753

94th Congress }
2d Session }
JOINT COMMITTEE PRINT

CHANGING CONDITIONS IN THE MARKET FOR STATE AND LOCAL GOVERNMENT DEBT

LIBRARY COPY
(PLEASE RETURN)
JOINT ECONOMIC CTTE.
G 133 NEW SENATE OFF. BLDG.

A STUDY

PREPARED FOR THE USE OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

APRIL 16, 1976

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE
68-626 WASHINGTON : 1976

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price $1.15

JOINT ECONOMIC COMMITTEE

(Created pursuant to sec. 5(a) of Public Law 304, 78th Cong.)

HUBERT H. HUMPHREY, Minnesota, *Chairman*
RICHARD BOLLING, Missouri, *Vice Chairman*

SENATE

JOHN SPARKMAN, Alabama
WILLIAM PROXMIRE, Wisconsin
ABRAHAM RIBICOFF, Connecticut
LLOYD M. BENTSEN, JR., Texas
EDWARD M. KENNEDY, Massachusetts
JACOB K. JAVITS, New York
CHARLES H. PERCY, Illinois
ROBERT TAFT, JR., Ohio
PAUL J. FANNIN, Arizona

HOUSE OF REPRESENTATIVES

HENRY S. REUSS, Wisconsin
WILLIAM S. MOORHEAD, Pennsylvania
LEE H. HAMILTON, Indiana
GILLIS W. LONG, Louisiana
OTIS G. PIKE, New York
CLARENCE J. BROWN, Ohio
GARRY BROWN, Michigan
MARGARET M. HECKLER, Massachusetts
JOHN H. ROUSSELOT, California

JOHN R. STARK, *Executive Director*

SENIOR STAFF ECONOMISTS

WILLIAM A. COX
JERRY J. JASINOWSKI
LOUGHLIN F. MCHUGH
JOHN R. KARLIK
COURTENAY M. SLATER

RICHARD F. KAUFMAN, *General Counsel*

ECONOMISTS

WILLIAM R. BUECHNER
ROBERT D. HAMRIN
RALPH L. SCHLOSSTEIN
SARAH JACKSON
GEORGE R. TYLER
LUCY A. FALCONE
L. DOUGLAS LEE
LARRY YUSPEH

MINORITY

CHARLES H. BRADFORD (Senior Economist)

GEORGE D. KRUMBHAAR, Jr. (Counsel)
M. CATHERINE MILLER (Economist)

LETTERS OF TRANSMITTAL

APRIL 13, 1976.

To the Members of the Joint Economic Committee:

Transmitted herewith is a study entitled "Changing Conditions in the Market for State and Local Government Debt." This study was prepared for the Joint Economic Committee as part of the committee's observance of the 30th anniversary of the Employment Act of 1946. It is one of a number of studies being undertaken by the committee to examine State and local government fiscal conditions and their relationship to the Employment Act goals of "maximum employment, production and purchasing power".

This study describes the changing conditions in the municipal bond market and their effect on the availability and cost of State and local government debt. It describes recent changes in the supply of and demand for tax-exempt securities. I believe Members of the Joint Economic Committee will find this study most helpful and informative.

The views expressed in this study are those of the author and do not necessarily represent the views of the Members of the Joint Economic Committee or of the committee staff.

Sincerely,

HUBERT H. HUMPHREY,
Chairman, Joint Economic Committee.

APRIL 8, 1976.

Hon. HUBERT H. HUMPHREY,
Chairman, Joint Economic Committee,
U.S. Congress, Washington, D.C.

DEAR MR. CHAIRMAN: Transmitted herewith is a study prepared by Dr. John Petersen, entitled "Changing Conditions in the Market for State and Local Government Debt." This study is the first in a series of papers being prepared for the Joint Economic Committee dealing with the fiscal condition of State and local governments. These studies are part of the Joint Economic Committee's 30th anniversary study series.

Dr. Petersen's paper describes in great detail the recent changes that have occurred in the municipal bond market. He concludes that the increased supply of and reduced demand for tax-exempt securities has increased the borrowing costs of State and local governments. He also discusses several proposals to broaden the market for State and local government debt, thus reducing borrowing costs.

The views expressed in this study are those of the author and do not necessarily represent the views of the Members of the Joint Economic Committee or of the committee staff.

Sincerely yours,

JOHN R. STARK,
Executive Director, Joint Economic Committee.

CONTENTS

Page

Letters of transmittal — III

CHANGING CONDITIONS IN THE MARKET FOR STATE AND LOCAL GOVERNMENT DEBT

I. Recent developments — 1
  Introduction — 1
  Recent trends in State and local borrowing — 4
II. New and controversial types and uses of tax-exempt debt — 9
  Short-term borrowing — 9
  Moral obligation bonds — 10
  Housing and mortgage finance borrowing — 12
  Hospital and health care facility financing — 14
  Tax increment bonds — 15
  Advanced refunding bonds — 16
  The pollution control bond — 17
III. A changing fiscal environment — 23
  The large city borrowers — 23
  City financial management — 27
IV. The impact of changing monetary conditions — 29
V. Changing patterns in the demand for municipal bonds — 33
  Patterns of investment in municipal bonds — 33
  Commercial banks — 35
  Fire and casualty insurance companies — 38
  Households — 38
VI. Growing concerns over credit quality and information — 41
  Demand for more information — 43
  Municipal bond market regulation and disclosure — 44
VII. Future demand for capital funds — 47
  Public construction in the years ahead — 48
VIII. Policy options to improve the municipal bond market — 52
  Broadening the market for State and local securities — 52
  Efficiency of the subsidy mechanism — 55
  The tax equity effects of tax exemption — 58
  Improving marketability and creditworthiness — 60
  Recent proposals for Federal credit assistance to State and local governments — 61
  Reducing the supply of tax-exempt bonds — 64
IX. Conclusion and postscript — 65

CHANGING CONDITIONS IN THE MARKET FOR STATE AND LOCAL GOVERNMENT DEBT

By John Peterson*

Chapter I. RECENT DEVELOPMENTS

Introduction

To pick a certain date as marking the beginning of a new era in any field is always difficult and usually arbitrary, especially when changes are evolutionary and complex with implications that continue to emerge. Nonetheless, the year 1969 can be identified as a watershed for the municipal bond market. It was in that year that tax exemption was actively debated in the Congress and defenders of the tax-free market were victorious in preserving the almost exclusive reliance upon the tax-exempt bond as the capital-raising vehicle for State and local governments. [1]

But while the political defense of the tax-exempt bond was successful, other forces unfolding at the same time would lead to new challenges for the State and local borrower and investor in the 1970's. These changes have benefitted certain borrowers and investors, but their overall impact has been to shrink the demand for the conventional debt of most governments and to make debt-financing more costly.

The more important changes in the municipal bond market and the environment in which it now must operate are:

(1) The national economy in the late 1960's passed into a prolonged period of inflation and recurring tight money conditions that have exacerbated the problems in all debt markets—and the municipal bond market in some special ways.

(2) The demand for municipal bonds has changed significantly. The major purchasers of tax exempts in the 1960's were the commercial banks, which bought municipal securities for tax shelter. By the early 1970's it became increasingly evident that banks could no longer be counted upon to maintain their previous level of demand for municipal bonds. In the absence of other large institutional support, the household sector—consisting largely of individual investors—must be relied upon to support the credit needs of State and local governments.

(3) Municipal bonds since the late 1960's have been used increasingly for other than the traditional purposes of financing school, highway, water and sewer projects. Public-purpose activities began to include

---

* Washington director and economist of the Municipal Finance Officers Association. The views expressed herein are solely those of the author, and do not represent the position of his employer.

[1] Tax-exempt securities are generally defined as those debt securities issued or guaranteed by states or territories, their political subdivisions, agencies or instrumentalities, and any security issued by a government that is an industrial revenue bond, the interest of which is exempt from Federal income taxation, as described by Section 103 of the Internal Revenue Code of 1954. The definition of "exempted" security in Federal securities laws parallels that used for tax exemption purposes in the tax code.

the tax exempt debt-financing of projects that were owned or operated essentially by private entities, and, ultimately, were linked to a private, profitmaking enterpise. Although the Tax Reform Act of 1969 restricted the blossoming practice of using tax exempt bonds to finance industrial development, it also left large exceptions to this prohibition. These exceptions have since led to the use of tax exempt bonds for pollution control equipment, housing market support, hospital financing, stadiums, and an assortment of publicly financed but private operated facilities.

(4) A complex array of new financing devices has appeared in response to the use of tax exemption for varying purposes. Novel financial arrangements have been designed to accommodate the legal and practical implications of new forms of public activity and, not infrequently, to bypass certain legal constraints that otherwise would limit or preclude borrowing for such purposes. Perhaps the most noteworthy of the new financing vehicles was the moral obligation bond. But other arrangements—such as advanced refunding and tax-increment financing—have led to a swelling in the supply of special purpose bonds that are nontraditional both in their use and structure.

(5) Short-term loans have become increasingly important to State and local borrowers as a result of spiralling interest rates in the late 1960's early 1970's. In 1969, a sudden surge in short-term borrowing occurred as the volume of note sales doubled. There were several reasons for this trend. The most prevalent seemed to be that governments felt released from old prohibitions against short-term indebtedness and saw temporary financing as a means to borrow more cheaply and to time long-term bond sales more advantageously. As the same time, the seeds of uncertainty and cash crises were sowed for States and localities which became too immersed in short-term liabilities and might be too dependent upon their future ability to sell bonds. These concerns over credit quality and information were crystallized by the New York City and State crisis of early 1975 and now pervade the entire municipal bond market.

(6) More attention now is being given to the fiscal condition of State and local borrowers and how information on this condition is reported and analyzed by investors. Until recently, this was a lingering, but seldom pressing, uneasiness in the market. In part, the concern about credit quality has been reflected in intermittent criticism of the heavy reliance placed by the municipal bond market upon the opinions and reporting documents of the two national bond rating agencies, Moody's and Standard & Poor. More recently, the reduced growth and obvious fiscal pressures in the State and local sector have focused attention on timely and accurate reporting to the market by the governments themselves, especially in the disclosure of material information at the time of bond sale. That concern has been reinforced by an emerging recognition of legal liabilities on the part of underwriters and issuers under the antifraud provisions of the Federal securities laws.

Changes in the municipal bond market in the late 1960's and early 1970's have occurred against the background of older and continuing questions raised about the market. These questions concern the efficiency and equity of the vast uncontrollable Federal tax subsidy involved in granting an exemption from Federal income taxes to income from State and local securities. That unique feature of municipal bonds has lowered interest costs to State and local borrowers through the years. It has also meant that part of the subsidy must be shared

with investors in the bonds. Furthermore, the tax-exempt feature of municipal bonds—combined with the financial structure of major investing institutions and their tax liabilities—has made the market highly susceptible to changing market conditions and has produced wide swings in investor group participation and the cost of borrowing.

Another persisting concern in the municipal market has been posed by certain problem borrowers. Generally, these are defined as the very small and unsophisticated governmental borrower and the large, improvident urban area. Both types of borrower may encounter difficulties when they enter the bond market to borrow from private investors. A wide variety of measures have been taken through the years to assist such borrowers, but the long-term problems of a highly diffused and variegated market remain.

The final item of concern now faced by the market for State and local debt is linked to the national worry about capital adequacy in the future. The question here is whether the municipal bond market, as presently constituted, can compete succesfully and efficiently for what appears to be an increasingly limited supply of investible capital. The issue, of course, transcends the essentially mechanical concerns of efficiency and equity in the municipal bond market. This lifts the discussion to a consideration of how much capital will be available for long-term investment by all sectors of the economy; how much of that should be claimed by the public sector; and what is the appropriate role to be played by the municipal market in allocating limited capital to State and local governments.

Although this study does not purport to answer such cosmic questions, it will review future demands for capital facilities and borrowed funds by State and local governments. This can give insights into the relative magnitude of potential demands and the ability of the present—or a modified—municipal bond market to meet those demands at a reasonable cost.

The following chapters review first the changing supply of municipal securities both in terms of the volume of debt instruments by type and maturity, and the uses for which the borrowing takes place. A discussion will follow on the questions of credit quality and information, particularly as these are reflected in the recent appearance of wide differentials in the cost of capital by region, use of proceeds, and type of instrument. At this point too the paper will discuss the current problems of special classes of borrowers, ranging from the fiscal hardships now being visited upon our largest, oldest, and particularly Eastern cities to the continuing difficulties of the smallest borrowers whose market is usually confined to local and regional markets. Next, recent developments in the compositions and strength of demand for municipal bonds will be surveyed. Special attention will be given to the recent evolution in commercial bank investment policies and its ramifications for the tax-exempt market. As a corollary, the support of other sectors—notably, the household sector—will be examined. At this point the response of State and local government borrowing to monetary and fiscal policy will be discussed, for the State and local sector has exhibited a peculiar sensitivity to changes in the availability and cost of money.

While the current performance and structure of the market present numerous problems that suggest various changes in policy, the market and the needs it meets are dynamic. Therefore, it is equally important

68-626—76——2

to judge the future capability of the market to provide capital for new and growing public purposes. This involves forecasting not only the desired level of borrowing by the State and local sector but also projecting the economic and financial environment in which these units will contest for funds from private investors.

The final section of this paper reviews an array of current and potential problems and discusses a broad selection of solutions that have been recommended. The discussion will consider the variety of objectives to be met by reforms and will compare specific suggestions for reform with their objectives. Of course, radical changes in the level and distribution of public services may alter, in turn, the size and nature of borrowing. Nevertheless, the policy options discussed are oriented towawrd borrowing and are predicated on the thesis that State and local governments will continue to rely heavily on borrowing for both long-term improvements and seasonal or occasional short-term needs.

Recent Trends in State and Local Borrowing

The volume of State and local government borrowing has increased dramatically since 1960, and the composition of the debt has changed greatly during the same period. The total of State and local bonds and notes sold rose from an annual level of $11.5 billion in 1960 to $55 billion by 1974. As a result, total outstanding indebtedness of governments grew from $71 billion at the end of 1960 to $207 billion by the end of 1974. Despite the difficulties experienced in the municipal bond market in 1975, it appears that total bond and note sales for that year will exceed $60 billion, a record amount.

These large dollar volumes and strong trends in the aggregate cloak an amazing degree of diversity within the State and local bond market. All types of government borrow in the credit markets, so the markets consist of issues of all sizes and kinds, ranging from very short-term notes to bonds with a maturity of 40 years or more. Chart I sketches some of the more significant trends in the municipal bond market. As may be noted, there seems to be a long-term reduction in the percentage of general obligation bonds sold to the total and a corresponding increase in use of the revenue bond.[2] Even more pronounced is the rapid increase in short-term notes.[3] The ratio of short-term debt compared to total bond sales reached 100 percent in 1969 and has remained at or above that level ever since.

The lower panel of chart I shows that the growth in municipal bonds has not been a smooth, upward climb but rather has been sensitive to changing financial conditions and has demonstrated a changing mix in types of debt instruments. A review of the last 15 years indicates that there was a relatively smooth growth in bond sales through 1968 at which point the market reacted negatively to the credit crunch of 1969. In 1970 and 1971 the market appeared to regain its growth and to make up some of the sales delayed by the earlier tight-money period. Subsequently, in 1972, 1973, and 1974, the market showed essentially no growth in bond sales and a continuing reliance on short-term borrowing. In 1975, the market evidently moved to a record level of sales despite high rates of interest.

---

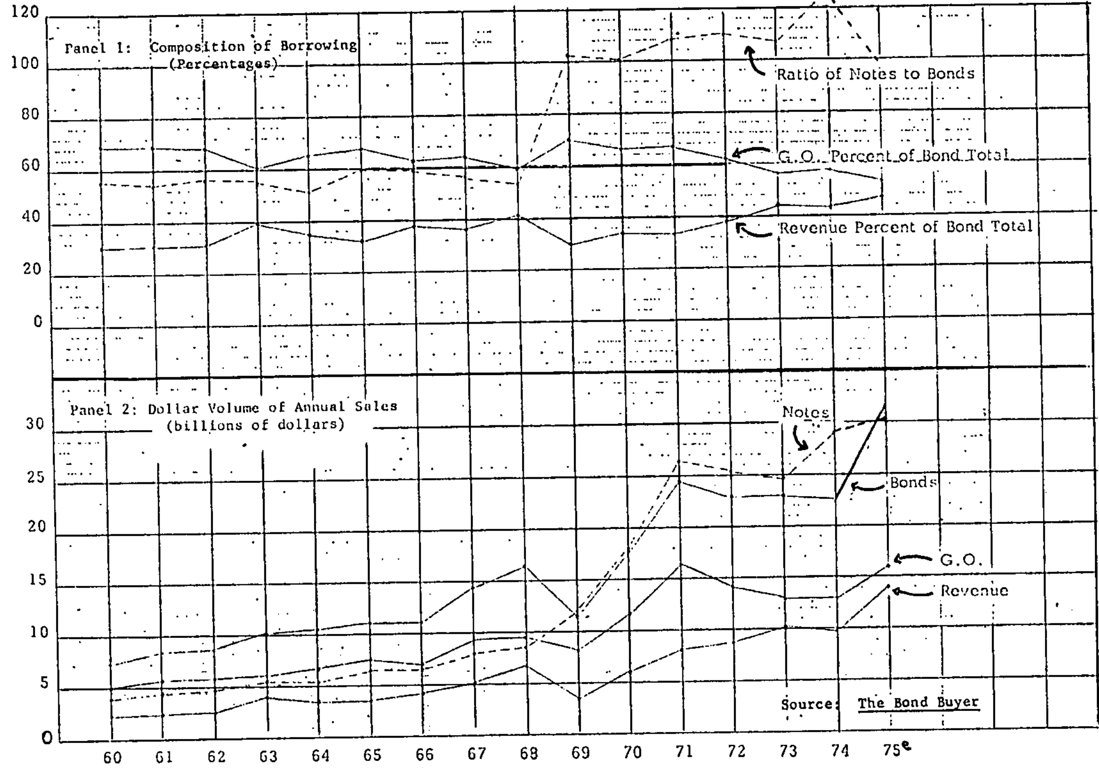
[2] The convention of the municipal bond market is to divide debt obligations into two broad categories: (1) general obligations, secured by the full faith and credit and taxing power of a government; and (2) revenue or special fund obligations, secured on the revenues or receipts of a project or special fund and not backed by full taxing power of a borrower.

[3] Short-term obligations are generally those of 1 year or less in original maturity.

Chart I

STATE AND LOCAL GOVERNMENT BORROWING

Notes, Bonds and Type of Bond 1960-1975 (est)



Also, of significance in the 1970's has been the growth of revenue bonds in comparison to general obligation securities, demonstrating an increasing reliance upon user charges and rental fees to secure debt instead of securing debt directly by taxes.

Table 1 gives a more detailed breakdown of State and local government borrowing by type of security. As may be seen, over the last 15 years there has been significant growth in the total amount of revenue bonds and also interesting changes in their composition. The rental revenue bond, which is secured on lease arrangements between the issuing authority and the actual operator of the facility, has grown from a miniscule portion of total revenue bonds sold to more than half of current sales. Many of these bonds represent debt issues sold on behalf of housing, pollution control facilities, industrial development, and various arrangements entered into by general units of government to finance public facilities outside of their own debt limitations. Therefore, it is the revenue security—and a particular class of revenue security—that is the major growth area in the municipal bond market today.

TABLE 1.—STATE AND LOCAL BORROWING BY TYPE OF ISSUE, SELECTED YEARS 1960 TO 1975 (ESTIMATE)

[In billions of dollars]

	1960	1970	1972	1974	1975 (estimate)
General obligation	4.36	11.85	13.33	13.57	16.60
Revenue	2.07	6.10	9.40	10.21	14.50
Utility	1.79	4.59	6.99	6.53	4.80
Special tax	.08	.34	.25	.46	3.80
Rental	.19	1.17	2.17	3.22	5.90
New housing authority	.40	.13	.96	.46	----------
Total long-term	6.81	18.19	23.75	24.32	31.10
Total short-term	4.01	17.81	25.27	29.54	30.00

Note: Details may not add up to totals because of rounding.

Source: Investment Bankers Association, "Statistical Bulletin"; Securities Industry Association, "Municipal Market Developments" (various issues). Estimates are the authors on the basis of sales recorded through October 1975.

Another vantage point from which State and local debt may be viewed is by the level and type of government. As table 2 illustrates, debt issuances by general units of government have diminished in importance. Here again, classes of special district debt changed in relative importance. School district debt, which represented more than 20 percent of bonds sold in 1960, dropped to less than 9 percent in 1974. Other local district debt also decreased in importance. The strongest growth element was found in statutory authority, which occurs at both the State and local levels.

TABLE 2.—LONG-TERM DEBT SOLD BY TYPE OF ISSUER, 1960 TO 1975 (ESTIMATE)

[Billions of dollars]

	1960	1970	1972	1974	1975 estimate
State	1.00	4.17	4.99	4.79	7.60
Local general government	2.54	6.21	7.25	8.66	9.50
School district	1.35	2.13	1.92	2.16	2.20
Special district	.66	1.16	1.51	1.27	1.60
Statutory authority	1.30	4.39	8.01	7.37	10.20
Total	6.85	18.08	23.69	24.24	31.10

Source: Securities Industry Association and author's estimates.

Although the definitions used are not completely consistent, the growth in special district and authority debt on the local level is reflected in the debt outstanding figures published by the U.S. Bureau of the Census.[4] The debt of local special districts (including local authorities) has grown more rapidly than that of school districts or general units of government. Likewise, State level borrowing—both general unit and authority—has grown more rapidly than that of local general government units.

The growth in authority and special district debt and the increasing reliance on lease-rental revenue obligations are clearly intertwined. Before World War II, most state and local debt was sold in general obligations. However, growing out of the Depression, there came an increasing reliance on "special fund" obligations, which are secured on a special revenue source—usually a user charge. The move toward revenue bonds was stimulated by the public housing assistance programs in the 1930's and the availability of Reconstruction Finance Corporation loans.

After World War II, several factors led to the increasing use of revenue obligations and, frequently, to the creation of special districts and authorities. These were:

(1) The widening scope of the definition of public purpose, which increased the activities for which bonds could be sold by public entities and, hence, on a tax-exempt basis (in many cases this could only be accomplished by enabling legislation creating the special-purpose district, the debt of which was payable solely from project revenue);

(2) The desire to circumvent legal limitations on general obligation indebtedness or, sometimes, the requirement for voter approval; and

(3) The desire by officials to apportion costs for improvement on a *quid pro quo* or user charge basis rather than on taxation.[5]

Investors have typically viewed limited obligation bonds as being riskier than those backed by the full taxing power of governments and have commanded a higher yield for purchasing such bonds.[6] As investor familiarity with the revenue bond grew, the interest rate differentials between it and general obligation bonds waned. Concurrently, State legislatures continued to authorize and courts approved as public purposes a great variety of facilities and undertakings, including airports, redevelopment districts, housing, stadiums, and transit facilities.[7]

The growing variety of uses of State and local borrowing are depicted in table 3, again using bond sales data collected by the Securities Industry Association and its predecessor, the Investment Bankers Association. Loans for education and transportation grew rapidly through the 1960's—and then leveled off dramatically. Two other areas, social welfare and utilities and conservation, exhibited strong growth throughout the period. There has been a pronounced change in the composition of borrowing. In 1960 education, transportation,

---

[4] The Securities Industry Association data on special districts includes both State and local authorities, whereas the Bureau of the Census includes statewide authorities in the State debt figures. Unfortunately, the Census does not report the authority (as opposed to other revenue-secured debt) separately.

[5] See Lennox Moak, *Administration of Local Government Debt*, Municipal Finance Officers Association (1970), pp. 17–18.

[6] For most varieties of revenue bonds, the reoffering yields have been 15 to 20 basis point (one-hundredths of a percentage point) higher than general obligation bonds of similar credit rating. See George Hempel, *The Postwar Quality of State and Local Debt* (1971), pp. 142–144.

[7] See Frank Curley, *State and Local Public Facility Needs and Financing, Vol. 2*, Joint Economic Committee (1966), pp. 156-172.

and water and sewer bond sales amounted to $4.6 billion or 65 percent of total bond sales; by 1974 their combined share had slipped to 35 percent of total sales.

TABLE 3.—STATE AND LOCAL GOVERNMENT BONDS SOLD BY USE OF PROCEEDS

[Billions of dollars]

Purpose	1960	1970	1972	1974	1975 estimate
Education	2.28	5.03	4.98	4.73	5.00
Transportation	1.31	3.17	2.99	1.71	2.20
Utilities and conservation	1.30	3.47	4.68	5.64	7.30
Water and sewer	1.02	2.40	2.45	1.99	2.70
Pollution control (ind.)			.60	1.71	2.20
Other utility and cons	.28	1.07	1.64	1.94	2.40
Social welfare	.60	1.47	3.82	4.45	4.60
Public housing	.43	.13	1.92	1.69	.70
Hospitals	NA	NA	.50	.78	2.10
Other	.17	1.30	1.41	1.98	1.80
Industrial aid	.04	.11	.33	.50	.50
Others (general purpose)	1.53	4.20	5.30	6.50	10.50
New capital	7.06	18.00	22.12	23.51	30.10
Refunding	.05	.11	1.57	.73	1.00
Total	7.11	18.11	23.69	24.24	31.10

Source: Securities Industry Association and author's estimates.

Various aids to private business have had a major impact since 1960. Industrial development bonds—sold to build facilities for lease or resale to private companies—flourished in the early and mid-1960's and then were cut back to a trickle after changes in the allowable uses of tax exemption under section 103 of the Federal Internal Revenue Code, which took effect in 1969. However, the same legislation gave birth to a new instrument, the pollution control bond. These are issued on behalf of corporations for purposes of installing pollution abatement facilities.

Although the inability to disaggregate by purpose a substantial portion of the debt sales (other uses) somewhat fuzzes the trend in volume by function, it is abundantly clear that the "traditional" uses of debt have been supplemented by an array of new purposes. Many of these new uses are financed by special authorities with the aid of complex financial arrangements and the revenue bond.

To summarize recent trends, it is clear that State and local debt has shown dramatic shifts in the directions of increased short-term borrowing, a greater use of special authority financing, and growing use of the revenue bond. Both the general obligation and general purpose governmental borrower, while still of great importance, have seen their relative positions recede with the advent of new definitions of the public purpose and a galaxy of new borrowing instrumentalities and debt instruments to accommodate those purposes. The next chapter examines more important and, frequently controversial, new purposes for tax-exempt borrowing and new financing vehicles.

Chapter II. NEW AND CONTROVERSIAL TYPES AND USES OF TAX-EXEMPT DEBT

SHORT-TERM BORROWING

One of the most noticeable phenomena of the 1970's has been the meteoric rise in short-term borrowing by State and local governments. Commencing in the tight money period of 1969, note sales began a steep ascent, eventually trebling by 1974, when they totaled nearly $30 billion. In that period, short-term debt outstanding grew from $11 to $18 billion.[1]

Several reasons may be cited for the jump in note sales. Clearly, many long-term borrowers, faced with the steep rise in long-term rates, were waiting for better market conditions and, therefore, sought to postpone definitive financing. Leading users of notes for interim financing have been the state housing authorities, which had $2.4 billion in short term debt outstanding in 1974.[2] Also, the pace of growth of note offerings was quickened by the sales of U.S. Government-backed public housing and urban renewal notes, which grew from $4.9 billion in sales in 1968 to $10.5 billion by 1974. A third factor was that, as the 1970's progressed, some units were finding short-term borrowing against current deficits a convenient, if misguided, way to forestall increased taxes or reductions in expenditures. New York City, which alone accounted for one quarter (or $7 billion) of short-term note sales in 1974, was no doubt the leading, if not the sole, practitioner of this use of short-term credit.

A fourth kind of demand was created by governmental units that preferred not to pay off their short-term indebtedness with available assets but rather to keep the latter invested in taxable obligations at higher rates of return than they needed to pay out on their own debt. Although Federal arbitrage regulations have cast a pall over this practice, it is undoubtedly the case that governmental debators, even when faced with relatively high short-term tax-exempt rates, may find it worthwhile to stay in debt and to use other funds to earn a profit on the differential between tax-exempt and taxable yields.

Although the high levels of short-term borrowing are worrisome to some observers, the fact is that the use of short-term debt in the State and local sector continues to be mild in comparison to other sectors. Short-term market debt comprises only 9 percent of all the sector's outstanding debt in comparison to nearly 50 percent for the nonfinancial corporate sector.

The traditional use of short-term borrowing in anticipation of locally levied taxes that may legitimately be expected to be collected within the revenue cycle always has been used and is widely accepted.

---

[1] Federal Reserve Board of Governors, *Flow of Funds*.
[2] "State Housing Finance Programs," *Moody's Bond Survey* (Jan. 6, 1975), p. 1795.

However, the early 1970's saw the introduction of a new type of short-term borrowing—borrowing done in anticipation of assistance payments due from another level of Government and, therefore, dependent upon the appropriation process of that unit.

Finally, another traditional means of interim financing, the bond anticipation note, also has ben used more and more. With the recent turbulence in the financial markets this poses new problems, because paying off the short-term debt is often dependent solely upon the future ability of the borrower to convert his short term liability into long-term debt.

This adds a new element of risk—the inability to borrow long term because of future problems—of which investors are increasingly conscious in the wake of the New York Urban Development Corporation default of February 1975. Such moneys were rampant by the end of 1975 when the municipal note market was in serious disarray in the Eastern United States, primarily in reaction to the protracted crises in New York State and surrounding areas. Recent estimates are that the cost of short term borrowing has leaped by 2 to 5 percentage points for borrowers in New York State because of credit concerns.[3]

Moral Obligation Bonds

The moral obligation bond, which has greatly widened the scope of tax-exempt financing, is now under heavy fire—both in the markets and by public critics. Use of the financing device began in 1960 with the creation of the New York State Housing and Finance Agency and has since blossomed to more than $8 billion in outstanding bonds. The distinguishing feature of the moral obligation bond is its backing by a unit of government which agrees to meet any deficiency in a reserve fund established to back up the debt.

The unique attribute is that although the government is morally obligated and authorized in the future to make such deficiency payments, the unit is not legally liable for the debt, and it does not constitute part of the debt of the unit.[4]

Needless to say, the ability to finance certain projects by this back door or contingent guarantee has proved most attractive, especially in view of the fact that revenue-supported projects need not be approved by public referendum (because their debt is not that of the sponsoring and morally obligated unit).

Typically, a public corporation or agency is formed for the purpose of selling—and ultimately retiring—the tax-exempt bonds. As in other areas of debt finance, New York State gave the initial impetus to

---

[3] See Ronald Forbes and John Petersen, "Costs of Credit Erosion in the Municipal Bond Market," Municipal Finance Officers Association (revised Dec. 1975), p. 17. Also, Stephan Chilton et al., "Trends in Short Term Borrowing Costs for New York State Localities," State University of New York at Albany (Dec. 1975).

[4] "The mechanics of the 'moral obligation' generally involve the following steps: (1) A capital reserve fund is created and funded; (2) any deficiency by reason of withdrawals or otherwise is certified by the chief officer of the agency to the top officials of the state; (3) the certified deficiency funds are paid over to the capital reserve fund by the state. The third element is generally hedged, however, and the statement is usually in bold type so there can be no misunderstanding: (a) all moneys paid by the State are subject to prior appropriation by the legislature; (b) the legislature is not obligated to appropriate the moneys, and the state is not obligated to pay them; (c) but should a future legislation elect to appropriate such moneys, it may legally do so, 'in the opinion of bond counsel.' The divorce of the State's legal responsibility is completed by statements, again in bold type, that the State shall not be liable on the bonds and that the bonds shall not be debt of the State." (*Moody's Bond Survey*, Sept. 17, 1973, p. 568.)

this type of financing; however, as table 4 depicts, 15 other States and Puerto Rico have followed suit in using the device. As table 4 also illustrates, most moral obligations have been sold by State-created instrumentalities to finance housing construction or to support the residential mortgage market. Funds for the payment of interest and principal are derived from mortgage payments, lease rentals, and governmental subsidies of one form or another (often, Federal housing subsidies). Other uses have been found for the moral obligation, including the repackaging of local government bond issues in bond banks (Vermont, Maine, and Puerto Rico have been active thus far).

While the use of the moral obligation has flourished, it has presented special analytical problems for the bond analyst and the rating agencies. There are analytically three forms of risk to evaluate:

> (1) The risk that the project itself will not be self-sustaining; (2) the risk that the State will not "back up" the "moral obligation"; and (3) the risk that the State, if it does honor its contingent liability, will jeopardize the credit standing of its own obligation.[5]

TABLE 4.—*Moral obligation bonds, outstanding as of February 1975*

State:	*Millions of dollars*
Connecticut	$180
Illinois	196
Kentucky	52
Maine	111
Massachusetts	119
Michigan	277
Minnesota	84
New Jersey	472
New York	6,336
North Carolina	17
Rhode Island	4
South Dakota	27
Tennessee	33
Vermont	90
Virginia	113
Wisconsin	38
Puerto Rico	55
Total	8,204

Source: *Moody's Bond Survey* (Apr. 7, 1975), p. 1429.

Moody's rating agency (expressing uncertainty about the strength of the commitment and looking first to the self-sufficiency of the projects themselves) has evidently discounted the moral obligation as a binding pledge.[6] As a rule of thumb, rating agencies have tended to rate the bonds a notch below the rating assigned the morally obligated unit.

The question of the security of the moral obligation catapulted into the headlines with the temporary default of the Urban Development Corporation on $100 million in short-term notes in March 1975. Although the State of New York ultimately stood behind the note issue, it initially maintained that the short-term borrowings of the corporation were not covered by the moral obligation that backed the bonds,

[5] Ronald Forbes et al., "Evaluating Credit Assistance Programs" in *Planning for Research on Improving Municipal Credit Information and Credit Quality*, Municipal Finance Officers Association (1974), Appendix, p. 17.

[6] *Moody's Bond Survey* (Sept. 17, 1973), pp. 568–69.

a legal point that did not reassure investors in the sincerity of the State's pledge to back up the agency's financing.[7] Soon thereafter, the general loss of confidence in New York securities and the moral obligations in particular displayed itself in an inability of New York City and various State agencies to refinance billions of dollars in short-term loans, either by rollovers of the notes or their funding into long debt. This has led several of the New York agencies to the brink of default and has raised questions about both the willingness and ability of the State of New York to stand behind either the notes or debt service on the outstanding bonds.[8]

Bond anticipation notes sold by agencies backed by moral obligations have suffered especially from the lack of investor confidence. The Commonwealth of Massachusetts, in order to avoid default by that State's morally obligated Massachusetts Housing Agency, was forced to convert the agency's maturing notes into general obligations of the Commonwealth.[9]

The immediate future for moral obligation financing is bleak. The difficulties experienced by the various New York State agencies has put a crimp in confidence that will be hard to straighten out. One consequence of the problem is that the high cost of borrowing will probably forestall many activities of the State housing agencies unless and until they can devise more acceptable methods of borrowing.[10] Furthermore, interrupted financing will lead to slippages in partially completed projects. This will reduce these projects' ability to pay for themselves and perhaps make it necessary to invoke the moral obligation of the sponsoring State government in some cases.

Housing and Mortgage Finance Borrowing

A rapidly growing use of the tax-exempt security has been to finance housing construction either directly or by purchases of mortgages originated by private lenders. Such programs are now in effect in 32 States, and reportedly have financed more than 270,000 new housing units since 1968, with a total of nearly $6.3 billion in debt outstanding as of mid-1974.[11]

The structure of such programs varies greatly though, as has been discussed, the use of moral obligation securities has been heavy. Four types of programs have been used by the State housing agencies: (1) The direct development approach, where the agency actually engages in the construction and ultimate operation or sale of multifamily housing projects; (2) mortage loans, where the agency makes direct loans to purchasers of housing; (3) mortgage purchases, where mortgages may be purchased from portfolio or originators of new mortgages; and (4) the newest approach, loans-to-lenders, where loans are made directly to private lenders who are required to make new loans and to collateralize their loans from the State agency.[12]

---

[7] Alan Bautzer, "New York Agency's Insolvency Shakes Markets," *Money Manager* (Mar. 3, 1975), p. 1.

[8] Reacting to the financial difficulties and dismal prospects for the army of New York State financial authorities, Governor Carey of New York created a special study group, the Moreland Commission, to investigate the downfall of the Urban Development Corporation and to recommend measures to avert future disasters.

[9] "Municipal Market." *The Daily Bond Buyer* (Oct. 14, 1975), p. 6.

[10] "State Housing Finance Agencies," *Housing and Development Reporter* (Nov. 17, 1975), p. 49.

[11] *Ibid.*, p. 43.

[12] *Moody's Bond Survey* (Jan. 6, 1975), p. 1795.

From the outset, State housing agencies have depended upon the availability of housing subsidies from the Federal Government. The availability under the 1968 Urban Development Act of sections 235 and 236 money, part of it allocated directly to the State agency, led to the initial formation of many State housing agencies in the late 1960's and early 1970's. With the impoundment of housing assistance programs early in 1973, the Agencies switched to use of section 23 leased housing programs. Collaterally, they developed indirect assistance programs to support the mortgage market. Typically, these permitted original lenders to liquidate their existing holdings by selling them to State mortgage finance agencies which, in turn, sold tax-exempt bonds in the capital markets. The fact that many of the mortgages were guaranteed by FHA or VA enhanced the security of the borrowings. Although, technically, many housing agency activities fall in the category of industrial development bonds, they were spared for the tax-exempt market by virtue of the exclusions written into section 103 in the 1969 Tax Reform Act.

They have also been given special dispensation under the arbitrage bond regulations to allow them a higher markup between their borrowing and lending rates.[13]

The Housing and Community Development Act of 1974 provided a role for the agencies by replacing section 23 with section 8, which is basically a leasing program that shifts financial risk to the developer and owner. HUD has encouraged the activities of the State agencies by making bulk set asides of section 8 subsidies. Devising a workable financing scheme has presented problems for the agencies, but these problems have not deterred them fom continuing support of the housing market.

Faced with dire conditions in both the housing and bond markets in 1974, the agencies borrowed long term about $1.5 billion and sold $2.2 billion in notes. Thus, State borrowing to support housing has represented about 6 percent of recent State and local bond sales and 8 percent of short-term borrowing. As of the end of 1974, total long- and short-term housing debt came to $4.7 billion and $2.4 billion respectively. In view of the high level of outstanding short-term debt and the continued demand for low and moderate-income housing support, it was widely anticipated that housing agencies would be heavy borrowers in the market in 1975. However, the combination of high interest rates, the concern over the frequently-used moral obligation security form, and the difficulties in developing section 8 arrangements acceptable to the market have held down such financing in 1975. Bonds sold have tended to carry considerably higher rates of interest than similarly rated general obligation bonds, and during the chaotic months of fall 1975 several issues were canceled or reduced in size.[14]

Although the housing construction industry is demonstrably a hard-hit sector and public involvement in housing support is a longstanding tradition, the use of tax-exempt bonds for such purposes has been criticized. First, it is obvious that the heavy volume of borrowing has brought increased pressures to the bond and note market. Bonds sold

---

[13] *Housing and Development Reporter* (Nov. 17, 1975), p. 50.

[14] William J. White in *Debt Financing Problems of State and Local Government*, Hearings before the Subcommittee on Economic Stabilization, House Committtee on Banking, Currency and Housing, Part 2 (Oct. 27, 1975), pp. 1364–1368.

for housing tend to have long-term maturities—as do other large revenue bond issues—and, therefore, along with pollution control borrowing have an especially heavy impact on the relatively shallow long end of the tax-exempt market. Second, it may be argued that the bonds constitute a misuse of public funds, especially when proceeds are channeled directly to private mortgage activities and to the refinancing of conventional mortgages or—as sometimes has been the case—commercial mortgages. Certainly, in cases where the agency merely acts as a conduit to private, profitmaking lenders, bonds maintain their Federal tax exemption only by virtue of the exception granted housing section 103(c).

On efficiency grounds, the use of tax-exempt housing bonds can be attacked because as long as some savings are possible by borrowing in the tax-exempt market, benefitted parties will continue to push bond issuances to the point where tax-exempt rates become very close to those on taxable mortgages. (With yields on some new issue tax-exempt housing bonds approaching 10 percent in fall 1975, this argument is not without foundation.) Accordingly, the impact on other tax-exempt yields lessens the value of the exemption for all State and local government borrowers.

Hospital and Health Care Facility Financing

The construction of hospitals and health-care facilities is another rapidly growing and controversial area of tax-exempt financing. Although the owning and operating of hospitals has long been an acknowledged public purpose, the use of revenue bonds to finance construction or acquisition for not-for-profit entities is a development of the 1970's. In 1974, $1.3 billion in hospital and health care facility bonds were sold, and it appears there was an even greater volume of sales in 1975—perhaps $2 billion.

The typical arrangement is that the bond-issuing entity, a special authority or unit of local government, enters into a lease agreement under which the hospital makes payments toward debt service of the bonds. Such agreements are usually secured as a first claim on gross revenues, which frequently consist of medicare and medicaid payments that, in turn, give the bonds the aura of a partial Federal guarantee.[15]

Because of their newness and the novelty of both the purpose and form of security, hospital bonds have been accepted by investors only if they carry relatively high rates of interest. In addition, they present analysts with new problems in assessing credit quality. A special concern in new construction is whether future net income will be sufficient to cover future debt service payments. These estimates and levels of payment depend on the feasibility studies of consultants hired to make projections. Since hospitals compete with one another and other health care facilities, it is also important that plans for future hospital construction in the patient customer area be known.

As in the case of housing, hospital financing by tax-exempts is attractive so long as there is some savings over a taxable bond or mortgage rate. This means rates on these bonds can be much higher than those normally paid on tax-free bonds and still make projects feasible.

[15] *Moody's Bond Survey* (Jan. 6, 1975), p. 1797.

Reportedly, tax-free hospital bonds with interest costs up to 9½ percent can still be the lowest-cost financing vehicle for construction.[16]

The tax-exempt hospital bond market was shaken by the notorious Covington Hospital case involving fraud on the part of the underwriter and financial adviser.[17] Subsequently, there has been greater circumspection and selectivity in the market for these bonds and wide interest cost differentials between higher and lower credit quality bonds. Hospital bonds appear to be supported primarily by individuals and bond funds, with sparce institutional sales.[17a]

Tax Increment Bonds

A relatively new and controversial use of tax-exemption is the tax increment or, as it is sometimes called, the tax-allocation bond. These bonds are a peculiar breed of the limited obligation security where bonds are secured on a projected increase in property tax revenues that will be generated from the improvement the bonds finance. The key attraction is that the burden of debt does not fall upon the existing property or reduce the tax base of the existing property tax, but rather falls upon future increases or increments in the taxable value of the improved area. The bonds, when secured solely upon such incremental increases in value, must be viewed as fairly risky, since there is no guarantee that the development or renewal effort will be successful and the tax base will rise to pay off the debt service.[18]

Cities in California have been the most aggressive users of tax increment bonds, evidently having issued over $230 million by mid-1974. Reportedly, 13 other States have authority to issue such bonds and several others are contemplating their use.[19]

Tax allocation bonds, which may be issued by a local redevelopment authority or municipal government, are usually sold as part of overall development plan that includes commitments by private developers to the project. Often, they are also backed by long-term lease agreements with public bodies for purposes of building public facilities. Most tax allocation projects involve the redevelopment of urban blight areas as well as new industrial or commercial facilities. As revenue bonds, they do not count against the general government's indebtedness nor do they require voter approval.

The device has been defended on the grounds that it permits financing redevelopment without incurring general debt, burdening existing property owners, or cutting into the tax base. Further, it is argued that the projects must be inherently productive—hence, an added tax source—in order to be salable in the bond market.[20]

On the other hand, the device earmarks future taxes in the project area for debt repayment, thereby freezing the tax base, even though the development that is financed may engender higher levels of public spending. Abuses have been reported where the developing agency

---

[16] "Hospital's Use of Tax Exempt Financing Tops $1.4 Billion," *The Daily Bond Buyer* (Oct. 15, 1975), p. 15.

[17] *Ibid.*, p. 15.

[17a] *Ibid.*, p. 15.

[18] Gerald M. Trimble, "Tax Increment Finance for Redevelopment," *Journal of Housing* (November 1974). G. H. Jefferson and Tee Taggard, "Tax Increments Criticized" *Journal of Housing* (January 1975).

[19] National Council for Urban Economic Development, *Tax Increment Financing* (September 1975).

[20] *Ibid.*, p.6.

has designated as the increment zone large areas that do not really benefit by the project in order to capture the growth in future taxable values. In addition, tax increment financing is a risky and expensive use of tax exemption and one that can benefit a select group of private parties. When incremental revenues fall short, a community, while legally free of responsibility, is still faced with the ethical question of whether it should bail out the bonds or face the opprobrium of default.

Advanced Refunding Bonds

Another much-criticized use of tax exemption has been the advanced refunding bond. These bonds are sold prior to the redemption date of the issue which they replace. The proceeds from the sale of the advanced refunding issue are used to retire the outstanding bond when it becomes callable. Since the old issue and issues to refund it are outstanding at the same time, the total supply of tax-exempt bonds can be inflated by a multiple of the amount actually needed to finance the improvement. In fact, prior to the enactment of certain constraints on the use of advanced refunding bonds, advanced refunding issues were pyramided in order to earn a profit from the investment of tax-exempt bond proceeds in higher yielding taxable securities.

Advanced refunding becomes increasingly attractive when interest rates drop and as a result, most activity occurs when yields are at cyclical lows. The exact volume of refunding bond sales is not known, but one estimate is that approximately $2.7 billion were sold between 1971 and 1974, with the bulk of sales occurring during the recoveries of 1971 and 1972.[21]

There are three basic reasons for advanced refundings:[22]

(1) Long term savings of interest cost, either because the general level of interest rates has dropped or the borrower has improved his relative credit position;

(2) Prevention of default because current debt service is reduced by selling a refunding bond that stretches out the debt; and

(3) Modification of restrictive convenants on original issues which have inhibited present development or have become undesirable for other reasons.

These purposes have traditionally been achieved by straight refunding, that is, selling a new issue to replace an outstanding one near the maturity or at a call date of the original bond issue. Advanced refunding is different because the funds to be used to retire the original debt are sold in advance of the maturity date. Thus, where advanced refunding occurs, there are two bonds outstanding. The proceeds of the advanced refunding bond issue are set aside in an escrow account, and the cash flow from the investment in escrow is used to support the debt service on designated portions of either the original or refunding bond issues.

Most advanced refundings employ what it termed the standard defeasance method. With this technique, the issuer sets aside the full amount of the outstanding bonds in a pledged escrow account. Under most State laws this serves to "defease" the claim of the existing bond-

---

[21] Salomon Brothers, *Supply and Demand for Credit in 1975* (1975), p. 16.

[22] C. W. Ritter, *Advanced Refunding Techniques of Municipal Debt Reorganization* (June 1975), pp. 1–3. See also Thomas F. Mitchell, "Advanced Refunding of Municipal Bonds: Concepts and Issues," University of Oregon (July 1975).

holders on revenues and frees the issuer to modifiy the original covenant restrictions.[23]

The effect of advanced refunding is to erase the original debt from the issuer and owners of the original bond issue are given an alternative and usually superior backing for their holdings. Another important aspect is that when secured by a deposit of Federal securities or their equivalent, the original issue becomes eligible for unlimited holding by banks.

Traditionally, there have been two policy objections to advanced refunding. First, the device has been used for the sole purpose of earning an arbitrage profit for the borrower. By investing refunding bond proceeds at yields in excess of borrowing costs, issuers could earn a profit without risk. This use has been almost eliminated by Treasury regulation and the arbitrage provisions of the 1969 Tax Reform Act.[24] Second, advanced refunding increases the supply of tax-exempt securities without financing genuine public improvements. The added tax-exempts keeps tax-exempt yields from being as low as they otherwise might. The potential of advanced refunding issues acts as an overhang on the market, since these issues frequently are sold when interest rates drop and refunding savings are most attractive. This keeps the tax-exempt market from recovering as quickly or completely as it might and diminishes the reward to issuers who have stayed out of the market during periods of high interest rates and congestion.

A third and more recent objection to advanced refunding derives from the impact of current arbitrage regulations on potential profits when borrowers can borrow at rates lower than they must pay. This arises because the issuer is required by Federal arbitrage rules to invest 85 percent of refunding bond proceeds at a yield that is not substantially higher than that on the refunding issue. As a result, those supplying securities for the escrow account have a chance to price those securities artifically at a price higher than they paid for them or to bid an artificially favorable price for the refunding bonds, knowing that they will make up the underwriting loss with compensation from third-party profit. The existence of the third-party profit, which issuers cannot themselves reap, creates an inducement for underwriters to promote the issuance of advanced refundings, even when they represent little or no gain to the issuer.[25]

The Treasury has been aware of the unhealthy pressures that can develop from the existence of the third-party profit. In 1973 it proposed changes in the arbitrage laws that essentially would require investment of escrow funds in special government issues.[26]

The Pollution Control Bond

The use of tax-exempt bonds to finance pollution control expenditures for private corporations has increased greatly over the past 4 years, posing both philosophical and practical problems in the munici-

---

[23] The obligation acquired usually is either direct or guaranteed obligation of the Federal government. This transforms the outstanding bond issue to "AAA" status. Ritter, *op. cit.*

[24] *Ibid.*, p. 17. See also Daniel L. Goldberg, "The New Proposed Arbitrage Bond Regulations—And a Comparison With the Old," *Urban Lawyer*, vol. 6 (1974), pp. 76–77.

[25] Unless the present value of all costs and future savings are calculated, issuers may actually realize losses on future interest cost "savings" even though they may appear to profit in the nominal amount of interest paid.

[26] U.S. Treasury, *Proposals for Tax Change* (Apr. 30, 1975), p. 148.

pal bond market. Annual reported sales of these obligations—which typically are for large amounts and issued for a long term—have now reached a level of $2½ billion.

The pollution control bond is the product of two converging trends: (1) The growth and transfiguration of the industrial development bond; and (2) public concern as expressed in legislation to abate or eradicate pollution.

The use of public tax-exempt credit to finance private firms has its modern origins in the industrial revenue bond. Beginning in the 1930's in the South, industrial revenue bonds were issued by State and local governments to finance the plant and equipment expenditures of new or expanding firms and, thereby, to bolster their own economies. In the early years, industrial development bonds were limited mainly to small borrowers in the South and received little attention. Through the 1960's, their use rose dramatically, culminating in $1.6 billion in new issues by 1968—or 10 percent of all long-term tax-exempt bond sales. Finally, the Department of the Treasury and then the Congress took steps to halt what became acknowledged as an abuse of tax exemption and a threat to the conventional municipal bond market.[27] As a result, industrial development bonds were excluded from tax exemption by addition of section 103(c)(1) to the Internal Revenue Code. However, section 103(c)(4) of the code allowed an exception to the exclusion. That section exempted certain facilities financed by industrial revenue bonds on behalf of private firms from the size-of-issue restrictions, namely, residential property; sports facilities; convention facilities; transportation facilities; sewerage, water, solid waste, and energy facilities; industrial parks and—most notably—air and water pollution control facilities. The basic law ultimately spawned the usual extensive regulations from Treasury. But, for the time being, industrial development bonds were quiescent. Sales fell from a peak of $1.6 billion in 1968 to only $50 million a year later.

However, a second trend was at hand, one which would make the pollution control exception of particular interest. This was, of course, the flood of Federal legislation aimed at cleaning up the environment. In 1969 the National Environmental Protection Act was passed. Soon after, Congress created the Environmental Protection Agency (EPA) whose function was to establish and enforce standards of environmental protection.

Two Federal acts provided substance and economic impact to the EPA's mission: the Clean Air Act of 1970 and the Water Pollution Control Act of 1972. The Clean Air and Water Acts together required that certain standards be promulgated and enforced—primarily by the States—to prevent or abate pollution by toxic and hazardous substances in air and water. The economic effect was to require large scale investments by industry.

The cost of the mandated national clean-up for industry (pollution related to site or stationary point emissions) has been estimated at $5–15 billion a year. Such investments are likely to reach a peak by the late 1970's and to decline gradually through the 1980's. Recent reports show expenditures to be roughly on target for the first few years.

[27] Public Law 90–364, Sec. 107, 90th Cong. (June 28, 1968), as amended (Oct. 24, 1968).

In 1974, industry spent an estimated $5.6 billion on new plant and equipment for pollution abatement.[28]

To be tax exempt, pollution control financing must be done through a State or local government entity empowered to enter into agreements and sell debt. Typically, special authority for this purpose is created by legislation or constitutional amendment and exists in perpetuity or for the life of a particular project. The borrowing undertaken for this special and limited purpose constitutes a revenue obligation and is not a general debt of the governing body that authorized it.

In their relatively brief existence, pollution control bonds have assumed various financing arrangements. They share certain features, however, that allow these bonds to qualify for tax exemption. While pollution control bonds meet the statutory definitions for industrial development bonds, they enjoy tax exemption through the exception granted by section 103(c)(4) of the code and a complex set of governing regulations.[29]

Besides helping to clean up the environment, the tax-exempt pollution bond—much as its predecessor and companion, the industrial development bond—has several advantages for the assisted company. First is the savings in interest cost on borrowed capital (or the lower lease payments). Pollution control bonds have sold at yields ranging between 70 and 80 percent of those on comparable corporate, taxable securities. In recent markets, this has meant savings of 1.5 to 2.0 percentage points or about $4 million in total interest expense on a 20-year, $10 million issue. In addition to interest cost savings, certain Securities and Exchange Commission registration fees and related legal expenses are avoided because the bonds are not registered.

Acquired facilities may also receive advantageous tax treatment. Generally, under the lease (or installment purchase) arrangement, the leasing firm can treat the property as being owned and can depreciate it. In addition, relief from State and local taxes may be offered. A final advantage is that 100 percent financing is available for facilities that do not increase productivity and profitability of the plant.

The growth in reported pollution bond sales since their inception in 1971 has been spectacular, rising from the $93 million reported by the Bond Buyer in 1971 to an estimated $2.5 billion in 1975. In the last 2 years, pollution control bonds have represented about 7–8 percent of all long-term municipal bond sales. Together with "conventional" industrial revenue bonds, many of which are sold in conjunction with pollution control bonds, pollution bonds for private firms represent approximately 10 percent of all reported tax-exempt bond sales.

Widespread nonreporting of transactions makes it hard to compile accurate figures on pollution control and development bond sales. Perhaps the greatest unknown is the extent to which commercial banks

---

[28] John Cremeans et al., "Capital Expenditures by Business for Air, Water and Solid Waste Pollution Abatement," *Survey of Current Business* (July 1975), pp. 15–19.

[29] Treasury Regulations, sec. 1.103–9. Generally, the regulations place heavy emphasis on the relationship of the pollution abatement improvement to the overall industrial process and its design. The stickiest point comes in showing, as is required by the regulations, that two significant purposes are met: (1) The improvement would not have been made except to control pollution and (2) it is not designed to meet any significant purpose other than pollution control. Unless both tests are met, only that part of the expenditure attributable to pollution control—and not materially increasing productive capacity or useful life of the production facility—can be used for the pollution control exception and tax-exempt financing.

68-626—76——4

finance such facilities through tax-exempt loans. Combining unreported bank lending and the estimates for unreported direct placements (on the basis of the earlier development bond experience), it is conservatively estimated that pollution control financing and industrial development bond financings were under-reported by at least $1 billion in each of the last 2 years.[30]

Forecasters agree that pollution control outlays will climb in the years ahead under existing laws. Recent surveys initiated by the Bureau of Economic Analysis show that non-farm business spent $5.6 billion on pollution abatement facilities in 1974 and planned to spend $6.3 billion in 1975.[31] These figures agree with both McGraw-Hill and EPA estimates. However, in subsequent years the projections diverge greatly (EPA envisages as much as $15 billion annually by the late 1970's whereas McGraw-Hill predicts a leveling off to $7 billion annually).[32] Assuming that there is no substantial change in the pollution control laws and allowing for inflation, a reasonable forecast for pollution control expenditures is $10 to $12 billion by the late 1970's. Given the present patterns of financing, it is probable that pollution control borrowings should reach a level of $4 to $6 billion through the late 1970's under existing laws.[33]

Pollution control bonds present major issues for the capital markets. From the standpoint of the industrial borrower, the greater the cost saving it can realize by borrowing on a tax-exempt as opposed to a taxable basis, the greater the inducement to use the pollution control bond. But, from the standpoint of the State and local borrower and the public at large, the greater the sales of pollution bonds in the tax-exempt market, the greater the supply of tax-exempt bonds will grow in relation to the demand for them, forcing interest rates to rise. This not only adds to the cost of all municipal borrowing, it also reduces the efficiency of tax-exemption as a subsidy.

Recent studies of the relative market performance verify that net interest cost savings on pollution control issues have dropped as volume has grown.[34] This means that tax exemption is increasingly less efficient in lowering the interest cost of pollution control bonds. Thus, in order to sell all the bonds desired, issuers must pass more of the benefits of tax exemption to investors and keep less for the firm and improvement which is being financed. In addition, increased supply raises interest costs for all municipal borrowers, who must compete for limited funds seeking tax shelter.

On the basis of several econometric studies, the interest rate impact of additional tax-exempt debt—given the level of funds available for

---

[30] John Peterson, 'The Tax Exemption Pollution Control Bond," Municipal Finance Officers Association, *Analysis* (March 1975), pp. 4–5.

[31] John Cremeans et al., *op. cit.*, p. 15.

[32] George Peterson and Harvey Galper, "Tax-Exempt Financing of Private Industry's Pollution Control Investment," Public Policy (Winter, 1975).

[33] Evidently, the share of pollution control outlays financed by tax-exempt bonds is approximately 40 percent and approaching 50 percent. Another factor in the growth of pollution control bonds has been adoption of enabling legislation by states. As of the end of 1974, all but two—Washington and North Carolina—had some legislative authority to accommodate this type of financing. But, of much greater consequence are the Federal laws and complex regulations that permit use of the pollution bond. For example, it was administrative foot-dragging and Treasury opposition to certain techniques that kept pollution bonds from being used until 1971. See Petersen, "Pollution Control Bond," pp. 5–6.

[34] *Ibid.*, pp. 6–7.

the tax-exempt market—probably ranges between 5 and 20 basis points per billion of added borrowing.[35]

Pollution control bonds also have been examined in terms of their overall costs and benefits as a tax subsidy. The subsidy offsets part of the expense incurred by private industry to reduce or eliminate industrial pollution. However, the subsidy's costs are borne by the public in three ways: Federal taxes on interest income are foregone when tax-exempt bonds are used instead of taxable securities; State and local taxes are foregone because of the exemption of such bonds from many State income, personal property, and real property taxes; and borrowing costs are higher for other tax-exempt bond issuers because the increased supply of bonds pushes up interest rates. Benefits are distributed between the principal target—the firm making the improvement—and an unintended beneficiary, the purchaser of tax-exempt bonds, who receives greater tax shelter for otherwise taxable income.

A recent study of pollution control impacts in 1973 estimated that the $2.1 billion sales in pollution control and industrial revenue bonds resulted in combined first-year costs for Federal, State, and local governments of $66 million.[36]

Looking at the benefit side, firms using pollution bonds saved $40 million in reduced borrowing costs for the first year. The other $26 million of the subsidy flowed to investors as additional tax shelter income. Hence, industrial firms were able to enjoy only two-thirds of the Government subsidy; the rest was passed on to purchasers of pollution and industrial revenue bonds.[37]

While the 1973 figures are impressive, they are a dead letter. The bonds have been sold, and the subsidies are largely sunk costs to be incurred over the next 25 to 30 years. The real issue is future growth. With the long life of the pollution bond and its ability to drive up rates in tight money periods, it is the cumulative impact on the remainder of the tax-exempt bond market that should be examined.

Projecting to 1980, it has been estimated that the total annual tax loss on $25 billion in outstanding pollution control (and industrial revenue) bonds that will have been issued during the decade of the 1970's would be $640 million. In addition, State and local governments by then would be paying an additional $150 million each year in debt service costs. Corporations would enjoy a total of $425 million in interest savings, while investors would be receiving about $365 million in added tax-sheltered income. In that case, firms would be realizing only 54 percent of the benefits of tax-exemption.[38]

---

[35] *Ibid.*, p. 9; footnote 26, pp. 12–13. In a recent study, Peter Fortune estimated that in 1974, pollution control bonds had increased long term tax exempt rates by 30 basis points. See his "The Financial Impact of the Federal Water Pollution Control Act: The Case for Municipal Bond Reform," Harvard Institute for Economic Research (October 1975), p. 12. See also Peter Fortune, "Impact of Taxable Municipal Bonds: Policy Simulations with a Large Econometric Model," Federal Reserve Bank of Boston (1974) and Harvey Galper and John Petersen, "An Analysis of Subsidy Plans to Support State and Local Borrowers," *National Tax Journal* (June 1971).

[36] The governmental cost included foregone Federal tax receipts ($50 million), state and local taxes ($3.5 million) and increased state and local borrowing costs ($12.5 million). Since these bonds probably had an average life of 25 years, this means a total of $1.35 billion in foregone taxes over their lifetime and $150 million in higher borrowing costs over the typically shorter lifetime of the other tax-exempts sold that year. See Petersen, "Pollution Control Bond," pp. 8–9.

[37] *Ibid*, p. 9.

[38] *Ibid.*, p. 9. These estimates, compared to what impacts could be, are conservative. For example, were the stock of outstanding pollution bonds to be $40 billion by the end of 1980 (up from $4.5 billion at year-end 1974), interest cost impacts and foregone tax revenues could push annual total costs of the subsidy to nearly $1½ billion by 1980. See Galper and Petersen, *op. cit.*, p. 101.

The unfavorable impacts on the State and local bond market and the overall poor marks given pollution bonds on efficiency and equity grounds are not the only criticisms of these instruments. Two other complaints are the pollution bond's relative lack of availability to small borrowers (and, conversely, its overuse by large firms that could finance control facilities by other means) and its potential for undermining the concept of tax-exemption.

The swelling body of evidence against the pollution control bond, coupled with the recent lackluster performance of the tax-exempt market, has led several industry and public interest groups to oppose continued use of the device. The Municipal Finance Officers Association adopted a resolution of opposition in April 1975.[39] This was followed by similar statements from the American Public Power Association, the National Association of County Officials, the National League of Cities, and, most recently, the Securities Industry Association.[40] Meanwhile, the Treasury continues to express opposition, both through formal statements and informally by increasingly tightfisted interpretation and enforcement of controlling regulations.

---

[39] Statement of John Petersen in *Federal Response to Financial Emergencies of Cities*, Hearings before committee on Government Operations, U.S. House of Representatives (June 25, 1975), p. 144.

[40] Statement of the Public Finance Division of the Securities Industry Association before the Committee on Ways and Means, U.S. House of Representatives (Jan. 21, 1976), p. 7.

Chapter III. A CHANGING FISCAL ENVIRONMENT

The emergence of the New York City crisis and related credit crises in New York State brought from the cellar of neglect the question of municipal bond credit quality. Since the Great Depression, few analysts have devoted much time or effort to the financial health of State and local governments or their ability to support debt. The sector had shown stable growth through the post-World War II period, and there had been a noticeable lack of systematic default. There was little doubt that the debt of local governments was "money good" and that governmental borrowers had sufficient fiscal stamina and integrity to meet contractual debt service payments. What concerns there were (and payments difficulties) were restricted largely to more speculative, revenue bond-financed enterprises that depended not on taxes but on user charges from a commercial activity or were backed by leases from private firms with shaky prospects.

By the end of 1974, bond market concerns over credit quality began to surface. There were many contributing factors. Undoubtedly, New York City's difficulties in its November and December 1974 borrowings cast lengthening shadows not only over its prospects in the tax-exempt market, but also over those of many other State and local borrowers. New York's ordeal, while pivotal to the municipal bond market's recent performance, has been the focus of most attention and has been recounted in great detail elsewhere.[1] Here it is useful to examine the impact of the crisis on the market at large and its consequences for other State and local governmental borrowers—and, most particularly, for those that have become tainted by the market's perception of them as sharing common problems with the city.

THE LARGE CITY BORROWERS

The enormous bow-wave of investor concern created by New York has had its initial and strongest impact on other large, old big-city borrowers located in the East and Midwest. For years, an assortment of social scientists and politicians have pointed to the decline of these central cities and the implications for the Nation as a whole. Although these borrowers were by no means the most favorable received, such cities as New York, Philadelphia, Boston, Cleveland, Baltimore, and Detroit had retained reasonably good access to the credit market. In fact, as sustained national prosperity rolled into the early 1970's, accompanied by fresh Federal cash infusions from general revenue sharing, many of the governments either improved or at least maintained their credit ratings despite the gradual softening of their local economies. By early 1975, the municipal bond market was beginning

---

[1] For excellent summaries, see Congressional Budget Office, *New York City's Fiscal Problem: Its Origin, Potential Repercussions and Some Alternative Policy Responses* (October 1975) and Joint Economic Committee of Congress, *The New York Fiscal Crisis* (November 1975).

to take a harder look at the bigger cities. Often, the market did not like what it saw.

Opinion on the uniqueness of the New York City situation is divided, but most would agree that many fundamental problems relating to demographic-economic-fiscal relationships are shared by other major urban centers. From the standpoint of city borrowing in the capital markets, however, the ramifications of these problems and their relevance to particular situations are usually obscure and often ephemeral. Certainly, much of the investor's opinion will hinge on the existence of problems or uncertainties, and how local politicians and administrators will conquer, cope with or, perhaps, attempt to conceal them.

The debt-paying ability of cities can be changed by many factors: the basic strength of the income stream and stock of wealth that can be tapped by the local revenue system; the efficiency and resiliency of the revenue-raising devices; the cost and controllability of expenditures in the budget; the overall political and administrative climate in a city that fosters fiscal prudence or permits profligacy; and, in the final measure, the legal and political power to force the debtor to pay in full and on time, even if this happens on his fiscal deathbed. Looking first at the basic economic prospects of the major cities, it is clear that many have declined in vitality over the past decade or so. Not only has population dropped in several major eastern and midwestern cities, it has changed in nature, becoming progressively older and relatively less affluent.[2] While the percentage of population below the poverty line decreased nationally between 1960 and 1970 from 18 percent to 11 percent, the improvement was smaller in major urban areas. Of the 24 largest cities, all but 7 had higher than the national average of population below the poverty line; only 1 did not show a relative increase in the proportion of the Nation's poor living within its boundaries.[3]

Private sector employment—the generator of the income and wealth that sustains the local tax base—has undergone a secular decline in many central cities as industry and jobs fled to suburbia or exurbia.[4] Between 1960 and 1970 about half the 24 largest cities saw a loss or no significant increase in the number of jobs. Since 1970 the job flight has been exacerbated by recession. Between June 1974 and January 1975, the national unemployment rate increased from 5.2 percent to 8.6 percent. By June 1974, fully 21 of the 24 largest cities had unemployment rates higher than the national average (9 with 10 percent unemployed or more), and 15 had seen their rates—already at relatively high levels in June 1974—increase by more than the national average.[5]

A second set of concerns grew out of the rapidly rising costs of governmental services which, when linked with declining economic bases and absorption of high-need population groups, put the screws

---

[2] Joint Economic Committee, *New York Financial Crisis*, pp. 11–15. Of the 24 largest cities, 11 of 13 in the East and Midwest experienced reduction in population between 1960 and 1973. (One, Indianapolis grew only by virtue of annexation.) Of 11 southern and western cities, 3 showed declines between 1960 and 1973, and an additional 3 declined between 1970 and 1973.

[3] *Ibid.*, pp. 15–17.

[4] Roy Bahl et al., "The Impact of Economic Base Erosion, Inflation, and Employee Compensation Costs on Local Governments," paper 23, Maxwell School, Syracuse University (September 1975), p. 2.

[5] *New York Financial Crisis*, pp. 19–21, *Survey of Current Business* (October 1975).

even tighter to the governmental fiscs. State and local governmental employment has grown rapidly in the past quarter-century—moving from 7.6 percent of total employment to 13 percent by 1973—and average wages have risen faster than in the private sector.[6] The myriad of supplemental benefits in addition to wages grew even faster than did wages themselves until they came to represent 11.5 percent of wages and salaries. While cities shared in this growth in employment and employee compensation through the early 1970's, many began to slow down or cut back on public employment by 1973 and 1974; but, not until a wave of increased wages and benefits had passed over them.[7]

A special concern among rising employee costs centers on the cost implications of public employee pensions. Either because of inattentiveness to changing times or in a deliberate effort to hold down taxes, many local governments in effect were transferring part of the rising costs to future generations by insufficiently funding the pension liabilities that public employees were accruing. Even in those cases where funding was taking place, it was evident that pension costs were a large and largely uncontrollable item in city expenditures.[8]

The problem of employee costs was reinforced by the unparalleled pressure that the inflationary surge of the mid-1970's placed on local governments. Recent research indicates that between 1967 and 1972 inflation had a fairly symmetrical impact on governmental expenditures and revenues: While the cost of goods and services went up, they did not on average outpace the inflationary increases in the tax base. Local governments, on the whole, appeared to come out slightly ahead in the early inflationary period.[9] However, the hyperinflation of 1973 and 1974 caused estimated tax bases to grow by only 15 percent while expenditures—holding 1972 levels of real goods and services constand—increased by 25 percent. As a result, State and local purchasing power between 1972 and 1974 declined by about 10 percent or $10 billion, an amount almost equal to the total general revenue sharing entitlements in 1974 and 1975.[10] Clearly, the State and local tax base was incapable of holding real expenditure levels in place, much less supporting higher levels of real public goods and services.

This erosion in financial power, while obvious in some areas, was not immediately evident throughout the State and local sector. During the early 1970's, Federal aid to State and local governments had grown by leaps and bounds. With the initiation of general revenue sharing payments, Federal aid increased by 22 percent in 1972 and 25 percent in 1973, far ahead of the already impressive rate of growth of 13 percent a year between 1955 and 1970.[11] The aggregate figures fail to reflect, however, that much of the aid in the case of large cities was a substitution for other Federal programs that were either impounded, cut back, or shelved, so that the net benefits of the increase to such cities were proportionately much less. Moreover, by 1974, the rate of growth in

---

[6] Bahl, "Impact of Economic Base Erosion," p. 6.

[7] Employment in cities of more than 50,000 grew by only 0.8 percent in 1974, and 10 of the largest 20 cities actually reported declines in employment in 1973, 1974, or both years. *Ibid.*, p. 7.

[8] See Bernard Jump, "Financing Public Employee Retirement Programs in New York: Trends since 1965 and Projections to 1980," paper No. 16, Syracuse University (1975).

[9] D. Greytok and B. Jump, *The Effects of Inflation on State and Local Government Finance*, Syracuse University (1975).

[10] Bahl et al., "The Impact of Economic Base Erosion," pp. 23–24.

[11] *Ibid.*, pp. 26–28.

Federal aid slowed temporarily, but drastically, to about 5 percent a year, although by 1975 it appeared that Federal assistance, much of it to provide temporary public employment, was once more on the rise. Meanwhile, the States—many under fiscal pressure themselves—showed little appetite for assuming the more costly functions of the cities. Between 1965 and 1972, States increased their relative share of combined State and local revenues by only 2.2 percent and of expenditures by only 1.3 per cent.[12]

As noted earlier, the financial pressure began to manifest itself in the growing deficits of the State and local general government sector in late 1973 and 1974. While an analysis of these deficits cannot be simple or straightforward, it was obvious that the sector was depending more and more on the capital markets and/or running down investment assets in an effort to finance itself. By the last quarter of 1974 the State and local sector was dissaving at a rate of $16 billion a year, a deficit position maintained through 1975.[13]

The tightening economic situation, against a backdrop of secular decline, evidently brought forth the classic response from most city governments. A survey by the Joint Economic Committee early in 1975 determined that cost cities were tightening their belts by cutting expenditures or raising taxes to cope with the consequences of recession and inflation.[14]

That study found that the burdens of the recession were falling in a highly predictable pattern: those States and cities with the weakest financial conditions—the smallest surpluses and poorest revenue prospects—were taking austerity measures to balance outlays with diminished income. Not surprisingly, governments in energy-exporting and agricultural regions of the country—West and South Central—were relatively best off with substantial surpluses and strong revenues.[15]

Local governments in high unemployment areas, with little or no surplus in their operating budgets, where heading toward deficits unless taxes were raised or expenditures cut back. The magnitude of needed adjustments were five times as great (7 to 8 percent of the budget) for high-unemployment governments than for those with unemployment rates less than the national average.[16] The study estimated that about $600 million to $1 billion in capital spending would also be pruned, in order to reduce borrowing costs and thus free capital funds for operating uses. All told, the JEC research estimated that State and local governments in 1975 would make $7.5 to $8 billion in expenditure cuts or tax increases in an effort to balance their budgets.[17]

While the JEC study emphasized the deflationary nature of these adjustments, the alternative and, from the standpoint of financial markets, the most relevant interpretation was that States and localities were playing by the rules. Unable to control their local economies and without the benefit of unlimited access to credit, very few State and local governments indulged in countercyclical deficit spending; those that have, do so only at their own peril. Investors might buy a specula-

[12] *Ibid.*, p. 28.

[13] See Federal Reserve Board, *Flow of Funds* (various numbers). For the first three quarters of 1975 the sector deficit was $13 billion.

[14] Joint Economic Committee of the Congress, "The Current Fiscal Positions of State and Local Governments" (1975).

[15] *Ibid.*, pp. 28–29.

[16] *Ibid.*, p. 31.

[17] *Ibid.*, p. 38.

tion of brick and concrete or forgive an occasional accidentally unbalanced budget, but they have no confidence in a deliberate operating deficit, and they abhor a string of them.

CITY FINANCIAL MANAGEMENT

Recognizing the rules of sound management for municipal borrowers, the question of the fiscal condition of cities has another dimension. This is how well the government manages its affairs, acknowledges its fiscal limitations, and lives within its means. A study, *City Financial Emergencies*, done by the Advisory Commission on Intergovernmental Relations in 1972, proved to be a thorough and somewhat prescient analysis of what brings on financial crises and how they can be avoided. Its principal conclusion was that in the early 1970's most large cities were "free of conditions that present a treat of financial emergency." [18] This was not to say the economic and public spending pictures were rosey for cities, but rather that budget crises could be averted through good management.[19]

Management basically involved a set of traditional actions to retain a balanced budget: (1) Keep operating receipts in balance with expenditures and avoid deficit financing of current outlays; (2) do not allow unavoidable deficits to extend past 1 year; (3) keep a consistent pattern of operating expenditures; and (4) collect rapidly any delinquent taxes. The Commission also cautioned that pension fund liabilities were worrisome and that "poor budgeting, accounting, and financial reporting may be indicative of impending financial crises." [20]

In a recent reappraisal of conditions, one of the principal authors of the ACIR study, while acknowledging that times are tougher now for cities, pointed to the fact that the majority knew the rules and were applying them. He contended that there was no widespread indication of fiscal trouble in major cities in 1974, save for New York City, and concluded:

> That a major factor has been strong financial management by most major cities. The report of the Advisory Commission on Intergovernmental Relations, *City Financial Emergencies*, pointed out that "sound financial management stands out as a key element to the prevention of financial emergencies in local government." A main component of financial management is balancing cash receipts and expenditures on an annual basis. It appears that as fears about the national economy have become widespread, city financial officials have aggresively moved to balance their receipts and expenditures and to maintain a good cash position. It is significant to note, that when receipts are compared to expenditures . . . the average increase in revenues of 9.3 percent from the prior year exceeded the 7-percent increase in expenditures. Thirteen of the 30 cities reported receipts increasing faster than expenditures in 1973–74.[21]

The studies cited above and widespread press reports of city budget cutbacks document the rapid fiscal retrenchment of most State and local governments. However, the unfolding spectacle of New York City's excesses, the resulting closure of the bond market to it, and the city's public humiliation as a supplicant for Federal help brought

---

[18] P. 56.
[19] *Ibid.*, p. 4.
[20] *Ibid.*, p. 4, pp. 59–73.
[21] Philip M. Dearborn, Statement before House Committee on Government Operations (July 15, 1975), p. 4.

on a wave of public concern over the financial conduct of State and local governments and, particularly the large cities. A municipal bond market, already sensitive to quality considerations and struggling with a tide of new issues in the face of limited investor demand, became obsessed with the need to search out and discover other "New Yorks." As a result, pronounced size, location, and credit quality premiums began to appear in municipal interest costs, rippling out across the country from the desperate situation of the financial markets in New York State. These are discussed in subsequent chapters of this paper.

Chapter IV. THE IMPACT OF CHANGING MONETARY CONDITIONS

The municipal bond market is influenced by many forces beyond the immediate control of State and local governments. Major determinants of the demand for, supply and cost of borrowed capital are changing monetary conditions as influenced by the monetary and fiscal policies of the Federal Government. Monetary policy, through its impact on the level of interest rates and on the behavior of commercial banks—the prime investors in municipal bonds for the last 15 years—has a significant impact on bond sales and capital outlays by States and localities. Fiscal policy likewise works through a host of specific revenue and tax measures, as well as through the total balance of receipts and expenditures, to influence the overall level and composition of municipal borrowing.

As is depicted in chart II, the last decade and a half has witnessed a jolting rise in the cost of borrowing for all sectors, including the municipal bond market. Because of certain peculiarities in its structure, the market for municipals has been subject to greater variability than markets for taxable debt securities.

The impact of changing monetary conditions on State and local governments has been the subject of much research. Numerous studies have documented the response by State and local governments, beginning in the 1950's, to tight-money conditions, by adjusting their financing and spending plans to varying circumstances in the credit markets.

A survey by the Federal Reserve Board plotted the reaction of the State and local sectors to the tight-money intervals of 1966, 1969 and 1970 and its behavior in subsequent periods of relative ease. In both the 1966 and 1969–70 episodes, State and local governments displayed a high degree of sensitivity to interest rates in their borrowing plans and a lesser, but still significant, impact on their capital outlays.[1]

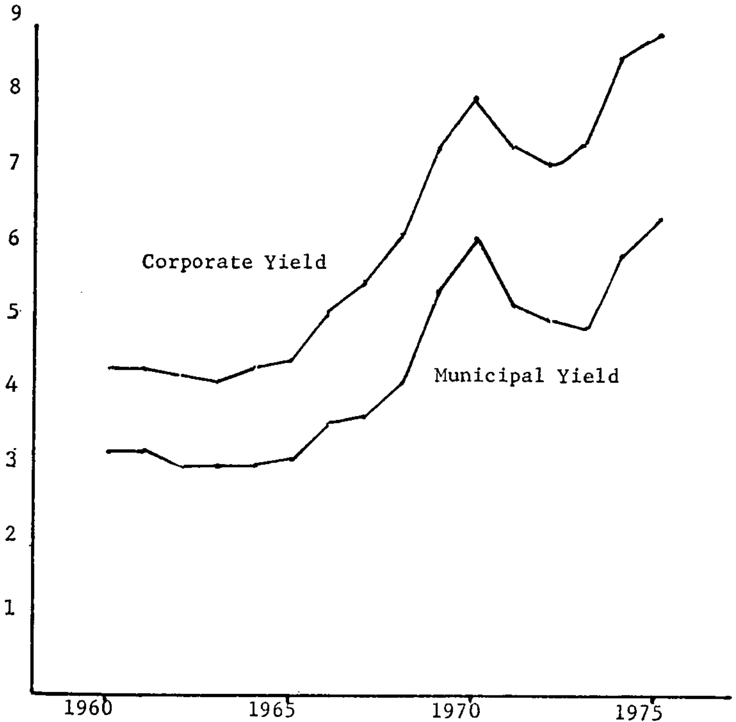
---

[1] It has been estimated that States and localities in 1966 postponed $2.3 billion in bond sales and reduced expenditures by $.7 billion because of high interest costs. In the 1969–70 credit crunch, the then record high interest rates derailed $5.2 billion in bond sales and $1.6 billion in spending. See Paul F. McGouldrick and John E. Petersen, "Monetary Restraint and Borrowing and Capital Spending by Large State and Local Governments in 1966" and "Monetary Restraint and Borrowing and Capital Spending by Small Local Governments and State Colleges in 1966," *Federal Reserve Bulletin* (July and December 1968). See also John E. Petersen, "Response of State and Local Governments to Varying Credit Conditions." *Federal Reserve Bulletin* (March 1971) and Harvey Galper and John Petersen, "Strengthening the Municipal Bond Market," pp. 7–8.

CHART II

Corporate and Municipal Aaa Bond Yields
Annual Averages: 1960-1975 Est.

Percent
Interest



Source: Moody's Investor Service.

Essentially, studies found that while all governmental units reacted to tight credit by postponing long-term financing, the effect on spending plans varied directly with size and available financing alternatives. Small units, in particular, displayed both the greatest tendency to persevere in selling bonds, and if unable to do so, the highest propensity to sack spending plans. But most governments were able to keep their spending plans on track by a combined use of short-term borrowing and running down financial assets. Subsequent to the tight money bouts, State and local borrowers rebounded impressively in late 1971 and 1972, issuing more than $23 billion in long-term debt and making up for repressed borrowing needs.[2]

[2] Paul Schneiderman, "Planned and Actual Long-Term Borrowing by State and Local Governments," *Federal Reserve Bulletin* (December 1971).

Conditions remained relatively relaxed in the tax-exempt market through 1972 and 1973, as the annual volume of long-term borrowing reached a temporary plateau of between $22 and $25 billion. Certain changes were taking place, however. Short-term borrowing continued at high levels as many issuers and investors felt liberated from earlier inhibitions against sustained short-term indebtedness. Also, as has been reviewed in detail, new uses of tax exemption generated a growing supply of revenue securities, many of very long maturity. On the investor side, the large banks began to cut back on their holdings of municipal bonds. Their lessening interest went largely unnoticed, however, as smaller or country banks stepped up their purchases and fire and casualty companies gave strong support to the long-term revenue bond market.

Another important development in the financial picture of State and local governments was the reversal of strong growth in capital outlays in the 1960's. The growth in fixed capital formation by the sector dropped from about 10 percent a year in 1965–68 to only 4 percent between 1968 and 1972.[3] Several factors contributed to the decline in capital formation, including the higher level of interest rates, the shifting of priorities to current operating outlays for social welfare programs, and the generally lessened need for capital equipment.[4] Furthermore, growth in Federal funds for capital projects was erratic and slower than that in other forms of Federal assistance because of impoundments by the Federal Government.

While capital spending perked up somewhat under the influence of Federal revenue sharing and increases in categorical assistance in 1973, there was growing evidence that State and local gross capital formation in real terms was not keeping up with a severe inflation in prices. Between 1968 and 1973, real capital formation was estimated to have dropped at a rate of 2.5 percent a year. In 1974, a sharp recovery in capital spending took place under the impetus of revenue sharing, the freeing of impounded Federal assistance, and the receptive bond markets of 1973 and early 1974. However, early estimates for 1975 indicate that tight bond markets, a leveling of Federal grants, and widespread stringency in the financial condition of State and local governments kept capital expenditures from growing to any noticeable extent in that year.[5]

Several econometric studies have explored the question of the impacts of both interest rates and Federal grants as determinants of State and local expenditure, revenue, and borrowing decisions. While such studies can be confounded by rapidly changing conditions and changes in behavior, they enjoy the benefits of specificity and quantification.

Turning first to the relationship between State and local borrowing and capital spending decisions, several investigators have found that rising interest rates decrease bond sales and, to a lesser extent, construction outlays. While experts differ on ways to estimate this effect, it appears that an elasticity of 0.4 to 0.6 (i.e., a 10 percent

---

[3] Paul Schneiderman, "State and Local Government Gross Fixed Capital Formation: 1958–73," *Survey of Current Business* (October 1975), p. 18.
[4] *Ibid.*, p. 19.
[5] *Ibid.*, p. 26.

change in the interest rate involves a 4 percent to 6 percent change in the opposite direction in the gross new supply of bonds) is about in the middle of the range.[6] The sensitivity of State and local construction outlays to interest rates has been the subject of recent studies. These indicate a fairly high sensitivity to rising rates, with a negative elasticity in the order of −1.0 that over time diminishes to an equilibrium value of approximately −0.2.[7]

One recent review of the impact of the New York City crisis on the bond market and capital spending has estimated that sustained interest rate increases of 60 to 100 basis points would decrease total State and local construction expenditures on the order of $3½ to $4½ billion in 1976.[8] Spending cutbacks in response to high interest rates are predicted to reduce total GNP by $5–$9 billion.[9]

---

[6] See Harvey Galper and John Petersen, *op. cit.* (1972).

[7] See Edward Gramlich and Harvey Galper, "State and Local Fiscal Behavior and Federal Grant Policy," Brookings Paper on Economic Activity I (1973), pp. 30–36. These elasticity values are somewhat higher than those found in the Federal Reserve Board studies.

[8] Edward Gramlich, "The New York City Fiscal Crisis: What Happened and What Should Be Done?" A paper presented to the American Economic Association Meetings, Dallas (December 1975), p. 21; F. G. Adams and J. N. Savitt, "Macroeconomic Impact of New York City Default," *Debt Financing Problems of State and Local Government: The New York City Case,* Hearings before the Subcommittee on Economic Stabilization of the Committee on Banking, Currency, and Housing, U.S. House of Representatives, 94th Cong., 1st Sess., II (Oct. 23, 1975), p. 1568.

[9] Gramlich, *ibid.*, p. 21, and Adams and Savitt, *ibid.*

Chapter V. CHANGING PATTERNS IN THE DEMAND FOR MUNICIPAL BONDS

The municipal bond market is part of the larger private capital market where governmental borrowers compete for the investment funds of private investors. In this competition for funds, municipal securitries are sometimes more successful than others and the degree to which they are depends greatly on the resources and appetite of those investor groups that find tax exemption of advantage. But factors other than tax shelter condition the market's demand for municipal bonds. Investors must weigh available tax-exempt yields against an assortment of risks to their funds that are committed, including the possibility that borrowers may default or that securities will drop in value for some other reason.

Out of the maze of calculations performed thousands of times each day, the market establishes its price for borrowed money. That price, in turn, enters into the decisions of would-be borrowers when they elect to sell new bond issues or wait for a better day.

Patterns of Investment in Municipal Bonds

The municipal market is distinguished by the nature of the investor and the volatility of his participation. The municipal security has certain appeals. Typically, these have been the attractiveness of tax exemption to those in high marginal tax brackets, the relatively high degree of safety of the investment and the availability of serial maturities. But at the same time, the demand for tax-exempt securitries has become inordinately volatile because the major institutional investors on whom the market relies for support are unusually subject to the pressures of monetary policy, the ravages of inflation, and sudden changes in portfolio policies. Furthermore, the dowdy municipal bond traditionally has been a second and third choice for investor groups, who—unless they envisage a long-term stay in high marginal tax brackets—usually seek out more lucrative and flexible tax shelters.

Records available on the ownership of municipals since 1933 indicate that there have been only three major groups of investors in municipal bonds: individuals, commercial banks, and insurance companies. Their combined holdings have constituted between 70 percent to 90 percent of all municipal bonds outstanding over the past 35 years.[1]

The exemption of municipal bond interest from Federal and many State and local income taxes is its greatest attraction to investors and shapes the market for municipals. Generally, investors in high marginal tax brackets have found it worthwhile to buy municipals, so long as the after-tax return is better than, or at least as high as, that on

---

[1] Unless otherwise indicated, the financial statistics in this section are taken from the Board of Governors, Federal Reserve System, *Flow of Funds Accounts 1945–72* (August 1973) and *Flow of Funds*, 3rd Quarter 1975 (November 1975).

taxable investments of similar quality. By the same token, investors who pay little or no taxes (pension and life insurance companies) have exhibited little interest in municipals.

In the period immediately following World War II, municipal bonds were a favorite form of investment by commercial banks, which, with lots of government securities and little loan demand, found themselves in a very liquid position. As the supply of municipal bonds expanded during the 1950's, commercial bank participation in the market began to fluctuate in a manner that was to become an important feature of the market. The household sector replaced banks as the dominant buyer in the 1950's; increasing support was also given by State and local retirement funds and insurance companies.

Higher rates of interest for tax exempt compared to taxable securities had an equally significant impact on the composition of the market for municipals. Under the pressure of a greater bond supply, the ratio of tax exempt to taxable yields went up from 60 percent for AAA bonds in 1950 to 72 percent by 1955 and about 75 percent by 1960 and 1961. For the lower grades the relative escalation was even worse, as the ratio of tax exempts to taxable bonds reached levels higher than 80 percent in the mid-1950's.[2]

Looking retrospectively at the 1950's, one notes that the rate of increase in outstanding municipal debt was a spectacular 12 percent per annum between 1949 and 1960 (at a time when a prices were rising only 4 percent a year). During the same interval, commercial bank deposits increased annually at only 6 percent, while bank loans rocketed upward at 10 percent per annum, as banks increased their loan to deposit ratios and gradually ran down their massive holding of U.S. Government securities.

Beginning in the early 1960's the municipal bond market entered a new and more favorable phase of investor participation. The essential elements were a greatly increased interest by commercial banks, which almost swamped the investment behavior of the market, fairly stable albeit relatively minor support from fire and casualty insurance companies, and sporadic—but in time very important—support from the formerly dominant household sector. The market was virtually abandoned by the other investor groups, notably life insurance companies and public pension funds.

These changes are reflected in the ownership figures for the last 25 years which are presented in table 5. As may be seen, between 1960 and 1970, banks acquired two-thirds of all the net new supply of municipal bonds, increasing their holdings to almost one-half of all outstanding municipals. This offset much more modest growth in household and fire and casualty company holdings and a net decline in municipals owned by all other investor groups.

Table 5, however, does not reveal an important characteristic of the tax-exempt bond market that emerged in the 1960's: the rapid ebb and flow of commercial bank purchases and offsetting investment of the household sector. Careful inspection of table 5, which gives annual net purchases of municipal bonds for the key investor groups from

---

[2] John E. Petersen, *The Rating Game,* The Twentieth Century Fund (New York: 1974), p. 36.

1960 through 1975, shows a fascinating contrapuntal motion between changes in bank holdings and those of the household sector. The relationship is particularly evident in the tight credit years of 1966, 1969, and 1974–75. Looking at 1970–75, both tables 5 and 6 indicate a rapid slowdown of commercial bank investment in municipal bonds since 1971 and the increasing importance of individuals and fire and casualty companies. In the last 2 years, in fact, the household sector has absorbed 60 percent of the net new supply of municipal bonds.

TABLE 5.—OWNERSHIP OF STATE AND LOCAL SECURITIES, 1950–75

[Dollar amounts in billions]

	1950		1960		1970		1975[1]	
	Amount	Percent of total	Amount	Percent of total	Amount	Percent of total	Amount	Percent of total
Banks	$8.2	32.6	$17.7	25.0	$70.2	48.0	$102.0	45.7
Individuals	10.0	39.6	30.8	43.5	47.4	32.5	72.3	32.4
Fire and casualty insurance	1.1	4.4	8.1	11.5	17.8	12.2	33.7	15.1
Others	5.9	23.4	14.2	20.0	10.8	7.3	15.2	6.8
Total	25.2	100	70.8	100	146.2	100	223.2	100

[1] Estimate are the authors.

Source: Federal Reserve Board, "Flow of Funds."

TABLE 6.—ANNUAL CHANGES IN HOLDINGS OF MUNICIPAL BONDS 1960–75 (ESTIMATE)

[In billions of dollars]

Year	Commercial banks	Fire and casualty insurance companies	Households	Other	Total change
1960	0.7	0.8	3.5	3.0	5.3
1961	2.8	1.0	1.2	1.0	5.1
1962	5.7	.8	−1.0	−.1	5.4
1963	3.9	.7	1.0	.1	5.7
1964	3.6	.4	2.6	−.6	6.0
1965	5.2	.4	1.7	0	7.3
1966	2.3	1.3	3.6	−1.6	5.6
1967	9.1	1.4	−2.2	−1.5	7.8
1968	8.6	1.0	−.8	.7	9.5
1969	.2	1.2	9.6	−1.1	9.9
1970	10.7	1.5	−.8	−.1	11.3
1971	12.6	3.9	−.2	1.3	17.6
1972	7.2	4.8	1.0	1.4	14.4
1973	5.7	3.9	4.3	−.2	13.7
1974	5.5	1.8	10.0	.1	17.4
1975[1]	2 2	2.2	10.0	1.0	16.2

[1] Estimates are the authors.

Source: Federal Reserve System, Board of Governors, "Flow of Funds."

COMMERCIAL BANKS

Over the last 15 years, changes in commercial bank behavior have dominated the course of the municipal bond market. Besides being attracted during the 1960's by tax exemption, banks experienced a rapid growth in assets, changed their attitudes and strategies toward portfolio investments, and developed new techniques for managing their liabilities. The end result was that while bank assets increased at an

annual rate of 8.3 percent during the decade of the 1960's (while GNP grew at 6.8 percent), bank holdings of municipal bonds grew at an annual rate of 13.7 percent. Municipal bonds grew from 7 percent of bank investments in 1950 to 22 percent in 1960 and finally peaked at 51 percent of portfolios by 1972. Banks thus were able to finance 70 percent of the growth in municipal debt between 1959 and 1969.

Although the market had its difficulties in periods of credit stringency, the huge appetite of the banks was a boon to the nimble borrower and municipal bond yields relative to those on taxable securities were at their best levels of the postwar period. The 1960's was a time of relatively sustained prosperity. With deposits growing more rapidly than loan demand in the early years of the decade, banks sought municipals as a profitable outlet for funds. Toward the end of the 1960's, banks came under increasing reserve pressure on occasion (notably in 1966 and 1969). But rather than keeping large stocks of short-term securities, they found it more profitable to run off their U.S. Governments and to meet their liquidity needs by promoting purchase of their liabilities, particularly through the sale of marketable certificates of deposit.[3]

Shorter term municipal bonds were also increasingly relied upon to meet cash needs.

As the 1960's wore on, banks became increasingly aggressive bidders for time deposits and, as the cost of these increased, so did their interest in municipal bonds. Reportedly, banks came to depend more on purchases of longer-term and lower-grade municipals in an effort to improve their current income.[4] The recurring tight-money periods toward the end of the 1960's, however, encouraged prudence and banks began to increase their holdings of short-term municipal notes. With the switching out of U.S. Governments and the liquidity binds that maturing CD's could create, the investment in municipal securities became an increasingly important form of liquidity.[5] Banks in the 1960's had other reasons to find municipals more attractive than did other investors. Perhaps the most significant was the banks' privilege—not shared by individuals—of deducting the interest cost of funds borrowed to acquire tax-exempt securities. Thus, as interest costs on deposits rose, banks were motivated to increase their holdings of tax-exempt bonds.[6]

By the early 1970's it was obvious that the powerful thrust of bank support in the municipal bond market had certain one-shot qualities.[7] During the 1960's banks had switched heavily into municipals and out of U.S. Governments, the latter falling from 31 percent of total assets to 13 percent by the end of 1970. This seemed to be a dangerously low level of liquid securities for banks, making them too dependent on their ability to sell increasingly expensive short-term liabilities to meet cash

---

[3] Robert Huefner, *Taxable Alternatives to Municipal Bonds*, Research Report No. 53, Federal Reserve Bank of Boston (1972).

[4] *Ibid.*

[5] *Ibid.*, p. 159.

[6] Brian J. Fabbri, *Commercial Bank Investments in the Postwar Period* (New York: 1975), p. 27.

[7] See Frank Morris, statement before the Committee on Ways and Means, U.S. House of Representatives, Panel No. 8, *An Alternative to Tax-Exempt State and Local Bonds* (February 1973), p. 29.

needs. Further, bank appetite for tax-exempt bonds was being dulled by availability of other tax shelter vehicles. Most notable has been increased use of direct leasing operations, which grew from almost nothing in 1963 (when it was authorized for commercial banks by the U.S. Comptroller) to $790 million in 1970 and then exploded to $2.4 billion by the end of 1974.[8]

In addition, banks have rapidly expanded foreign operations. In the last 10 years, these have grown 16-fold to the point where they now represent nearly 20 percent of total bank assets. Foreign assets reportedly contributed more than 40 percent of the total 1974 earnings of the 10 largest banks.[9] Domestic banks are permitted to take a foreign tax credit against domestic taxes and also, in the case of foreign subsidiaries, are permitted to defer taxes on income until it is repatriated.

Both leasing and foreign income operations require large amounts of capital and are therefore most attractive to the largest banks. And, not surprisingly, it is those banks that have displayed the least interest in municipals since 1970. In fact, bank support for the municipal bond market has come almost exclusively from the smaller country banks. From year-end 1972 through 1974, banks with deposits in excess of $500 million actually ran down their holdings of municipals, while banks with deposits of less than $100 million increased their holdings by $7.2 billion or 75 percent of the total increase in bank holdings during the period.

Another factor that has influenced bank demand, but one that is changing, is the need for securities to act as collateral on public deposits, a practice known as pledging. Typically, U.S. Government and municipal securities have been used for this purpose and, as public deposits grew, so did the demand for these instruments. For many banks, the volume of pledged assets has reportedly represented up to 75 percent of their security portfolio, and it has been estimated that the share of pledged securities grew from 22 percent of total bank investments in 1959 to nearly 40 percent in 1974.[10]

In 1975, legislation was passed that raised the level on Federal insurance on public time deposits from $10,000 to $100,000. Since such insurance usually suffices for a pledge, this action has probably diminished the demand for municipals for this purpose.[11]

The most recent development in bank investment policy has been the major shift into short-dated U.S. Government securities during the present cyclical contraction, a time that used to favor municipal purchases. Increasingly concerned about liquidity and quality and less sanguine about aggressive liability management, banks have largely forsaken the municipal bond market to finance the Federal deficit and to stand by for the rise in loan demand which recovery is expected to bring.

---

[8] Fabbri, *op. cit.*, p. 31. Leasing is extremely profitable in that it permits not only higher income than normal loan charges, but enjoys the tax advantage of the investment tax credit permitted of the purchased equipment to be leased and its accelerated depreciation.

[9] *Ibid.*, p. 32.

[10] *Ibid.*, p. 5.

[11] See John Petersen, "Pledging Requirements and Full Insurance of Public Deposits," *Analysis*, Municipal Finance Officers Association (1974). The effects of the change in the level of deposit insurance are being examined in a study by the Advisory Commission on Intergovernmental Relations.

Summarizing the recent developments in bank demand for tax-exempts, one commentator has observed:

From the issuers' point of view, the increased portion of their debt taken down by banks increases their financing exposure disproportionately to the vagaries of restrictive monetary policy. In addition, as larger banks continue to expand their leasing and foreign branch banking activities, their needs for tax-exempt income derived from state and local securities will diminish. This further restricts state and local governments into a more concentrated market for their debt financing, since funds will be provided by only the medium and small size banks, and thereby increases their market risks.[12]

Fire and Casualty Insurance Companies

The only other consistently important institutional investor in municipal bonds is the fire and casualty company sector. Though much less important than the banks, the growth in buying interest of fire and casualty companies has been relatively stable over the long run. It too displays variability from year to year, however, that can either offset or reinforce the demand of banks.

Fire and casualty companies' investment in municipals is affected both by the availability of investible funds and by their needs for tax shelter. Generally, these companies buy tax exempts only when they need to shelter profits that otherwise are taxable at the full marginal corporate rate. Their acquisitions have been shown to be sensitive to changes in policyholders' surplus.[13] When industry profits are declining, the companies will generally shift to taxable bonds. From time to time, they also acquire equities, which is their alternative tax shelter to tax exempts. Last, their investment demand can be subject to drastic fluctuations due to large claims generated by disasters against which they have insured.

Fire and casualty purchases are especially important to the longer end of the municipal bond market, and, frequently, in lower-rated revenue bond issues, since insurance companies buy for yield rather than liquidity. In the early 1970's, these companies were unusually active in the municipal bond market, as they acquired nearly 30 percent of net new issues. (See table 6.) However, as a result of galloping inflation and its impact on claim levels and the inability to raise premiums, the fire and casualty industry has been depressed by operating losses.[14] Both their overall acquisition of assets and their demand for municipal bonds have consequently dropped drastically. Prospects for rapid recovery in the sector are poor, so it is unlikely that their investment demand, apart from occasional spurts, will become proportionately greater.[15]

Households

The household sector, while diminishing in importance as an investor in municipal bonds over the past 20 years, has continued to play

---

[12] Fabbri, *opp. cit.*, p. 33.
[13] Huefner, *op. cit.*, pp. 172–74.
[14] Salomon Brothers, "Fire and Casualty Industry—Earnings Review" (Dec. 5, 1975).
[15] *Ibid.*, p. 4.

a vital role in the market. Historically, it has picked up the slack when institutional demand has ebbed for tax exempts. At such times—generally, when money is tight—rates on municipal bonds have increased faster than rates on taxable securities, and individual investors have become very important in supplying funds to the market.

The household sector is, in fact, a conglomeration of investor groups. It is the residual after known institutional holdings are subtracted from the total stock and flow figures collected by various regulatory agencies. As such, the household sector consists of individual investors, personal trusts, unincorporated business holdings of bond funds, and discrepancies. Individual investors are thought to own directly about half of the household sector's holdings of tax exempts, with trusts and bond funds accounting for the other half.[16] Information on this investor group is scanty because there is no direct regular reporting of individual holdings of municipals (a factor that probably contributes to demand from more secretive investors). But there is no evidence to controvert the widely-held and traditional belief that most individual owners are wealthy, high-income individuals who acquire fixed-income securities because they are a relatively safe form of tax shelter. However, for certain issues and at times when municipal bond yields are high, a cadre of smaller individual investors interested in high returns at the sacrifice of some liquidity and risk probably swings into the market. The advent of the tax-exempt bond fund has also made the market more accessible to the smaller investor of moderate means.[17]

Information on the economic status and market behavior of individual investors may be derived from several sources; none, unfortunately, is of recent origin.[18] However, it is clear that although individual holdings of municipals are relatively important to the tax-exempt market, they represent a small and relatively stable share of individual holdings of financial assets. As table 7 shows, municipal bonds have represented about 3 percent of wealth of the household sector over the last 25 years. This is in contrast to stock ownership, of which the relative proportion rose to more than 40 percent in 1960 and fell to 25 percent in 1974.

Recent studies indicate that municipal bond ownership, while covering a spectrum of income levels, is highly concentrated in the upper-income brackets. The average marginal tax rate for municipal bond owners has recently been estimated to be approximately 55 percent. Evidently, about 70 percent of municipal bonds held by households are owned by units with incomes of $50,000 or more.[19]

Furthermore, because inflation pushes investors into higher marginal tax brackets as nominal income rises, it can be expected that tax-exempt holdings will increase in the highest marginal tax brackets simply because more taxpayers find themselves there.

---

[16] Petersen, *Rating Game*, p. 68.
[17] See Huefner, *Taxable Alternatives*, pp. 168–170.
[18] *Ibid.*, pp. 57–58.
[19] Harvey Galper and George Peterson, "The Equity Effects of a Taxable Municipal Bond Subsidy," *National Tax Journal* (December 1973), p. 617.

TABLE 7.—MUNICIPAL SECURITIES AND CORPORATE STOCKS AS A PERCENTAGE OF HOUSEHOLD FINANCIAL ASSETS

[1950–74]

Year	Percentage of financial assets	
	Corporate stock	Municipal bonds
1950	30.9	2.9
1960	40.9	3.2
1970	38.2	2.4
1974	24.0	2.8

Source: Federal Reserve Board, "Flow of Funds."

Some analysts contend that this "bracket effect" will be of growing importance to municipal investment by individuals and might meet the future demand for municipals.[20] However, there is no evidence that it has been a significant part of total household demand to date.

[20] A. W. Sametz et al., "The Financial Environment and the Structure of Capital Markets in 1985," Graduate School of Business, New York University, Paper No. 24 (n.d.), p. 25.

Chapter VI. GROWING CONCERNS OVER CREDIT QUALITY AND INFORMATION

Throughout 1975, the municipal bond market experienced an erosion in credit quality. That is to say, the market began to worry about debt being repaid and, accordingly, began to demand higher rates of interest on borrowings and, in some cases, was unwilling to muster any bids at all for certain borrowers. Of course, other factors were depressing municipal bond demand. Still, the bulk of recent evidence indicates that the market was turning a sharp and, for most governments, an expensive corner in its perception of the risk associated with municipal debt.

Credit crises of the Urban Development Corporation and New York City led to financial turbulence in the municipal bond market, and borrowing costs rose significantly in 1975 for some units. Front-page examples of the erosion in credit quality were New York State and its agencies and localities, as well as other large cities and various agencies.

At the same time, it was also clear that since not all borrowers faced the same suspicions in the market, the cost of waning confidence was not affecting all borrowers equally. In fact, some observers argued that borrowers with high quality credit standing might even have benefited by the flight of funds from lower-grade credits.

A review of the trend in bond rates prior and during the New York debacle left little doubt that, whatever the specific reasons, the capital market was casting an increasingly jaundiced eye on the borrowings of State and local governments. Interest rates rose throughout 1974 and, after a slight drop in spring 1975, displayed a volatile and uncertain rise through June 1975. Thereafter, the rise in yields accelerated through the third quarter and remained near their October highs for the remainder of the year.

These general movements in interest costs reflect several forces at work in the tax-exempt market and, indeed, in all the capital markets. These include the credit crunch and associated bank liquidity crises that peaked during the third quarter of 1974; the rapid deterioration of the economy in late 1974; the emerging fiscal pressures on State and local governments in 1974 and 1975; and, in the latter stages, a growing fear of the consequences of default by the two largest municipal borrowers—the city and State of New York.

Such conditions make it difficult to identify a specific date signalling a distinct erosion in market confidence about municipal credit quality. However, from the present vantage point, it seems that the first offering of the Municipal Assistance Corporation (M.A.C.) bonds to assist the city of New York at the beginning of July was a pivotal event. Hopeful of persuading private capital to provide $3 billion in 3 months, the municipal market quickly acknowledged that its capacity

to absorb M.A.C. debt was practically exhausted by the first batch of $1 billion.

It became evident that there would be no solution short of default without the involvement of the Federal Government and the market slid even deeper through the fall of 1975.

When New York's problems reached the Congress and the question of what to do about them became a national issue, greater attention was given to the city's relationship with the deteriorating municipal bond market. Rapidly rising costs of borrowing for all, and astronomical interest charges for some, began to focus the attention of many on the market's general woes. Moreover, it was clear to many that, whatever might be the longer term consequences of a default for the city and State of New York, the market was discounting such a possibility. The impact of this process on the market as a whole seemed serious enough to justify helping the sick borrowers simply to keep the contagion of weakening confidence from spreading throughout the municipal bond market.

Several attempts have been made to gage the costs of the New York syndrome to the rest of the municipal bond market. Early estimates were hampered by lack of data and procedures to make allowances for other factors that were also changing. Nevertheless, even casual review of bond sales and interest rate indices showed that borrowing costs were rising severely, particularly for those borrowers in the lower rating categories. However, a reasonably comprehensive statistical study released early in November 1975 provided much evidence that not only were interest costs rising for municipal borrowers throughout the country, they also were displaying strong regional and credit quality differentials.[1] The study estimated that, using the pattern of interest rate impacts present in the third quarter, the deterioration in investor confidence was producing added interest costs for State and local governments on the order of $150 million per year. Because the debt sold under such conditions would be outstanding for a period of years, the total additional costs would sum to approximately $1½ billion over the lifetime of the bonds.[2]

The incremental costs, moreover, were not spread uniformly throughout the Nation. The study estimated on the basis of a large cross-section sample of sales that the increase in borrowing costs in the third quarter of 1975 ranged from a relative small one-tenth of one percentage point in the North Central region to approximately one-half of a percentage point for New York State localities (other than New York City) and borrowers in other Middle Atlantic States.[3] Even more startling than the increases in bond yields were the upsurges in short-term interest rates, which the study estimated were hiking annual short-term borrowing costs by $200 to $300 million, with most of the effect concentrated in the Northeast.[4]

In another recent study, Edward Gramlich used regression techniques to measure the interest rate difference between yields on munici-

---

[1] Forbes and Peterson, "Costs of Credit Erosion," *op. cit*

[2] *Ibid.*, p. 15.

[3] *Ibid.*, p. 8.

[4] *Ibid.*, p. 17.

pal and corporate bonds of the same rating.[5] He then calculated that the interest rate spread between like-rated corporate and tax-exempt bonds had narrowed in 1975 much more than historical experience would have suggested. For the first three quarters of the year, Aaa tax-exempt rates were estimated to be 13 basis points higher than predicted while those on Baa bonds were 74 basis points higher. Concentrating on the third quarter, Gramlich found a weighted average increase in yields on municipals of more than 60 basis points. While it would be an extreme assumption to attribute all of this impact to the New York crisis, it is clear that a massive erosion in credit confidence had taken place and that the great majority, if not all, municipal borrowers were suffering from increasing exactions for risk.

Demand for More Information

Worries about fiscal condition of borrowers had several sources. An important part of the speculation stemmed from concern over the quality and timeliness of information about governmental finances and how to interpret financial statistics, once having acquired them from governmental borrowers. This concern was not limited to the citizen-layman, but also infiltrated the highest circles of the national political and financial community. The fact was that after years of disinterest, the reading and understanding of public financial statements took on an immediacy and importance it had not had for 40 years. As the long prosperity of the post World War II era had gained momentum, investment bankers and investors became less interested in the particulars of municipal financial statements and delegated the examination of credits to a small coterie of experts and, in particular, to the nationally recognized rating agencies of Moody's and Standard & Poor.[6]

Aside from periodic squabbles with issuers who thought they deserved higher ratings—especially New York City—the municipal bond market and the public at large seemed content to see ratings gain influence. It was, after all, an economical and easily understood system. Besides, the impact of ratings and interest cost differentials, while significant, declined throughout the past 2 decades as the market's memories of Depression defaults dimmed.

Nevertheless, occasional fears were expressed that there was not enough current information about financial conditions and that the agencies, while meeting the market test for information, could not and should not be expected to do the job for everyone. A major complaint was that the ratings conferred were essentially public property, being purchased by the issuers, but the criteria used to assign them were not.[7]

Aside from greater disclosure of how ratings were constructed, the other suggestion most often heard has been to establish a national clearing house of information on State and local financial information.[8] But even were such an entity to exist, there remains the problem

[5] "The New York Fiscal Crisis, *op. cit.*, p. 20.
[6] For a recent examination of the credit rating agencies, their influence on the market, and proposals for change, see Petersen, *The Rating Game, op. cit.*
[7] *Ibid.*, p. 8.
[8] *Ibid.*, pp. 14–18.

of timeliness, uniformity, and completeness in gathering financial data. Obviously, the optimal solution to these problems depends upon the use to which the information will be put.

State and local governments are capable, as are most organizations in the age of the computer, of generating enormous supplies of data. The questions of both how and what data should be provided to meet the analytical needs of the financial markets is the subject of at least one research effort, that being conducted by the Municipal Finance Officers Association. With an estimated 40,000 State and local entities having 120,000 outstanding bond issues and 8,000 new bond and note sales occurring each year, the problem will not easily be solved.

With the current mood of caution and uncertainty, the municipal bond market has displayed increasing wariness of all municipal borrowers and, by latest reports, a disposition to shun or heavily penalize those that might be suspect. In the absence of "enough" facts and confidence in how to analyze them, it now appears that rumors might suffice to discriminate among credits.

To complicate an already muddled situation, two other events unsettled the municipal securities industry at the end of 1975: New, less restricted Federal bankruptcy laws were progressing through Congress and the industry was brought under regulation, from which it had been previously exempted. The proposed amendments to the Federal Bankruptcy Code, coupled with the moratorium on certain New York City notes that was enacted by the State of New York, reinforced doubts about the ability of some governments to pay, with misgivings about their continuing willingness to pay their debts, when presented with the option of going into bankruptcy. Promoted as part of the New York City assistance package, the bankruptcy measure sped through the House and Senate in December amid warnings that its enactment would cause many investors to lose further confidence in general obligation bonds in particular. As of the end of 1975, the bankruptcy legislation still had not been subject to a final vote in Congress.

Municipal Bond Market Regulation and Disclosure

Another element of uncertainty in the municipal bond market has been the passage of the Securities Acts Amendments of 1975, which were signed into law on June 5, 1975. These amendments extended regulation to the municipal bond market under the Federal securities laws. The new municipal regulation calls for registration and regulation of municipal security dealers by the newly-created municipal securities rulemaking board. Prior to passage of the amendments, brokers and dealers doing business solely in municipal securities were not subject to regulation by the Securities and Exchange Commission or any other regulatory agency of the Federal Government. Now the rulemaking board has the responsibility for developing regulatory provisions, subject to SEC oversight.[9]

As the central authority in what is basically a system of industry self-regulation, the 15-member municipal securities rulemaking board

[9] John Petersen and Robert Doty, "Regulation of the Municipal Securities Market and Its Relationship to the Governmental Issuer," *Analysis*, Municipal Finance Officers Association (December 1975).

has very broad powers for establishing periodic examination and inspection programs, recordkeeping requirements, and rules to assure fair market practices. Yet, while the board has power to adopt rules, the SEC retains the ultimate authority to delete or amend such rules or to compel adoption of new rules, if necessary.

Under the amendments, governmental issuers retained their exemption from the registration requirements of the Securities Act of 1933 and from the registration and reporting requirements of the Securities Exchange Act of 1934. Of particular importance, neither the SEC nor the board can require an issuer of municipal securities to file information prior to the sale of securities. In addition, the board cannot require an issuer to furnish information on itself, either directly or indirectly through a municipal securities dealer or otherwise. (The board can require dealers to supply only such information about issuers that is generally available from a source other than the issuer.[10])

However, the Senate report on the legislation noted that, although the new law would not permit direct or indirect requirements for review of issuer documents prior to sale, they remain subject to antifraud provisions: "The bill assures that access of State and local governments to the capital markets will not be regulated in ways not now permitted under the fraud provisions of the Federal securities laws." [11] Thus, from the perspective of the governmental issuer, the exemptive amendments in the Securities Act Amendments of 1975 are of only limited effect. Despite these amendments, the antifraud provisions of the Federal securities laws still apply to offerings and other transactions in municipal securities. Consequently, issuers had and are still meant to have an obligation under the Federal securities laws not to misstate or omit material information.[12]

The objective of the issuers' exemption was to preserve existing practice and responsibilities in the municipal bond market for provision of information. However, with the eruption of the New York Urban Development Corp. note default in March and the emerging crisis in New York City, dealers began to believe that some control over credit information might be needed. As a result, they objected to some of the exceptive language.[13] But these objections came late, and the nature of these controls was never broached in the hearings on municipal regulation.

Recently, amid the national focus on New York City and its financial practices, several critics have called for regulation of information provided by issuers.[14] Proposed approaches have been registration of municipal securities under the Securities Act of 1933, or repeal of exemptions under the 1934 act to permit regulation of issuer information by the rulemaking board.[15] Another proposal has been the creation of a new regulatory scheme or body made up of issuers to deal with governmental disclosure problems, probably under the Federal

---

[10] Section 15B(d) (1) and (2) of the 1934 Securities and Exchange Act.

[11] Senate Report No. 94–75: Securities Act Amendments of 1975 (April 1975), p. 47.

[12] The antifraud provisions include Section 17 of the Securities Act of 1933 and Section 10(b) of the Securities and Exchange Act of 1934.

[13] Committee on Interstate and Foreign Commerce, House of Representatives, Hearings on H.R. 4570 (March 1975).

[14] Robert J. Cole, "Holding Municipal Bonds up to the Light," *New York Times* (Oct. 26, 1975), Section 3, p. 1.

[15] Bills to this effect were introduced by Senator Eagleton and Congressman Van Deerlin. SEC Commissioner Arthur Sommer and Treasury Secretary William Simon have also indicated the need for legislation in this area.

securities laws, or some form of regulation on a voluntary basis.[16] In the absence of such regulation, the main discipline is provided by the market, reinforced by state laws, to enforce the acceptance of standards of disclosure and diligence procedures that underwriters and others would require of governments in order for them to sell securities.[17]

At the heart of the current disclosure problem is the uncertainty surrounding legal liability of bond dealers for existing antifraud provisions. The two forces converging are the evolutionary development of the antifraud provisions (that predate the 1975 Securities Amendments) and the fear of large-scale defaults in municipal bonds. Should losses occur, they might give substance to long-standing legal exposures of which securities dealers and others were oblivious when markets were better. In practical terms, regulation of the issuer and a mechanism to promulgate and enforce disclosure requirements would permit dealers at least to identify their duties and legal liabilities for disclosure.

---

[16] See Lennox Moak, statement before Committee on Banking, Housing and Urban Affairs, U.S. Senate (Oct. 9, 1975).

[17] See Petersen and Doty, *op. cit.*, and "Suggested Guidelines for Disclosure and Municipal Bond Offerings," Municipal Finance Officers Association (Nov. 10, 1975, draft).

Chapter VII. FUTURE DEMAND FOR CAPITAL FUNDS

The bulk of State and local borrowing over the next 5 years will be to finance construction of public facilities. As discussed earlier, these governments engage in numerous capital projects, although their share of real capital formation in the economy has declined since 1965. Looking ahead, one must make interlocking assumptions about the real forces of demand for capital goods by State and local governments, how these demands will be constrained by the overall financial resources of governments and, as a result, how much the capital markets will be called upon to finance capital spending through the sale of State and local debt. There are other problems, not the least of which is whether the capital markets, as they seek to match the supply and demand for funds, will have the capacity to absorb desired levels of borrowing at rates of interest that governments are willing to pay.

The problem is complex, but, fortunately, there are studies that give insights on how these factors will interact over the next 5 years to produce relative strain or ease in the tax-exempt bond market. From that analysis one may infer also whether the market must be altered or changed. The conclusions of these studies and assumptions which underlie them are summarized in table 8.

TABLE 8.—SELECTED STATE AND LOCAL GOVERNMENT OUTLAYS AND BORROWING AS ESTIMATED FOR 1980

[Billions of dollars]

Source	GNP	Estimate State and local in 1980			
		Total expenditure	Capital outlays	Long-term borrowing	Total debt
Tax foundation [1]	2,140	326	58.4	35.0	285
Bosworth et al.[2]	2,387	381	66.6	33.0	292
Fortune [3]	2,533	NA	69.1	36.5	NA
Taylor [4]	2,418	373	NA	41.7	351
Ott & Ott [5]	2,428	399	55.0	31.0	NA

[1] Tax Foundation, "The Financial Outlook for State and Local Governments to 1980" (1972). GNP: 8 percent annual growth rate, 1970 to 1980 (p. 25). Expenditure: $320,000,000,000 adjusted by ratio of expenditures as defined by Bureau of Census to that defined by Department of Commerce in National Income Accounts, 1.018 for fiscal and calendar year 1973, respectively (p. 75). Capital outlays, borrowing debt: as preceding the original figures have been adjusted to calendar year by 1973 ratio of 1.008 (pp. 100–101).

[2] B. Bosworth, J. Duesenberry, A. Carron, "Capital Needs in the Seventies" (1975). GNP 9.2 percent annual growth rate 1973 to 1980 (p. 12). Other items are as published (pp. 35, 57).

[3] P. Fortune, "The Financial Impact of the Federal Water Pollution Control Act; The Case for Municipal Bond Reform" (1975). GNP 9.0 percent annual growth. Capital outlays derived from adjustment of construction expenditures by 1.180 (table 3); borrowing calculated from values on table 3 and equations (table 2); $4,500,000,000 in borrowing is for pollution control purposes (table 7).

[4] S. Taylor, "A Financial Background for Project Independence" (1974?. Current dollar GNP 9.2 percent annual growth rate, 1974–80 (table 1); expenditure (table 1), borrowing $25,800,000,000, net flow (table 3) plus $15,900,000,000 long-term debt requirements; debt (table 5).

[5] D. Ott and A. Ott, "State-Local Finances in the Last Half of the 1970's" (1975). Current dollar GNP 9 percent annual growth rate, 1974–80 (p. 91), Expenditures (table 5-2), adjustment to a capital outlay base; borrowing (calculated from equation E.12, p. 28).

PUBLIC CONSTRUCTION IN THE YEARS AHEAD

The nature of State and local public construction will continue to change. The prospect is for continuing reductions in real capital outlays for schools and highways, with moderate growth in other traditional categories and greater emphasis on environment and transit needs. This was the thesis of the recent Brookings study, *Capital Needs in the Seventies*, which called for generally higher levels of State and local capital spending.[1] It is estimated that waste treatment and sewer expenditures (in 1972 dollars) stimulated by the Federal water pollution program, will rise sharply to $5.7 billion in 1977, easing to $5 billion by 1980.[2] Of the total $38.8 billion the study projected to be spent between 1972 and 1980 by State and local governments, a total of $25.8 billion is expected to be financed by Federal grants. In the area of mass transit, the Brookings Needs study foresees nonhighway transit and utility system rising over the next 5 years, stimulated in part by increasing Federal grants.

The Brookings study foresees a continuing growth in total State and local government spending, with capital spending staging something of a comeback through the remaining 1970's. It predicts that construction outlays for waste treatment and mass transit will more than offset slowdowns in school and highway construction, thus increasing total capital spending by nearly 10 percent per year between 1973 and 1980. This would be significantly higher than the 7 percent growth rate of the 1960's [3], and would reverse the decline in real capital spending of the last 6 years.

The accuracy of these projections will depend heavily on available methods of capital financing. Perhaps the most notable feature of the Brookings report is the belief that a large part of increased expenditures will be supported by Federal grants. Federal grants for capital projects are expected to rise faster than other grants (9.9 percent versus 6.2 percent), and they are estimated to support 26 percent of state and local capital outlays by 1980. But grants alone won't do it, and the Brookings study also foresees a growing reliance on additional nondebt financing of funds. As a result, bond sales for capital purposes are anticipated to grow at only 7 percent per annum through the late 1970's, as opposed to the 7.4 percent increase in the 1960's and 11.2 percent in the 1950's. By 1980 it is estimated that bond issues will be supporting 50 percent of State and local capital spending.[4]

The *Capital Needs* projections are unique in their integration of uses and sources of capital funds and their implications for the financial market. A study by the tax foundation also forecasts State and local government spending and borrowing and thus presents us with results from differing assumptions and a basis for analysis of *Capital Needs*' conclusions. The tax foundation study, carried out in 1972 on the basis of 1970 data, used the definitions and data bases of the Bureau of the Census, and it requires some adjustments to facilitate comparisons. It assumed less inflation and more real growth than the economy has experienced in the first 5 years of the 1970's.

---

[1] B. Bosworth, J. Duesenberry, A. Carron, *Capital Needs in the Seventies* (1975).
[2] *Ibid.*, pp. 20–21.
[3] *Ibid.*, p. 36.
[4] *Ibid.*, pp. 56–57.

The major contrasts are that the tax foundation study forecasts a somewhat smaller share of GNP for State and local expenditures (15.2 percent as opposed to 16 percent in the *Needs* study), their capital outlays as being a bit more important in such expenditures (17.9 percent as opposed to 17.5 percent and borrowing as being much more significant as a source of funds for State and local outlays (60 percent compared to 50 percent). By and large, the tax foundation study provides an estimate of capital outlays and demands for borrowing if the economy and State and local sector were to grow more slowly in accordance with traditional spending and revenue patterns.

The above studies can be criticized on several grounds. Both suggest high levels of Federal gants ($67 million for *Needs* and $63 billion for tax foundation, annually by 1980), an assumption which is increasingly less realistic. The $17.1 billion in Federal capital grants forecast for 1980 by the *Capital Needs* study would require a 12½ percent rate of annual growth over the next 5 years to rise from the level of $9.5 billion budgeted for Federal grants in fiscal year 1975.[5]

The *Needs* study, as one critic has noted,[6] calls for an absolute growth in municipal bond issues equal only to that experienced between 1965 and 1973 ($1.5 billion a year). Correspondingly, it foresees a relatively large increase in the amount of support to capital spending from nongrant and nonborrowing sources. Other financing—short-term loans and current receipts—is expected to triple by 1980—up to $16.5 billion from $5.2 billion in 1973.[7] Since is is unlikely that financing from other sources, especially current receipts, will increase sufficiently to accommodate as much as 26 percent of capital expenditures, borrowing may be expected to carry a greater part of the load. If, for example, the composition of financial support were to remain the same in 1980 as it was in 1973, bond sales would equal $41.9 billion, approximately the amount of borrowing envisaged by the Taylor projections (to be discussed below. And if, indeed, the State and local sector is experiencing an $18 billion deficit by 1980, as the *Needs* study suggests, it is likely that pressure on current revenues for current outlays will be too great to permit much funding of capital expenditure.[8]

A relatively optimistic view of the overall balance of receipts and expenditures in the State and local sector and of the difficulties in meeting capital financing needs is presented in David and Attiat Otts' recent study, *State-Local Finances in the Last Half of the 1970's*. Assuming a relatively moderate rate of real growth and inflation, they project the sector moving toward budget surpluses and, because of demographic changes, having relatively low levels of capital outlay requirements. Meanwhile, Federal grants are projected to grow rapidly to meet most environmental and mass transit financing needs, reducing the need for borrowing.

In fact, the Ott study foresees moderate capital spending as a critical factor in helping to hold the lid on State and local spending and as

[5] *Special Analysis*, Budget of the U.S. Government for fiscal year 1976 (1975), p. 69.
[6] E. Renshaw, "The Financing of Capital Expenditures by State and Local Governments in the Remainder of the Seventies," mimeographed (1975), p. 10.
[7] *Capital Needs*, *op. cit.*, p. 69.
[8] *Ibid.*

permitting a surplus to develop by 1980.[9] The possibility of this outcome is reinforced, they calculate, because it is based on experience in the 1950's and 1960's when State and local revenues were estimated to be somewhat more responsive to inflation than expenditures, thus giving a boost toward a surplus position.

Two other studies have concentrated on the role of municipal bond demands in the capital markets, focusing on stresses and strains created primarily by the financing needs of business. The study by Peter Fortune on borrowing requirements to finance water pollution control illuminates the potential demand which the pollution control bond places upon the municipal bond market.[10] Fortune uses an econometric model of State and local construction and borrowing demands to tie additional capital requirements generated by the stiffening standards of the water cleanup program to projected levels of GNP and other investment determinants. Assuming a $2.5 trillion GNP by 1980, Fortune predicts both higher capital outlays and borrowing levels than those forecast by the tax foundation and Brookings analysts (although as a percentage of GNP, the differences among estimates are not drastic). The study is notable for the allowance for approximately $15 billion in tax-exempt pollution control bond demand over the last half of the 1970's. (In 1980, such sales are estimated to account for a relatively "modest" $2.2 billion in the total volume of tax-exempt sales along with $2.5 billion in bond sales attributable to State and local public plant and expenditure needs).[11]

The largest estimates of State and local borrowing needs in 1980 are contained in recent projections by Steven Taylor of capital market stocks and flows for 1980 and 1985.[12] Taylor's analysis, done in 1974, uses a national income real demand model to develop estimates of credit flows on the basis of historical patterns. It posits municipal bond sales at levels about 30 percent higher than those in the Brookings study. Taylor's study, which does not explicitly relate State and local expenditures to capital outlays, predicts a high, 12 percent annual rate of increase in State and local net borrowing—greater than that experienced in the 1960's. The Taylor study, like the Brookings endeavor, assumes growing Federal surpluses and a high-investment economy,[13] for capital spending and borrowing. It seems most realistic to forecost municipal bond borrowing nearer to $40 billion. This has ramifications for the demand, in turn, on the capital markets.

Both the Brookings and Taylor studies project State and local borrowing needs as part of the total demand for capital in the economy. Both, using somewhat different base years, call for a GNP of approximately $2.4 trillion by 1980, and both project generally higher levels of private domestic investment than those conceived in the late 1960's and early 1970's. Perhaps most significant is the assump-

---

[9] Based on statistical models, the Otts find forecasted state and local construction expenditures are held down by the pressure of inflation on interest rates (to which real capital expenditures are sensitive; however, in dollar terms, they grow enough to offset the impacts of the higher cost of capital. *State-Local Finances in the Last Half of the 1970's* (1975), pp. 95–98.

[10] "The Financial Impact of the Water Pollution Control Act," *op. cit.*

[11] *Ibid.*, table 7.

[12] "Financial Background for Project Independence" (1974).

[13] *Ibid.*, pp. 15–16.

tion shared by both that the Federal Government will run surpluses and, in the case of the *Capital Needs* study, ample ones. But the studies vary considerably in their projections of capital market claims.

In reviewing the competition for credit, the *Needs* study makes the major assumption that higher levels of business borrowing will be largely offset by slower growth in State and local government debt and a decline in the volume of publicly held Federal debt. Also foreseen is a growing role for depository institutions. Generally, the *Needs* study is sanguine about the ability of the capital markets to absorb State and local debt through the traditional source of demand, commercial banks and people with high incomes.[14] The Taylor study, while projecting a much higher level of net municipal borrowing, envisages a mixture of investors in municipals much as in 1970, except that commercial bank holdings are supplanted by increased holdings by individuals and, interestingly, by direct Federal loans.[15]

[14] *Capital Needs*, p. 69.
[15] Taylor, Table 15.

Chapter VIII. POLICY OPTIONS TO IMPROVE THE MUNICIPAL BOND MARKET

Preceding chapters have reviewed several changes in the municipal bond market and a number of problems that attend them. Many concerns are long standing—for example, those relating to the cyclical nature of demand for tax-exempt bonds and the gyrations in their rates of interest. Others are of relatively recent vintage—the soaring use of tax exemption to finance nontraditional activities and the reappearance of apprehensions about municipal creditworthiness after years of absence of doubt in the minds of investors.

Most problems in the municipal bond market have been the subject of professional and congressional discussion at one time or another, and a host of solutions have been devised to moderate or eliminate them. In this section, the problems of the tax-exempt bond market are organized into broad groupings that are potential targets for policy action. Briefly, such targets might be broadening the market, improving the efficiency of the tax-exempt subsidy, improving the tax equity of tax exemption, and lowering the cost of borrowing for particular borrowers. Next, recent proposals for credit assistance to State and local governments at a national level are reviewed. They are then discussed briefly in terms of this ability to meet certain criteria, implicit or explicit, that have specified for Federal involvement in the borrowing decisions of State and local governments.

BROADENING THE MARKET FOR STATE AND LOCAL SECURITIES

Many complaints about the tax-exempt market can be traced to the nature of a market that relies heavily on a limited number of institutional and individual investors with a limited appetite for a long term, tax-exempt security. As a result, the supply of tax-exempt bonds intermittently has outpaced demand, at which times the market cannot be cleared except at higher rates of interest. At such times tax-exempt rates rise relative to yields in other markets, tend to fluctuate greatly, and occasionally, congestion occurs in the market.

There are several subarguments in this proposition. The major one has to do with the peculiar attributes of tax exemption as a means of attracting investor interest. Tax exemption, while it lowers the cost of borrowing, is of greatest benefit to investors in the highest marginal tax brackets. By and large, investors in the highest marginal tax brackets have only limited use for long term credit market instruments. On the other hand, the bulk of long term money is advanced by insurance companies, pension funds, and assorted thrift institutions that are either untaxed or in relatively low marginal tax brackets.

There is a limited supply of investible funds seeking tax exemption at each rate of interest. As a result, municipal bonds must be priced

to yield progressively higher returns so that all the bonds outstanding and coming on the market may find a buyer. Thus, when the supply of bonds grows in relationship to funds seeking tax shelter, municipal bond yields rise relative to other interest rates in order to appeal to investors who are less in need of tax exemption. As interest rates on municipal bonds approach those on alternative taxable investments, the market is broadened in the sense that more investors can profit from tax shelter. However, the smaller the savings from tax exemption to the issuer, the greater is the return to the investor. The ultimate extreme, of course, is when the supply of bonds so outdistances the demand for tax shelter that tax exemption loses all value to issuers and the tax-exempt and taxable bond market merge.[1]

The sign of a "good" municipal bond market from the standpoint of borrowers in a low ratio of tax-exempt to taxable bond rates. Market pressures have shown up in the municipal bond market in fluctuations in the ratio of interest rates and, from time to time, in large volumes of postponements caused by very high interest-rate bids, no bid, or voluntary withdrawals of issues. Furthermore, as discussed above, the ratio of tax-exempt to taxable bond rates is negatively associated with high levels of investment by investors in high marginal tax brackets—commercial banks and fire and casualty insurance companies. Conversely, participation on a large scale by the household sector has typically been purchased by paying high interest rates and a resulting relatively high ratio of rates.

The above discussion is a simplified presentation of some of the many real-world factors which inhibit broader investor participation in the municipal bond market. There are others. First, the municipal market is broadest at the shortest end of the maturity spectrum, since the ratio of tax-exempt to taxable yields is typically lowest in the debt with shortest maturity and rises as the years to maturity lengthen. This may reflect the preference of the high tax bracket institutional investor for short term and relatively liquid securities. It also points out that the benefits of near term tax shelter are fairly certain, but that future benefits are speculative, depending upon the future tax bracket of the holder. For individuals this can be a major reason for demanding a higher yield than one's current tax bracket might imply; much of the income on a bond held into the future may be taxed at a lower level as the investor passes beyond his peak earning period.

Another frequently cited constraint on the market for municipal bonds is the diffusion and thinness of the secondary market.[2] In part this is attributable to the serial nature of most of the securities and the comparatively large number of small issues, which make it difficult to list securities and often impossible to establish continuous price quotations for individual issues.

---

[1] Analytically, this relationship whereby the investor compares the after-tax yield $r_t(1-t_m)$. where t^m is the marginal tax rate) on alternative taxable investments with that available on tax-exempts, r_e, of like investment characteristics. Investors will continue to purchase tax-exempts so long as the tax-exempt yield exceeds that available on comparable investments after taxes $r_e > (1-t^m)r_t$. When sufficient demand is forthcoming to meet the supply of bonds, then for the market rate will equilibrate at $r_t(1-t^m) = r_e$, where t^m is the marginal tax rate of investors who are at the point of indifference as to whether they purchase a municipal or a taxable bond.

[2] Very little has been written on the municipal secondary market, but see William Staats, "The Secondary Market for State and Local Government Bonds," *Vol. 3 Reappraisal of the Federal Reserve Discount Mechanism* (1972), pp. 1–24.

It may be argued that such detractions could be remedied were economic incentives sufficient, but there are several institutional and practical barriers to such a change. As a matter of fact, the serial maturity—as opposed to the term bond structure used in the corporate bond market—keeps the average maturity of municipal debt short because banks prefer to buy shorter term tax-exempt bonds and are willing to accept lower interest rates in exchange for greater liquidity. On the other hand, designing bonds for long-liver projects for too rapid a payback period and for too high a level of debt service can seriously impair the borrowers' liquidity.

Additionally, certain aspects of the Tax Code as it applies to tax-exempt bonds have been held to be prejudicial to a stronger market for municipals. In particular, the prohibition against borrowing short-term for investing in municipal bonds has been cited as contributing to lack of speculative support for the tax-exempt market on downturns.[3] The prohibition against open-end mutual funds being able to pass through tax-exempt interest income to mutual fund investors has kept financial intermediaries from supporting the market.[4] Unfavorable legislation, later upheld by a U.S. Supreme Court decision, abolished the practice of applying tax-exempt income against policyholder reserves and succeeded in eliminating in the late 1950's what had been the minor but growing interest of life insurance companies in municipal bonds.[5]

As noted, certain tax changes have acted to stimulate some demand for municipal bonds.

While certain operational characteristics of the market might be changed to reduce frictions in municipal bond transactions, few would argue that this would tap any great reservoir of new demand for tax-exempts. Furthermore, as is discussed below, expansion of tax subsidies, such as allowing more favorable tax treatment of interest costs on funds borrowed to purchase municipals, has been resisted by the Department of the Treasury. Thus, broadening the market significantly, while maintaining a favorable ratio of interest rates between taxable and tax-exempt securities, involves either tapping into some major new source of demand for tax-exempt securities, reducing the supply of tax-exempt bonds to allow the market to clear at a lower interest rate, or a combination of both. A transfer of some portion of State and local government borrowing to the larger, more stable taxable bond market could reduce the volume of bonds in the tax-exempt market. This in turn could relieve the pressure of supply against demand and lower interest rates on tax-exempt bonds relative to those on taxable securities.

Another option, of course, is to "broaden" the market by simply reducing the magnitude of the supply. This would involve limiting tax-exemption to a shorter list of allowable uses (most likely through tighter restrictions in section 103 of the code).[6]

---

[3] *Ibid.*

[4] See Advisory Commission on Intergovernmental Relations, *Federal Approaches to Aid State and Local Capital Financing* (1970), p. 34; Life Insurance Company Income Tax Act of 1959 (Public Law 86–69).

[5] *United States* v. *Atlas Life Insurance Co.* (381 U.S. 233 (1965)).

[6] This of course, has already been done in the prohibition of the big-issue industrial revenue bond and the arbitrage bond. The desire to limit supply is also part of the rationale behind recent moves to outlaw or curb the use of pollution control bonds.

Akin to efforts to broaden the market for State and local securities is the desire to reduce the cyclical volatility of interest rates on municipal bonds. As noted above, the ratio of rates tends to rise in periods of stringent credit market conditions, when major institutional support wanes. This is an indication of an over-reaction by tax-exempt yields to changes in the interest rates in the larger, long-term taxable securities market. The way to reduce the volatility of rates on new-issue municipal bonds relative to those in the taxable area is to change the composition of buyers to those who have a stronger natural interest in long-term securities. But, as has been explained, these investors have little or no interest in tax-exempt securities; hence, this suggestion revolves around the transfer of State and local borrowing to the taxable bond market.

Broadening and stabilizing the municipal bond market to provide an increased flow of investible funds at generally lower and more stable rates of interest is an objective advanced primarily on behalf of the issuer of municipal bonds. But there are other—and intimately related—apprehensions about the efficiency and equity of the existing method of subsidizing municipal bond sales through tax exemption, which is discussed next.

Efficiency of the Subsidy Mechanism

A second major set of concerns arises over the efficiency of tax exemption as a method of assisting State and local governments. There are several levels of sophistication to this argument. The first is that, for better or worse, the tax-exemption of State and local governmental interest payments cannot be viewed as a subsidy because it is beyond the volition of the Federal Government to do much of anything about it, at least as it applies to the essential money-raising functions of the sovereign States and their subdivisions. Beyond the legal arguments surrounding constitutional protections, it is clear that the economic effect of tax-exemption is to lower the cost of borrowing for State and local governments. The exemption does cost something—specifically, the avoided taxes—and, therefore, is fair game for analysis on efficiency grounds.

Before discussing benefits and costs of the present system, objections to the prejudicial effect of tax-exemption upon the allocation of capital between the public and private sector and upon the use of capital versus labor in the State and local sector should also be noted. Indeed, economic theory holds that giving governments a preferential low cost of capital tends to direct investment into public capital with a lower rate of social return than capital in the higher-cost private sector. This has the overall effect of lessening total productivity of the combined public and private sectors.[7]

Besides these broader objections, there is the policy question of how efficient is the present subsidy and how might it be improved. The efficiency problem revolves around the narrowness of the tax-exempt

[7] See David and Attiat Ott, "The Tax Subsidy Through Exemption of State and Local Bond Interest." In *Part 3: Tax Subsidies* in *The Economics of Federal Subsidy Programs*, Joint Economic Committee (July 1972), pp. 305–316. The Otts roughly estimate that misallocation of capital in the state and local sector led to a reduction of income from total capital stock of $100 million, which would equal 0.25 percent of total income from capital in the period 1953–59.

market and what happens when, in order to sell bonds, tax-exempt rates must be progressively raised relative to those on comparable taxable securities. As rates rise to attract funds from taxpayers in lower marginal brackets, tax benefits spill into the laps of investors in higher marginal tax brackets and, at the same time, flow away from issuing governments. This happens because the relatively fixed supply of funds seeking tax shelter in municipal bonds at each taxable income level, forces tax-exempt securities to be priced so that total investment demand can absorb all of the bonds. From the standpoint of efficiency, it is unfortunate that the municipal borrower—facing a competitive market—cannot discriminate among buyers on the basis of their marginal rates. Thus, investors who would be attracted at lower rates still must be paid the higher rate of interest required to attract other investors on the margin of indifference between buying a tax-exempt bond or some alternative investment.[8]

This suggests that tax exemption is less than totally efficient when tax-exempt bonds are being sold at levels that make them attractive to those in less than the highest marginal tax brackets. As a result, there is a surplus of avoided Federal taxes that are not passed on to the issuer of tax-exempt securities.[9]

There have been numerous estimates of the efficiency of tax exemption, that is, the relative magnitudes of the amount of tax revenues foregone by the Treasury and the amount by which State and local government interest costs are lowered.[10] Recent estimates suggest that in fiscal 1976, of the approximately $4.8 billion in foregone Treasury receipts, $3.5 billion was passed on to State and local borrowers in reduced interest costs and $1.3 billion was retained by investors.[11] Expressed as a ratio of interest savings to foregone tax revenues, this implies a 0.73 efficiency ratio.

Since interest savings and lost revenues are not directly observable, they must be estimated and the estimates depend heavily upon basic assumptions on how the municipal bond market operates and the comparability of the tax-exempt security to other investments. First, it must be assumed that the Treasury loses an amount equal to taxes investors would have paid, were they to have invested in taxable investments of essentially similar characteristics (usually assumed to be a corporate taxable bond). However, many believe that because of its poor secondary market and other market characteristics of the tax-exempt bond, these bonds carry higher interest rates than might otherwise be expected.[12] To the extent that other tax shelters are available,

---

[8] For example, when tax-exempt rates are at 80 percent of those on comparable taxable yields, this means that an investor in the 60 percent tax bracket is enjoying a before tax return equal to twice that which would be required to attract him to a tax-exempt security. This happens because bonds are having to be priced to attract investors in the 20 percent marginal tax bracket.

[9] State governments also frequently exempt interest income on their own municipal bonds and those of their subdivisions (and, sometimes those of other States) from taxation. Such exemptions face the same efficiency problems in terms of the benefits being passed on to issuers. See Huefner, *Taxable Alternatives*, pp. 170–171.

[10] For a historical review, see R. Huefner, *ibid.*, pp. 51–53.

[11] "The Municipal Bond Market: Why It Needs Help," *Congressional Record* (Dec. 17, 1975), S. 22558.

[12] For example, see Frank Morris, "The Case for Broadening the Financial Options Open to State and Local Governments—Part II, *Financing State and Local Governments* (September 1970) and David J. Ott and Allen Meltzer, *Federal Tax Treatment of State and Local Securities* (1963).

investors in higher tax brackets would require higher taxable rates to be attracted to fully taxable bonds than those involved in comparisons of tax-exempt and taxable bonds. The effect of these arguments is that the ratios used for comparison somewhat overstate the true ratio, that the subsidy is more efficient than it appears.

Another key assumption concerns the marginal tax bracket of current municipal bondholders. By and large, this presents little problem for institutional investors active in the tax-exempt market, but as noted above, there are data gaps for individuals. Recent estimates place the average marginal tax bracket at about 45 percent for all holders of tax exempts. This, of course, is well above that implied by the historical 70-percent ratio of tax-exempt to taxable rates.[13]

An important point and one frequently lost in discussions of costs and benefits of tax exemption is that the calculations of the amount of tax avoidance and interest cost savings used for the entire stock of tax-exempt debt outstanding cannot be applied to estimate results of incremental changes in investor holdings as they move between tax-exempt and taxable securities.[14] Since this point and the assumptions up on which it is based are important to understanding various proposals to improve market efficiency, the reasoning will be examined briefly.

Estimates of the costs and benefits of tax exemption on the basis of all debt outstanding differ from those based on incremental or marginal changes in outstanding debt. The main reason is that the average of the marginal tax rates for all present holders of the outstanding stock of municipal bonds (now 45 percent) is higher than the marginal tax rate of those investors who now find it just slightly more advantageous to hold tax exempts rather than some form of taxable investment (now 20 percent to 30 percent, depending on market conditions and security characteristics). These marginal investors would be those who would transfer their assets into taxable investments if the taxable rate relative to the tax-exempt rate were to rise slightly. Thus, the appropriate tax rate to apply in calculating changes in Treasury revenues generated by switching from tax-exempt to taxable investments would be the *average* of the marginal tax rates of those investors who are induced to make such a shift in their assets.[15]

In addition, the tax-exempt bond market is likely to be least efficient (the ratio of tax-exempt to taxable rates the highest) in times of generally high interest rates and tight credit. As a consequence, the level of tax avoidance is relatively greatest at the very time that the actual borrowing cost is highest for States and localities. Thus, the efficiency of the subsidy tends to fluctuate inversely with the degree to

---

[13] From regulatory and survey information on holdings of municipal bonds, we can identify the weighted average marginal tax bracket of holders of tax exempts, which is approximately 0.45. Next we can solve for the implicit marginal tax bracket that equates the historical series of tax-exempt and taxable yields $(1-t^m)r_t = r_e$; therefore, $t^m = 1-(r_e-r_t)$.

[14] See letter from J. Petersen and H. Galper to Congressman Henry Reuss in *Housing and Urban Development Legislation—1971*, Hearings before the Committee on Banking and Currency, U.S. House of Representatives, 92d Cong., 1st Sess. (September 1971), p. 852.

[15] For example: Were the ratio of tax-exempt to taxable bond yields to move from 0.75 to 0.65, the relevant marginal tax rate for estimating incremental revenues would be a tax rate lying approximately midway between the rates that would equilibrate the two yields. Such a movement in the yield ratio indicates an applicable marginal tax rate of 30 percent (because a rate of 25 percent would equilibrate the 0.75 ratio of tax-exempt to taxable yields and one of 35 percent would equilibrate a 0.65 ratio.

which it must be used to attract marginal investors. Also, as reviewed above, the ratio of tax-exempt to taxable rates tends to be highest and efficiency lowest at the long end of the market when interest rates also tend to be highest and where the future impact of current interest costs will be of the longest duration.

In summary, the efficiency of tax exemption has been criticized because, on average, between 25 and 30 cents of every dollar of income tax revenues foregone by Treasury is not passed on to State and local borrowers, but is retained by high tax bracket investors. The efficiency of tax exemption is lowest in times of tight money and in the long-term end of the bond market, that is when the market is narrow and the ratio of tax-exempt to taxable yields is high.

The cost to Treasury versus the benefits to State and local debtors of incremental changes in the supply of tax exempts cannot be inferred from the overall ratio of avoided taxes to reduced borrowing costs for all bonds outstanding, but rather must be calculated on the margin to those to whom tax-exemption is of the least value. This is because both theory and observation indicate that it is those investors at the margin—in the lower marginal brackets—that do the shifting between tax-exempt and alternative taxable investments.

The Tax Equity Effects of Tax Exemption

A major political argument against tax exemption has been its effect on the equity of the income tax system. There are two facets to this complaint: first, that the benefits of tax shelter are concentrated in the highest marginal tax brackets, reducing the effective progressivity of the income tax; and, second, that it discriminates horizontally among taxpayers in otherwise similar circumstances because it permits one form of economic income to avoid taxes while others are taxed. While these arguments occasionally crop up in discussions of corporate tax treatment, for the most part they are directed toward the high-income individual taxpayer.

As was discussed in a previous section on individual investors in tax exempts, the bulk of interest income on State and local securities is received by those individual taxpayers with the highest income, wealth, and marginal income tax brackets. About 50 percent of tax-exempt income is received by individual taxpayers with adjusted gross incomes that exceed $50,000 and with marginal tax brackets ranging between 50 percent and 70 percent.

It is primarily because of the concentration of tax-exempt income in the highest tax brackets that removal or significant reduction of tax exemption has been an appealing tax reform measure to many and has been proposed perennially.[16] However, the spectacle of rich investors who pay no taxes because they clip tax-exempt bond coupons, while damaging to the public's concept of tax exemption, is not accurate in the case of rational investors. Practically all investors in municipals have some taxable income (that is why they are in high marginal tax brackets!). They only seek out tax shelter income when it renders a

[16] For an historical discussion of the repeated assaults on the practice of tax-exemption, see Huefner, *Taxable Alternatives*, Chapter I.

higher return after tax than additional investment income from a taxable source.

The crux of the equity problem is not that the borrowing costs of State and local governments are subsdized by the Federal Government, but that they are subsidized through a progressive tax system that increases the value of exempted income to those in highest marginal tax brackets. Were tax exemption completely efficient in the sense that each taxpayer accepted a reduced rate of return on tax-exempt securities that just matched his foregone Federal taxes, then tax exemption would operate simply to transfer Federal payments directly from one part of the taxpaying public (those that bought tax-exempt bonds) to State and local borrowers, the intended beneficiaries of the subsidy. However, as is true generally with tax deductions or income exclusions, the value of the exclusion grows with the taxpayer's marginal tax rate. Since the supply of municipal bonds exceeds the volume of available investment funds from the highest tax brackets, the level of tax-exempt rates must be high enough, as we have seen, to attract lower tax-bracket investors. Thus, investors in tax brackets above the marginal rate that clears the municipal bond market—say, those above the 30 percent bracket—enjoy a surplus of tax-exempt income above that which would just match the Federal taxes they would have to pay on income from a taxable investment. Because the exemption means a loss of tax revenues in excess of the value of the tax subsidy to borrowers, it also means that taxpayers who do not purchase tax exempts must subsidize those who do by making up the difference.

The real rub of tax exemption's effect on the progressivity of the tax system does not revolve around the existence of tax-exempt income or its receipt by a particular income group. Rather, the problem is that taxes avoided exceed the lowered borrowing costs and that the benefits of that excess are concentrated in the highest brackets and increase in proportion to the level of the tax bracket.

This aspect of tax exemption's impact on equity is important because it underscores a benefit of reforms that improve the efficiency of tax exemption (by reducing the ratio of their rates to those on taxable securities). The benefit is that such reforms will also reduce the amount of tax shelter retained by investors and will increase the progressivity of the tax system.

The argument against the horizontal equity effects of tax exempts is that within an income class, the exemption of interest discriminates among taxpayers with different sources of income. This objection assumes that the policy objective should be to subsidize the cost of capital to State and local governments. It is relevant only to the extent that there are barriers to individuals being able to invest in municipal bonds or that the resulting dispersion in effective tax rates within a given income class is inherently unfair. But aside from tax-exempt investment's requirement of a modicum of wealth—and a predictable level of taxable income high enough to justify seeking tax shelter—there seems to be nothing especially prejudiced about municipal bonds from the standpoint of horizontal equity.

In summary, improving the equity effects of tax exemption is directly related to improving efficiency, so long as subsidizing the cost of

State and local borrowing is seen as desirable. Complete removal or cutting back on the exemption through partial taxation or allocating deductions against tax-exempt income brings greater progressivity to the Federal tax system, but at the cost of increased borrowing costs for State and local governments. To improve the tax equity of tax exemption while retaining benefits of lower borrowing costs for governments requires a method of transferring the Federal subsidy other than the exemption of interest income.

IMPROVING MARKETABILITY AND CREDITWORTHINESS

The target here is to lower the cost of capital or to make borrowing possible for certain classes of borrowers. There are two problems that policy might seek to overcome: (1) Removing barriers in the existing marketplace that unfairly or inefficiently penalize certain borrowers, or (2), if the market is already operating in an optimal fashion, then changing its terms and conditions for certain borrowers. The latter justification implies one of two things. Either the purpose for which funds are to be borrowed is of high social priority deserving a subsidy, or society should offset a lack of intrinsic creditworthiness in the borrower by absorbing some or all of the risks normally left to private investors.

The municipal bond market, although dealing in governmental securities, is a private market that rations private capital by matching return versus risk. It is not surprising that borrowers who demonstrate the least ability to repay are asked to pay the most. Until recently, the trend in the market, because of the low historical incidence of default in the state and local sector, has been to reduce interest cost differentials among various quality classes of municipal borrower.[17] Still, there has remained a group of problem borrowers, normally considered to be the very large cities or the very small local government issuers.

As noted, many very large borrowers now must contend with credit problems. In addition, there appear to be problems in the efficient marketing of large and frequent issues because of the depressing influence of oversupply and a lack of bidding competition, especially in times of tight money. Very small issuers also have problems, attributable primarily to lack of borrower sophistication, a nonexistent secondary market, and the absence of economies of scale in the marketing of small issues, and, occasionally, insufficient bidding competition. There may also be a somewhat greater intrinsic credit risk for small issues.[18]

Some states have taken active steps to assist smaller issuers in their bond marketing practices. A prime example is the state bond bank that bundles smaller issues in an effort to permit economies of scale and to spread risk throughout a portfolio of underlying loans. Others have gone a step further and devised sundry loan guarantee and insurance programs for local borrowers. There are also private municipal bond insurance programs.[19]

At the Federal level, assistance to problem borrowers raises the same issues involved in any Federal program, but are complicated by prob-

---

[17] Forbes and Petersen, "Cost of Credit Erosion," p. 12.
[18] Petersen, *The Rating Game*, pp. 132–135.
[19] *Ibid.*, pp. 135–139.

lems discussed above in conjunction with tax exemption. Furthermore, state and local governments have been leery of Federal aids that bring Federal participation in their financing decisions, unless there is absolutely no alternative source.

Federal credit assistance can take several forms: Debt service subsidies to lower effective interest cost to borrowers; direct loans at subsidized levels; loan guarantees to assure payment in case of default; and loan insurance programs to which borrower or lender or both contribute a premium.[20] All have been used to assist State and local borrowers at one time or another.

The use of credit assistance, while of obvious help to assisted units, normally involves costs for unassisted borrowers—including the taxpayer at large. First, there is the problem of "leapfrogging" borrowers that normally would pay a higher cost to a preferred position by virtue of subsidized loans or guarantees. This can place pressure on other borrowers of superior credit quality to step down a notch in the credit quality ladder and lower the cost of borrowing. Second, to the extent that borrowers who would not borrow otherwise are given assistance to do so, then pressure on the market increases and interest rates for the remainder of the market go up. Insurance programs have the drawback of being very expensive if the premium is based on true risk or being a subsidy if they are not. And, since they too interpose a reduced credit risk between borrower and lender, they can lead to the leapfrogging phenomenon and operate to the relative disadvantage of the unassisted borrower. Last, there is the traditional complaint that insulation from the private market leads to a lack of fiscal discipline, while inclusion in a Federal program leads to redtape, delay, and Federal domination. But, direct loans, while they involve the maximum of involvement, also appear to be the most efficient and straightforward method of assistance.

Federal direct loans and, to a lesser extent, interest subsidies are frequently frowned upon because they lead to budget outlays as opposed to various guarantee and insurance plans that can go off the budget. The budget impact problem is frequently solved by creating an off-the-budget agency and declaring its debt not that of the Federal Government.

These arguments against Federal credit assistance do not generally preclude the desirability or necessity of such assistance in special circumstances that are clearly beyond the scope of the private market. In fact, the arguments suggest the designing of special assistance programs to meet such cases as efficiently as possible to account fully for the cost involved, and to have the least troublesome side effects for other borrowers.

Recent Proposals for Federal Credit Assistance to State and Local Governments

The last session of Congress, in grappling with the New York crisis, brought forward many proposals to broaden and stabilize the municipal bond market or to assist particularly hard-pressed local govern-

---

[20] See Joint Economic Committee, *Economics of Federal Subsidy Programs:* A Staff Study (January 1972), pp. 31–35.

ments. As has been noted, these are two distinct, if interrelated, purposes and the differences should be apreciated in the discussion of the economic and political efficiency of such proposals.

State and local issuers as a group traditionally have been wary of Federal credit assistance. Their wariness springs from several sources: a fear of undermining tax exemption, of becoming involved in redtape and delays, and their desire to maintain autonomy as to borrowing and capital outlay decisions. These views usually are shared by those who underwrite and trade municipal securities, with the particular emphasis that a private competitive market—one consisting of many buyers and sellers—should be the centerpiece of the state and local capital raising mechanism. These views have been cemented, therefore, around the preservation of the existing tax-exempt market and the subsidy it entails, which in almost any circumstances still provides state and local borrowers with the maximum autonomy in decision-making and the lowest cost of capital in the financial markets.

The concerns of issuers, dealers, and investors were aroused in 1969 when Congress steered a course toward partially taxing municipal bonds, in effect offering State and local governments a subsidized taxable bond in exchange. They were kept kindled in the subsequent 2 years when the administration and Congress begain proposing and, on occasion, creating various new agencies and lending programs to finance certain State and local activities. A perennial proposal was (and continues to be) creation of a special agency, "Urbank," as it is usually captioned, to provide direct loans to eligible governments who could not find reasonable accommodation in the capital market.[21] This led to difficult questions as to eligibility, control of subsidy levels, and how the agency might compete with conventional sources of capital.[22] At that time, there was a deep concern that the tax-exempt bond market either would be swallowed up by a massive federally sponsored bank or taken down in detail by an array of separate lending programs. Furthermore, State and local governments were worried that hard dollar grants would be replaced by soft loans on guarantees; in other words, that Federal credit assistance would become a substitute for grants.

Thus, in the early 1970's, with the market disruptions of tight money and tax reform still fresh in memory and the developing threat of Federal credit programs close at hand, various interested parties—issuers, industry, and academic—examined the relationship between Federal credit assistance and the traditional tax-exempt market. There were differences in detail, but a consensus began to emerge that such assistance should be consistent with the following criteria:

1. Use of any Federal credit assistance programs by State and local governments should be entirely voluntary.
2. Such assistance should be free of Federal interference and intervention in matters of State and local concern.
3. Such assistance should be simple, dependable, and free of delay.

---

[21] Urbank derives from the National Urban Development Bank proposed in 1968 by President Johnson's Task Force on Urban Problems. For a general description of the mechanism, see Charles Haar and Peter Lewis, "Where Shall the Money Come From?" *The Public Interest* (Winter 1970).

[22] See Remarks by Senator William Proxmire, *Congressional Record* (Feb. 22, 1972), S. 2202.

4. Such assistance should not be viewed as an alternative to Federal grant assistance where the latter is appropriate and necessary.

These similar criteria were set forth by the National Governors' Conference and supported by the National League of Cities, the National Association of Counties, the Municipal Finance Officers Association, and the Securities Industry Association.[23]

Applying those criteria, the various groups began to focus on particular aid mechanisms. Cognizant of the difficulties of exclusive reliance on tax exemption and hostile to direct credit assistance, several groups moved toward the proposition that a properly designed and administered taxable bond option could meet those criteria. Approaching the question from a defensive posture, many were agreed that it was at least preferable to Federal taxation of traditional tax-exempt bonds or to continuation of the proliferation of Federal lending programs. Others were convinced that the option had strong positive advantages in terms of lowering borrowing costs, increasing the efficiency of tax-exemption, and providing stability to the market. The particulars of the option's operation and its ability to meet various policy targets have been discussed exhaustively elsewhere.[24] In April 1973, the Treasury introduced a taxable bond option as one of its tax reform proposals of that year. However, soon thereafter attention began to shift away from the option and the threat of Federal credit assistance programs. The stream of special agency proposals receded and the municipal bond market, while not without pressures, generally performed well. Furthermore, opposition arose to the taxable bond option idea, either on the grounds that it would not work, or if it did, that the Federal Government—by intent or circumstance—would use an option to entrap State and local governments and then would withdraw tax exemption, leaving them at the mercy of the direct subsidy program.[25]

In response to the fiscal problems of New York City and other municipal borrowers, several bills were proposed in 1975 to provide a means by which States and localities could borrow, either to avoid outright default or to improve their marketability and reduce their interest costs. Such proposals can be divided into two groups: creation of a Federal Government agency designed to purchase, refinance and remarket municipal debt instruments; and authorization of emergency loan guarantees to State and local governments.

Despite certain mechanical differences, all of the proposals sought to provide a bridge of stronger credit between the lender and the borrower, thereby reducing the former's risk and the latter's cost of borrowing. Most contemplated direct assistance and all called for direct Federal assessment of the borrower's financial conduct.

---

[23] See statements of the above cited groups in *Federal Financing Authority*, hearings before Senate Committee on Banking, Housing, and Urban Affairs (May 15–17, 1972).

[24] The literature on the taxable bond is large and continues to grow. An intellectual and political history of its development is detailed in Robert Huefner, *Taxable Alternatives;* the theoretical model of the subsidy is developed rigorously and empirically by H. Galper and J. Petersen, "An Analysis of Subsidy Plans"; an extensive discussion of its operation and desiderata is found in Committee on Ways and Means, U.S. House of Representatives, *An Alternative to the Tax Exempt Bond: Panel No. 8* (Feb. 23, 1973); and extensive quantitative analysis of the subsidy impacts have been done in Peter Fortune, "The Impact of Taxable Municipal Bonds: Policy Simulations With a Large Econometric Model," *National Tax Journal* (March 1973).

[25] See Grady L. Patterson, "The Case Against Tampering With Tax Exemption," *Bulletin*, Municipal Finance Officers Association (January 1975).

As noted above, there are several potential problems with direct assistance programs including the market impacts on unassisted borrowers and the direct intervention of Federal authorities in setting eligibility, terms and conditions of aid, and ensuring that the Federal loan or guarantee is adequately protected. While this level of involvement was viewed as unfortunately necessary in the case of a lender of last resort to one on the brink of default, it was not viewed as desirable as a basis for assistance to State and local governments in general.

Exhibiting a sensitivity to these reservations about direct Federal credit assistance and looking for ways to revive the market as a whole, first Treasury and then Senator Kennedy and Congressman Reuss revived the taxable bond option.[26]

Reducing the Supply of Tax-Exempt Bonds

With limitations on demand for tax-exempt securities, another way to improve the market for them is to reduce the supply. Here too, there is a Federal role; not by using the carrot of a subsidy to accomplish a transfer of debt to taxable status but rather the stick of disallowing the use of tax exemption for certain purposes. The likely targets are those industrial assistance bonds that have retained tax-exempt status.

A major way to reduce the volume of tax-exempt debt is by amending section 103 to deny tax exemption for certain uses. Leading examples of this in the past are the large issue industrial revenue bond and arbitrage bonds. As was noted, the prohibition of industrial bonds in 1969 was not complete. Several purposes are excepted from the prohibition, including issues sold on behalf of corporations for pollution control. Furthermore, conventional industrial development bonds are permitted to be sold if they were below $5 million in size and met certain other conditions. These and other exceptions have grown rapidly and the large volume of financing for such purposes in the tax-exempt market has a depressing effect on that market.

Essentially all public interest groups and the Securities Industry Association have adopted positions calling for the elimination or at least a major cutback of the pollution control bond and its replacement by a more efficient subsidy vehicle. Other uses of tax-exemption have been publicly criticized from time to time, especially advanced refunding bonds, which can lead to a multiplication of outstanding tax-exempt debt for a particular project.[27]

In summary, the restriction of the supply of tax-exempt debt helps those borrowers and users that remain in that market, simply because the value of tax exemption is less diluted.

By the same token, credit assistance plans, either specific or general, that increase the supply of tax-exempt bonds without in some way increasing demand for them will lead to higher rates, relatively, in that market.

---

[26] The Kennedy-Reuss bill was jointly introduced in December 1975 as S. 2800 and H.R. 11214. Hearings on the House proposal were held Jan. 21, 22, and 23, 1976, by the House Committee on Ways and Means.

[27] Lennox Moak, *Outline of Statement*, testimony before the Joint Economic Committee, *Hearings on the Financial Condition of Cities* (June 20, 1975).

Chapter IX. CONCLUSION AND POSTSCRIPT

At the outset of 1976, the municipal bond market was faced with an inordinate number of uncertainties. It also was the object of an unaccustomed amount of public attention. Much of the commotion was the result of the recurring New York City financing crises of the previous year—the lessons of which many hurriedly were attempting to learn and apply elsewhere. But there were other, deeper anxieties. These grew out of complex and often confusing arguments over the appropriate size and future capacity of the tax-exempt market and over the extent of involvement of the Federal Government in the borrowing decisions of States and localities.

In January, the Ways and Means Committee of the House of Representatives held hearings on the taxable bond option proposal sponsored by Senator Edward M. Kennedy and Congressman Henry Reuss. Testifying in support of the taxable bond option were the U.S. Treasury, the American Bankers Association, various tax reform groups, and the National League of Cities and U.S. Conference of Mayors. While the mayors and cities favored the plan, the other State and local organizations looked on apprehensively. Their earlier opposition to the idea had obviously softened, as they became more convinced of the economic logic of the option and more worried about the future capacity of the traditional market. But, many still were hesitant to embrace Federal participation in the marketing of municipal securities which a direct subsidy payment would require. Others continued in staunch opposition.[1] In light of the changing mood of the intended beneficiaries of the taxable bond option reform, it appeared likely that the option would be reported by the Ways and Means Committee and might possibly have its market-broadening promises tested before the year was out.

On other fronts, however, the State and local governments definitely were on the defensive. In December 1975, the House and Senate passed differing versions of the municipal bankruptcy amendments. The rush to amend the Federal bankruptcy statutes came in response to the New York City crisis, and the obvious impracticability of existing bankruptcy procedures. Although the administration-sponsored legislation had been aimed at New York City, the scope of the bill, as it raced through Congress, was expanded to include all local governments. But, these governments and the municipal bond industry steadfastly opposed the new bankruptcy legislation. There was a storm of protest both from Government officials and bond dealers who thought that the integrity of their credit and merchandise, respectively, was being unfairly impugned by the bankruptcy amendments. The bankruptcy bills bogged down in conference in December. The Treasury Department, desirous of having the bill pass, under

[1] See statements before U.S. House Ways and Means Committee, "Hearings on Proposals Relating to Tax-Exempt Bonds" (Jan. 21–23, 1976).

pressure from issuers and aware of adverse market reaction, successfully lobbied the conference committee to have the eligibility provisions of the bill stiffened. This unusual procedure was an effort to reassure investors that getting out from "under" governmental debt obligations would be neither an easy nor a commonplace event.[2]

Methods of reducing the supply of tax-exempt securities—other than the optional substitution of taxable for tax-exempt securities—were also being explored. Several of those who testified on the taxable bond option before the Ways and Means Committee pointed out that removal of the pollution control bond would ease supply pressures in the municipal bond market.[3] Furthermore, the Internal Revenue Service moved to curtail the use of tax-exempt securities by not-for-profit corporations.[4] Under existing regulations, such entities may issue tax-exempt bonds on behalf of governmental units even though they themselves do not possess governmental powers. The newly proposed regulations impose stricter requirements on the relationship of such authorities to governmental units and, thereby, restrict tax-exempt financing by private, not-for-profit corporations. The new regulations would require large scale and, perhaps in some cases, impossible statutory revisions of the structures of many industrial development, educational, and health and hospital authorities. Thus, their publication stirred strong protests from the affected parties.

Nowhere were the repercussions of the New York trauma more visible than in the new-found sensitivity of bond dealers and investors to municipal credit quality and how information about credit quality should be disclosed. Throughout the fall of 1975, as the extent both of New York's budget gimmickry and the fiscal difficulties of other large cities became evident, the municipal bond market became increasingly anxious about the level and quality of credit information. This was heightened by dealers' recognition that they were subject to the antifraud provisions of the Federal securities laws. While State and local issuers, and other market participants, also had responsibilities for disclosure, they were not subject to direct regulation of the Securities and Exchange Commission. A major problem, ironically, was that there were no clear precedents regarding fraud by issuers; neither court decisions nor SEC actions had defined the responsibilities and liabilities of underwriters, issuers, and other participants under the securities laws. The filing of lawsuits in August by aggrieved New York City bond purchasers, broad allegations of fraudulent behavior from various congressional and SEC sources, and the inclusion of dealers under Federal securities regulation in December served to exacerbate the tensions.

Although the market continued to function at a record-setting volume, several postponements of planned offerings did occur because

[2] "Report Agreement on Changes in Municipal Bankruptcy Bill," *The Daily Bond Buyer* (Feb. 19, 1976), p. 1.

[3] As the Public Finance Division of the Securities Industry Association expressed it: "This committee can act to reduce municipal borrowing costs and increase the efficiency of the tax-exempt market by returning the market to exclusive use of public state and local governmental issuers. We ask this committee to eliminate private pollution control and industrial development financing from the tax-exempt market." Statement before the Ways and Means Committee (Jan. 21, 1976), p. 5. See also at the same hearings, the statements of the Municipal Finance Officers Association (Jan. 22, 1976), and the Tax Foundation (Jan. 23, 1976).

[4] Department of the Treasury, "Interest Upon Obligations of States, Territories, Etc." *Federal Register* (Feb. 2, 1976), p. 4829.

of disclosure or credit problems. Underwriters asked for large profit spreads as insurance against uncertainties, and bond issuers saw fewer bids or an insistence by underwriters upon negotiated offerings. To add to the torment, New York State as part of the New York City "solution" in November, passed a moratorium law that forced holders of $1.6 billion in maturing New York City notes to swap or extend these securities. In January, the SEC took the highly unusual step of announcing an investigation of New York City for possible violations of the Securities Acts.[5]

The following month, the Securities Subcommittee of the Senate Banking Committee held three days of hearings on measures to bring the issuance of municipal bonds within the regulatory skein of the SEC. The proposal that got the most attention, Senator Harrison Williams' Municipal Securities Full Disclosure Act, S. 2969, called for issues of $5 million or more to meet disclosure standards at the time of sale along lines drawn by the Commission. Similarly, issuers with more than $50 million in debt outstanding would have to make audited annual reports. Accounting standards for the area would be set by the SEC.

Reactions to the regulation plan varied, but from the governmental issuers there was distress over the cost and controls of regulation and concern about the unresolved questions of legal liability. However, it was clear that more information, whether by market forces or government fiat, would be forthcoming in the municipal bond market.

[5] SEC press release, Jan. 17, 1976.

754

THE PRESIDENT'S PROPOSED TAX CUT AND BUDGET CEILING

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-FOURTH CONGRESS

FIRST SESSION

OCTOBER 28 AND NOVEMBER 7, 1975

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE
67-569 WASHINGTON : 1976

JOINT ECONOMIC COMMITTEE

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

HUBERT H. HUMPHREY, Minnesota, *Chairman*
WRIGHT PATMAN, Texas, *Vice-Chairman*

SENATE

JOHN SPARKMAN, Alabama
WILLIAM PROXMIRE, Wisconsin
ABRAHAM RIBICOFF, Connecticut
LLOYD M. BENTSEN, Jr., Texas
EDWARD M. KENNEDY, Massachusetts
JACOB K. JAVITS, New York
CHARLES H. PERCY, Illinois
ROBERT TAFT, Jr., Ohio
PAUL J. FANNIN, Arizona

HOUSE OF REPRESENTATIVES

RICHARD BOLLING, Missouri
HENRY S. REUSS, Wisconsin
WILLIAM S. MOORHEAD, Pennsylvania
LEE H. HAMILTON, Indiana
GILLIS W. LONG, Louisiana
CLARENCE J. BROWN, Ohio
GARRY BROWN, Michigan
MARGARET M. HECKLER, Massachusetts
JOHN H. ROUSSELOT, California

JOHN R. STARK, *Executive Director*

SENIOR STAFF ECONOMISTS

JERRY J. JASINOWSKI
LOUGHLIN F. MCHUGH
JOHN R. KARLIK
COURTENAY M. SLATER
RICHARD F. KAUFMAN, *General Counsel*

ECONOMISTS

WILLIAM R. BUECHNER
ROBERT D. HAMRIN
RALPH L. SCHLOSSTEIN
WILLIAM A. COX
SARAH JACKSON
GEORGE R. TYLER
LUCY A. FALCONE
L. DOUGLAS LEE
LARRY YUSPEH

MINORITY

GEORGE D. KRUMBHAAR, Jr. (Counsel)
M. CATHERINE MILLER

CONTENTS

WITNESSES AND STATEMENTS

TUESDAY, OCTOBER 28, 1975

Page

Humphrey, Hon. Hubert H., chairman of the Joint Economic Committee:
- Opening statment 1

Greenspan, Hon. Alan, Chairman, Council of Economic Advisers 8

FRIDAY, NOVEMBER 7, 1975

Humphrey, Hon. Hubert H., chairman of the Joint Economic Committee:
- Opening statement 47

Simon, Hon. William E., Secretary of the Treasury, accompanied by Sidney L. Jones, Assistant Secretary, Economic Policy; and Robert. A Gerard, Deputy Assistant Secretary, Financial Resources Policy Coordination 51

SUBMISSIONS FOR THE RECORD

TUESDAY, OCTOBER 28, 1975

Greenspan, Hon. Alan:
- Prepared statement 11
- Response to additional written questions posed by Senator Percy 41

Humphrey, Hon. Hubert H.:
- Article entitled "Who's in Charge Here, Anyway?", by James P. Gannon, from the October 21, 1975, issue of the Wall Street Journal 3
- Letter to Hon. William E. Simon, Secretary of the Treasury, from Chairman Humphrey, dated October 18, 1975, requesting additional information concerning the President's recent proposal for tax and spending reductions 5
- Letter of response to Chairman Humphrey from Stephen S. Gardner, Acting Secretary of the Treasury, dated October 23, 1975, with an enclosure, transmitting additional information concerning the President's recent proposals for tax cuts and spending reductions 6

FRIDAY, NOVEMBER 7, 1975

Humphrey, Hon. Hubert H.:
- Opening statement of Senator Robert Taft, Jr 50
- Table showing Federal finances and the gross national product, 1954–76 93

Simon, Hon. William E., et al.:
- Prepared statement, together with additional material 58
- Response to Chairman Humphrey's request to supply the main elements of an increase of $53 billion in spending outlays in fiscal year 1977 74
- Response to Representative Brown of Michigan's request for a perspective on municipal bond yields 88
- Response to Representative Hamilton's query regarding the impact of the President's program on the deficit figure for fiscal year 1977 90
- Tabular response to the colloquy with Chairman Humphrey regarding total government spending and gross national product, calendar years, 1955–74 93
- Response to the assertion by Chairman Humphrey that the New York financial crisis had caused a dropoff in municipal bond and note new issue volume after July because tax-exempt issuers refused to come to the market as a consequence of high borrowing cost 95

THE PRESIDENT'S PROPOSED TAX CUT AND BUDGET CEILING

TUESDAY, OCTOBER, 28, 1975

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

The committee met, pursuant to notice, at 9:37 a.m., in room 5110, Dirksen Senate Office Building, Hon. Hubert H. Humphrey (chairman of the committee) presiding.

Present: Senators Humphrey, Ribicoff, Kennedy, Javits, and Percy; and Representative Long.

Also present: John R. Stark, executive director; William R. Buechner, Lucy A. Falcone, Robert D. Hamrin, Jerry J. Jasinowski, L. Douglas Lee, Loughlin F. McHugh, Courtenay M. Slater, and George R. Tyler, professional staff members; Michael J. Runde, administrative assistant; George D. Krumbhaar, Jr., minority counsel; and M. Catherine Miller, minority economist.

OPENING STATEMENT OF CHAIRMAN HUMPHREY

Chairman HUMPHREY. We are very grateful to you, again, Mr. Greenspan, for agreeing to be here this morning. Of course, the purpose of your presence here today is to discuss the recent proposal of the President for a tax cut and expenditure reductions.

Now, I thought it would be a good idea to get things straightened out in the beginning of our session. This hearing is about economics and not about politics. There has been a good deal of the politics on the outside. I think we will keep the economics here on the inside.

There has been some discussion as to whether or not the President's proposal will or will not help him politically. That is not the business of this committee. But since this is a bipartisan committee and a joint committee we have only one question to examine: Will the proposals offered by the President be beneficial to the economy? That, of course, is what you will address yourself to here.

Speaking for myself, I have serious doubts as to the degree of benefit. The tax cut, if taken alone, might be beneficial in insuring that economic recovery continues at a rapid pace next year. I am concerned, though, as to whether or not that tax cut, if taken alone, would not be too large. Coupled with an expenditure reduction, which would sharply reduce economic growth in the final quarter of next year, I fail to see the kind of benefits in terms of economic stimulus that will result. This economy has been, according to my judgment,

at least, on a roller coaster operation long enough. It is time to get off and get straightened out.

If this tax and spending package is not beneficial to the economy, then why was it proposed? I am sure that you will indicate to us, with your own logic, that it is beneficial. You are privy to the internal deliberations at the White House, and I am not. So we are going to be interested in how the judgment was arrived at. I must tell you that to those of us looking at the question from the outside, it does not appear that the President is listening to his economic advisers. Now, that is quite a statement for me to make and easy for you to refute if the facts bear you out.

I call your attention to a recent article by James Gannon, the Washington correspondent of the Wall Street Journal, who, in an article entitled "Who's in Charge Here, Anyway?" writes: "Whose advice on economic matters is President Ford relying upon, now that it's obvious that he is often ignoring the counsel of his economic advisers?" Now, I did not say that. That is what the Wall Street Journal said.

Both the Ways and Means Committee and the House Budget Committee have indicated that they will support extension of the tax withholding rates which are presently in effect and that this extension of the 1975 tax reduction should not be tied to any arbitrary limit on 1977 spending—as distinguished from responsible, carefully considered, spending reduction actions under the budget control process that has been implemented by the Congress.

I would like to make the point here that the Congress is not saying that there ought not to be any reductions. Congress is simply saying that we have a budget process to bring about reductions, and they ought to be looked at item by item.

Whether we also need a large permanent tax reduction—and I underscore the word permanent, because that is what the President's proposal called for—and to what extent it should be coupled with expenditure reductions is a separate question and a very complicated one. According to information which has just been supplied to me by the Treasury Department, the tax cut proposed by the President would cost $29.5 billion in 1976, but by 1980 the revenue loss would grow to over $37 billion. Now, those are rather impressive figures.

That may be appropriate. It may be that we need a tax cut of this magnitude or even larger to offset the effect of inflation in pushing up tax liabilities.

But before I would commit myself to support any such major tax reduction, I want to see what it will do to the balance in the budget. With the existing tax structure and existing spending programs, we can balance the budget at full employment. I regard that as a prime test of fiscal responsibility. Surely we have to be able to look forward to the day when this recession will be behind us, the sooner the better, and that the economy will be at high employment, and the budget will be balanced.

But before I support tax reductions, I want to know whether we still will be able to balance a full-employment budget and at the same time meet legitimate public needs. I am very much in favor of achieving reductions on the spending side of the budget. Indeed, I have yet to meet the person who is not in favor of eliminating

"wasteful" and "unnecessary" spending. But most of what the Government spends is legitimate and necessary. We are not going to eliminate it. We must not cut taxes so much that we cannot finance the legitimate functions of Government.

These are issues which must be analyzed in connection with the President's recent proposals. So far the administration has failed to supply the information that is needed by any responsible committee to make this analysis. We do not know what the President wants to cut. We do not know the administration's assessment of the economic impact, and, until I wrote Secretary Simon, we did not even know the full cost of the proposed cut. And interestingly enough, the proposed cost of the full cut is considerably higher, than the proposed cut.

I think I should also make note of the fact that there are those of us who are concerned about what the President may want to cut. We are concerned because as we study when the President has used his veto in the past, we get some idea of where he thinks the cuts ought to be made. That has not always been the most reassuring development of recent months.

I ask consent that the article by James Gannon from the Wall Street Journal of October 21, 1975, and the correspondence which I sent to the Secretary of the Treasury, William Simon, on October 18 and the response received from the Acting Secretary of the Treasury, Stephen Gardner, on October 23 be placed in the hearing at this point.

[The material referred to follows:]

[From the Wall Street Journal, Monday, Oct. 21, 1975]

WHO'S IN CHARGE HERE, ANYWAY?

(By James P. Gannon[1])

Washington—The making of economic policy in the Ford administration is taking such odd twists and turns that it's time to ask some fundamental questions:

Is President Ford really serious about cutting taxes, slashing federal spending, deregulating American business, pouring $100 billion into energy development and letting New York City sink or swim? Or is he playing political games with such issues?

Whose advice on economic matters is President Ford relying upon, now that it's obvious that he is often ignoring the counsel of his economic advisers?

Who speaks authoritatively for the President on economic matters? Is it Treasury Secretary William Simon, Vice President Rockefeller, Press Secretary Ron Nessen or none of the above?

At the moment, there aren't any clear-cut answers to these questions. In the past few weeks, the development and articulation of White House policy on basic economic matters appear to have grown unusually confused and contentious, if not downright chaotic. The White House is emitting such conflicting signals that even some administration economists are baffled. Congress is suspicious, and the public must wonder if anyone is in charge.

"It is weird, really weird," muses one member of Mr. Ford's economic team. "Strange things are happening."

One of the strange things is Mr. Ford's sudden decision to propose a bigger tax cut than even liberal Democrats in Congress dared to suggest, tied to a controversial proposal to restrain future federal spending. For weeks, Mr. Ford and his advisers said the decision on whether to seek renewal of the temporary 1975 tax reduction would hinge on the state of the economy this fall. The President told a press conference on Sept. 16 that he'd propose "a continuation of the present tax cut" if it appeared the economy needed such stimulus, but "if we find that

---

[1] Mr. Gannon, a member of the Journal's Washington bureau, covers economic affairs.

the economy is continuing to come out of the recession, as it is, and there is no danger of added inflationary problems, we would probably not recommend a continuation of the tax cut."

Less than three weeks after saying that, Mr. Ford had a big new idea and a whole new rationale for it. Though the economy is recovering faster than his economists expected, Mr. Ford rejected the no-tax-cut advice of Treasury boss Simon and Federal Reserve Chairman Arthur Burns and went beyond the middle-road counsel of other economic aides who urged a continuation of this year's tax-withholding rates. Mr. Ford's long touchdown bomb, almost Nixonian in its spectacular boldness, couples a $28 billion tax-cut proposal with a rigid spending limit of $395 billion for the year starting next Oct. 1. Furthermore, Mr. Ford vows to veto any tax cut measure that doesn't include the budget lid.

A CHANGE OF PLAN

Starting another round of tax cuts Jan. 1 and delaying the spending holddown until after Oct. 1 obviously, would benefit the economy in the months before Election Day, 1976. But the President now says his plan wasn't aimed at affecting the economy at all. The aim, he says, is to get a handle on escalating government spending, and unless the Congress goes along, there won't be any tax cut at all, regardless of the state of the economy.

This stance raises the strong possibility that taxes will go up rather than down on Jan. 1, if Mr. Ford's veto threat isn't hollow. Is that what the President really wants? Probably not, though such an outcome would put him in a position to blame Congress for blocking "the biggest tax cut in history" by rejecting thrift in government.

The President presumably wants just what he proposed, but even that is quite a switch from his previous position. Remember the budget defiict line that Mr. Ford drew on national television last March, insisting that this year's red ink be held to $60 billion? That line drifted above $70 billion, without fanfare, when the President proposed his big tax cuts.

And whether happened to "crowding out"? Treasury Secretary Simon for months had warned that the big dificit and heavy Treasury borrowing would push up interest rates and crowd other borrowers out of credit markets; only days before Mr. Ford's deficit-deepening proposal, Mr. Simon asserted the feared results actually were coming to pass, even earlier than he'd expected. But now the Treasury chief brushes off the larger 1976 deficit in the current fiscal year as nothing to worry about, an acceptable price to pay for long-term restraint in federal outlays.

The presidential rhetoric about reducing federal spending and governmental interference with the economy is hard to square with another recent decision that has Mr. Ford's economic advisers nearly gagging. Adopting Vice President Rockefeller's brainchild, the President is prodding Congress to create a new $100 billion government corporation which would finance nuclear power plants, synthetic fuel facilities and other energy projects.

Treasury chief Simon, White House economist Alan Greenspan and other economic aides thought Mr. Rockefeller's idea was such a bad one that they battled fiercely in inner councils to kill it. The scheme, they argued, ran counter to administration policy on numerous grounds: It would create a new government agency, increase federal demands on credit, put basic economic decisions in the hands of bureaucrats, substitute federal for private effort and it would employ a disreputable "off-budget" accounting technique that Mr. Simon had often attacked as fiscal gimmickry.

These arguments fell on deaf ears in the Oval Office. The plan gave Mr. Ford a flashy centerpiece for his energy program. Even better, it showed Mr. Ford "doing something" about the energy crisis while Congress hemmed and hawed. In unveiling it, the President didn't miss a chance to complain that Congress hadn't enacted his earlier energy proposals.

The Vice President's success in selling one unlikely idea to Mr. Ford seems to have encouraged Mr. Rockefeller to try to sell another: a financial bailout of New York City. The once-clear and firm position of the Ford administration against federal aid to the nearly bankrupt city grows mushier and murkier by the day.

Congress wonders whether to heed Mr. Rockefeller's urgent call to pass a quick bailout bill, or to believe Mr. Ford's repeated assertions that he's against the idea. The President has stopped short of flatly promising to veto any bailout

legislation, and some Ford-watchers doubt he'd risk it: if a veto were followed by a New York City default which toppled financial dominoes across the land, the political blame would fall squarely on the President.

A CURIOUS CACOPHONY

Arthur Burns' ominous warnings about possible dire consequences of a New York City default seem directly at odds with Mr. Simon's repeated assertions that the fallout would be minimal. Press Secretary Nessen's frequent attempts to harmonize all this cacophony only contribute to the impression that the orchestra is out of control and the maestro can't find the baton.

This confusing pattern has undermined the credibility of Mr. Ford's economic advisers and spokesmen, and has cast doubt on the President's consistency and control. It is worth noting that, since the beginning of his administration, Mr. Ford has displayed a curious penchant for proposing economic programs with fanfare, and then abandoning them.

A year ago, Mr. Ford was wearing a WIN button and asking Congress to raise taxes to fight inflation. As the economy went down the recession tube, Mr. Ford executed that famous "179-degree turn" and proposed tax cuts in January to fight unemployment. A special program of tax relief for electrical utilities, proposed in May, has been all but forgotten and appears superseded by the $100 billion energy-development plan. In July, Mr. Ford sent Congress a complicated "capital formation" plan to reduce the double taxation of corporate dividends but now that's been overtaken by his substitute tax-cut plan, which includes different tax reductions for business.

The President has a right to change his mind and adapt his program to changing economic conditions, of course. But the record of flipflop and zigzag raises questions: Will this month's brainchild be next month's stepchild? Will Mr. Ford quietly disown Rocky's energy offspring, decide that New York needs a bailout after all, or accept a tax cut passed by Congress without his budget lid? The answers aren't obvious.

What is obvious, though, it that the President and Congress are in a new contentious posture with each other. Coloring all of the President's actions, and Congress's reactions, are the politics of 1976. In the weeks since Mr. Ford officially declared his candidacy for election next year, the political factor has become a dominant influence in policy formulation, and is certain to remain so for the next year.

Mr. Ford's strategy for 1976 seems clear: He is running against "horrendous" federal spending, the "swollen federal bureaucracy," high taxes, government red tape, and—most of all—the "can't do" Democratic Congress. Even if Mr. Ford doesn't expect to achieve his economic programs, they ably lend themselves to this campaign strategy.

When Mr. Ford took office last year, ending the long national nightmare of Watergate, he wisely fostered a spirit of reconciliation. The new President promised to Congress "a policy of communication, conciliation, compromise and cooperation."

But now the Mr. Nice Guy period is over. The old four C's are replaced by a new set: confusion, contradiction, confrontation and can't-do. Look out, everybody, here comes 1976. It's going to be a long year.

OCTOBER 18, 1975.

Hon. WILLIAM E. SIMON,
Secretary of the Treasury,
Washington, D.C

DEAR MR. SECRETARY: The Treasury Department has been quite helpful in providing to the Congress and the press information concerning the details of President Ford's recent proposal for tax and spending reductions. I would like to request, however, two pieces of information which I do not believe have been made available.

The first is the projected loss in Federal revenues that would result from the President's proposals in each of the next five years. We would like to know the loss that would occur based on the 1975 law as well as that which would occur based on the 1972–74 law. It would be helpful if this could be broken down into each of the major provisions of the proposals, but in any case we would like to

know the projected losses for the proposed individual tax reductions and the business tax reductions. In order to evaluate these estimates, we will also need your assumptions on total gross National Product, total receipts, personal income, and corporate profits.

The second request relates to the lack of a recommendation with respect to the earned income credit. It is my understanding that the President's lack of a recommendation implies a recommendation that this provision expire at the end of this year. However, since the refundable portion of this credit has been reclassified as a budget outlay, the impact of some taxpayers who benefit from the credit is not reflected in the Treasury's tables showing the tax liabilities under the President's proposed 1976 law by adjusted gross income class. We would like to know the effect of the proposed 1976 law with respect to the 1972–74 law and the 1975 law if the outlay portion of the earned income credit is taken into consideration. We would appreciate you making this adjustment to tables 6, 7, 8, 9, and 10, in the "Memorandum for the Press: October 8, 1975" and supplying the adjusted tables to the Committee.

The Joint Economic Committee is planning to hold hearings the last week in October to explore these and other issues related to the President's proposals. Therefore, we need this information by October 23, so that we will have an opportunity to examine it prior to those hearings. If you have any questions concerning this request please speak with Mr. Douglas Lee of the Committee staff. I appreciate your cooperation and look forward to hearing from you.

Best wishes.

Sincerely,

HUBERT H. HUMPHREY,
Chairman.

THE SECRETARY OF THE TREASURY,
Washington, October 23, 1975.

Hon. HUBERT H. HUMPHREY,
Chairman, Joint Economic Committee,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: In the Secretary's absence, he has asked that I reply to your letter of October 18, 1975 requesting additional information concerning the President's recent proposals for tax cuts and spending reductions.

The enclosed table shows the revenue loss by provision from 1976 through 1980. In each of the 5 years, the revenue estimates are shown under 1974 law and 1975 law. For the purpose of this exercise it was assumed that the temporary provisions of the Tax Reduction Act of 1975 are extended through the projection period.

We have answered your second question concerning the budget outlay portion of the earned income credit in a recent discussion with Mr. Douglas Lee of the Joint Economic Committee staff.

The revenue figures underlying the estimates of changing tax liabilities in the table are prepared by the Department of the Treasury using various techniques summarized in the testimony before the House Budget Committee on September 29, 1975 (pp. 8–15). The general economic forecasts that are used in making revenue estimates are published periodically by the Administration as a basis for developing economic policies. The most recent five-year estimates published by the Administration appeared on May 30, 1975 in the Mid-Session Review of the 1976 Budget. It should be emphasized that such five-year economic estimates involve a two-year forecast of probable economic conditions during those two years and projections of those figures over the remaining period using assumptions that are consistent with moving gradually toward relatively stable prices and maximum feasible employment. The Administration will prepare a new five-year economic projection as part of the regular process of developing the Fiscal Year 1977 Federal budget. It is my understanding that the Office of Management and Budget will not publish new five-year economic estimates in submitting the current services budget on November 10 but that the Congressional Budget Office does plan to develop new five-year estimates. If there are further questions concerning the revenue estimating procedures, please contact us and we will try to explain the figures further.

I hope the above information will be helpful to you.

Sincerely yours,

STEPHEN S. GARDNER,
Acting Secretary.

Enclosure.

CHANGE IN CALENDAR YEAR TAX LIABILITIES DUE TO THE PRESIDENT'S TAX CUT PROPOSALS

[In billions of dollars]

Provision	Calendar years—									
	1976		1977		1978		1979		1980	
	1974 law	1975 law	1974 law	1975 law	1974 law	1975 law	1974 law	1975 law	1974 law	1975 law
Individual:										
Earned income credit [1]		+0.3		+0.3		+0.3		+0.3		+0.3
Change in personal exemption	−10.6	−5.3	−11.1	−5.3	−11.7	−5.8	−12.3	−6.2	−12.9	−6.6
Change in standard deduction	−4.2	−1.7	−4.4	−1.9	−4.6	−2.0	−4.9	−2.1	−5.1	−2.2
Rate reduction	−6.8	−6.8	−7.2	−7.2	−7.5	−7.5	−7.9	−7.9	−8.3	−8.3
Increase rate of investment tax credit	−.5		−.6		−.6		−.6		−.7	
Total	−22.1	−13.5	−23.3	−14.1	−24.4	−15.0	−25.7	−15.9	−27.0	−16.8
Corporation:										
Change in corporate rate and surtax exemption	−1.5		−1.7		−1.8		−1.9		−2.1	
Decrease corporate surtax rate	−2.5	−2.5	−2.5	−2.5	−2.7	−2.7	−2.9	−2.7	−3.2	−2.7
Increase rate of investment tax credit	−2.8	+.4	−2.9	+.4	−3.0	+.4	−3.1	+.4	−3.1	+.4
Utility relief	−.6	−.6	−.8	−.8	−1.2	−1.2	−1.5	−1.5	−1.7	−1.7
Total	−7.4	−2.7	−7.9	−2.9	−8.7	−3.5	−9.4	−3.8	−10.1	−4.0
Grand total	−29.5	−16.2	−31.2	−17.0	−33.1	−18.5	−35.1	−19.7	−37.1	−20.8

[1] Excludes $1.2 billion since this amount is classified as a budget outlay rather than a tax reduction.

Note: 1975 law base case assumed the extension of the Tax Reduction Act except for the 5 percent new home credit.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Oct. 22, 1975.

Chairman HUMPHREY. Mr. Greenspan, will you please proceed now with your statement? I hope you will allude to some of the comments I have offered this morning.

Senator KENNEDY. Would the Senator yield just for a very brief comment?

Chairman HUMPHREY. Yes.

Senator KENNEDY. I want to thank the Chair for holding these hearings. I can remember when Mr. Greenspan was here before the committee. I think it was about 2 months ago.

There were a number of us at that time who asked Mr. Greenspan about the needs for a tax cut. And I think he indicated he was unprepared to make any kind of a statement or commitment on that. Many of us were urging that there be a continuation of tax cuts starting in January in the withholding area that would have been anywhere from $7 billion to $9 billion.

Then, as the Chair points out, we have this dramatic kind of position which has been taken by the administration, which is the $28 billion out in terms of tax cut and $28 billion in terms of spending cuts. I must say, quite frankly, having listened to Mr. Greenspan, and listening to his sense of caution about this whole kind of issue, and in being willing to express a viewpoint, and then the dramatic kind of posture that has been assumed by the administration, it would appear to many of us—although I am sure he will make the case this morning that this is not the case—that it is basically for more political reasons than for sound economic reasons, particularly as the tax cuts come before the election and the spending after, with the kind of boom and bust economic pros-

pects. I am hopeful that you will be developing at least the reason and the justifications for this position.

Finally, let me say I saw the President on television the other night, talking about that the spending cut is really up to the Congress, that there are Members of Congress that talk about noncontrollable items and that, basically, noncontrollable items can be controlled by the Congress. I assume on that, he means that items such as the social security, items such as the interest on the payment, things which obviously have a strong kind of a responsibility—Congress has the power but, obviously, it cannot get into the situation.

I would not think—and if I am wrong about it, I would hope that you would be able to clarify where we are going to be able to, even though we have the legislative power, to stop the payments on social security; that this, obviously, would be a clear violation of moral responsibility to the millions of people that paid into that.

I would be interested, when you do talk about areas in which there are going to be cuts, that you outline some of those noncontrollable items where we can make these cuts, and that you are going to be as specific as possible, in terms of the general areas where you think these cuts can take place.

I just want to thank the Chair for holding these hearings, and I hope Mr. Greenspan would address it. I, unfortunately, will not be able to be here during all the time on his testimony, but I will try to get back, and I will read with great interest his comments.

Chairman HUMPHREY. Congressman Long, do you have any comment?

Representative LONG. I have no statement, Mr. Chairman.

Chairman HUMPHREY. Mr. Greenspan, I think the concern expressed by Senator Kennedy and the questions that he has asked, as well as those that I asked, pretty well state the kind of questions that are being asked in the Budget Committee of the Congress.

Under the requirements of the Employment Act of 1946, as you know, the Joint Economic Committee has to analyze the budget and make a report to the appropriate committees of the Congress. So we will be looking at the President's proposals and his budget recommendations with meticulous care.

In fact, if I am not mistaken, we have just finished sending out our letters, asking for considerable detail on the budget. Go right ahead.

STATEMENT OF HON. ALAN GREENSPAN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. GREENSPAN. Thank you, Mr. Chairman.

I have, in my prepared statement, a fairly extensive discussion of the current economic outlook which I would like submitted for the record, and which I will not repeat at this particular moment, but will allude to it as is necessary during the questioning period.

Just in summary, I think that the data that we have been observing in recent months clearly indicates that the recovery which is now 6 months old has been moving ahead, somewhat ahead of our forecasts, and has a fairly solid momentum to it.

There are, as always, a number of problem areas. In fact, it is almost never—really, never the case that all of the economic news is unqualifiedly good. But there is no doubt, I think—and I suspect that one could very easily observe this—that we have had a good deal larger proportion of good news of late, rather than bad news, which I must say is a great improvement over the extraordinarily bad sets of data and statistics that we had earlier this year.

Now that the recovery is underway, it is even more important to focus upon the problems that we are going to confront in the next year and beyond. Unless we carefully assess the lists that are involved of alternate policies, we may exacerbate the problems which we will face by late next year, and greatly increase the chances of setting off another inflation-recession cycle.

The dilemma is how to achieve recovery without recreating recession. At this juncture in the recovery, ideally one would want assurance that fiscal and monetary policy would be adequate to support the continuation of a healthy recovery. At the same time, the improvement in the economy makes it even more important to assure that the thrust of fiscal and monetary policy does not have imbedded in it the seeds of future inflation.

A second, and in a sense more difficult problem is that consumers and businessmen are not convinced that the dilemma of achieving recovery without inflation can be resolved. Recent experience has made them wary, watchful, and mindful of the risks which the various policy alternatives pose for the future.

Past experience indicates that it is easy to continue expansive policies, but it is very difficult to curb budget deficits and hold monetary expansion to rates which are appropriate for high employment price stability. Rightly or wrongly, our past mistakes have created a situation in which recovery itself is dependent upon confidence that policy will become significantly less expansive when and as circumstances require.

Fiscal and monetary policies are, in my judgment, generally suitable for present circumstances. But as circumstances change, policy must, of course, also change. The budget deficit must be closed as the recovery proceeds, and unless we are able to rein in the rapid rise in Federal outlays, I do not believe that we can count on the passive growth in revenues from the recovery to fully close it.

In fact, it is this longer-term fiscal problem to which the President's program—to tie a $28 billion cut in the growth in Federal outlays to a comparable cut in taxes—was addressed. It was not proposed for its short-term effects, although the discussion and the criticism has tended to concentrate upon these aspects.

The major economic thrust of the President's program is directed at what we perceive to be one of the most important long-term economic problems confronting the United States. It is directed at what is clearly an accelerating and increasingly uncontrollable rate of increase in Federal outlays.

The flexibility, or so-called controllability, of our expenditures has sharply decreased during the last decade. Nearly three fourths of the budget now is in outlays for programs for which payment is required

under existing law or contracts. These payments must be made unless substantive law is changed.

Government payrolls make up an additional one-sixteenths of the Federal budget. The largely discretionary remaining one-tenth includes mainly non-payroll purchases of goods and services. In 1967, when such analyses were first initiated, one-fifth of the budget was discretionary. And I am sure, were we to discuss data for earlier periods, a number would have been progressively higher.

An even more important problem is that the rate of increase in non-defense budget outlays, in real terms, in recent years, has exceeded the real growth in the economy. Payments to individuals, again in real terms for example—that is, adjusted for inflation—rose at a 10.9-percent annual rate between fiscal years 1965 and 1975. Real outlays for all non-defense programs, excluding NASA and interest payments, rose at an annual rate of more than 8 percent.

The size of the developing problem has been obscured for years by the decline in real defense outlays following the Vietnam war peak. Between fiscal years 1968 and 1975, such outlays declined by an average of 6.4 percent per year.

The sharp shift in the underlying composition of outlays in the budget, and practical realities of the forces that have produced it, clearly suggest three choices: a sharp curb in the growth of domestic programs, a further gradual dismantling of our Defense Establishment, or significant tax increases.

Even should we, as a Nation, short-sightedly opt for either of the latter two courses of action, we would be only postponing again the inevitable confronting of the unsustainable real rise in domestic programs.

The full significance of this acceleration in outlays became particularly evident during the spring and summer of this year as the fiscal year 1977 budget began to take shape. As the magnitude of the increases in outlays which would have to take place under existing law became clear, the President directed the Office of Management and Budget to devise measures and ways by which the expenditure growth could be slowed. He further directed that any savings be refunded to the American taxpayer in order to maintain private purchasing power and job creation.

One problem that the President had in formulating his program was that the temporary tax cut for calendar year 1975 expired on December 31. Unless the new permanent tax structure were put in place as of January, income tax rates would have risen automatically. In order to reduce the uncertainty with respect to taxes, he—that is, the President—decided to recommend his tax legislation to be effective as of January 1, 1976.

Should the spending curtailment lag the tax cut, the deficit for the first 9 months of calendar year 1976 would, of course, be increased, and this in itself is admittedly undesirable. Additional fiscal stimulus does not seem to be necessary considering the extent of the economic recovery now underway. As a consequence, the President has indicated that he would support further curbs in fiscal year 1976 expenditures.

In any event, the increases in the deficit are certainly not large when compared with a program of an extension of the current tax withholding rates and prospective outlays. As a consequence, the impact on the path of economic recovery would not be significant.

What would be significant are the effects on the levels of Federal outlays during the fiscal years 1978, 1979, and beyond. The $28 billion cut in the fiscal year 1977 rate of increase in outlays, which the President has proposed, would help insure that the dangerous acceleration in Federal spending would be dramatically slowed. This would be a major first step toward defusing the very strong inflationary bias that has gripped our economy.

I might just add paranthetically, Mr. Chairman, that the growing effect of the reduction in taxes through 1980 which was cited also has its counterpart in the rise in the cut in the rate of increase of expenditures, because clearly by, in a sense, inserting a wedge of approximately $28 billion into the fiscal year 1977 growth outlay rise would also produce a reduction of substantially more than $28 billion in the level of expenditures which otherwise would prevail in fiscal year 1980.

As a consequence, these are parallel effects both on taxes and on spending in the President's program. Thank you.

[The prepared statement of Mr. Greenspan follows:]

PREPARED STATEMENT OF HON. ALAN GREENSPAN

I am pleased to appear before this Committee today to discuss the economic impact of the President's tax and expenditure proposals for next year. As necessary background however, I should like to begin by touching first upon some of the recent evidence on the state of the economy and the recovery which has been underway for six months.

The surge in industrial production and gross national product indicate that the rebound in economic activity from the depressed levels of last April has been running ahead of forecast. Over the same period, there has been an excellent gain in total employment and a more rapid decline in joblessness than we had expected last spring. Equally important, the flareup in prices during June and July abated during the past two months, and the easing of pressures in the farm product markets have served to allay partially the widespread concern regarding an early renewal of strong inflationary pressures. One result has been the restoration of a much better expectational climate in the money and capital markets and a retreat in interest rates from this summer's highs. The recovery is underway and in its initial stages at least, it is stronger than we could have prudently expected.

The course of the economy this year has been dominated by sharp movements in business inventory investment, as I have pointed out before this Committee on earlier occasions. The preliminary estimates indicate a very sharp inventory swing in the third quarter. Although inventories were still being rundown the much slower pace of liquidation acounted for more than half of the gain reported in GNP. We have known for some time that the inventory liquidation of earlier in the year was simply unsustainable and that its reversal was inevitable, as the excessive inventory overhang which was built up last year was worked off. Moreover just as inventory movements accentuated the recession earlier in the year they will continue to be a source of strength—although a decline one—over the next two or three quarters at least.

One impressive aspect of the third quarter figures is the strength in final demand. Final sales in real terms rose at an annual rate of 4.4 percent, just about as rapidly as in the second quarter of the year, largely because of a continued strong rise in personl consumption expenditures. Consumer outlays in real terms rose at a 7 percent annual rate—slightly more rapidly than the 6.3 percent rate of advance during the second quarter. I should point out that some of these growth rates are exaggerated by a quirk in the statistical techniques used to put the GNP in constant dollars. The real GNP gain during the third quarter would be closer to 9 percent than 11.2 percent if more updated techniques were used in removing the effects of inflation from the current dollar GNP levels.

Perhaps more important to the immediate outlook, the evidence to date for October indicates that the pickup in economic activity has continued into the present quarter. Retail sales of durable goods are exhibiting special strength as

automobile sales, following the introduction of the new models, are continuing the pattern of increase which began in the first quarter of the year. The strength in final demand is laying a solid foundation for a further recovery next year and this is more important than the precise pattern and timing of the inventory swing which we are now experiencing.

A second encouraging aspect is that recent evidence suggests a somewhat earlier bottoming out in business capital investment outlays than many have anticipated. Business fixed investment in real terms held even during the third quarter despite the a wide margins of excess capacity which prevails throughout the economy. Nor is this development without support. Following the sharp declines of late last year, the inflow of new orders for capital goods in August was up by 12 percent from the March low and this level held up in September. Production of business equipment in the industrial production index rose at a nearly 10 percent seasonally adjusted annual rate between June and September. There are also indications of a more favorable upturn in corporate earnings in the second half and this would facilitate the recovery in investment. There are still reasons, however, to question the speed and the timing of the upturn in business investment next year but the evidence continues to provide support for the possibility of an earlier and a more substantial upturn in capital outlays than past experience might indicate.

As one would expect the sharp pickup in production has resulted in a correspondingly marked improvement in the employment situation. Between March and September civilian employment, as measured in the monthly household survey, rose by 1.5 million. In recent months, and especially since June, rising employment in the household survey has been accompanied by a significant pickup in nonfarm payroll employment. Although the labor force has continued to expand at a rapid 2.0 percent annual rate since December, the level of unemployment has declined, and the decline from the second quarter peak has been more rapid than we had anticipated.

Of course there are problem areas and we all recognize them. The recovery in housing has lagged expectations. Housing starts in September were at a seasonally adjusted annual rate of 1.24 million units, a full 41 percent above the levels of December 1974. Nonetheless they were still below our earlier expectations for this time and the levels consistent with the country's long-term housing needs and a healthy residential construction sector. Mortgage interest rates have moved upward in the past several months, and by September the rise in short-term interest rates seemed to imperil the inflow of funds into the mortgage lending institutions. Although mortgage interest rates remain at very high levels, short-term rates have come down. The savings flow data now indicate resumed inflow and a more reassuring outlook for the availability of mortgage financing in the months ahead. Accordingly we expect the gradual recovery in housing to continue in 1976.

Even with the easing of the June and July price flareup, consumer prices have risen at a 7 percent annual rate so far this year, a rate which is too high in comparison with historical standards and the requirements for a stable prosperity. High inflation and inflationary expectations moreover have their direct counterpart in high interest rates. Perhaps most important of all consumers and businessmen are not yet convinced that economic recovery can be achieved without setting off another set of forces which will quickly recreate the virulent inflationary conditions of 1973 and 1974. These are problems which policy must recognize and deal with.

But it is important to recognize that economic conditions have undergone a marked improvement in recent months. Quite apart from the inventory swing, the recovery appears to be resting upon solid enough foundations to suggest a continuation during the present quarter and into next year as well.

Now that the recovery is underway it is even more important to focus upon the problems which we are going to confront in the next year and beyond. Unless we carefully access the risks that are involved with alternative policies we may exacerbate the problems which we will face by late next year and greatly increase the chances of setting off another inflation-recession cycle.

The dilemma is how to achieve recovery without recreating inflation. At this juncture in the recovery, ideally, one would want assurance that fiscal and monetary policy will be adequate to support the continuation of a healthy recovery. At the same time the improvement in the economy makes it even more important to assure that the thrust of fiscal and monetary policy does not have embedded in it the seeds of future inflation.

A second and, in a sense, more difficult problem, is that consumers and businessmen are not convinced that the dilemma of achieving recovery without inflation can be resolved. Recent experience has made them wary, watchful and mindful of the risks which the various policy alternatives pose for the future. Past experience indicates that it is easy to continue expansive policies, but it is very difficult to curb budget deficits and hold monetary expansion to rates which are appropriate for high employment price stability. Rightly or wrongly our past mistakes have created a situation in which recovery itself is dependent upon confidence that policy will become significantly less expansive when and as circumstances require.

Fiscal and monetary policies are, in my judgment, generally suitable for present circumstances. But as circumstances change, policy must also change. The budget deficit must be closed as the recovery proceeds and unless we are able to rein in the rapid rise in federal outlays I do not believe that we can count on the passive growth in revenues from the recovery to fully close it.

In fact it is this longer-term fiscal problem to which the President's program, to tie a $28 billion cut in the growth in federal outlays to a comparable cut in taxes, was addressed. It was not proposed for its short-term effects—although the discussion and the criticism has tended to concentrate upon these aspects. The major economic thrust of the President's program is directed at what we perceive to be one of the most important long-term economic problems confronting the United States. It is directed at what is clearly an accelerating and increasingly uncontrollable rate of increase in federal outlays. The flexibility, or so-called controllability, of our expenditures has sharply decreased during the last decade. Nearly three fourths of the budget now is in outlays for programs for which payment is required under existing law or contracts. These payments must be made unless substantive law is changed. Government payrolls make up an additional one-sixth of the federal budget. The largely discretionary remaining one-tenth includes mainly nonpayroll purchases of goods and services. In 1967 when such analyses were first initiated, a fifth of the budget was discretionary.

An even more important problem is that the rate of increase in nondefense budget outlays, in real terms, in recent years, has exceeded the real growth in the economy. Payments to individuals in real terms for example, rose at a 10.9 percent annual rate between fiscal 1965 and fiscal 1975. Real outlays for all nondefense programs excluding NASA and interest payments rose at an annual rate of more than 8 percent.

The size of the developing problem has been obscured for years by the decline in real defense outlays following the Vietnam War peak. Between fiscal years 1968 and 1975 such outlays declined by an average of 6.4 percent per year. The sharp shift in the underlying composition of outlays in the budget and practical realities of the forces that have produced it, clearly suggest three choices—a sharp curb in the growth of domestic programs, a further gradual dismantling of our defense establishment, or significant tax increases. Even should we, as a nation, short-sightedly opt for either of the latter two courses of action, we would be only postponing again, the inevitable confronting of the unsustainable real rise in domestic programs.

The full significance of this acceleration in outlays became particularly evident during the spring and summer of this year as the fiscal 1977 budget began to take shape. As the magnitude of the increases in outlays which would have to take place under existing law became clear, the President directed the Office of Management and Budget to devise measures and ways by which the expenditure growth could be slowed. He further directed that any savings be refunded to the American taxpayer in order to maintain private purchasing power and job creation.

One problem that the President had in formulating his program was that the temporary tax cut for calendar year 1975 expired on December 31st. Unless the new permanent tax structure were put in place as of January, income tax rates would have risen automatically. In order to reduce the uncertainty with respect to taxes, he decided to recommend his tax legislation to be effective as of January 1, 1976.

Should the spending curtailment lag the tax cut, the deficit for the first nine months of calendar year 1976 would be increased and this in itself is admittedly undesirable. Additional fiscal stimulus does not seem to be necessary considering the extent of the economic recovery now underway. As a consequence,

67-569—76——2

the President has indicated that he would support further curbs in fiscal 1976 expenditures.

In any event, the deficit increases are certainly not large when compared with a program of an extension of the current tax withholding rates and prospective outlays. As a consequence, the impact on the path of economic recovery would not be significant.

What would be significant are the effects on the levels of federal outlays during the fiscal years 1978, 1979 and beyond. The $28 billion cut in the fiscal 1977 rate of increase in outlays, which the President has proposed, would help insure that the dangerous acceleration in federal spending would be dramatically slowed. This would be a major first step toward defusing the very strong inflationary bias that has gripped our economy.

Chairman HUMPHREY. Thank you very much, Mr. Greenspan.

I have to confess I am very perplexed by one part of your statement. Much of it, of course, is statistical information about the so-called controllable and uncontrollable items, the rise in the increase in the number of items that are for payroll and for social programs. All of those are matters which the congressional Budget Committees are wrestling with. And might I say that all of these matters will be examined with meticulous care by the appropriate committees of the Congress.

I think we have a pretty good record already with the Budget Committee; we are getting our new estimates that will be coming out very shortly.

But in your prepared statement you bring to our attention the fact that the temporary tax cut for the calendar year 1975 expires on December 31. Therefore, there is a need to make a decision as to whether you will extend the 1975 cut, or what kind of a tax program you will offer. I think it is important that the American business community, the consumers as well, understand what our policy will be.

Your next paragraph states:

> Should the spending curtailment lag behind the tax cut, the deficit for the first nine months of calendar year 1976 would be increased, and this in itself is admittedly undesirable.

Then you go on to say:

> Additional fiscal stimulus does not seem to be necessary considering the extent of the economic recovery now underway. As a consequence, the President has indicated that he would support further curbs in fiscal 1976 expenditures.

Let us follow the logic of your own argument here. First of all, you say that the first nine months of calendar 1976 will have an increased deficit. Is that not correct?

Mr. GREENSPAN. The change in the deficit that we perceive is small but it is an increase over the deficit that we had previously been expecting.

Chairman HUMPHREY. Yes.

Mr. GREENSPAN. I would prefer that there be no increase in the deficit, and hopefully the Congress will move on many of the expenditure curtailments that the President has already proposed to the Congress.

Chairman HUMPHREY. Well we have had quite a go-around on that already with vetoes and passage of legislation. And I think the fact is that theAmerican public ought not to be fooled. They know what the attitudes are. The President has made his vetoes; the Congress has attempted to override some of those vetoes, and we failed. And

therefore, we have cut back on at least some of our congressional proposals.

I think the point being made by you is that the proposed deficit for the first nine months of calendar 1976 would be increased. And up until now there has been a wringing of hands and copious tears and the gnashing of teeth and the beating of breasts about the size of the deficit, and now you are going to add to that deficit.

The interesting thing is that your curtailment proposals do not come into effect until later on in the year. As Mr. Burns said, and I am not saying I subscribe to this, but Mr. Burns' point was that the tax cut and the spending cuts ought to be concurrent.

You point out that deficit increases are certainly not large when compared with the program of extension of the current tax withholding rates and perspective outlays. But my point is that you know that the Congress, right off-hand, is not going to be able to act immediately on budget cuts. We have a budget process; we are not even going to get the President's budget down here until February most likely.

Mr. GREENSPAN. I believe it is January, Mr. Chairman.

Chairman HUMPHREY. Well maybe you will do it in January this year but generally speaking, it comes a bit later.

Mr. GREENSPAN. As I understand it, the date is pretty firmly fixed, and the Office of Management and Budget intends to meet that specific date which is in January.

Chairman HUMPHREY. The latter part of January, right?

Mr. GREENSPAN. I believe it is closer to the middle.

Chairman HUMPHREY. The budget—we will wait and see.

Mr. GREENSPAN. The submission.

Chairman HUMPHREY. I have been around here 30-some years now, and I want to say I have not seen very many budgets reach the Congress of the United States in January. But you may be able to pull a miracle, and if you can we will give you credit for it.

But here you have a situation where the administration has been pounding away at the public about the dangers of deficits, and you admittedly come in and propose a larger one.

You also said that you really do not need the tax increase for fiscal stimulus, and then you propose a larger one.

For the life of me, I cannot understand what is going on. You deplore the deficit. Then you say, let's add on to it even though it is undesirable. You say, we have substantial recovery and you point out that you do not really need any further tax cut for recovery, so you propose one bigger than anybody else has proposed. It is sort of like the convert that becomes a true believer; you know, you have gone the whole distance, and some of us sort of feel that you might have found a happy meeting ground somewhere along the line.

I think it was unanimous in this committee to support a continuation of the 1975 tax cut, exclusive of the rebate. On the majority side of the committee, there was a feeling that there might be an additional tax cut, but we want to monitor the economy and see how it is coming along as to whether or not you needed to go further. But even then we were talking around $22 billion, at a maximum, $22 billion, $23 billion. And the Secretary of the Treasury indicates that the impact from your tax cut the first year will be $29.5 billion. That is a substantial amount, when you add that to the current deficit.

You have nothing in here about reducing the interest on the public debt. What is the interest on the public debt today, Mr. Greenspan?

Mr. GREENSPAN. The aggregate amount?

Chairman HUMPHREY. Yes; about $50 billion; $48 billion?

Mr. GREENSPAN. Since I have data in front of me, I might as well give you the latest revised testimony.

The total figure for fiscal 1976, interest on the public debt, is $37.8 billion.

Chairman HUMPHREY. $37.8 billion.

What other debt do we have on which the Federal Government is paying interest?

Mr. GREENSPAN. I am not sure what you are——

Chairman HUMPHREY. Are there any other items that are not classified in the debt column? The bookkeeping of the Government is very confusing.

Mr. GREENSPAN. I am sure the data are not included for the financing of the off budget programs.

Chairman HUMPHREY. Yes; that is what I mean.

Mr. GREENSPAN. But I could not, at the moment, give you a number on what the interest payments on that debt are, sir.

Chairman HUMPHREY. Why did you wait until October to start your spending cuts, Mr. Greenspan?

What is the magic of that? I mean, if we are dying of a kind of terminal disease, called deficit spending, why did you want to prolong the agony?

Mr. GREENSPAN. Well Mr. Chairman, I think that the President has been fairly consistent in attempting to curtail Federal outlays. In fact, as you commented in endeavoring to curtail the fiscal 1976 outlay structure, he has proposed a large number of cuts which Congress has not yet acted upon. And the reason for the specific ceiling of $395 billion is that fiscal 1977 is the first year in which a specific ceiling can be implemented through the budgetary process.

Now to come back to your earlier points, Mr. Chairman, the basic thrust of the President's program is largely, as I indicated in my prepared testimony, to attempt to drive a wedge in the accelerated rise in Federal outlays because this is a major potential destabilizing force in the economy.

Ideally the program would have attempted to match tax cuts and Federal outlays. It turns out, because of the peculiarity of the calendar and various laws which prevail, the choices that he had with respect to this issue were not simple ones; there is no easy way to make the tax and the expenditure actions mesh in a concrete way without having some very peculiar tax policy changes during calendar year 1976.

Now I must say I do not consider myself much of a politician, but I have heard—and I am often a little puzzled by the thought—that the particular sequence of events proposed was selected largely because of political considerations. And I must say that, having been in on the discussions, I know this was not the basis for the decision. I find the idea that it would be politically desirable to curtail politically popular expenditure programs several weeks before an election to be odd.

The tax cuts are way in advance of election while the spending cuts come just before it. I do not know what that means politically——

Chairman HUMPHREY. No, no, let me just help you. You surely are not a politican.

Representative LONG. You really are not.

Chairman HUMPHREY. Don't you run for office.

Mr. GREENSPAN. I am always glad to be instructed by a professional.

Chairman HUMPHREY. You see, there is momentum in trends. And thus you can stimulate the economy with those tax cuts, with this excessive deficit spending. And I charge the administration with reckless deficit spending in the first 9 to 10 months of 1976, exactly as it did in 1972.

In 1972, Mr. Greenspan, you take a look and see what happened. They opened the floodgates at the Treasury. They opened up the floodgates of the impounded funds and let them flush on out like a tidal wave, and Mr. Burns apparently could not get his hand on the shutoff valve on the money supply until around July.

Mr. GREENSPAN. I am always delighted to be instructed by you, Mr. Chairman.

Chairman HUMPHREY. Let me, then, give you my lesson, the economics of politics or the politics of economics is trend. When you get that sudden injection that you are putting into the economy in copious quantities of $28 billion, you give it a real stimulus.

Mr. GREENSPAN. Let me first say that one, with respect to 1972, I was not here then.

Chairman HUMPHREY. But I was around.

Mr. GREENSPAN. Well, I must say that I doubt that your description of monetary policy describes my view of it at the time.

Chairman HUMPHREY. Well, it may not be your view, but would you believe the statistics?

Mr. GREENSPAN. Well, it is the motives which you have cited that I find rather inconsistent.

Chairman HUMPHREY. Well, the motives—let us assume that they were——

Mr. GREENSPAN. Inconsistent with my view of Chairman Burns.

Chairman HUMPHREY. They were made with innocence, but let me tell you, they contributed to the sin.

Mr. GREENSPAN. I bow to your political views. Let me confront the economics of this question.

Senator RIBICOFF. I think it is important, Mr. Chairman, to get to the politics of this. It really is, because you opened it up.

I have been in public life some 40 years. I do not think, in the entire 40 years, I have ever seen such a cynical political play as the present proposal of President Ford. I am rather shocked that men like yourself lend yourself to this type of cynical politics, Mr. Greenspan. What always shocks me, too, is the intellectual experts coming to an administration, and what they would decry intellectually on their own, they never hesitate to make themselves handmaidens to any President of the United States and the politics that he wants to exercise at any given time, and I make no exceptions. Democratic and Republican Presidents have used men like yourself, and I have seen them used.

May I say this, Mr. Chairman. In some 13 years on the Finance Committee, and many of those on the Joint Economic Committee, I have never known a Secretary of the Treasury—and I make this

blanket statement—or a member of the Council of Economic Advisers, that has ever told the people of America and the Congress the truth. And if we have these problems that we have in economics today, we have a right to expect the truth from the Council of Economic Advisers about economic factors and economic facts, and I back you up completely, Mr. Chairman, on what you have been saying.

The great problems we have today, to have foisted on the American people and the Congress this ploy, and the President is going to fail, and the reason he is going to fail with his proposal is because the people are not fools. The people of America are pretty savvy, and they know they are being trifled with. And a President trifles with the American people at his own political peril. But what is even worse, economic advisers trifled with the people of America and the world, with their bad economic advice.

Now, I hope that before this day is over, Mr. Chairman, we get from you where these $28 billion cuts are going to be made. I think the President has an obligation to tell the Congress and the American people, if he is asking for a $28 billion pay cut, and a $28 billion budget cut, he has got an obligation to tell the Congress and the people what he is going to cut in that $28 billion. And I have not seen any figures or programs, as of yet, unless I have misread the newspapers, or I have not seen it, Mr. Chairman.

Chairman HUMPHREY. Thank you, Senator Ribicoff.

All right, Mr. Greenspan, equal time.

Mr. GREENSPAN. Thank you.

All I can say, Senator, is I sat through the deliberations with respect to this whole question of expenditures and taxes. I know the deliberations with respect to both, and the procedures that were involved in identifying the levels of expenditures, the methodology which might be used to achieve the cuts, the levels of taxes, and the methodology for achieving those redutcions and also the timing of both the tax and the expenditure actions.

I submit to you that I know of no issue raised with respect to politics in that area——

Senator RIBICOFF. They do not raise it that way.

Mr. GREENSPAN. No; but may I—I understand I——

Senator RIBICOFF. You know, I have been a member of a Cabinet, too. I have sat around a Cabinet table, and I have been in conferences with Presidents of the United States, too. It is never done that way. A President does not have to talk about politics, because a President knows that he can use men like you, Mr. Greenspan, because I have seen Presidents use men like you. So it is not a question—the President does not talk about politics. He does not raise it. But where can you have anything more cynical than what you have proposed right now?

Mr. GREENSPAN. Senator, first of all, the President is not using me in that sense. You are implying that we believe that somehow, by creating deficits, we are going to spur the economy. It is our view that that is just precisely what is not likely to happen, especially in the event that we have the types of deficits that you are talking about.

Senator RIBICOFF. I am not saying that. What I am asking is for the President and you to tell the Congress and the American people where you expect to make that $28 billion cut.

The Ways and Means Committee is marking up a bill now. The Finance Committee, of which I am a member, once they get through, will start marking up, having hearings and marking it up. So far, I have seen no figures on where you expect the tax cut to be, conditioned on the $28 billion budget cut. I have seen no figures on it.

Mr. GREENSPAN. First of all, I think there are two issues with respect to that. The President will fully detail his priorities in the $395 billion budget which will be presented in January.

Senator RIBICOFF. In January, but you have to have a tax bill before January 1.

Mr. GREENSPAN. I understand that, that is my second point. The question with respect to the issue of expenditures and taxes in the aggregate is precisely what the new congressional budget committees have been constructed for, to recognize that there are implications with respect to the issue of outlays in which the total has a significant meaning, in and of itself.

Now, the level of $395 billion is a number which the Congress is quite capable of understanding both in the sense of the total and also types of cuts would or could be required under various different options. The Congressional Budget Office has got the same detailed information that the Office of Management and Budget has.

And all I can indicate is that there is a purpose to setting a total level of expenditures independently of the component parts and there is a very important fiscal policy meaning for doing so. Now, that is not to say that numbers should be arbitrarily pulled out of the hat just in order to say, let us do this, or let us do that.

What was done, in fact, and done in a very arduous way, throughout the summer months, was to evaluate the structure of the budget, the types of increases that have been occurring in recent years, and the options which would be available to the President including those which might reasonably be used to arrive at a $395 billion total.

Now, all I am saying is that we want taxes and expenditures to be considered in parallel in the decisionmaking process. However, given the information which we all have, I do not think it is necessary, once one is convinced of what the feasible level of outlays is, to in fact delineate all of the individual prices prior to setting the overall totals.

Senator RIBICOFF. You could not be more wrong, because there is a problem of priorities, and the decision of priorities are made up by both the President and the Congress.

Now, I would gather what you are saying is that the administration, the executive branch, wants to abdicate its responsibility of setting priorities, and let the Congressional Budget Office do it. The Congressional Budget Office is not charged with coming up with a budget until the President comes out with his budget.

But the Ways and Means Committee for the House—and they expect to be through by November 15; then the Senate Finance Committee must come out, sometime before the first of the year, with some hearings and a bill; then you have to go to conference. But all of this has to be done before January 1, if you are going to get the tax-collecting process in the works, so you cannot—there is no way that you can possibly intermesh these two problems of a $28 billion tax cut and a $28 billion cut in the Federal outlays until that is shown.

Now, if the President and yourself had the courage of your convictions, then you should tell the Congress and the people of the United States where you expect to cut $28 billion. Then we have it before us, then maybe the Budget Committees, under Senator Muskie and Congressman Adams, can get their committees together and say, let us take a look at it and make a recommendation to the Ways and Means Committee and the Finance Committee. But they do not have anything before them at this present time.

So what you are doing, you wanted always—and this is why I talk about the most cynical political play I have seen in 40 years in politics, and I have seen a lot of cynical plays, Mr. Greenspan.

Mr. GREENSPAN. Well——

Chairman HUMPHREY. Congressman Long.

Well, go ahead, Mr. Greenspan; then, Congressman Long.

Mr. GREENSPAN. One quick statement. The problem of tying taxes and expenditures is one which the Congress has even now. For example, the Ways and Means Committee is marking up a tax bill, and yet, we still do not have a judgment with respect to what the level of fiscal 1977 outlays will be.

Now, this is a problem which is difficult for both the Congress and the administration. There are timing difficulties, and there are procedural difficulties which we recognize, and it is a matter of weeks, really, before the official budget document will be sent up here in full detail.

Senator RIBICOFF. I know, but what you are asking the Congress and the American people, if I may continue, because you have answered, is to buy a pig in the poke, to take the President on faith. But the entire history of economic decisions of the Nixon-Ford administration since 1969, gives no cause for the Congress and the American people to have faith in that pig in the poke. And this is the problem of what President Ford and you are asking the American people and Congress to do, and they are not going to buy it.

Congress is not going to buy it, Republicans and Democrats. They cannot buy it and still maintain their self-respect as representatives in the Congress of the United States, to buy a pig in the poke that way.

Representative LONG. I think, Mr. Greenspan, if you recall, that this little colloquy started out by you saying that you were not very much of a politician, or a very good politician.

Mr. GREENSPAN. I think I have demonstrated that, Mr. Long.

Representative LONG. Well, I was about to make that point. I think this is really very significant that evidently, those of you who are economic, financial experts within the administration did not recognize the political implications of what the program was that was adopted and set forth by the President.

Let me show you another thing that made me particularly suspicious. When the President presented his tax spending cut, it appeared to be a balanced package, and that was $28 billion in spending cuts and $28 billion in tax cuts. But if you look at the figures the Treasury Department presented to us, if you look at them in detail, this is really not true, because according to the estimates that they have, the tax cut in fiscal 1977 will not be $28 billion but it will be $31 billion. And that

just makes me, as a politician and I use that in the good sense of the term, suspicious of the whole thing. At the same time, the spending cut would be about $28—the $28 billion that the President set forth.

And then, the failure to recognize the political implications of the timing of this whole matter really caused, I think, everybody on the Hill, Republican, Democrat, people that react politically, again, in the good sense of the term, great consternation.

Mr. GREENSPAN. Well, Mr. Long, let me just confront two questions here. One issue is that the difference is small between the President's program and one which would merely extend the existing withholding rates and accept the expenditure increases as they would otherwise occur—frankly quite small. More importantly, it is by no means clear that there would be any substantial fiscal impact in more rapidly pushing the economy forward. In fact, as you know, I think that it is a very dubious proposition which I have argued before this committee on many occasions. The argument that we are trying to spur the economy is false.

The second issue is whether we were holding back on expenditure cuts for political reasons. I would point out again that the President has not been pushing expenditures. In fact, a wide variety of bills has been vetoed and the evidence is very strongly in opposition to the idea that he has or is hesitating in proposing unpopular expenditure actions.

The President is endeavoring to confront the extraordinary, long-term problems implicit in the sharp rise in budget expenditures.

I may not be a good politician, but I am certainly not naive, and I would suggest to you that the presumption that there is some political gimmickry involved in this program is not something I have any evidence of.

Representative LONG. Some of the most intelligent people that I know are some of the most politically naive people that I know, Mr. Greenspan.

Now, let me ask you a question about the field in which you really are an expert—the economic field. The Treasury Department figures on this whole problem estimate that by 1980, the President's proposals would reduce revenues by $37 billion if we extend it out—that is, by 1980, it would come down to $37 billion. Can you tell us the effects of the President's spending cut proposals in 1980? I mean, if we look at that, we are looking at half of the cake.

If we look at the reduction in the revenues to the extent of the $37 billion in the 4-year period, I guess, 4 fiscal years; and consequently, the question that results from that, of course, is that would the—when you balance the two off, would the proposals that the President has made lead us in the direction of a financial restraint, really: or would it result in financial stimulus over a period of several years?

Mr. GREENSPAN. Well, Mr. Long, I commented very briefly on the question in my opening remarks. Let me see if I can expand on it.

In a growing economy, clearly, when you introduce a particular tax cut, the initial impact upon revenues are those calculated with respect to the then-current levels of income. Clearly, as those levels of income in dollar terms increase year after year, the aggregate amount of revenue reduction will increase in relation to the tax rates that existed previously. But the same phenomenon also operates with respect to expenditure programs. To the extent that you change legislation—

and, as you recall, because of the fact that approximately four-fifths of existing outlays are currently under law; and a very big chunk in addition to that is payrolls——

Representative LONG. May I interrupt? I did not follow one thing you were saying. You were speaking of the phenomenon that existed on the correlation between the two. Right before that, I did not follow that.

Mr. GREENSPAN. What I am saying, Mr. Long, is that any estimate of the impact of a particular cut in taxes in one particular year or a cut in spending of a comparable amount representing changes in legislation—which most such cuts obviously must have——

Representative LONG. Right.

Mr. GREENSPAN [continuing]. Would create an increasing amount of money as you move from fiscal 1977 through fiscal 1980, both on the tax side and both on the expenditure side.

Now, on the expenditure side, the specific effects depend upon the very specific program changes that take place. But offhand without getting into the details of the program, the effect on expenditures could be more or less than the effect on taxes.

Representative LONG. So we really do not know whether this gap would widen or not, do we?

Mr. GREENSPAN. We will have data on that in full detail. I do know this; that underneath the data themselves is an implied projection which brings fiscal 1979 to a balanced budget; and in that sense, the effects of this particular expenditure tax program does not, at least in the total context, lead us toward an overly increasing deficit as a result of that.

Representative LONG. Thank you, Mr. Chairman.

Chairman HUMPHREY. I have a couple of questions more to get right down to some specifics.

Obviously, when the $28 billion tax cut was recommended, and the $28 billion limitation was brought into the consultation, you in the Council of Economic Advisors, the Office of Management and Budget, and others who were working on the budget, had a picture of where these cuts would be made. Now, that is what Senator Ribicoff is asking about; give us the picture, I mean, not just the generalities—not something off here on the horizon that looks like a mirage. But what are the factual pictures that you have of where cuts ought to be made?

Mr. GREENSPAN. One of the problems that I have is that a number of different options are being discussed with the agencies at this moment. And the President basically will not make specific final decisions until the agency heads and the Cabinet members, have their full say on the different aspects of programs.

Nonetheless, I have seen a number of different sets of potential ways of getting to the $395 billion. I am not at liberty, sir, to indicate the details to you. But I will say that neither the overall level nor the various ways of getting there were picked out of the air. These were the result of very extensive analysis by the Office of Management and Budget.

Chairman HUMPHREY. All right.

I just have a couple of more questions. There is considerable argument as to the total figure in the budget. The President has said that without his proposed budget cuts, spending in fiscal 1977 is headed toward $423 billion. Where does that figure come from? Because it is

not consistent with the Office of Management and Budget estimates of the current services budget which, though not yet completed, appeared to be running at around $410 billion.

The Congressional Budget Office has placed the figures at around $415 billion. To the outside observer, it appears that the first $8 billion to $13 billion of the proposed $28 billion of the budget cut can be achieved simply by making a more realistic estimate of where the spending is headed, in the absence of policy changes. What I am getting at is that the OMB preliminary estimate is $410 billion. Mrs. Rivlin's office of the Congressional Budget Office shows around $415 billion. Where did you get that figure, $423 billion?

Mr. GREENSPAN. Mr. Chairman, the figure was presented by the agency in detail by James Lynn before the Senate Committee on the Budget on October 21, and appears in a table following page 6 in that testimony.

Chairman HUMPHREY. Yes.

Now, Mr. Lynn has been doing some fancy dancing with figures. The fiscal 1977 budget does not follow immediately on fiscal 1976, as you know. There is an extra quarter in there, due to the budget change of the fiscal year. So if one calculates a percent change in spending from fiscal 1976 to fiscal 1977, one is calculating a change over a five-quarter period. Is that not correct?

Mr. GREENSPAN. That is correct.

Chairman HUMPHREY. If spending is on an upward trend one expects a five-quarter change to exceed the annual change. Is that not correct?

Mr. GREENSPAN. Yes, sir.

Chairman HUMPHREY. Would you tell Mr. Lynn, when he keeps talking about these figures, we would like to have him remember that there is a five-quarter change instead of a four-quarter?

Mr. GREENSPAN. I shall.

Chairman HUMPHREY. He is a delightful fellow, and very enjoyable to have a nice argument with, but he has forgotten that little extra quarter in there. And when that gets out over those television programs and on these radio programs, these figures get fixed in the public mind, and that is what bothers us a little bit around here.

Have you calculated what impact the tax cut will have on spending and unemployment? What do you think is going to happen to unemployment in this country, and inflation, if for 9 months you really whoop it up? You have already testified that we are having a very rapid recovery, and then you whack on the brakes, and you are not at all sure what Mr. Burns is going to do. Does anybody know what he is going to do on these matters with the money supply?

Mr. GREENSPAN. I have fairly frequent discussions with him on the issues of economic policy generally, and monetary policy.

Chairman HUMPHREY. I am sure you do. But I would like to know—since we know what the President wants for a budget ceiling, and we know what he wants for a tax cut, and we know what he wants for a spending limitation, would you tell me what Mr. Burns wants for a monetary policy during this period?

Mr. GREENSPAN. Well, first, Senator, I would scarcely describe the type of package we are talking about as whooping it up.

Chairman HUMPHREY. You would not?

Mr. GREENSPAN. No; I would not.

Chairman HUMPHREY. Well, now I take your own records, Doctor. You say we do not need any fiscal stimulus.

Mr. GREENSPAN. I agree with that.

Chairman HUMPHREY. All right. So $29.1 billion should give it to us by a syringe, force feeding.

Mr. GREENSPAN. First of all, the difference in the actual budget deficit with an extension of the existing withholding rates, coupled with the expenditure trend which will occur under present circumstances and the outcome under the President's proposal is really quite small.

Chairman HUMPHREY. I disagree, and I will tell you why. Because you are assuming, No. 1, that you want the $28 billion tax cut starting in January.

Mr. GREENSPAN. No; I am taking that into consideration.

Chairman HUMPHREY. And the spending program, in light of what the administration thinks of the Congress, is going to continue on just like it is, right up to October 1. You have added approximately $16 billion worth of tax cuts.

Mr. GREENSPAN. No; because that presumes that you are starting from a base in which taxes are increased as of January 1, and I do not think that is the credible position to take. I think in analyzing the impact that you must reasonably begin from where we are now on the revenue side and where we will be on the expenditure side unless we adopt actions to alter that trend.

Chairman HUMPHREY. All right, good.

Where are we now? The present tax withholding and all is about a $12 billion deduction, is it not?

Mr. GREENSPAN. Yes.

Chairman HUMPHREY. And you want to pump it up to $28 billion for 9 months of the year.

Mr. GREENSPAN. No; The comparable figures are not $12 billion. It is $17 billion or $18 billion.

Chairman HUMPHREY. Why?

Mr. GREENSPAN. Because the $12 billion is only personal taxes.

Chairman HUMPHREY. Yes.

Mr. GREENSPAN. The $28 billion includes not only the individual taxes, but also corporate taxes. The comparable figure, as I recall, is $17 billion or $18 billion.

Chairman HUMPHREY. What is the total tax cut that is effective, exclusive of the rebates for 1975?

Mr. GREENSPAN. You mean in the President's program?

Chairman HUMPHREY. No, as of the action of the Congress in 1975.

Mr. GREENSPAN. I believe it is $17 billion.

Chairman HUMPHREY. Exclusive of the rebates?

Mr. GREENSPAN. I believe so.

Chairman HUMPHREY. All right.

So, you would add $11 billion. Now, we have got our figures straight now.

Mr. GREENSPAN. That is correct.

Chairman HUMPHREY. You have already said we do not need any fiscal stimulus.

Mr. GREENSPAN. That is correct.

Chairman HUMPHREY. All right—and we have had inflationary pressures.

Mr. GREENSPAN. I am glad you mentioned that.

Chairman HUMPHREY. And you have always attached inflation to deficits. And now, you are going to increase the deficit, at least for a period of time. You know, you cannot——

Mr. GREENSPAN. Well, wait. First of all, if one is concerned about the overall question of inflation as I am, and as I think you are, Senator, the basic issue is not a particular quarter, or 6 months, or any particular year. In fact, when we discussed the size of the deficit earlier this year—and you will recall, then, we were talking in the $50 billion to $60 billion range—the point I tried to make was that under those circumstances that particular number did not basically alarm me, as long as it was a short-term type of deficit which would gradually disappear as the economy recovered.

In a similar sense, what is important about the President's program is that the combined impact during fiscal 1976 and fiscal 1977 is a reduction in the overall deficit. There would be a very significant reduction in fiscal 1977, fiscal 1978, and fiscal 1979.

Now—as I indicated in my testimony—while I do not like to see even a small increase in the deficit during the first part of next year, it does not in my judgment make that much difference when it is part—and a necessary part, because of the timing problems—of a sharp reduction in the overall trend in the deficits in the years ahead.

Chairman HUMPHREY. OK, I have got you.

We have said, for example, if you can get people employed in an employment program, if you could reduce unemployment, then you would sharply reduce the deficit. One of the best ways to reduce the fiscal deficit is to reduce unemployment. But when we pass legislation to reduce unemployment—particularly in public service jobs or emergency public works—down comes the guillotine.

Now we come along with the President's proposal. And all at once, it has a whole new set of figures in it. I just do not understand. I have seen no projections from the administration about a $28 billion tax cut, plus a $28 billion ceiling later on, or reduction of expenditures. What is it going to do to unemployment? I have heard nothing about it at all. What is your estimate of what it will do to unemployment?

Mr. GREENSPAN. Let me try to address that question directly, Senator. As you may recall in my last testimony here and also before other committees in both the House and the Senate I have been projecting an unemployment rate by the end of 1976 somewhere between 7 and 7.5 percent. Our analysis is that the President's program will not appreciably change that estimate. It remains about the same.

Similarly our view is that aggregate economic growth over the same period, as you can imagine, because of the unemployment figure, also will not be significantly affected. I submit that the President's program will not have any major change on employment or production through the end of 1976 when compared with an extension of the tax cut and with basically the types of expenditure programs which we estimate will otherwise occur.

In other words, we may change inflation or unemployment or real growth by 0.1 or 0.2 percentage points but these are relatively small

changes and well within the error range of our forecasting capacities. So I would repeat that there is no appreciable range in the short-term economic outlook produced by this program. The purpose of the program was not short-term. We were not endeavoring to alter the configuration of short-term economic activity. We were attempting to confront a very substantial, major, long-term problem.

Chairman HUMPHREY. I understand your objective. All I can say is that if you are going to make the $28 billion cut in the short term, it is going to mean that some people are going to suffer and it is going to mean they are going to suffer plenty because that $28 billion has got to come out—in part—out of money for social security or veterans. And it is going to have to come out of school lunches and food programs.

These are cost items. I do not deny they are high-cost items. And the other thing I worry about, Mr. Greenspan, and you ought to worry about it, is what you are doing to the permanent tax base of this country, the public needs of this country, a country privately rich for few and publicly poor for many.

Many of our public services today are in deplorable condition. I see nothing, for example, in this program that gives any hope to our cities where our people live; for the infrastructure of our cities, for the rebuilding of our transportation system, As a matter of fact, if there is any one thing that worries me about the Joint Economic Committee forecast itself, it is that we have not taken into adequate consideration what I consider to be the great public needs of this country.

One final question: Will you recommend a veto to the President on a simple tax extension such as the House Ways and Means Committee has proposed and apparently the Finance Committee is considering if this Congress does not put an expenditure ceiling on at the time of the tax cut?

Mr. GREENSPAN. It is not a question of what I would recommend or not recommend. I think the President has indicated what his position was with respect to that earlier.

Chairman HUMPHREY. What would you recommend?

Mr. GREENSPAN. I would agree with the President.

Chairman HUMPHREY. In other words, you are simply saying that unless the Congress puts on that $395 billion spending ceiling——

Mr. GREENSPAN. Senator, I would say this.

Chairman HUMPHREY. Now, wait a minute. I want to get my question out.

Mr. GREENSPAN. Yes.

Chairman HUMPHREY. Unless the Congress puts on the $395 billion spending ceiling, and a tax reduction or a continuation of the tax reduction so there is not a tax increase, that you would recommend a veto?

Mr. GREENSPAN. Yes, sir.

Chairman HUMPHREY. Well, I just want to say that I consider that digging yourself into your own political, economic grave for this country and this administration.

Mr. GREENSPAN. Can I explain?

Chairman HUMPHREY. It is a most regrettable policy. You know, Mr. Greenspan that every time the Congress has set a spending ceil-

ing without knowing what the parts are going to be, it has never worked. In other words, we have had spending ceilings over the years. Congress passes a resolution as a way of demonstrating that we are fiscally responsible. And it has proven to be a total failure.

So, what did we do? We set up the budget process after 2 years of hearings; an incredible amount of negotiation. One of the members, Senator Ribicoff, was involved in that process deeply, as were others of us. And now for the first time we have a budget process in which we can analyze what each committee of this Congress is going to do and put it together and analyze it with the work of the Budget Committees of the House and the Senate; the Joint Economic Committee, the Congressional Budget Office, and then come up with a ceiling and a ceiling that is adjustable under the law one way or another, in what we call another October date line.

And you are asking us to follow the policy that has been a total failure for as long as I have been in Congress. I consider it not only irresponsible, I consider it the worst kind of economics. It is fiscally, politically, and socially irresponsible.

Senator RIBICOFF. Would the Senator yield at that?

And what would happen, Mr. Chairman, is that, let us say that Congress were as cynical as the President and Mr. Greenspan and they passed a tax cut bill and then wrote in there next year we are going to have a $395 billion limitation on spending. Then comes the budget process the following year. The President has not told us. We do not know. And then comes cuts in social security, cuts in medicare, cuts in the very substance of what helps the country and the average American. And then Congress does not live up to it.

Chairman HUMPHREY. Well, we just look like a bunch of hypocrites.

Senator RIBICOFF. That is right.

Chairman HUMPHREY. We have told the American people that we are going to give them an honest budget process. We have been accused for 25 years or longer of not having a handle on the budget. And now we are following our Budget Committee. Some of us who are accused of being spenders have gone along with our own Budget Committee because we said we set our ceilings. Now we are being told that we are to set the ceilings without ever knowing what the parts are.

Senator RIBICOFF. You know, Mr. Chairman——

Chairman HUMPHREY. I just cannot understand it.

Senator RIBICOFF. Last Friday Lou Harris had just finished a poll as of October 20 and it said contrary to the conventional wisdom, the American people have great faith and confidence in our institutions. Where their doubts and cynicism comes in is the failure of political leaders, the President and the Congress, to tell them the truth. They want the truth. They want to know where they stand and it is the disillusionment with political leadership that is dishonest with them that causes the great problems in the social and economic and political fabric of the Nation.

And here we have the President of the United States asking Congress and the American people to be cynical in their approach to something as important as taxes and expenditures.

Chairman HUMPHREY. Congressman Long?

Representative LONG. I have no further questions, Mr. Chairman.

Chairman HUMPHREY. Senator Ribicoff?

Senator RIBICOFF. I have no further questions.

Chairman HUMPHREY. Well, Mr. Greenspan, I guess you have gathered this morning that there are some strong feelings here, and not just feelings of who is going to win the election. That is not the question. We have got a budget process set up here. I do not know if you have testified before Senator Muskie or not.

Mr. GREENSPAN. Yes; I have, Mr. Chairman.

Chairman HUMPHREY. I imagine it was quite a session.

Mr. GREENSPAN. May I comment incidentally on this?

Chairman HUMPHREY. Yes, please.

Mr. GREENSPAN. First of all, I have commented on many occasions that I think that the Senate and the House Budget Committees and the law which established them were one of the most important pieces of legislation to come out of the Congress in a long time. It set into motion finally a structure and mechanism which will enable us to confront the problem, which I think has been at the root of the erosion in the economy of the United States in recent years.

I want to say further that the problem that we have with respect to this issue of accelerating spending over the longer term is a far graver problem than I think we have been aware of. It is, as I indicated in my testimony, being obscured by sharp declines in real national defense outlays. And we are confronting, as a nation, some very significant and serious longer run choices.

Now I cannot specifically comment about the effects upon budgetary process but I understand from Director Lynn that it is not a significant deviation in the process itself. But I would say that it is far more important to recognize and confront the problem. I would suggest that unless and until we become aware of what the future potentials and implications of the uptrend in these expenditure categories, that we are going to miss some very important issues with respect to where our country is going.

Now there are unquestionably going to be very grave difficulties as we attempt to deal with this problem. I do not think anybody has said it is going to be something without pain or difficulty for our society and our economy. We have in motion today trends and a series of events which have got to be slowed down.

I think that the President has recognized this very major long-term issue and in my judgment he has attempted to construct a program to deal with it. I do not deny that we have short-term problems with respect to timing, which I consider unfortunate. But I am very much concerned that if we focus continuously on the timing problem we will lose sight of the broad overall objective which I think we all subscribe to.

Chairman HUMPHREY. I do not want to take issue with you on the necessity of a most meticulous and careful budget and policy review. I think that is the duty of any government and surely of any administration. It would obviously have to be done because times change, things change and we need to constantly reassess.

I wish this administration was as deeply concerned about the ever rising tide of residual unemployment in this country after every recession as they are concerned about the Federal outlays to the people of

the United States. It is not as if somehow or other these outlays escape the country. But every recession we have had has left us with just a few more people called unemployables. And we have satisfied ourselves of late of taking a 4 percent unemployment figure as being the normal unemployment rate in America and calling it full employment; when in fact, for a long period of time, we have not had 4 percent unemployment.

We have been holding hearings here on the future growth of this economy. We have had some very good people in; the president of the Bank of America and top people in economics and so forth. Senator Lloyd Bentsen has chaired 2 years of studies in this field and we find there are some very great needs, that we are concerned about. For example, capital formation; public facilities; the erosion and deterioration of our cities; the breaking down of the infrastructure of our cities; and the problem of unemployment and getting this economy to function at a rate that will reduce governmental costs.

Many of the governmental costs which you are worried about and which I am worried about are the result of an economy that just does not provide for its citizens. It provides for most of us, but it does not provide for a very substantial number. And when you find that more people have gone back into the area of poverty since 1970 than we had before that time, it is very discouraging. And while you focus on one part of the picture, Mr. Greenspan, and I do not want to pretend that that is not a serious problem, it seems to me that the basic problem in the economy is how it functions to meet the needs of all of our people. And where it does not function to meet those needs, then that is where Government steps in. And if we cut down unemployment by 2 percent then we are going to save $30 billion or more dollars in the budget.

But you keep fooling around with the tax base of this country and making permanent cuts, and what you are going to end up with is that those of us that can afford to buy our homes out on lake fronts and those of us in upper and middle income that can afford all of the goodies of life are going to have it fine. But for the average guy out here, his lake front is the public park and he does not get a chance to buy a yacht or a private airplane. He is the kind of a fellow that has to worry about whether or not there is going to be an airport in his town and he is going to have to worry about whether there is a public beach.

And one of these days we are going to have to find out that we have to have something else besides interstate highways. We are going to have to find out that a railroad system has to work in this country. There are just a lot of things that are not going to happen simply because we keep reducing the tax base and hoping this is going to take care of everything because it just does not.

There are certain public needs that the country is going to have: schools; hospitals; clinics; transportation; recreation; and parks. We have a tremendous need right now and I wish that the President would work to get our unemployed young people out planting good trees in our forests, cleaning up the underbrush, fixing up something around this country.

All of the administration's calculations ignore the people who cannot care for themselves, ignore the constant rising rate of unemploy-

67-569—76——3

ment in this industrialized society of ours. There is no calculation that tells us that there is much hope of getting below 6 percent. Is that not what you said? 1980? Six percent unemployment? Is that not your projection?

Mr. GREENSPAN. No, sir.

Chairman HUMPHREY. Well, those are the last ones we read. Are they 7 or have they gone up?

Mr. GREENSPAN. I think they have gone down.

Chairman HUMPHREY. When did that happen?

Mr. GREENSPAN. I think you are asking for revisions of longer term forecasts. And I would say, based on recent evidence, the figures would be lower than they were in the report that we put out in conjunction with the Office of Management and Budget in January of this year.

Chairman HUMPHREY. We will scrutinize them very, very carefully.

Representative LONG. Mr. Chairman——

Chairman HUMPHREY. Yes, sir.

Representative LONG. Could I ask one question?

Mr. Greenspan, looking at these proposals, it appears to me that if you take a family that has one dependent earning $5,000 and you take into consideration the fact that the President did not recommend continuation of the earned income credit under the social security aspect of this whole thing, that the family earning $5,000 a year would end up, under the President's tax proposal paying somewhere between $275 and $300 a year more in income taxes. Or at least when you add that and the social security together he would have at the end of the year that much less money that he can spend. And this appears to me to be the group that really needs the help.

Mr. GREENSPAN. Mr. Long, as I recall, and I may be subject to correction, the adjustment for the earned income credit was made in the budget outlay figures.

Representative LONG. That is right.

Mr. GREENSPAN. In the tax bill as I recall, equivalent amounts of money go to similar types of income levels, but some of these are included on the expenditure side.

Representative LONG. But they would still at the end of the year, no matter which way we look at it, they would end up at the end of the year of having between $275 and $300 less a year to spend.

Mr. GREENSPAN. That is true in taxes, but I am sure that is not true in benefits, Mr. Long.

Representative LONG. You are sure it would what?

Mr. GREENSPAN. It is not true in benefits. In other words, this is the same issue, which as you know the Ways and Means Committee has dealt with.

That is, it also drops the earned income tax credit from the tax side. The reason for it, Mr. Long, is that it is essentially considered a transfer payment, that is, a payment which a number of people would argue should be on the expenditure side. Not in this exact form, but there is a good deal of debate upon the applicability of that provision.

And I think that the question of its applicability was dealt with by the Ways and Means Committee.

Representative LONG. As it was by the Treasury or at least by the President in his recommendations?

Mr. GREENSPAN. Yes, sir.

Representative LONG. But you do agree that the net effect of it is going to be that the family, in the example that I used of a $5,000 a year income, is going to end up at the end of the year with $300 more or less to spend?

Mr. GREENSPAN. Mr. Long, I cannot comment on your particular statistics. I know no reason to disagree with them. But I would suggest to you that while it may be true on the tax side, depending on what that same family is doing, I cannot honestly say what the net effect of governmental actions, both on the tax and on the expenditure side, would be to an average family of that type.

Representative LONG. Well, let me ask you another question, then. Do I conclude from the fact that the President did not include it in his recommendations that he does not recommend a continuation of the earned income credit?

Mr. GREENSPAN. He did not recommend a continuation of the earned income credit in his package, Mr. Long, that is correct.

Representative LONG. Then I am to conclude it does not favor a continuation of it.

Mr. GREENSPAN. That is my understanding.

Representative LONG. Thank you, Mr. Chairman.

Chairman HUMPHREY. Senator Ribicoff.

Senator RIBICOFF. I would just make one comment. You had better tell the President, if he thinks he is going to get to eliminate the earned income credit over Chairman Russell Long he has failed to learn a lot of lessons that Chairman Russell Long has taught a lot of Presidents and Secretaries of the Treasury over the years. I cannot imagine a tax bill coming out which eliminates that. I use that just as a practical problem.

Chairman HUMPHREY. You can rest assured.

Senator RIBICOFF. Now, again you have—just ending up the colloquy we had before—you have high praise for the new budget process of the Congress.

Mr. GREENSPAN. I do, Senator Ribicoff. It is one of the most important acts passed.

Senator RIBICOFF. If you have such high regard and respect for the new Budget Act, how can the Budget Committee come to the Ways and Means, the Finance Committee, the House and the Senate and endorse a $395 billion budget as of October 1, 1976 without knowing what the parts are, how can they honestly come before the Congress and tell us they do not know?

In other words, what you are trying to do, and this is why I talk about the political cynicism, you are trying to get a commitment before Congress has had a chance to examine the President's proposals, which he will not make until January.

And the act has to be passed sometime in December. They cannot examine it. The committee of Congress cannot examine it. The people cannot examine it. You want that commitment. Then that becomes a fait accompli, then you come in with these horrendous, cynical cuts as are indicated above and below the surface by many members of the Cabinet in this administration of where their thinking is going, which

runs so contrary, in my opinion, to the congressional thinking, but also the thinking of the public, and then you say you have a commitment made. Then you say to the Budget Committee, you go ahead and do it because they have given the President a blank check.

The Budget Committee cannot give the President a blank check. Congress cannot give the President a blank check in the sum of $28 billion. If it does, it has abdicated completely their responsibility as a legislative body, Mr. Greenspan.

Chairman HUMPHREY. Senator Kennedy.

Senator KENNEDY. I would be interested in hearing Mr. Greenspan's response to that, if he has any.

Mr. GREENSPAN. Senator, I will repeat some of the things I said earlier with respect to this question.

Senator KENNEDY. Well if——

Senator RIBICOFF. Well, this is a different variation, I think it deserves——

Mr. GREENSPAN. Well this is the issue of whether in fact Congress can make a judgment with respect to a ceiling, without knowing all of the specific details directly and immediately. The argument is that if one does not know what the individual items of the total are one cannot make such a judgment.

However, the data on the numbers of programs and the structure of information is available to the Congress now. This is, incidentally one of the side benefits of the new law, will enable the Congress to make the judgment as to whether they want to reduce taxes still further by curtailing the aggregative level of outlays.

Now, there are a large number of ways of arriving at $395 billion. In other words, it is not that there is a specific Presidential package, which is the secret as to how one might get to a $395 billion spending total. There are a great number of different packages which would achieve the same end.

And, so far as the total of $395 billion is concerned, it really rests upon the issue, can one identify a series of particular actions or changes which would enable a $395 billion total?

Now I would say that the answer is that you can. And what the President is proposing is that the increase in fiscal 1977 outlays, as now envisaged be cut back by $28 billion, and that those revenues, be used to cut the taxes of the American people.

The presumption that you somehow need a single budgetary document from the President does an injustice to the amount of information, and the capabilities of the people in the Congress, in the Budget Committees, and in the Congressional Budget Office.

Senator KENNEDY. Well, Mr. Greenspan, I would like to deal in what I think is the real world. And I know that you have touched on this in response to the chairman somewhat earlier and that is that there will be action that will be taken by the Congress for cuts and I think that the best reasonable assumption will be that it will be somewhere between the $15 and $17 billion figure, and that the cuts will be deferred in terms of the Budget Committee's process to the next year as the law provides.

Do I understand that your position is that if the Congress acts, which it will, I believe, in providing this kind of a cut, that you are going to recommend to the President that he veto it with all of the risks that that has in terms of putting our economy right back in the

economic ringer because of the resumption of those withholding taxes next year?

Mr. GREENSPAN. Well, first of all——

Senator KENNEDY. And let me just say I ask this because I think we should have learned a rather critical lesson over the period of this last year on sort of the all or nothing policy on energy, where the President kept on banging away at the Congress and they tried to, the Congress, to provide at least some degree of input. On the issue certainly of prices there was absolutely no real kind of compromise. It has been sort of an all or nothing kind of experience as far as I have been able to see.

You might have a different view. But it would appear from your response earlier to a question about whether the President would accept a tax cut of that dimension, which I think in all realism is where we are going to go, that it would appear that the administration is prepared to take an all or nothing proposition on this one as well, risking putting the economy right back into the soup.

And I would be interested in what your recommendation would be if we were to pass a $15 to $17 billion tax cut and with withholding provisions and perhaps some other kind of modest adjustments. Would you recommend a veto of that proposal?

Mr. GREENSPAN. I am sorry, Senator, are you referring basically to the holding of withholding tax rates, the same as they are and that you are originally getting above the $12 billion integrating the corporate benefits? Am I correct?

Senator KENNEDY. Yes.

Mr. GREENSPAN. The President has stated, as you know, that mere extension of the existing tax cut, without an expenditure ceiling, which he recommended, would be vetoed.

Senator KENNEDY. Would be what?

Mr. GREENSPAN. Would be vetoed. That is what he stated. And he has stated that on several different occasions. The only aspect of that to which I would address myself is the economic impact of a particular increase in withholding rates. Most of our analyses of the impact of changes in withholding rates largely comes from our econometric models which we use fairly extensively.

And it is certainly true that the structure of the models which we, as all others tend to use, would, if they represented reality suggest that the economy, that is in the real world, would be subject to a fairly substantial slowing down in the rate of increase in economic activity, were withholding rates to rise by approximately $12 billion, as they would if we went back to the 1974 tax laws.

Now, our experience with these models is that when you deal with numbers of those dimensions that the impact that we infer directly from the model, even with that, say, $12 billion change, is well within the range of our error in forecasting capacity. So that while I would certainly not say that an increase of $12 billion does not have some slowing effect in and of itself. all other things equal, I would certainly not argue that that will be a significant factor in determining the path of economic activity during calendar 1976.

And I raise this issue. Senator, largely in the context of the type of economy we have experienced so far this year. As you know, we have had a quite considerably stronger rise in levels of economic activity and much lower levels of unemployment than our models would have

indicated under the existing policies, which were implemented so far this year.

I merely indicate that while these are crude tools and are useful as crude tools, I would not, in my judgment, consider that should withholding rates rise looking at the total impact of the economy as a whole and all of the other thinks that will be going on that would have a major impact on economic activity.

Senator KENNEDY. Well, is there a danger there or is there not a danger there. And if there is, what is the extent of it? It seems that you are minimizing it.

Mr. GREENSPAN. I would not use the word danger. I would say that if we were talking about much larger numbers, I would certainly say there would be. But when you are talking about $12 billion, it is really a relatively small number in the context of the size of the economy which we are dealing. I would not describe it, Senator, as a danger and would not be concerned particularly about the strength of the economic recovery, should that occur.

Although, as I have indicated, I do not believe that is the optimum policy.

Senator KENNEDY. Well you are suggesting here that the administration is prepared to take that risk. If the Congress were to act to continue the rates under the withholding tax and any other kinds of modest adjustment on the corporate income to get up to what I do feel is probably the real figure of maybe $15 to $17 billion, that you are suggesting, first of all that you would recommend that the President veto it and whatever risk is there in terms of its adverse impact, in terms of our economy that you minimize what that would be and that whatever this is in real terms, you feel that the administration would be wise in following that recommendation.

Mr. GREENSPAN. Let me clarify the issue of the size of the tax cut. As I recall, the investment tax credit under the 1975 temporary legislation extended for 2 years, and that is a large part of the difference; so that, even should a specific extension not be replaced, my recollection is that the investment tax credit continues under existing law. As a consequence, the change, as I recall, is mainly in the area of the withholding taxes.

But in answer specifically to your question, Senator, I think that the numbers involved are not of sufficient dimensions to have a significant impact on economic activity. I think the major issue which the President is endeavoring to address the basic question of bringing the accelerated rate rise of Federal outlays under control.

Senator KENNEDY. Well, you know, Mr. Greenspan, I do not know what the experience of my colleagues has been over the period of the eight- or nine-day break, but, you know, the experience that I have felt in my own State of Massachusetts is that the people just cannot understand the prophecies of good news that we keep getting, either from you or from others within the administration, on how well the economy is going.

The problems that they are facing, in terms of the serious unemployment and continuing kinds of economic problems that they are facing—they just, I am sure, will continue to be amazed at the observation that you make this morning. In terms of looking at what your own statements were for the tax cut and you thought it at least

was worth taking a look at. Then, you come in and support the administration's position, within a period of 7 or 8 weeks, of a $28 billion tax cut.

Then, to minimize, even if the Congress were to go the route of the $14 billion, $15 billion restoration of the withholding rate—I was thinking, that is going to be a rather minimal kind of impact, in terms of the economy. It seems that these approaches sort of work comfortably and conveniently for the administration's rationale of these areas, rather than in terms of the true economic impact on it. That is my own view about it.

Could you tell us, just briefly, how your own thinking altered or changed from when you were here a couple of months ago, and you were so cautious on the issue of the tax cut? Now you are for a $28 billion tax cut, and you are going to recommend any tax cut that would have a $14 billion or $17 billion tax cut with the commitment—and I think, based upon the record of the Budget Committee, has shown it to be responsible in trying to eliminate inefficient or ineffective government spending. What was your own—how did you get here from there in the period of a couple of months?

Mr. GREENSPAN. Well, Senator, first of all, when I was here the last time, as you correctly stated, the President had not yet reached his decision with respect to the tax cut extension largely because the process of analyzing the effects of various types of expenditure cuts had not been completed.

In other words, the issue of the extension of the 1975 tax cuts was being examined at the same time that the 1977 budget deliberations were underway. As the size of the increase in outlays projected for fiscal 1977 and beyond began to become clear the President decided that it would be a mistake to examine the tax reductions without examining the expenditure trends also.

The issue in whether or not an extension of the 1975 tax cuts would be recommended was the question of the deficit and the longer-term implications of those deficits on the stability of the economy. As a consequence of this, I think it is not quite correct to talk in terms of a tax cut, say of $12 billion or $15 billion or whatever, $17 billion or $28 billion, without recognizing in effect, what is occurring on the expenditure side of the budget.

That is not the same thing as merely comparing one tax cut with another. I think one might look at the question of a tax cut extension alone as one option, and the combined option, which the President decided upon, as the other. I would consider that one could opt either way on option A and still come out for option B.

By that I mean, if one's concern regarding the economic recovery, also included concern with the consequences of a possible reignition of inflationary forces, you could come out either way on the tax cut extension. But the critical difference here is, while the tax cut extension is an issue of short-term economic analysis, as I indicated originally, the essential thrust, the real purpose and the underlying basis for the President's $28 billion tax cut-spending cut relationship was to confront what we consider to be a very important, long-term program.

Senator KENNEDY. My time is up.

Chairman HUMPHREY. I understand, Mr. Greenspan, that you have another appointment very shortly. Is that correct?

Mr. GREENSPAN. Yes; Mr. Chairman.

Chairman HUMPHREY. I have spoken to Senator Javits and Senator Percy. We will move it right along.

Senator JAVITS. Mr. Chairman, I will do with 5 minutes, if the Chair would inform me when 5 minutes have expired.

Mr. GREENSPAN. I appreciate it, Mr. Chairman.

Senator JAVITS. Mr. Greenspan, I was interested in Mr. Otto Eckstein's comment just last Thursday. He is the former staff director of this committee.

Mr. GREENSPAN. I know him well.

Senator JAVITS. About the problem of New York City, insofar as it would be a factor in reversing or threatening to reverse our ongoing recovery, of which you speak rather fully in your statement. He said, "Major repercussions across the national economy are to be expected if there is a New York City default." He calls it a major disturbance that will slow down the recovery and create a risk of tipping the balance against recovery.

Now, do you see any such consequences?

If you do, what are you prepared to recommend to the President be done about it?

Mr. GREENSPAN. Senator, we have evaluated, in conjunction with the Treasury and the Federal Reserve Board, the impact, should it occur, of a default. I would say, in a sense, limited default, because what we are really talking about are short-term notes on the financial——

Senator JAVITS. May I interrupt to say, Mr. Greenspan, that that is completely erroneous. We are talking about no money to operate the essential services of New York, and that is what I want to ask you. Because the facts are that the notes are due beginning in—say along about March to June, but the city does not get its tax collections until March. From December 1 to March 1, it is an absolute desert.

And if we do not have cash flow money, we will not—quite apart from debt service—even if we defaulted on debt service—we cannot pay our bills, and we cannot operate our services. That is what I am asking.

Mr. GREENSPAN. Senator, I am aware of the data to which you allude. We have looked at those data in great detail. All I can comment on at the moment is the impact that these specific developments would have on the economy as a whole. I have no question that there are, obviously, many other issues involved here.

The main impact has to transmit itself through the financial system, if it occurs. And the essential question largely is, what would default do to the municipal bond markets, the holders of New York City securities, and a number of other related questions?

An analysis by the Treasury Department concluded that while the effects would be significant in a number of individual banks, there would not be any overwhelmingly significant secondary effects on the commercial banking system as a whole. And Chairman Burns, in numerous testimonies of late, has indicated that the Federal Reserve has the capacity, in conjunction with, if necessary, the FDIC, to offset the financial side effects that could emerge, as a consequence of default. I would say, having looked at the data, I think is a fairly reasonable conclusion.

There are other difficult considerations which relate largely to the secondary or so-called psychological impacts. They are very difficult matters to judge.

I would say, however, that I have heard of a number of studies which contain some forecasts of what those repercussions would be, for which I find little or no evidence. There have been a great number of statements, Senator, which I believe carry that data and analysis further than I think we can. In evaluating this type of situation, I am hopeful that we will continue to try to make the best judgments that we can and try to recognize the areas where we know and those where we do not know.

Senator JAVITS. Mr. Greenspan, would you say, therefore, that you agree or disagree with Mr. Eckstein when he says, "a major disturbance that will slow down the recovery and create a risk of tipping the balance against recovery?"

Mr. GREENSPAN. I would say that the probabilities of that occurring are small.

Senator JAVITS. How do you account, therefore, for the protests, among others, of a man like the Chancellor of the German Federal Republic who fears exactly that in terms of the world economy, which, if it happened, would certainly be applicable to the U.S. economy?

Mr. GREENSPAN. Everyone, Senator, must make his own best judgment where, in effect, we are dealing with very difficult analyses.

Senator JAVITS. I am going to ask my last question, Mr. Greenspan.

If you had to tell the President what you think about the—if you could avoid this default without the United States running any material risk, though it might require some U.S. action—would you advise him to forget about it, or would you advise him to try to do what would not take any material U.S. risk?

Mr. GREENSPAN. I do not advise on particular decisions of this sort, Senator. What I try to do is indicate to the President, my judgment of what the conomic impact of various different types of options are and try not to make what is a very difficult judgment.

Senator JAVITS. Well, now, the three leading bankers in New York think, with Mr. Eckstein, that it would have a very deleterious effect on recovery. They are David Rockefeller, Walter Wriston, and Ellmore Patterson, of the three principal banks of the city and the country, aside from the Bank of America. How do you evaluate that?

Mr. GREENSPAN. Well, again, economic analysis requires one to look at what the facts are as best they can be judged. If someone has information which can change your judgment, then I think it is very important to get that. I respect the judgments of others in this area, because I fully recognize the difficulties involved. I must say, however, that my judgment is not quite similar to theirs.

Senator JAVITS. Finally, would you say, even with your judgment, that we are running a risk, we will let New York go?

Mr. GREENSPAN. Let me say that, obviously, any default in the financial area, any aberration in the economy, clearly poses risks. I mean, this occurs all the time. There are all sorts of events which occur in our economy which can be described as risks.

Ideally, we would prefer that those things never occur. But there is always a cost involved in every endeavor that the Federal Government would take in attempting to avert change or somehow ameliorate

these risks. That is, whenever you are involved in any particular program whose action is to basically alter the types of events which we consider risky, there are other consequences which I think are important to evaluate, especially in the longer term.

So, yes, certainly, any sort of default does have risks involved with it. I think one must evaluate those against the risks in Federal action, because I think these are the way these very tough decisions should be appropriately made.

Senator JAVITS. Will you at least agree, Mr. Greenspan, that the default of New York would be a major event in respect of the financial markets and bank conditions and the economy of the country?

Mr. GREENSPAN. Yes, certainly. And I would suggest to you that the very types of actions and preliminary plans, which, for example, Chairman Burns has announced, suggest that nobody considers it or should consider it a minor event.

Senator JAVITS. Thank you, Mr. Chairman. My time has expired.

Chairman HUMPHREY. Senator Percy.

Senator PERCY. Mr. Chairman, I have five or six questions, and I realize time is short, and so if Mr. Greenspan would like to expand on his answers, I would ask unanimous consent that the record be kept open for at least this week.

Chairman HUMPHREY. Yes.

Senator PERCY. First, on the New York situation, would you say that a condition precedent to the Federal Government doing anything ought to be that there would be a restructuring of the debt so that if it was to be sacrificed, the bondholders would have to sacrifice something in the way of principal and restructure and rollover the interest rates, at least, so that voluntarily or involuntarily they take it on the chin along with everyone else that has to take it on the chin in New York and that they may not be held harmless for having made an investment that to date does not appear to have the value that it did at the time they made that investment.

Mr. GREENSPAN. There are rewards and risks when one purchases securities and I do not think that one should be basically insulated more against one than against the other. I would not comment on any specific policies with respect to this issue. I think, however, that anyone who has looked at the data for the city recognizes that some very serious changes in budget and expenditure policy is going to be necessary to restore the borrowing capacity of the city of New York, and this is not going to be an easy process for anybody.

Senator PERCY. On the question of the overall deficit, I am very—having worked for so many years with Senator Javits on the budget control bill in the Senate, I am very anxious to work with the administration in any way we can to bring this deficit down because it is an oppressive thing.

I am not optimistic about cutting the budget $28 billion, and I am not after working all last year to try to cut $10 billion out of it. I do not see $28 billion from a practical standpoint. I think it is just a will-o'-the-wisp to think we can do it when 75 percent of the budget is really uncontrollable. Would it not be safer for us in trying to close that gap then, even though it is an election year coming up, to recognize that as we reduce certain taxes and keep a reduction in there from the regressive tax that we loaded on other areas, and that we take a tax

that has not been—three taxes that have not been increased for 23 years, gasoline, and try to pick up $9 billion to $10 billion there through a direct Federal tax increase, alcohol and tobacco that have not been increased, and pick up another $5 billion or $6 billion there. Would it not be safer for us to tax those items which, so long as we exempt 500 gallons of gas for necessary driving, would have a social benefit and would not have an adverse economic effect on the recovery, but would pick up and help us close that gap and then go for, say, a $10 billion or, say a $15 billion cut, which is far more realistic, but close the gap between expenses and income, so we do not have to repeat at the Federal level someday what we have in New York, where their main problem is, they just constantly spent more than they took in.

Mr. GREENSPAN. Senator, I think that you may describe the problem of cutting expenditures as a difficult and, in a sense, impractical problem. If you look at the trends which underlie our budgets, however, it is also evident that it is going to be impractical not to cut them. I mean by that, we are caught in a very difficult dilemma, and I think we do not have the luxury of saying and acting as though it is impractical to cut outlays. I would certainly grant you——

Senator PERCY. By that amount.

Mr. GREENSPAN. Well, no——

Senator PERCY. I am not saying you cannot cut something.

Mr. GREESPAN. Well, I would say that the momentum of the types of outlay increases that we are confronted with now means that the size of the numbers that have to be cut out of this budget next year, the year ahead, and the year ahead of that is very substantial, unless we are willing to impose very substantial tax increases.

Now, the problem I have with increasing taxes in order to curb the deficit is that it really does not cut the deficit, it merely delays confronting what, in my view, is the critical issue which we must come to sooner or later. It is not a substitute for cutting expenditures——

Senator PERCY. I am proposing both.

Mr. GREENSPAN. I understand that. What I am essentially saying is that I do not think we have the luxury any longer to operate in a business as usual fashion with respect to expenditure programs. All you have to do is to examine the extraordinary momentum that is being built into the level of outlays and ask yourself, do we want to allow ourselves to be placed in the situation which those trends would put us. I think any sensible analysis of the impact of the various expenditure trends would say no.

Now, as we all know, there is never a good time to cut the growth of expenditures. I think the chairman has alluded to the great difficulties we have had over the years in cutting expenditures. There is never a good time to do it, and, yet, we are confronted with the dilemma that unless we act to do so, this country is going to be in very severe difficulties. So that I would argue that it is best that we confront the problem of expenditures, as difficult as it is, because the same types of problems which make it difficult for us to cut spending will also make it difficult for us to raise the types of taxes which you are suggesting, Senator.

Senator PERCY. I would like to just take your own words and now ask you to speak as an individual, not representing the President and his point of view because he might not have expressed himself on this

recently to you, but can we afford the luxury of continuing to have the cheapest gasoline, tobacco, and liquor in the world, literally, in a sense, subsidized, and continue to not tax those products which are not in the national interest, which consumed in excess are contrary to the national interest, and which are easy to pick up revenue on and easy to collect it?

There is little chance for fraud. Can we afford the luxury of just not moving in and taxing those items when we need the revenue and when, by taxing those items, you really are not setting back the cause of recovery?

Mr. GREENSPAN. Well, Senator, as I once said to our esteemed chairman a while back, perhaps a year ago, the luxury of making personal evaluations in advance of economic policy by the President is something I lost when I entered Government service.

Senator PERCY. I think that is possible, Mr. Greenspan, for you to comment personally just between us.

[General laughter.]

Chairman HUMPHREY. Mr. Greenspan, take my advice. Do not do it.

[General laughter.]

Senator PERCY. Will you meet me outside and tell me what your views are? Well, I just want to simply say that I feel very strongly about it, strongly enough to have put legislation in, and I would like to report that though I have had a few letters on it, most people say, look, you are right, you cannot just continue to raise expenses the way we are and not raise revenue, and certainly in the face of reducing personal income taxes, you have got to find someplace else to pay for it, and we are not going to be able to cut all that we anticipate.

I think we are living in a fool's paradise if we consider it impractical now to not move into that area, and with that I will not say anymore.

In your prepared statement, you have talked about the strength of our recovery and, yet, so many people feel if it is going well—and it is—why is not the unemployment figure coming down more dramatically? My feeling is that the answer lies—and I would like it confirmed by you so people can understand it from an experienced expert—the feeling is that when you have a crunch in the economy, everyone squeezes to get more efficiency and productivity increases. You do not hire new people; you work them overtime more. It is less costly because of training time and all of that, and because there is a fear of unemployment, people work harder and more effectively and turn more out, and you have got that intangible increase in productivity where goods and services can go up, but unemployment does not go down. Is that a reasonable explanation we can offer people and that there will be, if that recovery continues, there is going to be a reduction in unemployment, but the efficiency factor is the factor that must be taken into account?

Mr. GREENSPAN. In general, Senator, we first must recognize that, while it is certainly true that the recovery in the last 6 months has been quite vigorous, we are none the less still well below capacity and have not yet even restored the level of economic activity to the previous peak, so that you have to distinguish between the rate of change, which has been very considerable, and the level. The absolute level of unemployment is still quite high.

In fact, even though it is quite high, according to past statistical relationships which embodied the type of analysis which you are suggesting, the unemployment rate is actually a bit lower than would normally be expected at this point in the business cycle. But the analysis we do in order to estimate the expected level of unemployment at various rates of real GNP does embody the considerations that you have indicated.

Senator PERCY. Mr. Chairman, out of consideration for Mr. Greenspan's schedule, I would just like to ask a few questions and ask that they be submitted so that they can be answered in writing for our record.

I would like to know to the best extent that you have knowledge what did people do with their tax savings? Did they spend them on consumables? Did they put them under the mattress? Did they put them to work in savings and loans, or did they put them to work in commercial banks, and what happened as an end result?

We are being asked to continue that program. What was the end effect of that program, and how can we be sure that if we do it again, it is going to pay off for us?

Second, the 235 housing extension, I was delighted Carla Hills did this. What was the reasoning behind the administration doing it? How much ripple effect will there be? How soon do we get that program underway? When will it have an effect in the housing industry, and when can we feel it in the economy?

As I understand it, nothing is going to be done in this fiscal year. It will not be done until next fiscal year. Why, if it is a good program, why do we not get started with it right away, and would it not stimulate recovery in a very end of the economy that we desperately need stimulus?

Third, why do you suppose the Federal Reserve has shifted suddenly to an expansionary monetary policy if they have available the same figures that you have, that recovery is underway, and it is stronger even than we prudently could have expected it to be, as you said?

And, last, what general program areas would you prefer to see included in the spending ceiling or the effect of $395 billion cut in spending that has been suggested by the President? I know you do not have the details, but what large areas would you like to see cut back, and, roughly, how much do you think we can expect to get out of those so that we have some sort of a target to work toward, analyzing and studying in our Senate Budget Committee?

Thank you, very much, Mr. Greenspan.

Mr. GREENSPAN. Thank you, Senator. I will submit those answers for the record.

Chairman HUMPHREY. Mr. Greenspan, that will keep you busy over the weekend.

Senator PERCY. I hope your staff.

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

RESPONSE OF HON. ALAN GREENSPAN TO ADDITIONAL WRITTEN QUESTIONS POSED BY SENATOR PERCY

Question 1. Could you please break down the result of the Tax Reduction Act of 1975 on consumers' consumption and savings patterns? For example, can you

give an idea how much the savings rate was increased or decreased from the cut in withholding rates?

Answer. Our experience suggests that savings rates are not raised permanently by tax reductions. Tax reductions and rebates or lump sum payments initially tend to go into savings and improving consumer liquidity with expenditure patterns being adjusted more gradually. This was illustrated by the rise in the savings rate from 7.5 percent in the first quarter of this year to 10.6 percent in the second following the $8.1 billion rebate of 1974 taxes and the $1.6 billion one-time special payments to social insurance recipients. These payments created a large bulge in disposable income, and the first reaction of consumers was to allow the increase in income to accumulate as savings. Subsequently, as expected, consumers began to readjust their expenditure patterns and the savings rate declined to 7.7 percent in the third quarter, a rate which is close to the average for the seventies. We anticipate further moderate downward adjustments in the savings rate in the next several quarters as the tax reduction has its full effect.

Question 2. Could you please comment on the Sec. 235 housing program that was recently put back into effect by the Administration. We would like to know the reasons why this program was reintroduced as well as the date for its scheduled implementation. We would also like to know to what extent this housing program is expected to impact on the housing recovery as well as on the economy.

Answer. The structure of the Section 235 homeownership program has been altered by cutting the maximum size of the subsidy. Instead of making up the difference between market rates and 1 percent mortgage financing by Federal subsidization of interest costs, only the difference between market rates and 5 percent financing will now be covered. In addition, significant downpayments will be required and it is estimated that a larger proportion of these families acquiring homes under the program will be middle-income. As a result of these changes prospective waste and default risks have been reduced in a manner that has lessened some of our earlier objections to the program. From the macroeconomic standpoint, some 50,000 to 100,000 Federally assisted starts may be initiated under this program during the coming year and this would raise housing starts by several percentage points at a time when we expect total starts to still be well below long-term sustainable levels.

Question 3. Tight money growth has existed for most of 1975. Can you tell us the reasons for the seemingly sudden shift of the Federal Reserve Board to an expansionary monetary policy?

Answer. As you know I hesitate to discuss monetary policy directly, but it does not seem to me that monetary policy this year should be characterized as tight. The various monetary aggregates expanded very rapidly between February and July, at rates which were in fact well in excess of the Federal Reserve targets. During the past month or two the growth of the various measures of the money supply has showed but I believe this to be a temporary pause due to certain technical factors. I expect that monetary expansion in the months ahead will be along the lines spelled out by the Federal Reserve stated objectives and targets.

Question 4. What sectors of the economy do you see as being capable of carrying the economy after the push from reduced inventory liquidation ceases?

Answer. Both business fixed investment and residential construction are expected to expand rapidly during the next year from the low levels that currently prevail. Furthermore, we expect that strong growth in personal income coupled with the improving confidence associated with rising employment and moderate rates of inflation, will be the basis for a continued strong expansion in consumer expenditures. We anticipate a broadly based recovery with strength in consumption, business investment, and housing.

Question 5. How do you propose to insure that funds diverted from the public sector as a result of the spending limitation as proposed by the President find their way into productive investment and thereby help alleviate the capital shortage?

Answer. Under the President's program, the bulk of the additional tax cuts would go to individuals rather than corporations or businesses. A permanent 2 percentage point reduction in corporation income tax rates and continuance of the 10 percent investment credit past 1976, coupled with the strong expansion in consumer demand will help initiate an earlier than normal turnaround in business fixed investment. Before-tax profits have already risen appreciably since the first quarter of this year and corporate liquidity has also improved.

There are a number of other factors which we believe will contribute to a strong performance by business investment next year. In many of the sectors which experienced capacity shortages in 1974 expansion plans are going forward.

In addition, we expect heavy outlays for the modernization of plant and equipment and in order to help adjust facilities to the new higher relative prices of energy. It is my belief that the potential backlog of capital outlays is very large and that circumstances favorable to investment would cause a large rise. If the rate of inflation is held in check and confidence is more fully restored to the capital markets business spending, particularly for equipment, will recover without any extra stimulus than those measures already proposed.

Chairman HUMPHREY. Why this rush act, Mr. Greenspan? Why didn't you propose that we start the whole process in 1977 with budget cuts and tax reductions concurrently? It would seem to me that that might have had a little more credibility to it.

Mr. GREENSPAN. Well, Mr. Chairman, we actually looked at a variety of similar proposals. One thing which was causing difficulty was the nature of the 1975 temporary tax cut. A continuation of existing liabilities in effect, would create a change in withholding in any event. What you are in a sense suggesting is a one year extension of the existing program with another program going into place as of January 1977.

Chairman HUMPHREY. No, I was taking you at your word. Your word to me this morning was as follows: That additional fiscal stimulus does not seem to be necessary considering the extent of the economic recovery now underway. Your whole argument here about the tax cut and the spending cut has not been about fiscal stimulus, it has been about the budgetary process. You have painted the picture of the long-term increases in government outlays as you look down the road. All right now, I do not deny that there is considerable reason for concern about these things. You have already said that it would cause the deficit for the first 9 months of calendar year 1976 to be increased, and this, in itself, is admittedly undesirable.

Now, you know that our dear friend, Mr. Arthur Burns, is going to have a slight tremor when he sees that the deficit goes up, particularly when there are no spending curbs in the first 9 months, but the important thing you have said is that additional fiscal stimulus does not seem to be necessary, considering the extent of economic recovery now underway.

All right now, on the one hand, you are adding to the deficit, which you know is almost a cardinal sin in this administration. On top of this, you say, we have really got recovery underway now, so if that is the case, you do not want a larger deficit. If you are worried about the long-term impact of these outlays, why did you not wait until 1977 to make the whole program effective for 1977 concurrently?

Mr. GREENSPAN. Because that raises the issue of the 1975 permanent tax rate structure then would go into effect as of January 1976. That is, it would be temporary with the 1975 act expiring.

Chairman HUMPHREY. Yes.

Mr. GREENSPAN. Then you swing around again on January.

Chairman HUMPHREY. But you are going to veto that.

Mr. GREENSPAN. But, Senator, you are asking basically for the reasoning with respect to this question. I am merely trying to suggest the types of options which emerge.

Chairman HUMPHREY. Yes.

Mr. GREENSPAN. One way to have done this which is, I presume, what you are suggesting, is to have in effect a tax increase for 1976.

Chairman HUMPHREY. No, no, I am not suggesting that at all. I made my suggestions a long time ago. They are in the printed record of the Joint Economic Committee.

I am talking about what you are suggesting. No. 1, the President's program is going to increase the deficit for the first 9 months.

Mr. GREENSPAN. By a small amount.

Chairman HUMPHREY. There is argument over that. The Treasury Department figures show there would be about a $16 billion difference in tax. The Treasury shows $16.2 billion additional tax liabilities as compared to what you were giving us earlier, something around $11 billion.

But whatever it is there is going to be an additional deficit. Do you agree to that?

Mr. GREENSPAN. Yes, sir.

Chairman HUMPHREY. OK. And that is bad, is it not?

Mr. GREENSPAN. I would prefer that it were otherwise—Well, let us put it this way—

Chairman HUMPHREY. From you that means it is bad.

Mr. GREENSPAN [continuing]. I would like to put it in perspective. The reason the deficits are bad is that—because they have persisted, in the long run they have a destabilizing effect upon economic activity.

Chairman HUMPHREY. I agree with that.

Mr. GREENSPAN. Merely because one puts red ink down, you know, one does not make a judgment that deficits by their very nature are bad. You have to consider the size of the deficit and how long it is in place. So it is essentially a question of the types of deficits that we foresee in the future under existing expenditure policies.

Chairman HUMPHREY. I understand your thesis. I understand it and therefore on the basis of your thesis, why then did you not wait until 1977 to have concurrent budget cuts and tax reductions?

Mr. GREENSPAN. Well, I am not quite sure what wait means because one action one way or another had to be taken with respect to taxes as of January 1, 1976.

Chairman HUMPHREY. Well, OK. Let us assume for the period that we just have a simple extension.

Mr. GREENSPAN. Well, a simple extension then raises the question: Are you extending the withholding tax or are you extending the liabilities?

Chairman HUMPHREY. Let us extend the withholding tax and we have 2 years already on the investment tax credit. You said to Senator Kennedy, for example, that the $12 billion increase which is the extension of the withholding primarily plus some other things would not be significant. You know, you toss that $12 billion off here as if it really was not going to have too much impact on the economy one way or another. Is that not correct?

Mr. GREENSPAN. That is correct, sir.

Chairman HUMPHREY. All right. If that is the case then let us assume that whether you extend it or whether you do not extend it, it is not going to have very much impact on the economy.

Mr. GREENSPAN. It has an effect but it is not a major one.

Chairman HUMPHREY. Not a significant effect—that is what you said but I do not buy that.

Mr. GREENSPAN. That is right.

Chairman HUMPHREY. But that is what you said. Now let us assume then that we either continue the $12 billion or we do not continue the $12 billion for the coming year, 1976. Why did we not wait until 1977?

Mr. GREENSPAN. Well, for precisely the reason you suggest, Mr. Chairman, namely that the difference between waiting on the issue of tax or putting it in later would not have a major economic impact. But one thing which we attempt to avoid is frequent changes in tax law.

And it was the President's judgment that the variations that would have been involved in getting tax changes were undesirable, considering the fact that the effect on the economy one way or the other would not be a major issue.

Chairman HUMPHREY. Yes, well, Mr. Greenspan, let me say this. I think the tax reduction has been helpful. I think the economy is showing some healthy signs or some signs of good recovery. But practically every person that you talk to, practically every bank letter that you read, practically every economic analysis that is made tells us that it is a fragile recovery yet.

There are still many weak spots in the economy and therefore there are those who seem to feel that the best process for us to follow is a game plan which seems to be working. Why not continue the current tax reductions? Why replace it with a package of excessive fiscal stimulus now and excessive fiscal restraint later when you could have a simple extension of the current tax reductions which have worked beneficially.

I hope the President will listen to some of his friends in Congress who will tell him that it is prudent, sensible, and pragmatic to continue the tax reductions of 1975 exclusive of the rebates. I am including in that the investment tax credit. And finally I would say what is needed in this country is not one of these businesses where you erode the tax structure, because this country has got big things to do ahead, but what you need to have is basic structural reform. And that is something different than just reducing taxes.

I have yet to see anything really coming down from the administration that looks at the tax laws that have accumulated here over the last 50 years. Every one of them had a purpose.

But what is needed in the tax structure today is to take a look at our economy. And what do we see in this economy? We see conglomerates, we see mergers. We find, for example, that the tax structure itself forces mergers. It forces this very same thing that we have got a Justice Department out here supposedly to prosecute. On the one hand the IRS and the tax code makes it beneficial, economically desirable, to merge. And then after they have merged, the Justice Department says, "Well, now you are violating the Clayton Act and the Sherman Antitrust Law."

We really need to take a look at the structural organization of our economy and then we need to relate our tax laws to it. We need to understand how you use tax laws for incentives to accomplish objectives in this administration, long-term goals and objectives of energy, transportation, of food policy, of whatever else may be necessary.

Thank you, Mr. Greenspan.

Mr. GREENSPAN. Thank you, Mr. Chairman.

Chairman HUMPHREY. I wish I did not like you so well.

Mr. GREENSPAN. I have the same problem, Mr. Chairman.

[Whereupon, at 12:16 p.m., the committee recessed, to reconvene on Friday, November 7, 1975, at 10 a.m.]

67-569—76——4

THE PRESIDENT'S PROPOSED TAX CUT AND BUDGET CEILING

FRIDAY, NOVEMBER 7, 1975

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

The committee met, pursuant to recess, at 10:15 a.m., in room 1202, Dirksen Senate Office Building, Hon. Hubert H. Humphrey (chairman of the committee) presiding.

Present: Senators Humphrey, Proxmire, and Javits; and Representatives Hamilton and Brown of Michigan.

Also present: Richard F. Kaufman, general counsel; Robert D. Hamrin, L. Douglas Lee, Loughlin F. McHugh, and Courtenay M. Slater, professional staff members; and M. Catherine Miller, minority economist.

OPENING STATEMENT OF CHAIRMAN HUMPHREY

Chairman HUMPHREY. I call the meeting of the Joint Economic Committee to order.

Our first witness this morning is the Secretary of the Treasury, William Simon. Later this morning, we will also have Mr. Shiskin with us to go over the cost of living index, the wholesale price index, and the employment figures.

I might say this ought to be a very interesting hearing.

We appreciate Secretary Simon being with us here to answer some of our questions regarding the President's recent recommendations for a $28 billion tax cut beginning in 1976 and an equivalent program of spending restraint beginning in fiscal 1977.

Mr. Secretary, in my judgment, so far no one has made a very good case for the specific proposals made by the President. There is widespread agreement that some tax reduction is needed in 1976, and the majority of this committee so recommended; and there is universal agreement that spending restraint is desirable not only in fiscal 1977, but on a continuing basis.

The Senate Budget Committee and the House Budget Committee and the Congressional Budget Office have been demonstrating a very sound pattern of fiscal responsibility. Every bill that we debate in the Congress, whether it is appropriation or authorization, has to fit within the budget targets established by the Congress. No longer is there this hit and miss, one at a time legislative operation, either on authorizations or appropriations. We are staying within our budget targets. I think it is fair to say that the Congress has acted in the

most responsible manner possible. I might also add that the administration has added some $16 billion on budget requests since its original budget came before us. These are matters which are frequently not noted in the public print because they come in piece by piece. But, my last calculation was around a $16 billion figure of additional budget requests. And I don't believe that takes into consideration the new Middle East authorization for military assistance and economic assistance. I think some of it was considered, but not totally.

The prevalent opinion certainly seems to be that there are better ways to cut taxes and better ways to restrain spending than those recommended by the President. However, it is in all fairness and I think necessary to afford this opportunity this morning, as in other days, for the administration to bring its case to us and to give it every chance to be persuasive.

Mr. Secretary, in a recent letter to the Washington Post, you listed five "basic economic needs" which the President's tax and spending cuts are designed to address. I must say that if this is the strongest case you can make for the President's proposals, I am of the opinion the President's proposal does not have much chance. The first "need" you list is "to make more certain the sustainability of the economic recovery that got underway in late spring." This seems to contradict testimony given this committee last week by Mr. Alan Greenspan. He said that the President's proposals would have very little impact on the economic recovery and he has not revised his forecast of economic growth or unemployment based on the President's proposals. Not only that, he also said the temporarily enlarged deficit the President's program would imply is "admittedly undesirable."

The second "need" you list is "to avoid a negative psychological reaction to increases in tax withholding rates which might disrupt the strong pace of personal spending which is so important to the strength and durability of recover." The tax increase could of course be avoided by simply extending current withholding rates as Congress may very well do. The President's program is certainly not necessary to objective just standing on its own.

The third "need" you list is "to return to individuals the opportunity to personally decide how they will spend a larger share of their family earnings." The President's proposal would achieve this for some individuals, but not for others. Because the President's proposals do not include extension of the earned income credit, families earning $5,000 or less would have as much as $300 less disposable income under his proposal than they did under the 1975 tax law.

The fourth "need" you list is "to take some meaningful actions to encourage capital formation which is needed in the short run to sustain the recovery and in the long run to create the necessary jobs for this Nation's growing labor force." This may be a legitimate need, Mr. Simon, but if so I don't think your proposals meet the need. In the President's proposals only $2.2 billion—the result of a 2 percent corporate rate reduction—is new. The other business tax cuts you have proposed are all extensions of the 1975 act or special provisions for utilities which have previously been proposed. I find it difficult to believe that the $7 billion package of business tax cuts contained in the administration's bill will have a large impact on sustaining the recovery or creating additional jobs. However, I would be

very pleased to have any further information that you can give the committee to substantiate your claims.

And might I add that a good deal of that $7 billion is in the investment tax credit and the adjustments that were made in the 1975 act.

The fifth "need" you listed was to reverse the trend of rising Federal spending which has been based on the false assumption that the American people support the sharp expansion of the role of government in their lives." I just don't believe your charge that there has been a sharp expansion in the role of Federal Government in people's lives can be substantiated. In the first place, according to the 1976 budget, the size of the Federal bureaucracy has actually declined by about 187,000 people since 1969.

I might add there is a larger number of people at the high salary figure in what we call the supergrades. That supergrade has been added to the supergovernment.

While it is true that total government employment has increased, this is because of the rapid increase in State and local government and not because of the Federal Government.

Second: you and I both know that the rapid rise in Federal spending can be largely attributed to programs which are tied into inflation—for example, the Department of Defense comes charging down here and says, "We've got to have this additional money, Senators, because look at the inflation rate," and there isn't of course a single agency that hasn't asked for some increase because of the inflation rate or at least most agencies have. And this is understandable. With the foreign aid bill, you have the same thing. I handled that on the floor of the Senate this week. It was a larger bill than a year ago. The main argument we had to use was: Look, we are buying goods and services and when we buy goods and services we have to take care of the inflation rate. And then, I might add that the rise in unemployment has also added a very heavy burden to the Federal budget and to the deficit, and not to the provision of additional services. Actually, there are fewer people now on the food stamp program, for example. The food stamp program has been cut back. We will do some more cutting back on it.

Mr. Simon, I would repeat that if your letter is the strongest case that can be made for the President's proposal, it is a very weak one indeed.

Now, I might add at this particular point that since we last got together, the economic situation has changed considerably. All of these rosy tinted forecasts, Mr. Secretary, have taken on a peculiar coloration in the last few days and in the last few months. The wholesale price index is out of hand. And I want to say right now that I am going to order this committee to make an entire structural study of why prices are rising the way they are when there is still 30 percent of our plant capacity unused and still 8½ million Americans unemployed. What is happening in some of the structural areas of American industry that precipitates one of the sharpest rises in wholesale price indexes we have had for years? I know this is not necessarily your responsibility this morning, but it ties in with the entire fiscal operation.

The Wholesale Price Index on commodities has increased in prices at 13½ percent annual rate over the last 3 months. And you know I am not taking just the last month. The last month would have been almost 20 percent. But in the last 3 months, the Wholesale Price Index has gone up at the annual rate of 13½ percent.

And let me say right offhand that corn is $2.50 a bushel, soybeans are $4 a bushel, but farm prices are lower right now than they were a year ago. It is a gross misconception that agriculture is responsible for the price increase.

Well, Mr. Secretary, I know you have to leave early, but I just thought I would get that off my chest before I went any further. But we have been hearing for a long time that the reason that the Wholesale Price Index and the cost of living index is going up is because of farm prices. And this is just a lot of nonsense. And I want to point out that farm prices are basically down and not up. And the prices that are up are prices of automobiles, of steel, and of these commodities which are controlled by the administrative structure of business, and not the prices of people who are producing the raw materials out on the farmlands of America.

I want to place in the record a statement by Senator Taft. Senator Taft was unable to be here this morning, but he has asked that his opening statement be submitted for the record and I want it printed at this point. So I do now ask that Mr. Taft's statement be made a part of our record here.

[The opening statement of Senator Taft follows:]

OPENING STATEMENT OF SENATOR ROBERT TAFT, JR.

As became evident during Mr. Greenspan's recent testimony before this committee on the President's tax and spending proposals, there is clearly developing here yet another political confrontation between the White House and the majority.

While I do not question the President's motives in setting up the timing of the tax cuts and spending cuts, I must say I think they could have been better timed.

It is true that some form of tax cut must begin in January, to avoid a jump in withholding rates.

It is also true that a ceiling on spending under the new congressional budget rules will not be feasible until October.

But surely we can manage a compromise program which can bridge this gap. Why should we not continue the tax cut at present levels, to prevent a tax rise and to strengthen the recovery? Then, in October, when we can see better how the recovery is progressing, could we not consider increasing the tax cuts towards the levels proposed by the President, and cutting expenditures by the amount of the new tax cuts at that time? By then the recovery should be in good shape, and some restraint will be needed. It could be applied gradually in 1977 and 1978, with a gradual spending cut, until the budget does move into balance.

I think that the timing problems created by the date of expiration of the current tax cuts, and the date of the new fiscal year, can and should be overcome, and without too much trouble, and I urge the administration and the Congress to be flexible in this matter.

We do need a bit more stimulus to personal income. Inflation is still pushing people into higher brackets. We do need tax cuts to counter that, if for no other reason. And we do need spending cuts, to keep the Federal share of the

Gross National Product from rising forever. I just think we should delay that excess part of the tax cut, from $18 billion to $28 billion, until we can begin to cut spending as well. Otherwise the deficit will be pushed up unnecessarily, and inflation with it.

Chairman HUMPHREY. All right, Mr. Secretary, please proceed.

STATEMENT OF HON. WILLIAM E. SIMON, SECRETARY OF THE TREASURY, ACCOMPANIED BY SIDNEY L. JONES, ASSISTANT SECRETARY, ECONOMIC POLICY; AND ROBERT A. GERARD, DEPUTY ASSISTANT SECRETARY, FINANCIAL RESOURCES POLICY COORDINATION

Mr. SIMON. Thank you, Mr. Chairman. What I would like to do, if it is all right with you, is several things. One is, if I might, because my time is limited today, but I would like to respond for the record to your opening statements on my letter to the Washington Post. Unfortunately, letters to the Post or the Times or any other newspaper are constrained by the number of words you are allowed to write. So therefore you can't adequately respond in sufficient detail, because it can't be printed——

Chairman HUMPHREY. I understand that.

Mr. SIMON. So, it does get chopped up.

Chairman HUMPHREY. Might I say, Mr. Secretary, if you want to place your entire statement in the record and then just address yourself to the basic concerns of the tax proposals, we would welcome that, because there will be questions and I think your responses to the questions will be more helpful than almost anything.

Mr. SIMON. Sure, and what I would like to do, first of all, is just attempt to go quickly through the detailed statement, summarize it, if I may, and then I will respond to the tax cut-expenditure cut, Mr. Chairman, as you have requested.

First, I don't think you ever heard me say, or anyone from the administration say, or indeed blame, food costs for our inflation problem. Food is a part of it, sure, and in September and October, farm products and processed foods and feeds did increase at a high rate, 2.3 percent in September and 1.7 percent in October. But that pressure fluctuates from month to month, and December through March it declined pretty well.

Chairman HUMPHREY. And it is declining now, Mr. Secretary. This is my bag. I understand this part of the economy very well.

Mr. SIMON. Sure. As I say, nobody in this administration is blaming the high cost of——

Chairman HUMPHREY. Well, when we have had reports before, there have been comments—and I think it is fair to say not only from the administration but general comments are that the reason for the rise in the cost of living is food prices and energy. Well, energy can take

its fair share of blame, but I just simply want to say as far as the farm producers are concerned, when I met yesterday with representatives of farm organizations from Ohio, Minnesota, Missouri, the Mountain States, and found out what the price of wheat is, as compared to last year and what the price of soybeans are as compared to last year, then I said to myself that I am not going to let this get by today without at least mentioning it. Because when you are out there producing soybeans for $3.90 or $4.00, well that is like asking a worker accustomed to getting $6 an hour to take $4.50. I just wanted to put it on the record.

I represent the part of the country that is known as the Midwest and I know what is happening to us. And I know the kind of pressures under which people are living today. And I know if it were not for our State banks being willing to continue these loans to those farmers, there would be mass liquidations of their holdings, of their crops, which would precipitate a decline in farm income that would make New York City look like it was a part of Iran living in the glory of oil riches. But, go ahead.

Mr. SIMON. Mr. Chairman, I am pleased to appear before you today to review current economic conditions and policies. My analysis will hopefully contribute to a better understanding of the economic recovery now underway and the policy initiatives required for achieving long term economic goals regarding inflation, unemployment, and our national output. Policy initiatives now under consideration will affect both the near term pattern of recovery and the longer term outlook for achieving the basic objective of national economic policy, as set forth in the Employment Act of 1946: "To promote maximum employment, production, and purchasing power" through actions consistent with "other essential considerations of national policy." The disappointing inflation and unemployment performance of the past decade indicates the basic need for a longer term perspective in setting our current policies. This is a difficult adjustment but if it is not made, future economic developments will be even more disappointing and the margin for error will diminish.

Given the basic importance of economic issues in shaping the future of our country, the Joint Economic Committee has a unique role in influencing the decisions of Congress. I hope that our joint analysis of the current problems and policy initiatives will contribute to more reasoned and effective decisions and I look forward to working with this committee toward that goal.

In planning its economic policies for 1975 we believed that recovery would begin by midyear if three fundamental adjustments could be accomplished: (1) The unwanted accumulation of inventories could be liquidated and new orders increased; (2) real incomes of consumers could be restored by reducing the double-digit level of inflation and initiating tax reductions and rebates which would stimulate personal consumption; and (3) employment would begin to improve.

Now the next seven or eight pages of my statement relates to what indeed has occurred.

The turning point for our economy was reached slightly sooner than we expected. We think the pattern of the recovery was somewhat stronger than any of us expected. However, the conclusion that we are now several months into an economic recovery does not mean that our

fundamental economic problems have suddenly been solved or that we will not continue to experience specific economic disappointments during the coming months. There are still many factors of the economy where our current performance is inadequate and we can never be satisfied until the existing level of excessive inflation and unemployment are substantially reduced.

A third serious problem affecting the strength and sustainability of the economic recovery involves the negative impact of massive Federal debt financing requirements. When we talk about how the economic recovery is progressing, financing needs are not automatically fulfilled with interest rates at the level they are and I know you are only too familiar with our borrowing problems on the capital market. Our funding requirements and heavy Treasury borrowing are going to continue throughout this year and into the future. The danger, Mr. Chairman, and gentlemen, is what happens when we move into a period of high economic activity if we are indeed financing these massive deficits what with the financial dislocations that are apparent today, as we have seen in the financial press in recent weeks. And the question being asked is who is going to finance this broad-based economic expansion? And we know that General Motors and United States Steel and the big boys can get their money today. They have access to the long term markets. But what I am talking about, Mr. Chairman, is the small business people in this country. And of course the consumers are affected by high interest rates in everything that they do with their money. The small businesses, medium sized businesses, the lower rated businesses, the IBM's of tomorrow, perhaps, are all effectively barred from the longer term sector today. They are either barred because they cannot afford to finance at these present interest rates or they have limited access opportunities with their present ratings.

After carefully reviewing the progress of our economic recovery to date in the near term prospects, the President recently proposed a balanced package of Federal tax and spending recommendations. We hope that Congress and the general public will seriously consider these proposals as a means for sustaining the current recovery. And by that, and if there is an apparent contradiction to your opening statement about what Alan said last week, Mr. Chairman, I mean there is no doubt, and we all agree, I believe, that the economic recovery now underway is going to provide us with satisfactory growth. We estimate somewhere in the area of 7 percent real growth on the average through June of 1976.

And when I talk about "sustained" I am again talking about a longer view, a durable and lasting recovery, which indeed we all desire. And I am talking about more fundamentally of correcting the long-term pattern of rapidly rising government spending and the chronic deficits.

The increased spending and cumulative deficits have increasingly eroded our fiscal flexibility and created serious economic distortions, which in turn have contributed to the unfortunate boom and recession sequences during the past decade.

Mr. Chairman, we believe that the President's recommendation to provide a meaningful step towards gaining fiscal control and greater equity by returning more decision-making discretion to individuals and

families, to determine how they will allocate their incomes and personal financial resources.

The President's recommendations involve two basic actions: (1) a permanent reduction in Federal taxes totaling approximately $28 billion in 1976 with three-quarters of the relief for individuals and one-quarter for business firms; and (2) a slowing down of the upward momentum of Federal spending through cooperative efforts of Congress and the Administration to hold down spending during the rest of this fiscal year and by establishing a spending ceiling of $395 billion for fiscal year 1977 that begins October 1, 1976. It is important to consider these actions as a package if we are to maximize the long-term benefits.

The proposal to establish a spending ceiling of $395 billion for fiscal year 1977 would still result in a large budget increase of $25 billion, or almost 6.8 percent, above the anticipated outlays of $370 billion this year. Therefore, Federal outlays will continue to rise; our realistic goal must be to slow down the rapid growth of spending, not the absolute growth. Unless such action is taken, spending in fiscal year 1977 could increase by approximately $53 billion without adding any new programs, according to preliminary estimates by the Office of Management and Budget. This unfortunate surge of spending would result from the cumulative pressures we have legislated into or system. In fiscal year 1966, Federal budget outlays totaled $134.7 billion. In just 9 years they doubled, rising to $268.4 billion in fiscal year 1974. If outlays actually rise to $370 billion during the current fiscal year, that would represent an increase of $101.6 billion, or 38 percent, in just two fiscal years. Therefore, it should not be surprising that a large Federal budget deficit of $43.6 billion was recorded in fiscal year 1975 and an even larger deficit of at least $70 billion is expected this year.

Some analysts have suggested that deficits of this size are not particularly burdensome if they are compared to the current GNP figure totals. This mechanistic view, in our judgment, of comparing a residual figure against the total level of economic activity ignores the fundamental issue: (1) the increased government claims against future output; (2) the inflationary impact of increased Federal spending that occurs if additional claims are added to total demand when resources are already fully employed even though the original government spending decisions may have been made during earlier periods of economic slack; and (3) the serious disruptions in the financial markets that result when such massive deficits must be financed.

Some analysts also claim that the surge of Government spending and deficits are only temporary and that more moderate outlay growth rates and budget balances will return as soon as economic conditions stabilize. It is true that part of the budget outlay increases can be traced to the "automatic stabilizers" that should respond to recession problems. For example, unemployment compensation benefits have increased from $6 billion in fiscal year 1974 to over $19 billion this fiscal year. However, a review of the actual budget figures or the recommendations included in the first concurrent resolution to the Congress prepared by the Congressional Budget Committees clearly indicates that large spending increases are occurring across the traditional programs of the entire Federal Government. These spending increases

cannot realistically be considered as "temporary" since Government programs are rarely eliminated or curtailed.

It has also been claimed that the President's program is unrealistic because he has indicated that the slowdown in the upward momentum of spending should occur across all existing programs. This is an ironic criticism when the record of fourteen deficits in the last fifteen fiscal years or the near quadrupling of outlays from $97.9 billion in fiscal year 1961 to approximately $370 billion this year is considered. It is realistic to believe that we will balance the Federal budget annually or over the economic cycle in the future when that disappointing record is examined? Nor has the full-employment budget concept prevented deficits from being reported using those definitions. In short, there is certainly a need for discipline but the guidelines of the past have not provided the necessary realism.

The President has also emphasized that establishing a spending ceiling of $395 billion for fiscal year 1977 does not remove the need for discipline in holding down current Government spending between now and October 1, 1976. Last January the President proposed a budget for fiscal year 1976 calling for outlays of $349.4 billion. Since then the bulk of the budget rescissions and deferrals have been rejected by Congress and numerous spending increases have been legislated. The President has vetoed many of these spending initiatives which he considered to be excessive and most of his vetoes have been sustained. Nevertheless, fiscal year 1976 spending continues to rise steadily beyond the levels he has asked for. The President is now asking for spending discipline this year and next year and into the future. In a meeting with several news media representatives held on October 14, 1975, he commented on the claim that the formal spending ceiling for fiscal year 1977 might imply a relaxation of the discipline he has asked for during the past year.

The President has emphatically stated that spending discipline by the Federal Government must be applied across the board and has instructed his budget officials to work toward the spending ceiling goal in developing the fiscal year 1977 budget which will be presented in the January budget message to Congress. The Office of Management and Budget is already working with the individual departments and agencies to determine what spending programs can be moderated. These specific actions will be indicated in the regular budget publications in January. And Congress and its budget committees will have the usual opportunities and responsibilities, as well, to evaluate and adjust those budget recommendations. The call for cooperation in setting a spending ceiling for fiscal year 1977 is simply that—a cooperative effort to introduce a sense of realism into regaining fiscal control. This approach does not disrupt the normal budget preparation process of the executive office nor does it usurp or disrupt the functions of the Congress or its new budget committees. Each body retains the same responsibilities and powers. Setting a realistic target does not change the ultimate responsibilities; instead, it provides a necessary foundation for the tax relief recommendations.

The second part of the package of recommendations involves extensive and permanent tax relief action beginning in 1976. The recommended changes in the individual and business income tax structure are detailed.

As indicated, three-quarters of this permanent reduction would be provided for individuals and one-quarter to business firms. Even the one-quarter share allocated to businesses will directly benefit individuals by providing incentives for capital investment which will create jobs and contribute to increasing personal income. Capital investment is also needed to create the productive capacity required if our future economic goals of lower unemployment, moderate price increases and improved productivity are to be achieved.

Analysis of the President's tax reduction proposals indicates the distributional effects, which are summarized in all these tables accompanying my testimony. These tables indicate that among our middle-income category, we see the larger share of the tax reduction recommended and a larger percentage reduction in tax liabilities, compared to the law last year.

Analysis of the tax changes recommended in our tables indicates that the President's recommendations would provide even more benefits to individuals, an additional $11.8 billion above the relief provided by the 1975 act and $2.5 billion additional relief for businesses. We believe this amount of tax relief will help sustain the economic recovery now underway, particularly the strong personal spending, and provide necessary incentives for increasing future capital investment. We also believe that the low-income tax brackets where the impact of inflation is particularly severe and the middle-income tax brackets where the bulk of tax payments are collected. Those who are already paying heavy taxes should obviously participate in the relief as a matter of equity and to provide incentives for continuing to work hard hard to provide for personal and family financial security. The "progressive" nature of the tax system is clearly emphasized by minimizing the percentage distribution of the tax reductions to higher income brackets.

In developing this balanced package of proposals, we felt strongly that the fundamental policy requirement at this time is to regain fiscal control so that the economic distortions of the past decade can be moderated. We also believe that the potential benefits should result in tax relief for the American taxpayer to maintain private purchasing power and for businesses as an incentive to increase capital investment to create jobs. Therefore, the two proposals are inextricably tied together. Action on taxes is obviously required at this time to avoid reverting back to the 1972–74 tax statutes. While it is popular to propose tax reductions, in our judgment it would be irresponsible to reduce revenues without simultaneously considering the difficult job of slowing down spending—during the rest of this fiscal year and in fiscal year 1977. To act only on tax reductions would increase the enormous deficit we already face and that distortion would ultimately lead to even more undesirable inflation and unemployment.

It would be most unfortunate to have excess stimulus in the form of tax cuts, which are usually popular, without corresponding action on spending. The lagged impact of economic policies would lead to unwanted overheating of the economy if a 9-month gap between tax reductions and the initiation of necessary spending discipline is allowed to occur. We have needed budget discipline for some time and we certainly require it now. The President has repeatedly acted to hold down spending over the past year and this effort will continue. The

identification of a spending ceiling for fiscal year 1977 would not change that effort nor would it disrupt the normal budget processes of the Congress or the Executive Office as they develop together specific spending proposals and legislative decisions within the general guidelines adopted. What it would do is indicate together our serious intent to finally take some meaningful action. The American people would welcome some positive signal that the Congress and the administration will cooperate in strong and realistic actions. The familiar rhetoric of the past is hardly persuasive when compared with the actual results of rising Government spending, chronic deficits which vary only in size over the economic cycle, excessive inflation, and economic distortions that ultimately lead to recession and unemployment. The Congress and the Executive Office have jointly established spending targets in the past and it is obvious that our serious fiscal situation requires similar responsible action at this time. We have already talked this issue to death; the American people would like to see some results.

Therefore, the major economic thrust of the President's program is directed at what we perceive to be the long-term economic problems confronting the United States. It has two goals: (1) To slow down the upward momentum of Government spending and eliminate the chronic Federal budget deficits that have occurred in 14 of the last 15 fiscal years—or, in 38 of the last 46 years; and (2) to return more of the decisionmaking power to individuals and families in determining how they will use their income. These actions would help to improve the efficiency of our economy and the permanent changes would create additional stability which would enable individuals and business firms to plan for the future with more confidence.

Turning the basic direction of fiscal policy will not be easy because of the legislative momentum that has been accumulated over the years. Budget experts continually describe the "uncontrollable nature" of most of the Federal budget which rises each year as the number of programs increase. It is now estimated that nearly three-fourths of the budget is committed to programs for which payment is required under existing law or contracts.

I do not believe that there is any such thing as an "uncontrollable" Federal budget commitment because they all depend upon legislative priorities. I do believe that there are different priorities and that all good things are not equally good. There is a solution to the problem if the congressional Budget Committee will require more careful consideration of these priorities and the elimination or curtailment of ineffective programs during the annual appropriations process. We must correct the historical approach of merely continuing existing outlays so that any new claims are always "add-ons." But for that process to occur the underlying discipline of economics in matching priority claims and limited resources must occur. The Joint Economic Committee can provide that economic leadership for the rest of Congress.

Although the major thrust of the President's program is to emphasize long-term goals, a major policy change of this sort affects the near-term pattern of economic activity as well. In a $1½ trillion economy, there obviously are uncertainties in predicting potential changes in economic activity and the specific impact of fiscal policy recom-

mendations. In preparing the President's package of policy initiatives we analyzed the probable course of economic developments that would result if existing Government spending trends were to continue and if the tax relief provided by the Tax Reduction Act of 1975 were to be continued essentially in its present form—and I discussed what would happen under various assumptions.

The process of governing is never easy as members of this committee well know. Nevertheless, a challenging set of fiscal policy decisions must be made in the near future. The current recovery from the recession is likely to proceed during the coming months but the long-term outlook for achieving our basic national economic goals is clouded by the cumulative pressures of past policy decisions. Although the issues are stated in economic terms they really involve the entire political process required to coordinate the diverse interests represented in our Nation. If we do act now, we can regain fiscal control and restore balance to the Federal budget which is required if we are to stabilize savings and investments in the future. Positive action on the President's recommendations could lead to the desired Federal budget balance, within 3 years. If we do not act now the disappointing record of economic instability and budget deficits will continue into the future.

We strongly believe that maximum long-term benefits will result if we act now to slow down the upward momentum of Government spending, restore balance to the Federal budget and extend broad tax relief to the American taxpayers so they can decide how to allocate more of their resources. This is all familiar rhetoric which one can listen to every day coming from diverse sources. However, our actions have never matched our well-intentioned rhetoric. This gap results from the extreme difficulty of making decisions on individual spending programs and tax policies and the compromise that always occur. We believe that the President has presented a balanced package of tax and spending proposals that make economic sense by emphasizing longer-term goals. I hope that you will consider carefully these economic arguments as the decisionmaking processes unfold over the next few weeks.

I have left significant portions of this testimony out for your later reading.

Chairman HUMPHREY. Yes; we will include, Mr. Secretary, all of your testimony, including the backup material that you have.

Mr. SIMON. Thank you, sir.

Chairman HUMPHREY. And the original text, as part of your testimony.

[The prepared statement of Secretary Simon, together with additional material referred to for the record, follows:]

PREPARED STATEMENT OF HON. WILLIAM E. SIMON

Mr. Chairman and members of this distinguished committee: I am pleased to appear before you today to review current economic conditions and policies. My analysis will hopefully contribute to a better understanding of the economic recovery now underway and the policy initiatives required for achieving long-term economic goals regarding inflation, unemployment and national output. Policy initiatives now under consideration will affect both the near-term pattern of recovery and the longer-term outlook for achieving the basic objective of national economic policy, as set forth in the Employment Act of 1946: "To promote maximum employment, production, and purchasing power" through actions consistent with "other essential considerations of national policy" in ways "calculated to foster and promote free competitive enterprise and the general welfare . . ." The disappointing inflation and unemployment performance of the past decade indi-

cates the basic need for a longer-term perspective in setting current policies. This is a difficult adjustment but if it is not made, future economic developments will be even more disappointing and the margin for error will diminish.

Given the basic importance of economic issues in shaping the future of our Nation, the Joint Economic Committee has a unique role in influencing the decisions of Congress. I hope that our joint analysis of the current problems and policy initiatives will contribute to more reasoned and effective decisions and I look forward to working with this Committee toward that goal.

I. ECONOMIC BACKGROUND OF POLICY RECOMMENDATIONS

A brief review of general economic developments is a necessary background for evaluating the specific economic recommendations recently made by the Administration. In planning its economic policies for 1975 we believed that recovery would begin by midyear if three fundamental adjustments could be accomplished: (1) the unwanted accumulation of inventories could be liquidated and new orders increased; (2) "real incomes" of consumers could be restored by reducing the double-digit level of inflation and initiating tax reductions and rebates which would stimulate personal consumption; and (3) employment would begin to increase rapidly enough to reduce the unemployment rate and strengthen consumer confidence. Fortunately, these adjustments have been achieved and the turning point of economic recovery evidently occurred by April.

During the first three months of 1975 the real output of goods and services continued to decline sharply at the seasonally adjusted annual rate of 11.4 percent, but the economic situation was beginning to improve as personal consumption strengthened and the necessary liquidation of inventories began. Most of the remaining recession weakness was concentrated in the private investment sector where residential construction and business investment declined and a large liquidation of inventories occurred. During the last three months of 1974 business inventories accumulated at the seasonally adjusted annual rate of $18 billion in current dollars. In the first quarter of 1975 the situation was reversed as business inventories were liquidated at a seasonally adjusted annual-rate of $19 billion. In the second quarter the pace of liquidation accelerated to a level of $31 billion before dropping back, according to preliminary figures, to a rate of $9½ billion in the third quarter. This massive swing in inventories was a necessary precondition for economic recovery even though it did restrict the growth of total GNP early in the year. Inventory accumulation should become a positive factor in the near-term outlook.

As spring progressed other significant economic improvements occurred. The annual rate of consumer price increases dropped from the double-digit level of 1974 to a 6 to 7 percent zone. This improvement, along with the Tax Reduction Act of 1975 passed in March, resulted in a sharp increase in real disposable personal income during the second quarter, following five consecutive quarterly declines. That improvement in consumer purchasing power stimulated personal spending, which had already started to improve early in the year. As these favorable developments pushed final sales above current levels of production, a runoff of inventories begain at the retail level and spread back through the system. New orders for durable goods turned up in April and have increased in five of the last six months and inventory restocking has begun at the retail level. Total industrial production bottomed out in April and relatively strong gains have been reported since then, although the general level of output has not yet recovered to the pre-recession pace. Exports also continued to grow, despite the economic recessions in other nations, and it now appears that a record merchandise trade surplus will be reported this year.

As economic conditions improved, employment began to rise again in April and total employment, as measured by the household survey, has increased 1.6 million workers since then. The "lay-off" rate has declined sharply since the beginning of the year and the average number of hours worked in manufacturing and the amount of overtime hours have increased. The unemployment rate has declined from 9.2 percent in May to 8.3 percent in September. While this level of unemployment is far too high, the improvement in employment and the increase in the number of hours worked provides encouraging evidence that the unemployment rate will continue to decline as the economic recovery proceeds.

The situation in residential construction and new car sales also stabilized in the spring and moderate improvement has occurred in both of these basic industries. The seasonally adjusted annual rate of new housing starts averaged 1¼

million units during the third quarter compared to a trough of 980 thousand units begun in April. However, the recent level of housing starts is still far below the underlying annual need for new residential construction and considerable improvement must occur in the housing sector. Similarly, sales of new automobiles have significantly improved over the relatively low figures reported in late 1974 and early 1975 even though the domestic output of autos remains well below the record levels of 1973.

The general performance of the economy can be summarized by the swing in total output of goods and services as measured by changes in the "real" GNP figures which are adjusted to remove the effects of inflation. After declining at a seasonally adjusted annual rate of 11.4 percent during the first three months of 1975, output increased at an annual pace of 1.9 percent in the second quarter and then surged upward at an 11.2 percent rate during the third quarter according to preliminary estimates. However, over one-half of the third quarter gain resulted from the inventory swing which is nearing completion. Therefore, gains of the magnitude reported in the third quarter are not expected to continue and the "real" GNP will probably expand at an average annual rate of 7 percent during the next year before gradually returning to the long-term growth rate of approximately 4 percent. Nevertheless, the total GNP figures do highlight the aggregate shift in the direction of the U.S. economy.

The most encouraging aspect of the recent economic statistics has been the growth of "real" final sales at an annual rate of approximately 4½ percent during the last six months. The key element in that solid recovery has been the strength of personal consumption which increased at a seasonally adjusted annual rate of 7.0 percent in "real" terms during the third quarter. Durable goods sales, including the stronger new car performance, led the improvement but outlays for nondurable goods and services also increased. The near-term outlook for sustained economic recovery is heavily dependent upon continued personal spending gains which will stimulate continued inventory buying never be satisfied until the existing levels of excessive inflation and unemployment are substantially reduced. Even though the underlying rate of inflation has dropped to approximately one half of the double-digit rate of 1974, the threat of renewed inflation pressures can cause an immediate negative reaction among consumers and businessmen as demonstrated last summer when the June and July Consumer Price Index reports were announced. Since that flurry the various price measures appear to have returned to the 6 to 7 percent zone but even that rate is far above our historical level of inflation and is still a disruptive force in our economy. Similarly, the current level of unemployment continues to create serious economic and social problems.

A third serious problem affecting the strength and sustainability of the economic recovery involves the negative impact of massive Federal debt financing requirements. Although some analysts assume that the financial needs of an economic recovery can be automatically filled, the reality is that mortgages, consumer debt and business spending for fixed investment and inventories must compete against unprecedented Treasury borrowing requirements which will continue throughout this year and into the future. The Treasury has announced that it will need to borrow new money totaling $44 to $47 billion during the second half of Calendar Year 1975. When these anticipated needs are added to the $36.1 billion actually raised during the first half of Calendar Year 1975 the annual total rises to $80 to $83 billion. This excludes new money raised by the issuance of guaranteed securities and government-sponsored agencies which we estimate at $6 billion and $3 billion respectively in the current calendar year.

We also have substantial refunding requirements. Apart from the rollover of the $77 billion of privately-held regular weekly and monthly bills, $23 billion of privately-held U.S. Treasury coupon issues will be refunded this year.

The heavy Treasury borrowing requirements have become the dominant factor in the financial markets at the same time that private sector needs are expected to increase. The severity of the recession, particularly the rapid runoff of inventories, has moderated the private demand for credit, enabling the Treasury needs to be met, but there is already clear evidence that some firms have been unable to obtain desired financing and even successful borrowers have had to pay historically-high interest rates. The future pace of the economic recovery will depend upon the availability of credit across the broad spectrum of economic activity. If specific sectors, such as residential construction, or large numbers of businesses who do not have top-level credit ratings, are unable to obtain necessary financing, both the strength and sustainability of the recovery will be disappointing. The impact of such large Treasury borrowing needs resulting from

the deficits must receive greater attention in preparing general economic forecasts since we can have only as much economic expansion as available financing will support. This was the basis of our warnings about financial disturbances involving restricted access to funds and rising interest rates that would result when private borrowing needs generated by the recovery have to compete against Treasury borrowing. Unfortunately, financial market developments already indicate that these problems are occurring.

II. FISCAL POLICY RECOMMENDATIONS

After carefully reviewing the progress of economic recovery to date and near-term prospects, the President recently proposed a balanced package of Federal tax and spending recommendations. We hope that Congress and the general public will seriously consider these proposals as a means of sustaining the current recovery and, more fundamentally of correcting the long-term pattern of rapidly rising government spending and chronic budget deficits. The increased spending and cumulative deficits have increasingly eroded our fiscal flexibility and created serious economic distortions which, in turn, have contributed to the unfortunate boom-and-recession sequences during the past decade. We believe that the President's recomendations provide a meaningful step toward regaining fiscal control and greater equity by returning more decision-making discretion to individuals and families to determine how they will allocate their incomes and personal financial resources.

The President's recommendations involve two basic actions: (1) a permanent reduction in Federal taxes totaling approximately $28 billion in 1976 with three-quarters of the relief for individuals and one-quarter for business firms; and (2) a slowing down of the upward momentum of Federal spending through cooperative efforts of Congress and the Administration to hold down spending during the rest of this fiscal year and by establishing a spending ceiling of $395 billion for Fiscal Year 1977 that begins October 1, 1976. It is important to consider these actions as a package if we are to maximize the long-term benefits.

The proposal to establish a spending ceiling of $395 billion for Fiscal Year 1977 would still result in a large budget increase of $25 billion, or 6.8 percent, above the anticipated outlays of $370 billion this year. Therefore, Federal outlays will continue to rise; our realistic goal must be to slow down the rapid growth of spending. Unless such action is taken, spending in Fiscal Year 1977 could increase by approximately $53 billion without adding any new programs according to preliminary estimates by the Office of Management and Budget. This unfortunate surge of spending would result from the cumulative pressures we have legislated into our system. In Fiscal Year 1966 Federal budget outlays totaled $134.7 billion. In just nine years they doubled, rising to $268.4 billion in Fiscal Year 1974 (see Table 1). If outlays actually rise to $370 billion during the current fiscal year, that would represent an increase of $101.6 billion, or 38 percent, in just two fiscal years. Therefore, it should not be surprising that a large Federal budget deficit of $43.6 billion was recorded in Fiscal Year 1975 and an even larger deficit of at least $70 billion is expected this year.

Some analysts have suggested that deficits of this size are not particularly burdensome if they are compared to the current GNP totals. This mechanistic view of comparing a residual figure against the total level of economic activity ignores the fundamental issues: (1) the increased government claims against future output; (2) the inflationary impact of increased Federal spending that occurs if additional claims are added to total demand when resources are already fully employed even though the original government spending decisions may have been made during earlier periods of economic slack; and (3) the serious disruptions in the financial markets that result when such massive deficits must be financed.

Some analysts also claim that the surge of government spending and deficits are only temporary and that more moderate outlay growth rates and budget balance will return as soon as economic conditions stabilize. It is true that part of the budget outlay increases can be traced to the "automatic stabilizers" that should respond to recession problems. For example, unemployment compensation benefits have increased from $6 billion in Fiscal Year 1974 to over $19 billion this fiscal year. However, a review of the actual budget figures or the recommendations included in the First Concurrent Resolution to the Congress prepared by the Congressional Budget Committees clearly indicates that large spending increases are occurring across the traditional programs of the entire Federal Government (see Table 2). These spending increases cannot realistically be con-

67-569—76——5

sidered as "temporary" since government programs are rarely eliminated or curtailed.

It has also been claimed that the President's program is unrealistic because he has indicated that the slowdown in the upward momentum of spending should occur across all existing programs. This is an ironic criticism when the record of fourteen deficits in the last fifteen fiscal years or the near quadrupling of outlays from $7.8 billion in Fiscal Year 1961 to approximately $370 billion this year is considered. Is it realistic to believe that we will balance the Federal budget annually or over the economic cycle in the future when that disappointing record is examined? Nor has the full-employment budget concept prevented deficits from being reported using those definitions. In short, there is certainly a need for discipline but the guidelines of the past have not provided the necessary realism.

The President has also emphasized that establishing a spending ceiling of $395 billion for Fiscal Year 1977 does not remove the need for discipline in holding down current government spending between now and October 1, 1976. Last January the President proposed a budget for Fiscal Year 1976 calling for outlays of $349.4 billion. Snce then the bulk of the budget recisions and deferrals have been rejected by Congress and numerous spending increases have been legislated. The President has vetoed many of these spending initiatives which he considered to be excessive and most of his vetoes have been sustained. Nevertheless, Fiscal Year 1976 spending continues to rise steadily beyond the levels he has asked for. The President is now asking for spending discipline *this* year and *next* year and into the *future*. In a meeting with several news media representatives held on October 14, 1975 he commented on the claim that the formal spending ceiling for Fiscal Year 1977 might imply a relaxation of the discipline he has asked for during the past year:

"If Congress is concerned about this, there is no reason why they can't cooperate in a number of the authorizations and appropriation bills that they and I will be considering between now and January 1, which will have an impact on the spending in the first six months or nine months of calendar year 1976."

"As a matter of fact, we are probably going to have that struggle during that period of time anyhow, and our emphasis will be, as it has been, to hold the line on some of these spending proposals, whether it is an authorization, appropriation, or substantive legislation."

"So, in effect, I will be seeking to put some lid on the second half of fiscal year 1976 spending." (The White House Briefing by the President, William E. Simon, Secretary of the Treasury, Alan Greenspan, Chairman of the Council of Economic Advisers, and James T. Lynn, Director of Office of Management and Budget for Eighteen Newspaper Columnists, Office of the White House Press Secretary, October 14, 1975, pp. 6–7.)

The President has emphatically stated that spending discipline by the Federal Government must be applied across the board and has instructed his budget officials to work toward the spending ceiling goal in developing the Fiscal Year 1977 budget which will be represented in the January Budget Message to Congress. The Office of Management and Budget is already working with the individual departments and agencies to determine what spending programs can be moderated. These specific actions will be indicated in the regular budget publications in January. And Congress and its Budget Committees will have the usual opportunities and responsibilities to evaluate and adjust those budget recommendations. The call for cooperation in setting a spending ceiling for Fiscal Year 1977 is simply that—a cooperative effort to introduce a sense of realism into regaining fiscal control. This approach does not disrupt the normal budget preparation process of the Executive Office nor does it usurp or disrupt the functions of the Congress or its new Budget Committees. Each body retains the same responsibilities and powers. Setting a realistic target does not change the ultimate responsibilities; instead, it provides a necessary foundation for the tax relief recommendations.

The second part of the package of recommendations involves extensive and permanent tax relief action beginning in 1976. The recommended changes in the individual and business income tax structure are as follows:

	Individual tax cuts (billion)
Increase personal exemption from $750 to $1,000	$10.1
Replace $1,300 low income allowance and $2,000 maximum standard deduction with flat amount standard deduction of $2,500 for married couples ($1,800 for a single person)	4.0
Reduced tax rates	6.6
Total individual tax cuts	20.7

	Business tax cuts (billion)
Extension of 1975 corporate rate and surtax exemption changes	$1.5
Permanent extension of investment credit increase (from 7–10; 40–10 for utilities)	3.0
2 percent corporate rate reduction (48–46 percent)	2.2
Utilities tax relief previously proposed (see annex C)	0.6
Total business tax cuts	7.2
Total tax cuts	27.9

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Revised, October 24, 1975. Note: Numbers may not add to totals due to rounding.

As indicated, three-quarters of this permanent reduction would be provided for individuals and one-quarter to business firms. Even the one-quarter share allocated to businesses will directly benefit individuals by providing incentives for capital investment which will create jobs and contribute to increasing personal income. Capital investment is also needed to create the productive capacity required if our future economic goals of lower unemployment, moderate price increases and improved productivity are to be achieved.

Analysis of the President's tax reduction proposals indicates the distributional effects which are summarized in Tables 3 through 13. As summarized in Table 3, personal income taxes would be reduced by $20.7 billion from the $129.4 billion amount that would otherwise be collected if we revert back to the 1972–74 tax statutes. The distribution of tax reductions and the percentage reduction in tax liabilities for each adjusted gross income class compared with the 1972–74 law are summarized in Table 3. The specific types of reductions by adjusted gross income class are shown in Tables 4 and 5. Comparisons of the President's recommendations with the Tax Reduction Act of 1975 are summarized in Table 6. The proposed impact of additional tax relief recommended by the President on different types of individuals and families is summarized in Tables 8 through 12. Finally, a comparison of proposed business tax changes with the 1975 Act reductions is shown in Table 13. The various tables indicate that the low- and middle-income categories receive a larger share of the tax reduction recommended and a larger percentage reduction of their tax liabilities compared with the 1972–74 laws and the Tax Reduction Act of 1975.

Analysis of the tax changes recommended in Tables 3 through 13 indicates that the President's recommendations would provide even more benefits to individuals, an additional $11.8 billion above the relief provided by the 1975 Act (Table 6) and $2.5 billion additional relief for businesses (Table 13). We believe that this amount of tax relief will help sustain the economic recovery now underway, particularly the strong personal spending, and provide necessary incentives for increasing future capital investment. We also believe that the changes are equitable because the reductions are concentrated in low-income tax brackets where the impact of inflation is particularly severe and in the middle-income tax brackets where the bulk of tax payments are collected. Those who are already paying heavy taxes should obviously participate in the relief as a matter of equity and to provide incentives for continuing to work hard to provide for personal and family financial security. The "progressive" nature of the tax system is clearly emphasized by minimizing the percentage distribution of the tax reductions to higher income brackets (see Tables 3 and 6). In fact, the extremely low percentage reduction in the tax liabilities of higher-income tax classes might

raise questions about equity and incentives but it was felt that the proposed distribution of tax relief properly reflects current needs. Both the 1975 Act and the President's proposals emphasize the importance of offsetting part of the debilitating impact of inflation which has significantly increased the "real" tax burden by pushing tax payers into higher marginal tax brackets even though the eroding effects of price increases have held down their "real" gains over much of the past decade.

In developing this balanced package of proposals we felt strongly that the fundamental policy requirement at this time is to regain fiscal control so that the economic distortions of the past decade can be moderated. We also believe that the potential benefits should result in tax relief for the American taxpayer to maintain private purchasing power and for businesses as an incentive to increase capital investment to create jobs. Therefore, the two proposals are inextricably tied together. Action on taxes is obviously required at this time to avoid reverting back to the 1972–74 tax statutes because the Tax Reduction Act of 1975 was a temporary law. While it is popular to propose tax reductions, it would be irresponsible to reduce revenues without a simultaneously considering the difficult job of slowing down spending—during the rest of this fiscal year and in Fiscal Year 1977. To act only on tax reductions would increase the enormous deficit we already face and that distortion would ultimately lead to even more undesirable inflation and unemployment.

It would be most unfortunate to have excess stimulus in the form of tax cuts, which are usually popular, without corresponding action on spending. The lagged impact of economic policies would lead to unwanted overheating of the economy if a nine-month gap between tax reductions and the initiation of necessary spending discipline is allowed to occur. We have needed budget discipline for some time and we certainly require it now. The President has repeatedly acted to hold down spending over the past year and this effort will continue. The identification of a spending ceiling for Fiscal Year 1977 would not change that effort nor would it disrupt the normal budget processes of the Congress or the Executive Office as they develop specific spending proposals and legislative decisions within the general guidelines adopted. What it would do is indicate our serious intent to finally take some meaningful action. The American people would welcome some positive signal that the Congress and the Administration will cooperate in strong and realistic actions. The familiar rhetoric of the past is hardly persuasive when compared with the actual results of rising government spending, chronic deficits which vary only in size over the economic cycle, excessive inflation and economic distortions that lead to recession and unemployment. The Congress and the Executive Office have jointly established spending targets in the past and it is obvious that our serious fiscal situation requires similar responsible action at this time. We have already talked this issue to death; the American people want some results.

III. THE ECONOMIC IMPACT OF THE RECOMMENDATIONS

Although economic recovery is well underway there is concern in some quarters about its sustainability. The American public, labor and business leaders and other nations repeatedly, express their concern about long-term prospects. Therefore, the major economic thrust of the President's program is directed at what we perceive to be the long-term economic problems confronting the United States. It has two goals: (1) to slow down the upward momentum of government spending and eliminate the chronic Federal budget deficits that have occurred in fourteen of the last fifteen fiscal years—or, in thirty-eight of the last forty-six years; and (2) to return more of the decision-making power to individuals and families in determining how they will use their income. These actions would help to improve the efficiency of the economy and the permanent changes would create additional stability which would enable individuals and business firms to plan for the future with more confidence.

Turning the basic direction of fiscal policy will not be easy because of the legislative momentum that has been accumulated over the years. Budget experts continually describe the "uncontrollable nature" of most of the Federal budget which rises each year as the number of programs multiply and the number of participants in those programs increase. It is now estimated that nearly three-fourths of the budget is committed to programs for which payment is required under existing law or contracts. These payments must be made unless substan-

tive changes in the laws occur. Government payrolls make up an additional one-sixth of the Federal budget and the residual one-tenth involves mainly nonpayroll purchases of goods and services. These facts make the job of regaining fiscal control difficult. They do not make it impossible. We have listened to so many economists describe why things cannot change that too many people are beginning to believe them. I do not believe that there is any such thing as an "uncontrollable" Federal budget commitment because they all depend upon legislative priorities. I do believe that there are different priorities and that all good things are not equally good. There is a solution to the problem if the Congressional Budget Committee discipline will require more careful consideration of these priorities and the elimination or curtailment of ineffectve programs during the annual appropriations process. We must correct the historical approach of merely continuing existing outlays so that any new claims are always "add-on". But for that process to occur the underlying discipline of economics in matching priority claims and limited resources must occur. The Joint Economic Committee can provide that economic leadership for the rest of Congress.

Although the major thrust of the President's program is to emphasize long-term goals, a major policy change of this sort affects the near-term pattern of economic activity as well. In a $1½ trillion economy, there obviously are uncertainties in predicting potential changes in economic activity and the specific impact of fiscal policy recommendations. In preparing the President's balanced package of policy initiatives we analyzed the probable course of economic developments that would result if existing government spending trends were to continue and if the tax relief provided by the Tax Reduction Act of 1975 were to be continued in essentially its present form, except for an upward modification of approximately $4 billion which is necessary to maintain existing personal withholding rates. Since the Administration strongly believes that the existing growth rate of government spending must be curtailed and that change in the distribution of tax relief should occur, a second forecast based on the President's recommendations was also prepared.

Under either set of assumptions, economic recovery would move forward over the next year with an annual rate of growth of real GNP of approximately 7 percent, gradual reduction of unemployment to the 7 to 7½ percent zone by yearend 1976 and a continuation of the current pattern of consumer price increases of inflation 6 to 7 percent over the next few quarters. Comparing the two forecasts, we find that under the President's program the quarterly path of "real" GNP is slightly higher between now and mid-1976 and slightly lower subsequently as the government spending restraints take effect. These forecasts are subject to the usual caveats with respect to forecasting errors, particularly when the differences are so small relative to the gross national product. Therefore, the President's program must be judged in terms of its long-term benefits since economic forcasts indicate that there will not be significant economic stimulus or restraint in the immediate future as a result of the President's policy recommendations.

IV. SUMMARY

The process of governing is never easy as Members of this Committee well know. Nevertheless, a challenging set of fiscal policy decisions must be made in the near future. The current recovery from the recession is likely to proceed during the coming months but the long-term outlook for achieving our basic national economic goals is clouded by the cumulative pressures of past policy decisions. Although the issues are stated in economic terms they really involve the entire political process required to coordinate the diverse interests represented in our Nation. If we do act now, we can regain fiscal control and restore balance to the Federal activity and provide the necessary environment for savings and investment in the future. Positive action on Federal budget balance, perhaps within three years. If we do not act now the disappointing record of economic instability and chronic Federal budget deficits will continue into the future.

We strongly believe that maximum long-term benefits will result if we act now to slow down the upward momentum of government spending, restore balance to the Federal budget and extend broad tax relief to the American taxpayers so they can decide how to allocate more of their financial resources and to businesses as an incentive to increase capital investment as a means of creating more jobs. This is all familiar rhetoric which one can listen to every day coming from diverse sources. However, our actions have never matched our

well-intentioned rhetoric. This gap results from the extreme difficulty of making decisions on individual spending programs and tax policies and the compromises that occur. We believe that the President has presented a balanced package of tax and spending proposals that make economic sense by emphasizing longer-term goals. I hope that you will consider carefully these economic arguments as the decision-making processes unfold over the next few weeks.

TABLE 1.—FEDERAL BUDGETS, CHANGES IN THE UNIFIED BUDGET OUTLAYS, BY FISCAL YEAR, 19€1-76

[Dollar amounts in billions]

Fiscal year over preceding year	Federal outlays	Dollar increase	Percentage increase	Surplus or deficit
1961	$97.8	$5.6	6.1	−3.4
1962	106.8	9.0	9.2	−7.1
1963	111.3	4.5	4.2	−4.8
1964	118.6	7.3	6.6	−5.9
1965	118.4	−0.2		−1.6
1966	134.7	16.3	13.8	−3.8
1967	158.3	23.6	17.5	−8.7
1968	178.8	20.5	13.0	−25.2
1969	184.5	5.7	3.2	+3.2
1970	196.6	12.1	6.6	−2.8
1971	211.4	14.8	7.5	−23.0
1972	231.9	20.5	9.7	−23.2
1973	246.5	14.6	6.3	−14.3
1974	268.4	21.9	8.9	−3.5
1975	324.6	56.2	20.9	−43.6

Source: "Economic Report of the President, February 1975," table C-64, p. 324, for years 1961 through 1974; 1975 figure frm "Final Monthly Treasury Statement of Receipts and Outlays of the United States Government," for period from July 1, 1974, through June 30, 1975.

TABLE 2.—CHANGES IN BUDGET OUTLAYS BY FUNCTION: FISCAL YEAR 1976 OVER FISCAL YEAR 1975

[In millions of dollars, fiscal years]

Function	1975 [1]	1976 [2]	Change over 1975	Conference report recommendation of Congressional Budget Committees [3]	
				1976	Change over 1975
National defense	87.4	91.5	+4.1	90.7	+3.3
International affairs	5.0	5.1	+.1	4.9	−.1
General science, space, and technology	4.3	4.3		4.6	+.3
Natural resources, environment and energy	9.7	11.4	+1.7	11.6	+1.9
Agriculture	1.8	2.3	+.5	1.8	
Commerce and transportation	12.6	17.6	+5.0	17.5	+4.9
Community and regional development	4.6	6.4	+1.8	8.65	+4.05
Education, manpower and social services	15.0	17.9	+2.9	19.85	+4.85
Health	27.6	30.9	+3.3	30.7	+3.1
Income security	109.1	128.7	+19.6	125.3	+16.2
Veterans benefits and services	16.7	18.2	+1.5	17.5	+.8
Law enforcement and justice	3.0	3.3	+.3	3.4	+.4
General government	2.7	3.3	+.6	3.3	+.6
Revenue sharing and general purpose fiscal assistance	7.0	7.3	+.3	7.2	+.2
Interest	31.2	35.4	+4.2	35.0	+3.8
Allowances		1.4	+1.4	1.2	+1.2
Undistributed offsetting receipts	−14.1	−18.5	−4.4	−16.2	−2.1
Total	323.6	366.5	+42.9	367.0	43.4

[1] Mid-Session Review of the 1976 Budget, May 30, 1975, table 9, p. 15.

[2] Fiscal year 1976 administration estimates from the statement of James T. Lynn, Director of the Office of Management and Budget, before the Senate Committee on the Budget, Oct. 21, 1975, p. 11.

[3] 1st concurrent resolution on the budget—fiscal year 1976, Conference Report, 94th Cong., Report No. 94-198, May 9, 1975, p. 9.

TABLE 3.—INCOME DISTRIBUTION OF PRESIDENT'S TAX REDUCTION PROPOSAL AT 1975 LEVELS OF INCOME AS COMPARED TO 1972-74 LAW

[In billions of dollars]

Adjusted gross income class	Tax liability based on 1972-74 law	Proposed 1976 tax liability	Tax reduction	Percentage distribution of tax reduction [1]	Percentage reduction in tax liability
0 to $5,000	2.0	0.8	1.2	5.9	61.2
$5,000 to $10,000	14.1	9.1	5.0	24.0	35.3
$10,000 to $15,000	23.1	17.6	5.5	26.6	23.8
$15,000 to $20,000	23.7	19.5	4.2	20.2	17.7
$20,000 to $30,000	28.0	24.7	3.3	16.0	11.8
$30,000 to $50,000	16.9	15.9	1.0	5.0	6.1
$50,000 to $100,000	12.1	11.7	.4	1.8	3.2
$100,000 plus	9.4	9.4	.1	.4	1.0
Total	129.4	108.7	20.7	100.0	16.0

[1] Based on unrounded liability figures.

Note: Detail may not add to totals due to rounding.

TABLE 4.—INCOME DISTRIBUTION OF THE COMPONENTS OF THE PRESIDENT'S TAX REDUCTION PROPOSAL AT 1975 LEVELS OF INCOME AS COMPARED TO 1972-74 LAW

[In millions of dollars]

Adjusted gross income class	Components			Total
	$1,000 personal exemption	Standard deduction change	Rate reduction	
0 to $5,000	515	608	102	1,225
$5,000 to $10,000	1,908	1,961	1,098	4,967
$10,000 to $15,000	2,548	925	2,040	5,513
$15,000 to $20,000	2,056	342	1,788	4,186
$20,000 to $30,000	1,867	154	1,287	3,308
$30,000 to $50,000	802	31	204	1,037
$50,000 to $100,000	330	5	48	383
$100,000 plus	80	1	10	91
Total	10,105	4,026	6,580	20,711

Note: Detail may not add to totals due to rounding.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

TABLE 5.—*Comparison of individual tax cuts in President's proposal and in Tax Reduction Act of 1975*

	(Billion)
President's proposal:	
Standard deduction	$4.0
$1,000 personal exemption	10.1
Rate changes	6.6
Total	20.7
Tax Reduction Act of 1975:	
Standard deduction	$2.5
30 personal exemption credit	5.3
Earned income credit	[1] 1.5
Housing credit	.6
Total	10.0

[1] Includes the refundable portion of the earned income credit.

Source: Office of the Secretary of the Treasury and Office of Tax Analysis, October 6, 1975.

TABLE 6.—INCOME DISTRIBUTION OF PRESIDENT'S TAX REDUCTION PROPOSAL AT 1975 LEVELS OF INCOME AS COMPARED TO 1975 LAW

[Dollar amounts in billions]

Adjusted gross income class	Tax liability based on 1975 law [1]	Proposed 1976 tax liability	Tax reduction	Percentage distribution of tax reduction [2]	Percentage reduction in tax liability [2]
$0 to $5,000	1.2	9.8	0.4	3.3	32.3
$5,000 to $10,000	11.5	9.1	2.4	20.4	21.0
$10,000 to $15,000	21.1	17.6	3.5	29.6	16.5
$15,000 to $20,000	21.9	19.5	2.4	20.5	11.0
$20,000 to $30,000	26.8	24.7	2.1	17.5	7.7
$30,000 to $50,000	16.6	15.9	.7	5.6	4.0
$50,000 to $100,000	12.0	11.7	.3	2.4	2.3
$100,000 plus	9.4	9.4	.1	.6	.8
Total	120.5	108.7	11.8	100.0	9.8

[1] Includes effect of changes in the standard deduction, the $30 e emptionjcredit; the home purchase credit, the home nonrefundable portion of the earned income credit. The refundable portion of the earned income credit is treated as an expenditure item.
[2] Based on unrounded liability figures.

Note: Detail may not add to totals due to rounding. Minor differences may arise in totals appearing on other tables due the different methods used in estimating these income distributions.

TABLE 7.—INCOME DISTRIBUTION OF THE COMPONENTS OF THE TAX REDUCTION ACT OF 1975 AT 1975 LEVELS OF INCOME AS COMPARED TO 1972-74 LAW

[In millions of dollars]

Adjusted gross income class	Tax reductions: Standard deduction change	Tax reductions: $30 credit	Tax reductions: Earned income credit	Tax reductions: Home purchase credit	Total tax reduction	Refundable portion of earned income credit (outlays)	Tax reduction plus outlays
0 to $5,000	502	298	29	6	835	890	1,725
$5,000 to $10,000	1,062	1,190	250	53	2,555	223	2,778
$10,000 to $15,000	374	1,505	0	144	2,023		2,023
$15,000 to $20,000	527	1,079	0	156	1,762		1,762
$20,000 to $30,000	240	824	0	176	1,240		1,240
$30,000 to $50,000	46	257	0	68	371		371
$50,000 to $100,000	8	75	0	19	102		102
$100,000 plus	1	15	0	4	20		20
Total	2,760	5,243	279	625	8,908	1,113	10,021

Note: Detail may not add to totals due to rounding.

TABLE 8.—TAX LIABILITIES FOR FAMILY WITH NO DEPENDENTS, FILING JOINTLY WITH ITEMIZED DEDUCTIONS OF 16 PERCENT OF ADJUSTED GROSS INCOME [1]

Adjusted gross income	Tax liability: 1972-74 law	Tax liability: 1975 law [2]	Tax liability: Proposed 1976 law	Proposed reduction from—: 1972-74 law	Proposed reduction from—: 1975 law [2]
$5,000	$322	$170	$60	$262	$110
$7,000	658	492	335	323	157
$10,000	1,171	1,054	800	371	254
$15,000	2,062	2,002	1,750	312	252
$20,000	3,085	3,025	2,780	305	245
$25,000	4,240	4,180	3,950	290	230
$30,000	5,564	5,504	5,328	236	176
$40,000	8,702	8,642	8,444	258	198
$50,000	12,380	12,320	12,080	300	240

[1] If standard deduction exceeds itemized deduction, family uses standard deduction.
[2] Assumes that taxpayer is not eligible for the home purchase credit.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

TABLE 9.—TAX LIABILITIES FOR FAMILY WITH 1 DEPENDENT, FILING JOINTLY WITH ITEMIZED DEDUCTIONS OF 16 PERCENT OF ADJUSTED GROSS INCOME [1]

Adjusted gross income	Tax liability			Proposed reduction from—	
	1972–74 law	1975 law [2]	Proposed 1976 law	1972–74 law	1975 law [2]
$5,000	$207	$73	0	$207	$73
$7,000	526	386	$190	336	196
$10,000	1,028	938	640	388	298
$15,000	1,897	1,807	1,535	362	272
$20,000	2,897	2,807	2,530	367	277
$25,000	4,030	3,940	3,660	370	280
$30,000	5,324	5,234	4,988	336	246
$40,000	8,406	8,316	8,054	352	262
$50,000	12,028	11,938	11,630	398	308

[1] If standard deduction exceeds itemized deduction, family uses standard deduction.
[2] Assumes that taxpayer is not eligible for the home purchase credit. Also assumes that taxpayer is not eligible for the earned income credit. Taxpayers maintaining a home in the United States for a dependent child are eligible for the earned income credit (EIC) if they earn less than $8,000. If eligible for the EIC under 1975 law, taxpayers with earned income of $5,000 would have no tax liability and would receive $227 in direct payments from the Government. Taxpayers with earned income of $7,000 would have tax liabilities of $286.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

TABLE 10.—TAX LIABILITIES FOR FAMILY WITH 2 DEPENDENTS, FILING JOINT RETURN WITH ITEMIZED DEDUCTIONS OF 16 PERCENT OF ADJUSTED GROSS INCOME [1]

Adjusted gross income	Tax liability			Proposed reduction from—	
	1972–74 law	1975 law [2]	Proposed 1976 law	1972–74 law	1975 law [2]
$5,000	$98	0	0	$98	0
$7,000	402	$186	$60	342	$126
$10,000	886	709	485	401	224
$15,000	1,732	1,612	1,325	407	387
$20,000	2,710	2,590	2,280	430	310
$25,000	3,820	3,700	3,370	450	330
$30,000	5,084	4,964	4,648	436	316
$40,000	8,114	7,994	7,664	450	330
$50,000	11,690	11,570	11,180	510	390

[1] If standard deduction exceeds itemized deduction, family uses standard deduction.
[2] Assumes that taxpayer is not eligible for the home purchase credit. Also assumes that taxpayer is not eligible for the earned income credit. Taxpayers maintaining a home in the United States for a dependent child are eligible for the earned income credit (EIC) if they earn less than $8,000. If eligible for the EIC under 1975 law, taxpayers with earned income of $5,000 would have no tax liability and would receive $300 in direct payments from the Government. Taxpayers with income of $7,000 would have a tax liability of $86.

TABLE 11.—TAX LIABILITIES FOR FAMILY WITH 4 DEPENDENTS, FILING JOINT RETURN WITH ITEMIZED DEDUCTIONS OF 16 PERCENT OF ADJUSTED GROSS INCOME [1]

Adjusted gross income	Tax liability			Proposed reduction from—	
	1972–74 law	1975 law [2]	Proposed 1976 law	1972–74 law	1975 law [2]
$5,000	0	0	0	0	0
$7,000	$170	0	0	$170	0
$10,000	603	$372	$190	413	$182
$15,000	1,402	1,222	965	437	257
$20,000	2,335	2,155	1,816	519	339
$25,000	3,400	3,220	2,830	570	390
$30,000	4,604	4,424	4,008	596	416
$40,000	7,529	7,349	6,896	633	453
$50,000	11,015	10,835	10,280	735	555

[1] If standard deduction exceeds itemized deduction, family uses standard deduction.
[2] Assumes that taxpayer is not eligible for the home purchase credit. Also assumes that taxpayer is not eligible for the earned income credit. Taxpayers maintaining a home in the United States for a dependent child are eligible for the earned income credit (EIC) if they earn less than $8,000. If eligible for the EIC under 1975 law, taxpayers with earned income of $5,000 would have no tax liability and would receive $300 in direct payments from the Government. Taxpayers with income of $7,000 would have no tax liability and would receive direct payments of $100.

67–569—76——6

TABLE 12.—TAX LIABILITIES FOR SINGLE PERSON WITHOUT DEPENDENTS, WITH ITEMIZED DEDUCTIONS OF 16 PERCENT OF ADJUSTED GROSS INCOME[1]

Adjusted gross income	Tax liability			Proposed reduction from—	
	1972–74 law	1975 law [2]	Proposed 1976 law	1972–74 law	1975 law [2]
$5,000	$490	$404	$307	$183	$97
$7,000	889	796	641	248	155
$10,000	1, 506	1, 476	1, 227	279	249
$15,000	2, 589	2, 559	2, 037	282	252
$20,000	3, 847	3, 817	3, 553	294	264
$25,000	5, 325	5, 295	5, 015	310	280
$30,000	6, 970	6, 940	6, 655	315	285
$40,000	10, 715	10, 685	10, 375	340	310
$50,000	15, 078	15, 048	14, 725	353	323

[1] If standard deduction exceeds itemized deduction, family uses standard deduction.
[2] Assumes that taxpayer is not eligible for the home purchase credit.

TABLE 13.—A COMPARISON OF THE LIABILITY EFFECTS OF THE TAX REDUCTION ACT OF 1975 AND THE PRESIDENT'S TAX CUT PROPOSAL ON BUSINESS INCOME[1] (1975 LEVELS OF INCOME)

[In billions of dollars]

	Tax Reduction Act of 1975	President's tax cut proposal	Change
Increase the corporate surtax exemption to $50,000 with a 2 percentage point reduction in the normal tax	−1. 5	−1. 5	
Increase the rate of the investment tax credit to 10 percent[2]	−3. 3	−3. 0	+0. 3
2 percentage point reduction in the corporate surtax		−2. 2	−2. 2
Utilities tax relief previously proposed		−. 6	−. 6
WIN credit	(3)		(3)
Total	−4. 7	−7. 2	−2. 5

[1] These figures show the difference between 1972–74 law liability and the 2 tax programs as applied to calendar 1975 income.
[2] The Tax Reduction Act of 1975 included an additional 1 percent investment tax credit where that additional credit is used in conjunction with an employee stock ownership plan (ESOP). The President's proposal does not include this credit.
[3] Less than $50,000,000.

Note: Detail may not add to totals due to rounding.

LETTER TO THE WASHINGTON POST

A letter to the editor of The Washington Post presented five arguments favoring the tax proposals and spending limitations proposed by the President. The justifications for these arguments include the following points:

(1) to sustain the economic recovery—most economists now believe the turning point in the economy occurred in April or probably March. Personal consumption expenditures were the fundamental factor in this improvement as indicated by the following figures:

	Percent change (annual rate)
1974.III to 1974.IV	−2. 4
1974.IV to 1975.I	+8. 0
1975.I to 1975.II	+11. 6
1975.II to 1975.III	+14. 1

Much of this improvement resulted from the gains in personal disposable income. The Tax Reduction Act of 1975 was an important factor in increasing personal disposable income this year. While it is generally recognized that a moderate-to-strong economic recovery has begun, there is justified concern about its sustainability. The severe recession just experienced clearly demonstrated that the U.S. economy can be constrained by shortages of oil and other industrial raw materials. Consumer sentiment is still fragile and directly dependent upon future employment developments. Business capital investment must be increased if the near-term expansion is to continue and needed productive capacity and future

jobs are to be created. Because the immediate pattern of business investment will be largely determined by the strength of personal consumption, it is crucial at this stage of the recovery that a surge of new inflation pressures be avoided. Prices are still increasing at an unsatisfactory seasonally adjusted annual rate of 6 to 7 percent. An escalation of current prices—or of inflationary expectations—during the next few months would quickly disrupt both personal and business spending plans which would, in turn, curtail both the strength and sustainability of the recovery. Therefore, current policies must guard against fiscal and monetary excesses which would disrupt the current expansion and complicate the problems of creating a more stable economy.

For all of these reasons it is believed that personal spending is a fundamental factor in the economic recovery anticipated over the next several quarters.

(2) To avoid a negative psychological reaction to increased tax withholding rates—although the Tax Reduction Act of 1975 was a temporary piece of legislation, scheduled to expire on December 31, 1975, many individuals assumed the tax relief provided would remain available as a stimulus to continue personal spending. Although the impact on consumer sentiment cannot be anticipated in advance, it is probable that an escalation of the withholding rates would be a depressant to consumer spending plans.

(3) To return to individuals the opportunity to personally decide how they will spend a larger share of their family earnings—one of the most serious policy issues we now face is to keep a proper balance between the impact of taxes on personal disposable income and the rising level of expenditures. It is readily apparent that the Federal tax system is poorly structured for a period of rampant inflation. Millions of taxpayers now legitimately complain that the extraordinary high rates of inflation we have experienced recently have caused serious problems as inflation has eroded their real purchasing power and pushed them into higher tax brackets.

Because of the rapid growth in the size of government at all levels since the early 1960's, the portion of personal income that must be paid into Federal, State, and local tax coffers is rising steadily. Many of you are familiar with the Conference Board study published this spring showing that the item which rose the fastest in the American family budget during the last six years was taxes. While the general cost of living climbed about 40 percent during that period, the total bill for taxes—Federal, State, and local—jumped by 65 percent.

(4) To take some meaningful actions to encourage capital formation which is needed in the short-run to sustain the recovery and in the long-run to create the necessary jobs for this Nation's growing labor force.—It is becoming more widely recognized now that the Federal tax system is discouraging savings and investment when we need three times as much investment in the next decade as the last decade. By taxing corporate profits twice—once at the corporate level and then at the level of the shareholder—the United States is imposing a heavier tax burden on its business enterprises than in most other major industrialized nations of the Free World. And by allowing corporations to deduct interest payments on their debt but refusing to allow deductions for their dividends, the tax system is encouraging businesses to rely too heavily upon the debt markets, so that the corporate financial structure is increasingly unbalanced. Economists are properly cautious in saying that the way we collect taxes may not totally determine how much we save and invest. But the fact is that the share of our GNP devoted to capital investment over the last 15 years has been lower than in the economies of any of our major competitors. We have also had one of the poorest records in terms of productivity gains and in terms of real income growth. Furthermore, our recent unhappy experience in terms of high inflation is in part attributable to past inadequate capital formation. The Federal tax system has been a major influence on all of these developments.

(5) To reverse the trend of rising Federal spending which has been based on the false assumption that the American people support the sharp expansion of the role of government in their lives.—As indicated in Table 1 of the testimony of November 7, Federal expenditures have risen rapidly in recent years. In fact, if Federal outlays reach the anticipated level of $370 to $375 billion this year, the increase would total $102 to $107 billion in just two fiscal years from FY 1974 to FY 1976, a jump of 38–40 percent in two years. The Table indicates that deficits have occurred in 14 of the last 15 fiscal years and spending has risen from $97.8 billion in FY 1961 to $324.6 billion in FY 1975. The rate of increase since FY 1961 has been more rapid than the comparable revenues, as indicated

by the chronic deficits reported in all but one year, and was significantly faster than the growth of the total economy during that period.

While it can be argued that the government has been taking on more jobs, which explains the rise in outlays, the figures indicate that we have been unable to pay for the expansion of existing programs and the addition of new spending initiatives. These disruptions have contributed to the economic distortions of the past decade.

Chairman HUMPHREY. The first thing I would like to say is that one of the problems we have all had in dealing with the budget is due to the administration's original estimates, which were way off due to its under-estimation of the rate of inflation and also its under estimation of the rate of unemployment. All of this results in larger deficits. I think we've just got to get the record plain and clear.

The original budget estimate was $349.4 billion. There were estimates in that budget that did not hold up due to the fact that unemployment was larger than had been anticipated by the Office of Management and Budget, or by the President's budget; second, the rate of inflation is higher than had been anticipated. Now, we on the Budget Committee have had an analysis made of the budget. We have the original budget estimate here, the budget request, and we have Presidential changes and congressional changes and reestimates. Actually, the Congress has compelled that cuts be made in the budget and this does not include the more recent cuts that will be coming in, that is, cuts in the defense budget of approximately $2 billion.

For example, the President withdrew what he called the petrodollar financing facility, because of the strong resistance here in the Congress. It was perfectly clear it wasn't going to sell. It didn't have a prayer, not a hope, and the leaders of the Congress said so. In fact, the President was told so in the leadership meetings.

Second, there was the withdrawal of Southeast Asia reconstruction assistance, which we in Congress made very clear we would not accept. So that had to be reestimated. The President revised his budget accordingly. That was $1.6 billion.

Congress also has thus far, exclusive of what appears to be a budget cut in the defense bill, has reduced the budget $300 million. Now, we are looking at revisions that have come along. The defense cut accepted by the President was $2.5 billion. We think there will be an additional $5 billion, at least.

Next was rejection of the highway deferral, and we added $400 million; rejection of the food stamp cuts, and we added $600 million; rejection of the energy equalization payment, which was a congressional change, and we reduced the budget by $1.2 billion; rejection of the social security inflation cap, and we added $2.2 billion, and we added $200 million for veterans.

But, our total reduction in budget changes was $300 million, plus the $1.6 billion on withdrawal of the petrodollar financing facility and the withdraway of the Southeast Asian reconstruction assistance.

Now, we come to what the President sent up here. He sent up an additional request of $16.6 billion. That is due to offshore receipts, which were overestimated. There is an increase in the interest of $1 billion reflecting that; there is an increase in veterans benefits of $2.5 billion; public assistance of $1 billion due to the recession; food stamps, $3 billion due to the recession; unemployment, $1.5 billion due to the recession: Medicare and medicaid, $2.8 billion.

Now these are President Ford's budget reestimates. So that the President's budget, as of October 31, 1975, was $367 billion as compared to $349 billion. So I thought we would just get deficits into focus. Nobody likes deficits. May I say there have been more deficits in recent years than almost in any other period of our national history, save the Great War. And I really believe that this tells you something about what has been happening to the economy and what the Government's policies have been relating to the economy. The deficits that the administration complains about are deficits that the administration itself is responsible for, or at least they were empowered at the time.

Now, the President has used his veto a number of times, and the Congress has not been able to override it. So, all of that has been taken into consideration here. I just don't want to hear the budget estimate was $349.4, because that is not true. The budget the President sent us is $367 billion and the Congress has cut the budget by $1.9 billion so far. We are going to make a bigger cut in the budget and you can make no mistake about that. I would say we will cut at least $5 billion more and maybe more. I think it will be more, because we are going to cut foreign aid more.

We don't like deficits. I don't like deficits. But the main reason we are getting into this deficit business is because of the condition of the economy.

Now, let's turn to a little matter that I want to call to your attention. You have given us some estimates about the President's tax and spending cuts. The President has said without his proposed budget cuts, spending in fiscal 1977 is headed toward $423 billion. Is that correct, Mr. Secretary?

Mr. SIMON. Yes, sir; it is.

Chairman HUMPHREY. We are wondering where that figure comes from. The Office of Management and Budget estimates are $410 billion. Mrs. Rivlin of the Congressional Budget Office has placed the estimates at $415 billion.

To the outside observer, it appears the first $8 billion to $13 billion in the President's proposed $28 billion budget cuts can be achieved by making a more realistic estimate of where the spending is headed in the absence of policy changes.

Now, anyone can achieve unlimited budget cuts by that method, but they are meaningless. I wonder if you can explain the $423 billion, or can you explain away Mrs. Rivlin's $415 billion, or OMB's $410 billion. These are figures that are rather staggering for the average person. You know, just to drop a billion dollars here and there is not exactly a tip at the local nightclub.

[Laughter.]

Mr. SIMON. Let me, if I may, submit for the record this. Because the last time Jim Lynn and I testified together with Secretary Dunlop before the Budget Committees a couple of weeks ago, Mr. Chairman, we provided a separate sheet here, a list of the increase from $370 billion to $423 billion, a $53 billion increase, and I will supply that to you for the record.

Chairman HUMPHREY. Thank you.

Mr. SIMON. I would like to make a comment about several things relative to this question, as it relates to your former comment, Mr. Chairman.

Chairman HUMPHREY. May I interrupt a moment? Wasn't about $5 billion of that increase a real increase in the defense spending?

Mr. SIMON. There was an increase, yes, Mr. Chairman, but I am not sure what the exact dollar amount was. But that will be specified in what I submit for the record.

Chairman HUMPHREY. Fine, and we will accept that.

[The information referred to follows:]

III. BACKGROUND ON FEDERAL SPENDING

A. Unless action is taken to restrain federal outlays in FY 1977, spending can be expected to increase by around $53 billion in a single year. Budget outlays are approaching $370 billion in FY 1976. Without specific legislative action to limit spending, outlays in FY 1977 will reach $423 billion or more. The main elements of an increase of $53 billion are as follows:

	(Billions)
Interest on the public debt will rise as the size of the debt grows. If current interest rates are maintained, the increase will approach	$9
Civilian and military salaries increase automatically unless the President and Congress agree on an alternative plan. Would add more than	+6
Retirement benefits for retired federal military and civilian personnel also rise automatically with the cost-of-living	+3
Social security and railroad retirement payments increase automatically based upon the cost-of-living- index	+12
Medicare and Medicaid payments rise as costs increase and the number of eligible recipients go up	+5
Public assistance, food stamps, housing subsidies and related programs are tied to the formulae set in law or in existing contracts	+2
Major construction of wastewater treatment plants now underway will add nearly	+2
Essential procurement and research and development of military hardware and maintenance of necessary military facilities will add over	+3
Increases for energy research and development and transportation programs and inclusion of Export-Import Bank in budget	+4
Other likely net changes including effect of Congressional inaction on budget reduction proposals heretofore proposed by the President and the effect of probable Congressional initiatives	+7
Total	53

Mr. SIMON. No. 1, Mr. Chairman, I am heartened by the determination of both committees that I testified before on several occasions, by their attempt to work on bringing down the budget deficit.

Second, certainly this year the recession has been a major contributor to the budget deficit. As we lose revenues on one side because of the recession, then the unemployment benefits balloon, as I said in my testimony, from $6 billion to $19 billion during this year. And those automatic stabilizers always come into play during a period like this. That is why we are intent on reducing unemployment.

But we must also recognize that additional programs are continually enacted. And you never heard me put the blame on various parties for spending in excesses and about deficits. This has been going on for a long time and it doesn't do any good to point fingers.

You know, when we try to do an economic forecast and look into the future, that there is necessarily going to be an uncertainty.

Chairman HUMPHREY. Sure.

Mr. SIMON. Every year, we in the Treasury Department, several times a year, estimate revenues. I don't know if it has ever been told to you in this way before, Mr. Chairman, but every year we are wrong and every couple of months when we do it, we are wrong. We are going to be wrong every time we do it for the future. The question is how much are we going to be wrong by? Judging what the gross national product is going to be, what corporate profits are going to be, what individual profits are going to be, judging the potential tax changes, all of these estimates are based on a broad array of assumptions. You see, a 1 percent error is going to produce a $14 billion to $15 billion error in the money GNP. And so we have been pretty good, when you look at the small percentage of the total budget where our revenue estimates have been off, but it is necessarily implicit that this process will be imprecise.

But, we have been wrong.

Also, the additional spending requests that the President sends to the Congress reflects changing events, changing priorities and, at the same time, he tries to send up deferrals and rescissions. And in the normal democratic process, Mr. Chairman, we are going to have differences of opinion about where our spending ought to go. The President feels strongly about national defense. We can debate about the total amount for national defense. Some people think that is not the top priority in the country. Some people think foreign aid is. Some people think we ought to do other things. And this is where the debate and cooperation is so necessary. And this is where I think, going back to my first statement, that the Budget Committees are so useful in this process. That, to me, as I said before, is a piece of landmark legislation in this country. And what we need is to work continually and closely to make sure that we get going in the direction that both of us want. So, let's devise the best way to get there.

Chairman HUMPHREY. Mr. Secretary, I surely don't disagree with you on that. I think we both feel that way. As a member of this committee, I was very active in proposing this kind of budget control, as were other members of this committee. My only point is that we get in the public's mind figures that seem to stick and then all at once somebody seems to be at fault. And I would simply point out that there have been revised budget estimates from the original budget, which was laid down before us; and that the Congress itself, with all of its limitations, has not yet finished all of its appropriations bills, but our budget will be under the President's budget, I assure you.

I would just ask this final question, then. You are a strong proponent of the crowding-out theory in the money markets in terms of financing with the heavy deficits that have to be financed. Mr. Henry Coffman of Salomon Brothers has estimated that the President's tax cut will necessitate that in the first half of 1976 the Government borrow $40 billion. as compared to $35 billion if the original tax cuts of 1975 were extended.

Now, since you have been a strong proponent of the crowding-out theory, do you think that extra $5 billion would nudge a few more people around?

Mr. SIMON. I don't think that there is any doubt about it, Mr. Chairman, and that may seem to be a strange thing for me to say.

Let me tell you a little bit about the "Hobson's choice," or at least a partial Hobson's choice that we face, when we look at financing requirements as they relate to budget deficits.

As we look ahead to fiscal year 1977, even assuming no action on new spending and our best estimate of what the economy is going to do, we anticipate a budget deficit of $60 billion to $70 billion in fiscal 1977. It is our economic forecast that at that point you are going to be experiencing a period of high economic activity. To finance a deficit of that size during that period would seriously endanger aborting the economic recovery. As far as the normal economic recovery and the duration of the normal economic recovery that we experienced after past recessions that we have had since the end of World War II we expect a strong economic recovery.

So, beginning to get control over the deficit—where we can see light at the end of the tunnel—if you will, we hope for a balanced budget in 3 years, Mr. Chairman. That effort would do several things. It transfers part of this borrowing from fiscal 1977 into fiscal 1976, when we still have slack in our economy. And if I had my druthers, I would rather avoid such heavy borrowing. But, if I had to pick a druther, I would rather finance during a period of economic slack then I would as we move into a period of high economic activity.

We do have a capacity problem. We do have the notion, as you said at the outset, that we have a 30-percent gap in our capacity. But this is not true, as it relates to many of our basic industries, Mr. Chairman. There is a good article on that in the Wall Street Journal, which appeared yesterday. Serious bottlenecks appeared in the economic recovery of 1972–73, and that period clearly showed capacity strains. And we haven't made sufficient progress in the relatively short period of time since then, Mr. Chairman, before we are going to be pushing up against capacity limits again. This is going to have an effect on prices, as the recovery continues in our basic industries, such as in steel and other commodities. So this is what we have to consider.

So, clearly, as I say, we have a Hobson's Choice and no econometric exercise ever takes this into consideration because it is impossible as a matter of judgment. We must consider confidence, the confidence of the American people and what makes them confident that the Government is finally getting control over its spending and its deficits. The fact that they can see that we will have a balanced budget, the fact that their real earnings will have increased as the result of this reduction and that we can reduce spending and reduce their taxes at the same time will help create this atmosphere of confidence. It will help business investment. And anything that produces—and I know you will agree with me, Mr. Chairman—anything that reduces the tax on capital is going to have a positive effect as far as the creation of jobs and higher real earnings.

And of course, as we create more goods, that means cheaper goods for the American consumer.

Chairman HUMPHREY. Senator Javits.

Senator JAVITS. Mr. Secretary, I heard with great interest your expressions of the importance to the economy of the American people having confidence in it. Is it your judgment that if the premier city of the country goes bankrupt, that this will be a good thing for the American people? Do you recommend it?

Mr. SIMON. No, sir, we haven't recommended that at all. I am sorry if there has been misunderstanding in the President proposing a change in the bankruptcy law to make a default applicable to a municipality where today it would be disruptive in the absence of the passage of this law. In other words, it is to provide this legal mechanism for orlerly handling of this situation, if indeed they went into default, and I am sorry if there has been a misunderstanding.

I, for one, have never nor would I ever say that New York City should go into default. It is still, even after 8 months, avoidable. I am hopeful that the plan—and I have only seen the bare bones outline—but the plan the MAC people put up yesterday will work. That appears to be one alternative and there are many others.

Senator JAVITS. Well, it has only been avoided because we have broken our backs in the process. Don't you consider your statement that we should get no Federal help, but instead get just a piece of legal machinery to liquidate us, is tantamount to saying that the city has no alternative but to go through bankruptcy?

Mr. SIMON. No, it is not.

Senator JAVITS. Well, the President said he will veto any bill that comes from the Congress that will do anything else. What conclusion are we to draw?

Mr. SIMON. Because the President believes that the solution to avoiding default rests in New York State and New York City. And we have said quite often——

Senator JAVITS. Well, that is what I am trying to get to. The fact is that the Federal Government recommends—no, I withdraw that. The fact is the Federal Government will take no steps which will stop bankruptcy from occurring, but on the contrary, will give us the rope with which to hang oursleves; to wit, a new bankruptcy law.

Mr. SIMON. I wouldn't say that, Senator. We think it is our responsibility in the Federal Government to make sure the legal mechanism is there if indeed the officials in New York City and New York State (a) either fail to avoid default with all the tools at their command or (b) decide that a restructuring of the debt, which is a technical default, gives them a better ability to negotiate with the unions, to deal with fringe benefit costs, and to deal with the other causes of the problem.

Senator JAVITS. Well, Mr. Secretary——

Mr. SIMON. Well, I agree with you. You know you asked a question, and I didn't answer it, sir.

Senator JAVITS. All right.

Mr. SIMON. You asked a partial question that I didn't answer. I agree with you that it would not be a positive event with regards to the confidence of the American people. Yes, I would agree with that. I think we have seen a tremendous erosion of confidence on the part of the American people in all institutions. I would say as far as a decline in confidence is concerned, the Government is the greatest recipient. And I would say that the decline has occurred over a long period of time for all the causes that you and I are well aware of. We are going to have to work awfully hard to get back the respect of the people.

Senator JAVITS. Well. Mr. Secretary, I have been troubled as a Senator, having responsibility for the country, as well as my State. I have been troubled by this rather simple question of Mayor Beame's:

"What would be the opinion of the world and result on U.S. confidence if France let Paris go into bankruptcy? And what would be the opinion of the world about the United Kingdom if it let London go into bankruptcy or if Japan let Tokyo go into bankruptcy?" It just seems to me that confidence would be extremely disrupted. And if confidence is a critical matter in the recovery of our country, as we certainly know it is, how is it that all kinds of confidence is thought to be inspired, except the confidence from the United States not allowing its premier city to go into bankruptcy. And all this real deception by the use of the word "bailout" is very untrue, unfair, and false. But wouldn't applying Dacronian measures be a big boost in the confidence of the buyers and the retail establishments and so on, because it would show the United States has a responsibility for the people of the State of New York. I would like to emphasize not just the city of New York, because the Governor sat right where you are sitting and he said that if the city goes, the State is likely to go, too. And let me ask you as the administration's economic spokesman, Mr. Secretary, aren't you and the President missing a great factor to inspire that confidence by the American people, by turning your back——

Mr. SIMON. No, Senator Javits, I think this debate about the implications in foreign countries really has not hit on what the relationship is between our Government and a city and between a London or a Paris and their governments. The fact is that the cities over there are really wards of the state. Here we have a different form of government where the autonomy of our States and local governments is extremely important. And I think the transferral of all this decisionmaking, as you have heard me say very often, would be extremely dangerous. I think a negative ripple effect, if you will, could occur. I am a cynic when it comes to temporary anything being temporary in government, because nothing ever, unfortunately, turns out to be temporary. And I wonder if a board, created by the Government, mandating all of these changes is the proper way that we should run our country? I wonder if we should mandate that they should have taxes, as in Senator Proxmire's bill, or that they should raise their taxes by x amount. We would be getting into wondering whether to make them remove rent control before we give them additional moneys, and so forth, or we would be bargaining with their unions.

Well, I don't think, at least according to the newspapers this morning, that the unions even want to bargain with us.

The traditional way to run a government is to have a mayor, who is duly elected by the people of the city of New York, and the government of the State of New York, and New York City is the most important city, obviously, in that State and throughout the country, and the proper way is to have them continue to maintain its autonomy.

I don't believe, Senator Javits, but again, this is a matter of one's judgment, but I don't believe that it is going to have any international effect whatsoever.

Senator JAVITS. Well now, do you really want us to believe, Secretary Simon, that the people of other countries, or even the people of the United States, are attributing the reason that the United States will let New York City go broke at the door of a juridical relationship? I just can't believe that, Mr. Secretary. As far as the people are concerned, they think the Federal Government is saying to New York

City. "We turn our back on you, so you can forget it." Do you think the people in our country understand that what you gentlemen are doing is honoring the Federal relationship between the United States and New York?

Let me ask you this specific question. Suppose New York were besieged, would you say the mayor and the Governor had to handle it?

Mr. SIMON. New York was what?

Senator JAVITS. Suppose it were besieged by an enemy, would you say that the Federal Government had to handle it? Suppose New York had pestilence, would you say the Federal Government had to handle it? Suppose New York was struck by a typhoon, would you say the Federal Government or the mayor, and the Governor had to handle it?

Mr. SIMON. Why, of course—well, let me go back to the first thing you said. We talk about New York City going broke, but New York City is not going broke. New York City is not broke, and they are never going to be broke. They have a solid revenue base. The revenues have increased more rapidly than most other major cities in this country. All of this has been well documented, in our judgment.

The financial event of restructuring their short-term debt, if indeed that is what they wish to do, is not a default other than legally and technically—a postponement of their paying their debt while they are putting their house back in order. This is much different from invasion or a typhoon or pestilence or a siege, or any civil disorder.

Sure we have a responsibility and we have always reacted to this responsibility.

Senator JAVITS. Well, Mr. Secretary, you know some things you can't argue with, because they just won't be believed. And I don't believe you will be believed, and I say this without any denegration or insult to you, when you say that New York is in fine shape and all its income has gone up and things are just great.

Mr. SIMON. No; I didn't say that——

Senator JAVITS. If I may finish? Here New York is dying and its officials are coming down here day after day and week after week, saying to the Federal Government "We can't pull out unless you give us some kind of a hand." But yet you wish us to believe that New York is in fine shape. You say that individual things New York can do will fix it up, but you gentlemen have yet to name those individual things New York can do.

Mr. SIMON. I have, sir. On many occasions, I have listed what they could do, although I did it reluctantly because I do not think it was the Federal Government's responsibility to set the criteria for New York City and indeed, New York State. I will supply for the record a three-page paper I have here, with a review of the actions that could be taken to solve their long-term problem.

When I talk about New York City and its revenue base—and I acknowledge that its tax base has eroded because they have been taxing too much, mainly because they have been spending too much—but when I talk about their revenue base, I am talking about their fundamental economic health, about the viability and the vibrance, if you will, of this great city of the United States that is still the financial and business center of our country. And I believe this. It is a matter of getting the expenditures in line with revenues and taking into concern and consideration and rectifying the problems that are

very familiar to all of us, like union negotiations, fringe benefits, welfare. And indeed, we have a changing responsibility here in the Federal Government, but that cannot be done quickly enough to certainly avoid the cash problem they've got now and——

Senator JAVITS. I was going to say that you've got a big gap, a big gaping hole coming up from December 1 to April 1 that nobody can bridge. So all you are saying is that you are going to save us from an abyss that may not come for months and years, but you are ignoring the abyss presently at our feet. But, be that as it may, I doubt you and I can agree on this. But I do think it is a very big element in forming American confidence and that confidence is going right out the window because the Federal Government is taking this stonefaced position.

Let me ask you this. In your prepared statement, you say:

> If specific sectors, such as residential, construction, or large numbers of businesses who do not have top-level credit ratings, are unable to obtain necessary financing, both the strength and the sustainability of the recovery will be disappointing.

Doesn't that include municipal finance too?

Mr. SIMON. Yes, sir, of course municipal finance, the municipal market suffers today from a different disease. It suffers from high interest rates, and it is affected by high interest rates, but basically, it suffers from great structural changes that have occurred in the past 10 years. The volume of borrowing has doubled from $100 billion outstanding to a little over $200 billion. And during this period, the demand for municipal securities has not kept pace with the supply. The banks don't need tax exempts the way they used to. So for these reasons, we have proposed the taxable municipal.

But, sure, they have had problems, but not the way they have been demonstrated to you down here. It was interesting this morning that over the Munifacts wire there were comments on municipal problems—Munifacts is owned by the Bond Buyer of New York, which is the professional paper of the investment banking fraternity related primarily to municipal securities—and they talk about displacements. You know, we heard a great deal of rhetoric about municipalities that have been unable to borrow. That is called displacement. That is the technical term used when, for one reason or another, they have a high interest rate and they have a legislative limit and they can't borrow above this interest rate, or for whatever the reason they cannot borrow. And I will quote:

> The October municipal bond displacements fell to their lowest level in almost 2 years. Of the 11.5 million, only five issues failed to reach dealer's hands.

And we would have to see what the five issues were. This represents a drop from September and also the years before.

And in 1975, in a year where we had record municipal borrowing, Mr. Chairman, in the third quarter of this year, $13.5 billion worth of bonds and notes were sold in the municipal market. And just a normal extraordinary jump in borrowing during that period would have an effect on interest rates in the absence of the problems that New York City is having.

But to go on with this quote:

> The 1975 displacement aggregates now stands at about $1.1 billion, and is running $850 million behind the previous January total.

So, it has been cut in half. So displacements actually are lower than it had been.

Senator JAVITS. Mr. Secretary, my time is up.

Chairman HUMPHREY. Senator Javits has been suggesting to you, Mr. Secretary, that you be the friendly doctor with the right prescription and he feels you recommended a mortician with the hope of resurrection. [Laughter.]

Senator Proxmire.

Senator PROXMIRE. Mr. Secretary, in following up to some extent what Senator Javits said, I, as you know, share his views that the default of New York could have—and we don't know for sure and it may not have a catastrophic effect—but it could have a very serious effect on confidence in the country in all kinds of ways. And it comes at a time when I think we have to look at this recovery, which was excellent in the third quarter; but nevertheless, I think we have to take a clear look at it.

You are testifying this morning, as I understand it, on the policies that the Federal Government is going to follow to try to insure that that recovery continues.

One: Half of that recovery, and more than half, actually, was because of a change in inventory policy on the part of industry. There was only about a 4.4 percent increase in real terms in final sales.

Furthermore, we know this morning and we knew yesterday, I guess, that inflation is looking very bad indeed. Wholesale prices are up more sharply than they have been in more than a year. The annual rate as reflected in the October wholesale price figures is more than a 20 percent increase in the last month, and the most troublesome part of that, as the chairman pointed out, is the fact that industrial prices, which never seem to fluctuate downward, are up very sharply.

Two: Unemployment is up. We see this this morning. And if you drop out April and May, which may have been abberations unemployment has continued at the same discouraging 8.5, 8.6 and 8.4 percent level all year.

Three: Housing is in the doldrums. We heard testimony just 2 days ago from the Secretary of HUD on that. And there is no indication that housing is going to recover. You and I know how important that is for economic recovery.

Four: The business investment in plant and equipment is another weak sister. McGraw-Hill just indicated this morning they expect no increase in physical terms in business investment in plant and equipment in the coming year. They expect a dollar increase, but no increase in physical terms. Furthermore, on election day, which was Tuesday, some $7.5 billion in capital investment by cities and villages around the country—about 90 percent of what was up—was turned down. That means many jobs, as we know.

Now, in this context, if New York City defaults, no matter how optimistic you are, it seems to me it is going to have a chilling effect on the policies that result in the employment of 14 million people in this country employed by State and local governments. And I think that we have to consider that aspect very seriously.

I have one other point in connection with Senator Javits' very helpful colloquy with you. There is no way we can escape the Fed-

eral Government's involvement with New York City. As Senator Humphrey has pointed out, it is just a matter of when we provide the assistance. If New York defaults, there is no way that a defaulted city is going to be able to borrow the $2 billion or $3 billion they are going to need without having the Federal Government guarantee it. That means either you or somebody else is going to be overseeing that. So, I think what we have to recognize is the Federal Government is going to be involved, and the best opportunity for getting New York City back in the capital market with discipline, is to avoid bankruptcy.

Now, let me ask you about the inflationary situation, because I think this is something that both the Congress and the executive branch just haven't faced up to. The wholesale price indicators that we have before us this morning indicate that in October we have not only a 1.8 percent increase overall in wholesale prices, but industrial commodities were up 1.2 percent and the increase was in automobiles, steel, and in lumber and wood products.

Now, Mr. Secretary, every one of these areas we have excess capacity. In every one of these areas, Mr. Secretary, there is weak demand. In steel, for example, demand dropped off last month, yet they had an increase in steel prices of 5 or 6 percent. In your view, isn't there something wrong with this market mechanism and wouldn't it be desirable for the Federal Government to have a more effective policy of at least calling attention to this and having some tough jawboning? Isn't there something we can do about this, that we are not doing?

Mr. SIMON. Our analysis on the wholesale price increase published yesterday is certainly not complete, but initial indications are that there is a one-time increase in automobiles, as far as the pricing is concerned, and undoubtedly in steel as well. The industrial components have fluctuated, Senator, over recent months. The industrial commodities, on a seasonally adjusted basis, have gone up from a 0.1 percent increase in March to 1.2 in its most recent. Of course, that is alarming. We all know we have a fundamental problem.

Senator PROXMIRE. Well, it is particularly alarming when you recognize 12 or 13 industrial categories went up. It wasn't just isolated to a one-time increase in automobiles. It was an increase across the board everywhere. It was universal.

Mr. SIMON. And as the economy recovers from this deep recession, as we have said for a long time, we are going to see at the same time upward pressures on prices. Now, our Council on Wage-Price Stability has been very active in any increases in any area of our economy. They have asked the various industries to justify these increases——

Senator PROXMIRE. I think you understand in this stage of recovery, the pressure on prices is not naturally stronger; it is lesser. The fact is that as we recover, our productivity increases and labor costs, unit labor costs, do not increase, and the pressure on prices would not be that great.

Mr. SIMON. But Senator Proxmire, we are 6 months into this recovery already. We also have an extraordinary rate of inflation, as you know, considering where we are in this economic cycle. And part of the increases are justified by the cost of replacement of the necessary capital that is going to be required in order to provide the additional goods and services that ultimately are going to bring the prices down and make them more reasonable.

Senator PROXMIRE. But at any rate, the point I am trying to make, Mr. Secretary, you know how heartily I agree with you that excessive Government spending has been responsible to some extent for our inflation. But I think in this particular inflation the energy prices and administered prices in these areas are also responsible, and we shouldn't close our eyes to it or walk away from it or fail to act by doing what we can. And I think Government can do a great deal, short of controls, to discourage those price increases, but I don't think we have done it.

Mr. SIMON. I don't think we have any disagreement in that area whatsoever. Antifreeze comes to mind, just as an example of what you are saying, where we think that a price increase of that magnitude is not justified at this time. And we do not hestitate to jawbone, as you said, and this jawboning does indeed work.

Senator PROXMIRE. Now, Mr. Secretary, I am concerned about the President's proposal to reduce taxes by $28 billion in the coming calendar year and then increase spending really in the year beginning October 1, 1976. I don't say it is political, but the effect of this would be to have a big tax reduction before the election and a big spending decrease after the election. And I realize in the text of your statement you indicated that Congress doesn't have to do this and we can reduce spending in this fiscal year, but I would like to ask you how we can do it? The fact is that when you look at the various appropriation bills we already acted on, you see we acted on the Education Division of HEW and that has been signed by the President now into law; we acted on the legislative; we acted on HUD; we acted on the State Department and the Justice Department, the Commerce Department, Agriculture, the Treasury Department, and the Postal Service. But there is one appropriation bill we have not acted on finally, and which is over the budget and which could be reduced, and that is Labor, and Health, Education, and Welfare. We have taken care of the Education already. Now that is about $1 billion over the budget. It is in conference right now. However, the defense appropriation bill is $7 billion under the budget. The foreign aid appropriation bill as not been acted on and that is well under the budget. I don't see how we can take action, how the Congress can take action that would do any more to reduce spending in this calendar year to make it accommodate the President's notion that tax cuts and spending cuts should be interrelated.

Mr. SIMON. Well, that has been one of the problems, Senator Proxmire, with the so-called dollar-for-dollar approach. When we first studied this back in August, September, and October 1974, the mechanics of it were most difficult. And as I indicated in my opening statement, we are trying to take a longer-term view of what we are doing. And having satisfied ourselves, as we have, about the economic effect of these proposals, the result would be relatively neutral, as again I say in my statement.

And we recognize the difficulty in doing it prior to the commencement of the fiscal year, because the fiscal year is in process right now and it is very difficult to cut back significantly as to what we are asking. However, having said that, the President has also sent up deferrals and rescission. That mechanism has been given to us by the budget

format. And those were sent up and need to be acted upon, and that is a positive step.

Now again, there is going to be disagreement, Senator Proxmire, as to where it ought to be cut. That is the debate that we have always had. We have to work together and work out whatever compromises are necessary.

Senator PROXMIRE. But you come in with detailed, explicit, and specific tax reductions. You told us just exactly where they are, but we have no such detailed and specific notion or understanding of how in this coming calendar year at the same time we have these tax cuts, how we are going to have the spending cuts. Where are they?

As I say, I agree we should have those spending cuts, but I would like to know where the administration urges us to do it.

Mr. SIMON. The first thing we did, Senator Proxmire, in studying this a couple of months ago is—and we didn't go into this with any fixed dollar amount of reductions in spending—but the first thing we did was to identify various areas—and the OMB was doing this exercise as the budget experts—to identify the areas of potential cuts. Then the President sent to all the departments and agencies the target goals for all of these agencies and what the specific areas are. And then we in the Treasury and HEW and Agriculture and Defense say: "But wait a minute, we don't particularly like this cut in this program and would rather substitute and try to do it in some other way." Well, at that point, the President makes the final decision as to where the specific cuts are going to be made and then they are presented to Congress.

But now we have a budget process, we have two Budget Committees, and we can be working as the specifics are developed and we can be gleaning ideas from these committees as to where they think it should be cut. And I think that is going to be helpful.

Senator PROXMIRE. That is fine for 1977, but the 1977 fiscal year, but I am talking about calendar 1976. Many of these appropriation bills, as I said, have already passed. But there has to be some kind of agreement between the President of the United States and the Congress on appropriations we have already made, if we are going to make this kind of reduction in 1976, Mr. Chairman, so that we won't have some kind of inflationary effect, some kind of a super deficit if we do engineer this tax reduction, but don't then follow up with a spending cut.

Mr. SIMON. That is why, when the President made this comment, it was in response to a question asked to him about this 9-month gap, and the President just said:

"Well, if there is a way for them to cut back to shorten the period or make the period simultaneously, that would be fine with us, too." That was not a recommendation to the Congress to do this.

Senator PROXMIRE. Well, my time is about up. Let me just ask one question, if the Chair would permit, with respect to New York City.

I made the statement—and you didn't have an opportunity to respond—that in the event of default, there is every reasonable likelihood or certainty that the Federal Government would have to be involved, that is to say, there would almost certainly be guaranteed or direct loans to New York City by the Federal Government and that there would have to be the same degree of involvement with respect to those loans as there would be for a guarantee before default. Therefore, it is not a matter of your not wanting to be mayor of New York

or the President not wanting to be involved directly with the city of New York. There is no way you can avoid it.

What is your answer to that?

Mr. SIMON. I have not, as I responded to Senator Javits before, I have not and can never agree that the default is absolutely inevitable. And indeed, having wasted a lot of time, and the time period of growing very short, Senator, but if they still take action, such as the proposals that were made yesterday, and——

Senator PROXMIRE. Well, as Mr. Rohatyn said, that is like an 80-yard pass with 10 seconds left. It is 1 chance in 20. No, it is 1 chance in 100.

Mr. SIMON. I don't know, Senator. I have always been a believer, Senator Proxmire, that crises have always acted as a catalyst to bring divergent groups together who ordinarily would perhaps approach the goal in different directions. And I think this is going to be bringing them together in a cooperative mood. I think the unions and the bureaucracy and the politicians and all the rest, and the bankers, are going to have to say we are all going to have to do our share.

Senator PROXMIRE. Then your answer is there won't be a default. However, if there is a default, you have not disputed my contention that the Federal Government will be clearly involved and directly involved, not only with the Federal court, but with the Federal Government having to oversee a guarantee or a loan just as they would be under the bill we have proposed to try to avoid default.

Mr. SIMON. No; not to that extent, because the President said our involvement would not extend to the purchase of the debt that was outstanding to avoiding default, if you will, which the present bill address themselves to. We would work with the courts in the absence of these actions that I have spoken of before, Senator, in making sure that the citizens of New York City do not suffer a loss of essential services as the result of going into default. He stated that.

Senator PROXMIRE. Well, my time is up. Thank you, Mr. Secretary.

Chairman HUMPHREY. Congressman Brown.

Representative BROWN of Michigan. Thank you, Mr. Chairman.

Mr. Secretary, you have referred to the idea that dollar for dollar we would have tax cuts and spending cuts, but you don't put it in the same time frame. Would you explain to me again why you believe that there should be a tax cut now and a spending cut later? I know you said that we can cut spending sooner, if we wish to, but that is not your recommendation. What is the rationale behind the administration's delayed spending cuts vis-a-vis a present tax cut?

Mr. SIMON. Well, I think if we understand how the President at this time had to make a recommendation on whether to continue with the tax reduction of 1975, it obviously had something to do with the climate. So we faced the question of shall we extend or shall we not extend the tax reduction of 1975? And as the discussions continued, amongst the economic groups downtown, I think the weight of the opinion was that it would be dangerous and irresponsible to extend the tax cuts and not address ourselves to the critical problem of expenditure cuts. Recognizing that the fiscal year is well underway, other than deferrals and rescissions, which are indeed up here in the Congress awaiting enactment, I think the weight of the opinion was that we had to get a handle on the growth, on the explosive growth in Federal spending, which will be growing at 15 percent during the year from

just our analysis right now. And as you well know, it will grow even more. So this is high by any historical measure.

The real gains from the President's program, Congressman Brown, are the long-term gains. You know this is a new policy in this Government. We are beginning to look at this as to the longer term and not react to what the economy is going to be like 6 months or a year from now. And so we know the continuation of past policies of the past 10 years, in our judgment, are going to lead us down the road to disaster. So it is time to turn it around to where we can truly see a balanced budget 3 years hence. And we think there are significant long-term benefits.

Again, the mechanics have changed. We have the change in the fiscal year. We had the situation where at the middle of this fiscal year we had the President having to make a decision on tax cuts right now, and this forced this disparity. But, let's not focus on just what's going to happen over the immediate months ahead and rather think about the long-term benefits that I have been talking about to the other Senators here.

Representative BROWN of Michigan. But, Mr. Secretary, this has been publicized as a $28 billion tax cut and a $28 billion spending cut. But as a practical matter, because the spending cut is delayed, it is not a wash.

Mr. SIMON. Again, Congressman, it is a wash. The fact that there is a 9-month lag in the effectiveness of this, as I say, cannot be avoided at this time unless one wants to extend the income tax or enact the $28 billion reduction and say it is not going to be effective until fiscal 1977, until October 1. We did discuss that possibility, but we thought that constant changes in tax policy were indeed counterproductive. We thought the taxes would go up effectively on January 1 and then would decline again in October. And after doing the economic analysis, as I said, from the standpoint of neutrality, and looking at this proposal and looking at the long-term benefits, which would be primarily the budget in balance over 3 years and capital formation reduction in growth and that means a reduction in the growth or the size of the Federal Government as a percent of gross national product, after looking at all this, we think the benefits far outweigh any criticisms, not to mention the psychological effects that I talked about for addressing ourselves to the confidence of the American people.

Representative BROWN of Michigan. But the President has not just advocated that we extend the existing tax cuts, the temporary tax cuts, but he is proposing additional cuts. And it seems to me there have been many who have questioned the real value of further taxing cuts.

Mr. SIMON. In the absence of spending cuts, the President has said he would not consider that, Mr. Brown.

Representative BROWN of Michigan. That he would not consider extending?

Mr. SIMON. Right. Absolutely not. He would be opposed and indeed would veto a continuation of the tax——

Representative BROWN of Michigan. Well, then, instead of making that threat, why not agree to an extension of the existing tax cuts tied to prospective further cuts when spending cuts become effective?

Mr. SIMON. Because that is, if I understand what you are proposing correctly, because that is half a loaf, if you will, or less than half a loaf, and increases our deficit and our problems in financing the deficit and

all the other things I have described before. We think the time has come to address once and for all the problem of spending and the rest of it. You know, we have tried to address spending, Congressman Brown. But we see increased beneficiaries every year, and budget increases almost without any actions any longer. We tried the impoundments method and lost that in the courts. And we think that this program that the President is recommending indeed deals with the fundamental problem of the decisionmaking factor and giving the money back and letting the American people decide what their priorities are, rather than the Federal Government. It is not that we are cutting out absolute spending, sir. We are going to still have a healthy, almost 7 percent increase in spending.

Representative BROWN of Michigan. We talked this morning about figures. In these discussions we always relate your figures and your projections, et cetera, with those that have been done by the Congressional Budget Committee. I know a lot of my constituents and I am sure a lot of people in the country, have great problems wondering how people working with the same figures and anticipating the same changes, have come up with such grossly disparate conclusions. To what extent does the administration attempt to coordinate, work with, et cetera, the Congressional Budget Committees?

Mr. SIMON. Well, we analyze the Congressional Budget Committees' results and we work, as I said to Senator Humphrey, we work very closely with the Budget Committees. The difference is—and I would agree with you that it is confusing. It is a very complex subject for people to comprehend. There are different assumptions in the way we approach it, and the way Congress, at times, approaches it. Also, there is this notion that when we put something forward, that that is the way it is going to be for all time, but that is not the way it works, because economic policy is an ever-evolving event where we must respond to events that are totally unforeseen. We therefore must make shifts and provide the necessary flexibility to take care of these changing events. As the events change, we make the necessary adjustments in our policy and usually it is going to have a revenue impact and it changes all the other numbers. And that is the reason why there is this confusion.

Representative BROWN of Michigan. Moving into the discussion you had with Senator Javits regarding the impact of the New York default on the bond market, I notice that in Michigan and in several States like Maryland and counties in Virginia, they have all gone into the market recently and have really found a good market for their debt instruments and at decent rates, whereas at the same time, a State like Massachusetts, because apparently it has some internal problem, has had difficulty. I was interested the other day to hear a witness before one of our other committees compare both quantitatively and ratewise the market for municipal bonds a year ago, as of now, even with the problem of default.

Do you have a comparison you could give us in that regard?

Mr. SIMON. Congressman Brown, I will submit it for the record, and will again say Salomon Brothers comments on values explains the relationship of municipal securities by rating categories.

To get an understanding of how the municipal bond market function, you must gage what interest rate is paid by various rated categories vis-a-vis its taxable bond counterpart of similar quality. And

indeed, many of your better issues today, that is, those that have the confidence of the investor, have conducted their affairs properly over the years—I am speaking now of those such as Maryland, Minneapolis, and many other municipalities and States of the United States—they have indeed benefited due to this higher quality preference because there is more money chasing the quality issues.

Others that are perceived to have difficulties, do have more difficulty, but they are still able to borrow, albeit at a higher rate.

We've got a large quality spread than I would have thought imaginable years ago. It is about 200 basis points from the quality issues to the lower quality issues. And this reflects the investor's demands for financial and fiscal integrity and for more financial information, which really was never provided in the degree that it was necessary, plus you have the uncertainty now that New York City, which for years was constitutionally mandated to have a balanced budget, but indeed did not, in the final analysis, have a balanced budget.

So, we are going to have investors asking all sorts of questions they didn't ask before. But I will provide for the record a detailed study of the municipal bond market today as to the rates that are being paid and how indeed it looks from a percentage point of view as to the prime and better quality issues and their financing at a lower rate. Just the sheer size of what has happened in the third quarter, the $13.5 billion in bonds and notes, is an indication of that, even though there have been some distortions and higher interest rates paid by certain municipalities.

[The information referred to follows:]

PERSPECTIVE ON MUNICIPAL BOND YIELDS

There has been much talk of late as to the extent to which the financial plight of New York City has impacted the entire market for municipals. Unfortunately, yield series on many of the numerous sectors of the municipal market do not exist. Yield data on general obligations, however, indicate that yield relationships within municipals are currently more unusual than are the relationships between municipals and taxable. Within the municipal market, for instance, medium-grades have recently deteriorated much more than prime issues. As a consequence, long prime municipals are currently equal to 88% of medium-grade municipal yields (see accompanying table), about the lowest proportion of the year. This percentage is down from the 92% July highs for the year, and the 92 to 95% range of annual averages for the last four years.

LONG MUNICIPAL BOND YIELDS—INTRA- AND INTER-MARKET RELATIONSHIPS

[In percent]

1st of month data	New G.O. scales 30-yr		Primes as percent of—			Medium grade percent of new A utilities
	Prime	Medium grade	Medium grade municipals	Long Government[1]	New long Aaa utilities[1]	
1971 annual average	5.55	6.00	93	91	73	75
1972 annual average	5.20	5.55	94	88	71	73
1973	5.20	5.45	95	74	68	69
1974 annual average	5.90	6.40	92	74	65	65
1975:						
1st half:						
Maximum			92	82	74	73
Minimum			89	77	68	67
Average	6.49	7.17	91	80	71	70
July 1	6.70	7.25	92	82	74	71
Sept. 1	8.55	7.25	90	78	70	68
Oct. 3	6.75	6.65	88	79	70	70

[1] Based on before tax yields.

The present ratios of prime municipals to long taxable Governments and new Aaa utilities of 79% and 70%, respectively, are 3% to 4% less than they were at their 1975 peaks in early July, but are still about equal to the average for the first six months. These proportions, while 5% above the averages for 1973 and 1974, are nonetheless still below the 1970 and 1971 averages.

Medium-grade municipal yield relationships to taxables, have changed little on balance since July, and are at present about equal to the average for the first half of the year. As with the primes, the current 70% ratio of medium-grade municipals to new A-rated utilities is still less than it was in the early 1970's. Relative to the past, it would appear that medium-grade municipals have been a little stronger relative to A-rated utilities this year than primes have been relative to Aaa utilities.

Mr. SIMON. But, since the President's speech, it has been interesting to me that a municipality called me some weeks ago and told me that they would be interested in coming down after the bill passed the Congress to talk to me about the Federal guarantees, because they had a problem. And the day after the President's speech, they got together with their banker and indeed have been working at putting their budget back in balance and the bankers have indicated that they will purchase the securities once they have put forth a credible plan. And that is a positive ripple effect of what has happened. And thousands of other municipalities have already made these tough decisions.

I know the mayors and Governors have suffered, have all suffered from a decline in revenue during the recession and terrible inflation that we have all experienced, but they have run their affairs well, too.

Representative BROWN of Michigan. Thank you, Mr. Secretary. My time has expired. Let me just say that it seems to me that your remedy for New York, as well as the remedy that has been passed, which I understand labor is opposing because they don't want someone to step in to renegotiate contracts and benefits, et cetera, but it just seems to me both solutions are really diametrically opposed to the conclusions that have been reached. That is to say, New York City is a unique situation. And we don't want to provide remedies for every municipality that comes in. If anything, you want to have the New York situation be a discipline to other municipalities so they don't get in the same situation.

Yet, you come in with a proposal for a general amendment to the bankruptcy laws. And the proposal that we reported out of the Banking and Currency Committee is a proposal to provide a Federal guarantee to any municipality that wants to come in and apply. And it seems to me that in all of these cases, we should have been true to our basic philosophy that the New York situation should be dealt with as an individual situation with an individual remedy.

Mr. SIMON. But don't you think, Congressman Brown, when we propose a change in the Bankruptcy Act, recognizing the conditions that exist up here today and recognizing the proposal is for cities of 1 million people or more, which severely limits the bankruptcy proposal. Is it not the responsibility of the Federal Government to provide the orderly mechanism to do this. I dont' think this is encouraging fiscal irresponsibility. Indeed, I see no indication that other cities have the same problem that New York City does. And I don't believe mayors would like to come down and take the political defeat, if you will, which would to me be certain if they indeed went the same route as New York City.

No; I don't consider that an encouragement whatsoever. I consider that a responsibility where a danger clearly exists, rather than having

the anarchy that would develop in the absence of an orderly, legal mechanism. So there is going to be a certain amount of difficulty, and I think it would be better to have an orderly process in that case——

Representative BROWN of Michigan. My time has run out. Thank you.

Chairman HUMPHREY. Congressman Hamilton, it is good to have you with us.

Representative HAMILTON. Thank you very much.

Mr. Secretary, your prepared statement gives us some projections for next year in the event the President's program is adopted. It does not include the impact of the deficit figure. That may be in one of the tables, however. I haven't had an opportunity to read your whole statement.

What is the impact of the President's program on the deficit figure for fiscal year 1976?

Mr. SIMON. That was the $5 billion figure that I stated in the first part of the testimony.

Representative HAMILTON. An additional $5 billion? What is the impact on 1977, on the 1977 fiscal year?

Mr. SIMON. We will provide that for the record. We don't have that.

[The information referred to follows:]

OFFICE OF THE SECRETARY OF THE TREASURY,
OFFICE OF TAX ANALYSIS,
December 1, 1975.

In fiscal year 1977 the effect of the President's program would be to reduce the Federal deficit by $17 billion. This assumes that in absence of the President's program—which imposes a $395 billion spending ceiling—outlays would be $423 billion and receipts would be reduced by an extension of the 1975 tax and withholding cuts.

Representative HAMILTON. Let me share with you a problem that we have in the House today and I would like to at least inform you of it and get your reaction to it.

We have, coming up on the floor next week, the budget resolution, which you are familiar with, under the congressional budget procedure.

In the House, we have a resolution which provides for $72 billion which you are familiar with. That resolution does not consider the President's Middle East package, so that that would have to be added on. Now, we confront this situation. It is tough enough to get that $72 billion figure approved by the Congress, as you can appreciate, but even if it is approved it doesn't provide a single dime for that Middle East package. I understand the Senate situation is similar. They have a budget deficit figure of about $74.3 billion in their resolution, which they reported out yesterday, and they do not include in that budget resolution any money for the Middle East package. We understand the importance the President places on his Middle East package.

Congressman O'Neill, the majority leader, is going to offer a motion to the House resolution next week to increase the deficit figure by $1 billion to accommodate the Middle East package. It is my judgment that unless that motion has very strong support for both the Democrats and the Republicans we have no chance of getting it adopted, and even if it does have strong support, there is a real question about it. I guess my question is whether or not you are prepared to support

whatever motion that is necessary to increase that deficit in the House resolution in order to accommodate the Middle East package.

Mr. SIMON. In anticipation of my testimony this morning, I met with Henry Kissinger on this last night. And the President told me he is going to address this very subject in the next couple of days as well. So, the subject will be addressed in time to inform the Congress on that. I know this is a problem, and I know your responsibilities in the foreign policy area. I know how difficult it is to justify politically what our responsibilities are to the rest of the world, and what it means to maintain peace in this world and how difficult it is to provide these moneys and how easy it is to turn inward during periods of economic strain. This is a problem for the American people, that is, to explain to them how beneficial it is to us, and yet how costly it is to us and, if it is rejected, how much more costly it will be if we don't have peace in the world.

This is an international welfare program that the Federal Government provides in its loans to generate exports and jobs and billions of exports meaning 75,000 new jobs in our economy. So this is very important.

Representative HAMILTON. Do I understand, Mr. Secretary, that the President has not reached a decision on whether or not to support this?

Mr. SIMON. No; he has not. When I left this morning, I was assured that he would offer one in the next couple of days.

Representative HAMILTON. Let me just suggest to you that the time is a very critical factor here.

Mr. SIMON. Yes, sir, I know it is.

Representative HAMILTON. Because to get the kind of support that is necessary to have an additional $1 billion added on to your deficit is going to take a good deal of work on the part of a lot of people. And if the President delays the decision and doesn't make it until early next week, I am afraid it may be too late. As I understand the situation, if this resolution is adopted, if the $72 billion deficit figure is adopted, then any subsequent appropriations which run over those resolution figures would be subject to being knocked out. So we are at a real crunch at this point. And I cannot emphasize to you too strongly that without very solid support from the President and from Secretary Kissinger for the O'Neill motion, well, in effect, I just think that it has no chance of passage in the House.

Mr. SIMON. As soon as I get back down there, Congressman Hamilton, I will call the President personally and speak to him.

Representative HAMILTON. I would appreciate that, sir. May I ask one other question about the President's proposals?

As I understand them, his proposals actually increase the tax liabilities of a family in the low-income bracket because he does not recommend an extension of the earned income tax credit. So, for example, a family with one dependent earning $5,000 would have their taxes increased by $227 and a family with two to four dependents earning $5,000 would pay $300 more.

Now, what is the rationale for increasing taxes for those who are in such a low income tax bracket as earning $5,000 or less a year?

Mr. SIMON. In dealing with this tax proposal, of course taxes affect the budget of the Federal Government and tax reduction reduces revenue to our government. The earned income credit is an expenditure, is a payment for a specific amount of money. It is literally a

transfer program, a welfare program, if you will, Congressman Hamilton.

As you know, the President has decided to take a completely comprehensive look at the total issue of welfare and address the earned income credit and all the other components of welfare at the same time. The Ways and Means Committee, I guess, also agrees with it, because they have not addressed the subject of the earned income credit in their present deliberations.

Representative HAMILTON. Well, what concerns me, Mr. Secretary, is that no matter how you classify it or identify it, people with $5,000 or less are going to end up with substantially less money in their pocket. It just doesn't seem to me that any kind of tax reform or tax change program that has that result is acceptable to the people that are being hurt the most in this country today.

Mr. SIMON. They are still, of course, getting a very large reduction and they were the major beneficiaries last year of the 1-year temporary tax reduction of 1975.

Representative HAMILTON. I understand that, Mr. Secretary, but to come along now and hit them with another $300 when they are just earning $5,000 or less, that is just not acceptable as far as this Congress is concerned.

Thank you very much.

Chairman HUMPHREY. I might add they are also hit with a 9 percent inflation tax, or an 8 percent inflation tax on top of that, and they are the least able to pay for inflation.

Mr. Secretary, I know your time has run out. I just want to place in the record the following:

The percentage of budget outlays, as related to the percentage of GNP, I want to place that—and you know the argument is often made about the incredible acceleration of the Federal budget. And of course the budget has accelerated, and the deficits are incredibly high, too high, but I do think we have to relate everything to the gross national product, which represents the production of goods and services by the American people. And if you go back to 1968, the budget outlays as the percentage of GNP were 21.6; in 1970, 20.6; in 1972, 21 percent. The budget outlays as percentage of GNP in 1975 were 21.9. Now, I am trying to point out that insofar as the budget outlays are concerned, there is a rather consistent pattern going back to even 1954, when the percentage of budget outlays as a percentage of GNP was 19.6.

And it has been in that 19 range and 20 range since 1954. When you go over to the debt side, the Federal debt, that is the Federal debt as related to the percentage of GNP, in 1954 it was 62 percent. The Federal debt was 62 percent of the gross national product. In 1961, it was 47.1 percent. In 1966, it was 36.7 percent. In 1971, it was 30.1 percent. In 1975, it is 27.2 percent. So let's give a little confidence to the American people. Everything hasn't gone down the drain.

The percentage of budget outlays as related to GNP today is not appreciably different than it was 10 years ago. As a matter of fact, 10 years ago, or in 1968, it was 21.6 and today it is 21.9. As far as the Federal debt, even though it is large and we ought to not have it as big as it is and it is a burden because you have the interest charges, but today it is 28.4 percent of GNP and 10 years ago, in 1965, it was 40 percent of the GNP.

So, I ask that this table, which appears in the budget of the U.S.

Government, official document of the Executive Office, on page 366, I ask that this entire table, number 19, be printed at this point in the record. I think it is important that we have it.

[The table referred to follows:]

TABLE 19.—FEDERAL FINANCES AND THE GROSS NATIONAL PRODUCT, 1954–76

[Dollar amounts in billions]

Fiscal year	Gross national product	Budget receipts: Amount	Budget receipts: Percent of GNP	Budget outlays: Amount	Budget outlays: Percent of GNP	Federal debt, end of year, Total: Amount	Federal debt, end of year, Total: Percent of GNP	Federal debt, end of year, Held by the public: Amount	Federal debt, end of year, Held by the public: Percent of GNP
1954	362.1	69.7	19.3	70.9	19.6	270.8	74.8	224.5	62.0
1955	378.6	65.5	17.3	63.5	18.1	274.4	72.5	226.6	59.9
1956	409.4	74.5	18.2	70.5	17.2	272.8	66.6	222.2	54.3
1957	431.3	80.0	18.5	76.7	17.8	272.4	63.1	219.4	50.9
1958	440.3	79.6	18.1	82.6	18.8	279.7	63.5	226.4	51.4
1959	469.1	79.2	16.9	92.1	19.6	287.8	61.3	235.0	50.1
1960	495.2	92.5	18.7	92.2	18.6	290.9	58.7	237.2	47.9
1961	506.5	94.4	18.6	97.8	19.3	292.9	57.8	238.6	47.1
1962	542.1	99.7	18.4	106.8	19.7	303.3	55.9	248.4	45.8
1963	573.4	106.6	18.6	111.3	19.4	310.8	54.2	254.5	44.4
1964	612.2	112.7	18.4	118.6	19.4	316.8	51.7	257.6	42.1
1965	654.2	116.8	17.9	118.4	18.1	323.2	49.4	261.6	40.0
1966	721.2	130.9	18.1	134.7	18.7	329.5	45.7	264.7	36.7
1967	769.8	149.6	19.4	158.3	20.6	341.3	44.3	267.5	34.8
1968	826.0	153.7	18.6	178.8	21.6	369.8	44.8	290.6	35.2
1969	898.3	187.8	20.9	184.5	20.5	367.1	40.9	279.5	31.1
1970	954.6	193.7	20.3	196.6	20.6	382.6	40.1	284.9	29.8
1971	1,012.1	188.4	18.6	211.4	20.9	409.5	40.5	304.3	30.1
1972	1,101.6	208.6	18.9	231.9	21.0	437.3	39.7	323.8	29.4
1973	1,224.1	232.2	19.0	246.5	20.1	468.4	38.3	343.0	28.0
1974	1,348.9	264.9	19.6	268.4	19.9	486.2	36.0	346.1	25.7
1975 estimate	1,434.0	278.8	19.4	313.4	21.9	538.5	37.6	389.6	27.2
1976 estimate	1,596.0	297.5	18.6	349.4	21.9	605.9	38.0	453.1	28.4

Mr. SIMON. May I have permission to respond to that for the record?

Chairman HUMPHREY. Yes, please do. That will also appear in the record.

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

TOTAL GOVERNMENT SPENDING AND GROSS NATIONAL PRODUCT, CALENDAR YEARS, 1955–74

[Dollar amount in billions]

Year	Total Government expenditure	Federal [1]	State and local	GNP	Ratio to gross national product (percent): Total	Ratio to GNP: Federal	Ratio to GNP: State and local
1955	$97.6	$64.9	$32.7	$398.0	24.5	16.3	8.2
1956	104.1	68.5	35.6	419.2	24.8	16.3	8.5
1957	114.9	75.4	39.5	441.1	26.0	17.1	9.0
1958	127.2	83.2	44.0	447.3	28.4	18.6	9.8
1959	131.0	84.2	46.8	483.7	27.1	17.4	9.7
1960	136.1	86.5	49.6	503.7	27.0	17.2	9.8
1961	149.0	94.9	54.1	520.1	28.6	18.2	10.4
1962	159.9	102.3	57.6	560.3	28.5	18.3	10.3
1963	166.9	104.7	62.2	590.5	28.3	17.7	10.5
1964	175.4	107.6	67.8	632.4	27.7	17.0	10.7
1965	186.9	112.4	74.5	684.9	27.3	16.4	10.9
1966	212.3	128.4	83.9	749.9	28.3	17.1	11.2
1967	242.9	147.8	95.1	793.9	30.6	18.6	12.0
1968	270.3	162.8	107.5	864.2	31.3	18.8	12.4
1969	287.9	168.9	119.0	930.3	30.9	18.2	12.8
1970	312.7	179.5	133.2	977.1	32.0	18.4	13.6
1971	340.2	191.4	148.8	1,054.9	32.2	18.1	14.1
1972	372.1	207.2	164.9	1,158.0	32.1	17.9	14.2
1973	408.0	223.6	184.4	1,294.9	31.5	17.3	14.2
1974	461.2	255.3	205.9	1,397.4	33.0	18.3	14.7

[1] Federal expenditures exclude grants in aid to States.

Source: National Income and Product accounts, USDC.

Chairman HUMPHREY. One other question. Mr. Ed Fiedler, when he was Assistant Secretary, agreed to ask your staff to prepare a paper for this committee describing the way you go about making long-range revenue estimates, because it is a problem. I understand that when Mr. Jones replaced Mr. Fiedler, he agreed that this project would go forward. We felt that this information would be extremely helpful to us in preparing our report on the current services budget. I just want to ask you if you can get it to us as soon as possible. We will send you a letter, so as to make it specific once again.

Mr. SIMON. We have done such a study, Mr. Chairman, and we will provide you with this and then we can embellish upon it, if that is not sufficient for you.

Chairman HUMPHREY. That would be very helpful to us. And very quickly, you mentioned earlier today the fact that the big companies can still get into that credit market, even with the high pressure that is on the market, but it is the smaller businesses that have the difficulty. I think that is correct.

We are going to have hearings on capital formation and we will be asking you to come before us. In speaking with the Federal Reserve's congressional liaison officer, one of our staff people was told that the Fed has no expertise at all in small business. The Fed says its job is to regulate banks, not to study to whom the banks lend their money. To say the least, I am personally shocked at this attitude. Small business accounts for about 50 percent of the Nations output of goods and services, but the Fed does not even have one person on its payroll that is responsible for evaluating the general health of the small business sector. I thought I would just let you know this, because I assume you would want to relate this in your conferences. I personally shall write Mr. Burns a note about it.

And I intend to introduce an appropriate resolution that will go to the Banking Committee to insist that the Fed have some in-house expertise on small business financing and small business credit needs.

Finally, Mr. Simon, I have recent data, which I have here in my hand, which shows the volume of the municipal bond market in terms of billions of dollars. And that data shows that you are right, Mr. Secretary that the market volume was way up through July. But look what happens in August, September, and October. Volume is reduced considerably, but even these numbers are deceptive, because they include MAC borrowing, that is, MAC up in New York, which is done in the long-term market rather than the short-term market. And when you take out MAC volume, the volume is down 30 to 40 percent.

Moreover, borrowing in the short-term market is also way down in the last 3 months because New York City is no longer in that market. And given these factors, it seems to be to be very difficult to say that the volume has remained strong.

Finally, with regard to displacement, isn't it true that it is a very deceptive indicator, because it does not take into account the number of jurisdictions that don't even initiate a bond issue because they know the market conditions are adverse?

Now, I am going to state for the record the volume of the municipal bond market for July, August, September, and October. And it will show you that the volume has dropped appreciably since July. In July, it was $3.542 billion. If you take out MAC, it was $1.941 billion

in August. In September, it was $1.537 billion. In October, it was $1.999 billion. You are at liberty to have your staff make an evaluation. This is what the committee staff gave to me.

Mr. SIMON. I will respond to that, Mr. Chairman.

[The information referred to follows:]

MUNICIPAL FINANCING

The Chairman asserted that the New York financial crisis had caused a drop-off in new issue volume after July because tax-exempt issuers refused to come to market as a consequence of high borrowing costs. The following table sets forth bond and note new issue volume for July–October 1975 and 1974:

[Dollars in millions]

	July	August	September	October
1975:				
Bonds	$3,434	$2,692	$2,112	$2,246
Notes	1,691	1,377	2,427	2,547
Total	5,125	4,069	4,539	4,783
Percentage change from previous month		−21	+12	+5
1974:				
Bonds	1,381	1,056	1,626	2,319
Notes	2,059	1,497	3,526	2,365
Total	3,430	2,543	5,152	4,684
Percentage change from previous month		−26	+103	−9

As can be seen, there are clear seasonal variations, but no meaningful differences in the two years. See also the ten year record of new issue volume (attached).

Moreover, backing out MAC now makes little difference:

	July	August	September	October
	5,125	4,069	4,539	4,78
Less MAC	1,175	840	807	280
	3,950	3,229	3,732	4,503
Percentage change		−18	+16	+21

It should be noted that, for comparative purposes, it is incorrect to back out MAC transactions because such transactions substituted for City borrowing.

Attachment.

A DECADE OF MUNICIPAL FINANCING—DATA COLLECTED BY "THE DAILY BOND BUYER" OF NEW YORK, SHOWS AT A GLANCE THE SALES BY MONTHS OF BOTH BONDS AND SHORT-TERM NOTES OF STATES AND MUNICIPALITIES IN THE UNITED STATES AND INSULAR POSSESSIONS AND MUNICIPALITIES THEREIN DURING THE PAST 10 YEARS

	Long-term loans									
	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975
January	$1,176,494,299	$1,450,438,673	$1,161,547,499	$1,244,252,741	$1,314,286,835	$2,613,800,300	$1,737,200,373	$1,887,144,456	$2,288,309,191	$2,158,546,904
February	845,458,533	1,156,979,873	1,133,597,200	974,215,589	1,198,316,047	1,822,913,919	1,942,359,360	1,445,342,221	1,970,423,036	2,328,830,657
March	847,592,788	1,436,791,214	1,362,883,810	519,622,041	1,504,144,844	2,103,516,087	2,185,040,732	2,296,817,220	2,091,451,394	2,037,839,364
April	1,181,137,970	1,128,798,663	1,276,549,376	1,627,198,334	1,624,504,944	1,858,566,804	1,962,524,835	1,687,660,121	2,321,869,205	2,263,123,526
May	877,421,169	1,209,392,144	1,133,687,149	1,088,346,723	973,907,768	2,114,198,837	1,923,925,001	1,870,018,032	2,176,946,282	2,532,416,759
June	1,118,458,628	1,460,664,740	1,360,353,654	710,286,404	1,057,960,924	1,988,122,574	2,222,403,920	2,030,899,127	1,941,610,160	3,001,048,087
July	677,805,556	924,697,876	1,422,027,497	1,052,032,575	1,309,688,559	1,950,531,857	1,783,604,609	1,991,596,623	1,380,732,870	3,434,120,352
August	764,097,306	840,495,663	1,665,848,629	793,656,034	1,318,022,457	1,849,841,632	1,897,964,807	1,474,455,168	1,055,926,295	2,692,088,390
September	991,851,334	1,273,202,380	1,423,173,273	530,760,278	1,649,862,884	2,044,463,963	1,701,046,242	1,629,554,255	1,625,716,737	2,112,225,585
October	735,998,837	991,329,320	2,260,216,412	1,254,172,626	1,882,158,414	1,679,251,863	1,969,681,285	2,232,243,798	2,318,666,796	2,246,323,635
November	949,619,420	1,320,176,808	1,036,770,929	853,339,233	1,683,724,385	2,286,253,301	1,814,154,500	2,223,783,079	2,245,085,770	
December	923,002,509	1,092,981,992	1,137,677,532	812,368,525	2,245,067,772	2,058,074,968	1,800,937,720	2,183,132,666	1,407,230,458	
Total	11,088,938,349	14,287,949,346	16,374,332,960	11,460,251,103	17,761,465,833	24,369,536,105	22,940,843,384	22,952,646,766	22,823,968,194	24,806,563,259
Number of issues	5,594	5,829	5,714	4,052	4,701	5,461	5,103	4,741	4,287	3,925
Negotiated								5,915,882,698	6,265,568,382	8,869,756,883
Revenue (including refunding)[1]	4,076,022,500	5,096,087,618	6,762,806,850	3,413,416,400	5,958,564,402	8,129,060,950	8,820,057,343	10,126,053,500	9,792,845,100	11,679,612,100
Refunding total[1]	220,573,500	173,608,200	137,997,900	51,314,600	56,220,500	452,583,000	1,568,537,000	1,234,808,000	581,466,500	787,976,196
General obligation	43,375,500	60,343,200	74,889,000	31,932,600	29,376,000	155,086,000	237,645,000	371,460,000	296,764,000	583,506,796
Revenue	177,198,000	113,265,000	63,108,900	19,382,000	26,844,500	297,497,000	1,330,892,000	863,348,000	284,702,500	204,469,400

[1] Included in yearly totals.

SHORT-TERM LOANS (12 MO OR LESS)

	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975
January	$354,701,600	$453,640,000	$569,264,000	$640,229,500	$877,685,500	$1,551,694,000	$1,593,523,925	$1,621,659,692	$1,859,600,563	$2,265,877,509
February	382,495,750	756,461,225	563,093,000	837,340,000	1,444,149,676	1,885,735,920	1,751,944,000	1,130,498,000	2,116,795,053	2,269,843,763
March	607,672,100	634,103,000	1,090,057,000	783,416,000	1,210,938,442	2,452,530,500	3,406,870,590	1,637,715,115	1,785,548,545	2,832,491,198
April	1,060,846,000	1,971,193,000	669,019,323	1,291,510,487	1,045,608,200	2,482,262,481	1,516,354,774	2,061,855,460	2,155,433,685	3,093,592,683
May	864,674,000	951,138,000	971,871,000	904,557,500	1,387,480,000	1,839,598,447	2,726,161,645	2,491,834,610	2,797,099,895	3,801,201,072
June	383,544,000	530,617,000	422,157,600	1,072,432,500	2,034,653,300	2,932,420,000	2,704,795,635	2,517,105,840	3,803,778,140	2,698,509,589
July	173,899,000	286,107,000	673,461,000	626,657,600	1,113,290,000	1,353,139,000	1,215,198,481	1,923,295,617	2,058,878,949	1,690,683,152
August	620,474,900	751,662,800	835,218,727	1,139,724,574	1,226,187,350	1,882,224,582	1,839,885,577	1,740,221,613	1,496,818,390	1,376,665,945
September	361,837,000	602,974,000	458,553,000	1,023,320,625	2,048,857,000	2,781,406,034	2,475,025,500	2,750,340,600	3,525,697,176	2,426,887,502
October	266,381,000	763,886,046	855,751,000	795,095,585	1,215,606,325	1,843,287,800	1,548,478,258	2,500,967,122	2,346,952,759	2,546,851,780
November	988,717,000	767,158,000	974,516,000	1,438,962,300	2,021,772,000	2,784,702,700	2,764,055,950	1,784,590,231	2,540,401,664	----------------
December	458,382,195	330,411,000	575,595,000	1,229,880,550	2,253,725,000	2,492,266,075	1,640,474,000	2,507,219,390	2,535,676,707	----------------
Total	6,523,534,545	8,025,331,071	8,658,556,650	11,783,127,124	17,879,952,793	26,281,467,539	25,221,168,335	24,667,357,290	29,040,681,526	25,002,604,193
Number of issues	(1,836)	(2,135)	(2,173)	(2,343)	(2,903)	(3,350)	(3,317)	(3,406)	(3,414)	(2,840)
Grand total	17,612,472,894	22,313,280,417	25,032,899,610	23,243,378,227	35,641,598,626	50,651,003,644	48,162,611,719	47,620,044,056	51,864,649,720	49,809,167,524
Total number of all issues	(7,430)	(7,964)	(7,887)	(6,395)	(7,604)	(8,811)	(8,420)	(8,147)	(7,701)	(6,765)

NOTE

Public housing authority issues: Included in this table are public housing authority bond and note issues, which in effect are backed by Federal guarantee of payment. Amounts included in the above table are as follows: 1966—Bonds $439,705,000; Notes: $1,740,229,000; 1967—Bonds; $447,510,000; Notes: $1,779,678,000; 1968—Bonds: $524,810,000; Notes: $2,061,681,000; 1969—Bonds: $397,885,000; Notes: $2,675, 184,000; 1970—Bonds: $130,790,000; Notes: $4,563,243,000; 1971—Bonds: $1,000,435,000; Notes: $5,960,964,000; 1972—Bonds: $958,960,000; Notes: $6,482,926,000; 1973—Bonds: $1,029,240,000; Notes: $6,638,023,000; 1974—Bonds: $460,985,000: Notes: $6,808,186,000; 1975—Notes: $6,033,304,000.

Preliminary loan notes: Also included in this table are preliminary loan notes issued by local public agencies to finance urban renewal projects. These are secured by the full faith and credit of the U.S. Government. Amounts included as short-term loans in the above table are: 1966—$1,806,432,000; 1967—$2,431,768,000; 1968—$2,812,014,000; 1969—$3,229,758,000; 1970—$3,832,950,000; 1971—$4,014,348,000; 1972—$4,237,040,000; 1973—$4,406,302,000; 1974—$4,621,853,000; 1975—$3,477,309,000.

Chairman HUMPHREY. Well, we have kept you long today, and I know you are late, but tell them you were just kept with this tough committee.

Mr. SIMON. It happens all the time.

Chairman HUMPHREY. But it is good to have you here. I wish we were in more agreement, particularly on the New York City situation. I must say I believe the answers today on the tax matter, Mr. Secretary, are no more satisfying to me than I believe it has appeared to a couple of other members of the committee. We have an increase in the deficit and an increase in the borrowing, and we have it despite the fact that Alan Greenspan said the tax reduction was not necessary.

We also have expenditure reductions coming most unusually and uniquely following the November election. It may be accidental, but if it is, what a fortunate accident for some people.

Mr. SIMON. I don't consider it fortunate.

Chairman HUMPHREY. I mean if you haven't run for office, then you wouldn't——

Mr. SIMON. I think if a person is running for office just at the very time he is telling people he is going to cut back on some of the spending that some people receive, I don't consider that terribly good politics.

Chairman HUMPHREY. Mr. Secretary, I want to tell you something. January through July, or January through August and September of 1972, the money market increased 14 percent on the average, that is, the availability of money and also a large number of recisions and impoundments were released. I am an old hand at this business around here, and I watch those numbers very carefully. They accused Franklin Roosevelt of putting more people on WPA just before the election, but he was a fellow that didn't understand the modern arithmetic that we've got today. When you get a $28 billion tax reduction from January through October, and then the election is on the 2d day of November, after which come the reductions, then I don't think that that is what you would call strictly economics. It may be, but it is a new kind of economics.

Mr. SIMON. Let's call a spade a spade. You know, nothing in this city doesn't ultimately become political. Everything is political, fine, but that is not, as is often said, a substitute for thinking. And the point is, if we can develop a method to do it simultaneously, then super. I don't think we possibly can, seeing as we are just about half way through the fiscal year.

The point is this is the only way, and we have tried all the others, to finally get a handle on growth and spending and——

Chairman HUMPHREY. Well, I think Congressman Brown today made a practical suggestion. He said to extend the 1975 cuts. If you need any further cuts, then tie those into spending cuts. I think that is sensible.

Mr. SIMON. It is not, because it just increases——

Chairman HUMPHREY. And may I say, if the President is going to veto a simple extension of the 1975 reduction he is going to have a fight that he won't forget around here for a long time.

Mr. SIMON. That is why I said I don't call that good politics, because if you send down a reduction in spending, if you send down an

extension of that bill in the absence of simultaneous spending cuts, as he requested, the President said he would veto the bill.

Chairman HUMPHREY. Well, all I can say is in light of the increase in unemployment, in light of this little notice I have here that came to my attention where it says Railway Express just announced today they have suspended all freight handlings because of the bankruptcy proceedings in New York, and that means thousands and thousands of employees will be thrown out of work, well, I just don't think this is a time to fool around when we can have an extension of the 1975 tax cut.

And Members of Congress of both sides agree on that. They think it is sensible. And we have budget restraints. We will try to curb deficits. We will cut budgets wherever they can be cut. And if there needs to be further tax reductions, I think the proposition put by our colleague here from Michigan Congressman Brown, makes a good deal of sense and we could tie those into spending cuts.

Well, good day, and it is good to see you.

[Whereupon, at 12:15 p.m., the committee adjourned, subject to the call of the Chair.]