *A Reappraisal of U.S. Energy Policy*, this Committee recommended legislative action to reduce vertical integration in the oil industry and limit ownership of multiple energy resources. We continue to believe that these are appropriate partial solutions to the growing concentration and the lack of efficient utilization of resources in the energy industry. Similar actions could appropriately be taken on other concentrated industries.

We urge prompt consideration and enactment by Congress of the Industrial Reorganization Act to permit government action in civil proceedings against corporations possessing monopoly power.

Congress should enact legislation requiring divestiture and reorganization in any industry where the possession of monopoly power prevents efficient resource development and effective price competition. It should begin by enacting specific legislation (1) to reduce vertical integration in the oil industry by requiring the major producers to divest themselves of pipeline facilities; and

(2) to limit ownership by a single corporation of multiple energy resources.[9]

E. Investment

A number of writers and witnesses before the Committee have contended that the recent profits boom is traceable largely to shortcomings in an inflationary period of first-in-first-out (FIFO) inventory accounting and of current depreciation accounting rules based largely on the historical cost of capital facilities. They have argued that a large share of these profits is of an artificial or "phantom" nature. These experts have asserted, therefore, that even recent record profit levels do not provide adequate incentives and financial means to maintain and expand America's industrial plant and that still higher profits and/or additional tax preferences for investment are needed.

Moreover, several projections of investment "needs" for the next five to ten years have been made, most of them arriving at estimates that appear vast in terms of today's magnitudes. Some commentators also feel, therefore, that there will be a chronic shortage of investment funds and that saving should be stimulated.

While this debate raged, plant and equipment investment held steady in real terms at the record rates of the 1973 boom, levels that are 25 percent higher than in 1968, the last year of the previous business expansion. The resulting large order backlogs for machinery makers were accompanied by very rapid price increases for capital goods.

It is paradoxical that widespread calls for new incentives to investment arose at a time of unprecented investment activity and rapidly rising plant and equipment costs. It also is ironic to find people advocating fiscal measures to ease an alleged capital shortage when a main cause of the shortage is to be found in the Federal Reserve's extremely tight money policy. Relaxation of the monetary restraints will help greatly to remove any capital shortage.

Another concern of those analyzing profits figures has been that the large increases in profits early this year were unevenly distributed among sectors. Many firms not sharing in the oil bonanza were languishing. It must be recognized, however, that the large price boosts for virtually all commodities following the end of price controls in April constituted a giant step to increase profits across the board.

---

[9] Representative Brown states: "This recommendation sounds good in general but the specifics are worrisome. In the United States where vertical integration of oil companies is common, consumers still pay the lowest prices for gasoline and heating oils of any major nation in the world. Could the integration have anything to do with that? As to forcing divestiture of multiple energy sources, who will provide the capital for the development of alternative sources to those now in common use? Horizontal integration has the advantage of providing capital through profits from one energy source (such as oil) which can be diverted into the development of another energy source which may be more economically competitive (such as liquefied coal). Certainly no bar should be permitted to outside competition, however. So a Federal watch against any monopolistic control of alternative energy sources should be maintained to encourage competition. But if the recommendations made in this report were ever to be fully implemented, the future problem in this country may very well be how to get private capital for the development of our future technological needs. There should be fewer barriers to that, not more. This is particularly true in light of the fact that government control of the gross national product has increased almost 50 percent in the last 20 prosperous years—and inflation has never been greater or future economic prospects much dimmer."

In examing the facts of the profits debate, one must address several questions: (1) how high are profits really; (2) what other sources of investment funds are there; (3) how do profits affect investment; and (4) how much investment is needed over the next several years?

Profits Measurement.—Most persons concerned that profits are too low make two major adjustments to reported profit data in gauging funds available for new investment projects and for payments to suppliers of funds. First, the inventory valuation adjustment is subtracted from profits; [10] second, the costs attributable to depreciation of capital facilities are calculated based on the replacement cost of these facilities, and the difference between this depreciation cost and the lower write-off allowed under current income tax regulations also is deducted from profits.[11]

These changes are proposed on the grounds that the deducted profits are required to replace inventories and capital stock and are not available for other purposes. The adjustments have become very large during the current inflation, rising in the first half of 1974 to an annual rate of over $45 billion for non-financial corporations out of after tax profits of $64 billion.[12]

The argument contains some validity and some exaggeration. The inventory valuation adjustment is estimated at an annual rate of $34.5 billion for the first half of 1974. Its measurement is crude, however, and there are reasons to believe that it is overstated for this period, but it is impossible to say by how much. Efforts are being made by the Department of Commerce to improve the accuracy of this statistic.

Only part of the current inventory profits will be reinvested in new inventories. As boom gives way to recession, inventory hoarding turns to liquidation, leaving some of the funds previously tied up in inventories available for other purposes during the downturn. Judging from previous recessions, an inventory liquidation as large as $5 to $10 billion could take place during the coming year. It must be recognized that firms using the FIFO accounting method choose it voluntarily and will realize tax savings from this method during any business down-turn with falling inventory prices. Companies wishing to change their method of inventory valuation may do so under procedures laid down by the Internal Revenue Service.

A depreciation formula that would cover the full replacement cost of capital depends on the relationship among inflation rates, interest rates, and income tax rates during the life of the depreciating asset, but this is not taken into account in proposed formulas for adjusting profits. If interest rates exceed rates of inflation, then replacement-cost depreciation could yield *more than the full cost of replacement.* The necessary rate of differential, however, is more likely to prevail in periods of low inflation than during high inflation, especially in view of the corporate tax liability on the interest earnings.

---

[10] The inventory valuation adjustment is applied to book profits before taxes in order to exclude the gains or losses due to differences between the replacement cost of goods taken out of inventory and their recorded acquisition cost.

[11] The recalculation of depreciation cost usually is done by inflating each year's depreciation allowance based on historical cost using an index of the prices of plant and equipment.

[12] See George Terborgh, "Inflation and Profits." Memorandum No. G–70 of the Machinery and Allied Products Institute, Washington, 1974.

Any actual conversion to replacement-cost accounting allowances on the other hand, would permit firms progressively to reduce the debt-equity ratio needed to maintain any capital plant, giving established firms in time an added advantage over would-be new competitors. This would occur because depreciation on the borrowed portion would create a surplus above the original debt. Such cash could be used to cut the borrowed share in the replacement period or for expansions, acquisitions, or other purposes, lending further impetus to concentration in American industry. Present capital recoupment rules, it should be noted, are not on a strictly historical-cost basis but encompass the investment tax credit, the accelerated depreciation range, and the double-declining balance formula, not to mention the percentage depletion allowance for minerals extraction.

In conclusion, the adjustment of profits that has been proposed is justified in part but exaggerated. The amount of exaggeration cannot be specified, mainly because of unanswered questions about the accuracy of the inventory valuation adjustment. Moreover, large price increases since May have increased profit margins across all sectors to an extent not yet fully reflected in the data.

Even if inventory profits are excluded, one finds that internal business cash flow—retained earnings plus depreciation and depletion allowances—was higher for the first half of 1974 than for any earlier times except 1973. Cash flow, moreover, is not the only source of investment funds. At present the equity-to-debt ratio of manufacturing industries is about 2.4 to one.[13] Thus about 30 percent of present assets are financed with borrowed money and about 70 percent with common stock and retained earnings.

New retained earnings of nonfinancial corporations, running at an estimated $35 billion per year, would sustain new borrowing of $15 billion without decreasing this equity-debt ratio. In a period of major plant expansion, moreover, this ratio might reasonably be expected to fall. With stockholders' equity in nonfinancial corporations estimated at over a trillion dollars, each percentage point increase in the debt share would signify over $14 billion in additional borrowing.

There are several elements of continuing investment strength, such as equipment investments for energy and agriculture and those for environmental protection. The latest Commerce Department survey of expected investment in business plant and equipment indicates that overall investment is now weakening. This weakness, however, is resulting from the recent worsening of the recession, which has caused businessmen to revise downward their expectations concerning demand for their products. The evidence does not support the contention that investment has been inadequate due either to the inadequacy of individual savings or to the lack of sufficient tax provisions which encourage investment. Rather, the two conditions most important for business investment are an accommodative monetary policy and a reasonable expectation that sufficient final product demand to permit profitable production will exist at the time the investment is completed.

---

[13] Federal Trade Commission, *Quarterly Financial Report for Manufacturing Corporations*, Second Quarter, 1974.

LONGER-TERM OUTLOOK FOR SAVING AND INVESTMENT

Beyond an analysis of data for the recent past and the outlook for the immediate cyclical downturn, there remains the question of whether a more or less chronic shortage of investment funds may prevail for the next five to ten years. Several recent projections have concluded that higher investment rates are needed to provide adequate supplies of goods and services and that a large boost in saving will be required to fund them. Some argue for a restructuring of the tax code to favor these objectives.

First, one must develop a concept of how to define an "adequate" level of capital investment. Basically we believe that its adequacy should be judged in terms of the capital needed to accompany employment for persons joining the labor force. Demographic factors indicate that the labor force will continue to grow rapidly through the late 1970s, after which its growth will taper off. These factors, however, are not encompassed in the investment projections.

One widely publicized study issued by the New York Stock Exchange projects a "capital gap" of $650 billion out of total projected investments of $4.7 trillion for the period 1974 to 1985.[14] The study reaches this conclusion, using a simplistic methodology, by juxtaposing a sharp increase in future private investment and a considerable *decline* in savings rates. It allows for no inflow of foreign capital. Another projection, introduced in testimony before the Committee, reaches similar conclusions about investment needs but foresees higher savings rates yielding a savings deficiency on a comparable basis of $380 billion for the period.[15]

All such projections must be analyzed judiciously. Any forecast aggregated over many years in the future, especially when stated in future prices with high rates of inflation, is not comprehensible in terms of current magnitudes. It must be restated in terms of implied annual growth rates of *real* saving and investment before it can be sensibly appraised. Our economy's capacity to generate savings and to fund investment will roughly double over the period 1974–85 even without inflation.

Second, all of these investment forecasts are made, at least in part, by aggregating the investment "wish lists" of various parties instead of by estimating requirements based on social criteria. Moreover, all presuppose the same growth rates for heavy industry as in the past—or indeed faster rates of growth, making allowance neither for likely shifts in consumption patterns or conservation, which clearly will play an increasing role in the future, particularly for energy. It would be a mistake to subsidize the continuation of past growth rates of heavy industry *per se* without first making deliberate policy decisions on the subject.

---

[14] New York Stock Exchange, "The Capital Needs and Savings Potential of the U.S. Economy: Projections Through 1985," September, 1974.

[15] Statement of Reginald H. Jones, Chairman, General Electric Company, in "Long-Term Economic Growth," Hearings before the Subcommittee on Economic Growth of the Joint Economic Committee, May 8, 1974, pp. 66ff.

Third, the dollar costs of capacity are highly uncertain even in today's prices. At recent hearings on the steel industry, estimates of costs of new capacity offered by two industry spokesman differed by no less than 60 percent.

Savings rates also are subject to uncertainty over the longer run due to variations in the many conflicting forces affecting these rates. Moreover, the projections of inadequate savings to finance investment are quite sensitive to variations in savings rates.

In the past, personal savings have fluctuated around 4.5 percent of GNP, and business savings (undistributed corporate profits, inventory valuation adjustments, and capital consumption allowances) have hovered around 11 percent of GNP. For example, personal savings averaged 4.2 percent of GNP from 1955 through 1965 and rose to 4.8 percent from 1966 through 1973. Business savings, by contrast, dropped from 11.6 percent of GNP for 1955 through 1965 to 10.9 percent for 1966 to 1973. Together these two sources of savings constitute about 15.5 percent of gross output.

A variation in these two combined savings rates of half of a percentage point, however, is sufficient to produce a change in cumulative savings from 1975 through 1980 of roughly $600 billion. This total also will vary with the assumed growth rate for nominal GNP. The change in aggregate savings through 1980 from an increase of one-half of a percentage point in average personal and business savings rates is approximately enough to make up the shortfall in savings occurring in the gloomier projections. But this amounts to only a 3 percent change in the average rate. In the course of economic events, such a change could easily occur.

The factors that can affect business savings, including profit rates, have been discussed above. There are a number of other developments which can affect personal savings and the extent to which the Government either draws upon or channels funds into credit markets. For example, the age distribution of the population is changing such that the number of high savers between ages 40 and 54 is declining in proportion to individuals between 20 and 35 years old, who typically save less and borrow heavily. The recent increase in inflation rates and the onset of recession have had conflicting impacts on the savings intentions of individuals and families. Accelerating inflation induces individuals to transfer their savings from financial assets to goods that are less likely than money to decline in value. On the other hand, increasing economic uncertainty provides the rationale for expanding the stock of resources that one can draw upon in the event that hardship actually arrives.

The devaluation and further depreciation of the dollar in recent years have substantially strengthened the U.S. competitive position in international trade. Even with the increase in oil prices that is likely to produce trade deficits, foreign dissaving on the part of the United States is likely to be much more limited than it would have been in the absence of the previous exchange rate adjustments. In addition, some portion—though it is uncertain how much—of the revenues earned by oil producing countries will be invested on a medium or long-term basis in the United States and will be available for financing investment.

Finally, to the extent that Federal, State, and local governments in combination run deficits, they withdraw funds from capital markets that would otherwise be available for financing private investment. On the other hand, if governments in combination run surpluses, outstanding debt is retired and additional financing is available for investment in the private sector of the economy. With all these conflicting forces affecting average savings rates, any prediction is unreliable.

A sober assessment of saving and investment projections, even encompassing some elements of possible exaggeration, does *not* lead to alarmist conclusions. In recent testimony before the Committee, James Duesenberry testified:

> Our estimates indicate that with normal growth our economy will be capable of meeting the capital demands that can be reasonably projected for the remainder of the decade without unusual sacrifices.[15a]

He stated that the foreseen expansion of business investment should be offset partially by a lower share of GNP going to residential construction, even allowing for fulfillment of the goals of the Housing Act of 1968. He also expects investments by State and local governments to decline because of lower capital outlays for education and roads.

Duesenberry, however, argued for more judicious management of the Federal budget than has been achieved in the past. He contended that surpluses in the full-employment budget may be necessary during periods of full resource use to avoid resurgence of excessive aggregate demand and extremely high interest rates. This proposal has been standard doctrine in economics for many years. New congressional procedures for budget review and control should make appropriate fiscal goals more readily attainable than in the past.

One point that these analyses make clear is that any "capital gap" will not be concentrated in the corporate business sector. This conclusion is amply confirmed by recent experience, as business investment has remained at record levels despite very stringent capital market conditions. For the future, likewise, business cash flow is projected to be adequate to finance the vast bulk of projected business investments, although some individual businesses may be net borrowers and others net lenders.

Primarily dependent on borrowed money to finance their investments are homebuyers and State and local governments. Also small businesses, especially new businesses, have difficult access to capital during tight periods. If there is a capital squeeze, it is these sectors whose needs will go unmet and for which relief must be devised.

The prescription to relieve a capital shortage, therefore, is not a set of new policies to stimulate business investment. These would only intensify the shortage. If future events indicate the development of such a shortage, a set of measures to increase private and Federal savings might be called for. Action is needed now to eliminate the regulations and institutional barriers that cripple the home-financing industry during every episode of monetary stringency.

[15a] Duesenberry, James, in "Financial and Capacity Needs" Hearings, Joint Economic Committee, (U.S. Congress) October 1, 1974.

Long-term projections of capital shortages should not be grounds for alarm at present. The immediate problem lies in overcoming recession. In the future, however, Federal budget planners should take greater cognizance than in the past of the effect of the budget on credit markets. Significant budget surpluses may be needed in times of full resource use, and this means of increasing credit availability to private users is preferable to creation or liberalization of tax preferences. Any such surpluses should be obtained by eliminating existing tax loopholes and constraining spending rather than through tax rate increases.

F. Agriculture

Crop production in the United States has been characterized by disappointing harvests and high prices in 1974. Except for rice, carry-over stocks either fell to all-time lows or remained at historically low levels. Table 1 summarizes supply and demand data for feed grains, wheat, rice, soybeans, and corn. Feed grain production is at its lowest point in the past four years; 1974–75 carry-over stocks are estimated to be one-half of year-earlier levels, down from 22.2 to 11.8 million tons. The outlook for wheat is only slightly better. Production in 1974–75 is estimated to be about the same as that in 1973–74. Carry-over stocks, therefore, are remaining at low levels. The picture for rice is the brightest of any of the grains, with production estimated to be at record levels in 1974–75. Carry-over stocks will likewise be replenished to their highest point in the past four years.

TABLE 1.—SUPPLY AND DEMAND OF SELECTED MAJOR AGRICULTURAL CROPS

Item	Beginning stocks	Imports	Production	Total supply	Domestic use	Exports	Total use	Ending stocks
Feed grains:[1]								
1972–73	48.4	0.4	199.9	248.7	173.2	43.1	216.3	32.4
1973–74[2]	32.4	.3	205.0	237.7	171.1	44.4	215.5	22.2
1974–75[3]	22.2	.4	164.6	187.2	144.4	30.9	175.4	11.8
Corn:[4]								
1972–73	1,126	1	5,673	6,700	4,733	1,258	5,991	709
1973–74[2]	709	1	5,643	6,353	4,629	1,243	5,872	481
1974–75[3]	481	1	4,621	5,103	3,943	875	4,818	285
Wheat:[4]								
1972–73	863.1	1.8	1,544.9	2,409.3	784.5	1,186.3	1,970.8	438.5
1973–74[2]	438.5	3.8	1,711.4	2,153.7	756.0	1,148.7	1,904.7	249.0
1974–75[3]	249.0	2.0	1,780.6	2,031.6	713.0	1,050.0	1,763.0	269.0
Rice (million hundredweight):								
1972–73	11.4	.5	85.4	97.3	38.2	54.0	92.2	5.1
1973–74[2]	5.1	.2	92.8	98.1	40.6	49.7	90.3	7.8
1974–75[3]	7.8	0	114.8	122.6	37.6	61.2	98.8	23.8
Soybeans:[4]								
1972–73	72.0	0	1,270.6	1,342.6	803.6	479.4	1,283.0	59.6
1973–74[2]	59.5	0	1,586.5	1,626.1	889.5	564.9	1,454.5	171.6
1974–75[3]	171.6	0	1,243.9	1,415.5	856.0	500	1,356.0	60.0

[1] Includes corn, sorghum, oats, and barley, in millions of tons.
[2] Preliminary.
[3] Estimate.
[4] In millions of bushels.

Source: U.S. Department of Agriculture.

Meat.—Table 2 summarizes production figures for beef and veal, pork, poultry since 1971. For each commodity, production in the third quarter of 1974 is above third quarter production in 1973. Table 3 shows that 1974 third quarter prices are much lower than those in the third quarter of 1973.

Although cattle on feed in 1974 dropped 18 percent from 1973 levels due to the high price and short supplies of corn and feed grains, total beef marketings may well be up in response to increases in the slaughter of cattle raised through open grazing. Increases in total beef supplies will not be as dramatic due to the lighter weight of the slaughtered cattle.

Hog slaughter in 1974 has been 18 percent to 20 percent higher than in 1973. Liquidation of breeder stocks has increased in response to high feed prices. Poultry producers have also been reducing the size of their stocks because of high feed prices.

In the short run, these factors will result in ample supplies for the next few months. But possibly half way into 1975, meat supplies will fall below year-earlier levels. Mid-1975, therefore, will very likely usher in a period of short meat supplies caused by presently high slaughter and stock liquidation rates.

TABLE 2.—PRODUCTION OF BEEF, VEAL, PORK AND POULTRY

[In millions of pounds]

Item	Annual			3d quarter	
	1971	1972	1973	1973	1974
Production:					
Beef and veal	22,448	22,878	21,634	5,071	5,870
Pork	14,972	13,640	12,751	2,791	3,247
Poultry	10,531	11,047	10,872	2,730	2,846

Source: U.S. Department of Agriculture.

TABLE 3.—PRICES RECEIVED BY FARMERS FOR CATTLE, HOGS, BROILERS, AND TURKEYS

Unit	3d quarter	
	1973	1974
Cattle (dollars per hundredweight)	47.70	34.80
Hogs (dollar per hundredweight)	47.10	34.76
Broilers (cents per pound)	31.3	21.1
Turkeys (cents per pound)	39.3	25.5

Source: U.S. Department of Agriculture.

Farm Incomes.—Table 4 reviews net farm income since 1969. In 1973 farm income experienced a dramatic jump. This rise was maintained through the first quarter of 1974, but in the second quarter of 1974, farm incomes fell sharply. According to the Department of Agriculture, net farm income in the year 1974 will probably total $25 or $26 billion. Although well below the 1973 level, this will still be the second highest net farm income level ever. The adjusted farm parity ratio, however, is below the 1965 level due to large increases in production costs, which have almost doubled since 1969 (Table 4). Also, summary data often camouflage exceptions, and in this case, dairy farmers and feed-lot owners are receiving low incomes, primarily as a result of high feed costs.

TABLE 4.—COMPONENTS OF FARM INCOME, 1969 TO 1974

[In millions of dollars. Quarterly figures at seasonally adjusted annual rate]

Year	Receipts	Marketing payments	Non money income	Realized gross	Production expenses	Realized net
1969	48,143	3,794	3,613	55,550	38,759	16,791
1970	50,455	3,717	3,652	57,824	41,030	16,794
1971	52,805	3,145	3,808	59,758	44,535	15,223
1972	60,671	3,961	4,208	68,840	49,167	19,673
1973	88,600	2,600	5,800	97,000	64,700	32,200
1974:						
I	[1] 98,000		[2] 7,000	105,000	72,100	32,900
II	[1] 91,300		7,100	98,400	74,500	23,900
III	[1] 94,500		7,600	102,100	76,500	25,600

[1] Annual rates.
[2] Nonmoney income for 1974 includes government payment figures.

Source: U.S. Department of Agriculture.

A National Food Policy

Agricultural producers and processors in the United States are relied upon to satisfy the needs of U.S. consumers, the regular export customers of the United States, poor countries suffering famine, and occasionally the demands of other agricultural producers when their own crops fail. At present, no clearly articulated policy exists to rank and coordinate these competing needs. The problem of excess food production and collapsing prices seems to have disappeared for the foreseeable future. To the extent that some farmers are experiencing a profit squeeze, this difficulty reflects primarily rising costs rather than falling prices. In the light of the global food shortage that will probably intensify during the next few years, the United States should formulate a new national food policy. To enable this Nation to meet the nutritional needs of Americans and of our regular export customers in addition to contributing significantly toward multilateral efforts to ease famines, the new national food policy should be based upon the establishment of reserve stocks of all major grains and oil seeds.

Given the prospective scarcity of food through the foreseeable future and the likelihood that prices may fluctuate widely around a rising trend, the United States should develop a new national food policy. The articulation of this policy should set forth production goals, should establish minimally adequate food reserves, and should specify the priorities according to which competing needs will be satisfied.

Export Policy

The U.S. agricultural export position has remained strong in 1974; total shipments will be valued at approximately $21.6 billion. The estimated surplus in agricultural trade this year is $11.6 billion. But the surplus will be smaller in 1975. Shipments of feed grains, wheat, corn, and soybeans are expected to drop. Only rice exports are predicted to rise next year. The United States, nevertheless, will still export a substantial portion of its grain and oilseed production. Over half of U.S. wheat and rice output is sold abroad, as well as significant fractions of feed grain and soybean yields.

With respect to each of its three major export crops—wheat, corn, and soybeans—the United States has on at least one occasion in the past two years been uncertain of its ability to meet export demand. During the summer of 1973, an export embargo was briefly placed on soybeans. To avoid the imposition of embargoes in the future, and to appropriately allocate scarce supplies, complete and up-to-date information is necessary on the size of prospective crops, existing export orders, and likely demand from other countries. Since orders from socialist countries have played a major role in destabilizing agricultural prices within the United States during recent years, it is essential that these nations participate in multilateral efforts to compile more accurate and up-to-date information on prospective agricultural output and demand.

An international food information system should be developed as quickly as possible to make supply and demand relationships more apparent and thus facilitate more equitable allocation of food resources.

Since the Congress has not acted to give the Secretary of Agriculture and the President authority to regulate agricultural exports in advance of a crisis, we reemphasize our standing recommendation:

> Congress should pass legislation establishing a system for managing exports of critical food and feed when projected market supplies are inadequate to meet domestic needs without drastically increasing prices. The Secretary of Agriculture should be authorized to (*a*) set up an export licensing system for agricultural commodities determined to be in critically short supply; and (*b*) require prior approval of such exports when necessary. If allocation of scarce exports is necessary, the highest priority should be given to countries needing food aid and the next priority to regular export customers.

Food Aid

The World Food Conference recently held in Rome publicized widespread malnutrition and starvation. In the past, the United States has met its food aid responsibilities through the authority granted under Public Law 480. The PL 480 program of donations and concessional sales of surplus agricultural products was designed to serve the dual purposes of reducing domestic surpluses and extending aid in the form of food. In doing so, the program has too often been used to meet military purposes rather than to alleviate the severe world-wide hunger situation. With minimal prospects for surpluses in the future, at least beyond the reserve stocks recommended above, the authority granted under P.L. 480 has become antiquated.

Existing methods and authority for delivering agricultural products to nations suffering famine or widespread severe malnutrition, including Public Law 480, should be thoroughly reviewed and changed to meet new conditions.

Structural Problems

Marketing Orders.—Although changes in crop prices primarily reflect changes in output, structural inefficiencies also can play an important role. A major example of just such a structural inefficiency is the marketing order. Marketing orders were conceived as a method of income maintenance for farmers. If a group of farmers determine that they grew so much of a particular crop that the crop's price would be unacceptably low, they can petition the Secretary of Agriculture to impose a marketing order for the crop in surplus. After hearings determine that a marketing order is necessary for income maintenance purposes, the Secretary of Agriculture implements it. By holding a particular amount of the crop off the primary markets, the farmers are allowed to maintain prices at a level higher than would otherwise obtain. In this way, the consumer finances the farmer's subsidy by paying prices that are in effect, set administratively by the Federal Government.

While marketing orders serve a necessary purpose—income stability for farmers—there is a better way to stabilize farm incomes. A direct subsidy paid to the farmer would be better. A direct subsidy could be financed through Federal income and corporate taxes, which are relatively progressive. Marketing orders, however, are price subsidies and are regressive.

The Commission on Economic Efficiency, which is proposed by members of this Committee in the Market Efficiency Study Act, should study the inflationary impact of marketing orders on farm prices and alternative schemes for providing income stability for farmers. If the study concludes that marketing orders are unduly inflationary, they should be eliminated as a farm income stabilization mechanism.

Market Spreads.—Market spreads, the difference between the price paid to the farmer and the price paid by the consumer, are a significant factor in rising retail food prices. Major cost components of the spread include labor, packaging, transportation, rent, and advertising costs, as well as profits and taxes.

Most of the debate surrounding the 1974 increase in market spreads is concerned with whether they reflect justifiable costs or excess profits. Those arguing that high spreads are cost-justified point to rising 1973 and 1974 labor, packaging, rent, and advertising costs. An investigation by the Joint Economic Committee finds, however, that the return on equity in the top fourteen U.S. food chains rose 115 percent from the third quarter in 1973, when companies' return on equity was comparable to historical levels, to the third quarter of 1974.[16] Although costs have risen, windfall profits appear to play a large part in maintaining excessive market spreads.

The Federal Trade Commission should conduct an investigation of the retail food industry to determine

---

[16] Hearings, "Food Chain Pricing Activities," Joint Economic Committee, U.S. Congress, December 9, 12, 16, 17, 1974.

whether the large chain stores are earning excessive profits through monopolistic or unfair trade practices. A report of the FTC investigation together with recommendations for increasing effective competition in the retail food industry should be submitted to the Joint Economic Committee within 6 months of the date of this Report.

Import Quotas.—Cattle farmers have been calling for import quotas on beef to help increase domestic beef prices. In general, import quotas aggravate inflation by removing the stabilizing impact of foreign sources of supply that could meet increasing domestic demand. In the case of beef, the imposition of import quotas would be especially inflationary. With cattle slaughter almost at capacity and the number of new cattle dropping fast, domestic beef supplies will likely be short relative to demand in the next six to nine months. It would therefore be shortsighted, inflationary economic policy to impose beef import quotas.

Import quotas on beef or any other agricultural commodity deprive consumers of the opportunity to purchase food at the lowest possible costs. There are few, if any, circumstances in which import quotas are an economically efficient method of assisting domestic producers faced by weak markets. Either the enforcement of the countervailing duty statute against foreign subsidies or Federal payments to farmers according to the difference between market and target prices are preferable ways of assisting agriculture.[16a]

G. Energy

Higher energy prices, including their effect on the cost of non-fuel commodities, contributed about one-fourth to one-third of the 12-percent increase in consumer prices in 1974.[17] Had prices of U.S. oil and gas not remained partly under control, the increase would have been much greater.

Accompanying soaring energy prices has been a redistribution of income from U.S. consumers to domestic and foreign energy producers, amounting to about $30 billion in 1974. Over one-half of this enormous sum has gone to domestic producers, and an additional amount has been paid to U.S. companies for imports of oil and oil products. Some crude oil from domestic wells whose output sold for $3.40 in 1973 is now being sold at $10.

The inflationary impact of exorbitant world oil prices has not yet run its course. For several years, as long-term contracts for coal and natural gas expire, this output and all new production will be marketed at higher prices. Under the present regulations also, more and more

[16a] Senator Proxmire states: "I disagree with the assumption inherent in this paragraph that we should be a dumping ground for the world's produce. For many years the European Common Market has been subsidizing the importation of its dairy products into the United States. These imports displace domestic production which must then be purchased under the price support program at a substantial cost to the taxpayer. If we allow foreign imports of this sort to flood into the United States, we may lose our self-sufficiency in food production. The dairy industry is an early warning signal."

[17] Federal Energy Administration, *Project Independence: A Summary*, Washington, D.C., 1974, p. 18.

oil moves into the category of "new and released oil" and thereby escapes control.

As a result of the oil price increases and the threat it poses to world economic and political stability, U.S. energy policy must be reformulated in an attempt to achieve three conflicting goals: (1) to halt the rise in energy prices; (2) to develop energy supply and conservation programs to meet priority demands while limiting petroleum imports; and (3) to eliminate excessive windfall profits to energy producers.

These goals, however, place the policymaker in a discomforting dilemma. Dominant concern with halting inflation would indicate an energy price freeze or a rollback of energy prices. A rollback, however, would weaken the incentive to conserve unless other effective measures to foster conservation were devised. Maximum domestic energy production is widely believed to require high prices unencumbered by heavy taxes, but this option unavoidably leaves much of the windfall profits in the hands of private producers.

Thus these three goals are difficult to pursue simultaneously. But none can be ignored. Therefore they must be pursued through careful study of the relationships involved. It has become clear from the past year's experience, however, that the United States must take its energy future—including energy prices—into its own hands. Neither foreign producing nations nor U.S. oil companies have an incentive to provide adequate supplies at more reasonable prices. Much necessary information and analysis have been gathered to elucidate the policy options before us. We must decide in the immediate future.

Taxation

The first step in any sensible energy policy should be a thorough reform of the existing loophole-ridden tax code applying to this industry. This issue has received extensive consideration during 1974 but, unfortunately, no legislative action has been taken. A wide-ranging consensus now exists on the subject, and it should be an item of top priority in the 94th Congress. Detailed proposals for energy tax reform were spelled out in the committee's report on energy issued in March.[18]

Prices, Production, and Profits

If energy prices have driven up the cost of living in 1974, then a rollback of these prices can contribute to price stabilization in 1975. An appropriate rollback can also eliminate excessive producer profits while leaving ample production incentive. Moreover, a rollback for "new" oil and coal would permit an increase in the price of new natural gas to comparable levels with less cost to gas consumers and a net saving to energy consumers overall. In view of the present wide disparity between oil and gas prices, a reduction in oil prices and an increase in gas prices appear very likely to make a net positive contribution to future conservation and overall U.S. energy production.

Table 1 shows an illustrative pattern of possible price controls that would improve equity and efficiency in energy production and consumption. These controls would lower the average price of all primary fuels in the United States in 1975 by about 10 percent. If passed

[18] *A Reappraisal of U.S. Energy Policy.* A report of three subcommittees of the Joint Economic Committee, March 1974, pp. 23–26.

through penny for penny, they would cut consumers' bills overall by $7.3 billion or about $100 per family. The controls also would prevent future price actions by Organization of Petroleum Exporting Countries (OPEC) from raising prices of domestically-produced fuels. The significance of price ceilings on "new" production would increase over time with the proportion of domestic output moving into this category. A rollback of new oil to $8 instead of $7, with a correspondingly higher level for natural gas, would reduce average fuel prices in the United States by about 7 percent.[19] Controls are not contemplated for synthetic gas or oil from yet undeveloped processes.

The detailed proposals and their impact will now be explained in turn:

TABLE 1.—AN ILLUSTRATIVE PATTERN OF PRICE ADJUSTMENTS FOR PRIMARY FUELS

Fuel	Estimated 1975 volume	Present price ($/barrel)	Implied sales revenue ($ billion)	Proposed price ($/barrel)	Implied sales revenue ($ billion)	Change in revenue ($ billion)
Crude Oil:		5.25	10.0			
"Old" oil	[1] 1.9	[redacted]	[redacted]	4.25	8.1	−1.9
"New, released and stripper"	[1] 1.3	10.00	13.0	7.00	9.1	−3.9
Imports	[1] 2.4	12.00	28.8	12.00	28.8	0.0
Totals [2]	[1] 5.6		51.8		46.0	−5.8
Average prices		9.25		8.21		
		($/m.c.f.)		($/m.c.f.)		
Natural Gas [3]:						
"Old" interstate	[4] 10.0	0.22	2.2	.22	2.2	0
"New" interstate	[4] 2.0	.50	1.0	[5] .50/.75	1.2	+.2
Totals	[4] 12.0		3.2		3.4	+.2
Average prices		.27		0.28		
		($/ton)		($/ton)		
Coal [6]:						
Old contracts	[7] 440	10.00	4.4	10.00	4.4	0
New contracts	100	40.00	4.0	22.50	2.3	−1.7
Totals	540		8.4		6.7	−1.7
Average prices		15.56		[illegible].41		
Grand totals			63.4		56.1	−7.3

[1] Billion barrels.
[2] Not including natural gas liquids.
[3] Trillion cubic feet.
[4] Intra-state natural gas is not included. Its price presumably will not be affected.
[5] Pre-1975 new gas is assumed to remain under the current ceiling of $0.50 per m.c.f. Gas committed to interstate commerce in 1975 could sell at $0.75 per m.c.f.
[6] Exports excluded.
[7] Million tons.

Oil.—The rollback of crude oil prices would lower the average price of all oil consumed domestically by about 10 percent. Reductions in final product prices would be smaller. Gasoline prices, for instance, should fall by about 4 percent (2.5 cents per gallon).

A reduction of $1 per barrel on "old" oil would reverse the Administration's decision granting an increase of this amount one year ago. Without justification, that 24 percent increase on already flowing oil transferred $2.1 billion ($5.7 million per day) from consumers to producers in 1974. It was not structured to stimulate new supplies or to serve any other appropriate purpose. It is now known that the Cost-

[19] This pattern of controls for oil and gas resembles that prescribed in general by S. Res. 425 introduced on October 9, 1974.

of-Living Council's staff evaluation labeled the increase to be unjustifiable, but was overruled. The fact that this abuse has been allowed to stand for a year is no reason to let it continue.

The rollback of *new* oil prices was suggested previously in the Committee's *Reappraisal of U.S. Energy Policy.*[20] Although the illustrative ceiling of $7 in Table 1 is double the level of the 1973 prices, oil producers will contend that it is too low to cover the production costs of oil now selling at $10. While production costs are rising, these costs, especially the costs of mineral rights, will adjust to absorb much of the profit at *any* price. But high fees for mineral rights do not produce more minerals. If oil prices are cut, then prices of oil-rights, equipment rentals and the like will fall accordingly. Under present rules, moreover, producers expanding output from existing leases get higher prices on *two* barrels for every one actually produced, so that the incentive to produce more oil will remain very powerful even at $7 per barrel.

Indeed the present definition of "new" oil would appear to be unwarrantedly generous. Much of the oil classified as "new" today consists in fact of the increase in output held back to support prices before 1973 by "demand prorationing." By definition, moreover, today's "released" oil, which sells at the "new" oil price, is continuing production from old wells. If these two categories of oil— amounting to perhaps 20 percent of domestic output—were properly classified as "old" production, the average price of oil would be reduced to about $8.10, or 13 percent below today's level. This would save consumers an additional $900 million per year.[21]

There is little real evidence that conventional oil production would be significantly expanded by prices above $7. Recent forecasts by experts at the Massachusetts Institute of Technology Energy Laboratory support this conclusion.[22] Indeed there is strong reason to believe that a reduction of the difference between prices of "new" and "old" oil would significantly expand the manpower and equipment available for true exploration by reducing the incentive to drill new wells in old reservoirs to qualify for the higher price. The Project Independence Report suggests that, with vigorous exploitation of resources on the Outer Continental Shelf, a price of $7 will be adequate to expand oil production by 40 percent by 1985, and this estimate appears to be quite conservative.[23] Certified exemptions from price ceilings may be desirable to induce use of certain high-cost technologies, such as tertiary recovery methods on depleted domestic wells. Such exemptions or even explicit subsidies to certain production and conservation options would be far less expensive to the consumer-taxpayer than higher price ceilings for all energy.

Many people contend, in fact, that a price of $7 per barrel is too high for domestic oil production relative to its pre-1974 prices in the absence of reliable cost data. Several independent studies, however, have estimated that the market price in the longer term will tend

---

[20] Joint Economic Committee. *Op. Cit.*, pp. 9–10.

[21] Most so-called "stripper" oil, which is exempted from control under present rules, also flows from old wells. It comprises 13 percent of U.S. production.

[22] *Energy Self-Sufficiency: An Economic Evaluation*, American Enterprise Institute, Washington, D.C., 1974, pp. 7 ff.

[23] Federal Energy Administration, *Op. cit.*, p. 8.

toward this range. Generous current profits are considered desirable, moreover, in conjunction with the current drive to expand domestic output and reduce imports. For these reasons, a price of $7 per barrel is used for illustration here.

There is much to be said for freezing the oil price ceilings for a period of, say, five years. Thereafter, if world market conditions continue to be such that price ceilings are required, they could be indexed to move with general price levels. Such a freeze would put producers on notice that they would get greater revenues in *real* terms (assuming some inflation over this period) by bringing output to market as soon as possible. Moreover, such a freeze would permit the price of natural gas to be brought into alignment with oil over this period without inordinate increases in its price.

Natural Gas [24].—It seems clear that an increase in the price of

---

[24] Senator Proxmire states: "This section, while it may have some merit as a staff illustrative example of one possibiilty in the conflict over energy prices, has many glaring weaknesses.

"It provides no evidence whatsoever that the producers of natural gas receive a low or unfair return on their investments which would justify any major price rise. The FPC now allows a highly generous 15 percent return and, in the absence of the hope of a multi-billion dollar bonanza through the deregulation of natural gas, should induce ample production.

"There is no discussion of the fact that the gas and oil companies provide the basic information about gas reserves on which many assumptions are based, and that this information has never been independently verified by a non-industry oriented group. The government and the public are now at the mercy of the industry for the basic facts on which to make judgments.

"There also is no discussion provided here of the artificial nature of the shortage.

"Further, the assumption that the B.T.U. or caloric equivalent between gas and oil is a key or important factor in their pricing leaves very much to be desired. The fact is that oil prices are monopoly prices, set by OPEC and the Federal Energy Agency, without the slightest proved relationship to costs, rate of return, or verified need for incentives to invest. To suggest that the price of natural gas should be raised to the B.T.U. equivalent of oil—even if that latter price is somewhat reduced—is to provide a false measure.

"Having established a monopoly price for oil, the industry now argues that natural gas should be raised to that same artificially high, monopoly price. If it were a truly competitive industry and if gas and oil were truly equivalent—which for a variety of reasons having to do with widely different costs for exploration, transportation, etc., they are not—one would expect the price of oil to fall to the level of the less costly, more competitive fuel of natural gas.

"Any suggestion that 'new' natural gas should be increased to the illustrative levels hinted at here should be based on a great deal more tough, hard evidence of costs, profits, and reserves than the oil industry, the FPC, or our staff and hearings provide. In other words, we have produced no factual evidence to justify such a price at a cost of billions of dollars in new inflationary prices to consumers.

"The way to induce gas production in this country is to let the industry know once and for all that it will not be deregulated; to insist that the FPC carry out the clear intent of the Natural Gas Act and the *Phillips* decision instead of the soft pro-industry regulation they are famous for; and to provide a regulated price for natural gas which gives producers their legitimate costs plus a fair return on investment including an incentive to drill for new gas.

"If this provides a somewhat higher price for new gas, so be it. But the FPC should get on with its job."

natural gas would yield greater dividends in both output and conservation than prices above $7 per barrel for oil. Even after recent increases in the price of "new" natural gas by the Federal Power Commission, this price remains at a level per unit of heat value (b.t.u.) that is less than 30 percent of today's price of new oil, even though it is calculated to allow a 15-percent return on producers' investments.

Although producers encounter some natural gas in searching for oil, they face greater incentive to use their resources to produce and market oil, or even coal, than gas. As prices of drilling and transport equipment go to scarcity levels reflecting the prices of oil, it becomes impossible to employ them for gas. Although these price disparities are somewhat attenuated at the consumer level, there is little incentive to conserve gas. Present prices discriminate harshly against the oil consumer relative to users of gas. This situation is inconsistent with the objectives of conservation, increased production and fairness.

Yet natural gas, comprising 40 percent of the Nation's total energy production, is a vitally important, clean fuel. The growing shortage, which may reach one-quarter of would-be gas demand by 1980, is forcing many users to resort to imported oil or to imports of equally high-priced liquified natural gas (LNG).

The illustrative price ceiling of $0.75 for "new" natural gas, used in Table 1, remains below b.t.u. parity with oil at $7. If the price of oil is reduced to $7 and held there, however, gas could reach parity in five years after boosts of 7 to 8 percent per year. This rate of increase would not warrant producer holdbacks because rates of return on revenues are likely to equal or exceed the appreciation of gas reserves. Nonetheless the level would provide an incentive to produce gas as strong as the present rush to produce oil. Supposing that some natural gas is now being held back, the production response should be prompt. According to one estimate, such a price increase would boost gas production by 60 percent or more by 1980 and by perhaps 25 percent more than it would grow without this change.[25] At that rate, natural gas could play a major role in the effort to reduce oil imports and keep the environment clean. The Federal Energy Agency projects a much smaller (9 percent) rise in total production, but without the price change, it foresees a large decline in output due to depletion of existing wells without development of new ones.[26]

The price ceiling in Table 1 would raise the average wellhead price of natural gas nationwide from about $0.27 per m.c.f. to about $0.28 in 1975.[27] Thus it would have no sharp impact on consumer prices. This small increase results from a rigorous definition of "new" gas and, to a substantial degree from regulatory lag. As with oil, however, the average price would rise somewhat year by year because more production would enter the "new" category. After the transition period described above, the wellhead price of new gas would rise to $1.15 per m.c.f. in 1980, and the average price could reach the range of $0.60. Current prices at the consumer level vary widely. Gas selling to consumers for $1.50 per m.c.f. would rise to about $1.85 (or by

---

[25] American Enterprise Institute, op. cit., pp. 27–32.
[26] Federal Energy Administration, op. cit., pp. 6 and 46.
[27] An m.c.f. equals one thousand cubic feet.

23 percent). The proportional increase to industrial users would be larger.

All gas users, large and small, would be on notice that the price of this fuel would increase in modest steps for several years. Combined with controls on coal at lower levels, it would give industrial users an incentive to convert to coal where possible. It would eliminate or greatly reduce the price differential between interstate and intra-state gas.

Coal.—For several reasons the ceiling on new coal is set at a level below the caloric parity [28] with other fuels. First, coal is extracted using completely different technology, and the cost of mining, especially surface mining, is far less than that of producing oil or gas even after costs of meeting modern reclamation and safety standards. Second, despite its short-term scarcity, no long-term supply shortage of coal is expected, because of limitations on its use through air-pollution controls. Third, it is desirable to provide a price incentive to change to coal for users who could do so.

Because of the widely varying grades of coal, the proposed ceiling should be interpreted as an average. The controls, of course, would not apply to exported coal, and it would therefore be necessary to impose some regulation of exports to see that domestic users receive their appropriate share of the supply so long as a shortage exists.

> **We recommend eliminating the tax subsidies presently given to the energy industries. We also draw attention to the desirability of reducing disparities between the prices of oil and natural gas. In this connection, we outline for illustrative purposes a pattern of price controls that could achieve this by rolling back the prices of oil and increasing the price of "new" natural gas. Coal prices would be controlled at a level which would provide users with a price incentive to choose coal in preference to oil or gas. It should be stressed, of course, that these price changes should form a composite package to rationalize and improve our national energy policies. Obviously any price increase without the concomitant measures would impose an additional inequitable burden on consumers. Such controls could yield a small reduction in average fuel prices and reduce producer profits without weakening incentives to produce oil and coal. They would significantly increase production and conservation of natural gas.**

Another significant pricing issue is the question of protecting investments in high-cost energy production from a precipitous drop in cartel-set, international prices. Price ceilings like those proposed above will prevent investments in extremely high-priced energy except for exempted projects involving new technology. Risks to conventional production, therefore, do not seem excessive. If it is determined, however, that risks to investors would deter demonstration of a promising new technology, the Federal government might consider ways to limit potential losses by agreeing to subsidize output sold at prices below certain levels. In exchange for price guarantees, such agreements

---

[28] Caloric parity refers to the price level per unit of heat value (Btu).

should include a provision for the government to receive a share of any future profits.

In the past the United States sought to protect its domestic energy production from cheap foreign imports through the Mandatory Oil Import Program. This program became extremely costly to consumers. It was removed in mid-1973 because it was no longer effective in guaranteeing an adequate amount of domestic production to meet the growing demand.[29] Any consideration of reimposing such limitations on oil imports to protect the domestic energy industries should be viewed skeptically and be thoroughly discussed.

There is no present or foreseeable need for the United States Government to guarantee a high minimum price for all energy resources through tariffs, import quotas or other measures to assure the profitability of energy production. Subsidies for certain types of experimental projects may be warranted on an individual basis.

These proposals cannot be interpreted as extreme in the context of the radical changes in energy markets in the past year. There is no free market in energy today, and a market dominated by an exploitative foreign cartel is not in the interest of the American public. Our proposals are an attempt to reduce the inequities that have plagued energy policy and to re-establsh balanced incentives for all producers and consumers.

Let no one believe that the oil industry will have insufficient funds to carry out needed investments. Its profits would remain very large even if such price adjustments and tax increases are enacted. Meanwhile, in addition to their large current profits, the international companies are receiving hundreds of millions in compensation for nationalized facilities in various OPEC countries and are being relieved of the financial requirements of maintaining and expanding those facilities. The industry enjoys enormous untapped borrowing capacity that will have to be exploited in any large, sustained expansion program. On the other hand, projected investment "needs" are unrealistically high; already some refinery expansions announced at the height of the gasoline shortage are being cancelled or postponed. Even if the proposed changes are introduced, the United States will remain the most liberal and secure country for private oil exploration.

Conservation

It is now recognized by all that energy conservation is vital to the political and financial viability of the United States and other oil importing countries. In fact, investments in conservation are equally as important to our future as investments to increase production. For most other industrial countries, the potential gains from conservation are much greater than those from increasing production.

---

[29] A critical analysis of the oil import program can be found in Cicchetti, Charles, William Gillen, "The Mandatory Oil Import Quota Program: A Consideration of Economic Efficiency and Equity," in *The Economics of Federal Subsidy Programs: Part 8.* A compendium of papers submitted to the Subcommittee on Priorities and Economy in Government, Joint Economic Committee, U.S. Congress, 93rd Congress, 2d session, July 29, 1974, pp. 995–1017.

Contrary to widespread perceptions, some conservation is taking place. Prices have risen sharply. Consumers have been made aware of the need to conserve by media coverage. The slump in the economy also results in lowered energy use. Conservation, moreover, will increase as energy purchasers gradually alter their habits, their homes and their work practices to reflect higher prices. Much of this will occur in the industrial sector, where energy-intensive firms that reduce this component of their costs most successfully will have significant advantages over others. Much of the adjustment, however, can occur only as more efficient equipment and vehicles are designed and put to use. Government can help to expedite and facilitate this process.

With proper direction from its leaders, moreover, the American public will conserve in the short run by changing its practices within the limitations of existing equipment. Such willingness was demonstrated during last winter's oil embargo, when people made extraordinary efforts to cut out wasteful use by lowering thermostats, turning off unneeded lights and reducing driving.

Voluntary conservation was relaxed, however, after official assurances that the need for a crisis response was past. Instead of that approach, the public should be aroused by its leaders to fight high energy prices and instructed how to conserve for the sake of family budgets as well as national goals. The public should be reminded that the more energy is conserved through voluntary actions, the less conservation will need to be imposed through higher energy taxes and regulatory measures.

In the short-run, however, all approaches must be combined to achieve a sharp, immediate reduction in oil imports. President Ford, in October, called for a cut of one million barrels per day in imports by the end of 1975. Secretary of State Kissinger has proposed much larger cuts in future years. Such sharp cutbacks inevitably will cause some inconvenience and hardship for most people. All of the many proposed conservation measures have drawbacks. If we are serious in our commitment to conserve energy, however, decisive actions must be taken soon.

An effective way to obtain a quick, sizeable reduction in oil imports is through a rebatable gasoline tax. Behind this statement is the belief that larger short-run cutbacks can be made with less real sacrifice in the area of vehicle use than in other uses of fuel. A tax of 30 cents per gallon, for instance, would cut gasoline consumption by an estimated 8 percent or by one-half million barrels per day during the first year. This is half of the saving President Ford has proposed. Savings from the tax would rise quite substantially within 3 to 5 years.

This tax would raise about $25 billion during the first year, which would have to be rebated concurrently to avert a harsh deflationary impact on the economy. Rebates could be made by reducing withholding or payroll taxes for qualified persons by enough to pay the tax on gasoline at the average consumption rate. Persons not employed could be paid quarterly by check.

Despite the rebate, everyone would be faced with a price for gasoline in the range of 85 to 90 cents per gallon. Each person would have to decide how much gas to continue purchasing at that price and how much of his rebate might better be spent on other things at pre-existing prices. In effect this tax is equivalent to coupon rationing with saleable coupons except that no one is bothered with coupons and no problem of counterfeiting must be combatted.

There will be legitimate concern that a gasoline tax would work against the recovery of the automobile industry. It must be recognized, however, that early imposition of a gasoline tax would be less deterrent to the purchase of new cars than any of the proposed excise taxes on the vehicles themselves. In fact, if gasoline efficiency in 1976 cars is markedly improved, a tax on gasoline should stimulate the replacement of less efficient existing cars with new ones.

Others have proposed an excise tax to be imposed on all oil at the crude level. Such a tax would result in modest increases in the prices of all oil products. Unlike a gasoline tax, this alternative would leave to refiners a choice about how to pass the tax through. To avoid losing sales, refiners would have an incentive to pass the tax through disproportionately on the most essential products with the least price elasticity of demand. If this were done, it would maximize the price inflation and consumer hardship from the tax and minimize the oil savings. The gasoline tax, on the other hand, bears down directly on the oil product expected to have the most elastic demand. Furthermore, the tax on crude might lack the shock effect needed to bring about a major consumer adjustment, because the tax would be spread in small increments among a large number of products. A crude oil tax raising revenues comparable to the gasoline tax discussed above would boost the price of gasoline by only about 11 cents per gallon.

A general energy (b.t.u.) tax has been proposed to apply to all consumption of fuel. This tax would enhance the incentive to conserve but its relatively mild effects would be felt mainly in the longer run. It would provide an equitable means of user taxation to fund energy research, stockpiling or other costly measures to obtain national energy goals. Unlike the two options discussed above, it would not discriminate significantly among consumers tied to different types of energy. A tax of 4 cents per million b.t.u.'s (one-half cent per gallon of gasoline) would raise $3 billion annually.

Such a tax, if phased in gradually in 1976 and after, also could provide an appropriate part of the financing of the tax relief for low and moderate-income people recommended elsewhere in this report. Any large excise tax imposed immediately, however, must be rebated separately from the tax relief already proposed to avert the depressive effect of a sharply higher budget surplus on the already weak economy.

Congress should consider enacting a fuel conservation tax to obtain a sizable immediate cut in energy consumption.

Despite the significant potential short-run savings from a gasoline excise tax, it is clear that much more must be done to reduce consumption if the United States is to cut its oil imports sufficiently. Many such approaches are available. Some can be implemented relatively quickly; others will take longer to devise. Some have relatively quick pay-offs; the effects of others will be felt only over several years. In fact, no limited set of measures can do the necessary job. Savings must be made in every sector to reach our goals.

Because of the importance of transportation as a consumer of nearly 60 percent of all petroleum in this country, the government must monitor the improvement of vehicle engine efficiency. Serious consideration should be given to setting mandatory efficiency standards for autos and trucks for 1978 and 1980, which producers could meet on a sales-weighted basis. By that time, the present downturn in auto production will be a thing of the past, and sales can be expected to have recovered. Auto replacements deferred during the present recession will be overdue, and increased gasoline efficiency itself will stimulate sales. A minimum standard of 20 miles per gallon for 1980 should be considered. A more flexible alternative would be a progressive excise tax on vehicles receiving less than 25 miles per gallon in 1980—with interim goals for 1978—and tax credits for vehicles reaching more than this level of efficiency. Some Federal funding to assist research and development for more efficient engines would be appropriate in reaching this national conservation goal. Achievement of an average of 20 miles per gallon for all automobiles in service by 1985 could save 2.5 million barrels of oil per day.

Another set of measures that can be taken relatively soon is the final preparation and promulgation of thermal efficiency standards for new buildings and structures renovated with the assistance of Federal funding or loan guarantees. States and localities should be urged to adopt such standards. Regionally differentiated standards already are in preparation. While the effects of these measures would be felt gradually, their contribution will become quite significant within a few years. The time to begin requiring energy efficiency in construction is now. A quicker pay-off can be had through renewed emphasis on restraint in heating and cooling existing homes, apartment buildings, stores, offices and factories. Federal, State and local governments must take the lead, however, by assuring that proper climate control guidelines are observed in public buildings.

Another move that can be undertaken soon would be the testing and labeling of home appliances to show their energy efficiency. Life-cycle energy labels would sensitize consumers to "think energy" and would emphasize this criterion in competition among producers. The potential savings through this option, however, are relatively modest.

The problem of establishing energy efficiency standards for vehicles, structures and mass-produced appliances must be addressed by Congress and Federal regulatory agencies in 1975.

The above proposals are things that we feel warrant action now. The Joint Economic Committee, however, has not yet held extensive hearings on the Project Independence Blueprint issued in November or on policy statements subsequent to it. The recommendations in this Report are not intended to comprise a thorough response to its alternatives. The Committee anticipates with interest the President's proposal. Hearings will be held early in the new session of Congress.

The Possibility of a Reduction in World Crude Prices

The quadrupling of world oil prices during 1973 rudely shocked the world by shifting the relative terms of trade sharply in favor of the producers of petroleum. The higher oil prices, accompanied initially by the embargo and production cutbacks, have caused an economic slowdown throughout the industrialized world and increased already high rates of inflation.

Efforts during the last year to force or persuade OPEC countries to lower their prices have been ineffective. Higher oil prices have cut world demand for imports by approximately 5 percent from the 1973 level, or 9 percent below the previous growth trend for 1974. During the first six months of 1974, production exceeded demand by approximately 3 million barrels per day, including the embargo period when production cutbacks were the greatest. By September, however, production cutbacks made by the OPEC members, principally the Middle East producers, had reduced surpluses to approximately half a million barrels a day. According to Treasury Department estimates, the producers have been able to shut down their capacity to produce by as much as 8 million barrels a day.[30] Without surplus production, there will be no real downward pressure on price.

While the cartel may be unable to hold together and maintain high prices in the long run, its present cohesiveness offers little hope that lower prices will result from such disintegration in the short run. Even the poorest OPEC members, such as Indonesia, Ecuador, and Nigeria, show little inclination to increase production in opposition to the OPEC mandate. It is quite understandable that these countries would stick with OPEC, which has successfully quadrupled their oil earnings within the last year, and in some cases wrested control of producing facilities from international oil companies. Furthermore, the few producers with the greatest potential for production and the largest surplus revenues can and have been willing to decrease production so that overall exports do not exceed demand.

Proposals to encourage OPEC members to deviate by lowering prices and selling more oil have been numerous. Few have been tried, however, because they generally rely on cutbacks in imports necessitating higher costs to the consumer and perhaps losses of industrial production as well. If such proposals were implemented in a confrontational way, they could further solidify the producers' commitment to a common OPEC position and hence be totally counterproductive.

The argument that the present extraordinarily high oil prices are not in the producers' own long-term economic self interest has been equally unconvincing to them. The oil producers do not believe that the sudden rise in oil prices will seriously damage the industrial economies on which the OPEC countries depend for capital goods, high technology, and investment opportunities. The producers are aware that oil prices account for only part of the current world inflation. They do not believe that developed countries can be so easily destroyed or that industrialized country governments will not undertake painful domestic adjustment measures rather than permit total economic collapse.

The oil producers also discount the argument that present high prices will accelerate the search for alternative sources of energy and thus cause a shift away from the reliance on OPEC exports. For example, as many projections show a continuing demand for all the world's

[30] "Secretary of Treasury Simon, *Hearings*, 'Kissinger-Simon Proposals for Financing Oil Imports,'" the Joint Economic Committee, November 25, 1974.

petroleum resources for energy and other uses (i.e., petrochemicals) as others forecast displacement by cheap energy sources.

The issue today may not be one of bringing world oil prices down, but rather one of keeping them from rising further. Without serious curtailment of demand through more efficient energy use, economies that wish to grow will continue to increase their consumption of energy. Since little new production outside of OPEC can be expected in the near future, the producers will be able to maintain a close balance of supply with demand for some time. Therefore, it is likely that OPEC will press for further price increases to offset current inflation. Iran, for example, has proposed indexing oil prices to world inflation rates.

Consumer Solidarity.—Efforts to draw together the consuming nations to prevail upon the producers to lower their prices have been relatively unsuccessful. The Washington Energy Conference in February 1974 set the groundwork for discussions between the principal industrial consuming nations. Because of the sharply differing perspectives of Japan, various European countries, and the United States, however, discussions have proceeded slowly. On November 18, 1974, the principal industrial nations agreed provisionally to set up an International Energy Agency under the umbrella of the Organization for Economic Cooperation and Development (OECD). With the necessary parliamentary ratification, the 16 member nations would share available energy supplies and cut back consumption in the event of another oil embargo. Although provisions of the Defense Production Act and the Emergency Petroleum Allocation Act presently do provide most of the authority needed to implement this agreement, U.S. participation will need additional enabling legislation in at least four areas: (1) stockpiles, (2) information sharing, (3) emergency demand restraint, and (4) authority to compel cooperation by the companies. Because this agreement involves an economic commitment and the delegation of sovereignty, Congress should pass appropriate legislation before the May 1975 deadline for full government approval.

The Administration should introduce enabling legislation forthwith so that the Congress can consider ratification of the International Energy Program.

Financial Assistance.—The fourfold increase in oil prices has imposed severe balance-of-payments burdens on some industrial countries. On November 14, Secretary of State Kissinger proposed a $25 billion financial solidarity fund to help meet these strains once a nation has exhausted its borrowing ability in capital markets and from the International Monetary Fund (IMF). The proposal was subsequently expanded by Treasury Secretary Simon. As many of the specific details remain to be negotiated, it is difficult to evaluate the appropriateness of the proposed facility. To be able to draw on the fund, borrowers would make commitments to cut their dependence on oil imports and to eschew trade restrictions and capital controls. Unless these commitments, along with others to pursue appropriate internal and external economic measures, are stringent and sternly policed, there is little reason to believe that the need to borrow will be of short duration or that funds borrowed on commercial terms will be repaid.

Without such assurances, the proposed mutual aid fund would become a massive foreign aid program rather than the "financial safety net" that has been proposed.

Secretary Simon in his testimony on November 25 [31] said that the lower world oil prices which would result from a major consumer conservation effort would permit the deficit countries enough relief to be able to pay off their borrowings. Nonetheless, borrowers will have to run trade surpluses with either the oil producers or with the lenders, like the United States, if they are to repay their emergency loans.

While no specific figure for U.S. participation has been set, it is estimated that our participation probably will be between 25 and 35 percent. Our share of the risk will apparently be substantially higher than what the United States would incur if such aid were channeled through the existing IMF oil facility. The United States has borne a larger share of the burden under other agreements, such as the General Agreement to Borrow (GAB), but these agreements were negotiated under significantly different circumstances. In recent years, the United States has sought to decrease its percentage participation in all international agencies. Furthermore, this country has not attracted a disproportional share of surplus revenues from the oil producers. If it does not in the future, drawings on the mutual aid fund would cause the U.S. Government to borrow in its capital markets in competition with domestic borrowers.

International Conservation.—In the near term, the only way to bring down world oil prices is through stringent conservation. The Kissinger-Simon proposal launches a major initiative to cut consumption in the industrialized countries by 10 percent, or 3 million barrels a day. It ties back-up financing to a country's willingness to cut its dependence on oil imports. Reduced oil imports are essential if the balance-of-payments burden on consuming economies is to be curtailed. Several European countries already have raised gasoline taxes sharply to this end. France has placed a ceiling of 51 million francs on the total value of its oil imports. Further measures are necessary if cutbacks approaching those sought by the Kissinger-Simon initiative are to be achieved. The OPEC producers might be able to absorb the proposed 3-million-barrel-a-day cutback as easily as they absorbed the present estimated 8 million barrels a day shut-in capacity.

Because the United States is the largest importer and the most profligate energy user, its participation is essential for such a conservation effort. Therefore, the fuel conservation tax proposed above is as essential for international purposes as it is desirable domestically. Without conservation in the United States, the other industrialized countries are unlikely to agree to the cutbacks required under the Kissinger-Simon mutual aid fund.

Cutbacks may be difficult to negotiate because of the disparate burdens they will create. For example, a 10 percent cut in Japanese petroleum consumption would directly affect its industrial production levels, but the United States could achieve the same percentage reduction solely by eliminating waste. The International Energy Agency needs to begin immediately exploring the potential for a

[31] Joint Economic Committee, *op. cit.*

43-168 O - 74 - 9

joint conservation effort and determining how the burden can be borne most equitably.

To the extent that the proposed oil financing facility will require industrialized nations to lower energy consumption, it should be supported. However, Congress should not consider authorizing funds for this safety net until (1) a stringent U.S. conservation program, such as recommended above, is in place and (2) the other member nations also have introduced appropriately stringent conservation measures.

Increasing World Supply.—Besides energy conservation, the Kissinger-Simon proposal seeks investment guarantees for joint projects to develop new non-OPEC energy supplies, and thus to bring further pressure on the cartelized world oil price. Few specifics are known of a fund for this purpose to be set up under the International Energy Agreement. The proposal, however, parallels closely the present effort to increase domestic energy supplies. As in the case of domestic energy production, it is unclear that subsidies are necessary or that guarantees are desirable. The fourfold increase in price has spurred discoveries in Bolivia, China, Malaysia, and Mexico, as well as the doubling of proven oil reserves in the North Sea. Present prices have also stimulated the search for other oil fields, as well as the development of coal, nuclear power, and other alternative sources for energy, even without the expectation of guarantees. Any plausible moderation of the world price would not make these investments worthless.

While individual countries may wish to guarantee activities of their own state oil companies in order to have greater control over their own energy resources, there is little reason to guarantee investments by the major international oil companies. In fact, serious attention should be given to assuring that there is effective competition among these companies internationally. The major oil companies still have significant advantages over smaller companies because of their traditional access to production in OPEC countries. It is clear that some countries like Japan are as anxious to decrease their dependence on the Anglo-American multinational corporations as they are to decrease their dependence on the cartel producers. Competition between companies is essential if they are to have any incentive to develop the additional supply necessary to permit world prices to drop.

The United States should exchange research findings in the development of unconventional energy sources such as solar. To the extent that these technologies can be developed quickly, they will benefit all countries and especially the poorer developing countries for whom present oil import costs are prohibitive.

The United States should not support international guarantees or an effort to set a price floor under the world petroleum market. We should, however, join other consuming nations in promoting research and technological development of all forms of energy.

Preventing Bank Failures.—While the financial safety net may provide the needed support for a few industrialized nations severely affected by the higher oil import prices, it is by no means a cure-all.

The private banking system will continue to bear the brunt of channeling the enormous flows of surplus revenue accumulated by the oil producers back into the consuming economics. To date many of these deposits have been very short term, causing severe liquidity problems. Interest rates on new short term deposits have begun to fall. This decline in itself should encourage oil producers to move into longer-term investments. But the international banking system will continue to be severely strained.

The Comptroller of the Currency and the Federal Reserve Board should immediately tighten their regulations and supervision to insure that U.S. banks do not overextend themselves in the hustle to acquire funds from the producing nations.

Aid to Developing Countries.—Even with the Kissinger-Simon "safety net" proposal, the IMF oil facility will need to be expanded to help other developed countries and the richer developing countries meet the burden of higher import costs. Presently the IMF guarantees fully the funds which the producers lend through the oil facility. It should consider equitable risk sharing with the producers such as guaranteeing only 85 percent of the funds channeled through the facility. The risk for the remaining 15 percent should be borne directly by the contributing producers.

The developing countries have been among the most seriously affected by the higher oil prices. These countries are also hurt by the higher cost of fertilizers, and the loss of exports due to the economic slowdown in the industrialized countries. Concessional assistance from the developed countries and from OPEC members would have to rise from $12 billion in 1973 to $18 billion in 1976 just to provide for a 2 percent annual increase in per capita incomes in the poorest countries. The present IMF oil facility has made some funds avaliable to these countries. The loans, however, have been at commercial rates, which these countries can little afford. Because the resource needs of these poor countries are more complex than just enough money to pay for oil imports, these needs can best be met through increased lending by the existing development banks. While the United States should continue to support concessional aid to these institutions, it should also continue to press the development banks to seek additional participation by producers.

The United States should support an expanded IMF oil facility for other industrialized and developing economies. It should also support increased concessional assistance for the developing countries channeled through the existing development banks.

SUPPLEMENTARY VIEWS OF CHAIRMAN PATMAN

I agree with the basic thrust of this report and particularly with the emphasis on the need for economic growth and productivity gains in order to control inflation and with its recognition that this is no time to cut necessary spending programs.

Excessively rapid acceleration of money supply growth in 1972 and the first half of 1973 contributed greatly to the still-raging inflation and, as the report states, excessively rapid deceleration in the rate of growth of the money supply since last April has intensified the current recession. It is essential that the monetary authorities act immediately to provide adequate but not inflationary money supply growth so that the economy and especially the home building and automobile industries can begin to recover from the present tragically depressed condition without setting off a new wave of inflation.

I also support the report's emphasis on the need for credit allocation—something I have advocated for many years. However, the report does not go far enough in this respect. Obviously there are many mechanisms available to allocate credit—using both the carrot and the stick. This could include special asset reserves, the purchase of agency paper by the Federal Reserve Open Market Committee, and tax incentives.

Another way to make credit available to consumer borrowers, small businesses, State and local governments, and homebuyers is to establish a National Development Bank. The concept of a National Development Bank has long been supported by me and a great many other members of Congress. Under my proposal, the National Development Bank would be capitalized by stock subscribed to by the Treasury. The Bank could hold debts totalling $20 billion. Loan funds would be obtained through the sale of Federally guaranteed Bank obligations to open market investors and when necessary to the Treasury.

Loans at reasonable rates would be made available to borrowers for housing, for business and industrial development and to State and local governments to finance urgently-needed public works and facilities when such borrowers are unable to obtain credit on reasonable terms from private sector lenders. The emphasis should be on new development and new jobs. The Bank should not be used for bail-outs of mismanaged concerns.

In essence, the existence of a National Development Bank would protect priority borrowers against the all too frequent periods of economic strangulation produced by a Federal Reserve which has been allowed to exist outside of the control of the Administration or Congress. It is my hope that the Committee will see fit to present more complete recommendations in this area in the near future.

I am pleased that the report calls attention to the way in which the Federal government keeps enormous amounts in accounts with the largest commercial banks. These accounts pay no interest and represent, in effect, a Federal subsidy to the big banks. If the banks are going to continue to have the privilege of using these funds, then the banks should certainly pay the government a fair return on its money.

The report makes many interesting proposals for dealing with the energy crisis. It goes without saying that the energy crisis constitutes one of the most serious domestic problems confronting the nation. This point should not be overlooked in any effort to revise the tax structure as it applies to oil companies.

Specifically, changes in the tax liability of oil companies should be designed, as far as equity permits, to encourage increased production and reduce a problem that reaches out to practically every aspect of the economy.

Small, independent oil companies, which have in fact begun to increase production, should not be discouraged in this pursuit in the name of requiring large international oil companies to pay their fair share of the total tax bill. The survival and prosperity of the small independent oil companies should be guarded so that they will continue, and hopefully expand, as a competitive market force.

The proposals for controlling mineral fuel prices are an imaginative contribution in an area where a new approach is bady needed. However, I cannot endorse them at this time without further study. Nor can I support any increase in the gasoline excise tax which would in any way impose any extra burden on low and middle income citizens who are dependent on the automobile as their only means of transportation.

Finally, I think we have to keep our options open and invite the new Congress and especially the newly-elected Members to have input into the formation of the nation's economic policies. This is a time to seek new answers and I think it would be well for the Joint Economic Committee and the legislative committees with jurisdiction over economic policy to broaden their search for new ideas.

SUPPLEMENTARY VIEWS OF REPRESENTATIVE BOLLING

I am pleased to join with my colleages on the Joint Economic Committee in making this Report to the Congress. I think that it is responsive to the letter and spirit of S. Con. Res. 93, which asked the Committee to do an emergency study of the economy, and particularly inflation, and report to the Congress before the year's end. The Report contains a considerable amount of analytical background and a number of proposed policy alternatives for dealing with problems of the economy. I think it will be most useful to the Congress in the difficult deliberations that lie ahead of us next year. In joining in this Report, I must state that the heavy pressures of other responsibilities made it impossible for me to participate fully in the hearings and Committee deliberations. For that reason, it would not be appropriate for me to endorse all of the particular conclusions and recommendations in the Report. I am, however, in agreement with its general emphasis and pleased with the unusual amount of analysis that it makes available to the Congress.

SUPPLEMENTARY VIEWS OF REPRESENTATIVE REUSS

While I am in full agreement with much of the Joint Economic Committee's analysis and recommendations, I believe that the staggering problems of inflation, recession, and energy need tougher action. We must go beyond the Committee recommendations:

(1) *Inflation.*—The Committee's suggestion that "More selective techniques for carrying out a tough voluntary incomes policy should be utilized" is like prescribing vitamin pills when antibiotics are needed.

It is true that *comprehensive* wage and price controls are both economically and politically undesirable at present. Experience has shown the distorting effects of controlling food prices, for instance. It is unnecessary to subject hundreds of reasonably competitive sectors to price controls.

The alternative to across-the-board controls, however, is not *no* controls (or giving a President who has proclaimed his undying antipathy to controls the power to use them at his discretion) but *limited* Congressionally-mandated controls—on those concentrated industries where administered prices resist the downward pressure of market conditions.

In its September Interim Report, the Committee stressed the importance of administered prices to inflation:

> Increasingly, a significant part of the current inflation can be understood only in the context of administered prices in concentrated industries which typically increase despite falling demand. Some part of this phenomenon can be explained by adjustments to overcome distortions created by the control program and some part by an upward adjustment to high world prices. However, a substantial part appears to be unexplainable except in terms of the ability of concentrated industries to resist competitive forces and to achieve a target return on investment in good times and bad (p. 3).

Again, in this Final Report, the Committee recognizes the impact of administered prices:

> Leaders of the large corporations in the concentrated national industries usually can count on other firms in the sector to respond cooperatively to initiatives increasing prices. Joint price boosts are usually in the short-term commercial interest of all, . . . (p. 29).

Extreme price increases in concentrated industries in 1974 alone have given "a powerful new thrust to inflation", the report concludes.

Then why not act to control these specific sources of inflationary pressure? Attorney General William Saxbe announced on December 6 that the Justice Department is investigating possible monopolistic concentration or price-fixing in the automobile, steel, tobacco, coal, aluminum, zinc, copper, chemical, beef, earth-moving, paper, and heavy electrical equipment industries. One cannot now foretell whether the Justice Department's inquiry will result in prosecutions for anti-trust conspiracy. What *is* clear is that competition in these and other concentrated industries (sugar, for instance) cannot be relied upon to hold back inflationary price increases.

We need an independent price control board, Congressionally-mandated and supervised, with full investigatory and enforcement powers. The board must be able to hold public hearings, issue subpoenas, impose price freezes, delay proposed increases, and roll back excessive prices in administered-price, noncompetitive industries. An important issue in the board's determination would be whether under price controls an industry could earn adequate profits, and not be under undue pressures to increase exports in order to obtain higher prices.

As to wages, it is simply unrealistic, as well as unfair, to expect workers voluntarily to sacrifice pay increases in a period of such high inflation. Wage moderation must come, but only after the government has provided some basic elements of worker security:

(*a*) *Jobs.*—A massive public service employment initiative, programs to bolster employment in the sagging construction and automobile industries, improved unemployment compensation benefits;

(*b*) *Prices.*—Strong controls for administered prices;

(*c*) *Money.*—Credit allocation away from speculative or inflationary purposes to vital credit-starved areas such as housing, small business, productive capital investment; and

(*d*) *Tax redistribution.*—Tax relief for low- and middle-income families, financed by plugging income tax loopholes.

As soon as the government shows good faith in pursuing such policies, workers, as their part of a *social contract*, can be asked to accept guidelines for wage increases—but not before.

(2) *Recession.*—The Committee report calls for a large public service employment program and improved unemployment compensation benefits, both of which I vigorously support. But what of the two most critical areas of unemployment—housing and automobiles? Can nothing be done specifically for these two sectors?

I believe that specific programs for both stricken industries—programs which are at once job-creating, energy-conserving, and environment-enhancing—are needed:

(*a*) *Housing.*—H.R. 17553, the Emergency Middle Income Housing Act, which I introduced in the House on December 3, could help solve the problem. Designed to build as many as one million additional new homes in each of the next two years, the bill would allow HUD to subsidize for four years the interest rate on mortgages to families in the \$10,000–\$16,000 a year income bracket so as to get mortgage interest payments down from their present 9½–10 percent to 6 percent. Knowing that the offer is good only for two years, homebuyers will hasten to take advantage of the offer. If as many as 1 million additional housing starts are stimulated, approximately 500,000 on-site jobs, 100,000 off-site jobs directly related to housing, and 400,000 jobs in related manufacturing (home furnishings, kitchen equipment, etc.) could be generated, according to the Library of Congress.

To qualify for the subsidy, the house being purchased must meet energy and land use standards set by the Secretary of HUD. Row houses, clustered housing, condominiums, and other forms of high-density homeownership cut down on waste of energy and land. The just-issued annual report of the Council on Environmental Quality shows that high-density housing requires significantly less energy consumption than low-density suburban and exurban sprawled housing, generates 45 percent less air pollution, requires 44 percent less investment to build, and is cheaper to operate.

The Emergency Middle Income Housing Act can help end the housing depression, provide hundreds of thousands of jobs for unemployed construction workers, provide an opportunity for younger working families to acquire a home—all in an energy-saving, environment-enhancing manner.

(*b*) *Automobiles.*—Unemployment in the auto industry is now over 30 percent, and some 240,000 workers have been laid off. With sales the worst in ten years, there is little hope for an immediate upswing. What can be done to help these workers?

Some auto industry executives urge that consumer subsidies be given car-buyers to stimulate demand for the gas-guzzlers of which the public is so rightly wary. But the automobile slump is no temporary phenomenon. It reflects the basic imcompatibility of the average American car with the facts of life. Scarcer, more expensive fuel is such a fact. Dangerous air pollution is such a fact. The disappearance of open spaces before a maze of super-highways is such a fact. The old American way of life based on the large automobile is on the way out.

What we must focus on instead is more energy-conserving and environmentally-harmonious forms of transportation. In World War II, Detroit turned overnight to maufacturing jeeps, tanks, self-propelled vehicles. Today, cannot unused production lines and unemployed skilled workers be put to work meeting newly-created demand for mass-transit equipment (buses, electrically-propelled vehicles, new modes), railroad cars and equipment, a truly compact inexpensive short-range automobile, bicycles?

This conversion would do two things. First, it would provide jobs for workers laid off because of slumping automobile sales. Second, it would get public mass transit off the ground for the first time.

It is true that we don't have the last word on mass transit systems yet. Since 1966, when the New Transportation Systems Research Act became law, we have seen every conceivable delay in the development of new transportation systems. In 1968, HUD concluded that six types of new systems—dial-a-ride, personal rapid transit, dual-mode, pallet systems, new systems for major activity centers, and fast intra-urban transit links—"were found to possess not only a high expectation of technical and economic feasibility, but also to contribute significantly to the solution of major urban problems". Yet today, none of these systems has been adequately tested and demonstrated.

We can't wait any longer for the federal bureaucracy to sniff around these research programs. We must simply choose a system and get to work. The situation is too grave for us to be finicky at this point. Like the Germans, who, oil-starved in World War II, liquified their coal at vast expense—not because the solution was ideal but because the crisis demanded it—we must find alternative jobs right now in mass transportation for workers unable to find jobs in the depressed automobile industry.

(3) *Energy.*—The Committee report suggests that the two ways to secure energy conservation (the present program having patently failed) are (*a*) rationing, and (*b*) an excise tax of some sort—most often described as an additional 30-cent-a-gallon gas tax. The report concludes that rationing is better than a tax in that "it would not contribute to inflation in the same way as would the adjustment to a tax" but would be equally effective in cutting consumption.

The Committee rejects the rationing alternative, however, on the ground that it would be too difficult to administer. Stuff and nonsense! We had a well-administered gasoline rationing plan 30 years ago, and it worked. The public is ready for it. Let's go.

The energy tax would raise prices to consumers not just directly, as in the price of gas, but in the price of millions of other commodities and services to the production of which fuel is a necessity. The burden of the tax would fall unfairly hard on those who live the farthest distance from their jobs—country doctors, travelling salesmen, migrant laborers, construction workers, commuters without alternatives—while many low- and moderate-income people who live in the city and don't suffer from higher gas prices would receive a windfall tax reduction. This is too haphazard.

The best way to cut consumption is by straightforward rationing according to need. Unless we do manage to cut consumption, we have no vantage point from which to bargain Arab oil-producing nations into lowering, or at least not raising further, their prices. In any case, only equitable rationing now will enable us to adjust to the energy-scarce future.

All of the measures suggested above are controversial. It is too much to expect the Republican administration to take alone the tough and no-doubt unpopular steps which must be taken if we are to lick inflation, recession, and energy shortages. It is likewse asking a lot for the Democratic Congress to go out on a limb. What we need for the year ahead is an informal, de facto, bipartisan coalition between President Ford, flanked by his leading economic officials, and the Congress on the commanding heights of the economy. Only in this way can consensus and widespread support for a serious, tough economic policy be achieved.

SUPPLEMENTARY VIEWS OF SENATOR HUMPHREY

I support the basic thrust of this report and most of its recommendations. In particular, the Committee is wise to emphasize the need to get the economy moving again if we are to make progress in the battle against inflation. It is not well understood in Washington that the recession actually contributes to the current cost-push inflation by reducing productivity and raising labor and material costs. Nor is it well understood how costly the current recession is and how long it will take to reverse the economic slump. The staff estimate that even with a resumption in economic growth next year the Nation will lose nearly $500 billion in production between now and 1980, is truly shocking and deserves the emphasis it has been given in the report.

There are several areas of the report, however, on which I have supplemental views, or areas with which I disagree.

While endorsing the $10 billion tax cut for 1975, I wish to advocate that we achieve such a cut in a somewhat different way than that recommended by the Committee. Because we must enact a tax cut as promptly as possible, it is my view that we should modify existing provisions of the tax law rather than to try to change the tax law in the process of cutting taxes. I have therefore proposed we cut taxes primarily for low and moderate income consumers by: (*a*) Increasing the low income allowance from $1,300 to $1,800; (*b*) increasing the standard deduction from 15 to 17 percent; (*c*) raising the personal exemption from $750 to $900; and (*d*) reducing social security taxes for low income families by $600 million.

Although the Committee notes the Administration impoundment of funds for Section 235 and Section 236 housing subsidies, I feel a stronger statement is merited. The housing industry is in a full-fledged depression in large measure because of the Administration's failure over the last two years to maintain adequate policies to encourage housing production. The impoundment of funds for Section 235 and Section 236 has contributed greatly to this housing market depression and cannot be justified on the grounds that these programs were inherently deficient. They worked well in areas like Minnesota where they were carefully managed, and they could work nationally. I therefore call on the Administration to cease its impoundment of Section 235 and 236 funds immediately as one way to reverse the depression in the housing industry.

I am pleased that the Report calls for an integrated and comprehensive national food policy, taking into account world food demands and the U.S. need to maintain open markets. I hope the committee will pursue this in further detail during the next year. We must improve farm income and production here at home, particularly in view of rising production costs and shortages. We must manage U.S. food exports so that international and domestic food priorities are balanced.

Finally, we must increase competition and efficiency in the processing and distribution sectors of the food industry. Such an integrated set of policies has not been developed by the present Administration, and I am convinced that the food markets will not be stabilized until we stop dealing with them in a piecemeal fashion.

In the context of a national food policy I would particularly stress the importance of enacting legislation to establish a system for managing export commodities in critically short supply. We do not want the United States forced into repeating the disruptive soybean embargo of June 1973. The Secretary of Agriculture should be given authority to license exports of agricultural commodities in critically short supply, and to require prior approval of such exports if necessary. These actions would allow the Department of Agriculture to gain tighter control over critical export situations without terminating trade.

Finally, I would disassociate myself from some of the remarks in the report about price supports, import quotas, and marketing orders. I support the careful review of such mechanisms in the food area to determine if they are ineffective. The report, unfortunately, is somewhat simplistic in its treatment of price supports and marketing orders. These techniques can yield substantial benefits in stabilizing farm prices, and such stability is necessary if we are to avoid a boom-to-bust cycle in agriculture.

With respect to the Report's recommendations in the energy area, I am not prepared to support a gasoline tax at the present time. A tax on gasoline should be considered only after all other alternatives to expand supply and reduce consumption have been attempted—something that has not yet been done. Greater efforts could be made to expand output by increasing competition in the oil industry.

On the other hand, greater efforts could be made to conserve energy, and I intend to introduce legislation in the next session of Congress to establish a comprehensive energy conservation program. Among the conservation actions I will urge on Congress, are the following:

(*a*) Mandatory fuel economy standards for autos beginning in 1978;

(*b*) Expanded research on new engine types that are economical and non-polluting;

(*c*) Mandatory conversion by refineries and utilities to coal and away from heavy dependence on imported oil;

(*d*) Extensive research and standards requiring development and sale of more energy-efficient appliances, lights and space heating systems; and

(*e*) Federal subsidies for the development and use of solar and geothermal energy.

SUPPLEMENTARY VIEWS OF SENATOR BENTSEN

I believe the most important point made by this report is that today's choice is not between fighting inflation on the one hand, or fighting recession on the other. We must fight both, and contrary to what some members of the Executive Branch have been telling the American people, there is *one* weapon that can successfully combat both inflation and unemployment—economic growth.

For 1975 and 1976 our objective must be to restore and maintain a healthy rate of economic growth in this country. The American economy is still the strongest economy in the world, but it is operating far below its potential. If we breathe some life back into it, and get it expanding again, we will not only put some of the six million without jobs back to work—we will also achieve the productivity gains which are the key to reducing inflation over the next several years. We heard a great deal of talk at the Economic Summit about productivity—but productivity increases during recoveries, not recessions. Our economic policies must be directed toward achieving that recovery.

In particular, I wish to stress the importance of the Committee's recommendation for $10 billion in tax relief for moderate and low income Americans to restore some of the purchasing power they have lost due to inflation. This threatens to be the worst of six recessions this Nation has suffered since World War II. Yet it is the only one during which the tax burden on wage earners is actually increasing. It is increasing because of rising payroll taxes and inflation putting wage earners in higher tax brackets.

I have previously advocated establishing a $225 tax credit as an option to the personal exemption and will introduce legislation providing for such an option when the new Congress convenes in January. This credit would be especially beneficial to middle- and low-income working families. It would make our tax laws more progressive and remove any income tax burden on individuals and families below the poverty line. For example, under present law a family of four making over $4,300 is subject to income tax even though the 1975 poverty level will be $5,442. The enactment of an optional $225 credit would remove any tax burden from those families with incomes up to $6,773 per year and provide a tax reduction for families making up to $25,000 per year.

While I very much support the Committee's recommendation for tax relief for moderate and low income wage earners as a needed stimulus to the economy, we must not repeat the mistake of previous tax reductions enacted for this purpose by failing to provide some means of balancing the Federal budget as the economy moves back toward full employment. In addition to the revenues from badly needed tax reform, I would suggest the use of a BTU tax on nonresidential energy consumption phased in over several years. Such a tax could provide needed revenues while encouraging energy conservation.

The report stresses a concern for energy conservation which I share; however, I do not agree with all of the recommendations concerning energy. In my view there is not a sufficient distinction made between domestic independent producers of energy who are doing most of the exploration in this country and the large multi-national oil companies deriving most of their production and profits from foreign operations.

On balance, however, I believe the Committee's report makes a very useful contribution to what must be a continuing study of this Nation's economic problems and the policy options available for their solution.

MINORITY VIEWS [1]

In our view, the preceding Report represents a comprehensive attempt to analyze the sources of our present serious, persistent inflation and to make recommendations with regard to reducing that inflation and helping our economy to recover from the deep recession which has accompanied it. Much of the analysis, prepared chiefly by the Committee staff, with regard to various aspects of the inflation and recession offers a solid foundation upon which to base recommendations for improvement. In particular, we believe that the analysis in the following areas is worth serious attention from economic analysts and policy makers in both the public and private sectors:

(1) The generally appropriate course for fiscal and monetary policy during the next several years, especially as those policies relate to an appropriate growth path in the economy for returning to full employment and the zone of potential growth in Gross National Product.

(2) The sources, both domestic and international, of our present inflation, and the inter-relationships among those sources.

(3) The importance of combatting inflation through the rising productivity gains generally associated with an expanding economy.

(4) The need to increase competition in certain sectors of our economy and to assure continued adequate competition in other sectors.

Further, in more specific areas:

(5) The many opportunities for energy development and conservation.

(6) Structural problems in the area of agriculture and steps which might be taken to solve those problems.

(7) Comprehensive reform of Federal income maintenance programs.

(8) The various economic costs and benefits of continued implementation of environmental regulations and the capital investment consequences of those regulations.

Many of the recommendations based upon these various analyses offer opportunities for fundamental improvements in the functioning of certain sectors of our economy, with the price and output benefits which would accompany such improvements.

As to other of the recommendations in the Report, however, we frankly believe that some of these recommendations entail more radical changes in the structure of our economy than can be justified on the basis of conditions or study to date, or that such recommendations involve fresh resort to old approaches which have been found inadequate in the past.

---

[1] Senator Schweiker and Representative Blackburn have not associated themselves with these views.

Those recommendations in the body of the Report which we feel are most important with regard to restoring our economy to an adequate path of real growth in conditions of reasonable price stability during the next several years, or which could result in the types of fundamental structural change in various sectors of the economy which evidence already available justifies, are as follows:

(1) In order to prevent the present serious recession from deepening even further, the proposal in the Report that net personal income tax relief of $10 to $12 billion at an annual rate would be appropriate in 1975 will have to be given serious consideration in the next Congress. Such a tax cut, of course, would reduce Federal revenues and worsen deficits in the Federal Budget substantially.[2] As appropriate as such a change in tax policy might be in the short term, depending upon economic developments in the next several months, such a reduction in the tax base would certainly have to be balanced by increased taxes within the next year and a half to two years in order to prevent permanent erosion of the tax base and continuing Federal deficits. The long period of Federal deficits, in good times and bad, justified and unjustified, extending back over forty years, cannot be lengthened further. Those deficits have made a continuing contribution to our present serious inflation.

(2) Substantial expansion in Federal public service jobs programs, accompanied by improved unemployment compensation programs, could make great contributions in reducing the impact of recession generally, helping specifically those families and individuals who would otherwise be hit hardest by the economic slowdown, and supporting partly the overall economic demand necessary as a base for later expansion.

(3) With regard to monetary policy in the period ahead, as stated in the Report the immediate task is to halt the continuing drop in real output which has taken place so far in 1974. Also, monetary policy must be directed toward supporting the fairly high rate of real growth which will be needed by the end of 1975 and later to maintain the economy on a path towards full employment and a high level of resource utilization, while at the same time being moderated sufficiently to avoid overstimulation and the inflationary consequences which would stem from such excessive growth and stimulation.

In general terms, with regard to the three preceding recommendations, we are well aware that there are inflationary dangers in moving towards restoring economic growth at a time when the rate of inflation in our economy is still extremely high. Nonetheless, we believe that modest moves toward expanding the economy are appropriate now and will be appropriate in the short to medium future. Given the

---

[2] Representative Brown states: "A reduction in taxes must be balanced by reductions in expenditures. For those who feel full-employment can only be encouraged by federal deficit, the reluctance of Congress to ever reduce or terminate programs will be sufficient to assure continuation of some deficit. But without a concerted effort to reduce federal spending to balance reduced federal income from taxes, that deficit increase will be so massive as to produce serious inflation even in times of recession and only make the pain worse in both recession and inflation."

dropping resource utilization in the economy and the rapidly rising unemployment which is accompanying that drop, the dangers of creating new inflationary demand pressures as a result of modest stimulation are fairly small. Indeed, as the Report points out, it is crucial towards combatting inflation at this point to produce the rising productivity gains generally associated with rising levels of economic expansion. Put alternatively, the most pressing danger right now, and the area which requires governmental assistance, is that of declining output, not rising prices. The natural course of the economy at this point has and will continue to exert a downward influence on prices, even though that influence has unfortunately not yet reflected itself in any sustained broad-based reduction in price increases.

In more specific areas, we feel the following recommendations are especially important:

(1) In the Committee's Interim Report on Inflation of September, 1974, we supported establishment of a Commission to recommend comprehensive legislation aimed at eliminating both governmental and private barriers to an efficient market economy. The body of this Report repeats that recommendation. A number of Members of the Committee, of both parties, introduced legislation in the Congress in October, entitled the Market Efficiency Study Act of 1974, to effect this recommendation. The President subsequently proposed a Commission to deal with Federal regulatory reform. A bill to effect that proposal is also pending in the Congress.

We urge that the Congress move ahead promptly in consideration of these bills. Reforms in both the public and private area which would improve the efficiency of the free-market economy in allocating goods and services could make a great contribution toward reducing our present high rate of inflation and the distortions in the economy which such barriers cause.

(2) With regard to environmental standards, we would emphasize the need to avoid relaxation of environmental standards in quest of some purported reduction in inflationary pressures which would flow from that relaxation. As the Report states, the benefits of environmental investment generally exceed costs, the contribution which these standards have made to inflation overall has been minimal (although there are certain areas and industries which have been hard hit by tighter standards), delay will increase the ultimate clean-up costs, and the expenditures on environmental investment in the short-run have a stimulative effect on employment which is most beneficial in our present recessionary condition.

(3) In the area of energy, the discussion in the Report regarding a limited increase in the price of "new" natural gas bears repetition. Under present circumstances, the price of natural gas is being held at artificially low levels which tend to stifle new development of this most important, low-polluting energy resource. The analysis in the Report makes a compelling case for an increase in the price of "new" gas in order to stimulate much-needed gas resource development.

43-168 O - 74 - 10

(4) Also with regard to energy, the energy conservation proposals, including the alternative energy tax proposals, examined at length in the Report must be given serious attention.[3] It is clear that the greatest opportunities for Americans in the energy field in the short run are in the area of conservation. New resource development can proceed only so quickly. The prospects for substantial reduction in the price of oil internationally in the short to medium term are certainly not good, to put it mildly. Some of the opportunities for conservation offer relatively painless sacrifices. Others will be quite painful. The material in this Report offers a good basis for considering and deciding among these various choices.

[3] Representative Brown states: "Care must be taken—if it is possible at all—to see that any energy taxes or other conservation programs do not fall unevenly on sectors of the economy or geographic areas. A heavy gasoline tax is unfair in areas where the private auto is the only means of getting to a job or where gasoline fuels farm tractors or trucks required to produce and deliver food economically."

SUPPLEMENTARY VIEWS OF SENATOR JAVITS

While I agree basically with the views of the Minority, there are several additional points that I would like to emphasize.

First, with respect to the consideration of a tax cut, I would support such a tax credit or such an increase in the personal exemptions as would give substantial relief to low and moderate income taxpayers. While the Minority is correct to recognize that a tax cut would reduce federal revenue in the short run, we should recognize that these revenues may even be more negatively affected by the continued downturn of the economy. We should also recognize that in the absence of corrective action to stimulate the economy, unemployment compensation and increased public service employment may cost more in the long run than the revenues foregone in a tax cut. It is important that any tax cut, in order effectively to aid the economy now, be enacted quickly and for a limited period of time by the new Congress. It is also necessary for us to find alternative sources of revenues to offset at least some of the increased deficit generated by a tax cut. Such new taxes should be designed to accomplish the twin goals of raising revenue and reducing energy consumption along the lines suggested by the Senate Republican Conference, while avoiding undue burdens on production.

I continue to be gravely concerned with the growth of the money supply and whether it is sufficient to meet the capital requirements of industry and housing. Although the slackening of demand has temporarily reduced the pressures for business borrowing, it may yet be necessary to consider the establishment of a capital markets advisory commission, such as I proposed in S. 4067, the Credit Allocation Act of 1974. The Committee would advise financial institutions as to which demands on the cerdit markets merit priority lending—i.e. housing and moderization of plant and equipment.

Third, regarding wage and price controls, I believe that the Council on Wage and Price Stability requires both more funds and additional powers to deal with major price and wage increases that would adversely affect the overall economy. In particular, the Council should be granted subpoena power and the power to delay (60 day cooling off period) or to roll back excessive wage or price increases.

I support strongly the call of the Minority for serious attention to energy conservation proposals including energy tax proposals. The prompt enactment of strict mandatory conservation authority which will significantly reduce consumption is essential coupled with a plan for reducing oil imports by at least 1 million barrels per day during 1975.

While these measures may have the effect of increasing the cost of individual units of energy, they will lead to a significant move towards self-sufficiency and the ultimate strengthening of our balance of payments.

DISSENTING VIEWS OF REPRESENTATIVE BLACKBURN

I believe that the recommendations in both the majority and minority reports represent a rehash of the same old belief in the omnipotence of government over the private sector for the purposes of manipulating social—economic—political policies by increasing the size of bureaucracy and the application of deficit spending.

It is precisely this kind of "big government" policy, accompanied by deficit federal fiscal policy which has created our present economic ills: inflation followed up by recession.

In the past forty-one fiscal years, our government and its bureaucracy have grown by leaps and bounds and the federal budget (even under the misleading "unified budget" concept of recent years) has enjoyed a surplus only nine times for a total of $35 billion, but has been in deficit thirty-two times for a total of $364 billion. In the process, our federal budget has grown to where it now plays an overwhelming role in national spending and a dominant role in national borrowing. Consequently, both the majority and the minority reports offer little encouragement of any return to sound economic policies, but on the contrary, they advocate measures which would only "add fuel to the fires of inflation and recession."

It was also interesting to note that in the majority draft report, one can find some quite good analysis of the problems. However, the remedies recommended are cliches of socialism down the throat of the American people. Consequently, I reject totally the recommendations which appear in the majority report.

In regard to the additional minority views, I agree with recommendation number one in principle. That is to say I favor a tax cut. However, I do have a reservation, because I believe that the net tax relief which advocates an annual rate of ten to twelve billion dollars, is insufficient.

I reject the recommendation regarding the increased public service employment, and especially, I reject its recommendations regarding an escalating money supply which, in the first place, was responsible for our present economic situation.

It is primarily the majority's recommendation, but these are also the implications resulting out of the Additional Minority Views, that the added federal programs and the increased deficit spending will solve our economic miseries.

Instead of eliminating federal deficit spending in order to reduce inflation and its inevitable follower recession one advocates the measures which will increase inflation and could possibly lead to depression. The problem is how to make real employment more productive, not how to make unproductive employment appear to be real. The problem is to be solved by reducing the size of the government and not by increasing it and jeopardizing the normal and healthy economic processes. In recent weeks, in spite of increases in unemployment, the duration of unemployment does not seem to be increasing—although that bears watching. Simple triggering devices really are not adequate to the complex issue of unemployment, welfare and Social Security supplements. The programs which would surely expand welfare rolls in boom times and fail to meet individual and public needs in poor economic times run contrary to the national interest.

Tax benefits and restrictions should be mentioned here. Among the burdens to economic efficiency should certainly be added the amount of paperwork and the excess controls under existing law as well as new laws to protect the environment, safety and health of employees, consumers, etc. The old and new laws as well as the old and new regulations which distort the normal human and economic processes certainly add to the unproductive costs of business—particularly small or new businesses which can ill afford to carry such burdens. They are not less responsible for our present inflation and resulting recession.

A Cause of Inflation and Remedies

The monetary expansion no longer works as a means of stimulating production; it simply causes inflation. In the regime of floating (flexible) exchange rates monetary stimulation by the Federal Reserve not only increases wage demands, but is immediately perceived by the foreign-exchange markets, causing depreciation of the dollar and an automatic increase in the price of imports. This raises costs and aggrevates inflation directly. It also raises wages and thus, quickly shows up in the Cost of Living Index.

To eliminate at least this cause of inflation, the Fed should temporarily halt open-market purchases of government securities, the traditional means through which it increases the basic money supply. The thrust of demand expansion must come from fiscal stimuli, and when the U.S. economy responds to that stimulus growth in the real money supply can come about through a prudent resumption in open-market purchases. At the same time, the reviving U.S. economy would draw money from the Middle East and Europe and thus protect the U.S. balance-of-payments. The dollar would appreciate against foreign currencies, which means the U.S. would then be able to buy a greater share of the world's goods and services with the same number of dollars. It goes without emphasizing that this would have an extremely beneficial impact on controlling inflation.

The second crucial remedy to our economic problems, as I see it would be the big tax cut on both personal and corporate incomes. Undoubtedly, that would stimulate the real economic growth.

I suggest the adjustment of income-tax brackets across the board and index them to correct for future inflation, as is now the practice in Canada. I recommend to reduce the corporate tax bite down closer to Canada's 40 percent.

The level of U.S. tax has become a drag on economic growth in the United States. The national economy is being choked by taxes-asphyxiated. Taxes have increased even while output has fallen, because of the inflation. The unemployment has created vast segments of excess capacity. If one could put that sub-economy to work, you would not only eliminate the social and economic causes of unemplyoment, one could increase aggregate supply sufficiently to reduce inflation. It is simply absurd to believe that increasing unemployment will stop inflation. To stop you need more goods not less.

A tax cut not only increases demand, but increases the incentive to produce. The government budget recycles tax dollars into the spending stream through expenditures, but in so doing it reduces the incentive to produce and lowers total production. With lower taxes, it is more attractive to invest and more attractive to work; demand is increased but so is supply.

In conclusion, it is my view that the best remedy for our present economic states of affairs are: first, to combat inflation by the use of tight monetary policy; second, we need a $30 billion tax cut; and third, we need to do away with laws and regulations which place the burden on the productive sectors of the economy in terms of unnecessary costs.

Appendix A

[S. Con. Res. 93; 93d Cong., second session]

CONCURRENT RESOLUTION

Whereas the United States economy has been suffering from serious and persistent inflation; and

Whereas unemployment continues to be an economic problem, for the present as well as the near future; and

Whereas extremely high interest rates have caused serious dislocations in the housing industry, in small business, and in other sectors of the economy; and

Whereas the economy of the United States has been upset by shortages of basic resources; and

Whereas prospective shortages continue to be a cause of concern; and

Whereas solutions to these economic ills require the consideration of a large number of interrelated policy questions; and

Whereas it is incumbent upon the Congress to develop more effective economic policies for the Nation and to provide more effective means for coordinating public policy decisions to the end that the national economic warfare be better served; and

Whereas such requirements require that experts throughout the country be utilized for the purpose of obtaining the best available judgment on these important issues; and

Whereas the Joint Economic Committee of the United States Congress is charged by law with the responsibility of conducting a continuing study of matters relating to the economic reports of the President and with providing guidance to the several committees of the Congress dealing with legislation relating to public economic policy: Now, therefore, be it

Resolved by the Senate (the House of Representatives concurring), That the Joint Economic Committee, or any subcommittee thereof, as authorized by the Employment Act of 1946, shall undertake, as soon as possible—

(1) an emergency study of the current state of the economy and of the problems relating thereto, with special reference to inflation, including, but not limited to, the causes of the current inflation and such inflation-related problems as Federal spending; tight money and high interest; food, fuel, and other shortages; credit policies; export policies; international exchange rates; and indexing; and

(2) to provide the Congress with specific recommendations for legislation to remedy the existing ills and improve the performance of the economy.

SEC. 2. (a) For the purposes of this concurrent resolution, the Joint Committee, or any subcommittee thereof, is authorized from July 1, 1974, through December 31, 1974, in its discretion (1) to make expenditures from the contingent fund of the Senate, (2) to employ personnel, (3) to hold hearings, (4) to sit and act at any time or place during the sessions, recesses, and adjourned periods of the Senate, (5) to require, by subpena or otherwise, the attendance of witnesses and the production of correspondence, books, papers, and documents, (6) to take depositions and other testimony, (7) to procure the services of individual consultants or organizations thereof, in accordance with the provisions of section 202(i) of the Legislative Reorganization Act of 1946, and (8) with the prior consent of the Government department or agency concerned and the Committee on Rules and Administration, to use on a reimbursable basis the services of personnel of any such department or agency.

(b) Subpenas may be issued by the Joint Committee, or subcommittee thereof, over the signature of the chairman or any other member designated by him, and may be served by any person designated by such chairman or member. The chairman of the Joint Committee or any member thereof may administer oaths to witnesses.

SEC. 3. The Joint Committee shall report its findings, together with such recommendations for legislation as it deems advisable, to the Senate and the House of Representatives at the earliest practicable date, but not later than December 31, 1974.

SEC. 4. (a) The Joint Committee is authorized, from July 1, 1974, through December 31, 1974, to expend under this concurrent resolution not to exceed $100,000, of which amount not to exceed $35,000 may be expended for the procurement of the services of individual consultants, or organizations thereof.

(b) The expenses of the Joint Committee under this concurrent resolution shall be paid from the contingent fund of the Senate upon vouchers approved by the chairman of the Joint Committee.

Appendix B

COMMITTEE ACTIVITIES PURSUANT TO SENATE CONCURRENT RESOLUTION 93

In order to carry out the mandate given to the Joint Economic Committee by Senate Concurrent Resolution 93, the Committee held approximately 30 days of hearings, has sponsored approximately 12 special studies which will be published during the next few months, and has prepared an interim and a final report. In addition, the Committee staff held several seminars with invited experts, attended a number of conferences, and consulted widely on an individual basis with leading researchers in economics and related disciplines. Several Committee members participated in the White House Conference on the Economy on September 27 and 28 as well as in most of the preparatory meetings held prior to that conference.

Reports

The Committee has published two reports. The first, or interim, report is entitled "An Action Program for Reducing Inflation and Restoring Economic Growth." It was prepared in response to the hope expressed by President Ford in his address to Congress on August 12, 1974 that the Committee could report within six weeks. The Report was presented to the President and the Congress on September 21 and was subsequently distributed to participants in the White House Conference on the Economy on Stepember 27 and 28. The Report contained recommendations for actions which could be taken immediately in four areas: fiscal and monetary policy; price-incomes policy; policies to help those hurt most by inflation; and policies to restore market efficiency.

The Committee's final report under S. Con. Res. 93 is entitled "Achieving Price Stability through Economic Growth" and is dated December 23, 1974. Longer and more comprehensive than the earlier report, the final report assesses the prospects for economic growth, prices and employment over the next several years and outlines a comprehensive program for ending the recession and initiating renewed progress toward full employment and price stability.

Hearings

As part of its study conducted pursuant to S. Con. Res. 93, the Committee held approximately 30 days of hearings on 11 individual subjects related to the study. Each of these 11 sets of hearings is described briefly below.

Mid-Year Review

Rampant inflation, declining real incomes, and the failure of output to grow at all in the second quarter demonstrated that current policies were not adequate to deal with the serious economic situation which confronts us. Therefore, on July 29, 30, August 1, 2, 6, and 14, the Joint Economic Committee scheduled a thorough mid-year review of the economy which served not only as an assessment of the immediate outlook, but also as the initiation of the emergency study of inflation.

Inflationary Impact of Pricing by Concentrated Industries

The Joint Economic Committee held three days of hearings on the inflationary impact of pricing by concentrated industries. During the first two days of hearings (September 4 and 9) academic and government witnesses presented background material. A follow-up hearing was held on October 7, with the top decision makers of three major steel companies (U.S. Steel Corporation, Bethlehem Steel, Inland Steel) testifying. In addition to the hearing, questionnaires were sent on October 2 to the major steel companies (including those who testified on October 7) asking them to submit data on their raw steel capacity and capacity utilization rates for the past five years, including 1974. As a result of the information gathered by the questionnaires, Senator Proxmire released information on steelmaking capacity and its utilization. This survey marks the first time in 15 years that the steel industry has made capacity and utilization data available to the public. A table summarizing the questionnaire data is available from the Committee. The complete responses of each company is to be published with the record of the October 7, 1974, hearing on administered pricing.

Inflation Outlook

Mr. Alan Greenspan, Chairman of the Council of Economic Advisers, testified before the Joint Economic Commitee on September 26, 1974. The purpose of this hearing was to assess the implications of recent price statistics for inflation and the economic outlook. The hearing looked into the following points: whether inflation was likely to continue to accelerate in the months ahead; why any price acceleration is occurring in a slack economy in the midst of a recession; and whether this recent acceleration in inflation is likely to throw the Nation into a much more severe recession. This hearing was held just after the August price statistics were released. The August increase in wholesale prices of 3.9 percent, coming on top of the 3.7 percent increase in July, had accelerated wholesale prices in the three months previous to an annual rate of increase of 37 percent. Consumer prices had also showed some acceleration, jumping 1.3 percent in August alone, which meant a 13 percent annual rate of increase in the three months previous.

Financial and Capacity Needs

On October 1, 2, 3, and 10, the Joint Economic Committee held hearings on methods for easing a financial shortage that is driving up prices and aggravating unemployment in construction, farming, and other basic U.S. industries. Business and industry have been especially hard hit by the financial crunch. The lack of financing is curtailing needed plant expansion in basic manufacturing. High interest rates have sent the homebuilding industry into a virtual state of depression. Contractors can't borrow money for building, nor customers for buying. Former Treasury Secretary Henry Fowler led the list of witnesses. The hearings concluded on October 10 with testimony from Arthur Burns, Chairman of the Federal Reserve Board.

President Ford's Economic Proposals

Three days of hearings were held on October 11, 16 and 18, to evaluate the economic proposals presented by President Ford on October 8. The witnesses included Treasury Secretary William Simon; Arthur Okun and Joseph Pechman of the Brookings Institution; John Kenneth Galbraith of Harvard University, Robert Nathan (Robert Nathan Associates) and Albert Rees, Executive Director of the Council on Wage and Price Stability.

Market Power, FTC, and Inflation

The November 18 hearing inquired into the reasons for the relative ineffectiveness of the Federal Trade Commission and the problem generally of market power, the abuses of market power, and how they contribute to the inflation we are experiencing today. Chairman Lewis A. Engman and Commissioner Mayo J. Thompson of the FTC and Gardiner C. Means testified.

The Economic Impact of Environmental Regulations

Three days of hearings were held evaluating the economic impacts of compliance by industries and local governments with environmental regulations. The hearings held on November 19, 21 and 22, 1974, focused on whether or not there is any merit to the argument that compliance with environmental regulations has contributed to the recent severe inflation. The hearings also seeked to determine what employment effects may have resulted from such compliance.

International Financial Problems Related to High Oil Prices

On November 25, 27, and 29 the Committee held hearings on the financial problems created by sharply higher world oil prices. Particular attention was devoted to the proposals recently put forward by the Secretary of State for a new international financing facility administered through the Organization for Economic Cooperation and Development (OECD) and for consumer nation agreement on oil price maintenance. Witnesses included the Chairman of the Federal Reserve Board, the Secretary of the Treasury, the Undersecretary of the Treasury for Monetary Affairs and the Assistant Secretary of State for Economic and Business Affairs.

Public Utility Industry

The hearing on December 4 examined recent developments in the electrical utility industry which have caused hardships for both consumers and the utility industry. The following points were discussed at this hearing: development of more efficient methods for converting primary fuels to electricity; examining more efficient use of our generating capacity, thus reducing the per unit costs of generating electricity; examining more carefully the propriety of charging small residential users twice as much as large industrial and commercial users; carefully examining the huge increases in the cost of constructing generating capacity, particularly nuclear plants in an attempt to reduce the huge costs of capital equipment which is passed through to the consumer; discussion of the feasibility of coal and nuclear fuel playing a large role in the generation of electricity.

Recent Developments in U.S. Energy Policy

Secretary of Interior Rogers C. B. Morton testified at the hearing on December 5 which focused on recent developments in U.S. energy policy and the impact of these developments on our major urban areas. Questions that the Committee examined included: (1) What mandatory conservation program is the Administration prepared to propose if voluntary measures fail? What impact will this mandatory conservation program have on the poor, the commuting worker, the construction industry and other important groups in our cities? (2) Will the Administration support a significant rise in the gasoline tax if voluntary measures fail and how will the Administration cushion the impact of this increase on various sectors of the economy? (3) What policy options in the *Project Independence* report is the Administration likely to implement and what will be the economic impact of these proposals?

Food Chain Pricing Activities

On December 9, 12, 16, and 17, the Committee held hearings on food prices and pricing policies of the major food chains. The Committee, as part of its inquiry into the causes of inflation in various sectors of the economy, has subpoenaed records and documents from the 17 largest food chains. A preliminary analysis of most of this data has been completed. However, at the time of these hearings some of the chains had not yet complied with their subpoena. The Committee's interest is in the structure of the food retailing industry and the resulting impact on prices.

Special Studies

The Committee has initiated about a dozen studies of special topics related to the problems which S. Con. Res. 93 instructed the Committee to investigate. Some of these studies are being conducted by the Committee staff, some by experts in various government agencies and some by outside consultants. Time has not permitted the completion and publication of all of these studies prior to the December 31, 1974, filing deadline for the Committee's final report. However, many of the studies were available to the Committee in preliminary form in time for some of the most important conclusions to be included in that report. The Committee expects that most of the studies can be completed and published within the next few months.

Among the subjects expected to be covered in these studies are the following:

(1) The differential impact of inflation by income class, with special attention to the impact on the poor,

(2) The contribution of exchange rate changes and international commodity price movements to inflation in the United States,

(3) A review and analysis of German economic policy,

(4) A simulation of the effects of various possible fiscal policies during 3 periods in the recent past,

(5) An analysis of problems with the use of the full employment budget concept in an inflationary period,

(6) An analysis of the factors which have contributed to the rising cost of residential construction,

(7) An analysis of concentration of ownership in retail food marketing and its effect on prices,

(8) An assessment of the outlook for food prices and supplies, with particular attention to the effect of the poor 1974 feed grain harvest on meat prices and supplies,

(9) An analysis of information needs in agricultural commodity markets, especially of the need for information relating to international transactions.

(10) An updated history of price patterns and policies to achieve price stability since the enactment of the Employment Act of 1946.