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JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

TOGETHER WITH

MINORITY, ADDITIONAL, AND SUPPLEMENTAL VIEWS

OCTOBER 10, 1978

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LETTER OF TRANSMITTAL

October 6, 1978.

To the Members of the Joint Economic Committee:

Transmitted herewith for the use of the Joint Economic Committee and other Members of Congress is the Joint Economic Committee's "Review of the Economy, October 1978," together with minority, additional, and supplemental views. In this report, the committee sets forth an analysis of key economic issues including an assessment of the system of floating exchange rates, a discussion of the inflation indexing of personal and corporate taxes, an examination of the feasibility of implementing a tax-based incomes policy (TIP), and an analysis of tax reduction proposals. Because these issues are controversial, we believe it is the responsibility of the Joint Economic Committee to discuss them and to inform Congress of expert opinions as we perceive them from our hearings and from other sources. We do not set forth any policy recommendations.

Sincerely,

Richard Bolling,
Chairman, Joint Economic Committee.

CONTENTS

Page

Letter of transmittal — III
General note — VII
Chairman's introduction — 1
I. The economic situation and outlook — 13
  Domestic developments in 1978 — 17
  Developments in the current account of the balance of payments — 25
  Public sector outlook in 1979 — 41
    Fiscal policy — 42
    Monetary policy — 44
    Inflation policy — 45
  Private sector outlook for 1979 — 50
    Consumption — 50
    Investment — 51
    Net exports — 52
    Prices and wages — 55
II. Key international economic issues — 58
  Introduction — 58
  The present international payments system — 64
  Managed floating and the need for surveillance — 69
  Exchange rate determination under a cleanly floating system — 74
  Are volatile exchange rate movements the result of destabilizing speculation? — 81
  Central Bank intervention in foreign exchange markets — 84
  The use of monetary policy for external purposes — 88
  Toward an assessment of floating exchange rates — 92
  The need for the international coordination of macroeconomic policies — 104
  The need to reverse the tide of growing protectionism — 111
  The continuing need to recycle surpluses — 117
III. Key domestic policy issues — 124
  Introduction — 124
  Productivity and investment — 127
  Tax policy and inflation — 145
    Need for tax reduction — 145
    Inflation correction of the individual income tax — 147
    Property taxes — 162
    Payroll taxes — 164
    The Kemp-Roth tax reduction proposal — 172
  Incomes policy to combat inflation — 180
Additional views of Senator William Proxmire — 191

MINORITY VIEWS

I. Introduction — 197
II. Inflation — 200
  Monetary policy — 201
  Federal budget deficits — 202
  Government regulation — 205
  Labor costs — 207
  Shortages and supply problems — 210
  The harmful effects of inflation — 212
    Harmful effects on individuals — 212
    Harmful effects on business — 218
    Distortions of relative prices — 222

	Page
II. Inflation—Continued	
Policies to curb inflation	223
Fiscal responsibility and the budget	224
Delay minimum wage increase	227
Reduce Federal regulation	229
Proposals not recommended	231
Price and wage controls	231
Tax-based incomes policy	232
"Jawboning"	235
III. Monetary policy	236
IV. International problems	238
The falling dollar	238
The basic problem	239
A substantive solution	240
The budget and the trade deficit	241
Inflation, the trade deficit, and the run on the dollar	242
Can we pay up?	244
Nonsolutions to the dollar crises	244
Nonsolution 1: The energy bill	245
Nonsolution 2: Wait for the cheaper dollar to boost exports	248
The "J" curve	248
Nonsolution 3: Swap agreements	252
Global consequences of the dollar crisis	254
V. Tax changes and fiscal policy	257
Enlightened tax policy	257
Taxation and economic growth	263
The need for growth	263
Personal income tax cuts	267
Corporate tax cuts	271
VI. Productivity and capital formation	280
Investment ratio	281
Government regulation	285
Demographic composition of the labor force	287
Policies to stimulate productivity growth	288
VII. Urban initiatives	293
VIII. Taxpayer revolt	303
IX. Conclusion	313
Additional views of Senator Jacob K. Javits	315
Additional views of Representative Clarence J. Brown and Representative John H. Rousselot	223
Supplemental views of Representative Clarence J. Brown	327
Additional views of Senator William V. Roth, Jr	332
Additional views of Representative Garry Brown	345
Additional views of Representative Margaret M. Heckler	348
Additional views of Senator James A. McClure and Senator Orrin G. Hatch	350

General Note

Statistical data used in this report were the most accurate available on October 1, 1978. Information released between October 1, and October 10 could not be incorporated in this report. However, it would not change either the analysis or the conclusions.

CHAIRMAN'S INTRODUCTION

Unlike our annual Joint Economic Report, which is mandated under the Employment Act and must deal comprehensively with current economic issues, the Review of the Economy, October 1978 of the Joint Economic Committee provides an opportunity for selective and in-depth analysis of economic problems that the Committee feels to be particularly timely, pressing, or of longer range significance.

Many of the issues discussed in this Report -- for example, the inflation indexing of personal and corporate taxes, the feasibility of implementing a tax-based incomes policy (TIP), and the system of floating exchange rates -- are highly controversial. We believe it is the Committee's responsibility to discuss these controversial matters and to inform Congress of expert opinions drawn from our hearings and other sources. Thus, we do not make any specific policy recommendations in this Report.

Last year our Midyear Review focused on inflation as a serious enemy of continued prosperity and growth. We also concentrated on monetary policy and analyzed the inappropriateness of the mix of monetary and fiscal policies during the recovery from the recession of 1974-75. In addition, we called attention to the poor coordination of fiscal and monetary policies. Recommendations designed to rectify these deficiencies were made both in the 1977 Midyear Review of the Economy and in the 1978 Joint Economic Report issued last March. 1/

1/ The 1977 Midyear Review of the Economy; Report of the Joint Economic Committee, Congress of the United States, together with Minority and Additional Views, September 26, 1977. The 1978 Joint Economic Report; Report of the Joint Economic Committee, Congress of the United States on the January 1978 Economic Report of the President together with Minority and Additional Views, March 21, 1978.

Our view that restrictive monetary policy has been partly responsible for the poor performance of capital spending and productivity growth in the recovery is now widely accepted. Moreover, the Federal Reserve has now apparently recognized the need for greater coordination of monetary and fiscal policies. Finally, most of the Committee's recommendations to improve the coordination of monetary and fiscal policy have been incorporated into the Humphrey-Hawkins bill.

When we planned our Midyear Hearings of June and July, we decided to pay particular attention to international economic problems, especially problems of international payments. We have avoided a lengthy discussion of trade policy questions, not because they are not important, or less important than international payments problems, but because we have only recently begun to examine these issues in detail. Our Subcommittee on International Economics has just begun that process with a focus on the need for a national export policy. The export performance of the United States over the past several years has been disappointing. We feel it is necessary to determine the reasons for the apparent loss in competitiveness of our export industries. The JEC's Subcommittee on International Economics will issue a study on this issue in the near future.

The stagnant world economy inhibits recovery and accounts for much of the present weakness of the dollar. Domestic employment considerations caused by stagnation have prompted a number of countries to abandon trade liberalization in favor of restrictive commercial policies to protect their domestic industries. Some countries have also engaged

in foreign exchange market intervention to protect their export industries. Continued economic stagnation thus poses a constant threat both to the goal of freer trade and to the flexible exchange rate system.

Because the world business cycle is out of phase another dimension has been added to the problem of stagnation. Although, the United States has enjoyed moderately rapid recovery from the recession, most industrial countries have continued along a path of inadequate growth. A weak world economy has kept the rate of growth for U.S. exports well below the growth rate for imports. The result has been a much larger current account deficit. Since a current account deficit means that we are a net consumer of foreign produced goods and services, the U.S. trade deficit subtracts from aggregate demand. Lower aggregate demand, in turn, creates pressures to continue a large Federal budget deficit to offset restrictive effects on the economy. The current account deficit in the U.S. balance of payments, finally, is a major source of the dollar's weakness in foreign exchange markets.

Our study of the international economic situation suggests that it is not possible to achieve balance-of-payments equilibrium and exchange rate stability when growth rates of individual countries are out of phase. In point of fact, it may not be possible to achieve external equilibrium without better coordination and synchronization of the domestic stabilization policies of the world's leading economies. One of the great advantages of the flexible exchange rate system is that it tends to provide countries with a larger degree of macroeconomic independence because the effects of external shocks can be cushioned by exchange rate

variations. Complete independence has not been achieved, however, and the need for coordination and synchronization continues to be great.

The shock-proofing mechanism that clean floating is intended to provide has been impaired, in part, because the fluidity of international capital movements has tended to interfere with exchange rate adjustments, and because countries have not permitted foreign exchange markets to operate freely. As under the old system, these countries have intervened by purchasing and selling foreign currencies in exchange for domestic currencies. Unless this trend is abated, it will degenerate into the readoption of the rigid system of fixed exchange rates that prevailed in the 1950s and 1960s.

The world economy would benefit from a set of orderly rules for combating generalized stagnation. More rapid economic growth should be provided by countries with strong currencies and balance-of-payments surpluses. If internal expansion is more rapid in the surplus countries, current account deficits and surpluses will be reduced all around, and weak currencies will be strengthened. The experience in the last two years, however, has been the opposite. The United States' net export position moved from surplus into deficit near mid-1976, and the deficit has widened considerably since that time. To a large extent, this deterioration was caused by more rapid recovery in the United States than elsewhere. A consequence of the deterioration has been the weakening of the dollar and the further strengthening of the strong currencies of West Germany and Japan. The recent trend, therefore, has been toward a widening disequilibrium that neither benefits nor pleases any party, and that

threatens to produce further disruption and possible breakdown in the world's trade and payments system.

The depreciation of the dollar has meant higher import costs. This has added to our inflation rate, but it has also improved the competitiveness of our export industries which should eventually contribute to the growth of our economy. At the same time, the appreciation of other currencies has slowed inflation rates abroad, put foreign export industries at a competitive disadvantage, and contributed to the continuing economic sluggishness of several key industrial countries.

In our view Germany and Japan ought to have been stimulating their economies by monetary and fiscal measures. Instead, both countries chose to attempt to protect their economies by artifically maintaining the competitiveness of their export industries through intervention in foreign exchange markets. The absence of coordinated international recovery has proved to be an impediment to the stability of the world economy. The absence of orderly adjustment is also jeopardizing the successful operation of the system of flexible exchange rates. When everyone waits for the other country to provide the locomotive, stagnation and the breakdown of trade and payments relations are the natural consequences. All countries cannot recover by trying to steal employment from each other.

There is, in fact, a move to devise international economic rules of conduct -- so-called "surveillance" rules -- to be followed by countries experiencing balance-of-payments problems in order to ensure an orderly adjustment process. We fear, however,

that the rules ultimately devised will be of the wrong kind because there is danger that the surveillance rules will be confined to rules for exchange market intervention, and not for the conduct of domestic macroeconomic policies.

The system of fixed exchange rates that existed under Bretton Woods -- as administered by the International Monetary Fund -- proved to be ultimately damaging because it placed pressure on deficit countries to deflate their economies. Since no corresponding pressure to expand was placed on surplus countries, the result of the asymmetrical pressure was a bias toward slower growth and higher unemployment. We do not wish to return to such a defective system.

The chapter on international trade and payments reviews these developments and reexamines the Committee's view that flexible exchange rates should be continued. We also examine the recent intellectual attack on flexible exchange rates by those who call themselves global monetarists. Our conclusion is that the global monetarist view is incorrect, and that the flexible exchange rate system remains the preferred system. This is not to say that small open economies might not be better off to join larger currency unions. We should, in fact, be prepared to cooperate in efforts to achieve monetary integration among countries as long as such cooperative efforts are not used by a country or a group of countries to gain unfair competitive advantage.

While this report emphasizes the international payments system, several recent domestic developments are of critical importance to the economic health of the

United States. Chapter III reviews these developments, explains their interrelationships, and discusses various proposals that have been suggested as possible solutions.

To begin on an upbeat note, employment in the economy has increased at an extraordinary pace. About 4 million civilian jobs have been created since the middle of last year and the unemployment rate has dropped a full percentage point. Unfortunately, the rapid growth in employment has not been matched by exceptionally rapid growth of real output. Each worker, therefore, is producing less than we would like. Put differently, the productivity performance has been extremely disappointing. During the first quarter, productivity in the private business sector fell at an annual rate of 4.7 percent. Although productivity in manufacturing picked up in the second quarter to a rate of 7.3 percent, after two quarters of decline, overall productivity in private business grew at a meager rate of 0.1 percent.

When productivity slumps, unit labor costs tend to rise more rapidly, which translates into a faster rate of increase in commodity prices. In the first quarter, unit labor costs in the private business sector rose at a rate of 17.4 percent. This was followed by a lower, though still excessively high, increase of 7.8 percent in the second quarter.

Combined with rapidly increasing farm prices, the growth of unit labor costs caused a much faster rate of increase in producer and consumer prices. Consumer prices rose by 6.8 percent during 1977, but jumped to a rate of 9.3 percent in the first quarter of 1978, and to an even higher rate of 11.4 percent in

the second quarter. The result has been a double digit rate of 10.4 percent for the first half of the year.

Slow growth of output and output per manhour relative to the growth of employment and labor force, has held back the rapid rise in per capita income that the American people have come to expect. This situation has been aggravated by reductions in take-home pay, caused by rapidly rising payroll taxes and by the negative effects of inflation that tend to push taxpayers into higher tax brackets. Inflation also raises property taxes and penalizes homeowners who cannot sell their homes except on pain of a heavy capital gains tax on largely paper profits. Inflation, finally, penalizes small savers whose interest earnings rarely exceed the rate at which their savings are eroded by inflation.

The stagnation of productivity and real income growth, combined with the effects of inflation on the system of progressive taxation of money income, have created a climate in which our citizens are attempting to increase their incomes by reducing government revenue. People say they are tired of over-regulation and of too much government attempting to do too many things. What their complaints also appear to reflect is real income stagnation and arbitrary and burdensome inflation-caused increases in taxation.

Clearly, we must deal with a number of crucial domestic economic policy issues. First, why is growth of output per manhour so low? Portions of Chapter III of this Report are devoted to an analysis of productivity. The analysis points to a number of policy prescriptions designed to raise the investment share of gross national product

33-958 O - 78 - 2

(GNP). We propose, as we have in the past, that the monetary-fiscal mix be shifted in a direction that fosters a higher investment-lower consumption mix of aggregate spending. More significantly, Chapter III explores the possibility of altering corporate accounting procedures for tax purposes to permit firms to expense long-lived physical assets on a basis that reflects the increase in the nominal value of these assets caused by general inflation.

We believe that the taxpayers' revolt is in part a revolt against the arbitrary and capricious effects of inflation on the tax system. We also believe that the economic outlook justifies a modest tax reduction in the $20-$25 billion range. We do not believe, however, that this problem of inflation and this question of tax reduction should be attacked by draconian measures that have recently been proposed. Instead, we feel that the issue of inflation's effect on the tax system should be confronted directly. Chapter III outlines possible procedures for and discusses the economic effects of indexing the personal income tax. The analysis also explores inflation correction of capital assets as an alternative to capital gains tax relief. In the same chapter, income tax indexation is discussed as a way of making the economy more resistant to destabilizing shocks and possibly lowering the rate of inflation.

Because inflation is central to the problems faced by our economy, we feel the Committee should continue to explore various proposals designed to bring inflation under control. At our Midyear Hearings, a number of witnesses focused their testimony on the proposal for a tax-based incomes policy (TIP). Without recommending or endorsing

such plans of action, the Committee has included in Chapter III a brief analysis of the general proposition. At the same time, we recognize that such proposals are subject to a great deal of justifiable criticism from the points of view of equity, administrative feasibility, and political acceptability.

Finally, of course, our Review of the Economy, October 1978 meets the Committee's obligation to monitor and report changes in economic circumstances, and to update our forecast. In Chapter I, the surprises of the first half of the year are compared to earlier expectations. We also present revisions in the economic outlook for the near-term future. Although there have been important unforeseen events, the basic forecast of the pattern and rate of economic growth have not changed dramatically. Inflation is worse than we thought it would be; but happily, employment is better. As expected, real growth has been quite moderate. The rapid rate of inflation, however, has forced the Federal Reserve into a more restrictive monetary posture than we had anticipated. Inflation has also been a factor in the decision by Congress to reduce and delay a cut in taxes. Although consumers are increasingly burdened with debt and are likely to slow their rate of expenditure increase, business fixed investment gives strong signs of snapping out of the doldrums, and our balance-of-payments deficit is apparently beginning to respond to improved competitive conditions caused by the decline of the dollar.

If we can avoid a monetary crunch, and if we make reasoned and responsible tax and expenditure decisions, we just might be able to maintain the expansion of the economy. And if we develop a serious and effective

anti-inflation program that does not rely on demand restriction, we might make headway against inflation as well.

I. THE ECONOMIC SITUATION AND OUTLOOK

The recovery from the recession of 1974-75 continued in the first half of 1978, though at a modest pace, as real GNP grew at a rate of 4.2 percent. From the bottom of the recession in the second quarter of 1975 to the fourth quarter of 1977, real consumer spending rose at an annual rate of 5.3 percent and real business fixed investment rose at a rate of 6.6 percent. However, during the first half of 1978 these rates were 2.2 percent and 12.4 percent respectively. Thus the first half of this year witnessed a quite remarkable and welcome transition away from consumption spending toward greater relative reliance on investment for the support of continuing economic growth.

Regrettably, the outlook for the economy has deteriorated since we issued our *1978 Joint Economic Report* in March. 1/ At that time we considered the Administration forecast of 4.7 percent real growth in 1978 ambitious but within reason. Since that time the Administration has lowered its forecast to 4.1 percent. We concur in the need for downward revision and believe that a growth rate of 4 percent is the upper limit of what can be expected.

1/ *1978 Joint Economic Report*, *op.*. *cit.*, Chapter 2, pp 10-16.

The more pessimistic appraisal of the economic outlook stems in large part from policy changes that have occurred in response to the unanticipated rapid acceleration of inflation and to the sharp drop in the international value of the dollar. These factors have prompted the Federal Reserve to embark on a policy of monetary restriction that has moved interest rates steadily higher to levels far beyond earlier expectations. At the same time, slower growth of personal income will hold down consumer spending, a situation which is aggravated by the President's determination to limit Federal pay increases to 5.5 percent. The deteriorating inflation situation is causing Congress to pare back the Administration's original request for a $25 billion tax reduction to less than $20 billion and to delay its introduction by three months to January 1, 1979. And Federal spending is currently estimated to be substantially less than the levels which were approved in the second Concurrent Resolution on the 1978 budget. Therefore, both monetary and fiscal policy are more restrictive than we had anticipated in our March forecast, and this is the reason for lowering our forecast for real growth in 1978.

We are by no means unique in lowering our expectations for the remainder of this year. Table I-1 shows how several econometric forecasting services have revised their projections since January. The Wharton forecast has been revised downward since Dr. F. Gerard Adams testified before the Committee in June. 2/ Other analysts are also becoming more pessimistic. For example, Dr. Gary Fromm referred in his testimony to "the significant probability that another recession will occur beginning late this or early next year." 3/ Dr. Jay Schmiedescamp discussed the deterioration in consumer sentiment. 4/ And Dr. Henry Kaufman emphasized the volatility of our economic recovery coupled with a "dangerously high rate of inflation." 5/

2/ Testimony of F. Gerard Adams, 1978 Midyear Hearings of the Joint Economic Committee, June 28, 1978.

3/ Testimony of Gary Fromm, 1978 Midyear Hearings of the Joint Economic Committee, July 11, 1978.

4/ Testimony of Jay Schmiedescamp, 1978 Midyear Hearings of the Joint Economic Committee, June 28, 1978.

5/ Testimony of Henry Kaufman, 1978 Midyear Hearings of the Joint Economic Committee, June 28, 1978.

TABLE I-1

ECONOMETRIC MODEL FORECASTS FOR 1978

	Data Resources		Chase Econometrics		Wharton EFA	
	Jan. 1978	Aug. 1978	Jan. 1978	Aug. 1978	Jan. 1978	Aug. 1978
Real Growth Rate	4.5	3.9	3.9	3.6	4.9	3.8
Inflation Rate	6.0	7.2	5.9	7.4	5.6	7.3
Unemployment Rate	6.6	6.1	6.7	6.1	6.8	6.0

Source: Data Resources, Inc.
Chase Econometric Associates, Inc.
Wharton Econometric Forecasting Associates, Inc.

Of course, a consensus among forecasters is no guarantee of correctness. The experience of recent years has shown forcefully that our ability to predict the future is quite limited. Nevertheless, it is necessary to do our best to anticipate economic events and to plan accordingly. Our confidence in our own views is strengthened by the fact that different forecasters have approached the problem with different theories and different methods but have all reached roughly the same conclusion.

Domestic Developments in 1978

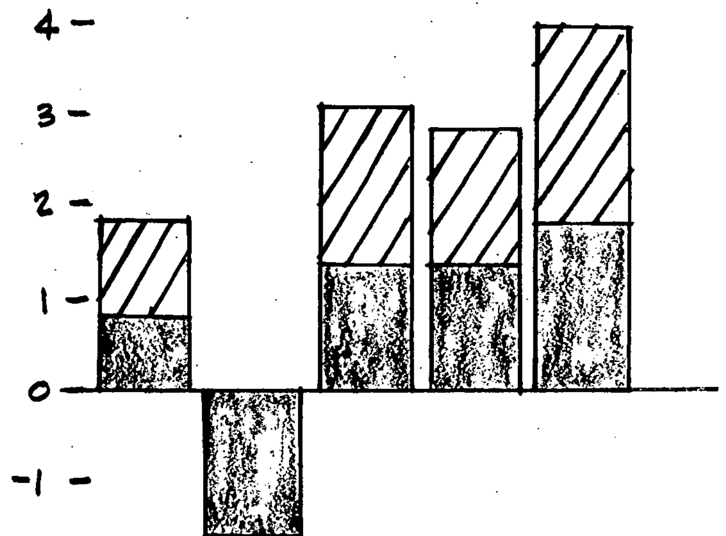
A review of some of the major economic developments of 1978 can provide important information about the likely behavior of the economy next year.

The most surprising event of the last 12 months has been the spectacular rise in civilian employment. Roughly 2 to 2.5 million new jobs are created in a normal year. But from the second quarter of 1977 to the second quarter of 1978, employment expanded by 4 million, and the unemployment rate dropped a full percentage point to the neighborhood of 6 percent.

The employment gains in the first half of 1978 were widespread. The increase in employment was particularly sharp among adult women. Thus, despite very large increases in labor force participation, the unemployment rate for white adult women dropped from 6.0 to 5.3 percent between the fourth quarter of 1977 and the second quarter of 1978, while the rate for nonwhite adult women fell from 11.8 to 10.9 percent.

Chart I-1

12 MONTH CHANGES IN NET EMPLOYMENT (MILLIONS)



'73/III-'74/II '74/II-'75/II '75/II-'76/II '76/II-'77/II '77/II-'78/II

FEMALE: [hatched] MALE [shaded]

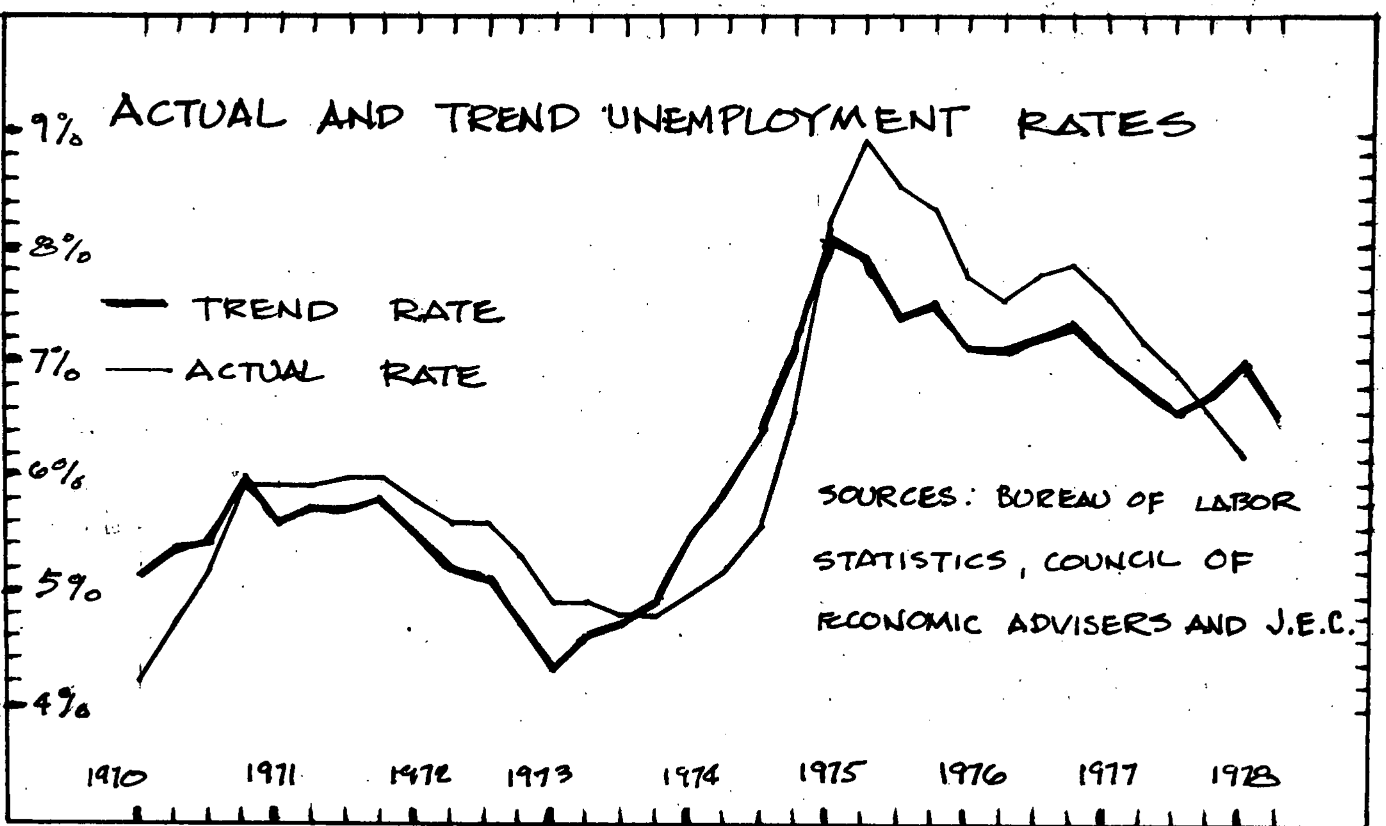
SOURCE: BUREAU OF LABOR STATISTICS (NOT SEASONALLY ADJUSTED)

Adult men also made substantial gains during the first half of the year as their unemployment rate dipped below 4.0 percent in June for the first time since 1974. This improvement was shared by both whites and nonwhites alike: the unemployment rate for white adult men fell from 4.2 percent in the fourth quarter of 1977 to 3.5 percent in the second quarter of 1978, while the unemployment rate for nonwhite adult men fell from 10.1 to 8.5 percent. And teenage unemployment, which had exceeded 20 percent during the mid months of 1975, finally fell below 15 percent in mid-1978. Unfortunately, this increase in teenage employment was not shared by nonwhite teenagers whose unemployment rate remains mired in the 35 to 40 percent range.

Some success was achieved in reducing structural unemployment during the first half of 1978. The number of persons unemployed for 15 weeks or longer decreased by about 500,000, a reduction of 27 percent. The reduction has been reasonably balanced between men and women and whites and nonwhites, but it is clearly adults who have benefited rather than teenagers. Only 20.2 percent of those now unemployed have been unemployed for more than 15 weeks. This is the lowest percentage in several years.

Surprisingly, by comparison with the dramatic drop in the unemployment rate, the growth in real output has been very modest. Indeed, on the basis of "Okun's Law" which requires output to grow at about 3.5 percent just to hold the unemployment rate constant, we would have expected a much smaller reduction in the unemployment rate than occurred during the last quarter of 1977 and the first half of 1978. This is illustrated in Chart I-2 where the unemployment rate

Chart I-2



derived by using Okun's Law is above the actual unemployment rate over this time period.

Okun's Law, of course, is not a precise relationship. However, as Chart I-2 shows, the unemployment rate implied by that law, over the past few years has remained very close to the actual unemployment rate. For reasons that are not at all clear, the recent slow growth in output has been reflected in very poor productivity performance rather than in slower growth of employment. If productivity advances normally, such as is implied by the present shift from consumption to investment, Okun's Law predicts that the unemployment rate will stabilize at between 6.0 and 6.3 percent for the remainder of the year.

In summary, the various factors that determine the outlook for employment suggest that it is highly unlikely that we will experience employment gains such as those of the past year. Rather, we will be fortunate if we maintain the gains that have been achieved. It would not even be surprising to see the employment situation deteriorate somewhat in the near future.

One of the most promising developments of the first half of the year is the long-awaited revival of capital spending. Real nonresidential fixed investment grew at an annual rate of 5.3 percent in the last half of 1977, but accelerated to a rate of 12.4 percent in the first half of 1978. And after remaining flat for almost a year, investment in nonresidential structures jumped 8.8 percent in the second quarter. Overall, capital spending has finally moved above its prerecession peak of early 1974.

The key question is whether this investment revival will continue. Among the favorable factors are strong second quarter profits and rising operating rates that are now within 2 percentage points of their prerecession peaks. On the other hand, rising interest rates and rapid inflation pose very serious threats to the further progress of capital spending.

Interest rates have been rising rapidly all year. In past years, comparable increases would have caused depositors to remove their funds from thrift institutions -- which are limited by law with respect to the interest they may pay -- and this process of "disintermediation" would have dried up mortgage credit and caused housing starts to drop. Recently the Federal Reserve has permitted thrift institutions to issue nonnegotiable six-month money market certificates with interest rates that vary with and are equal to or above the Treasury bill rate. This innovation has altered the distribution of the supply of credit. In particular, investors have been able to change the composition of their portfolios without creating the shortage of mortgage funds that normally accompanies rising interest rates. These new certificates combined with a robust secondary mortgage market provided by the Federal Government have kept housing starts strong throughout 1978.

It is important to note that while the new money market certificates have altered the distribution of credit in the economy, they have done nothing to increase its overall availability. In previous years housing tended to bear the brunt of high interest rates because housing could not successfully compete for funds. However, this burden will

now be shared by other forms of interest-sensitive expenditures. Therefore, while housing may continue to remain strong throughout 1978, this may come at the expense of nonresidential investment.

Inflation clouds the investment outlook in a number of ways. Many businessmen claim to be pessimistic because they continue to fear that wage and price controls will be reimposed. Inflation adversely affects the supply of savings because the practice of taxing nominal capital gains causes the rate of tax on real capital gains to be raised, sometimes to over 100 percent. Perhaps most important -- and as explained in Chapter III -- inflation causes nominal profits to be overstated because of tax laws that require physical capital to be expensed on an historical cost basis only. As a result, real profits are overtaxed so that real after-tax profits and the real rate of return on new investment are both reduced by inflation.

The testimony presented to the Committee, various capital spending anticipation surveys, and other pertinent information lead us to conclude that investment will be much weaker in the second half of 1978 than it was in the first half. The Commerce Department's survey of intentions, which forecasts growth of 5.5 to 6.0 percent for 1978 as a whole, is perhaps too pessimistic. We consider a range of 7.0 to 7.5 percent to be a more reasonable expectation.

With the exception of 1976 the performance of productivity in the private business sector has been exceedingly disappointing, proceeding at an average annual rate of only 1.1 percent during the 1973-77 period. The productivity performance this year has been

even worse. Under the impact of the coal strike and severe winter weather, output grew more slowly than expected. However, because employment continued to grow rapidly, productivity declined at an annual rate of 2.0 percent in the first half of the year.

The poor performance of productivity combined with an increase in labor compensation of 11.9 percent caused unit labor costs to rise at a rate of 17.4 percent in the first quarter. The compensation figure is bloated by such factors as an increase in the legal minimum wage and increases in employer payroll taxes for social security and unemployment insurance, so that the first quarter figures do not reflect the true trend of compensation and unit labor cost. Nevertheless, in the second quarter unit labor costs rose at a rate of 7.2 percent, which is well in excess of the 6.5 percent of 1977. There is, therefore, little doubt that the underlying rate of inflation has increased.

Although first quarter effects are frequently described as "one-time" compensation increases, the fact is that they happen almost every year. 1979 will be no exception. An even larger boost in social security taxes is scheduled, with the maximum taxable base rising from $17,700 to $22,900, and the combined employer-employee tax rate rising from 12.1 to 12.26 percent. The employer share will add about $5.2 billion to the wage bill. The minimum wage will rise from $2.65 per hour to $2.90 per hour, and this will add $1.4 billion directly to the wage bill. According to the Bureau of Labor Statistics, some 5.2 million workers will be directly affected by the minimum wage increase in 1979, compared to this year's 4.6 million. The combined effect of these tax

and minimum wage increases is expected to add about 2.3 percentage points to the overall annual rate of increase in labor compensation in the first quarter of 1979.

The price outlook for the remainder of the year is not favorable, although a slowing in the rate of increase of food prices may hold consumer price increases below the 10.4 percent rate of the first half of the year. However, categories other than food were also up sharply. The component for consumer commodities excluding food of the Consumer Price Index rose at a rate of 6.6 percent in the first half of the year and the services component rose at a 10.4 percent rate. Producer prices have also increased for a wide variety of categories. The overall index of producer prices rose 11.1 percent in the first half of the year, with industrial commodities up 8.3 percent and finished goods up 10.4 percent. It is abundantly clear that the Administration has no chance at all of achieving a deceleration in the inflation rate below the average of the preceding two years. Instead, consumer prices, which increased 6.5 percent in 1977, are likely to increase at least 7.5 percent in 1978.

Developments in the Current Account of the Balance of Payments

Turning to the international picture, the deteriorating foreign trade position of the United States and the accompanying decline in the value of the dollar have caused a great deal of concern. The Committee shares these concerns -- largely because balance-of-payments problems are interfering with the appropriate conduct of domestic economic policy. A careful evaluation is necessary to properly assess the impact of external

33-958 O - 78 - 3

developments on our economy and a considerable portion of this report is therefore devoted to an analysis of international monetary problems. This section provides the background information needed for that analysis.

The recent history of United States foreign trade is summarized in Table I-2. Net exports declined from a surplus of $20.4 billion in 1975 to a deficit of $11.1 billion in 1977. The deficit then reached an annual rate of $24.1 billion in the first quarter of 1978, but improved to $10.2 billion in the second quarter. The deterioration of our merchandise trade balance was even stronger as the deficit reached an annual rate of $44.8 billion in the first quarter of 1978; in the second quarter it improved to $31.2 billion. On the basis of the figures published in July and August, the merchandise trade balance improved further still in the third quarter running at an annual rate of $27.6 billion. United States imports of petroleum products have increased dramatically since 1975, reaching an annual rate in excess of $43 billion in the second quarter of 1978.

TABLE I-2

SELECTED U.S. FOREIGN TRADE STATISTICS
1973-1978/II
(Annual Rates, Billions of Dollars)

	(1) Merchandise Trade Balance	(2) Exports of Goods and Services	(3) Imports of Goods and Services	(4) Net Exports of Goods and Services ((2) - (3))	(5) Imports of Petroleum Products
1973	0.9	101.6	94.4	7.1	8.4
1974	-5.4	137.9	131.9	6.0	26.6
1975	9.1	147.3	126.9	20.4	27.0
1976	-9.3	163.2	155.7	7.4	34.6
1977	-31.0	175.5	186.6	-11.1	45.0
1978/I	-44.8	181.7	205.8	-24.1	39.6
1978/II	-31.2 p	200.9 r	211.1 r	-10.2 r	43.2 r

p = preliminary r = revised
Source: Department of Commerce, Bureau of Economic Analysis.

It is generally thought that an export surplus is an indication of economic strength, whereas a deficit is viewed as a sign of weakness. A deficit suggests that a country is uncompetitive in world markets; that it provides fewer jobs for its own citizens and more for foreigners; and that it causes the value of its currency to fall on foreign exchange markets and permits foreigners to acquire its goods and capital assets on the cheap. Although it is true that deficit countries have frequently suffered from sluggish productivity growth and high rates of inflation, it must be emphasized that the view that a trade deficit is invariably a sign of economic weakness is a pervasive and harmful fallacy.

In general, the demand for imports tends to rise if the country has a relatively rapid rate of inflation and/or if it has a relatively rapid rate of real economic growth. In the former case the rise in imports reflects a weakness, namely, the inability to control inflation, but in the latter case the rise in imports is the product of economic strength. Similarly, declining exports may be due to a loss of competitive edge because of inflation and poor productivity performance, but it could also be due to sluggish economic growth abroad. Thus the weaknesses that cause imports to rise and exports to stagnate could be local in origin, they could be foreign in origin, or they could be some of both. In any case, no *a priori* generalization can be made about the relationship between a trade deficit and the economic strength or weakness of any particular economy.

There is considerable evidence which supports the view that the changing distribution of current account surpluses and

and deficits worldwide over the past few years has been largely the result of disparate growth and employment policies pursued by different industrial countries. As shown in Table I-2, the United States had a surplus in its net exports -- even after paying for its oil imports -- through 1976. However, thereafter U.S. imports grew rapidly, while exports stagnated. The reason is that the United States has recovered more rapidly from the recession of 1974-75 than Germany and Japan. That is the single most important cause of our present trade deficit.

The differences in the real growth rates of the United States and the other major industrialized countries are shown in Table I-3. With the sole exception of the United States, the average real growth rates of all the major industrial countries in 1976-77 were substantially below their averages for the 1960-73 period.

TABLE I-3

GROWTH RATES OF REAL OUTPUT OF SELECTED INDUSTRIAL COUNTRIES

	1960-73 Annual Average (percent)	1976-77 Annual Average (percent)
United States	4.1	5.4
Germany	4.5	4.0
Japan	10.3	5.5
France	5.4	4.1
United Kingdom	3.1	1.7
Canada	5.6	3.7

Source: The Organization for Economic Cooperation and Development.

A narrowing of the growth differentials of the major industrialized countries in 1978 and 1979 would improve the U.S. current account. How much of an improvement, however, can we expect? In testimony before our Committee, Dr. Rudiger Dornbusch replied to this question as follows:

> If fiscal measures raised real spending in non-U.S. industrial countries by an average of 1/2 percent the effect would work out to perhaps as much as a one percent increase in the rest of the world real GNP. How much of a current account improvement could the U.S. expect from such a move? Real exports no doubt would increase with differences across commodity categories that average out to one percent or one and a half percent on the high side. There is some offset, however, from increased raw material prices including the possibility of a rise in real oil prices. Taking this into account, the resulting current account improvements may be as small as one or two billion dollars. 6/

6/ Testimony of Rudiger Dornbusch, 1978 Midyear Hearings of the Joint Economic Committee, July 18, 1978.

This conclusion suggests that a small change in growth rate differentials will not cause any large change in our current account in any particular year. However, a sustained increase in foreign growth rates relative to those in the United States will cumulate over time into a significant improvement in our current account. Thus, given the growth prospects of the United States and the other industrialized countries, we feel it is reasonable to expect a steady improvement in our current account over the next few years.

We believe it is fair to conclude that it has been the relative strength of our economy, not its relative weakness, that has been the source of much of the decline in our net exports.

The second factor that must be considered in evaluating our trade statistics concerns oil imports. While the need for an energy policy is not in dispute, we should recognize that the oil deficit arises in large part from the fact that the Organization of Petroleum Exporting Countries (OPEC) as a group do not have sufficient absorptive capacity to utilize the full amount of the proceeds from their oil sales to purchase imports. If they did have this capacity, our export sales would expand, and this would permit us to pay for our oil. However, since they do not have the absorptive capacity, they must run a surplus on current account, which means someone else must run a deficit. In 1974 and 1975, this deficit was largely shouldered by the developing nations. Since that time, the burden has shifted to a considerable extent to the United States.

There are constructive ways of dealing with our oil import problem. However, attempts to reduce oil imports by quotas and other devices are not among the constructive measures. And we reject outright one of the most effective ways of all of reducing oil imports -- another deep recession. This is not to say that we are opposed to the adoption of a strong energy policy that will spur domestic production and reduce consumption. However, we doubt that current legislation will have much of an impact on our oil imports.7/ For example, the imposition of a crude oil equalization tax could at best reduce U.S. oil imports by about 500,000 barrels a day.

7/ Senator Ribicoff states: "I strongly disagree with this assessment. While the various components of the pending energy legislation offer no simple solutions, we can no longer treat the energy crisis as a short-term problem. Energy savings will be achieved and our dependence on expensive foreign imports will be reduced. The cost of imported oil, for example, has increased tenfold in just five years. We cannot afford to spend $45 billion annually for imported oil.

Furthermore, failure to take decisive action on the energy crisis is a symbol to the entire world. Our Western European and Japanese trading partners, for example, are starting to believe that the United States lacks the political will to develop and to implement a comprehensive energy program. In the absence of a meaningful energy program there is fear that oil imports will accelerate, that the large trade deficit will continue well into the next decade, and that the dollar will fall still further. We must

Senator Ribicoff's footnote continues:

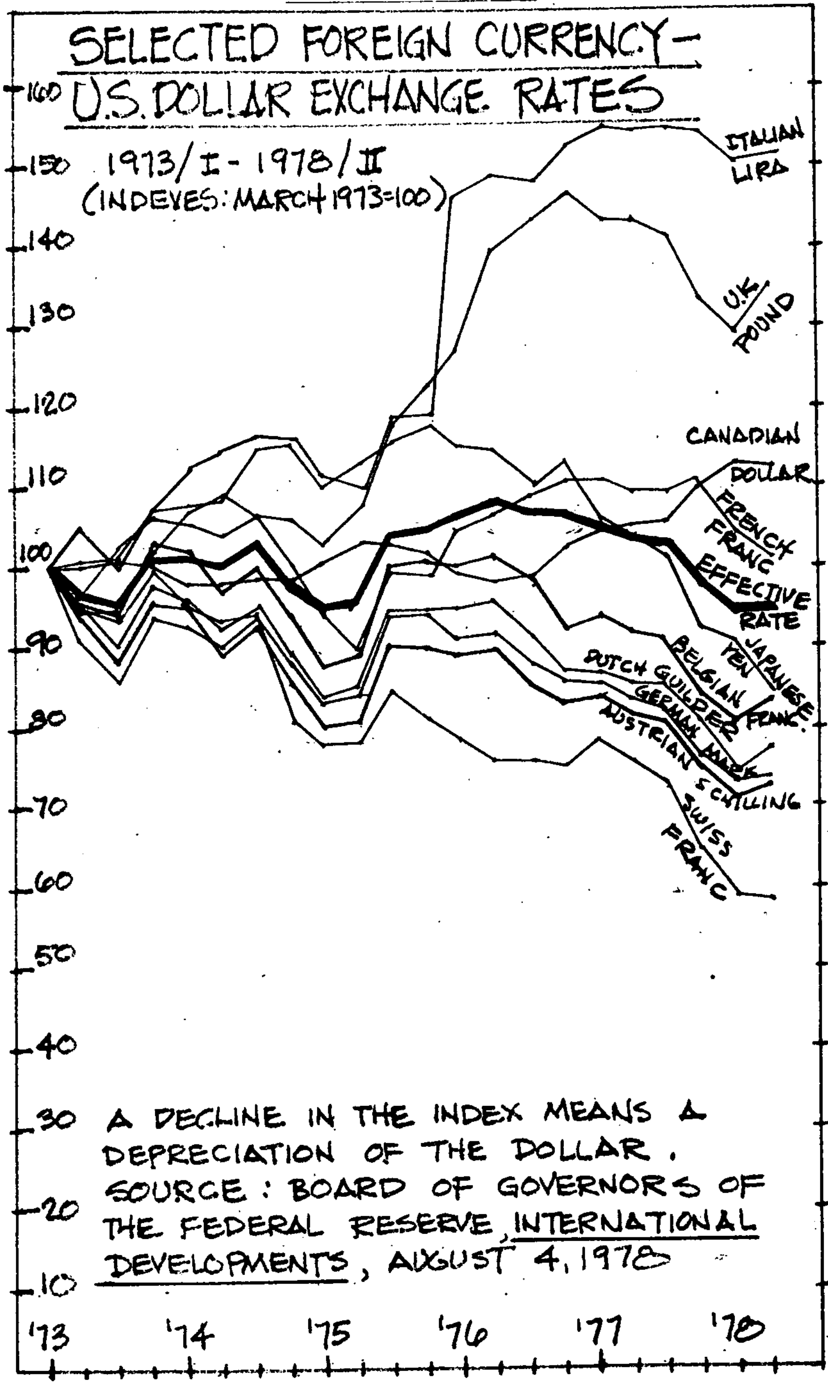
make clear to the world that we are capable of developing an energy program and enact the pending components of the national energy plan.

A third important influence on the U.S. current account has been the decline in the value of the dollar on the foreign exchanges. Generally, a reduction in the foreign exchange value of the dollar will cause the U.S. current account to improve because it cheapens our export goods abroad and makes imported goods more expensive. However, in assessing the current account impact of a decline in the dollar, we need to proceed very cautiously.

In the first place, the decline in foreign exchange value of the dollar has been nowhere near as dramatic as is commonly believed. The dollar has fallen sharply relative to the deutsche mark (DM) and the yen (39 percent and 40 percent respectively since March 1973), but these reductions vastly overstate the decline of the dollar relative to the currencies of all U.S. trading partners. Thus, whereas the U.S. dollar has declined in value relative to the DM and yen, it has increased in value relative to the Canadian dollar and the U.K. pound since 1973. Since we import and export goods from a wide variety of countries, it makes more sense to look at the trade-weighted change in the foreign exchange value of the dollar. Using the Federal Reserve Board's trade-weighted exchange rate index, the dollar has declined by only 10 percent since March 1973 to date (August 31, 1978). The decline has not been steady however. The dollar rose in value between March 1975 and June 1976. Since June 1976 it has declined in value by 19 percent.

These statistics cannot be used to measure the change in the relative competitive position of the United States in world markets because at least part of the change in the foreign exchange value of the dollar is attributable to differences in the U.S.

Chart I-3



inflation rate and those of her trading partners. If United States prices rose by 5 percent more than foreign prices, a 5 percent decline in the trade-weighted value of the dollar would leave the competitive position of the United States unaltered. Adjusting the U.S. trade-weighted exchange rate by relative inflation rates provides a more accurate measure of the real depreciation of the U.S. dollar. Such an adjustment is made in Table I-4, using both relative Wholesale Price Index (WPI) and Consumer Price Index (CPI) changes.

The data in Table I-4 suggest that there has been a fairly substantial increase in the relative competitive position of the United States since March 1973. After adjusting for differences in inflation, the dollar has fallen 10 to 17 percent relative to the currencies of our trading partners. Between March 1973 and June 1976, there was a substantial amount of fluctuation, but our competitive position has improved steadily over the past two years.

It is important to note that the above-described exchange rate changes are, at best, crude measures of competitiveness. For example, it makes a great deal of difference whether the exchange rates are adjusted by the WPI or the CPI. The CPI-adjusted rates show an improvement in our competitive position that is more dramatic than the WPI-adjusted rates. Moreover, since what matters is the relative price of tradable goods, we really need measures of price change that are less comprehensive than the WPI or the CPI. Such measures have not been developed, so considerable caution must be exercised in the use of these numbers. Nevertheless, we are

TABLE I-4

TRADE-WEIGHTED
AVERAGE REAL EXCHANGE RATE CHANGES
OF THE U.S. DOLLAR
(Percent Decline (-) or Increase (+)
since March 1973)

	WPI Adjusted	CPI Adjusted
1973 - June	-1.6	-4.1
- December	-1.7	+0.6
1974 - June	-6.0	-2.3
- December	-1.4	-4.0
1975 - June	-4.9	-10.1
- December	+3.8	-2.1
1976 - June	+4.0	-1.4
- December	+0.9	-4.6
1977 - June	+0.3	-6.1
- December	-4.2	-11.5
1978 - March	-6.2	-14.6
- June	-5.8	-13.7
- August	-9.8	-17.3

Source: Board of Governors of the Federal Reserve System.

persuaded that there has been a fairly substantial increase in the relative competitive position of the United States.

Although the gain in competitiveness reflected in these figures promises to cause an ultimate improvement in the U.S. current account, there are several reasons why the immediate improvement may not be substantial. The first has to do with what has been called the J-curve effect. In response to a change in relative prices, the current account may change in a manner that looks like a J-curve -- first down, then ultimately up.

Depreciation has both price and quantity effects. The price effects occur immediately but the quantity adjustments take place with a lag. Thus, the dollar value of imports rise by more than the dollar value of exports causing the current account to deteriorate. Subsequently, however, traders adjust to the price changes so that the volume of imports decreases while the volume of exports increases. When these lagged quantity effects begin to predominate, the current account begins to improve and the upward sloping part of the J-curve is reached. Empirical studies of the timing of quantity adjustments suggest that it may take two or more years before much of an improvement in the current account can be expected.

The increase in the relative competitiveness of the United States will also tend to be reflected in a larger volume of direct investment on the part of foreign producers. For example, if dollars are cheap relative to marks, it will pay Volkswagen to provide cars to the American market by building a plant in the United States rather than by producing cars in Germany for export.

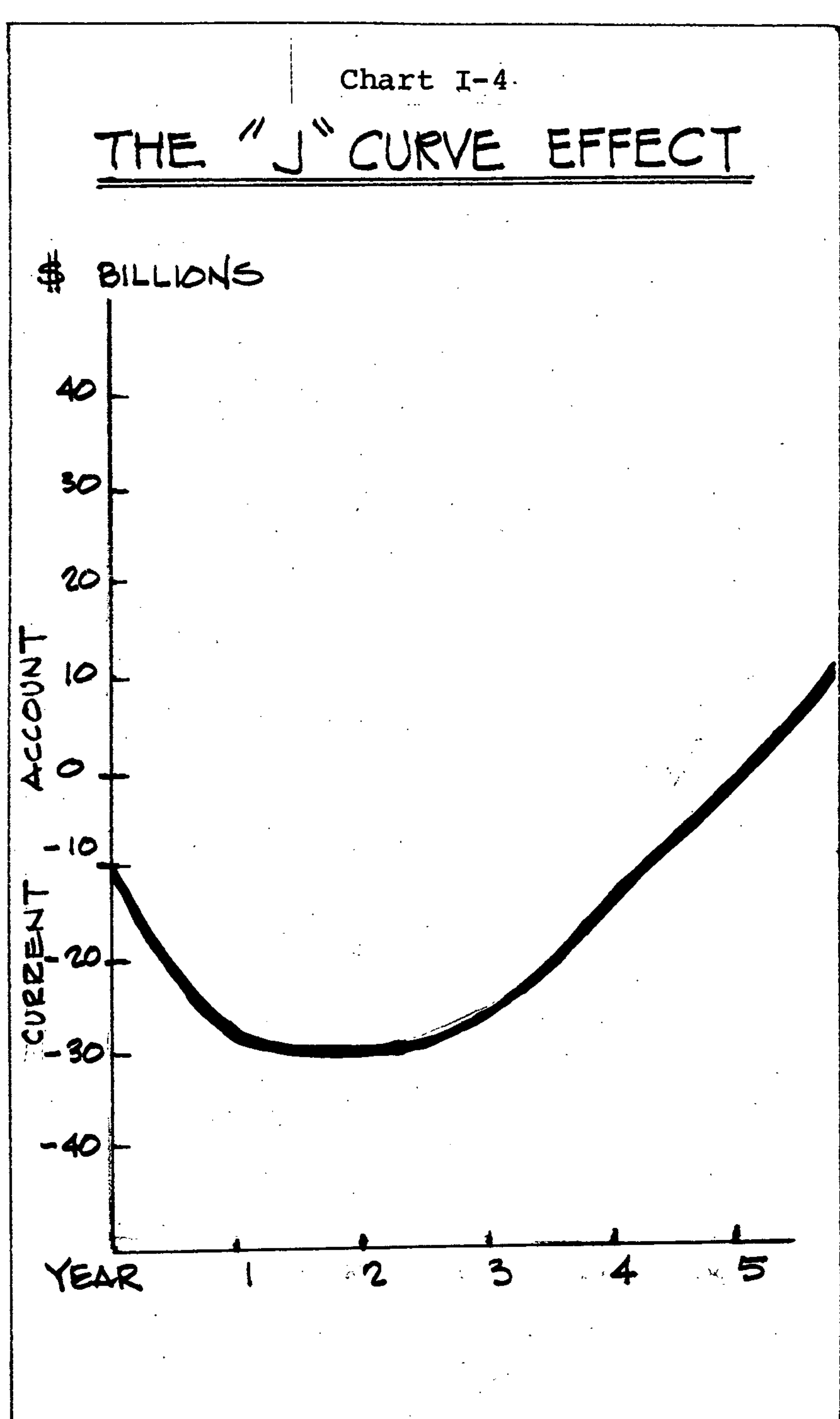


Chart I-4
THE "J" CURVE EFFECT
$ BILLIONS
CURRENT ACCOUNT
40
30
20
10
0
-10
-20
-30
-40
YEAR
1
2
3
4
5

Finally, exporters are sometimes willing to reduce their profits by absorbing part of the exchange costs in order to maintain their share of the market. For example, as the value of the dollar falls against the yen, a Japanese producer of autos might reduce the yen price of his exported cars so that the dollar price would rise less than the exchange rate would indicate. The exporter would try to maintain his share of the auto market hoping that the fall in the dollar is only temporary. When it becomes clear that the change is permanent, profit margins can no longer be squeezed, and the dollar price must rise to reflect the new exchange rate.

These forces have been at work in the past couple of years. Therefore, we should start to see some real improvement in the current account in the very near future. We believe it is realistic to expect a net export deficit of only $15 billion for 1978, despite the fact that it is currently running at an annual rate in excess of $17 billion. The prospects for a further improvement in 1979 are discussed below.

Public Sector Outlook in 1979

There is little that policy can do to influence economic performance during the remainder of the year. However, the decisions that are made now will determine whether economic growth can be sustained throughout 1979. Fear of inflation has produced a conservative policy climate. Probably the best that can be hoped for is that policy -- especially monetary policy -- will not become excessively restrictive, so that a recession can be avoided.

33-958 O - 78 - 4

Fiscal Policy

At the time this report was prepared, Congress had not completed this year's income tax legislation. We anticipate that a tax cut between $16 and $20 billion, effective January 1, 1979, will be approved. Unfortunately, a reduction of this magnitude will fall short of canceling out other tax increases that will occur in 1979. Inflation and real growth will push taxpayers into higher tax brackets, producing approximately $13 billion of "fiscal drag." In addition, social insurance taxes will rise about $10 billion. Therefore total tax increases of $23 billion measured against a tax reduction of $16 to $20 billion imply that tax policy will be mildly restrictive in 1979.

Examination of the full employment budget also indicates that fiscal policy will become more restrictive. As shown by Table I-5, the full employment budget would move from a deficit of about $5.5 billion in 1978 to a surplus of about $18 billion in 1979 if there were no tax cut. With the tax cut, the full employment budget will be roughly balanced in 1979. The movement from a small deficit to balance means that even with a tax reduction, fiscal policy will be more restrictive next year.

TABLE I-5

FULL EMPLOYMENT BUDGET ESTIMATES
NATIONAL INCOME AND PRODUCT ACCOUNT BASIS
(Billions of Dollars, Annual Rates)

	78:1	78:2	78:3	78:4	1978 Average	1979:1	79:2	79:3	79:4	1979 Average
Receipts *	429.8	447.3	459.6	473.9	452.7	496.3	511.7	525.9	542.3	519.1
Expenditures	443.5	445.8	463.9	476.6	457.3	483.8	492.6	507.5	520.7	501.2
Surplus (+) or Deficit (-)	-13.7	-1.5	-4.3	-2.7	-5.6	+12.5	+19.1	+18.4	+21.6	+17.9

* Assumes no tax cut.
Source: Joint Economic Committee

Monetary Policy

We have no way of knowing how the Federal Reserve Board will conduct monetary policy in the months ahead. In his testimony before the Committee in late June, Federal Reserve Board Chairman G. William Miller expressed satisfaction with the growth performance of the economy in the first half of the year and stated that he anticipated continuation of moderate, but satisfactory, growth for the remainder of 1978 and for 1979. He went on to add that "inflation must be characterized as our highest priority economic problem." 8/

8/ Testimony of G. William Miller, 1978 Midyear Hearings of the Joint Economic Committee, June 29, 1978.

Translating these subjective statements into a numerical forecast for monetary policy is perilous. Nevertheless, it seems safe to assume that the weakness of the dollar and the recent acceleration of inflation will cause the Federal Reserve to continue to place primary emphasis on inflation control as long as no sharp deterioration in production and employment takes place. Certainly this seems to have been the case thus far. While output has grown almost 4 percent and the unemployment rate has held steady in the neighborhood of 6 percent, short-term interest rates have increased 1 percentage point or more, and long-term rates have risen about one-half percentage point.

Since we are not expecting a recession but do expect a continuation of inflation, it is reasonable to assume that monetary policy will continue to be restrictive and that the high interest rates we have been experiencing will continue for the rest of the year and possibly into 1979. We can only hope that the rising trend in interest rates will halt soon. Unfortunately, there are lengthy lags before a change in monetary policy affects spending, so that unless the policy is reversed well before production begins to slow down, the result will very likely be a more drastic slowing of growth than planned, and a possible recession.

Inflation Policy

For the past year the Administration has pursued a two-pronged antiinflation policy. One part consists of monitoring by the Council on Wage and Price Stability (COWPS) of government actions which have an adverse impact on the price level. The other part is a jawboning policy that asks business and

labor to limit their price and wage increases to less than the average increases of the past two years. As readily admitted by Barry P. Bosworth, Director of COWPS, the anti-inflation program has thus far, and on balance, been a failure. Chapter III of this report contains a discussion of some fundamental alternatives that should be considered for adoption in the war against inflation. Here our purpose is to review the Administration's current policy efforts.

Despite the recent rise in the inflation rate, price monitoring by COWPS appears to have had some beneficial effects. Since January, COWPS has issued numerous reports analyzing the inflationary impact of proposed government activities. For example, COWPS estimated that a quota proposed by the International Trade Commission (ITC) on imported television sets would cost consumers an additional $43 per set. COWPS went on to estimate that each additional domestic job created by the reduction in imports would cost consumers $53,000. The President disapproved the ITC recommendation, presumably in response to the COWPS analysis. Similarly, in July COWPS opposed protective action to limit meat imports because this would have cost consumers about $500 million in higher prices. The ITC found that imports were not the cause of the difficulties encountered by the domestic meat industry and ruled against the proposed restrictions. COWPS may also have had an impact on the Occupational Safety and Health Administration's (OSHA) cotton dust control standards. When Labor Secretary Marshall announced the standards in June, he was careful to note that although there are costs associated with the standards, the costs had been reduced 75 percent from the original estimates.

In other areas, COWPS' evaluations have had little effect. Despite warnings that raising the support price of milk to 80 percent of parity would cost consumers and taxpayers over $900 million and add 0.2 percentage points to the Consumer Price Index for food, the higher level of price supports went into effect. Repeated recommendations to change the Interstate Commerce Commission's restrictive and wasteful regulations of the trucking industry have fallen on deaf ears.

A variety of proposals are now under consideration that would be inflationary if implemented. The Food and Drug Administration's proposed saccharin ban, which COWPS estimates would cost consumers over $100 million per year, is undergoing further study. The proposed restriction on sugar imports, which COWPS claims would cost consumers $2.4 billion annually and add a full percentage point to the CPI for food, is also still under consideration.9/ The ITC is considering a quota on copper imports, which COWPS says would cost several hundred million dollars per year. And the Department of Labor has proposed to expand the minimum wage coverage to presently exempted executive and administrative employees. The cost in added labor compensation is estimated to be $500 million.10/

9/ Congressman Long points out that various estimates of the inflationary impact of restrictions on sugar imports have ranged from less than $1 billion to more than $6 billion. However, Congressman Long states that there is good reason to believe that the actual cost involved will not even approach the estimates issued by COWPS. He therefore demurs from the suggestion that such restrictions are greatly inflationary.

10/ All of the estimated costs contained in the preceding paragraph are derived from various reports issued by the Council on Wage and Price Stability. The Joint Economic Committee has undertaken no independent verification of the COWPS' estimates.

While we are encouraged by the limited success of COWPS in bringing the inflationary consequences of government action to the attention of the public and government officials, we believe that there is substantial scope for strengthening COWPS and broadening its activities. Even though the Government is not generally an active participant in collective bargaining, it has a responsibility to monitor wage negotiations and to make their inflationary consequences known. COWPS' report on the labor settlement in the bituminous coal industry was very useful. Such efforts should be expanded, and we urge the President to support COWPS as it monitors wage and price developments. We also note that many of COWPS' efforts in the regulatory area are long-range programs which must be pursued for several years before they begin to bear fruit.

The jawboning effort of the Administration has been notable for its lack of success. An appreciable slowing in the rate of wage inflation is not to be expected in view of the acceleration of price inflation, the heavy bargaining calendar which lies ahead, and the recent willingness of the Administration to accept an inflationary settlement in order to end the coal strike.

To summarize: Government policy will contribute little to economic growth in 1979 and the main burden of inflation control will fall once again on the Federal Reserve. Fiscal policy will be neutral at best, and in all probability mildly restrictive. Monetary policy will be dominated by concern with inflation and the international condition of the dollar, and will therefore be restrictive. High interest rates can be expected to continue into 1979. The Administration's anti-inflation policy may

moderate the amount which the Government itself contributes to inflation, but it will do little to slow inflation in the private sector.

Private Sector Outlook for 1979

A wide range of opinion with respect to the outlook for 1979 prevails. The Administration anticipates above-trend growth, while some private forecasters are expecting a recession. In view of these wide differences, a detailed look at the components of demand is in order.

Consumption

Until the first half of this year, consumers had provided most of the impetus for recovery. Although the slowdown in the first half of 1978 was quite marked, many forecasters expect even further weakening in 1979. Some forecasters emphasize the steady increase in consumer debt and therefore forecast a retrenchment in consumer spending. It is true that consumer saving has fallen and installment debt has risen. The personal saving rate fell from 7.7 percent of disposable income in 1975 to 5.7 percent in 1976, and to 5.1 percent in 1977. A large fraction of consumer outlays has been on durable goods. Well stocked with durable inventories, consumers could easily reduce or postpone further purchases.

Other forecasters take a more sanguine view, anticipating that consumption will keep pace with income growth and that anticipated inflation will produce a buy-now psychology. They argue that despite high interest rates and high levels of consumer debt, the share

of dispoable income allocated to the interest payments necessary to service the debt has changed very little. In 1975 consumers spent 2.1 percent of their disposable income on interest. In 1978 they will spend about 2.3 percent. The reason for this lack of growth is the tendency to finance debt over a longer period of time. Therefore even though debt is high, consumers still find the burden manageable. This suggests that retrenchment need not occur either suddenly or sharply as long as high levels of employment and growth of income are maintained.

Our own expectation is that personal disposable income will grow at a rate of about 3.5 percent in real terms in 1979. Some small degree of retrenchment by consumers is to be expected so that consumption will grow at a slightly slower rate and the saving rate will show a moderate rise.

Investment

The recent pickup in business fixed investment, particularly in structures, has been most welcome. As much as we would like to see the revival continue, we do not consider this a realistic expectation. We anticipate that the combination of continuing inflation and high interest rates will cause real fixed investment in 1979 to grow less rapidly than in 1978. If the recent weakening in new durable goods orders continues, it would indicate a slower level of investment activity beginning early next year.

Housing has remained strong for reasons already noted. Since the 22-30 year age group will be growing, the underlying source

of new housing demand will continue and housing starts will remain in the 1.5 to 2.0 million units range. Homebuyers have shown that they are willing and able to compete with other borrowers as long as funds are available. Nonetheless, tight money poses a threat to housing as it does to other components of investment spending.

Inventory investment has proceeded in a smooth and normal manner during the current recovery. The absence of overbuilding of stocks is a major reason why a sharp swing in economic activity is not expected in 1979. The high cost of maintaining inventories undoubtedly helps to account for cautious inventory policies, and the current moderate level of stocks suggests that a slowing of consumption will not cause a sharp unwanted accumulation and subsequent liquidation of inventories.

In summary: we do not expect gross private domestic investment to be a strong source of economic growth in 1979, but neither do we expect it to be an important source of instability.

Net Exports

It has become increasingly apparent that any analysis of the U.S. economic outlook must pay careful attention to international economic developments. Exports and imports have grown rapidly relative to GNP and now represent roughly 10 percent of the total -- almost as much as business fixed investment. The importance now placed on international economic problems is demonstrated by a continuing series of economic summit meetings among our top government officials, and it is also reflected in this Report, which places

major attention on international monetary problems.

Unfortunately, the outlook for the international economy which comes from a dispassionate evaluation of world economic trends is pessimistic. The year 1977 was characterized by sluggish growth worldwide. This has continued through the first half of 1978, and the near-term outlook suggests that there will be, at best, only a moderate improvement. Thus, according to the most recent economic survey conducted by the Organization for Economic Cooperation and Development (OECD), real GNP growth for the OECD area as a whole is expected to be only about 3.5 percent for the remainder of 1978 and for 1979.11/

11/ OECD Economic Outlook, No. 23, July 1978.

The economic growth in the member countries of the OECD will be dominated by the behavior of Japan, Germany, and the United States. We have already emphasized that the outlook for the United States is one of very modest growth through 1979. A similar outlook can also be reasonably forecast for Germany and Japan unless they each undertake more expansionary macroeconomic policies than presently contemplated. Their slow growth is in part the result of the fact that the sharp appreciation of their currencies over the past year or so has caused their competitive positions in the world markets to deteriorate. This has already had the effect of cutting into their real net export growth, and this trend is likely to continue through at least 1979.

The growth prospects for the developing nations are also less optimistic for 1978 and 1979. Slow growth in the industrial countries will imply a corresponding slow growth in the export earnings of the developing countries. Additionally, evidence is mounting which suggests that the debt problems of the developing nations are deteriorating, which could mean a paring down of their development programs.

The major issue for the United States is how much improvement we can expect in our trade position. The continuation of sluggish growth abroad will make it difficult to expand our exports. On the other hand, the fall in the value of the dollar has improved our competitive position, and as our growth rate slows, our demand for imports will slow as well. We expect these competitive factors to improve our net exports later this year and we expect the improvement to continue in 1979. Domestically produced goods will tend

to replace more expensive imports, and as time passes exporters will learn of the competitive advantage they can enjoy by moving into foreign markets.

Our net export deficit should be about $15 billion this year and fall to $10 billion in 1979. The decline in the deficit will provide a positive contribution to growth in 1979 since more jobs will be created through export growth than will be lost through import growth.

Prices and Wages

While we anticipate no major shocks or unusual disturbances in 1979, rapidly rising unit labor costs place an effective floor under the rate of inflation. In the past few years this floor has gradually risen from the 5 to 6 percent range to its present 7 to 8 percent range, and there is no relief in sight.

As noted earlier the productivity performance of the economy has been exceedingly poor. If productivity follows its typical cyclical pattern, a productivity slowdown would be expected in 1979. But since productivity has been performing so poorly since 1976, it is difficult to know what to expect. Certainly no further slowdown is likely, and the recent acceleration of capital spending may raise productivity somewhat in 1979. A 1.0 to 1.5 percent rate of growth of labor productivity is as much as can reasonably be expected. Our inflation projection is heavily dependent on the realization of this rate of productivity growth.

In view of the heavy bargaining calendar, 1979 will be a crucial year in determining the path of wages for the next several years. Catching up to the steep price increases of 1978 and adding some allowance for real income gain will place the average rate of wage increase in the 8 to 9 percent range. To this must be added the large increases in social insurance taxes and another round of minimum wage increases. Even if wages were to rise by only 8 percent -- a very conservative estimate -- this in combination with a 1 to 1.5 percent increase in labor productivity would imply a unit labor cost increase of 6.5 to 7.0 percent. This is the rock bottom inflation floor.

Unfortunately, wages are not the only determinant of the rate of inflation. The decline in the dollar has increased the cost of imports and this factor will still be working its way through the cost-price structure in 1979. If the dollar declines still further, the situation will be that much worse. There is also the possibility that those commodity imports that are priced in dollars -- especially oil -- may be raised in price because of the decline in the purchasing power of the dollar. The outlook for food prices is fairly good, although this is always difficult to predict because of the vagaries of the weather. And finally, interest rates have reached the point where they add a substantial amount to the cost of borrowing. All of these factors argue for an inflation rate of over 7 percent in 1979.

Summarizing the outlook for 1979, we expect the economy to slow down to a rate slightly below its long-term trend. Recession is a possibility but not, in our view, the most likely outcome. The slowdown will be accompanied by a poor productivity

performance and approximately the same inflation rate as 1978. The unemployment rate will rise modestly from the 6.0 to 6.25 percent level anticipated for the end of 1978. If productivity grows more rapidly than anticipated, this will imply a lower inflation rate, but it will also imply a higher unemployment rate.

33-958 O - 78 - 5

II. KEY INTERNATIONAL ECONOMIC ISSUES 1/

Introduction

The problems facing the world economy continue to be serious, though crisis has been avoided. Huge payments imbalances, high rates of unemployment, low rates of capital formation, sluggish productivity growth, and high inflation rates abound; and the prospects for improvement in these areas remain uncertain. The debt problems of the developing countries are debilitating, and the financial structure that supports this debt is potentially unstable. Trade and capital restrictions are on the increase. And finally, the recently instituted system of floating exchange rates is under attack and showing signs of strain.

Many industrial countries are reluctant to undertake policy measures designed to improve their growth rates for fear of unleashing renewed inflationary pressures. Thus, it would be surprising if the German economy attained a growth rate of even 2.5 percent in 1978, and the Japanese performance is also likely to be lackluster by historical standards. Whether or not a significant improvement in the growth of these economies can be expected in 1979 is very much in doubt.

1/ Senator Ribicoff states: "This chapter combines a review of international economic problems facing the United States with review of monetary theories which more properly belong in scholarly journals.

Senator Ribicoff's footnote continues:

"I found especially useful the section on the need for future coordination of macroeconomic policies, and the potential damages of expanded protectionism. The point that exchange rate management will continue to be a key characteristic of the international payments system should be underscored. There should be better-defined rules of conduct for this management.

"I disagree that such guidelnes should rule out the occasional use of domestic monetary and fiscal policies for external purposes. Further, I do not accept ruling out the occasional need to restrict movement of goods and capital internationally. Specifically, I wish to dissassociate myself from the sentences and paragraphs footnoted later.

"While the practical issues raised in this report are valuable, I question the value of using the forum of this Congressional publication to endorse or refute a number of academic debates on monetary theory. This is not the substance of normal Congressional discussion. I think that such academic exercises should more properly be pursued in scholarly publications.

"The chapter's conclusions regarding U.S. participation in subsidizing OPEC loans to third world countries and backing expropriation insurance for such loans detract from the more practical worth of much of this paper."

Continued slow growth on the part of the major industrialized countries could threaten further the growth prospects of the developing nations. This sluggishness not only limits their export potential but causes the industrial countries to be less receptive than ever to developing country requests that their exports be given preferential treatment.

The payments imbalances that characterize the world economy are alarming. The current account deficits of the developing nations are monstrous despite recent improvements. And among the industrial nations, the huge U.S. deficit contrasts sharply with the equally huge surpluses of Japan and Germany.

The problems that characterize the world economy raise the risk that there will be a return to protectionism and economic isolationism that could interfere with both the flow of trade and its growth. What is at stake are the principles of economic liberalism and international financial cooperation that have been the hallmarks of the world economic system since World War II. The principal problem in our view is deficient economic growth. Unless the world's economies undertake policies to raise their growth rates and do so in a coordinated fashion, the trend away from a liberal international economic order will continue.

Stagnating world economic conditions and payments imbalances are threatening to undermine the smooth functioning of the system of floating exchange rates that came into being in the early 1970s. This is particularly worrisome to the Committee because we have long been persuaded that floating is the only exchange rate regime that is viable under today's world economic

conditions. While there is no serious move afoot to return to a system generally fixed rates, there is much dissatisfaction with the consequences of floating -- partly based on a lack of understanding. By contrast, fixed rates under present conditions would foster the imposition of trade and capital restrictions and the use of restrictive macroeconomic policies, all of which would be detrimental to the economic health of the world economy.

We do not suggest that floating is a panacea for the world's economic ills. It will not by itself ensure world prosperity. We believe that world prosperity is best served when each country pursues sound macroeconomic policies designed to foster growth, high employment, and reasonable price stability; when restrictions on the movement of goods and services internationally are significantly reduced; and when improvements are made in the recycling of funds from countries with large surpluses to deficit countries. Floating can facilitate the process of achieving world prosperity by providing sufficient price flexibility to rectify international payments imbalances. Price flexibility is essential to the adjustment process but is absent under fixed exchange rates.

For reasons that will be outlined in this chapter, we are concerned because the world economy may be unwittingly moving along a course that could end in an effort to reestablish fixed or near fixed exchange rates. Abroad, more than in the United States, this is still a lingering dream. That, in our view, is precisely the wrong course to follow. We need more exchange rate flexibility, not less.

A stable exchange rate system is desirable. Wild exchange rate gyrations of the kind that contribute needlessly to uncertainty and to the disruption of orderly trade and payments do not serve the interests of the world economy. However, in the face of underlying world economic and financial instabilities and uncertainties, even a well functioning and "stable" floating system will exhibit considerable volatility in the movement of exchange rates. Thus, if volatile exchange rate movements are present, the question needs to be asked whether the problem lies in the form of the payments system or in the underlying economic conditions of the world economy. If the problem lies with the system of floating, the system should be scrapped. If the problem lies elsewhere, the source of the problem should be identified and corrected, and floating should be retained. There is a great deal at stake and a scrapping of the payments system for the wrong reason could cause a great deal of harm.

Consideration of these issues at this time is important. A few weeks ago the dollar dropped sharply in value on the foreign exchanges, bringing a vast outpouring of worldwide criticism against U.S. economic policy. At home and abroad, the dollar's decline was widely interpreted as a worldwide vote of nonconfidence in U.S. economic policies and U.S. leadership. In response, the Federal Reserve forced interest rates up and dropped the reserve requirement on foreign borrowings of U.S. Federal Reserve member banks. In addition, the Administration agreed to double the size of its monthly gold offerings starting in

November, and there has been much speculation that the Administration is now seriously considering massive intervention in support of the dollar.

The dollar has been subjected to intense downward pressure before, most recently last fall and winter. These declines have added to our inflation rate. The growing uncertainty over the stability of major international currencies may well have also retarded investment and thus slowed world growth. Additionally, the sharp fall in the value of the dollar has forced rather sharp adjustments in the export industries of a number of our trading partners. These events have caused a great deal of understandable concern both here and abroad, and they have raised anew the question of the advisability of retaining our present international payments system. On the basis of our study of floating exchange rates, it is our view that floating should be retained, and that it should not be interfered with nearly as much as at present.2/

2/ Senator Ribicoff disagrees with this sentence. See his comment at the beginning of the chapter.

We conclude that there ought to be less tinkering with the present payments system and more concern with the absence of a worldwide approach to coordinated macroeconomic policies based on a serious multilateral commitment to growth and prosperity. We urge the reduction of restrictions on the movement of goods and capital and we call attention to the need for a continuing improvement in the recycling of funds from surplus to deficit countries.

The Present International Payments System

The present international payments system contrasts sharply with the former Bretton Woods system of fixed-but-adjustable par values. Under Bretton Woods, the value of the dollar was fixed in terms of gold, and the value of all other currencies was fixed in terms of the U.S. dollar. In order to ensure the maintenance of the fixed rates, countries agreed to follow certain rules. Thus, the U.S. stood ready to convert gold for dollars at a fixed price, and all other countries stood ready to buy or sell their own currencies at fixed prices whenever market forces were operating to push their exchange rates up or down.

Countries also agreed to change their fixed rates -- i.e., to realign the foreign exchange value of their currencies -- in cases of "fundamental disequilibrium." The meaning of "fundamental disequilibrium" was never precisely defined but was frequently interpreted to mean the existence of persistent international payments imbalances. However, as the Bretton Woods system evolved, it became apparent that the world's nations frowned on frequent exchange rate adjustments. The emphasis was on the fixed,

not the adjustable, part of the system. The devaluation or revaluation of a currency was to be used only in response to a crisis, and only when all else had failed.

During the first twenty years or so of Bretton Woods there were, in fact, remarkably few exchange rate realignments. In part, this was the result of the fact that the underlying economic conditions that characterized the world economy over much of that period of time were stable enough that repeated exchange rate adjustments were not called for. But when underlying economic conditions became less stable -- as they did in the late 1960s and early 1970s -- significant realignments took place with increasing frequency. And given the crisis atmosphere that surrounded each devaluation and revaluation, the Bretton Woods system became strained and finally gave way to a more flexible payments system.

Bretton Woods collapsed sometime during the early 1970s. It is difficult to pin down the precise date of its collapse, since between 1971 and 1973 the world economy vacillated between a system of floating rates and fixed rates of exchange. The suspension of gold convertiblity by the United States on August 15, 1971, constitued the first official step in the direction of abandonment of Bretton Woods. This was followed by a brief period of floating, which was followed in turn by the reinstitution of fixed rates in 1972. However, pressure to abandon support of fixed rates became overwhelming in the early part of 1973, and when Germany finally decided on March 19, 1973, to let its exchange rate go free, the Bretton Woods system was dead. Since that time, floating in one form or another has been a persistent

characteristic of the international payments system. ..."

The payments system that has evolved since the collapse of Bretton Woods is difficult to describe. It is not a floating exchange rate system in the sense that all of the world's economies are floating simultaneously. On the contrary, the vast majority of the world's currencies are pegged to one or more other currency, creating, thereby, several currency blocs. According to the latest available information, 42 countries are pegging their currencies to the dollar, 14 to the French franc, 5 to the pound sterling, 14 to the SDR, and 17 to some other currency composite. 3/

3/ International Monetary Fund, 29th Annual Report on Exchange Restrictions, 1978, p. 25.

Nearly all developing countries peg their exchange rates. Having no well-developed domestic capital markets, their currencies cannot be traded privately, and exporters and importers must deal directly with their central bank to obtain foreign exchange and local currency. For such countries, floating is not a viable alternative.

A somewhat different kind of currency bloc is provided by the European "snake" (whose present membership consists of Belgium-Luxembourg, Denmark, Germany, The Netherlands, and Norway). Under that arrangement, member countries observe narrow exchange rate margins with each other but float collectively against the dollar (hence the reason for the designation "snake in the tunnel"). The IMF approves other exchange rate arrangements as well: some countries allow their currencies to float relatively freely (e.g., the United States, Canada, France, Japan, Italy, and the United Kingdom) while others peg to one or more currencies but adjust those pegs periodically in response to changes in certain economic indicators (e.g., Argentina and Brazil).

Despite the many exchange rate arrangements, the present system is essentially a floating system. The bulk of the world's trade is conducted between countries which, technically, are floaters. And although a lot of countries peg their exchange rates, they do so with respect to the floaters (or with respect to currency composites the values of which are heavily dominated by the floaters) so that variations in exchange rates between floaters implies corresponding group-wise variations in the exchange rates of the countries constituting the respective blocs. Germany, for example, is not technically described as a floater,

but because the vast majority of its trading partners are, Germany's currency floats *de facto*.

Managed Floating and the Need for Surveillance 4/

Currently exchange rates float, but they are not determined solely by the free interplay of demand and supply. They are also heavily influenced by official intervention in foreign exchange markets and by other forms of rate management. Indeed, official rate management has emerged as one of the key characteristics of the present exchange rate regime.

4/ Congressman Hamilton states: "I agree that flexible exchange rates have served us well and that the Bretton Woods system of fixed exchange rates would have proved unworkable at the present time. At the same time, we cannot turn our back on a special international responsibility that comes with the dollar's role as the world's principal reserve currency. Sharp and disorderly fluctuations in the dollar create the kind of uncertainty that can affect trade and investment decisions. The result can be a loss of growth and employment opportunities for many nations.

"In addition, sudden international adjustments can cause severe political difficulties for many of our allies. The sheer rapidity of the dollar's fall against the currencies of Germany and Japan has already created a severe threat to their export industries. In light of Germany and Japan's strong surplus on current account, some adjustment was to be expected. But large year-to-year changes in export markets can lead to serious economic dislocations."

The purchase and sale of foreign exchange by central banks is the most common form of rate management; however, intervention is by no means the only way of managing exchange rates. Exchange rates can also be managed through the use of official or quasi-official borrowing and lending, through controls on the movement of goods and capital internationally, and by the use of domestic monetary and fiscal policies.

The trend is difficult to quantify, but the world economy has been moving in the direction of greater exchange rate management. The extent to which intervention has been used to stop the dollar's decline is crudely reflected in the net change in foreign official holdings of reserve assets. Whereas exchange market intervention according to this indicator amounted to about $7 billion in 1975, it rose to $18 billion in 1976 and mushroomed to $37 billion in 1977. On the basis of first quarter figures only, the annualized net change in foreign official reserve assets for 1978 could exceed $60 billion. If the recent sharp decline of the dollar causes foreign and U.S. central banks once again to intervene massively to stem the decline, intervention amounting to $60 billion could easily occur.

We note the trend toward greater rate management with alarm, not because we are opposed to intervention under all circumstances, but because it appears to us that the world economy is in danger of drifting back haphazardly toward a system of fixed par values; or worse still, towards an international payments system characterized not only by fixed rates, but also by exchange controls and trade restrictions.

We recognize that exchange rate management is, and will continue to be, a key characteristic of the international payments system. However, there do not as yet exist any well-defined rules of conduct with respect to the management of exchange rates. Article IV of the amended Articles of Agreement of the International Monetary Fund (IMF) does contain a number of loosely and vaguely defined principles governing the duties and responsibilities of national authorities and the IMF under the flexible exchange rate system. But effective rules of conduct cannot be developed until the nations of the world reach agreement on the basic issue of whether they want a floating exchange rate system that puts primary reliance on market forces, or whether the general preference is for exchange rate management. If the recent past is any guide, we are in danger of resolving the issue *de facto* in favor of rate management. In the absence of any generally agreed upon rules of conduct, it is possible that national authorities will pursue exchange rate policies that serve their own narrow self-interests only. Although such policies may ultimately prove to be self defeating and detrimental to world trade and development, this does not prevent short-run expediency from leading to their adoption.

In our view, the surveillance issue should be resolved as follows:

(1) For the industrialized countries, we urge the adoption of an exchange rate system that is, for the most part, cleanly floating;

(2) For those countries that float, intervention in foreign exchange markets should not be undertaken except to combat or to prevent the emergence of disorderly market conditions; and

(3) Additional rules of conduct governing the domestic policies of the respective national authorities should be devised, their objective being to ensure that each of the world's economies adopt policies to foster growth, high employment, and reasonable price stability.

Under no circumstance should countries be permitted to manipulate exchange rates to their own domestic advantage; for example to protect the competitive position of their export industries. These guidelines would require that domestic monetary and fiscal policies be aimed at domestic growth and price stability rather than at influencing the exchange rate. And finally they would rule out the use of policies to restrict the movement of goods and capital internationally.

These guidelines reflect our strongly held view that the free movement of goods and capital internationally is important for world prosperity and that a system of cleanly floating exchange rates is the best means of ensuring such free movement. This does not mean that each and every country must float freely. However, it does mean that the dominant industrial countries must accept the principle of clean floating and reject any other arrangement -- including currency unions -- if these arrangements interfere with the free movement of goods and capital.

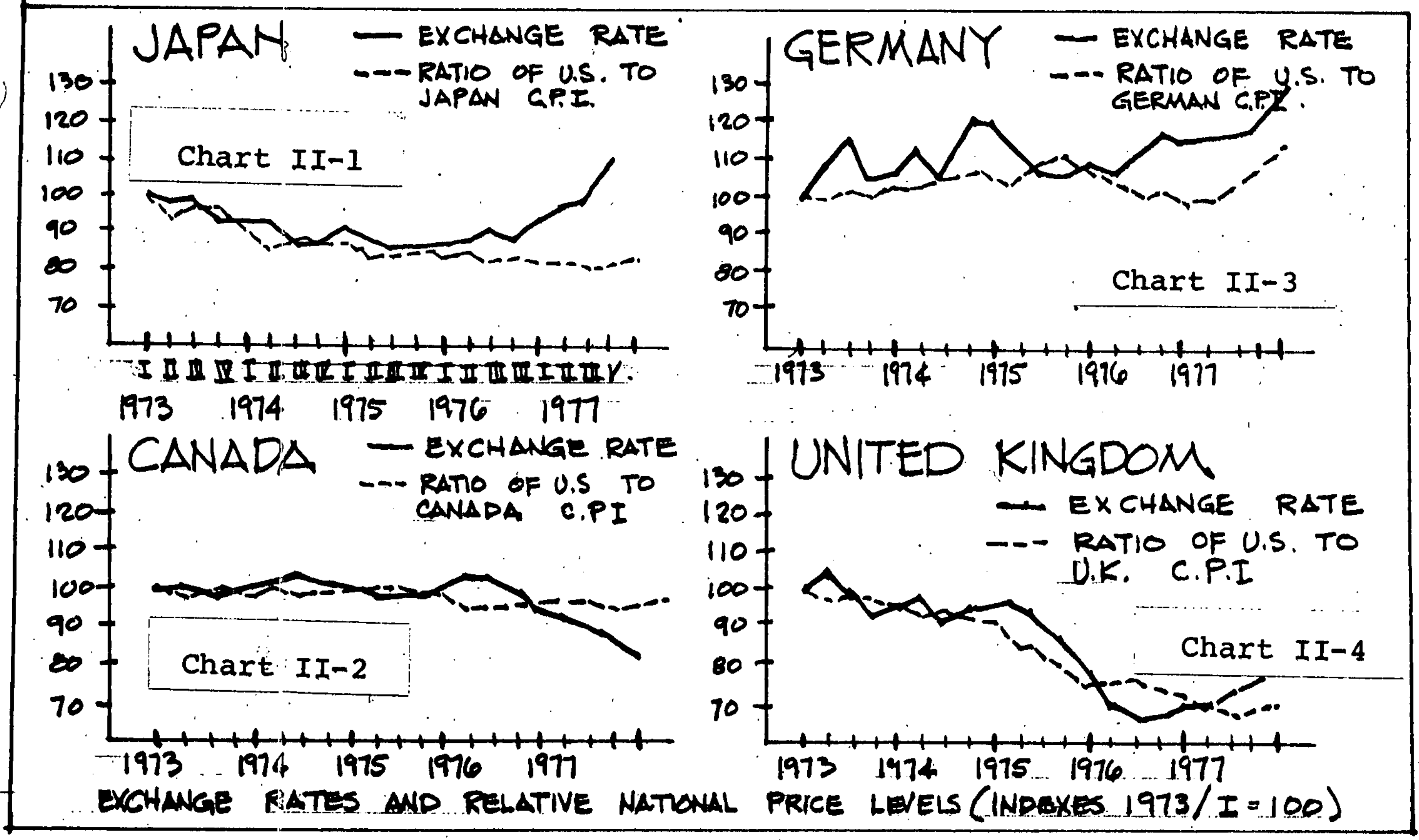
During the 1970s the world economy has been buffeted by a series of major shocks. One set of shocks was the tremendous currency revaluations that were the legacy of the rigid Bretton Woods system. Another shock was the inflationary monetary expansion that accompanied the reluctance of several major countries to accept the floating rate system. A third shock was the very poor harvests that plagued world agriculture during the early 1970s. Perhaps the most damaging shock was the quadrupling of oil prices by the OPEC nations in 1974. This created enormous dislocations and structural problems that have still not been ironed out. Furthermore, the problems of the 1970s have been compounded by the circumstance that the world business cycle is out of phase. As noted earlier, this has been responsible for the sluggishness of our export growth and this has accounted for much of our current account deficit since 1977 and therefore for the pressure on the dollar. Under the circumstances, it is something of a miracle that the international payments system has functioned as effectively as it has. To be sure, there have been periods of extreme exchange rate volatility, but these must certainly be largely attributed to the many adverse underlying conditions that have beset the world economy and cannot be attributed to destabilizing speculation or to any inherent weakness in the system of floating exchange rates.

33-958 O - 78 - 6

Exchange Rate Determination Under a Cleanly Floating System

Exchange rate movements are the product of a number of complex short-run and long-run forces. Because of its importance to the world economy, this issue warrants analysis in some detail. From a long-run perspective, one of the dominant forces governing the movement of exchange rates between countries is the relative movement of their respective price levels. One hypothesis -- known formally as the Purchasing Power Parity (PPP) theory of exchange rate movements -- asserts that a rise in the U.S. price level relative to prices abroad will be reflected in an equiproportionate depreciation of the dollar. If this happens, the competitive position of the U.S. economy relative to other economies will remain the same, and balanced trade will tend to be restored.

Charts II-1 through II-4 trace the relationships between movements in price levels and movements in exchange rates. The exchange rate curve on each of the four charts shows the dollar price of each of the respective currencies -- the yen, the DM, the Canadian dollar, and the pound sterling. An increasing (decreasing) index indicates a depreciating (appreciating) dollar. The price curve shows the ratio of the index of U.S. prices to the price indices of Japan, Germany, Canada, and the United Kingdom. A declining (increasing) ratio implies that U.S. prices are falling (rising) relative to foreign prices. On the basis of the PPP theory, we should expect to find a declining ratio of U.S. to foreign prices to be associated with an equiproportionate appreciation of the dollar. As is apparent from these four charts, however, the nature of the relationship is only approximate. It



EXCHANGE RATES AND RELATIVE NATIONAL PRICE LEVELS (INDEXES 1973/I = 100)

holds fairly precisely for Canada and the United Kingdom but is much looser for Japan and Germany. Thus the PPP relationship is not exact either with respect to the timing or the magnitude of the exchange rate movements.

There are several reasons for the absence of a precise correspondence between the movement of exchange rates and relative price levels. First because traded and nontraded goods are not perfect substitutes, the movement of relative national price levels reflects only imperfectly the prices of exports and imports, which is what counts when assessing relative competitiveness. Second, many factors other than relative prices affect the competitive position of each country. For example, a basis for trade can arise from product innovation and from the unavailability in some countries of specific natural resources. Third, the relationships displayed in Charts II-1 through II-4 really do not test the PPP relationship because exchange rates over this period of time were partly managed and not permitted to float cleanly. Because of the rapid growth in central bank intervention in foreign exchange markets as the float progressed, exchange rate movements came to reflect less and less the change in relative inflation rates. Finally, since the PPP theory is implicitly based on the notion that all changes in the exchange rate are attributable to forces affecting the current account, the theory ignores the influence of capital flows on exchange rates. Although the relationship is loose, there nevertheless is a clear tendency for the secular trend of exchange rate movements to mirror, though not exactly, the trend movements of relative national price levels. This is what is most often meant by the assertion that exchange

rate movements should reflect underlying fundamental conditions. However, 18 months to two years or more are required for relative price changes to have their full effects on import and export industries. And it is only the long-run secular movement of exchange rates that should reflect such fundamental changes. Short-term fluctuations in the exchange rate are quite another matter. For the most part, they are determined by a different set of forces, largely those associated with the factors responsible for the movement of capital internationally.

Short-term capital is normally thought to flow in response to risk-adjusted expected yield differentials between domestic and foreign financial assets. According to the traditional view, when international capital is highly mobile, funds will seek the financial markets with the highest yields, and capital movements will continue as long as the yield differential persists.

A competing hypothesis that has gained considerable support in recent years is known as the asset-market theory. Again funds flow in response to yield differentials, but in this case it is recognized that in order to induce investors to hold ever larger quantities of one asset relative to other assets, the yield on that asset must be steadily increased relative to the yields on the other assets. There is therefore a very important distinction between the traditional "flow" theory and the asset-market theory. In the former, a constant domestic-foreign yield differential implies a constant flow of capital per period of time. In the latter, for the necessary stock adjustments to occur, maintenance of a constant flow of capital will require ever wider yield differentials.

An implication of the asset-market theory is that a one-time increase in interest rate differentials will have only a temporary effect on the exchange rate. To illustrate, suppose the expected yield on German securities rises. This will induce American, German, and other investors to change the composition of their portfolios in the direction of a greater proportion of assets denominated in deutsche marks. Capital will flow into Germany, and this will cause the deutsche mark to appreciate while other currencies, including the dollar, will depreciate. However, once portfolios have been adjusted, the flow of capital will cease, and the dollar and other currencies will move back toward their original values.

The up and down movement of exchange rates in the short run can be seen to be a natural consequence of compositional shifts in portfolios. Since the factors that influence the expected yields of different assets can vary sharply over short periods of time, and since capital flows can move very quickly in response to changes in expected yields, exchange rate movements can exhibit a great deal of short-term variability. However, this in no way implies that foreign exchange markets are unstable. Indeed, the stock-adjustment mechanism suggests quite the opposite.

The asset-market theory implies that exchange rates are determined by all those factors that affect relative expected yields and relative risk. Not only will changes in interest rate differentials cause portfolio shifts and corresponding exchange rate movements, but portfolio readjustments can also come about as a result of other forces. For example, a threat by OPEC to establish a new pricing system for oil based on a basket

of currencies instead of just the dollar could well induce investors to adjust their risk-adjusted relative-expected yields in favor of nondollar denominated assets. Or if foreign exchange market analysts revise downward their expectations regarding Western European and Japanese inflation rates, and/or revise upward their expectations regarding U.S. inflation rates, the asset-theory would predict a sharp downward movement in the exchange value of the dollar in response. Or finally, if market participants expect central banks to intervene on behalf of a currency, this can also affect expected relative yields and relative risks, which in turn can cause sizable short-run capital flows. In sum, changes in exchange rates, like changes in stock prices, can come about as a result of changing expectations, fears and hopes. Although these movements can at times appear to be irrational, they are an unavoidable characteristic of free markets in the face of underlying instabilities and uncertainties. Volatile short term movements of exchange rates are not <u>per se</u> a reason to abandon floating.

It is clear from Charts II-5 and II-6 that short-term fluctuations in exchange rates are determined by more than just the interest rate differentials between countries. From Chart II-5 it is clear that the up and down movement of the DM-dollar rate corresponded in a rough way to the up and down movement of the U.S.-German interest rate differential until the beginning of 1977. However, the correspondence appears to be perverse thereafter. And in Chart II-6, a similar kind of perverse relationship between the yen-dollar rate and the U.S.-Japanese interest rate differential is implied.

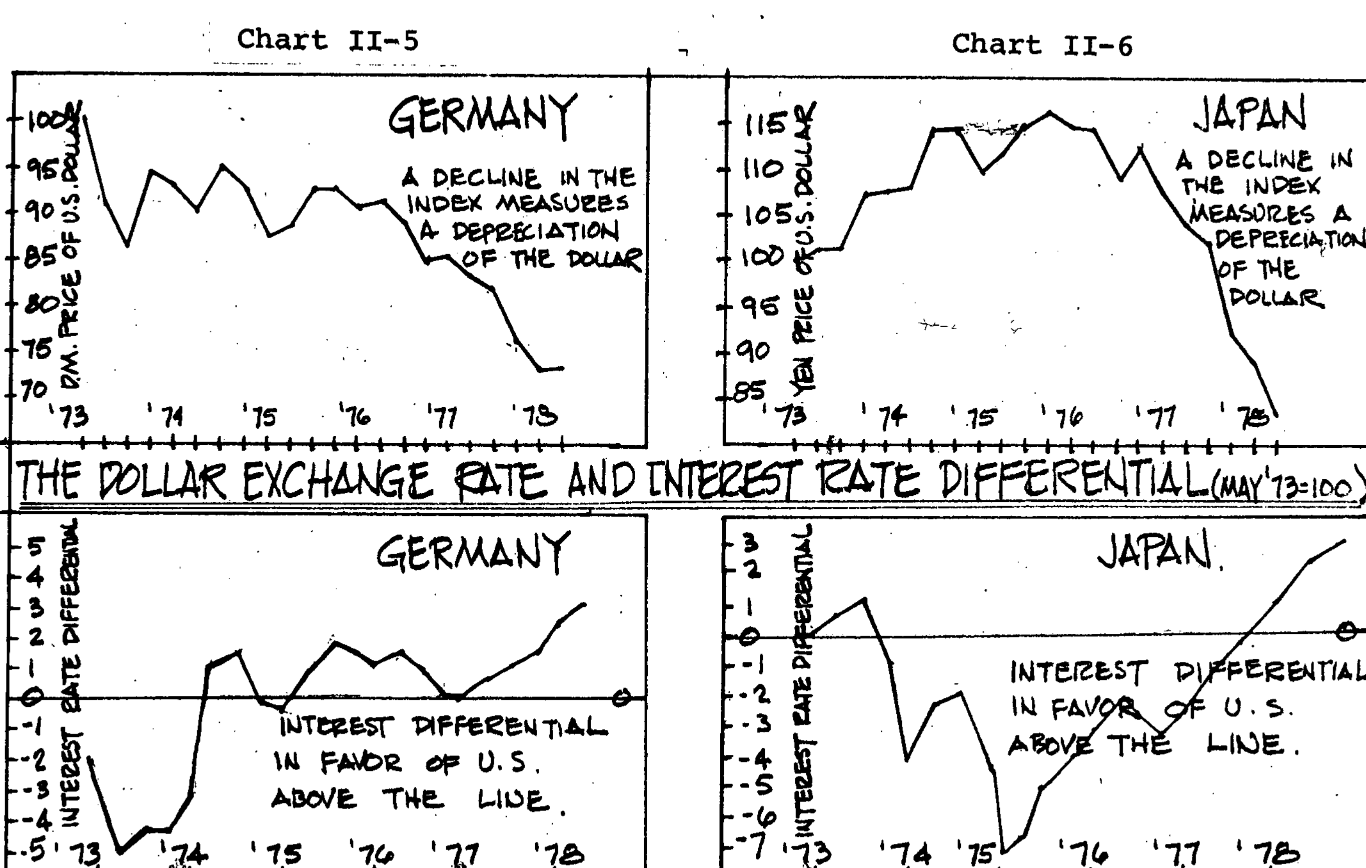


Chart II-5
Chart II-6
GERMANY
A DECLINE IN THE INDEX MEASURES A DEPRECIATION OF THE DOLLAR
D.M. PRICE OF U.S. DOLLAR
100
95
90
85
80
75
70
'73
'74
'75
'76
'77
'78
JAPAN
A DECLINE IN THE INDEX MEASURES A DEPRECIATION OF THE DOLLAR
YEN PRICE OF U.S. DOLLAR
115
110
105
100
95
90
85
THE DOLLAR EXCHANGE RATE AND INTEREST RATE DIFFERENTIAL (MAY '73=100)
GERMANY
INTEREST RATE DIFFERENTIAL
INTEREST DIFFERENTIAL IN FAVOR OF U.S. ABOVE THE LINE.
5
4
3
2
1
0
-1
-2
-3
-4
-5
JAPAN.
INTEREST RATE DIFFERENTIAL
INTEREST DIFFERENTIAL IN FAVOR OF U.S. ABOVE THE LINE.
3
2
1
0
-1
-2
-3
-4
-5
-6
-7

Are Volatile Exchange Rate Movements the Result of Destabilizing Speculation?

Since it is difficult to construct an accurate test of the complete asset-market theory -- in large measure because there do not exist accurate measures of expectations, fears and hopes -- we can perhaps approach the question of exchange rate volatility from a different angle. Specifically, is there evidence to suggest that the observed volatility is the result of destabilizing speculation?

On the basis of the empirical work that has been done to date, there is no evidence to suggest that the observed volatile movements have been exclusively or even largely the result of destabilizing speculation. There is some indication that speculation was destabilizing during the early part of the float, but that it has become much less so as the float has progressed.5/

5/ See Thomas D. Willett, Floating Exchange Rates and International Monetary Reform (Washington, D.C.: The American Enterprise Institute, 1977) and references cited therein.

It cannot be denied that there have been some bouts of speculative activity in the latter part of the float that, in retrospect, turned out to be destabilizing. The sharp decline of the dollar which began on August 14 of this year and the gyrations experienced in the foreign exchanges that followed might well qualify as one such bout. But looking at the period as a whole, there is little evidence to support the view that speculation has been systematically destabilizing. Moreover, in our estimation, the destabilizing speculative activity that apparently existed in the early days of the float in fact could have been the result of the relative inexperience of market participants with floating rates.

It is important to deal with another alleged source of exchange rate volatility -- namely, the huge volume of dollar-denominated assets in the hands of foreigners. It is true that foreigners hold upward of $600 billion worth of dollar-denominated assets. It is also true that the sale of as little as 10 percent of these assets could cause a dramatic decline in the value of the dollar. But what do these facts prove? That people will undertake to sell this quantity of assets just because they have such a huge quantity? Probably not. But apparently, according to advocates of this view, the sheer volume of these assets poses a threat in the following way. Any development which could adversely affect the value of the dollar will cause a massive shift out of dollar-denominated assets, causing the dollar to plummet sharply, and if the volume of dollar-denominated assets had been much smaller, the decline of the dollar would have been more moderate.

The difficulty with this view is that it confuses the volume of dollar holdings with the forces that motivate capital movements. In the first place, if people feel generally that the dollar will depreciate by 10 percent, they will instruct their foreign exchange dealers to sell dollars which has the effect of forcing the dollar down. Once the dollar has declined by 10 percent, and as long as expectations remain unaltered, they will undertake to buy or sell dollars in amounts required to maintain the rate at that new level. They may mistakenly oversell or undersell the dollar, but the volume of dollars sold will not necessarily be too extensive just because the volume of dollar holdings is extremely large. Put differently, the amount of dollars sold could well be the same whether the volume of dollar-denominated assets is $10 billion, $60 billion, or $600 billion.

Moreover, foreign exchange markets provide a mechanism for speculating against the dollar without having to own dollars. Also U.S. residents have the ability to use their own dollar holdings to speculate against the dollar. Consequently, we see little reason to isolate foreign dollar holdings. In short, the present argument mistakenly singles out foreign dollar holdings from all the potential sources of international capital mobility.

Central Bank Intervention in Foreign Exchange Markets

Volatile changes in exchange rates pose a dilemma for central bankers who undertake to intervene in foreign exchange markets when they become "disorderly" since volatility *per se* does not necessarily mean that the market *is* disorderly.

The Committee has defined a disorderly market as follows:

> Disorder emerges in exchange markets when for any reason dealers are unable to form reasonably firm expectations about direction or extent of exchange rate movements in the immediate future. In effect, fear overwhelms normal expectations upon which the ability to do business is based. Disorder is manifested by unusually wide spreads between bid and asked prices for currencies and by a severe drop in the volume of transactions from normal levels.6/

6/ "Exchange Rate Policy and International Monetary Reform," Joint Report of the Subcommittee on International Trade of the House Banking Committee and the Subcommittee on International Economics of the Joint Economic Committee, August 1975, p. 6.

The practical difficulty with this definition is that it is not possible, except in retrospect, to distinguish a disorderly market precipitated by an unexpectedly sharp change in basic trends from one caused by purely transitory factors. If the factors responsible for the exchange rate change are purely transitory, they should reverse themselves in a relatively short period of time.

If governments err and intervene to arrest the movement of exchange rates caused by changes in basic market trends, they will only delay the necessary processes of adjustment. Indeed central bank intervention could itself be a source of exchange market instability if it increases uncertainty by forcing traders and investors to guess where, when, and by how much central banks might intervene.

Despite the practical difficulties of defining a disorderly market, we still consider intervention permissible to combat or to prevent the emergence of characteristics normally associated with disorderly markets. However, in view of the potential dangers of intervention, any commitment by the United States should be minimal. If intervention appears necessary, this should be done cautiously and on a very modest scale.

We have frequently questioned the magnitude of the intervention operations undertaken by a number of the major industrialized countries -- most particularly, by Germany and Japan in the past year, and by the United Kingdom in 1976. The argument that these operations were undertaken to combat market disorders is not persuasive. In each instance, intervention

was undertaken for extended periods of time, and all of it was in one direction. Despite the substantial interventions, they have not been successful in arresting the slide of the dollar. The underlying economic forces that caused a fall in the dollar have simply been too powerful.

Despite the most recent sharp decline in the value of the dollar, we do not believe the United States should allow itself to be pushed into stepping up its foreign exchange intervention. Intervention interferes with the adjustment process, and much of it, as will be explained later, has the effect of slowing growth in our economy.7/

If other governments wish to intervene to stem the dollar's decline, that is their business. But we should not cooperate in such a potentially costly venture, since it would mean slowing our own economy while supporting the competitiveness of foreign export industries and promoting foreign employment at the expense of our own. It must be understood that such a policy stance means (on occasions such as the 1977-78 period) an acceptance of a decline in the foreign exchange value of the dollar. There is no need to wring our hands in dismay when the international adjustment process requires a lower exchange rate for the dollar. This is psychologically difficult for some people to accept and it creates needlessly alarming headlines. But it is an essential feature of a floating system in the face of a U.S. balance of payments deficit.8/

7/ Senator Ribicoff disagrees with this paragraph. See his comment at the beginning of the chapter.

8/ Senator Ribicoff disagrees with this paragraph. See his comment at the beginning of the chapter.

The Use of Monetary Policy for External Purposes

Normally, official intervention in foreign exchange markets to prop up a sagging currency has effects similar to a restrictive domestic monetary policy. That is, when a central bank enters the foreign exchange market to buy up its own currency, this will normally lower its foreign exchange holdings, causing a reduction in commercial bank reserves and a tightening of monetary conditions. This is not, however, what happens when the Federal Reserve Bank intervenes. Since the United States must borrow foreign currencies with which to buy dollars -- that is, since the swap network must be activated -- the increase in commercial bank reserves caused by the Federal Reserve's purchase of U.S. dollars is offset by the reduction in commercial bank reserves caused by the borrowing of foreign currencies.

However, as a result of the foreign loan, the reserves of foreign commercial banks are increased, which eases monetary conditions abroad. Thus, official intervention by the Federal Reserve has effects on foreign money supplies that are identical to those that would result if _foreign_ central banks intervened on their own to buy up dollars in order to prevent the appreciation of their currencies.9/

9/ For a detailed discussion, see Anatol B. Balbach, "The Mechanics of Intervention in Exchange Markets," _Federal Reserve Bank of St. Louis Review_, February 1978, pp. 2-7.

This difference is worth noting since it limits the damage to the domestic economy that might otherwise occur from foreign exchange intervention to combat disorderly markets.

Restrictive monetary policy can prop up the currency in two ways. First, by creating interest rate differentials between domestic and foreign financial markets, it can induce an inflow of capital. However, if the asset-market theory of exchange rates is correct, such inflows of capital will be temporary, and there will be no permanent rise in the exchange rate. Interest rates, however, will be higher, the money supply will be lower, and the level of economic activity therefore will be lower unless and until the monetary policy is reversed.

The second effect on the value of the currency comes about because the slowing of the economy will improve the current account. There may be less inflation, and the slower real growth will dampen the demand for imports. It was, however, precisely to avoid the need for this method of dealing with a balance-of-payments deficit that made the abandonment of fixed exchange rates an attractive option.

33-958 O - 78 - 7

This was true even before recent evidence showed that the inflation-unemployment trade-off in the United States economy has deteriorated to the point where the attempt to slow inflation by the use of restrictive monetary policy extracts a prohibitive cost in terms of lost production, growth, and employment. As Arthur M. Okun has noted:

> To cut today's inflation rate in half would require a recession deeper than the double-sized 1974-75 decline.10/

10/ Arthur M. Okun, "A 'Social Compact' to Slow Inflation?," The Washington Post, August 28, 1978, p. A-23.

We should not sacrifice domestic expansion for the purpose of maintaining the dollar. Nor does it make any sense for us to protect the export industries of Western Europe and Japan by deflating our economy when these countries could bring about a slower decline in the dollar and a slower decline in their relative competitiveness by undertaking internal policies to step up their real rates of growth.

This Committee has consistently opposed the use of monetary policy to secure international objectives, and we do so now. We recognize that the central role of the dollar in the world monetary system creates alarm abroad when the foreign exchange value of the dollar declines, and we understand the pressures on the Federal Reserve to respond to these concerns. But these pressures should normally be resisted and the eye of monetary policy should be kept firmly on the needs of the domestic economy.11/

Twice this year, once in January and again in August, the Federal Reserve forced interest rates up to stem the decline of the dollar. This is a futile and harmful use of monetary policy.12/

11/ Senator Ribicoff disagrees with this paragraph. See his comment at the beginning of the chapter.

12/ Senator Ribicoff disagrees with this paragraph. See his comment at the beginning of the chapter.

Toward An Assessment of Floating Exchange Rates

Our prescriptions stem from our belief that floating exchange rates have served the interests of the United States and the world economy generally. Floating may not be the best of all conceivable exchange rate arrangements, but among the possible realistic solutions, it has turned out to be a better system than we had reason to expect. Since floating became a reality in 1973, exchange controls and trade restrictions have for the most part been relaxed, not increased, and world trade in real terms has increased substantially. We are somewhat alarmed, of course, at the recent increased use of restrictive trade and exchange practices among the industrialized countries, but in our view, these developments have more to do with the continued sluggish recovery of the world economy than they do with the international payments system. Our views regarding floating rates and fixed rates can be summarized as follows:

(1) Floating has not provided the U. S. economy or any other economy with complete policy independence. But few serious students of international finance ever said that it would. If there were not capital mobility, overall balance-of-payments equilibrium and balance in the current account would be synonymous. A floating exchange rate would then ensure that the exchange rate would change in a way that would provide equality between exports and imports. Therefore expansionary policies pursued by one country would remain bottled up in that country rather than being transmitted abroad.

The insular properties of a floating exchange rate system are weakened by the presence of capital mobility. If the United States undertakes an expansionary fiscal policy, this will raise national income, increase the demand for imports and tend to cause the dollar to depreciate. However, the expansionary fiscal policy also raises domestic interest rates and this will attract capital from abroad. Since the exchange rate needs to change only by the amount required to restore overall balance-of-payments equilibrium, the dollar will depreciate by _less_ than is necessary to maintain equilibrium in the trade balance. The rest of the world will therefore experience an increase in its net exports and therefore in its GNP. Similarly, if the United States conducts an expansionary monetary policy, this will tend to raise national income, increase the demand for imports, and cause the dollar to depreciate. However, the expansionary monetary policy also lowers domestic interest rates and this would give rise to an outflow of capital. Therefore the dollar would depreciate by _more_ than is necessary to maintain equality between exports and imports.

As these examples show, macroeconomic disturbances can be transmitted abroad when capital is mobile internationally even when exchange rates are freely floating. Nevertheless floating does provide considerably greater independence than fixed exchange rates.

Consider the different policy objectives of some of the world's major industrialized countries. Germany and a number of other countries, including Japan, are anxious not to expand their economies too rapidly for fear of setting off another burst of

inflation. The United States, on the other hand, while concerned about inflation, is anxious to maintain its high level of economic activity and to lower further its rate of unemployment. Floating exchange rates are an important means whereby each of these countries can pursue these differing objectives with some degree of autonomy from the policies pursued by others.

If Germany does not want to import more rapid growth and inflation from the United States, it must allow its currency to appreciate relative to the dollar. If the United States does not want to import sluggish growth from Western Europe and Japan, it must not step in to stem the dollar's decline. There are, of course, a number of costs associated with these strategies. An appreciating currency reduces output and employment, while depreciation means more inflation. But these costs are the inevitable costs that must be incurred by countries if their stabilization policies are to be successful in an open world economy. Under fixed exchange rates, sluggish growth and inflation get passed around from country to country. Floating rates help to moderate this unfortunate form of interdependence.

(2) No exchange rate system will provide a country with protection from certain forms of disturbance. Floating did not and could not insulate the nonoil world from the consequences of the four-fold increase in oil prices by the OPEC countries in 1974. The output and employment losses, the real income transfers, and the inflationary impacts of the OPEC action were not diminished measurably because of the existence of a floating exchange rate system. Similarly, floating will not protect a country from the adverse consequences of externally imposed

trade restrictions. Likewise, floating will not protect countries from the negative effects of world food shortages caused by unfavorable weather at home or abroad.

(3) There has been a great deal of dispute over whether inflation worldwide would be higher or lower under floating or fixed exchange rates. Fundamentally, the issue boils down to whether or not a floating exchange rate system exerts a larger or a smaller disciplinary influence on the monetary and fiscal authorities of the world's economies. The case in favor of the proposition that floating causes less inflation can be stated as follows:

Under fixed exchange rates, a country that inflates its economy more rapidly than the rest is able to export some of its inflationary pressures abroad. This is possible because the other countries, in order to stop their currencies from appreciating, must intervene to buy up the inflation-induced excess supply of the inflating country's currency. This expands their monetary bases, their domestic money supplies, and, in time, their inflation rates. Symmetrically, the loss of reserves and the corresponding reduction in the monetary base of the country that inflated too rapidly serve to moderate its inflation rate.

Under a system of floating exchange rates, on the other hand, national money supplies are largely independent. A country that inflates more rapidly than the rest of the world will experience a depreciation of its currency. But a depreciating currency serves to intensify the inflationary pressures that were the source of the depreciation in the first place. Thus, for any given rate of

monetary expansion, the country in question will experience a higher rate of inflation under floating rates than under fixed rates, and this higher rate is presumed by advocates of floating to be a stronger inducement for the monetary authorities to slow their rate of money expansion than is the loss of reserves that would occur under fixed rates.

The argument that a floating rate system produces more inflation is based on the notion that the loss of reserves under a fixed rate system acts as a strong inducement to apply monetary brakes. Inflation tends to perpetuate a current account deficit, causes a loss of reserves, and ultimately forces a devaluation that may be politically damaging. The question of who is right is an empirical question that is far from settled. We do not feel that the case for or against floating hinges critically on this issue.

(4) We note further that floating has not eliminated trade or current account imbalances. Once again, few serious advocates of floating ever said it would. The trade account (which consists of merchandise exports and imports only) is but one component of the current account, and the current account in turn is but one component of the balance of payments. Cleanly floating exchange rates only ensure that each country's overall balance of payments will move toward equilibrium; it does not guarantee equilibrium in any given account or subaccount.

(5) There is an abundance of evidence which supports the view that floating exchange rates do tend to eliminate overall balance-of-payments disequilibria.13/ In the face of payments disequilibria, floating rates bring about the change in relative prices that are necessary to induce the resource shifts required for the restoration of balance-of-payments equilibrium. We therefore reject the so-called Mundell-Laffer "global monetarism" thesis which states that exchange rate adjustments no longer function to eliminate balance-of-payments disequilibria.*/

13/ See Thomas Willett, op. cit.

*/ The Mundell-Laffer thesis is based in large measure on what has been called "the law of one price" which states that identical goods will tend to sell at the same price after taking account of transport cost differences. Using this "law," they argue (correctly) that if all goods were perfect substitutes, changes in exchange rates would affect national price levels only, leaving relative prices unaltered. And in the absence of changes in relative prices, there can be no balance-of-payments adjustment response when exchange rates change.

There is an obvious response to the Mundell-Laffer thesis: not all internationally traded goods are perfect substitutes, nor are all internationally traded goods perfect substitutes for nontraded goods. Exchange rate adjustments do have an effect on the prices of nontraded goods, and it would be folly to ignore this relationship. But there is absolutely no empirical support for the general assertion that the prices of all

Staff footnote continues:

goods -- traded and nontraded alike-- will change equiproportionately in response to changing exchange rates. In the absence of such an equiproportionate change in all prices, the Mundell-Laffer thesis does not hold. The failure of relative price levels to change in proportion to changes in exchange rates is amply documented in Charts II-1 to II-4 presented earlier.

For detailed discussion of these issues, see Jude Wanniski, "The Mundell-Laffer Hypothesis: A New View of the World Economy," Public Interest, No. 39 (Spring 1975), pp. 31-52; Marina v.N. Whitman, "Global Monetarism and the Monetary Approach to the Balance of Payments," Brookings Papers on Economic Activity, No. 3 (1975), pp. 491-536.

(6) We feel it is important to dispel a number of misunderstandings about the meaning and implications of exchange rates.

a) We are unable to discover any objective way of determining whether a given currency is overvalued or undervalued. Indeed in a cleanly floating exchange rate system, the terms overvalued and undervalued have no meaning whatever. The exchange rate will be at the point required to ensure balance-of-payments equilibrium.

In this context, we think it is unfortunate that the meaning of exchange rate movements is frequently misinterpreted. To many observers, an appreciating currency is a "strong" currency, while a depreciating one is "weak." What do strong and weak mean? They do not mean that the country with a "strong" currency has a "strong" economy while an economy with a "weak" currency has a "weak" economy. Actually, one of the major factors responsible for the decline of the dollar in the past few years has been the more rapid growth of the U.S. economy relative to that of its trading partners.

The exchange rate is nothing more than a price -- specifically, the price of one currency in terms of another. Like all free-market prices, the exchange rate is determined by the forces of demand and supply. Thus, if we are to ascertain the causes of changing exchange rates, it is necessary to identify those causal forces that determine the demand for and supply of the various world currencies -- an extremely difficult task.

b) It is often alleged that the decline of the dollar has been a source of inflationary pressure within the United

States. That is, since the decline of the dollar causes the dollar price of imported goods and services to increase, a depreciating dollar adds directly to the U.S. inflation rate. There is some measure of truth in this claim but it is important that we do not overstate the inflationary impact that we assign to an observed depreciation.

If the depreciation merely reflects divergent underlying rates of inflation between countries, such a depreciation is <u>not</u> a source of <u>additional</u> inflation.

This is an important point because it is frequently asserted that the dollar should be propped up to prevent inflation. Our inquiry leads us to conclude that this is an incorrect policy response. If the United States pursues policies that are more inflationary than those undertaken by the rest of the world, the U.S. inflation rate will tend to be higher under floating rates than it would have been with fixed rates. Under fixed rates, the United States can export some of its inflation abroad. But under floating exchange rates, the United States is more limited in its ability to export its inflation. With fixed rates of exchange, a growing U.S. payments deficit forces the rest of the world to accumulate dollars which increases the monetary base, the money supply, and in time, the inflation rate of the rest of the world; the converse would be true for the United States.

Under floating, the relatively inflationary policies pursued by the United States will cause the dollar to depreciate which has the effect of keeping inflationary pressures bottled up at home. The deprecation of the dollar is the mechanism whereby the U.S. inflation rate is made

consistent with its own internal domestic policies. Put slightly differently, a depreciating dollar is the means whereby each of the world's economies can achieve the kind of policy independence they are supposed to achieve under floating exchange rates. Only if the depreciation of the dollar exceeds divergent inflation trends will it become an independent source of inflation.

c) It is important to understand that continuous divergent growth and inflation rates imply continuous changes in exchange rates. If the United States maintains an inflation rate in excess of world inflation rates, the dollar will continue to depreciate until these divergent inflation differences are eliminated.

(7) Although a great deal of attention has been focused on the depreciation of the dollar relative to the yen, the DM, and the snake currencies, these exchange rate movements vastly overstate the true depreciation of the dollar. If the movement of each of the exchange rates relative to the dollar is weighted by the importance of each respective country in U.S. trade (taking account of both bilateral and "third" country effects), one obtains a measure of the trade-weighted change in the foreign currency value of the U.S. dollar that more accurately reflects the patterns of U.S. trade. And as is apparent from our discussion in Chapter I, the trade-weighted or effective exchange rate shows a dollar that has depreciated by much less than it has against either the yen or the DM.

In many interpretations, the implication of the sharp decline of the dollar relative to the DM and the yen is that, at least with

respect to these currencies, the dollar has become seriously undervalued. These currencies have appreciated by much more than other currencies, even though there have been no significant structural shifts in the world economy to warrant changes of this magnitude. The paradox of the sharp decline of the dollar relative to these particular currencies can be explained as follows: the OPEC countries gained a huge terms-of-trade advantage over the United States as a result of the cartelization of oil supplies and the four-fold increase in oil prices in 1974. But OPEC oil prices are fixed in terms of the U.S. dollar. Since the United States has maintained a policy of allowing the foreign exchange value of its currency to be determined largely by the free play of market forces, that change in relative prices must be redressed through a depreciation of the dollar; and since exchange rates between the OPEC nations and the United States are essentially fixed, the dollar will naturally decline relative to the currencies of the non-OPEC countries. Moreover, since many of the developing nations have also increased their competitiveness relative to the United States, and since they also, for the most part, maintain fixed rates with respect to the dollar, this quite naturally puts further downward pressure on the dollar. As Rudiger Dornbusch concluded in testimony before the House Banking Committee on March 7, 1978,

> To achieve such a real depreciation the dollar has to depreciate significantly relative to the D Mark bloc and the yen because those are the only currencies relative to which a real devaluation can effectively be achieved.14/

Professor Dornbusch's reasoning raises serious doubts about the appropriateness of any policies to stem the dollar's decline relative to the yen and the DM.

14/ Statement of Rudiger Dornbusch before the Committee on Banking, Finance, and Urban Affairs, U.S. House of Representatives, Hearings on the Conduct of Monetary Policy, March 7, 1978.

The Need for the International Coordination of Macroeconomic Policies

In our view, the policy of the United States with respect to the dollar until very recently has been the correct one. We would be disturbed if the Administration were to engage in massive intervention operations in support of the dollar as has sometimes been rumored. We have expressed our concern at moves this year by the Federal Reserve to raise interest rates for international reasons. We are hopeful that the Administration and the Fed will stand by their original and basic position.15/

15/ Senator Ribicoff disagrees with this paragraph. See his comment at the beginning of the chapter.

That position, as represented by the United States at the Bonn Summit in July 1978, is not a policy of "malign neglect" as many have claimed. On the contrary, it constitutes a sensible and realistic approach to the problems that confront the world economy.

The Administration's original policy consisted of a three-pronged approach:

(1) The adoption of a forceful energy program by the United States;

(2) A combination of U.S. policy initiatives designed to slow inflation and reduce unemployment; and

(3) A commitment from the surplus countries, particularly Germany and Japan, to raise their real growth rates.

An approach involving these three elements was perceived by the Administration as being essential to combat the world's two main problems -- economic stagnation and external payments imbalances. The decline of the dollar was viewed as being symptomatic of the failure of the world economy to deal effectively with these problems. Underlying the U.S. approach to these problems was a strong commitment to a cleanly floating exchange rate, and to the free movement of goods and capital internationally.

Although the United States has not as yet met with much success in attaining its objectives, the policy perspective was, and still is, the correct one. As a result of the persistence of huge though declining OPEC surpluses, the non-OPEC world must run

33-958 O - 78 - 8

current account deficits. How the non-OPEC world deficit will be distributed among the countries of the non-OPEC world will be heavily dependent on the kinds of internal domestic policies each pursues. The rapid growth policies pursued by the United States, the high levels of aggregate demand maintained by the vast majority of the developing countries, and the cautious demand management policies adopted by a number of the industrialized countries -- the most notable examples being Germany and Japan -- explain, in large measures, why world current account imbalances are so disparate. Unless and until macroeconomic policies are coordinated, it will not be possible for the world economy to achieve a structure of payments imbalances that is less destructive of our payments system; and unless the coordination is based on a universal commitment to higher growth worldwide, it will not be possible to solve the problem of world stagnation.

Some of the surplus countries argue that the United States has an obligation to pursue on its own a number of policies to reduce its current account deficit. Certainly, strong and effective energy and anti-inflation policies are necessary for both domestic and international reasons. But the recommendation that the U.S. sharply curtail its rate of economic growth has properly been rejected by the Administration. And without a convergence of growth rates among at least the industrialized countries current account balance in the U.S. will not be achieved without a further decline in the value of the dollar. Thus, if the surplus countries do nothing to pump up their economies, the inevitable result will be a continued reduction in the inflation-adjusted foreign exchange value of the dollar until the U.S.

current account deficit is reduced through a sharp increase in the relative competitiveness of U.S. goods in world markets. As Rudiger Dornbusch argued in testimony before the Joint Economic Committee on July 18, 1978:

> Neither of these policies is desirable. They are disruptive of an already shaky recovery abroad, and they do little to deal with the fact that the world economy faces two problems -- aggregate slack and external imbalances.16/

16/ Testimony of Rudiger Dornbusch, 1978 Midyear Hearings of the Joint Economic Committee, United States Congress, July 18, 1978.

Professor Dornbusch's recommendation in this regard is one with which we are in agreement: there must be an adjustment strategy that is "coordinated" and that "involves a substantial growth contribution of the surplus countries, in particular Germany and Japan."

Professor Dornbusch summarized his case for a coordinated expansion as follows:

> In summary, the current position is one where the United States should no longer assume growth leadership but rather be concerned about arresting the acceleration of inflation and the decline in investment and productivity growth. Germany and Japan, by contrast, should (make a) serious commitment to real growth. Such a commitment is important for the world economy since their accumulated loss in competitiveness cannot fail to start cutting into their real growth and thus has to be offset. At the same time their growth leadership will allow the poorly adjusted surplus countries -- Italy, the U.K. and other countries that have been IMFed -- to take a more expansionary posture without endangering their external position. There is little doubt that such an expansion will be inflationary for the leading countries, but then their good inflation performance has in good measure been borrowed and now should be returned. The expansion will also improve the terms of trade of primary producers and their export revenue. This will spread the expansion to poor countries.

Given their high import propensities, we can be certain that most of that expansion will be spent on industrialized countries' output and thus add to the expansion or reduce the required initial stimulus.17/

17/ Rudiger Dornbusch, op. cit.

The coordination of macroeconomic policies and the worldwide commitment to rapid growth are also important for one additional reason -- together they solve the surveillance problem. Again, to quote from the testimony of Professor Dornbusch:

> The problem of exchange rate surveillance is largely the problem of a world economy with insufficient aggregate demand. . . . International coordination of the pace of economic activity is the essential route to reconcile divergent interests and the implied pattern of equilibrium exchange rates is one aspect of the coordination. In this perspective exchange rate surveillance for major countries without a commitment to coordination is entirely illusory as an international undertaking.18/

18/ Rudiger Dornbusch, *op. cit.*

The Need to Reverse the Tide of Growing Protectionism

Stagnating economic conditions and the persistence of payments imbalances have caused many of the world's economies to resort to the increased use of protectionist devices as a means of solving their economic ills. Unfortunately, trade and capital restrictions breed resentment and invite retaliation. In the long run the economic losses caused by these policies far outweigh their gains.

The varied forms of new protectionism have begun to have a real impact on trade flows. According to the Secretariat of the General Agreement on Tariffs and Trade (GATT), in the past two years alone, protectionist policies adopted by the industrial countries have restricted between 3 and 5 percent of world trade amounting to some $30 to $50 billion.

The types of protectionist devices now employed by the industrialized countries run the gamut from traditional tariff and non-tariff barriers to various forms of government subsidies, tax credits, loans and loan guarantees, and supplemental employment benefits. The proliferation of these restrictive trade practices raise special problems for the more advanced developing countries that have recently become major exporters of manufactured goods. For example, the new Multi-Fibre Arrangement (MFA) has imposed additional restrictions on the growth of developing-country textile exports. The previous MFA agreement allowed an average annual growth rate for textile exports of about 6 percent. Countries were also able to shift exports from one category to another with considerable freedom. Under the new agreement, current and potential

exporters will find their growth limited to between 0.5 and 4 percent a year. Shipments to the Common Market will actually be cut. And, further limitations on the diversification of exports have been added by many countries.

Increased protectionism on the part of the developed world constitutes a reversal of previous trade practices toward the developing nations. Until very recently, much of the industrial world adopted various forms of preferential treatment for developing country goods. Tariff cuts under the GATT were often extended to the developing world on a most-favored nation basis with no expectation of reciprocal tariff cuts. Moreover, export subsidies given by the developing nations to their new export industries were widely tolerated by the industrial powers. Thus, the Trade Act of 1974 allowed the President the authority to waive application to the statutory response tax (our countervailing duty law) to export subsidies.

There is no indication that the import pressures from the developing world are about to abate. Quite the contrary. The more advanced developing countries such as Brazil, Mexico, Korea and Taiwan are already beginning to diversify the range of their manufactured exports. Assembly and other labor-intensive operations are already moving from the more advanced developing countries to those less developed countries with lower production costs. Modern, capital-intensive industries are springing up in Iran and the Arabian peninsula.

The response of the United States and the rest of the industrial world to these growing competitive pressures will largely determine

the path of world development in the next quarter century. If preferential treatment is replaced by a series of import quotas or other protectionist devices the prospects for growth in the developing world will be considerably dimmed.

It is unfortunate that the United States has seen fit to impose trade restrictions on a number of imports.19/ 20/ During 1977, an orderly marketing agreement was negotiated with Japan to limit the import of color television sets; quotas were imposed on the imports of nonrubber footwear from the Republic of China and Korea; additional countervailing duties were imposed on the imports of handbags from Korea; a trigger-price mechanism was introduced to prevent the dumping of steel imports; a variable import fee was imposed on imported sugar; restraints on textile imports were tightened in agreements with several exporting countries; and the duty-free treatment of 115 items from specified developing countries was withdrawn from the Generalized System of Preferences because such imports exceeded "competitive need" limitations. Not all trade decisions undertaken during 1977 were protectionist in nature, of course, but the shift toward increased protectionism was quite distinct.

19/ Senator Ribicoff disagrees with this sentence. See his comment at the beginning of the chapter.

20/ Congressman Long states: "In my judgment, it is not so much unfortunate that the United States 'has seen fit to impose trade restrictions,' so much as it is unfortunate that our trading partners have often forced us into such a position by their own unfair trade practices, such as dumping excess supplies of sugar on a saturated U.S. market."

Trade restriction is undesirable. However, it is important to recognize that import competition may cause dislocations that need to be offset. The removal of previously existing trade restrictions constitutes a change in the "rules of the game," and compensation in such cases is especially justifiable. However, adequate relief for victims of import competition will require that our adjustment assistance program be revamped and expanded.

The history of trade adjustment assistance in the United States has not been a happy one. The original program, which was part of the Trade Adjustment Act of 1962, was built around payments to workers and loans to firms that had been injured by import competition due to the lowering of tariffs. The standards for application under the program were so high, however, that from the inception of the program to 1969 not a single worker received trade adjustment assistance. The rules were substantially revised in the Trade Act of 1974. Imports now need only be a "substantial" rather than the sole cause of injury, and the link to tariff concessions was broken. In addition, the program was expanded to include whole communities. However while some of the costs of dislocation have been covered by this program, it is still widely regarded as a supplemental unemployment insurance scheme that provides too little too late. In union circles, the program is often referred to as "burial assistance," and the complaint is made that little is done to replace the jobs that have been lost. In testimony before our Committee, a number of economists emphasized the need for an expanded and liberalized treatment of workers, firms, and communities. Professor J. David Richardson suggested that additional tax incentives,

loans, and grants be added to the trade adjustment assistance arsenal.21/ We should not delay investigating the possibility of adding these measures.

21/ Testimony of J. David Richardson, 1978 Midyear Hearings of the Joint Economic Committee, Congress of the United States, July 13, 1978.

The Continuing Need to Recycle Surpluses 22/

The huge payments imbalances that exist worldwide are an obstacle to economic growth and development. The drain in spending caused by the increase in the current account surpluses of some countries has not been matched by an increase in world spending sufficient to maintain high levels of world output and employment. As a result, the world economy has been stagnating, and unless something is done to convert surpluses into effective aggregate spending, the world economy is in danger of remaining in a permanently stagnant condition.

To ensure world prosperity, the savings generated at full employment must be matched by an equivalent level of private and public planned investment. If a group of countries undertakes actions to raise their current account surpluses, this raises planned world saving relative to planned world investment. The maintenance of world demand, then, necessitates that the countries of the rest of the world accept increases in their deficits or reductions in their surpluses by an equivalent amount. However, if they respond by attempting to reduce their deficits or raise their surpluses, planned investment will fall short of full employment saving. This is equivalent to saying that aggregate demand will be deficient and that part or all of the world economy will operate below its potential.

22/ Congressman Hamilton states: "The section on 'The Continuing Need to Recycle Surpluses' continues an intriguing suggestion to improve the recycling of the OPEC current account surplus to the developing world. The

Congressman Hamilton's footnote continues:

proposal involves the creation of a new world body, the commitment of the industrial countries to subsidize the interest on OPEC loans to developing countries and guarantees against default on the OPEC loans.

"Before any such scheme should be adopted, there are several factors that must be carefully weighed. First, the size of the OPEC surplus, relative to the world economy. Second, a move to establish a new world body should only follow a careful analysis of how well existing international economic institutions have recycled the OPEC surplus and an evaluation of OPEC's growing role in the world economy. Third, although I strongly support concessional assistance to developing countries, many of the large, oil deficit developing countries are important exporters of other goods and have access to world financial markets."

Unhappily, this is precisely what has happened in the wake of the fourfold increase in oil prices effected by the OPEC countries in 1974 and by the subsequent policy responses of the world's other economies since that time.

In testimony before the Committee, Arnold H. Packer, Assistant Secretary for Policy, Evaluation and Research of the U.S. Department of Labor, put the matter this way:

> Worldwide, we face the classic Keynesian situation where desired savings exceed investment. The imbalance between savings and investment within individual countries stems from a failure to make up for OPEC surpluses in terms of effective demand. Deficits induced by the higher costs of imported oil have made industrialized democracies extremely cautious in effecting policies to offset these imbalances.
>
> If investors were sufficiently confident and were able to obtain bank loans at low enough interest rates, private investment might rise by enough to replace the purchasing power lost through oil imports. But, this is not the prevailing situation. Quite simply, under current interest rates, investment will not rise enough to match desired savings. Similarly, governments could replace lost purchasing power through full employment budget deficits. However, again, most governments appear unwilling to take this risk.

> Instead, as Secretary Marshall noted before the Empire Club in Toronto, the industrial world leaders are uncomfortably balancing the political costs of budget deficits against those of high unemployment.23/

23/ Testimony of Arnold H. Packer, 1978 Midyear Hearings of the Joint Economic Committee, United States Congress, July 19, 1978.

This quote summarizes the problem. In 1974 and 1975, much of the burden of the OPEC price increases was borne by the developing nations. The 1974 deficit of the nonoil developing countries amounted to $32.5 billion; in 1975 it rose to $42.9 billion. In large measure, this group of countries was able to run deficits of this size because of the sharp increase in the availability of debt finance, particularly from private sources.

The responses on the part of the developed nations were mixed. Many of the Western industrialized countries significantly slowed the growth of their economies. The United States, on the other hand, pursued policies designed to maintain a high level of aggregate demand. Overall, however, the growth in demand on the part of the industrialized countries has been well below the rates achieved over the 1960-73 period. And as we emphasized earlier, sluggish growth is likely in the near future.

To avoid continued stagnation, it is desirable that world demand be kept strong. At the minimum, it is essential that the major industrialized countries not pursue restrictive policies, as some have done in the recent past. Additionally, some means must be found to recycle OPEC payments surpluses into effective demand. Such recycling will be assisted by the newly instituted Witteveen facility.

More needs to be done. The difficulty at present is that the OPEC nations as a whole do not have the absorptive capacity to utilize their oil revenues for the purchase of imports. This problem has diminished somewhat in the past year or so, but their overall surplus remains nonetheless sizable.

33-958 O - 78 - 9

Thus, other countries, such as the United States, must run deficits. Our own deficit could be eliminated and we could pay for our oil imports if we could increase our export sales to the nonoil-producing, less developed countries (LDCs). If these nonoil LDCs could obtain our goods, this would greatly enhance living standards throughout the world and provide an enormous boost to the rate of economic development. The difficulty is that the developing countries do not have the means to pay for our goods. However, if the OPEC nations would lend their surpluses to the nonoil LDCs, this difficulty could be overcome. The trick, of course, is to make it worthwhile and less risky for OPEC to lend its "petrodollars" to these countries.

In this respect, there is a possible solution that could overcome the difficulties the nonoil LDCs are facing. First, the United States could join with other industrial countries to subsidize the interest on the loans which OPEC would make to the LDCs. At present, the LDCs cannot pay a high enough rate of interest to satisfy OPEC. It can be argued that they ought not to pay more than concessionary rates and perhaps they should not be forced to pay interest at all. This would not be costly relative to other forms of development assistance, and it would probably prove to be a more effective way of providing such assistance than any device that has hitherto been employed.

Second, OPEC countries could be attracted to the scheme proposed here if it included insurance against expropriation. Such insurance could be provided by an international lending institution. The role of the institution would be to borrow funds from OPEC and issue guaranteed securities to

the OPEC lenders. The institution would then lend the funds to the LDCs for use in development projects. The task possibly could be handled by the present International Bank for Reconstruction and Development, or it might be better to establish a new institution that would serve this particular purpose.

A plan of this sort should be given serious consideration as soon as possible. It represents a triangular solution that would restore world growth and prosperity, enable the industrial countries to pay for their oil imports and eliminate their deficits, provide the LDCs with the resources needed for their development, channel OPEC surpluses into those areas where they are most needed, and contribute to international financial stability by moving the lending to LDCs from private into official channels.

III. KEY DOMESTIC POLICY ISSUES

Introduction

Almost 4 million more persons were at work in civilian employment in the second quarter of 1978 than in the second quarter of 1977, and the unemployment rate dropped from 7.1 percent to a level that has been hovering near 6 percent since February. On the other hand, real GNP has grown only at a modest 4.3 percent rate during that same period. This unimpressive output growth, combined with the employment increase of 4.6 percent, leads us to wonder if the employment gains can be sustained, and it further adds to a long-standing worry that productivity growth in the U.S. economy is not nearly what it ought to be.

During the 1950s labor productivity, or output per hour of all persons in the private business sector, advanced at an annual rate of 3.4 percent. In the 1960s it averaged 3.0 percent, although evidence of a slowdown began in 1967. Over the 1967-1977 period productivity rose at a rate of only 1.6 percent a year. And during the first two quarters of 1978 the behavior of productivity has been worse still and for reasons that are far from clear. During the first quarter productivity fell at an annual rate of 4.7 percent. Although in the second quarter manufacturing productivity picked up to a rate of 7.2 percent -- after two quarters of decline -- overall productivity in the private business sector groped along at a rate of 0.8 percent.

When productivity slumps, unit labor costs tend to rise more rapidly because the effect on the cost of producing each unit of output from increasing hourly employee compensation is not moderated by the ability of workers to produce a larger hourly volume of output. In the first quarter of 1978, unit labor cost in the private business sector rose at a rate of 17.6 percent. While some of this rise reflected increased compensation due to higher social security taxes and an increase in the minimum wage rate, the unit labor cost increase of 7.2 percent in the second quarter was still alarmingly high and it implied a substantial increase over the 6.4 percent increase of 1977.

These developments have made a rise in the rate of price inflation inevitable. Consumer prices, which rose 6.8 percent during 1977, jumped to an annual rate of 9.3 percent in the first quarter of 1978, and to an even faster rate of 11.4 percent in the second quarter. This averages out to a double digit rate of 10.4 percent for the first half of the year. While a portion of this acceleration can be attributed to increases in farm prices, there is little doubt that the underlying productivity and unit labor cost situation has deteriorated significantly, and that the basic inflation problem is therefore getting worse.

As noted in the introduction to this report, the combination of slow growth of output and productivity relative to the growth of employment and labor force has held back the rapid rise in per capita income and consumption that our people have come to expect. Total potential real GNP is now roughly 20 percent lower than it would have been had productivity after 1967 continued to grow at the rates of the two preceding

decades. This situation has been aggravated by further reductions in take-home pay caused by rapidly rising payroll taxes and by the tendency of inflation to drag taxpayers into higher brackets and to cause sharp and arbitrary increases in their property tax liabilities. Under the circumstances, it is quite understandable why a climate has been created in which citizens are attempting to enlarge their own incomes by cutting into Government's share of the national product. The so-called tax revolt, in our judgment, is very much a reflection of the combination of lagging productivity and inflation.

The purpose of this chapter is to deal with these concerns. Why is productivity performance so poor and what can be done about it? What is the most effective way to deal with the tax revolt? And how can the tax system be altered in a way that eliminates the arbitrary and capricious effects of inflation and at the same time slows inflation? What other measures can be taken to slow inflation yet preserve the operation of free choice in free markets and that do not slow economic growth and increase unemployment?

Productivity and Investment 1/

Table III-1 provides some essential facts that are of help in understanding productivity developments. Labor productivity for the private economy advanced at average annual rates of 3.3 percent during the twenty year period 1947-67. However, productivity growth dropped sharply thereafter, falling to a rate of 2.0 percent in 1967-73, and to 1.2 percent in 1973-77.

1/ Senator Ribicoff states: "In general I concur with the discussion of productivity in this chapter. I believe that the slowdown in productivity growth in the United States is one of our most serious problems.

"I also support the comments in this chapter regarding investment tax credits and accelerated depreciation for stimulating capital formation and investment."

The shifting of employment out of agriculture and into the nonfarm sector of the economy has been a significant source of past productivity growth. Average productivity in the farm sector has been less than in the nonfarm sector, so that shifts in employment from the farm to the nonfarm sector carry with them productivity gains. The movement of workers out of farming is now largely over and the net impact of this shift on productivity is therefore also at an end. As Table III-1 shows, this factor accounts for a drop in the growth of labor productivity of about 0.6 percentage points. There is, of course, nothing that can be done about this source of decline.

TABLE III-1

PRODUCTIVITY, CAPITAL STOCK AND RELATED GROWTH RATES
(Average annual percentage rates of growth)

	1947-57	1957-67	1967-73	1973-77
Output Per Manhour (Labor Productivity)				
Private Sector	3.3	3.3	2.0	1.2
Farm Increment	0.8	0.4	0.2	0.2
Private Nonfarm Sector	2.5	2.9	1.8	1.0
Capital Stock				
Gross Stock	3.7	3.4	4.2	3.1
Net Stock a/	4.8	4.0	4.2	2.5
Net Stock Excluding Environmental Capital	4.8	4.0	3.9	2.0
Capital Productivity b/	-1.1	0.1	-0.4	-0.8
Capital/Labor Ratio c/	3.7	2.8	2.2	1.7

a/ Net capital stock of the private nonfarm sector.
b/ Ratio of output of the nonfarm business sector to net capital stock (Q/K).
c/ Ratio of net capital stock to employed manhours.

Sources: Bureau of Labor Statistics and Bureau of the Census.

Labor productivity is sensitive to cyclical swings because employment generally declines proportionately less than output during recession. The poorer cyclical performance of the economy in the 1970s therefore helps to explain its poorer productivity performance. It should be noted, however, that the worst recent year for labor productivity was 1974 when it fell by almost 3 percent. Many analysts believe this to have been a one-time effect caused by sharp increases in energy prices rather than a normal by-product of recession.

A third factor that is frequently cited as a source of productivity decline is an alleged deterioration in worker attitudes and an increase in crime and dishonesty. These developments lower productivity because they reduce output and because additional labor inputs must be diverted from productive activity to the prevention of crime. However, if workers have poorer attitudes, they also have better education. Better education has been estimated to add about 0.9 percentage points to the annual growth of labor productivity.

A fourth factor of which much has been made is the relative rise in the number of women and teenagers in the labor force. Since these groups have less work experience and job training, a shift to greater relative employment of these groups lowers labor productivity. It should be noted, however, that the proportion of employment accounted for by women has increased at roughly comparable rates during the ten years before and after 1967. Therefore, although a rise in the proportion of women in the work force lowers productivity, this fact cannot explain the productivity deterioration of the last ten years.

The rapid growth of regulations governing health, safety, and pollution control is another important impediment to productivity growth. Such regulations necessitate the use of resources for safety and environmental protection. However, the output from these activities -- improved health, greater safety, cleaner air, and the like -- are not a part of measured output. Their provision therefore reduces labor productivity even though the well-being of society may be vastly greater than it would otherwise have been. In a recent study, Edward F. Denison estimated that growth of labor productivity was reduced by 0.26 percentage points in the 1969-75 period and by 0.47 percentage points in 1973-75 by the various environmental and safety laws and regulations. 2/

2/ Edward F. Denison, "Effects of Selected Changes in the Institutional and Human Environment Upon Output Per Unit of Input," U.S. Department of Commerce, Survey of Current Business Volume 58, No. 1, January 1978, pp 21-44.

Two of the most important sources of lagging labor productivity are the low level of research and development spending and the very slow growth of the stock of productive capacity relative to the growth of labor inputs. To separate out the importance of these two factors it is useful to partition output per manhour (Q/L) into the product of average output per unit of capital (Q/K), and the ratio of capital to labor (K/L). That is to say,

$$Q/L = (Q/K) \times (K/L).$$

Although this is a definitional relation, and although capital productivity and the capital-labor ratio are not independent, the partitioning sheds light on the separate importance of capital productivity and the capital-labor ratio, respectively, in determining labor productivity. It follows from this partitioning that the rate of growth of labor productivity is roughly equal to the sum of the rate of growth of capital productivity and the rate of growth of the capital-labor ratio.

Growth in capital productivity is reflected in all the factors that improve the _quality_ of the capital stock and that permit each worker to produce more output because he has a better machine or a more efficient production process to work with. Underlying the growth of capital productivity is new technology, and underlying new technology are research and development (R&D) activities.

R&D outlays (in constant 1972 dollars) reached a peak of $31.1 billion in 1968 after growing at an annual rate of 8.6 percent since 1953. Thereafter, real spending for R&D has declined, coming to only $28.5 billion in 1977, with both the Federal

Government's and the private sector's contribution declining sharply. This poses a very serious threat to the future growth of capital productivity and, therefore, also to labor productivity.

Nearly all studies of the returns to R&D outlays indicate that they are very high. Despite its overall profitability, sufficient R&D outlays from the private sector may not be forthcoming because of the high risk of failure, the difficulty of capturing the full return by the investing firm, and the long and unpredictable lags between outlay and return. For all these reasons a socially optimal level of R&D activity may require considerable government participation and support.

As noted above, the rate of growth of labor productivity may be calculated as the approximate sum of the rate of growth of capital productivity and the rate of growth of the capital-labor ratio. Therefore, with constant capital productivity, a 1 percentage point increase in the capital-labor ratio translates directly into a 1 percentage point increase in output per manhour. Table III-1 shows an alarming reduction over time in the growth of the capital-labor ratio. The link between this declining rate of growth and the deterioration of labor productivity is direct and striking.

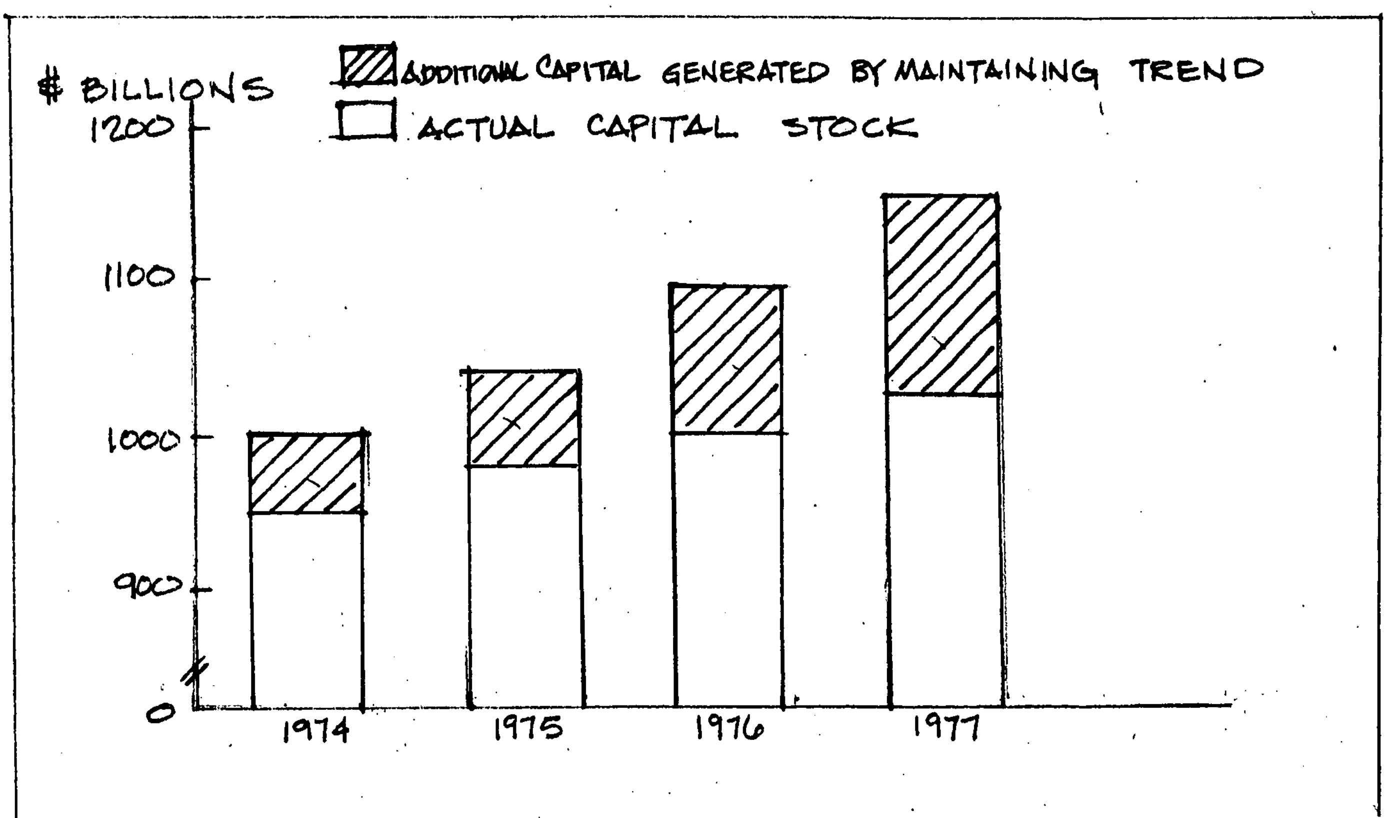
The problem, very simply, is that the U.S. economy is putting too few of its resources into the expansion of its capital stock. Although the ratio of real business fixed investment to real GNP has been very close to 10 percent in the 1970s, as it was in the 1960s, it has been well below 10 percent in 1975-77. In addition, the labor force has grown much more rapidly during the 1970s.

The growth of the capital-labor ratio has suffered for both reasons. Our capital expansion performance since 1973 has been exceedingly poor. Real capital spending fell sharply during the recession of 1974-75 and revived less rapidly than in preceding recoveries. By the end of 1977, it had not yet recovered to its peak of the first quarter of 1974. Fortunately, it is now showing strong signs of life. Since the second quarter of 1977 real business fixed investment has risen 8.9 percent and the previous peak was finally exceeded in the second quarter of this year.

Despite the very strong performance of the last four quarters, the cumulative loss of capital stock due to the recession, combined with projections for continued rapid labor force increase, strongly suggests that special measures to promote capital spending are needed if productivity growth is to recover even to the modest levels of 1967-73. Policies that would raise the ratio of real fixed investment to real GNP to the 11 percent range for the next few years would be extremely beneficial. Productivity growth would be restored; inflation would be moderated; our international competitive position would be improved; productive new job opportunities would be created; and there would be less pressure to seek tax relief and whittle away at the services that governments need to perform.

The first requirement of a program to raise the rate of capital formation is to ensure that the growth of the economy is sustained and not interrupted by another recession. New capacity will not be installed if there is no assurance that it will be regularly used.

Chart III-1



Recession causes excess capacity and the postponement or cancellation of capital projects. As in 1973, recovery may then find production straining against capacity even when unemployment is still high. The capacity bottlenecks raise the inflation rates. If this then induces policy to attempt to slow inflation by slowing the economy, the consequence may be yet another recession. Compared with a smoothly growing economy, the roller coaster economy, on balance, will put less capacity into place, it will enjoy lower growth of productivity and per capita income, suffer a higher average rate of unemployment, and it may also have more inflation. While the recessions of the roller coaster economy will tend to slow inflation, the periodic capacity shortages and sluggish productivity growth will exacerbate it. The most important task for economic policy therefore is to steer an even course that avoids abrupt turns and that maintains steady economic expansion.

In the 1977 Midyear Review and again in the 1978 Joint Economic Report,3/ the Committee devoted considerable attention to the mix of monetary and fiscal policy. Our analysis led us to conclude that recovery from the recession had been primarily supported by fiscal policy, while monetary policy had remained restrictive because of its concern with inflation and the international condition of the dollar. The consequence of such a tight monetary-easy fiscal mix has been to bias spending in the direction of consumption and away from investment. A growth-oriented policy would attempt to shift the mix in the other direction. It would attempt to release resources from government use by slowing the growth of government purchases and/or from consumption by permitting taxes on individuals to rise. The released resources can then be made to flow into investment by lowering the cost of capital. The principal way of doing this is to lower interest rates through an easier monetary policy.

3/ 1977 Midyear Review, op. cit., pp. 55-58; 1978 Joint Economic Report, op. cit., pp. 46-48.

33-958 O - 78 - 10

Chairman G. William Miller of the Federal Reserve has stated that a more austere fiscal policy would permit the Federal Reserve to ease monetary conditions. Congress has responded by delaying and scaling down the President's tax reduction proposals. However, thus far there is no indication that the Fed is ready to let up on the monetary brakes in the interest of supporting capital spending. Indeed, the steady escalation of the Federal funds and rediscount rates this year, and the recent decision to raise short-term interest rates to shore up the international value of the dollar, all indicate that the Fed is embarked on a dangerously restrictive course of action.

The use of tax incentives to stimulate capital spending has received much attention. Several studies show that per dollar of budget cost the best result can be obtained by liberalizing investment tax credits or depreciation allowances. Next in order of effectiveness is reduction in the corporate income tax rate. And well down the ladder are such measures as integrating the corporate and the individual income tax and reducing taxes on capital gains. The rationale for the hierarchy is easily explained by noting that the benefits from liberalization of investment tax credits and depreciation allowances are directly tied to additional spending on plant and equipment. The other measures provide investment incentives only indirectly. Reduction in the profits tax rate increases the availability of internal funds, but does not guarantee that the funds will be used to buy new capital assets nor does it do anything to provide capital to those who wish to start new enterprises. The link between a reduction in capital gains taxes and capital spending is even more remote, having to rely for its effect on an increase in savings, with no assurance at all that the savings will flow into investment in new physical assets.4/

4/ Congressman Reuss adds: "A reduction in the capital gains tax applicable to land values would produce a further unacceptable inflationary increase in those land values with little or no beneficial impact on investment. However, a reduction in the capital gains tax on common stocks could have a direct and positive effect on capital formation. Common stocks are now selling at a lower nominal rate and a much lower real

Congressman Reuss's footnote continues:

rate than a dozen years ago. A lowering of the capital gains tax on common stocks could well produce a speedy improvement in stock market averages. This would promptly improve the ability of corporations, large and small, to float equity capital, usable for both Research and Development and for investment in plant and equipment -- both leading inducers of inflation fighting increased productivity. In addition, a livelier stock market could grow by what it feeds on through the likely influx into the stock market of additional foreign capital.

"Common stocks constitute only about one-fifth of all wealth subject to the capital gains tax, a much smaller share than real estate. A reduction in the capital gains tax on common stocks alone deserves serious consideration: its ratio of economic benefits to revenue costs may be surprisingly favorable."

Under normal accounting practice, a firm that purchases new plant and equipment spreads the cost of the assets over their useful lives. Present law requires firms to reckon these "depreciation allowances" on the basis of the original cost of the assets even though inflation raises their replacement cost. If firms were permitted to depreciate assets on a replacement rather than an original or "historic" cost basis during a period of inflation, depreciation charges would be raised, nominal profits would be lowered, and so would corporate income tax liability. If there were no inflation, the method of accounting would make no difference. Thus under presently required accounting practices, a rise in the inflation rate raises real corporate tax liability, lowers real after-tax profits, and therefore reduces the real after-tax rate of return on fixed investment. This means that there is a direct adverse link between the rate of inflation and the level of capital spending, and this traps the economy in a vicious circle. Low investment and sluggish productivity help to raise the inflation rate, and the higher inflation rate helps to keep investment and productivity depressed.

A quantitative estimate of the adverse effect on profits of current depreciation rules was provided by Dr. Martin Feldstein who testified before the Committee as follows:

> We estimate that the historic cost method of tax depreciation caused corporate depreciation in 1973 to be understated by more than $25 billion. This understatement increased corporate tax liability by $12 billion, a 20 percent increase in corporate taxes. This extra inflation tax reduced net profits by 23 percent of the total 1973 net profits of $53 billion.

Dr. Feldstein concluded by stating:

> ...I want to stress that I think that this is the single most important adverse effect of inflation on capital formation. 5/

5/ Testimony of Martin Feldstein, 1978 Midyear Hearings of the Joint Economic Committee, United States Congress, July 11, 1978.

The mounting evidence that current accounting practices combined with inflation are impeding investment suggests that it may be time to permit firms to correct for inflation in computing their depreciation allowances. But such inflation correction should be made carefully lest the cure be worse than the disease. It would be very damaging to the economy's resource allocation mechanism if a firm were permitted to write up the value of physical assets on the basis of the replacement costs of specific assets rather than on the basis of an adjustment for overall inflation. To permit an ancient and obsolete machine to be depreciated in accordance with what it would cost to replace it today is not practical, and even if it were, permitting firms to do this would impair incentives to improve technology and to shift into the capital assets that embody the best and most economical technology. Relative price differences between different capital goods with different technologies should be maintained. Inflation correction based on specific asset replacement cost would obscure these relative price signals and would amount to use of the corporate income tax to subsidize the retention of obsolete technology.

Use of an overall capital goods price deflator would also be a dangerous and deficient procedure. While this would allow for relative price changes between capital goods, it would not allow for relative price shifts between capital and other inputs. If the cost of capital goods is rising relative to the cost of labor, this should signal the desirability of shifting to more labor-intensive technologies. But if the higher capital costs are offset by tax breaks because depreciation allowances are overly inflated by a capital goods deflator that

rises faster than other input prices, this relative price signal will be lost.

If provision is made for inflation correction of depreciation allowances, the price deflator that is used to make the correction should be a general price deflator such as the implicit price deflator for GNP or the price deflator for the private nonfarm economy. This would correct nominal corporate profits for the effect of overall inflation, and since it would not obscure or offset relative price movements, would not have adverse effects on the allocation of resources.

If inflation correction of business capital assets is introduced, it should probably apply only to the plant and equipment installed after a date specified in the legislation, although some retroactivity provision would be needed to prevent postponement of capital spending while the legislation is being considered. This way of designing the legislation would have a more favorable immediate effect on new investment than if the privilege were extended to all capital assets, and it would involve very little loss of revenue in the initial years. If the reform is successful in stimulating investment and growth, the revenue lost in subsequent years would be negligible as well.

Tax Policy and Inflation 6/

Need for Tax Reduction

As noted earlier, the combination of stagnant productivity and rapid inflation has placed a squeeze on the real take-home pay of the average citizen, and this has produced urgent demands for tax relief. Meanwhile, Federal taxes will rise quite substantially in 1979 unless such increases are prevented by speedy legislation. All of these factors, together with the outlook for a weaker economy in 1979, suggest that some Federal tax reduction is now appropriate. The issue, as always under such circumstances, is what form the reduction should take and what its magnitude should be.

6/ Senator Bentsen says the report's analysis of inflation is deficient because it does not address the relationship between government spending, federal deficits, and our inability to bring inflation under control.

The yield from all taxes tends to increase as GNP increases. But increases in yield that are proportional to the growth of GNP do not increase the relative burden and restrictiveness of the tax because the rate of tax -- the ratio of the tax to GNP -- is unaffected. It is when the yield from a tax rises more rapidly than the rise in GNP that the aggregate rate of the tax increases and its relative burden and restrictiveness rise. Such disproportinate increases are often referred to as "fiscal drag," and they may come about automatically, as in the case of the individual income tax where increases in money income shove taxpayers into higher brackets, or they may come about when previously legislated tax increases go into effect.

Under existing legislation, there will be a considerable amount of fiscal drag from both sources in calendar year 1979. If the only change in the individual income tax is to extend temporary measures presently scheduled to expire, the disproportionate increase in this tax will be about $13 billion. Because of preexisting social security legislation, the disproportionate increase in social insurance taxes will be close to $10 billion. Therefore, there is likely to be a total fiscal drag of $23 billion on the tax side in 1979, and an overall tax reduction of roughly this magnitude would be appropriate provided no additional fiscal stimulus is desired. Such a tax reduction would not reduce the Federal Government's share of the national product. It would help to sustain the expansion of the economy, and if carefully designed, it could help to reduce the rate of inflation.

Inflation Correction of the Individual Income Tax 7/

One aftermath of the adoption of Proposition 13 in California has been the introduction or resurrection of a number of other tax proposals. One proposal which has been taken quite seriously was to eliminate capital gains from the preference items subject to the minimum tax, and to impose a maximum tax rate of 25 percent on all realized capital gains rather than the first $50,000, as under current law. These proposals would have eliminated many of the changes in capital gains taxation that Congress enacted in 1969 and 1976.8/

7/ Congressman Hamilton states: "The agruments for indexing the personal income tax that are discussed in this report reflect considerable originality. They are very much the kind of new economic thinking that the Joint Economic Committee should present to the Congress. I remain concerned, however, that indexing the personal income tax will exacerbate rather than reduce the problem of inflation. We should not move to index the tax code without further extensive studies."

8/ Senator Bentsen says: "There are a number of distinguished economists who believe that enactment of this proposal would substantially increase the real growth of GNP and employment. For example, a study by Chase Econometrics indicates that a proposal along the lines described above could increase employment by 400,000 jobs and real growth by .2% by 1985."

Another measure that has picked up momentum recently is the Kemp-Roth bill which would reduce individual income tax rates by an average of 30 percent over a three-year period and would also provide for sizable cuts in corporate income taxes. In its third year, the tax reductions implied by this bill could be over $100 billion.

Several of the recent tax proposals, among other things, appear to reflect frustration over the burdensome and capricious effect of inflation on tax liabilities. In defending his bill, for example, Congressman Jack F. Kemp (R-N.Y.) has emphasized the problems caused by the tendency of inflation to pull taxpayers into higher brackets. Similarly, the thrust for capital gains tax relief appears to come less from very wealthy persons than from middle-income homeowners who wish to sell their homes but realize they cannot do so without paying a tax on a capital gain that may be largely or entirely the product of inflation. The revolt against property taxes, finally, may be less a reflection of resentment against Government than of the fact that when the rate of inflation of real estate values exceeds the rate of income growth, many taxpayers find it increasingly difficult to pay their real estate taxes out of these incomes.

As noted in our discussion of capital spending, the distortions imposed on our tax system by inflation are exceedingly harmful to the economy and should be corrected. But the way to effect such correction is to structure our tax laws so as to deal directly with inflationary distortions, rather than to dismantle our tax system in a destructive way because of frustration caused by inflation.

In our 1977 Midyear Review and again in our 1978 Annual Report 9/ we discussed inflation indexing of the personal income tax. We now feel that we have studied this problem sufficiently so that a more detailed blueprint for inflation correction can be presented for the consideration of the Congress. Whereas past reports tended to present indexing as a device for reducing the pain of inflation, this Report goes a step further and explores the possibility that indexing may actually make the control of inflation easier. However, a number of Committee members feel that indexing is a concession to inflation rather than an effective device to control it. They feel the foreign experience with indexing does not support the conclusion that it is an effective anti-inflation device. Accordingly, some members feel that indexing the income tax system would be a serious mistake.10/ 11/

9/ 1977 Midyear Review, op. cit., pp 69-71; 1978 Joint Economic Report, op. cit., pp 53-58.

10/ Senator Bentsen says that he is one of the Committee Members that has serious reservations about indexing.

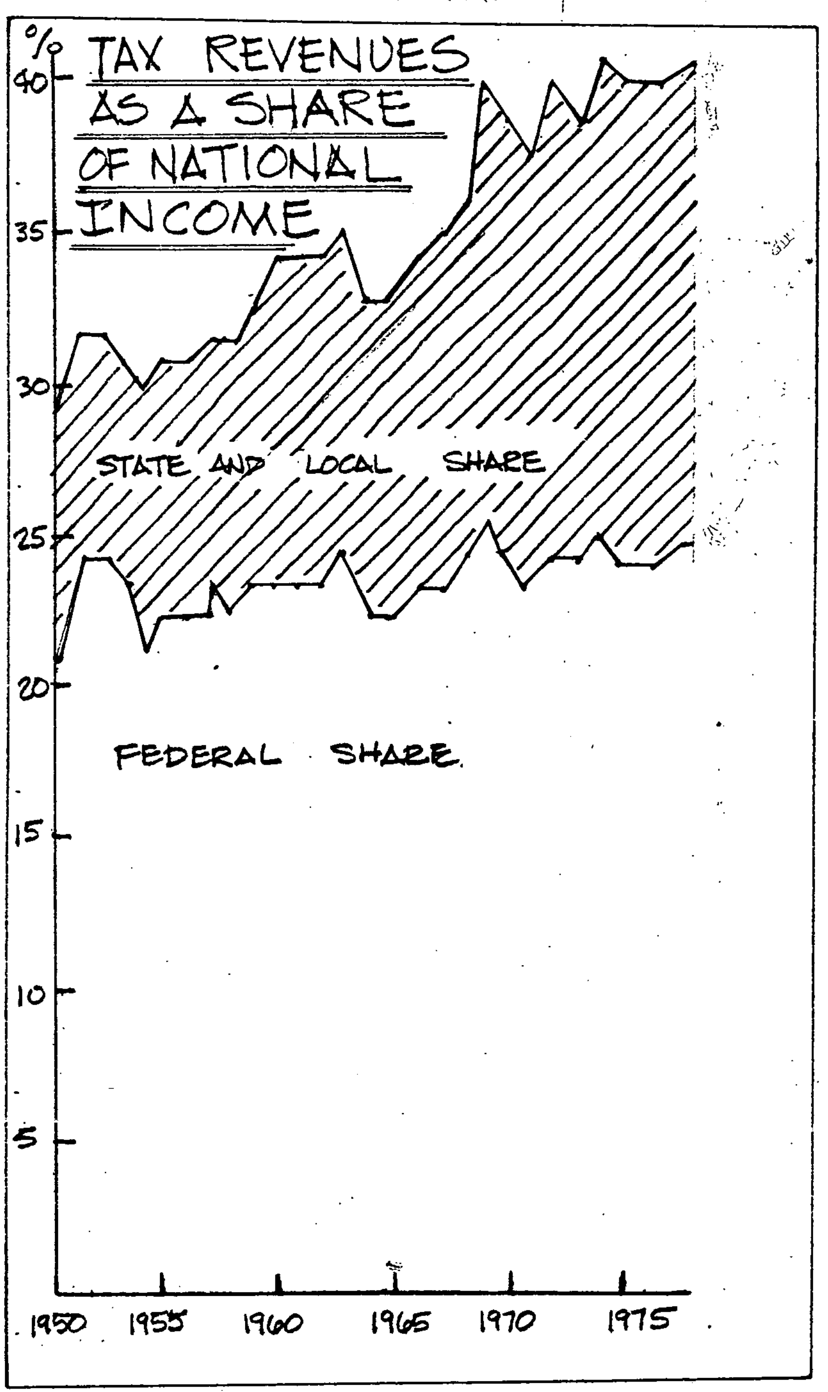
11/ Senator Ribicoff states: "I have serious doubts about indexing the individual income tax. All the evidence we have indicates that tax indexing does not stop inflation but rather has some tendency to build in inflation. Indexing merely attempts to hide the pain of inflation without attacking the problem."

In the past, discussions of tax indexing were frequently dominated by ideological considerations. Conservatives tended to favor tax indexing because indexing slows the rate at which the progressivity of the tax rates runs up Federal revenues, and thereby slows the rate at which the Federal Government is able to increase its claim over real resources. Liberals opposed indexation for precisely the same reason. History -- with considerable assistance from Congress -- has declared this war over the relative size of the public sector a stalemate. Since 1950, total Federal revenue has averaged 19.1 percent of GNP. It has exceeded 20 percent of GNP only in 1968, 1969 and 1974. The fact is that the Federal Government's share of the Nation's income has shown virtually no tendency to increase.

The reason for this stability is that Congress has granted periodic tax relief in a manner that offsets the tendency for the progressive income tax to increase the Federal share of national income. Consequently, the relevant issue is not the relative size of the Federal sector, but rather whether it is better for the economy for rising tax rates caused by inflation to be lowered by periodic and often poorly timed legislation, or whether it is better automatically to prevent the tax rates from rising in the first place.

An appropriately indexed progressive personal income tax would permit average tax rates for individuals to rise when real income rises, but not when an increase in money income is offset by a rise in prices. The way to achieve this result is to widen bracket limits, exemptions, standard deductions, and tax credits at a rate equal to the increase in the Consumer Price Index

Chart III-2



during the preceding year. In this way the real values of these categories are held constant and this prevents an individual from moving into a higher bracket if his money income increases no faster than prices.

In addition to the foregoing changes, appropriate inflation correction of the individual income tax would include a redefinition of some items of taxable income that are distorted by inflation. An obvious example is the taxation of nominal capital gains, a practice that is unfair, wasteful, and injurious to capital formation. Certainly a homeowner who has held his property for over twenty years ought not to have to pay a capital gains tax on that part of the gain that stems from general inflation. Under an indexed system only real capital gains would be taxed, a policy that would eliminate the bias that now discriminates in favor of speculative intermediate-term gains at the expense of long-term gains that are heavily dominated by the cumulative effect of inflation. Real capital gains could continue to be taxed and could even be taxed at higher rates; for example, as ordinary income without any of the special treatment that capital gains presently receive. In this manner the taxation of only real capital gains need not imply any loss of revenue.

Another area where redefinition of taxable income should be considered is the interest income of individuals. The practice of taxing nominal interest has been particularly rough on small savers. These small savers do not have access to the full scope of the capital market. They are likely to be restricted to saving deposits and similar instruments whose nominal yields are controlled by law. When the inflation rate

rises above these controlled interest rates -- as it did in 1974 and, as is now happening again -- these savers suffer an erosion in the real value of their savings. To add insult to injury, they are taxed on the nominal interest they earn, even though their real pre-tax return is negative.

One response to this problem is to tax only "real" interest. This can be computed by subtracting the rate of inflation from the nominal interest rate. If the resulting real rate is negative, the taxpayer would be permitted to reduce his taxable income by the amount of his loss. Had such a system been in effect in 1974, small savers would not have been disproportionately and unfairly punished for frugality, their wealth would not have been arbitrarily confiscated, and their consumption spending would have been bolstered at a time when this would have greatly benefited the economy.

If these simple reforms were enacted, the average aggregate rate of the individual income tax would no longer vary with the inflation rate. The question that must now be addressed is whether such neutrality with respect to inflation is desirable from the point of view of economic stability. Will the economy be more or less resistant to the effects of shocks? Will it be more or less inflation prone?

The conventional view has been that progressive taxation of money income contributes to the stability of the economy. During inflation the disproportionate rise in taxes in the unindexed system slows the growth of disposable (after-tax) income and consumer spending and thereby helps to moderate inflation. Conversely, progressivity causes tax yield to fall more

33-958 O - 78 - 11

rapidly than personal (pre-tax) income when economic activity declines. This prevents disposable income from falling less than otherwise and this helps to hold up consumer spending.

The conventional view would be correct if real and money income always moved in the same direction, as they would if excessive demand were the only cause of inflation. If this were the case we would not suggest that income tax indexing be considered. But recently we have learned that inflation can also come about from restrictions on the supply side. The supply shocks that stick out most vividly, of course, are the very sharp increases in world food and oil prices that occurred in 1973-74. Such supply restrictions tend to raise prices, and at the same time tend to reduce output. If the response to the shocks is restrictive monetary-fiscal policy, the decline in output will be that much greater, while almost no headway will be made against inflation because there is very little that domestic stabilization policy can do about prices that are determined by external conditions or misfortunes of nature.

Despite the inappropriateness of restrictive policy, it is what the economy was subjected to in 1974, and this was a major reason why the recession of 1974-75 was the worst since the great depression of the 1930s. A considerable fraction of the restriction that occurred in 1974 was the result of conscious policy decision. But considerable damage was also caused automatically because of the perverse response of our unindexed income tax during the acute stagflation of 1974.

Between the fourth quarter of 1973 and the third quarter of 1974, the period during which most of the damage was done, real GNP fell at an annual rate of 3.2 percent. However, because of the inflation rate of 11.1 percent (as measured by the implicit price deflator for GNP), money GNP increased 7.6 percent and personal income rose 9.4 percent. Personal income (net of government transfer payments) is the tax base for the individual income tax. Its rapid increase, combined with the progressivity of the income tax, caused revenue from the Federal income tax to rise 15.8 percent. The result was that the ratio of Federal income tax receipts to personal income rose from 11.0 percent to 11.5 percent during a time when real output and real wages were falling.

This did enormous damage to the economy. It meant that our income tax acted as a source of instability rather than as the automatic stabilizer that we had come to expect. An automatic stabilizer should cause the ratio of the tax to its base -- the aggregate tax rate -- to fall when real income falls. But in 1974, the opposite happened. Had the income tax been indexed, the aggregate tax rate, instead of rising to 11.5 percent, in fact, would have fallen to about 10.9 percent. This experience shows that indexing is the difference between an income tax that is an automatic stabilizer all of the time, and one that is an automatic stabilizer only some of the time.

As noted earlier, Congress has granted tax relief to keep Federal receipts roughly constant as a proportion of GNP. However, in the 1974-75 period this relief did not come until March 1975, at which time the recession was near its bottom. Clearly, it would have been better for tax reduction to have come

earlier. One trouble with discretionary policy is that it often does not get put in place until after the damage has been done. Indexing of the individual income tax would help to avert this problem, and this is perhaps the most important economic argument in its favor.

No economist who has appeared before our Committee has maintained that the economy would not have been far better off in 1974-75 had the income tax been indexed. Nevertheless, many regard that episode as a special case and feel that indexing will eventually add to inflation because they think it will imply lower taxes than the present system. They argue that indexing would be seriously de-stabilizing in a situation where excess demand was the prime cause of inflation. While it can be argued that our current inflation has been largely supply induced, there is no guarantee that future periods will not be dominated by excess demand inflation. Whether rising costs can be fully passed through to consumers does depend on the strength of demand in the marketplace. The stronger the demand, the easier it is to pass costs through. Hence, indexing to the extent that it keeps demand from softening as a result of rising prices would tend to propel prices upward even faster.

Opposing this view are those who note that the ratio of Federal taxes to GNP has remained fairly constant, is likely to continue to remain so, and that indexing creates no particular presumption that Federal taxes will be any lower. Indeed, some economists are coming to the view that indexing might actually reduce the rate of inflation and that it might make it easier

for policy to control inflation. This view is presented below.

A great deal of attention has recently been paid to the claim that high marginal rates of taxation reduce work effort, or what economists call labor supply. Most students of this issue would concede that this could be the case, but there is considerable dispute about its quantitative importance. Whatever the extent of the response, a reduction in labor supply caused by higher marginal tax rates implies an upward push of wages, a consequent rise in prices, and a reduction in employment. Tax increases are normally thought to reduce total demand and to lower prices and employment. But if the tax increase is also accompanied by an upward wage shove, the employment reduction will be accentuated since both the tax increase and the wage push tend to lower employment. However, the price effects tend to neutralize each other and, on balance, there may actually be more inflation since wages and prices are downwardly inflexible.

If this argument is valid, it implies that the unindexed tax system may act as a built-in mechanism that generates both higher prices and higher unemployment automatically. Inflation carries taxpayers into higher tax brackets. This may generate additional inflation and lower employment in several ways. The higher marginal tax rates reduce labor supply. This forces up both pre-tax real wages and prices and lowers the amount of labor employers are willing to hire. Employment is also reduced because higher taxes and higher prices reduce consumer real disposable income and consumption. And finally, employment is reduced because the higher prices reduce the real quantity of money, raise interest rates, and reduce

interest-sensitive expenditures. The result, then, is a built-in mechanism that worsens stagflation; it automatically contributes to inflation and to a higher rate of unemployment.

As we have noted, tax indexing is sometimes viewed as a concession to inflation. However, it could also be claimed that such indexing may be an indispensible ingredient of a successful incomes policy. This is a point that has been made by European economists who are familiar with the incomes policy experiments of their countries. The reason is as follows.

Incomes policies generally imply an implicit or explicit agreement between business and labor to freeze the relative share of the national income that accrues to labor income and to profits. As an example, suppose the index of nominal national income is 100 and let this income be divided into labor income of 75 and profits of 25. Suppose also that productivity is expected to advance at a rate of 2 percent and that the expected rate of price inflation in the next year is 5 percent. Suppose, finally, that the Government secures an incomes agreement that attempts to lower the inflation rate by one percentage point. Labor's part of the bargain is to limit its money wage demands to the 2 percent growth of productivity plus an inflation adjustment equal to the 4 percent target rate of inflation, for a total wage increase of 6 percent. Business' part of the bargain is to hold the rate of price increase to 4 instead of the expected 5 percent. If all goes well -- including realization of the productivity forecast -- actual wages will rise by the planned 6 percent and prices will rise by 4 percent. If employment remains constant, the index of national income will

rise by 6, of which 4.5 goes to wages and 1.5 goes to profits. The result is that the relative shares of the national income remain fixed at the preexisting 75-25 proportions.

So much for income before tax. But now suppose the higher labor income puts taxpayers into higher brackets. Because of this the after-tax real income of wage earners will rise less rapidly than the growth of productivity, the Government's share of the national income will increase, and labor's after-tax share will decrease. This sort of development is very likely to cause the incomes agreement to break down, or to be rejected by labor in the first place, and to promote the resumption or continuation of inflationary wage demands.

At the same time, and as noted earlier, nominal profits are overstated during inflation because of historical cost depreciation allowances, so that the share of real profits after tax also declines relative to the Government's share. Combined with wage pressure, the squeeze on real profits is likely to force firms to ignore the price guidelines, and rapid price inflation is therefore likely to continue.

These considerations suggest that the Government's own tax policy may inadvertently serve to undermine the wage-price restraint program that the Government is attempting to foster. This means that an agreement to fix the relative pre-tax income shares between business and labor is not enough. The Government must also play the game fairly by agreeing not to increase its relative share of the pie. Our current tax system is not compatible with that requirement.

How much would indexing of the individual income tax cost if such a scheme were introduced at the beginning of 1979? The staff estimates presented here are based on the same GNP and personal income forecasts as used in the earlier calculation of fiscal drag. It is expected that personal income will rise 12.3 percent in 1979 and that consumer prices will rise 7.3 percent. It is also assumed that the revenue effect of redefinition of taxable interest income is negligible, and that the base year for the calculation of real capital gains is 1979. Revenue from the personal income tax is estimated at $197.5 billion in calendar year 1978, so that with the usual assumption that a one percent rise in personal income raises the yield from the personal tax by 1.5 percent, revenue would rise by $36.4 billion. Of this total, $14.9 billion can be attributed to real growth, and $21.6 billion would be allotted to the effect of inflation. In the indexed system the portion due to inflation would be directly proportional to the rise in the price level and would come to $14.4 billion. Thus the net budget cost of indexing the individual income tax would be only $7.2 billion in calendar year 1979.

It is important to note that revenues will still rise progressively with respect to increased real income, and Congress therefore still has plenty of room to cut taxes in order to offset the fiscal drag that we estimate as $23 billion. But with an indexed system, Congress will have added incentive to address itself to the issue of how to raise the economy's real growth since new programs cannot be financed out of revenues produced by inflation.

To conclude this section on inflation and tax policy, we comment briefly on three tax

Chart III-3

$ BILLION

140

120

100

80

60

40

20

1974-I

1974-II

1974-III

1974-IV

ACTUAL FEDERAL PERSONAL INCOME TAX RECEIPTS AND NON-TAX PAYMENTS

INDEXED FEDERAL PERSONAL INCOME TAX RECEIPTS AND NON-TAX PAYMENTS

issues that have received prominent attention in recent months -- property taxation, social security taxes, and the Kemp-Roth approach to tax relief.

Property Taxes

Although property taxation is an issue that should largely be dealt with at the State and local level, inter-governmental fiscal relations in our country are so complex that the Federal revenues are also affected by local property tax reform. As the voters in California are about to learn, the $7 billion in property taxes they can no longer deduct in their Federal tax returns will cost them an estimated $2 billion in additional Federal income taxes. California also receives some 215 Federal grants-in-aid at a cost of about $7 billion. Because of matching requirements, three-fourths of this could be lost if local governments are unable to pay their share. Fifty percent in local matching is required for foodstamps and medical assistance. Water treatment plants require 25 percent matching, and highways and mass transit programs require 10 percent.

Inflationary real estate booms come along in different places and taxpayers who have no desire to sell their homes may get caught in a squeeze that may force them to sell because of the burden of sharp increases in property taxes. Because of the general inflation of real estate values in their area of residence, they may then be forced to downgrade their level of living by purchasing less desirable homes or moving to rental properties. Under current law they must also pay a Federal capital gains tax on one-half of the capital gain that is realized. This squeeze, finally, may be particularly acute

for older property owners because of the length of time they have held their homes, and because their incomes are less likely to have kept up with the inflation of real estate values than the incomes of younger persons.

A partial solution to the problem of excessive property taxation lies in two measures. The first, as discussed earlier, is the revision of the tax code so that only real capital gains are taxed, and the second is the enactment of "circuit breakers" on property taxes throughout the country. Initiated in Wisconsin in 1964, and since adopted in various forms by 30 States, circuit breakers place an upper limit on the property tax that an individual must pay. This upper limit is usually figured as a predetermined fraction of the individual's income.

Payroll Taxes

The Federal social security system covers the retirement program known as Old Age and Survivors Insurance (OASI), Disability Insurance (DI), and hospital insurance under Medicaire (HI). These programs, together with the Federal-State Unemployment Insurance (UI) and other programs, are financed by payroll taxes, known as Contributions for Social Insurance (CSI) in the National Income Accounts. With the exception of a handful of States, unemployment compensation is financed exclusively by employer contributions. Social security, on the other hand, has traditionally been financed by equal contributions from employers and employees. While efforts were recently made to increase the employer fraction, such proposals were rejected and the 50-50 parity remains. Tax liability is calculated by establishing a maximum taxable base and applying a flat rate to payroll income up to this base. For example, in 1978 the base is $17,700 and the rate is 6.05 percent. For workers with incomes below $17,700, both the employer and the employee pay 6.05 percent of the wage, but for workers with incomes of $17,700 or over, the employer and the employee each pay the maximum tax of $1,071 or 6.05 percent of $17,700.

The combination of depressed revenues caused by the 1974-75 recession, slow growth of real wages, increased benefit payments due to inflation, and the steady aging of our population, created a crisis in social security financing that led Congress to enact a major financing bill in December 1977. The bill will bring about very sharp increases in payroll taxes beginning January 1979. The total fiscal drag from CSI in 1979 will be about $10 billion, some coming from the new

law, some from earlier legislation that would have raised the base in 1979, and some coming from anticipated increases in Federal and State UI taxes.

During the course of this year many Members of Congress have had second thoughts about the desirability of heavy increases in payroll taxes. The alternative proposals, of which there are inumerable variations, normally involve the use of general Treasury funds to finance the removal of some part of social security from payroll tax financing. The most popular candidate for removal is the HI program since there is no link between contributions and benefits as is the case with OASI and to a lesser extent with DI.

Despite the second thoughts, there is great reluctance to repeal or delay the new law. One reason for this stems from Congress' intention to grant tax relief of some sort this year. This makes it appear reasonable to hold the line on social security, while undoing some of the economic damage by use of the individual income tax. However, this is a dangerous procedure which is leading to the continuing deterioration of the equity and economic efficiency of our tax system. Payroll taxes and income taxes are not substitutes for each other. A reduction in income taxes does not offset the economic harm done by an equivalent rise in payroll taxes. The reasons are as follows.

That part of the social security tax paid by employees is a proportional tax on wages up to a maximum taxable base. Labor income in excess of this base is not taxed at all; there is no allowance for the number of dependents or legitimate deductions; and nonlabor income such as rents, royalties, interest, dividends, and capital gains are

not taxable. The social security payroll tax is therefore a highly regressive form of taxation. To raise these taxes while lowering the progressive income tax causes the net progressivity of our overall tax system to be eroded. It also reduces consumer expenditures, because lower income families tend to spend a larger fraction of incremental income than higher income families.

While the employee portion of the social security tax has very serious distributional consequences, the employer portion may be an even more harmful tax. This is because the employer contributions are labor costs that tend to be shifted forward into higher prices. Increases in employer taxes therefore contribute directly to inflation, and they also slow growth and increase unemployment. According to a recent analysis by the Congressional Budget Office, a $10 billion increase in the employers' share of payroll taxes will increase the inflation rate by 0.7 percent after one year.

Because the higher prices reduce consumer real income, real consumer spending declines and production and employment therefore fall. The higher prices also invite the Federal Reserve to engage in additional monetary restriction. And even if the Fed does not slow the growth of the nominal stock of money, its real value will automatically decline because of the higher price level. Interest rates will therefore rise, expenditures on home construction and consumer durables will decline, and capital spending and productivity growth may also be adversely affected.

By contrast, higher income taxes can generally be expected to slow the rate of

inflation. Although there may be some cost passthrough if higher income taxes raise wage demands, this is apt to be far less important than the direct effects of a payroll tax increase. It therefore seems most unlikely that the adverse effects of higher payroll taxes on inflation and growth will be just cancelled by an equivalent income tax reduction. With the inflation rate on the rise, and with the economy in danger of slowing down, the present is a most unpropitious time for payroll tax increase. A better way to generate additional stagflation can scarcely be imagined.

Although the employee contribution to social security is generally a regressive tax, the increases scheduled for 1979 will hit middle-income families hardest. The rate increase from 6.05 percent to 6.13 percent is not extensive, and this helps to spare low-income families. On the other hand, there is an enormous increase in the taxable base of $5,200 -- from $17,700 to $22,900. Consequently, any covered employee with a wage or salary equal to or above $22,900 will have his social security taxes increased by $333. This increase amounts to a jump of at least 31 percent in the social security taxes of all employees who will earn $22,900 or more in 1979.

It is no wonder that middle-income taxpayers are frustrated and angry and it is also no wonder that Congress appears to be structuring its income tax legislation in a way that will remove some of the sting of the social security increases from these taxpayers. But because of the enormous differences between the economic effects of the two taxes, offsetting rising social security taxes by lowering income taxes is exceedingly poor policy. Two wrongs, in this

case, do not make a right; they make, rather, for an increasingly badly balanced tax system.

Unfortunately, present procedure follows historical precedent. In 1960 CSI came to 18 percent of total Federal revenue. By 1965 CSI had risen to 20 percent, by 1970 to 26 percent, and by 1977 to 32 percent. Whereas social insurance taxes were less than one-fifth of Federal revenue in 1960, they will amount to one-third or more just 20 years later. Meanwhile, the share of personal income taxes has remained roughly constant at about 45 percent, while the share of corporate income taxes has dropped steadily from 22 percent in 1960 to 16 percent in 1977. These trends show that regressive, stagflation-causing taxes have gradually but persistently become an increasingly important share of Federal revenue. We believe this to be an unfortunate trend and would like to see it reversed as soon as possible. A useful first step might be to remove HI from payroll tax financing and to reduce payroll tax rates accordingly. A second step might be revival of the President's proposal to trigger infusions of general funds into the social security Trust Fund accounts when recession reduces payroll tax revenue. 12/ It would be constructive, as well, to provide for such revenue infusions into State unemployment insurance trust fund accounts to prevent repetition of the enormous State UI tax increases that took place during the 1974-75 recession. Recession is no time to raise taxes, especially payroll taxes.

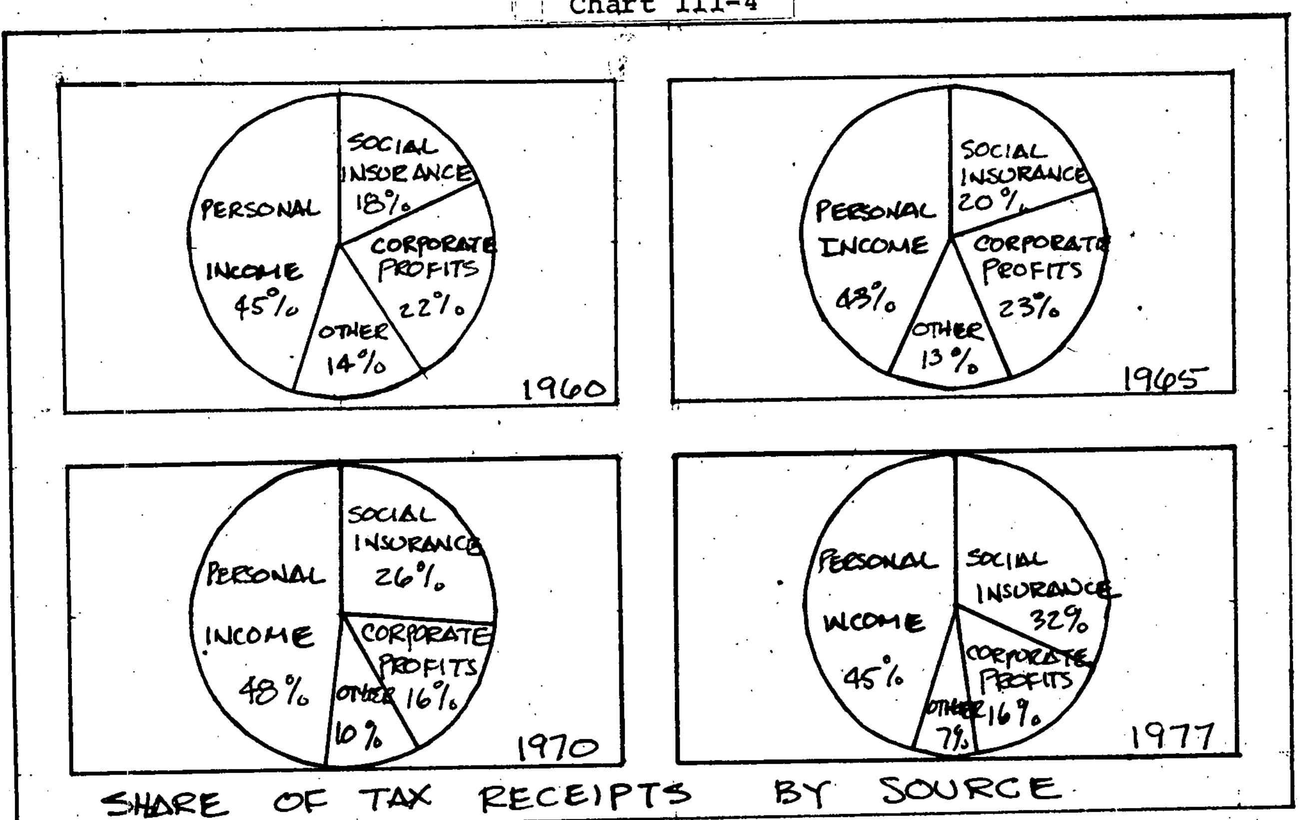
12/ Congressman Hamilton states: "During a recession, the use of general revenue funds to support the social security trust fund has a definite appeal. I remain fearful, however, that the general revenue financing of social security might join a long list of originally countercyclical programs that have

33-958 O - 78 - 12

Congressman Hamilton's footnote continues:

become permanent features of the fiscal landscape. In addition, there would be inevitable pressures to lower the degree of economic adversity that would trigger the use of general revenue funds. I would be very reluctant to adopt such a policy without first considering a wide range of alternatives to assure the economic viability of the social security trust fund."

Chart III-4



The Kemp-Roth Tax Reduction Proposal

Senator William V. Roth, Jr. (R-Del.) and Congressman Jack F. Kemp (R-N.Y.) have introduced a tax relief bill that has received a great amount of attention and support. The bill would:

(1) reduce all individual income tax rates by an average of 30 percent over three years;

(2) reduce the corporate rate from 48 percent to 45 percent over three years;

(3)increase the corporate surtax exemption for small businesses from $50,000 to $100,000 immediately.

If enacted to go into effect January 1979, the bill would reduce Federal income taxes about $30 billion in 1979. Estimates of the tax reductions in subsequent years are less certain, but reductions of $60 billion in 1980 and $100 billion in 1981 are within the ranges considered reasonable. The net effect on revenues will not be of such huge magnitudes because the tax reductions will raise money GNP and therefore generate considerable revenue feedback.

Opponents of the bill have pointed out that if it were fully effective in 1979, rather than phased in gradually, it would imply an immediate tax cut of some $80 billion, raise the deficit by at least $50 billion, and very likely cause a runaway inflation. However, in fairness to Kemp-Roth it must be remembered that a greal deal of fiscal drag will accumulate before the rate cuts become fully effective in 1981. Nevertheless, the bill would be the largest tax cut in history, amounting to about 3.6 percent of GNP when fully effective as

compared with 2.2 percent for the Kennedy-Johnson tax cuts of 1964-65. Inasmuch as this massive measure is being proposed at a time when the economy has very little additional slack left, it raises the danger of excessive fiscal stimulus and inflation and is, therefore, of very serious concern to the Committee.

If the magnitude and phasing of the Kemp-Roth bill roughly coincide with the fiscal drag due to taxes that will impinge on the economy in the next three years, the relevant question would be whether reduction of income tax rates in the Kemp-Roth manner is the best way to offset the drag. The drag of social security tax increases and the effect of inflation on income tax rates and after-tax corporate profits all need to be counteracted. Should this be done in the specific ways suggested earlier in this chapter, or by the Kemp-Roth approach? The latter further erodes the income tax, permits payroll taxes to keep rising, and fails to attack the effects of inflation on tax rates in a systematic way. The overall impact on the tax structure of the measure is regressive even though the percentage reduction of the present maximum rate of 70 percent to 50 percent is proportionately smaller than the reduction of the minimum rate from 14 to 8 percent.

A three-year tax commitment invites trouble. If the measure is inflationary, as most analysts think it will be, it will have to be repealed or suspended at some stage. The alternative to such an unpopular step is substantial restriction in government spending and/or a tighter monetary policy. However, Congressman Kemp denies this and claims instead that:

(1) GNP will rise by so much in response to the tax reduction that the expansion of the tax base will overcome the effect of the lower tax rates so that no revenue loss will occur;

(2) the tax reduction will not be inflationary because aggregate potential output can be expected to rise at a rate that will keep pace with the demand expansion caused by the tax reduction.

If these propositions prove to be valid, we will have experienced the modern counterpart of the miracle of the loaves and the fishes. The doctrine discomfits the more traditional tax cutter because there would be no reason to cut government spending.

Are the Kemp-Roth propositions tenable? Supporters argue the case from the supply side. The central point is that high marginal rates of taxation impair incentives to work and to save. Lower taxes will raise labor effort, increase the incentive to save, and (by an unspecified process) ensure that the additional savings result in substantial increases in investment. But whether the two basic free lunch propositions will follow depends on more than the reasonable claim that tax reduction will elicit favorable supply responses.

First, validity of the proposition that a tax rate reduction will cause no loss in revenue depends, not on the supply side, but on demand. Rough estimates of the overall marginal Federal tax rate with respect to GNP place its value at about 24 percent. The Kemp-Roth bill would reduce this rate to about 20 percent. This implies that if a tax reduction of $1 billion is to cause no loss in Federal revenue, the tax reduction would have to induce a GNP increase of $5 billion. Economists would say that the GNP "multiplier" with respect to taxes must equal the reciprocal of the aggregate tax rate in order for the self-financing proposition to be valid.

Such a high multiplier value is not consistent with empirical evidence. The upper limit on the GNP effect of a tax reduction of $1 billion is currently about $1.5 billion, and this could rise to no more than $2 billion as a result of the Kemp-Roth rate changes. With a marginal Federal tax rate of 20 percent, this implies a revenue feedback to the Treasury of no more than $0.4 billion so that the net addition to the deficit for every $1 billion of tax reduction is $0.6 billion.

Nevertheless, suppose that the first proposition is valid so that the deficit is not increased. Can the promise of no additional inflation be sustained? According to the Wharton School Long-Term Annual model, nominal GNP will be about $2,870 billion in 1981. This forecast incorporates a tax reduction of $15 billion to be effective at the start of 1979. By 1981 this would amount to about $20 billion. Therefore, if this $20 billion is replaced by Kemp-Roth, the net 1981 tax reduction -- at which time the rate cuts become fully effective -- would be about

$80 billion. The effect of this $80 billion tax reduction can then be added on to the Wharton forecast to assess the economic impact of the Kemp-Roth cuts.

With a multiplier of 5, the tax reduction of $80 billion will add $400 billion to money GNP, an increase of roughly 14 percent above the forecast. If this additional expenditure is not to prove inflationary, aggregate supply must also be capable of expanding by that amount at the same 1981 prices as would prevail without the tax cut. In other words, real output must be capable of being 14 percent higher in 1981 than in the forecast.

Is this possible? A 30 percent reduction in Federal income taxes will raise disposable income by about 5 percent. This probably will raise labor effort, but not by more than 5 percent at the outer limit without violating the fundamental law of economics that the first dollar earned by an individual is more important than the last dollar.

If there is some slack in the economy in 1981, as the Wharton forecast implies, labor input could also be expanded by lowering the unemployment rate. A 2 percentage point reduction in the unemployment rate would be enormous, and it would imply an increase in total employment of about 2 percent. In combination, the 5 percent increase in work effort and the 2 percent increase in employment due to the absorption of slack imply that total labor input can at best rise by 7 percent.

The percentage change in output per hour of labor input (labor productivity) equals the percentage change in total output minus the percentage change in total hours of labor input. Since previous calculations show

required output growth to be 14 percent and maximum additional labor input to be 7 percent, labor productivity must grow by 7 percent. Such a productivity explosion would be quite extraordinary. It would imply an increase in the capital-labor ratio of about 30 percent (at a time when tax incentives are raising labor supply), and an increase in usable capital stock of some 35 percent.

Even on the most favorable assumptions, these supply requirements are out of reach. The ratio of fixed investment to GNP might rise sharply, but it would take time to construct the new facilities, and in the meantime there would be a great deal of excessive demand. The Kemp-Roth bill, therefore, would be wildly inflationary and cannot be supported as responsible economic policy. If the self-financing conditions are met, the multiplier must be so high that the supply requirements to prevent inflation are unattainable. On the other hand, if the multiplier is low enough to permit the supply responses to be sufficient to prevent inflation, the tax base could not rise by enough to prevent revenue loss. The central propositions of Kemp-Roth are mutually inconsistent.

Supporters of the Kemp-Roth bill claim that their measure will have the same beneficial effects on our economy as the Kennedy-Johnson tax reductions of 1964-65. But this analogy is not applicable as was noted in testimony before the Committee by Dr. Walter W. Heller, Chairman of the Council of Economic Advisers at the time of the 1964-65 tax cuts. Dr. Heller noted that:

> ...the economic setting for the Kennedy tax cut was sharply different from our setting today. The 1964 cut was injected into an economy characterized by (a) plenty of slack in both labor and product markets, coupled with (b) virtual price stability -- inflation averaging about 1.2 percent per year -- and stable-to-falling unit labor costs. In other words, the "aggregate supply" capacity _already_ existed in the form of high unemployment and low industrial operating rates, and inflation was not a problem. So the tax cut was able to activate idle physical and human resources without more than minimal impact on the price level. 13/

13/ Testimony of Walter W. Heller, 1978 Midyear Hearings of the Joint Economic Committee, United States Congress, June 28, 1978.

The Kemp-Roth bill is not the answer to fiscal drag. If the sponsors of this measure truly wish to offset the depressing effects of rising social security taxes and of inflation, they should scrap their proposal and instead support measures that directly grant payroll tax relief and moderate the effects of inflation on tax liabilities. Regrettably, the magic formulas that provide free lunches or that show how to reconcile high employment with price stability are not yet at hand. The latter issue is the subject of the next section.

Incomes Policy to Combat Inflation 14/

The recent swing of fiscal and monetary policy in the direction of restriction is cause for considerable concern. Such policy is designed to slow the economy in order to bring inflation under control. But as past experience makes clear, restrictive macroeconomic policies, unfortunately, have little chance of being successful except at an intolerable cost in lost output and employment. A measure of what is at stake was supplied by Barry P. Bosworth, Director of the Council on Wage and Price Stability, who told the Committee,

> The best economic estimates are that it would take an additional one million unemployed for two years just to bring down the rate of inflation one percentage point. 15/

14/ Senator Ribicoff states: "I am in complete agreement with a call for a strong incomes policy. Certainly wage and price guidelines are in order. Tax-based incomes policies should be given serious study."

15/ Testimony of Barry P. Bosworth, 1978 Midyear Hearings of the Joint Economic Committee, United States Congress, July 20, 1978.

There is a widespread belief that the kind of softness in labor and product markets that is needed to moderate wage and price trends will be short lived because Congress -- quite properly in our view -- will not permit slow growth and high unemployment to drag on indefinitely.

In the _Joint Economic Report_ we said:

> We have long been on record in opposition to comprehensive wage-price controls and we do not recommend them now. However, we are deeply concerned that pressures will mount for such policies if we do not get inflation under control. We should therefore implement an incomes policy now so that we will not be driven into more drastic measures later. 16/

16/ _1978 Joint Economic Report_, _op. cit._, p 54.

We reaffirm that view here and add that the recent acceleration of inflation makes introduction of an effective incomes policy even more urgent now than it was at the time the Joint Economic Report was issued. Effective incomes policy is the most viable way to slow inflation while avoiding the twin evils of recession and direct controls.

The Administration's deceleration program asked business and labor voluntarily to hold their wage and price increases below the average of the preceding two years. These guidelines were vague and invited those who enjoyed the largest increases to continue enjoying them. If the jawboning route is to be effective, specific guidelines with which to measure performance should be adopted. For example, if the aim of policy is to slow the rate of price inflation to 5 percent in 1979, the rule for wage increases for all industry should be an increase in compensation equal to the expected overall rate of productivity growth plus a cost of living adjustment equal to the target rate of inflation of 5 percent. If such a wage guideline is effective, and the productivity forecast proves correct, unit labor costs will rise 5 percent, and the rate of price inflation will decelerate to an average of 5 percent. As suggested earlier, this also implies constancy between the relative shares of pre-tax income that accrue to wages and profits.

The jawboning approach suffers from the defect that existing economic incentives do not favor compliance. Hardly any worker or employer will deliberately forgo a large wage or price increase on the vague promise that if everyone does this, no real wage or real profit reduction need result from such restraint. The dilemma is that jawboning

without enforcement power will be ineffective, while jawboning with teeth implies a movement toward greater administrative interference in the economy.

An attempt to resolve this dilemma lies in recent proposals to utilize tax incentives to slow the rate of inflation. So-called "tax-based incomes policies," (TIP) would also set specific targets for wage-price changes, but would seek to achieve these targets, not by exhortation or control, but rather by the use of rewards and penalties supplied through the tax system.17/ For example, the target for wage increases might be set at 6 percent. Under TIP, workers whose wage increases exceed 6 percent could be charged a penalty tax in addition to their normal withholding, while those who receive wage increases below 6 percent could receive a reward in the form of a tax credit. The incentive to seek wage increases in excess of the guideline could thus be moderated. At least theoretically, some economists believe that a penalty tax on corporate income would stiffen employer resistance to inflationary wage demands.

17/ It should be noted at the beginning of this discussion that many members of the Committee are opposed -- on philosophical and equity grounds -- to the institution of TIP proposals that call for penalties and incentives for wages without corresponding incentives and sanctions for prices and profits.

Congressman Long says he is one of the committee members that has serious reservations about TIP.

The TIP approach, according to its proponents, is fundamentally different from jawboning or controls because it does not ask people to behave in ways that are contrary to their economic interests. No one, TIP's advocates maintain, is forced to comply or is castigated for noncompliance; nor is there administrative interference in the wage-price determination process, and relative prices remain free to move in response to market forces. Even though they may well suffer the additional burden of a higher tax, firms that are expanding and in need of additional labor can still offer higher wages to attract workers, and they are at liberty to raise product prices in response to favorable demand conditions.

The distinguishing mark of TIP is that it employs tax incentives and penalties to slow inflation. Tax incentives are currently used to promote investment, homeownership, and exports, to cite but three examples. Although some see little reason why tax incentives should not also be used to promote the commendable social goal of price stability, committee members opposed to the compulsory aspect of TIP guidelines correctly point out that support of such policies is a very different matter than recommending the sanctions of tax penalties. In addition, TIP would place an extra burden on a tax system already under heavy strain.

A poorly designed TIP program could certainly create serious difficulties for the administration of the tax system. It could also have adverse economic effects. Indeed, most of the specific proposals that have come to our attention seem flawed in one way or another. It is far from clear that a satisfactory, equitable, and effective TIP system can be developed. The Committee,

however, remains convinced that its obligation to seek a workable solution to persistent inflation requires us to explore TIP's possibilities to the fullest extent. We are apprehensive that faulty engineering might destroy a potentially useful concept. Although we do not advocate the adoption of any TIP system, we are convinced that no system should be accepted if it is ultimately self-defeating. We have therefore attempted to spell out some minimal guidelines that a TIP program would have to meet. Even if a TIP program proves to be administratively feasible, it may not meet the tests of equity and political acceptability.

One group of TIP proposals would make compliance voluntary. Annual target wage and price guidelines would be established. Firms that comply would receive tax rebates on their business income tax liabilities and their employees would receive rebates on their personal income taxes. The idea is to ensure that no one should lose after-tax income as the consequence of a willingness to slow the rise in wages and prices.

Though the voluntary and reward aspect of the "carrot" approach endows it with considerable political appeal, it is not likely to be effective. The firms and workers most likely to comply are apt to be in weak market and bargaining positions and thus unlikely to be able to obtain large wage and price increases. The noncompliants will be in strong markets where wage-price restraint is most needed. It therefore seems likely that the voluntary program will yield no wage-price moderation, and this failure will be accompanied by a considerable and pointless budget cost.

33-958 O - 78 - 13

Those who comply with a voluntary program will have to be assured that a tax rebate will make up for any after-tax real-wage loss that results from compliance. Workers might be willing to take 6 percent even if they could get 8 if the difference is made up by a tax cut. But while real income in the first year is protected, the worker who accepts the 6 percent will be at a disadvantage in subsequent years because he starts with a lower wage base from which to negotiate. Workers will not comply unless the deal is sweetened each subsequent year. Since this means ever bigger tax reductions it is very likely to be unworkable because of its budget cost and because the commitment to permanent tax benefits will not be credible.

One way to avert the wage-base problem is to slow all wage increases. Participation under these circumstances could not be voluntary but would have to be compulsory. Rewards would not be enough; tax penalties against excessive wage increases would also be required. No TIP can be successful unless it slows wage increases where they would otherwise be most rapid. A successful TIP program begins with the establishment of an annual wage guideline. Such a program would impose penalty taxes on wage increases above this guideline and provide for rebates where wage increases are below the guideline. Workers who receive a wage increase equal to the guideline would break even -- receiving neither a penalty nor a reward.

It is desirable to make the aggregate demand effects of a TIP program as neutral as possible. The pure reward program, for example, is almost certain to be destabilizing. If the economy picks up steam due to a rise in aggregate demand and labor markets tighten so that compliance requires

larger tax rewards, the magnitude of the tax reduction will increase at just the wrong place in the business cycle.

The pure "stick" approach, which would impose an extra penalty tax on the business income tax of firms that have granted excessive wage increases, is free from this particular objection but would give rise to other macroeconomic difficulties. If labor markets grow tight due to demand pressures, and firms begin competing for labor by bidding up wages, the penalty tax would then dampen demand, which would be appropriate under the circumstances. But, if the source of the excessive wage increase is a reaction to a supply shock such as an increase in the price of food and fuel, the penalty tax would be inappropriate from an aggregate demand perspective.

In addition to controlling inflationary wage demands, some TIP advocates believe it is also important to stiffen employer resistance to such demands. They suggest, therefore, that the reward-penalty system be applied to business income as well as to labor income. Firms that grant excessive wage increases would thus be obliged to pay an additional business income tax in proportion to the excess of the wage increase over the target increase. Similarly, firms that hold down wage increases would be entitled to a reduction in their business income tax liabilities. Again macroeconomic considerations suggest that the penalty-reward scheme be made neutral. Firms that neither add to nor subtract from the target inflation rate should not be affected by the program. Some members of the Committee who oppose the TIP concept suggest that such a program of employer penalties is entirely unrealistic. In their view, enterprises

engaged in competitive businesses do not need additional penalties to resist excessive wage demands. These members contend that, under some circumstances, businesses might face a kind of financial double jeopardy: once when they acceed (no matter how reluctantly) to a wage demand in excess of the government established target, and again when they pay a penalty tax as a result of the accession.

With the emphasis of TIP proposals on wage restraint, several members of the Committee are concerned that TIP may be unfair because there is no obvious assurance that prices and profits will be similarly restrained. TIP advocates explain that the focus on wages is a purely practical consideration. They argue that no one has been able to devise a TIP that concentrates on prices rather than wages without destroying the administrative feasibility of TIP. The key distinction between wages and prices is that the wage is a well-defined and measurable concept whereas the price of a commodity frequently is not. The unit of labor input is the manhour, and the effective wage paid by a firm can be computed by dividing total compensation of employees by total manhours. This can then be compared with the equivalent computation for the preceding year and the rate of wage increase can be ascertained unambiguously. The prices of products, on the other hand, are difficult to measure because the nature of the product itself can often be changed. If an electronics firm produces a better loudspeaker with more reliable components and raises the price of the speaker 10 percent, is this a price increase or a quality improvement? If it were treated as a price increase under a TIP program that penalizes price increases, the reward for quality improvement would be reduced and the

incentive to make such improvements would be impaired.

On the other hand, opponents of TIP have suggested that similar complexities exist with respect to determining the compensation of many employees. They ask, for example, why reducing incentives for product improvement should be considered as a determinant in the one instance, and the reduction of incentives for worker productivity be rejected on the other.

As suggested in the preceding paragraph, TIP proponents contend sufficient leeway to reward particularly productive and deserving employees because the rate of wage increase would be computed on an establishment basis rather than for each individual employee. Presumably all labor compensation -- from the salary of the company president down to the wages of the errand boy -- would be covered. While smaller firms may have less flexibility to change their internal compensation structure, such firms are likely to be in areas where a great amount of wage restraint is probably not critical to the successful operation of a national anti-inflation program.

TIP advocates maintain that the emphasis on reducing the rate of wage inflation does not imply inequitable treatment of labor. This is because prices have tended to be quite closely linked to unit labor costs in the past. Employee compensation amounts to about three-fourths of the total factor cost of production -- a relationship that has tended to remain quite stable -- and a reduction in the rate of increase of wages is therefore likely to bring down the rate of price inflation in a predictable manner.

Inflation remains a singularly intractable economic problem. The various proposals for tax-based incomes policies have attempted to tackle the problem of inflation directly while avoiding the difficulties of controls, on the one hand, or the costs of restrictive macroeconomic policies, on the other. The preceding analysis suggests several requirements that any potentially workable TIP program would have to meet.

ADDITIONAL VIEWS OF SENATOR PROXMIRE

The country now faces roaring, rampaging, endemic inflation. It is the number one economic problem.

The inflationary spiral must be stopped. However, the weapons are limited.

No one wants wage and price controls. Labor is against them. Industry is against them. Congress would not vote them. Even if they were put into effect they would not work. This is no solution.

Monetary policy cannot stop the inflation. Interest rates are now far too high. There is little more room to maneuver. If they are raised significantly they may well close down the housing industry and bring on a major recession.

Various proposals for a tax-based incomes policy (TIP) have merit in the absence of any other alternatives but they are very complex and even if proposed formally today would take months and months to perfect and pass.

Voluntary wage-price guidelines may have some value but are limited in their application and enforcement and subject to unfairness if employers use them to hold down wage increases but are able to raise prices indiscriminately.

This leaves only fiscal policy as a weapon. I believe that a five to ten percent cut in the federal budget is the single most effective way to combat inflation. It would send a message to the country and the world

that we mean business on inflation. Further, it is particularly appropriate at this time.

First, we are not in a recession. Demand has not fallen off. Such a policy need not start a recession. Combined with a more expansive monetary policy, cuts in the budget could reduce inflation without producing a recession.

Second, a five to ten percent cut in the budget could be made without harming essential services. There is scarcely an agency in the government which could not sustain such a cut and improve services if it were determined to do so.

While zero-based budgeting is applauded generally one can hardly find an example where it has been carried out specifically.

Let me make some specific suggestions as to where cuts could be made without harming the economy. No agency is immune.

-- We could cut big project foreign aid and reduce military aid abroad.

-- We don't need a nuclear carrier nor is the government required to pay out half a billion in shipbuilding claims.

-- A cut in spending would reduce the interest on the debt which would further reduce the budget and the deficit.

-- The LEAA program is in shambles.

-- Vast subsidies go out by way of subsidies to wool and sugar beet growers, reclamation projects, public

works, mineral purchases, timber, and shipbuilding and ship operators.

-- We know that welfare needs to be reformed and that there has been fraud in medicare, medicaid, and at the GSA.

-- Housing programs could be made more efficient and funds targeted to those who need them the most.

-- The highway program may represent one of the most mindless overall uses of funds -- in view of the need to save energy -- in the budget.

-- The Foundations for the Arts and Humanities have been stuffed with funds year after year.

-- The Space shuttle is an economic lemon with a losing benefit-cost ratio.

-- Research programs at NSF, HUD, the Institutes of Health, NASA, and almost all other agencies would greatly benefit from constructive criticism and pruning.

We should cut the budget because it should be done. It is the right policy at this time. It is the only effective weapon we now have to combat inflation.

MINORITY VIEWS

ON THE

REVIEW OF THE ECONOMY

OCTOBER 1978

I. INTRODUCTION

President Carter's economic program is floundering. It is fragmented, incomplete, and appears to be ruled by rhetoric. Because of this, the Carter Administration finds itself in a situation where nearly all economic factors are adverse.

Unfortunately, it is the American people who must suffer from the results of the Carter Administration's economic maladministration:

- An inflation rate which currently is at double digits and the Administration hoping that it will be no higher than 8 percent by December.

- A growing real tax burden and an adverse regulatory environment leading to a slowing of the growth of our real Gross National Product.

- Interest rates that are pushed higher and higher by inflation.

- Serious underinvestment, aggravating a failure to achieve a reasonable strategy for long-run economic growth.

- A serious threat of recession.

- Productivity increases in the American economy at less than 1 percent, as the American manufacturing plant continues to age.

- A continuing gnawing problem of heavy structural unemployment, especially among blacks and teenagers, despite welcome improvements in the total unemployment picture.

- A trade deficit seemingly headed back to record figures despite continual devaluation -- and headed back to such figures despite a decline in the relative importance of oil imports as a cause.

- A declining dollar whose value has hardly stabilized despite major efforts at economic intervention to protect it in recent weeks.

Cooperative efforts are required on the part of labor, management, and government to deal with the national and international problems which we have just cited. To date, the Administration has shown little understanding of these issues.

Clearly, the major economic concerns of Americans today are taxes and inflation. These issues and international economic problems are the major topics in these Minority views.

II. INFLATION

Some future economic historian will label the 1970's as the "decade of inflation." The persistence of sharp price increases since 1970 is unprecedented in our history. Consumer prices have already soared 69 percent in the first eight years of this decade. That is a compound average increase of 6.7 percent per year. And the average is likely to be higher by the time the decade ends in two years. At no time in our history has inflation persisted for so long at such high rates. And it has occurred in the face of relatively high unemployment and (until the past year) relatively low capacity utilization.

The rate of inflation accelerated substantially in the first half of 1978. Both consumer prices and wholesale (producer) prices rose at an annual rate of 10.4 percent. This year's rapid consumer price acceleration is, in large part, a consequence of an increase in food prices of nearly 20 percent, resulting from adverse winter weather and depleted cattle herds; the decline in the value of the dollar on foreign exchange markets; and January hikes in payroll taxes and the minimum wage. While some of these factors may not repeat, upward momentum of prices will continue. The economy may be reaching a new higher inflation plateau, and it is going to be very difficult to get off that plateau.

What has caused this high and long-lived inflation? The following is a brief portrait of the major contributing causes:

Monetary Policy

A traditional explanation, and one that must be recognized, is that inflation has resulted from an overly liberal monetary policy. The Federal Reserve, albeit unwillingly, has contributed to inflation the past eight years by liberal accommodation of demand pressures -- especially those arising from unprecedented Federal peacetime deficits. The Fed should have shown more backbone along the way. Since 1970, real GNP, M2 1/, and the GNP price deflator have grown at the following seasonally adjusted annual rates:

1/ Currency, demand deposits, and consumer time deposits at commercial banks

33-958 O - 78 - 14

Year	Real GNP (1972 Dollars)	M2	GNP Implicit Price Deflator
1971	3.0	11.4	5.1
1972	5.7	11.3	4.1
1973	5.5	8.8	5.8
1974	-1.4	7.1	9.7
1975	-1.3	8.5	9.6
1976	5.7	11.4	5.2
1977	4.9	9.8	5.9
1978 (first half, annual rates)	3.9	7.7	9.1

Clearly, over the past eight years, the money supply has been growing too fast, not too slow. Rising inflation at home and reduced demand for the dollar abroad indicate that the dollar, if anything, is in excess supply. Recent increases in interest rates are mostly due to a rise in the inflation premium, not to monetary tightness.

Federal Budget Deficits

While Federal deficits in and of themselves do not cause inflation, they can make it very difficult to avoid, and are a definite major factor in the inflation of the 1970's.

Federal budget deficits from 1971 through fiscal year 1978 have totaled $286 billion. This is by far the largest eight-year total deficit in our history.

The worrisome thing about these deficits is what they represent in terms of the growth of government. Over the Postwar years, government spending has risen faster than Gross National Product. Since 1970, Federal outlays have risen by 127 percent; GNP has risen by 112 percent. In 1970, Federal outlays were 20.6 percent of GNP. Today, they are 22.0 percent.

There has never been a balanced budget in the 1970's. The deficit in 1970 was $3 billion. The deficit next year will be $39 billion, on the heels of a $45 billion deficit in 1977 and a $51 billion deficit in 1978. These figures exclude off-budget expenditures of $13 billion in 1979, $9 billion in 1977, and $12 billion in 1978. There is little comfort from the fact that, after three years of economic recovery, the Federal deficit remains about $40 billion, and over $50 billion with off-budget outlays included.

The recent upsurge of inflation substantially raises the risks associated with large Federal deficits as the economy approaches its capacity. In this connection, the Federal Reserve capacity utilization rate for manufacturing is 85 percent, up 11 points from the 1975 recession low of 74.

The Federal Government accounts for only one-fifth of Gross National Product and, thus, can neither generate nor eliminate inflation single-handedly. However, it is a major factor in the picture, and government must set the tone with a clear signal of restraint to the economy.

Fortunately, Congress currently is moving in the right direction. The Federal deficit, for fiscal 1979, contained in the Second Budget Resolution (September 1978) is $12.1 billion below the First Budget Resolution (May 1978), and $21.7 billion below the Carter budget (January 1978). This is a 36 percent reduction from the initial Carter budget, and is fully justifiable in light of our economic progress from the 1974-75 recession.

Private consumer demand for durables, residences, and automobiles has been strong and sustained for over three years now. Capacity utilization rates are now approaching the pre-recession peaks of 1973. Continued high deficits, therefore, are a matter of political choice rather than a function of a fiscal policy required to stimulate deficient private demand, or a function simply of reduced revenues.

Investment and, consequently, productivity gains have lagged. But, as will be discussed in a later section of this report, Federal tax, deficit, and regulation policies have contributed to this weakness and must take the brunt of the blame for the ongoing base rate of inflation.

One concern is what the future portends. The last Ford Administration projection of budget authority for 1982 was $624 billion. The Carter Administration has raised that projection to $711 billion, an $87 billion increase, which means continued rising Federal outlays over the next several years.

Government Regulation

The heavy hand of Federal regulation causes inflation in three ways. First, there is the direct private-sector cost of complying with Federal regulations. Second, there is the cost to the taxpayer of operating the regulatory agencies. Third, regulations indirectly contribute to inflation by reducing productivity.

Regarding the first and second impacts, Professor Murray Weidenbaum, in a study for the Joint Economic Committee, estimated regulation compliance costs at $98 billion per year. In addition, $5 billion of taxpayer funds is spent to administer the agencies which do the regulating. The consumer ultimately pays this $103 billion

regulatory bill. For example, government safety and pollution control devices add $660 to the price of the average automobile. 2/

2/ Representative Clarence J. Brown states, "The natural gas bill, being considered by the Congress as this report goes to press, is a prime example of a regulatory nightmare which will increase costs to the public. Sheila S. Hollis, Director of the Office of Enforcement of the Federal Energy Regulatory Commission, labeled that bill 'so complex, ambiguous, and contradictory that it would be virtually impossible for this Commission to enforce it in a conscientious and equitable manner.' Although some modifications have been made to the bill, FERC Chairman Charles Curtis estimates that it will require the hiring of another 300 regulators in addition to the 500 new staff members provided for in the new Department of Energy Authorization Bill. These workers will be needed to handle the immense load of applications, rulings, and litigation the Commission expects to face in enforcing the bill."

Certainly, there are beneficial effects from Federal regulations. No one would call for their total elimination. Most regulators perform vital public service, protecting the health and safety of our citizens and correcting serious public problems. But it is high time that we turn our attention to the substantial and increasing costs of regulation and analyze them to determine the areas in which the costs are now exceeding the benefits. This is an area that needs a great deal of attention. Thorough cost-benefit analyses must be undertaken immediately. It will be difficult but it can, and must, be done.

The third inflationary effect from government regulation is the drag it causes on productivity. When scientists and researchers are diverted from constructive pursuits for which they are trained and qualified, to filling out government forms, and complying with government regulations, productivity declines, output is diminished, and inflation is fanned. Moreover, testimony of business experts before the Joint Economic Committee last June revealed that government regulation, and the uncertainties it conjurs up, is one of the major deterrents to business spending on new plant and equipment. This investment failure lowers productivity and feeds inflation.

Labor Costs

Increases in labor costs -- wages, payroll taxes, and fringe benefits -- of course, translate very directly into price increases. Wages, themselves, appear to have moderated

the past year or two by the existence of high unemployment. But higher social security and other payroll taxes and scheduled increases in minimum wages, which will have ripple effects throughout the labor cost structure, will keep the pressure on prices for some time to come.

Success in curbing the rapid rise in unit labor costs that feed inflation has been difficult to achieve because of a very poor U.S. productivity performance (discussed in a separate section) and because of the momentum of past inflation and the reciprocal relationship between wages and prices. Many union members and other workers are able to match the rise in prices with upward adjustments in their wages either through cost-of-living escalators (becoming more and more common) or by large catch-up wage increases when contracts are renegotiated. This can occur even in the face of high levels of unemployment. For example, average hourly earnings rose 6-3/4 percent in 1976, when the unemployment rate was 7-3/4 percent. In the following year, with joblessness at a still high 7 percent, the wage increase accelerated to 7 3/4 percent.

In addition, mandated changes in the minimum wage law, and recent legislated boosts in payroll taxes, have led to, and will lead to, further growth in employee compensation that is far in excess of productivity gains. For example, in the first quarter of 1978, worker compensation per hour in the nonfarm business sector rose 13 percent from the previous quarter; the

the minimum wage and payroll taxes are each estimated to contribute 2 percentage points to that first quarter increase. 3/

3/ Representative Clarence J. Brown notes that: "The votes on increasing the minimum wage were pretty much along party lines. On approval of the Conference Report, House Republicans voted only 17 For, but 124 Against; but Democrats voted 210 For and 63 Against. Clearly, the Majority party will have to bear the blame for the inflationary effects from these minimum wage increases.

"Regarding social security tax increases, the votes again were along party lines. On approval of the Conference Report, House Republicans voted only 15 For, but 109 Against. House Democrats voted 174 to 54 in favor of it.

"In addition to the inflation impact, with which we are concerned here, the Majority party must take responsibility for the unemployment effects of these two payroll actions, especially with regard to teenage and marginal workers."

The slowing in productivity gains has contributed in the past few years to a persistent rise in unit labor costs. The behavior of productivity followed the normal cyclical pattern of rapid increases during the first two years of the recent recovery, with an annual rate of increase of 4.2 percent. Since then, the growth rate has been reduced substantially and is currently running at less than 1 percent. This cannot support wage increases. Nonetheless, the wage increases do come, and they are reflected in higher prices.

Shortages And Supply Problems

The foregoing causes of inflation are standard explanations for our intractable inflation, with strong emphasis on aggregate demand policy, including Federal deficits and excessive increases in the money supply.

But prices are determined by two blades of a scissors -- demand and supply. Demand forces determine how fast total spending can rise. But supply forces determine how that spending growth is divided between inflation and increases in real GNP. In the second quarter of 1978, for example, GNP rose by 19.6 percent -- 10.7 of it due to inflation and 8 percent in real GNP growth. (This was an unusually high real growth and inflation quarter.)

The prime example of a supply-induced inflation was the Arab oil embargo of 1973, which cut off the supply of cheap energy and helped fuel double-digit inflation in 1974.

But, in a broader vein, it is time we realized that U.S. public policy, based for 45 years now on Keynesian aggregate demand analysis, is inadequate.

One-sided demand analysis did not cope well with situations such as 1975-77, when we had accelerating inflation in the face of high unemployment and its resultant low demand. This failure to take the supply-side factors into account is one of the main reasons why, after 31 months of unemployment above 7 percent, we failed to achieve price stability.

Professor Lawrence R. Klein, one of the major model builders, said, in his Presidential address, delivered at the nineteenth meeting of the American Economic Association in New York last December:

> It is worth considering whether a new basic model should guide our thinking about performance of the economy as a whole. It is not that the macro models of the past 25 years or so have failed to serve us well. When we consider the state of our knowledge about the analytics of the economy at the end of World War II and the apprehensiveness with which we approached the modern era of expansion, it should be evident that we have come a long way professionally. Yet the economic problems of today seem to be intractable when studied through the medium of simplified macro models...

> This is the motivation for my focusing attention on the supply side of the economy.

The Minority cannot agree more with Professor Klein. The theories of aggregate employment and output determination are demand oriented, and economic policy for the past half century has centered on demand management. It is time we recognize that there is also a supply side to economics. The incentives for production and work effort have been badly neglected. This has hurt productivity and output. We must realize that demand is not an end in itself. Policymakers, when they seek to influence demand, should bear in mind that the ultimate goal is maintenance of high and rising living standards.

The Harmful Effects Of Inflation

The continued high rates of inflation have adversely affected the economic security of individuals and businesses alike.

Harmful Effects on Individuals

The worker is harmed by inflation in two ways. First, and most obviously, it reduces the purchasing power of a worker's income. From 1970 through the first quarter of 1978, compensation to employees has risen 104 percent. During this same time, the prices that consumers have had to pay have increased 63 percent. In other words, the real gain

that workers have experienced from a doubling of their compensation is less than half of what it appears to be.

Second, the worker's real wage is further reduced by tax increases due to inflation. In fact, as is shown in Chapter VIII, Federal income and payroll tax increases over the past 13 years have completely negated all real income gains the worker has experienced during that time period. That is, wage increases are taxed at higher rates as the rising wages push the worker into higher tax brackets. Generally, wage increases equal inflation increases plus productivity increases. Though the recent small increases in productivity may have some tendency to hold down wage increases in some sectors, wages in general have increased sharply to keep pace with inflation. As inflation approaches double digits and as productivity rates continue to slide, nominal wage increases are quite large but are of little real value. And, the large nominal wage increases that workers need just to keep up with inflation, are taxed at higher and higher rates. Inflation and its effect on the progressive tax code have drastically reduced a worker's real after-tax income.

Savers and investors have been dramatically affected by inflation. Although inflation premiums are built into interest rates, small savers are hard put to find safe outlets for their savings which have interest rates higher than the rate of inflation. Almost all small savers face negative real rates of return, especially after paying taxes on the interest they have earned. Even

large investors find higher-yielding corporate bonds provide a negative real rate of return after taxes.

Capital gains have been eroded by inflation to such an extent that most reported capital gains are really losses when adjusted for inflation. Professor Martin Feldstein recently reported to the Committee on an exhaustive study of capital gains reported in 1973 tax returns. Taking all returns into account, the reported nominal gains of $4.6 billion were in fact real losses of nearly $1 billion, yet all the reported gains were taxed. Worse yet, the bulk of this overtaxation fell on middle income taxpayers. The tax code was never intended to operate in this way. On average, on those "gains" which were still gains even after adjusting for inflation, the real effective tax rate was doubled. Those who paid taxes on real losses were, in effect, subject to a capital levy, a tax rate in excess of 100 percent.

As we pointed out in the 1978 Joint Economic Report:

> Capital gains are already overtaxed. They are not ordinary income, and we should not be trying to tax them as if they were.
>
> Capital gains occur when the price of an earning asset rises. The price increase is generally caused by a perceived increase in the future earnings of the asset. Those future earnings will be taxed when they

occur. To tax the rise in the asset's value as well as the future earnings is to double tax those earnings. For this reason, no major nation treats capital gains as ordinary income.

To add to this double-taxation by imposing taxes on the portion of gains due to inflation raises the effective tax rate well above rates intended in the tax code. In fact, taxing real capital losses means we impose a tax in excess of 100 percent on the "profit" from many transactions. This combination of inflation plus a tax on capital transfers has "locked-in" thousands of investors and sharply reduced trading of all types of property. As a result, as several studies show, the government is actually losing more money because of discouraged activity than it gained by raising capital gains tax rates in 1969.

More importantly, the country has lost out on a great deal of growth because saving and the efficient allocation of capital have been retarded.

Inflation has other effects on savers and investors besides reducing their total saving. It encourages them to move into inefficient tax shelters, diverting their saving to low-productivity uses. Since 1964, inflation has increased marginal individual income tax rates substantially on every level of real income. Prices have doubled since then. Married taxpayers who earned $20,000 in 1964 were earning the equivalent of $40,000 in today's dollars. They (and many single taxpayers earning less) were just

entering tax brackets which made tax shelters attractive, and which encourage leisure and discourage saving. These people were filing only 2 percent of the tax returns, but they were the upper income groups doing perhaps 10 to 15 percent of the country's saving.

Today, in spite of tax code revision, the same tax rates still apply on $20,000 in taxable income, and make tax shelters attractive. However, five times as many people are earning $20,000 today. They file 10 percent of the tax returns and do 30 to 50 percent of the country's personal saving. Many of them were not using tax shelters 14 years ago. They are now.

By 1985, if the tax rates or brackets in the code are not changed, 25 percent of all tax returns, filed by people doing 80 percent or more of the country's saving, will be in the upper brackets. These people will be looking for tax shelters.

As more saving is directed into tax shelters, or simply spent, the U.S. industrial sector will probably have to pay sharply higher interest rates to attract funds. Modernization will lag; jobs will be lost to imports; single family housing will be injured. In fact, rising marginal tax rates on individual incomes are a major threat to employment, real wages, and the solvency of social security.

This phenomenon of inflation's pushing a taxpayer into higher tax brackets threatens a worker's economic security. James T. Lynn, former Director of OMB, estimates that these

inflation-induced taxes will take $82 billion out of the pockets of American taxpayers in this decade. The magnitude of the problem is obvious.

This combination of inflation and our progressive tax code have caused a major but little-known problem for the American worker. As stated in the Minority's 1978 Joint Economic Report:

> It is not commonly realized that inflation and the tax changes since 1964 have had the effect of raising marginal tax rates in spite of the fact that average tax rates have been held fairly steady. Increases in the standard deduction, and adoption of the general tax credit, have held down effective tax rates, while increased nominal income has been taxed at higher marginal rates.

These high marginal income tax rates -- that is, those tax rates which apply to the last few dollars of income -- are the tax rates which drastically reduce the economic gain from any wage increase. And millions of American workers now find themselves in these higher tax brackets though their real income gains have lagged.

The American worker finds himself in an economic vise. His real wage increase is severely reduced by inflation, and his real

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wage increase is further reduced by the high marginal taxes he must pay on that increase. This predicament will become more severe as inflation continues at unprecedented high rates.

Harmful Effects on Business

American business has also been harmed by inflation. Inflation hinders the growth of business activity and, therefore, job creation and wage improvements. At the core of the problem is inflation's effect on depreciation.

The U.S. tax code only allows the deduction of the historical cost of plant and equipment. The rational firm sets aside money for the replacement of its plant and equipment. As inflation pushes up the cost of new plant and equipment, the business finds that its tax deductible reserves for replacement are insufficient. Therefore, it must use a portion of its taxable income to maintain its productive capacity. Note that it costs the firm more merely to maintain -- not improve -- its productive capacity. A

legitimate business expense, real depreciation, is denied a write-off, and the firm faces larger effective tax rates on its real profits. 4/

4/ Small business is particularly hard hit. Small firms have great difficulty retaining funds for capital expansion and replacement of equipment. They can least affort to be denied a legitimate tax write-off, with resulting larger effective tax rates.

Thus, business is also caught in an economic vise. Depreciation is understated and real business profits are overstated. Therefore, inflation prevents the deduction of the real cost of doing business, unjustly increases a firm's tax bill, and reduces the firm's ability and incentive to grow.

The seriousness of the problem facing American business was pointed out in the Minority's 1978 Joint Economic Report:

> The Bureau of Economic Analysis regularly reports a data series designed to show the true value of corporate profits after allowance for real depreciation and the cost of replacing inventory. The goal is an accurate measure of business health. Reported profits are reduced by the "capital consumption adjustment" and by the "inventory valuation adjustment." What remains are true "economic profits." These may be reduced by corporate tax payments to produce "economic profits after tax," or set out in constant dollars to produce "real economic profits." . . . After-tax real economic profits are well below the levels of 1965 to 1968.

As inflation has increased, underdepreciation of inventory and equipment has assumed alarming proportions. In 1969, the sum of the inventory valuation adjustment and capital consumption adjustment, the amount of overstatement of corporate profits, was $2 billion, out of profits of $81 billion. In the first half of 1978, at

annual rates, the overstatement of profits was $36 billion out of $146 billion. In nine years, the overstatement of profits has risen from 2.5 percent to 25 percent of profits, drastically increasing taxes and decreasing rates of return on capital investment and production.

In fact, in recent years, effective tax rates on the real profits of such basic industries as steel, utilities, communications and transportation have actually exceeded 100 percent. Failure to adjust depreciation for inflation has imposed taxes of several billion dollars on phantom profits in struggling industries with real losses.

In addition, as was also mentioned in the Minority's 1978 Joint Economic Report, the BEA's adjustment of the capital consumption allowance seems to be too small. The results of an SEC survey suggest that the BEA allowance may be only half the proper amount. As the Minority states:

> Either way one looks at the depreciation allowance, one sees a sharp rise in the effective tax rate on pre-tax economic profits. The rate increased from roughly 40 cents on each dollar, after the tax cuts of 1962 and 1964, to roughly 50 or 60 cents by 1977. These are increases of 25 to 50 percent over the 1965 rate.

Distortions of Relative Prices

Most economic theory discusses prices and price changes in real terms -- as adjusted for the changes caused by inflation. Businesses, however, do not set prices in real terms. Rather they set prices in ordinary dollars, called nominal prices.

It is important for businessmen, particularly purchasing agents and cost estimators, to know that the prices they deal with regularly are not changing unpredictably in nominal terms. This information is vital for planning purposes, so that materials can be purchased and projects costed out successfully. In a time in which there is little or no inflation, prices fluctuate in accord with underlying costs, and it is easy for suppliers of goods and services to maintain relatively constant nominal prices, absorbing most price increases through reductions in profit margins. Suppliers want to do this to build and hold long-term customers through reliable prices and quality service. Some flexibility is provided in this system of otherwise fixed nominal prices because suppliers allow discounts to favored customers (off the relatively fixed list prices) when there is room in the profit margin to do so.

Thus, when there is little or no inflation, businessmen can successfully anticipate that a new price quotation will not be too much above a previous price quotation. Thus, planning, ordering, purchasing, and sales are all facilitated.

It is distinctly otherwise in a time of large-scale price inflation. The extra effort businessmen must go through in order to find out and keep track of current prices is an inefficiency -- a direct waste in the economy brought about by price inflation.

It is, of course, not just businessmen whose perceptions of prices are made obsolete by large and growing inflation rates. We all face this in one way or another. We all find that it takes substantial extra effort to evaluate ever-changing prices from differing sources for a good or service even as inflation erodes our incomes and makes such efforts at smart shopping increasingly necessary. Thus the basis of competition itself is undermined in part, as the changes in prices make it difficult for consumers and producers to know what the competitive price is.

Inflation is a serious problem that has caused serious economic harm to employees, employers, and the whole economy. The Minority feels that, unlike the President's program of jawboning, the country must take definite steps to fight inflation. Those steps are outlined in the following section.

Policies To Curb Inflation

Monetary policy and a solution to the dollar crisis are fundamental to an attack on inflation. However, these issues are intertwined with international developments,

and are, therefore, discussed below in separate sections. Here, we discuss a variety of fiscal and other policies to curb inflation.

Fiscal Responsibility And The Budget

The Minority strongly believes that the Congress and the Administration are guilty of overspending. To fight inflation, we call upon the leaders of this nation to follow a fiscal policy that is responsible and restrained.

We are concerned that Federal spending currently is running at a level of 22 percent of GNP. This is too high and seems to be retarding economic growth. This figure should be lowered over the next few years, unless a national emergency dictates otherwise. 5/

5/ Senator Javits believes that the appropriate level of Federal spending involves a number of elements, including a concern for the economic effects of Federal spending, the appropriate degree of fiscal restraint, the efficient management of Federal programs, the appropriate techniques for raising Federal revenues, and the beneficial effects of Federal spending.

To the Minority, fiscally responsible Federal budgeting means:

- A budgetary process in which benefits of Federal Government spending are weighed carefully against the costs -- not just the budgetary cost, but the total cost to society -- of that spending; ensure that the benefit/cost ratio for each program is positive; and ensure that the programs are properly balanced in size and composition.

- A process of budgeting in which budgetary cuts at the margin focus on efforts to eliminate waste and inefficiency and are made selectively in weak programs.

- A careful analytical process to link the outputs of the budget process -- the services which are delivered -- with the inputs into that process.

- A focus on productivity increases at the Federal, State, and local government levels; and

- Sunset reviews of Federal programs at periodic intervals; a real commitment to multi-year budgeting, revenue estimating, and expenditure estimating; ensure that private sources are used, where prudent and possible, for the delivery of services provided by government.

If these techniques are pursued with an eye to controlling, over time, the share of U.S. resources devoted to government, the Minority believes the result will be an improved budgetary process, and Federal outlays which increase at a declining real rate and eventually level off and decline. 6/

6/ Representative Clarence J. Brown favors specific limits on Federal spending, tied to the Gross National Product. Mr. Brown believes there should be a gradual reduction in the ratio of Federal outlays to GNP, now running at about 22 percent, to 20 percent or less by 1981.

Delay Minimum Wage Increase

The Minority recommends a one-year delay in the 25 cent increase in minimum wages secheduled for January 1979. 7/

7/ Senator Jacob Javits believes that there appears to be no pursuasive evidence to support the contention that modest increases in the minimum wage for the small proportion of the U.S. labor force at the bottom of the wage scale have a significant inflationary impact. See also Senator Javits' Additional Views.

This is not a heartless suggestion. The cruelest tax of all is inflation, and G. William Miller, Federal Reserve Chairman, told the Joint Economic Committee in July that next January's scheduled minimum wage increase would add one-half percentage point to inflation.

The minimum wage increase will have a domino effect. According to Mr. Miller:

> There will be upward pressure on wage rates from workers above the minimum who want to maintain their traditional relative wage position and from noncovered workers who attempt to emulate the gains made by covered workers... Since no additional productivity gain can be expected to accompany any minimum wage adjustment, unit labor costs will be boosted by a comparable amount, and historical evidence suggests that about two-thirds of the rise in unit labor costs is passed through into higher overall prices. In addition, these higher prices will have secondary effects on other wages that are linked to prices through escalator clauses.... Thus, if the January 1, 1979, minimum wage increase was deferred, the rise in prices could be reduced by nearly one-half percentage point from that which would have occurred otherwise.

Moreover, most responsible studies show that our minimum wage laws are having adverse impacts on the employment of marginal workers, especially teenagers. Delay in the

minimum wage increase will be especially helpful to small businesses that hire the marginally skilled employee and can least afford the 9 percent increase in the minimum wage, scheduled for next January.

Reduce Federal Regulation

Finally, government regulations must be reduced. As noted earlier, the cost of private-sector compliance with Federal regulations now totals nearly $100 billion (7 percent of personal consumption expenditures) and is a direct cause of price increases. In addition, from another direction, regulation exacerbates inflation by reducing productivity.

Edward Denison of the Brookings Institution has estimated that in recent years government regulatory deflections from productive services have resulted in a loss of approximately one-fourth of the potential annual increase in productivity.

When productivity falls in the face of rising wages, inflation makes up the difference.

The direct and indirect impact on inflation due to the heavy hand of government regulation must be removed. The Minority recommends that legislation be developed to establish a procedure for accomplishing this goal. As a beginning, the Minority

recommends legislation to reduce duplicative and conflicting Federal, State, and local rules or regulations. 8/

8/ Addressing this issue, Senator Bentsen has introduced S.3262 in the Senate and Representative Clarence J. Brown has introduced H.R.14165 in the House, designed to reduce by 5 percent per year the private sector costs of compliance with rules and regulations of Federal agencies. On the matter of reducing duplicative and conflicting regulations, Senator Bentsen has introduced S.3263 and Representative Brown has introduced H.R.14166.

If such legislation did nothing more than make the Federal regulators "cost-of-compliance" conscious, it would be worth the effort. But more must be done. The Office of Management and Budget, the Department of Commerce, and other relevant agencies must develop an analytical framework for assessing the costs and benefits of government regulations. This cost/benefit analysis is a crucial first step to reducing the regulations.

Proposals Not Recommended

The foregoing recommendations and monetary policy (discussed elsewhere) constitute the Minority package for inflation control. But we feel it is also important to note some policies that should be clearly rejected.

Price And Wage Controls

First and foremost, the case against peacetime price and wage controls is so clear, it is difficult to understand why they are proposed, even when inflation heats up to double-digit levels. They do not work for any length of time.

If controls hold down inflation temporarily, they do so at the serious cost of holding down production, which creates unrealistic supply and demand pressures and imbalances that subsequently exacerbate inflation.

Once controls end, both prices and production move to catch up, and prices rise faster than they would have, had controls never been imposed, and prices end up higher than otherwise.

This was the history of the 1971-74 four-phase control program, and a similar experience occurred in earlier efforts. The Minority urges the Administration and the Congress once and for all to take the lesson from past history and forthrightly reject any suggestion for price and wage controls. Even to hint at their possibility heats up the inflationary presssures they are supposed to stop.

Tax-Based Incomes Policy

There are a variety of other incomes policies to curb inflation that go up as trial balloons from time to time. One of the more popular current proposals is TIP (tax-based incomes policy), with two variations on the theme. One, the carrot approach, would reward firms that hold wage increases within Federally-designated guidelines by giving tax subsidies graduated to the amount that wage increases were below the guidepost.

The stick approach, on the other hand, would impose a special tax on firms, according to a schedule, if wage increases exceed the government-imposed guidepost.

Both variants are, in effect, a tax on wage increases. They are also a tax on the efficient reallocation of labor and production in response to changing technology and consumer preferences.

TIP seems to have much to commend it, particularly since it operates within the free market system. Firms can grant, or workers can extract, any reasonable wage increases, but tax penalties or rewards (depending on the approach) will limit, at the margin, how far firms or workers would be willing, or able, to go with such increases.

The major flaws are the thorny administrative problems -- almost as bad as with direct price and wage controls -- and a flaw in the economic theory associated with the idea.

As for the administrative problems, if the standards and procedures for granting tax breaks are too loose, the plan could collapse. If they are too tight, there will be undue burdens on business and government accountants, lawyers, and tax officials.

A few questions will illustrate what we are up against. Do wages include all fringes -- e.g., pension rights, dental care plans, executive stock options? How would cost-of-living escalators be evaluated? How can an average wage increase be computed? Must the average increase be calculated for the entire firm or can it be calculated by divisions, plants, or categories of workers? Would account be taken of changes in the mix of higher-wage and lower-wage workers, or of

effects on the average wage arising from new product lines, acquisitions, spin-offs, or shut-downs? Are exceptions to be made for that portion of wage increases that merely lets workers "catch up" with wage increases already granted to other workers, or that remove longstanding "inequities"? Needless to say, administration would be most difficult.

From the standpoint of economic theory, TIP will be counterproductive. A major flaw is TIP's reliance on the stability of the relationship between wages and prices. TIP proponents argue that this relationship is so close that lower wage inflation results directly in lower price inflation. Economic theory and empirical evidence show, however, that while wages and prices may be closely related in normal times, the relationship changes when government policies -- such as TIP -- disrupt the wage process.

TIP will lower wages since an excise tax lowers the demand for a good being taxed and results in a lower price (net of the tax) for the good, in this case, the wage. Even if TIP lowers wages, it may well raise general prices, not lower them, as intended.

Especially in competitive sectors of the economy, prices are determined by aggregate demand and aggregate supply (the schedules of all goods demanded and offered at given prices). Since, as TIP proponents have proposed, taxes and subsidies balance under TIP, aggregate demand will not be changed.

On the other hand, aggregate supply will be reduced. Faced with lower wages, more workers will substitute leisure for labor, thus lowering the amount of labor supplied, and production falls.

Since TIP will not change aggregate demand, but will reduce aggregate supply in these sectors, the average price level rises, and TIP turns out to be counterproductive.

"Jawboning"

Finally, "jawboning" approaches to inflation control cannot work very well in our type of society, nor in the present environment. The reason is that there is no consensus between labor, management, and government as to how to deal with it. "Jawboning" simply substitutes the appearance of action for action itself. As such, they are a substitute for realistic programs to reduce the disincentives and distortions created by past policies -- public and private.

III. MONETARY POLICY

In spite of severe political pressure, the Federal Reserve has held the growth rates of the monetary aggregates in the first half of 1978 to roughly the same rates as in 1977. However, little progress has been made in achieving the Fed's announced long-term goal of gradually reducing the rate of money creation to levels consistent with price stability.

M1 (currency plus demand deposits) grew at an annual rate of 7.9 percent in 1977, and 7.6 percent in the first half of 1978. M2 (M1 plus time deposits at commercial banks) grew at a 9.8 percent rate in 1977, and at a 7.7 percent rate in the first half of 1978.

However, a comparison of first and second quarter figures for 1978 shows that both M1 and M2 may be picking up steam. M1 grew at a 5.6 percent annual rate in the first quarter, and at a 9.5 percent rate in the second quarter. The corresponding figures for M2 were 6.9 percent and 8.3 percent, respectively.

Some analysts and policymakers have expressed concern over the fact that money supply growth has not been rapid enough to accommodate the growth of nominal GNP; that is, real growth plus inflation. As we pointed out in the 1978 Joint Economic Report, this is not our view of how to conduct monetary policy. If the Federal Reserve always "keeps up with GNP," it will

forever be chasing the rate of inflation by printing more money. This is obviously the wrong policy.

The Federal Reserve must not accommodate inflation. It must gradually reduce the rate of growth of the monetary aggregates toward levels which match the real growth of the economy. This is the way to squeeze inflation out of the system.

These same analysts and policymakers fear a general liquidity crunch if money does not accommodate inflation. These fears are unfounded. That view does not take into account the flexibility of the velocity of money, and the international situation of the dollar.

The decline of the dollar on the foreign exchange markets is a sign of an excess of liquidity. There is a substantial excess supply of dollars in world financial markets. As these dollars are sold off by foreigners, and as the Federal Reserve continues to encourage U.S. banks to borrow in the Eurodollar market, ample dollar balances will shift to the U.S. to relieve any possible shortage of funds. In fact, this is a perfect opportunity for the Federal Reserve to slow down the creation of new money balances.

IV. INTERNATIONAL PROBLEMS

Failure to provide a solution to the problems of the dollar and the U.S. balance of payments will have serious consequences for both the U.S. and global economies. It is possible that these strains could lead to disruption of trade, financial crisis, and severe recession.

The Falling Dollar

We are all aware of the sharp decline of the U.S. dollar in the foreign currency markets. Compared to other currencies, the dollar has fallen nearly 20 percent over the last year. This has pushed up prices of raw materials, traded goods of all types, goods in competition with traded goods, and, through cost of living adjustments, the cost of labor throughout the economy. Much of the increase in the rate of inflation in the last six months can be traced to the falling dollar. These spill-over effects of the falling dollar on domestic U.S. inflation are going to continue to worsen in the months ahead.

The rest of the increased inflation of recent months is due to the overly expansive rate of money creation of last year brought on by political pressure on the Federal Reserve to fund a record peacetime Federal deficit. Budget deficits contribute directly to this excess supply of dollars. The Federal Reserve has had to help fund the deficits by creating new money. The large

budget deficits and the new money have led to spending in excess of production, and a trade deficit with the rest of the world.

The Basic Problem

In an area as complex as international finance, institutional changes, expectations, and political and psychological factors all enter into decisions to buy or sell a currency. However, when all is said and done, the value of the dollar is determined by supply and demand. The decline in the dollar's value with respect to goods and services at home (inflation), and the decline in the dollar's value with respect to currencies, goods, and services abroad (the falling exchange rate), are domestic and international statements that the supply of dollars is rising faster than the demand. Americans and foreigners alike are telling the creators of dollars at the Federal Reserve Board that they have gone too far. Whatever the Board's assumptions may have been about satisfying public demand by having the money supply "keep up with GNP," the hard reality is that the public is saying that the money supply is growing too fast.

Swap arrangements, energy bills, gold sales, conferences between Secretary of the Treasury Blumenthal and Saudi Arabian officials, all are attempts to avoid responsibility, blame, and the real solution. These efforts may have short-run psychological benefits, but they must be followed up by substantive answers.

A Substantive Solution

To halt the decline of the dollar, the Federal Reserve must announce and follow through on a policy to slow down the growth of the money supply. But, as long as government overspends and runs up large deficits, this will be difficult without crowding out investment, growth, and jobs. Therefore, the Federal Government must work to reduce the deficit and bring total public and private U.S. spending into line with total U.S. production and income. These two steps will restore confidence in the dollar by restoring its real value. Unless the real value of the dollar is restored, the decline of the dollar will continue.

As for the trade deficit per se, instead of hoping that a depreciating dollar will spur U.S. exports, the Administration could take direct action to make the U.S. more competitive by reducing taxes on U.S. factors of production. The cost of employing U.S. labor could be held down by restraining payroll and income tax increases. The cost of creating and using U.S. capital could be held down by reducing corporate and personal income taxes to encourage businesses, savers, and investors. The government could further encourage competitiveness by offsetting the effects of inflation on personal tax rates and on depreciation allowances.

The Budget And The Trade Deficit

The trade deficit can be pictured, in somewhat simplified form, in terms of total U.S. spending and production. The United States, as a whole, is running a budget deficit, in the sense that all of us as a group, consumers, investors, and government, are together spending more than the Gross Domestic Product -- the sum total of all U.S. production. In other words, we spend more than we earn. That excess spending spills over into imports and creates a balance of payments deficit.

Consumer spending has not exceeded earnings. Consumers spend only part of their earnings, and save enough to provide $80 billion in investment money each year.

Business spending has not been excessive. Business saves through retained earnings, and borrows part, but not all, of the money the public saves. Business invests what it borrows to create more production and more jobs. In fact, economists of all viewpoints have been disappointed that business could not do more investing in this economic recovery.

Federal spending, however, has been sharply in excess of revenue. Business and consumers have earned more than they spent and invested, creating a surplus of saving that the government could have borrowed and added to taxes to finance government spending with no damage. However, the deficit far surpassed that amount. Government took up all of our excess saving and went on spending

even more by about $15 billion, roughly the size of our current account deficit (a trade deficit of over $30 billion partly offset by foreign investment income and earnings from services).

When a government runs a deficit larger than surplus saving, it pushes total national spending ahead of total national production and income. That excess demand for goods creates a trade deficit. Only by bringing the Federal deficit under control can we reduce total U.S. demand to levels that match total U.S. income and production.

Inflation, The Trade Deficit, And The Run On The Dollar

For its first 100 years, this country ran nearly continuous trade deficits which were paid for by borrowing from abroad. Foreigners had faith in our growing economy and our ability to repay our debts in money of constant real value. Our "current account outflow" was matched by a "capital account inflow."

Current account deficits normally are paid for by borrowing from abroad. U.S. efforts to spend about 0.75 percent more than it produced in 1977 led to a payments deficit of 0.75 percent of GNP, or about $15 billion. This $15 billion represents the amount of dollars or dollar bonds which foreigners added last year to their existing holdings. These overseas dollar holdings (*de facto*

loans to the U.S.) total about $500 billion in bank deposits and more than $100 billion in bonds.

It is not a sudden unwillingness of foreigners to take the excess $15 billion that has caused the dollar's fall. After all, $15 billion is not much larger than sums absorbed by foreigners in past years, as they sought to increase their dollar holdings to finance trade, earn interest, or diversify their assets. It is a small amount compared to the $600 billion they already hold. Rather, the major cause of the dollar's decline is the growing evidence that the U.S. has surrendered to inflation. Because of inflation, the entire $600 billion in dollar assets held by foreigners is now losing value faster than ever, with no let up in sight. Foreigners have not only refused to absorb another $15 billion, they have also started to sell off some of the $600 billion they already hold. The problem has gone beyond the trade deficit. It is now a full-fledged confidence crisis.

Thus, the U.S. is facing both a current account outflow and an attempted capital account outflow at the same time. Under a perfect float, without central bank intervention, these accounts must add to zero. We cannot spend without borrowing. But with foreigners in the private sector unwilling to acquire more dollars, the accounts cannot balance without a sharp fall in the dollar. To prevent an even worse decline, the central banks of Europe and Japan chose to absorb nearly $30 billion last year that were rejected by their private firms and citizens. The rest of the capital

flight was allowed to depress the dollar in hopes of choking off our excess spending. Our creditors are calling in their notes.

Can We Pay Up?

If foreigners continue to fear U.S. inflation, they will continue to reject additional dollars and will continue to sell off part of their $600 billion in dollar assets. At present exchange rates, how much of this selling can the U.S. Government redeem before it runs out of international assets? Not much. To "defend" the dollar, the U.S. has about $55 billion in gold and special drawing rights ("paper gold"). The U.S. also has about $35 billion in foreign currency "swap arrangements" and borrowing power at the International Monetary Fund, but swap arrangements and borrowing are basically symbolic. They are strictly temporary and must be repaid. Once our gold is exhausted, the dollar must fall.

The U.S. faces a $600 billion overhang, 8 to 10 percent inflation, and a $30 billion trade deficit. No swap arrangement, no gold sale, no energy bill is going to protect the dollar in the longer term, unless the basic problem, inflation, is faced and solved.

Nonsolutions To The Dollar Crisis

We are disturbed by the lack of focus on fundamentals such as inflation and productivity in Administration statements on

the dollar's problems. For the last year or more, the Administration viewed the falling dollar as a situation suited to benign neglect. When its concern was at last aroused, the "solutions" it proposed turned out to be fairly painless gestures such as gold sales and swap arrangements, rather than the real policy changes which are needed to cure the problem.

Nonsolution 1: The Energy Bill

Administration officials point to the decline of the dollar as an argument for passage of the natural gas bill. We do not here pass judgment on the intrinsic merits of the bill. However, the Administration's contention that passage of the natural gas bill is critical if we are to achieve stability for the dollar is based on three misunderstandings: first, that the dollar's decline is due simply to our balance of payments problem, rather than inflation; second, that energy is the major cause of the balance of payment problem; third, that any energy bill, whether effective or not in producing energy, will really solve the payments problem, or at least restore confidence to the needed extent. 1/

1/ Representative Clarence J. Brown states, "In fact, the natural gas bill has the intrinsic demerits of incredibly complex regulations which are bound to reduce gas production and exploration, and increase oil imports."

Oil did not cause the dollar crisis. The U.S. balance of payments deterioration and dollar decline did not begin with the quadrupling of OPEC oil prices in 1974. In fact, although the U.S. oil import bill increased from $8 billion in 1973 to $27 billion in 1975, the U.S. trade surplus rose from $1.7 billion in 1974 to $18.4 billion in 1975, and the dollar generally rose against most major currencies.

The U.S. trade balance did not shift into deficit until late 1976, but it deteriorated sharply thereafter. Yet, aside from seasonal fluctuations, the volume of U.S. oil imports has remained constant since mid-1976, and the price of oil has barely kept up with inflation since then. Department of Commerce and Treasury Department data show that increased oil import costs accounted for only 17 percent of the total increase in imports since the U.S. balance of payments began to deteriorate. Oil imports did not destroy the balance of payments.

The current drop of the dollar relative to other currencies cannot be blamed on oil imports either. Although U.S. payments for imported oil have increased from about $8 billion in 1973(the year of the OPEC oil embargo), to some $42 billion today, every other major industrialized country in the world has had to contend with similar price increases. In fact, these countries face a greater burden from high priced oil imports than the U.S. In 1977, oil imports accounted for 24 percent of total U.S. energy consumption, compared to 50 percent for West Germany and 70 percent for Japan. Even as a percent of Gross National Product, the cost of oil imports is significantly less for the

U.S. than for West Germany and Japan. (U.S. -- 2.34 percent; Japan -- 3.37 percent; West Germany -- 2.61 percent), yet Japan and West Germany have large balance of payments surpluses, and their currencies rise in value while the dollar falls.

Not only is oil not the chief cause of our payments deficit, but the energy bill is not going to cure the payments deficit. It takes five to seven years to explore for, discover, test, develop, and bring into production new oil and gas fields. Even Secretary of Energy Schlesinger has admitted it will be years before the bill has any impact on oil imports. If the bill works at all (and many believe that its complexity and red tape will render it useless), it will save little more than $1 billion a year in oil imports by 1985, a drop in the barrel compared to a $30 billion trade deficit.

Furthermore, oil producing nations spend and invest annually in the U.S. an amount equal to about 75 percent of our oil import bill. If we reduce our imports of oil, we will lose part of the savings through reduced exports to oil producing nations. A $1 decline in U.S. oil imports will reduce the U.S. payments deficit by far less than $1.

Therefore, whether the bill does or does not work eventually, as far as the dollar crisis is concerned, the bill will have almost no impact on the fundamentals over the next several years. Its value, if any, will be purely psychological, and will have to be followed by meaningful policy changes regarding inflation and productivity.

Nonsolution 2: Wait For The Cheaper Dollar To Boost Exports

The Administration appears to be overestimating the improvement in the trade balance we can expect from the decline of the dollar.

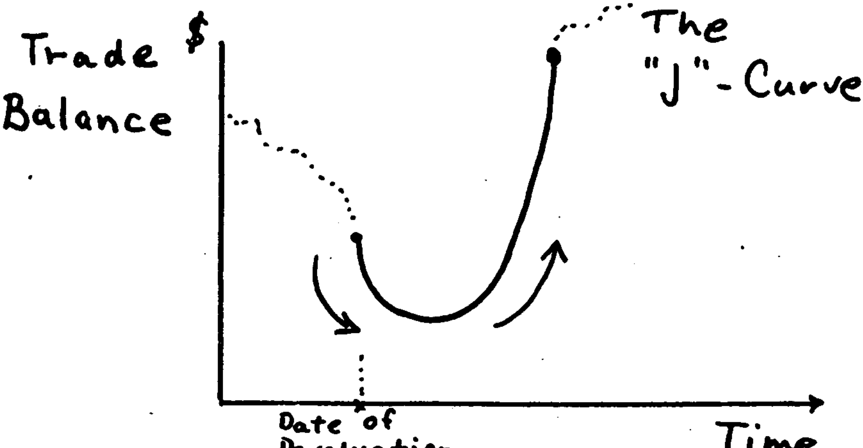
The "J" Curve

According to standard theory, a 10 percent devaluation of the dollar would first worsen the balance of trade, and then improve it gradually over time.

First, the devaluation raises the price of imports by 10 percent in dollar terms. The country's import bill jumps 10 percent, immediately worsening the trade balance.

Later, the public begins to cut back on imports because the price rose. Foreigners begin to place orders for additional U.S. products, because the U.S. goods now appear

cheaper in terms of foreign currencies. As these quantity changes occur in imports and exports, spending on imports recedes and export earnings rise. If the effect is strong enough, the trade deficit stops worsening, begins to improve and finally reaches a surplus. The process looks like a letter "J":



This theory neglects the fact that commodities, traded goods, and their substitutes compete together in world markets. Prices seldom diverge in the way the theory assumes. The spillover effects of a devaluation described below and in the 1978 Joint Economic Report, plus continued budget deficits and inflation in excess of that abroad, and productivity growth less than that abroad, cause domestic costs of production to rise relative to costs overseas. Insofar as these costs rise, the cost of producing exports and the price of exports rise to match world prices. U.S. exports may not become "cheaper" and there may be no export boom. The "J" curve may be an "L" curve -- all drop and no rise.

The theory that devaluations will actually improve the trade balance originated more than 40 years ago. Thirty years of refinement and theorizing took place during the deflationary Depression, the price controls of World War II, the reconstruction of Europe, and, finally, the 1950's. All these were periods with currency controls, trade restrictions, largely isolated economies, and no devaluations or revaluations of consequence. The theory was an untested intellectual construct until the late 1950's and early 1960's, when the French franc was devalued and the German mark and Dutch guilder were revalued. Since then, especially after the collapse of fixed exchange rates in 1971, we have finally begun to collect hard evidence on what really happens when currencies move. It is becoming apparent that the spillover inflationary effects from a devaluation are far more severe than the current theory predicts.

It is obvious why domestic importers of foreign goods must pay more for imports after a devaluation. If they do not pay world prices for imports, others will bid them away. That means paying more in cheaper, post-devaluation dollars to match the world price in marks, pounds, francs, and yen.

But this is also true for exports and domestically consumed goods which could be exported. If American buyers are not willing to match the world price of wheat, now higher in dollar terms, then American growers will sell abroad instead of at home. Boston must bid as much for Chicago wheat as Berlin and Bombay, or do without.

This tendency toward equality of world prices of traded and potentially traded goods affects commodities and basic traded (and potentially traded) manufactures. Price increases in such basic goods affect the cost of producing finished manufactured goods of all types, and raise finished goods prices. Also, goods which compete with imports feel more demand after a devaluation, and they rise in price. These price increases trigger cost-of-living adjustments, which affect labor costs even in the service sector where no trade is possible.

These spillover effects are reinforced by the continuation of the budget deficits, inflationary money creation, and lagging U.S. productivity growth which may have triggered the devaluation in the first place. Together, they continue to raise prices in all sectors of the economy, limiting the ability of a devaluation to reduce domestic costs of production relative to world costs. This limits the size of the export boom and import slowdown we can expect from a devaluation.

These considerations, plus the budgetary, spending, and production factors described above, explain the continued trade surpluses of Germany, Japan, and Switzerland in spite of their continual currency appreciation. They explain the bursts of inflation experienced in recent years of devaluation by the U.S., Sweden, Canada, Mexico, and Australia.

These considerations are a warning to the Administration and the Treasury that devaluation is more inflationary than is

commonly supposed. Devaluation is not a substitute for monetary and fiscal restraint. Indeed, devaluation will not "work" without monetary and fiscal restraint, and may have been unnecessary with them!

If the Administration wishes to lower the real cost of employing U.S. labor and capital, it must restrain payroll taxes on the use of U.S. labor; it must reduce taxes on personal and corporate income from labor, savings, and investment in the U.S.; it must offset the effects of inflation on personal taxes and on depreciation allowances.

Nonsolution 3: Swap Agreements

The Administration, and perhaps even the Federal Reserve, may be assuming that currency swap agreements are an effective means of strengthening the dollar by mopping up surplus dollars on the world money markets. This is not correct.

As we pointed out in the 1978 Joint Economic Report, the Federal Reserve buys and sells dollars both through its Foreign Exchange Desk and its Open Market Desk. Normal monetary policy is carried out through the Open Market Desk. The Open Market Desk trades tens of billions of dollars in Treasury securities a year, permitting a net increase in Federal Reserve credit, M1 and M2 over the last year of about $17 billion, $25 billion, and $60 billion, respectively. At the Foreign Exchange Desk, the Federal Reserve can engage in swap arrangements with foreign central banks, acquiring foreign

currency with which to buy dollars on the foreign exchange markets. Such purchases, in the hundreds of millions of dollars, are very small compared to the Open Market Desk operations, and are temporary in nature. Consequently, any reduction of the world supply of dollars by the Foreign Exchange Desk can be overwhelmed by dollar creation at the Open Market Desk. Unless basic monetary policy moves toward restraint, swap arrangements are symbolic, not substantive.

On a more technical level, the swap arrangements may be ineffective in reducing the supply of dollars even in the absence of offsetting Open Market operations. Assume that the Federal Reserve swaps currencies with the Bundesbank, exchanging $10 billion for DM20 billion. The Foreign Exchange Desk then uses the DM20 billion to buy $10 billion on the foreign exchange markets. The world supply of dollars in circulation falls by 10 billion, and deutschemarks in circulation rise by 20 billion. This should strengthen the dollar compared to the deutschemark. Unfortunately, the process does not stop there.

The Bundesbank does not hold its $10 billion in the form of cash. It buys U.S. Treasury bills to earn interest. The bills were issued to cover the U.S. federal budget deficit, which means that the proceeds are spent. Thus, the Treasury puts back into circulation as many dollars as the Foreign Exchange Desk removes.

Finally, the deutschemarks put into circulation by the Foreign Exchange Desk cause an increase in the German money supply.

The Bundesbank permits this only insofar as it was going to create deutschemarks anyway to meet its own money supply targets. Any excess deutschemarks are absorbed by the Bundesbank's own Open Market Desk.

In the final analysis, there is no change in the quantity of either currency in circulation compared to what would have occurred without the swap. The excess supply of dollars versus deutschemarks is unchanged. The process has only psychological value, value which is quickly lost if policies of real substance do not follow the swap.

Global Consequences Of The Dollar Crisis

Failure to provide real solutions to the problems of the dollar will have profound effects on the world economic, political, and military balance, as well as on the U.S. economy.

The sharp fall of the dollar beyond levels dictated by trade flows or inflation differentials does more than increase inflation in the United States. It creates deflationary pressures abroad, especially in countries with rising currencies. The resulting disruptions in trade, production, and employment lead to pressures on foreign governments to impose import barriers and subsidize exports. This, in turn, leads to threats of retaliation via countervailing duties and quotas by the United States and other nations.

Furthermore, rapid and unpredictable exchange rate changes make international investment planning and contract writing extremely difficult. This jeopardizes the international free flow of capital. Without such capital movements, countries in need of balance of payments financing may fail to receive needed funds. This problem is particularly acute for Third World nations who can least afford it.

These same nations are in urgent need of investment capital, plant and equipment, and technology transfers with which to raise living standards and to reach the take-off point where development becomes self-sustaining. Disruption of international capital markets for even a few quarters can lead to social unrest which costs years of development. These nations cannot afford to slip further behind in the race between technology and population growth.

There is also the threat that OPEC nations will raise the dollar price of oil by switching to a basket of foreign currencies as their unit of account. This would do more than raise the dollar price of oil. Such a display of lack of confidence in the dollar could lead to massive dumping of dollars by foreign holders, with disruptions to trade, prices, and employment beyond anything we have seen to date.

The falling dollar also raises the cost of maintaining our military presence in Western Europe and the Far East, leading to talk of troop cutbacks and fueling doubts about our commitment to NATO and Japan. In addition, hundreds of thousands of American military

personnel and their families overseas are finding it impossible to meet the cost of ordinary necessities. Their morale is bound to suffer.

The decline of the dollar is causing talk of a new effort at European monetary union. A unified European currency would compete with the dollar as a vehicle for international trade. The U.S. could lose thousands of jobs and billions of dollars in income from international banking and insurance services it now provides the trading community.

The falling dollar is not a matter for benign neglect. It is a matter for serious concern and prompt substantive action.

V. TAX CHANGES AND FISCAL POLICY

Enlightened Tax Policy

Both major Republican tax proposals, Javits-Danforth and Roth-Kemp, are nearly large enough to sustain aggregate demand by offsetting pending social security and inflation-induced tax increases. In addition, both bills address the adverse effect of rising marginal tax rates on aggregate supply, savings, and productivity.

On the personal side, the former proposal limits the increase of marginal tax rates by widening the tax brackets to offset most of this year's inflation. The latter proposal tries to undo part of the marginal tax rate increases of recent years by reducing tax rates on most levels of real income back toward the levels of 1964.

On the corporate side, both proposals reduce the marginal corporate tax rate. Javits-Danforth also increases rates of return on investment via the investment tax credit and more realistic depreciation rules.

The Administration proposals, and the House-passed bill, are too small to prevent substantial tax increases for virtually all taxpayers in 1979. Thus, the Administration and the Majority in the House apparently feel that fiscal restraint should be imposed by a tax increase rather than by a reduction in the growth of Federal spending. While the House bill does address the bracket-creep problem, the Administration proposals took no

action whatsoever. The Administration, the Treasury, and the Council of Economic Advisers still focus exclusively on average tax rates. Incentive effects and relative price changes are ignored. Their theory assumes that all relevant information on the impact of a tax cut can be deduced from the dollar amount of the cut. "Rate of return after tax" is an alien concept.

The recent reports on the incentive and revenue-raising effects of capital gains tax reduction show how inadequate the Administration and Treasury theory is. In fact, it is no great trick to give an example of a tax which involves no money at all and works purely on incentives.

Consider an example drawn from the economics of international trade. Suppose a prohibitive tariff, one so high that it chokes off all imports, is placed on French wine. Since no French wine is imported after the tax is enacted, no revenue is raised. Now, suppose the tariff is removed. No revenue is lost, but importation of French wine resumes. Thus, a tax cut of zero dollars results in an infinite percent jump in imports, some positive number of bottles imported divided by zero bottles in the year of the tariff.

The Administration pays far too little attention to straightforward price theory, and does not seem to understand the importance of real, inflation-adjusted after-tax rates of return in governing economic behavior. If, instead, the Administration could bring itself to realize that the

economy runs on incentives, it could work with the Congress to restore our growth rates to pre-inflation levels.

It is not difficult to cure the problems of inflation's impact on the tax code. The solutions have been known for years: 1/

1/ Senator Javits points out that there are other solutions to these problems than those listed here, solutions addressed elsewhere in the report.

- To prevent bracket-creep from further reducing saving and encouraging tax shelters, adjust the income tax brackets for inflation annually. 2/

- To encourage people to get out of inefficient tax shelters into taxable high growth investment, and to encourage saving in general, reduce marginal income tax rates. 3/

- To reduce double-taxation of capital gains and dividends, lower capital gains tax rates 4/ and integrate the corporate and personal income taxes.

2/ H.R.11413 by Representative Graddison, a bill that provides for inflation adjustments to income tax brackets, addresses this issue.

3/ S.1860 by Senator Roth and H.R.8333 by Representative Kemp, bills that would substantially reduce marginal tax rates, address this issue.

4/ S.3065 by Senator Hansen and H.R.12111 by Representative Steiger, bills that would reduce the capital gains tax substantially, address this issue.

- To prevent taxation of real capital losses, measure capital gains in real terms by adjusting the purchase price of capital assets for inflation. 5/

- To prevent taxation of phantom business profits caused by underdepreciation of equipment and undercosting of inventory, adjust depreciation and inventory write-offs for inflation. 6/

5/ H.R.13511 by Representative Archer, a bill that would index capital gains, addresses this issue.

6/ H.R.12323 by Representative Stockman, a bill which would establish replacement cost depreciation, addresses this issue. Also S.2815 by Senator Javits and Senator Danforth, a bill that expands the Asset Depreciation Range from 20 percent to 40 percent, addresses this issue.

- To increase rates of return after tax to productivity-raising capital investment, manpower training, research and development, inventory investment, hiring, and the building of modern plants, and to do so efficiently, and in a nondiscriminatory fashion, reduce the corporate tax rate. 7/

7/ S.2813 by Senator Javits and Senator Danforth and S.1860 by Senator Roth and H.R.8333 by Representative Kemp, bills which would reduce the corporate income tax, address this issue

Adoption of some or all of these proposals would unleash the productive drive of the American people. We would soon show the world that the productive spirit is alive and well in America. There has been no erosion of American character or moral fiber. The lack of productivity growth of recent years, the disinvestment, the reluctance to work and the underground economy, have been rational responses to inflation and an obsolete, anti-growth tax code. Restoring the incentives that made this country grow will restore the progress and upward mobility that once made us the hope of the world.

Taxation And Economic Growth

The Need For Growth

The United States is three quarters of the way through its first year of a $2 trillion GNP. It could have been $3 trillion.

Since 1950, the average annual growth of the U.S. economy in real terms has been 3.7 percent. Many other major industrialized countries have grown at annual real rates averaging in excess of 5.5 percent, and some have averaged more than 6 percent. If the United States had grown on average 1.5 percent faster each year since 1950, at a rate of 5.2 percent, its GNP would now be $3 trillion.

With a $3 trillion economy, incomes would be 50 percent higher than at present. Jobs would be plentiful. Federal revenues this year would be $200 billion higher, enough to provide for a balanced budget, welfare reform, national health insurance, and unquestioned military preeminence, with enough left over to let us reduce payroll and income taxes instead of raising them. Of course, price stability would have been another spin-off of the growth of real output and the balanced budget.

Faster growth, higher incomes, and plentiful jobs are exactly what the unemployed, the underprivileged, and the minorities of this country have been seeking for many years. It is no accident that the greatest gains in income, jobs, and dignity for minority workers have come during periods of rapid economic expansion.

We urge that steps be taken to bring about a significant increase in the rate of economic growth.

Real economic growth is affected by demography; capital investment, including accommodating tax and expenditure policies of government; increased expenditures on research and development, including emphasis on the role of innovation; improvements in worker morale; strong management and entrepreneurial skills (both public and private); availability of critical raw materials in adequate quantities; and the ability or inability of markets to function properly. In a properly functioning market economy, the profit motive encourages entrepreneurs to combine the above listed

items with factors of production -- land, labor, and capital -- to create economic growth more effectively.

When economic growth is subpar -- as it is today -- government may want to intervene. Strategies which may be used to promote economic growth through the creation of additional business investment are:

- Stimulation of aggregate demand, in the expectation that business firms would invest in additional plant and equipment to meet anticipated additional consumer expenditures;

- Creation of direct incentives for investment through policies designed to increase the expected real rate of return on investment;

- Improvement in the general environment for investment, through policies designed to reduce business uncertainty as to future economic conditions; and

- Provision of incentives to increase work effort, savings, and taxable investment on the part of individuals, leading to a reduction in real interest rates and incentives to switch from inefficient tax shelters into other, more productive uses of capital.

33-958 O - 78 - 18

These various strategies are likely to work with greater or smaller success, depending upon such factors as the state of the business cycle and the openness of an economy to foreign competition. Government usually will use tax policy as the major vehicle to advance these strategies to affect economic growth.

The Minority believes the last decade has seen an overreliance on promotion of economic growth through the stimulation of aggregate demand. The result has not been good. Inflation, lowered productivity, and distortions have been common. The Minority believes it is well past time to move to other methods of increasing economic growth through the use of the tax system to increase saving and productive investment. The Minority believes tax measures should be selected which increase the rate of return on investment, improve the general climate for investment, and provide incentives to increase work effort or savings on the part of individuals.

Obviously, these tax measures to increase economic growth must be considered in the context of other, nontax, measures to accomplish the same ends. Two taxes are most often used to make such changes -- the personal income tax and the corporate income tax. Broadly, the Minority believes that reductions in either of these taxes would positively affect economic growth, although these reductions might take many forms.

Personal Income Tax Cuts

Reductions in the personal income tax will increase disposable income in the hands of taxpayers. If those reductions are seen as permanent, they will, in large measure, be spent. A personal income tax cutting strategy based on considerations of aggregate demand alone will, if properly financed, make good economic sense in situations such as those in which there is substantial slack in the economy, or in which it is necessary to offset other tax increases.

That is far from the end of the story, however. The persistent, high, and rising inflation causes (as has been discussed earlier) significant movement of individuals from one tax bracket to the next, thus increasing their real tax burden as their nominal income rises to offset inflation. Because of the extraordinary gains in income to the Federal Government which result from the movements among tax brackets, reasonable Federal budgetary and fiscal responsibility is hard to maintain.

So, in fairness to individuals, it makes sense to reduce individual income tax payments to offset the effects of inflation. 8/ Failure to do that will also reduce personal savings over time as individuals are moved to higher tax brackets. In order to maintain a responsible budget posture, it makes sense to hold down receipts of the Federal Government. The economic growth issue is whether such a strategy can be pursued in the present economic environment without contributing significantly to inflation.

8/ S.2811 and S.2812, introduced by Senators Javits and Danforth, which adjust individual income tax brackets 6 percent per year for three years, and provide a tax credit to offset the effects of changes in social security taxes, address this issue.

To answer that, it is necessary to consider -- as the Minority regularly has in the past -- the interrelationship of aggregate supply and aggregate demand and how they both respond to tax changes. Thus, in addition to the size of any personal income tax reduction, consideration of aggregate supply has led the Minority to investigate the effects of such tax reductions on the incentive to save on the part of individuals.

The Minority believes that tax proposals of similar average burden can affect saving differently to the extent that they treat marginal income tax rates or other savings incentives differently. The more the tax reduction reduces such marginal tax brackets, the more total saving will be generated by a given tax reduction, and the less saving that will disappear into inefficient tax shelters.

This increase in total saving will surely reduce the real rate of interest at which investment dollars are available to potential borrowers. This reduction will lead to an increase in total investment, because projects which were previously passed over by potential investors will be selected at the new lower rate of interest.

While this effect of a personal income tax reduction on savings will occur, there is debate as to the size of the effect and the speed at which it will occur. If the effect is quick and large, then the resulting increase in income -- in economic growth -- will be large enough and occur quickly enough that a large personal income tax cut might

safely be undertaken when there is little slack in the economy -- as at the present time.

The evidence on the size and speed of the savings response is mixed and the subject is under considerable debate. There is, however, another, stronger basis for supporting large individual income tax reductions at the present time. The Minority believes it is possible that we have come to an historic juncture -- one which may determine for a long time to come Federal Government spending as a share of Gross National Product.

Significant reductions in individual income tax liabilities would thus be seen as an effort to control the Federal budget indirectly by cutting back the share of the nation's GNP which is collected in Federal receipts.

To make large personal income tax reductions without the assurance that those large expenditure reductions will also be made is a risky strategy -- for the required expenditure reductions might not occur. In that case, the individual income tax reductions would probably lead to unacceptable inflation.

Nonetheless, the Minority believes taking the individual income tax reductions now is an acceptable risk, for the need to impose fiscal responsibility on the Federal budget is at the heart of the Minority agenda.

Corporate Tax Cuts

As the Minority has noted, two taxes are generally used to affect economic growth -- the individual income tax and the corporate income tax. The effects of reductions in the corporate income tax in promoting economic growth are even more straightforward.

All taxes are ultimately paid by individuals. Thus, the corporate income tax is eventually paid by consumers of corporate products in the form of higher prices; by corporate shareholders in the form of reduced earnings on their investment in shares of stock in corporations; and by corporate workers in the form of reduced earnings. The Minority believes that the bulk of the corporate income tax is paid by two of these groups: corporate shareholders and consumers of corporate products, and recognizes that economists are divided on how the tax burden is divided between these groups.

Among the many effects of a reduction in the corporate income tax, we consider two which are particularly beneficial. First, it increases the rate of return on corporate investments, thus encouraging corporations to invest in additional projects, promoting economic growth. Second, to a smaller extent, it reduces the prices consumers pay for corporate products from what they would have been.

That simple story is true with two basic qualifications. First, the U.S. economy is now more open to foreign competition. Second, inflation affects depreciation, rates of return, and the investment tax credit.

Over recent years, the U.S. economy has become more open, and more closely integrated with the world economy. Thus, the U.S. economy has become considerably more subject to foreign competition over the last decade, although not to the same extent as economies such as the Netherlands or Great Britain.

This increased openness affects who pays the U.S. corporate income tax. Given the existence of investment opportunities abroad, investors have the option of responding to corporate income tax changes by shifting funds overseas. Thus, in the medium term, in an open worldwide economy, U.S. investors will attempt to avoid investments subject to the tax, if other investment considerations are the same. This means that, over time as investments shift abroad in response to the relatively higher U.S. corporate income tax, U.S. investors do not lose by the tax. They merely invest abroad. It is mostly U.S. workers who are hurt by the corporate income tax in the form of lower wages and a reduction in the number of jobs available to them.

Inflation affects the usefulness of reductions in the corporate income tax in encouraging economic growth in several ways.

- Inflation reduces the value of depreciation set asides, which are excluded from the purview of the category of corporate profits -- and thus protected from the corporate income tax. Thus, too small an amount is set aside for depreciation. The need for realistic replacement cost depreciation rather than historical cost depreciation has been stressed by the Minority a number of times.

- Inflation affects the corporate decisionmaking process by increasing the nominal rate of return required of specific investment projects prior to a favorable corporate decision to undertake them. This may ultimately require price increases in the good or service to be delivered to the consumer -- price increases which are so large that the project itself may become infeasible. Inflation which is differentially large in the U.S. creates incentives for corporations to move investment projects abroad.

Thus, there are two large factors adversely affecting economic growth -- differentially large U.S. inflation and the differentially large U.S. corporate income tax.

Reductions in the corporate income tax are likely, therefore, either to:

- Increase the rate of return on investment, to the extent that the U.S. is a closed economy. Increasing that rate of return would increase the amount of investment carried out in the U.S.; or

- Increase the number of jobs available to U.S. workers, to the extent that the U.S. is an open economy.

Thus, although the effects of corporate tax reduction are different when the economy is open than when the economy is closed, the broad result with respect to economic growth is the same -- economic growth is encouraged. Reduction in the corporate income tax is thus good economics, from the perspective of increased investment and increased U.S. jobs, leading to increased economic growth.

The Minority recommends changes to the U.S. corporate income tax. All have somewhat different detailed effects on economic growth:

- General, across-the-board corporate tax rate reductions;

- Use of some system of depreciation which is closer to replacement cost, rather than an historical cost basis; and

- Making the investment tax credit (ITC) permanent.

General corporate income tax rate reduction is probably the cleanest way to assist businesses to improve their performance and help the U.S. attain increased economic growth. The economic advantage to general rate reduction is that such changes do not distort corporate decisionmaking by favoring one variety of capital investment over another, or capital investment over hiring, manpower training, inventory investment, research and development, or improvement of structures. The argument against general corporate rate reductions is that a smaller proportion of any given amount of dollars of tax reduction goes directly to capital formation than from, say, the ITC or increased corporate depreciation allowances. On these grounds, it has been argued that general corporate rate reduction is inefficient. This ignores, however, the other sources of economic growth described above.

Improved accounting methods and depreciation allowances are needed to offset the effects of inflation on the capacity of business to replace plant and equipment. Normally, over a period of years, business

firms set aside depreciation allowances to finance the replacement of needed plant and equipment. In principle, these should reflect the real value of the depreciation. Correct measurement of net income requires that, among other factors, all revenues and expenditures be measured in dollars which have the same purchasing power. Various approaches have been tried to adjust for depreciation, including accelerated depreciation, and several different efforts to shorten the estimated useful lives of plant and equipment over which the depreciation might be taken. In the present situation, these approaches are not fully capable of adjusting for the adverse effects of inflation on the capital stock, effects which the Minority discussed in the 1978 Joint Economic Report.

The problems which have created severe underdepreciation are not merely those created by inflation. Energy prices have changed enormously in recent years, as the era of cheap energy draws to a close. This severely changes the relative prices of factor inputs into the production process, which means that much of the nation's capital stock has been rendered somewhat obsolescent as a consequence. Thus, facilities designed to use a great deal of energy become less competitive than those which use relatively less energy.

The need to protect the nation's environment has led to a variety of governmental regulations, which have in turn required additional investment of capital by business firms -- investments not anticipated in their past judgments about the appropriate

size of depreciation allowances. This reduces the availability of depreciation reserves to purchase new plant and equipment.

American business has seriously underdepreciated its capital assets, at least as compared with the requirements of replacement capital brought about by inflation, energy price changes, and the requirements of environmental protection.

The Minority supports revisions in depreciation tax policy to move the corporate income tax in the direction of a tax policy of replacement cost depreciation. The reporting techniques and price indices required for full replacement cost depreciation are readily available.

Another way of starting to deal with these difficulties is by expanding the use of the asset depreciation range, or ADR. The ADR approach gives businesses flexibility in determining the useful lives of plant and equipment. At present, the ADR is 20 percent. A partial adjustment to assist businesses in offsetting for effects of inflation on corporation depreciation reserves would be to increase the ADR from 20 percent to 40 percent with further increases in future years. This would allow a faster write-off of business plant and equipment.

The result of an improved depreciation adjustment to the corporate income tax would be that businesses could begin to move successfully to adjust to the problems created for business depreciation reserves by

inflation; the relative price effects of energy cost increases; and the effects of environmental regulations.

The third technique considered to assist corporations through business tax reductions is the investment tax credit, or ITC. Ever since its introduction, the ITC has been somewhat controversial, yet it could have a positive effect on economic growth by encouraging business firms to carry out additional spending programs through a reduction in the relative and absolute cost to them of additional machinery.

The ITC was initially introduced as a tool of discretionary fiscal policy, under the assumption that it could be increased or decreased on a schedule which would make it directly applicable to business decisions during the course of the business cycle. There is now ample econometric evidence that the required judgments as to when to increase and decrease the ITC have been made at inappropriate phases of the business cycle. The Minority, therefore, believes that the correct course of action is to make the investment tax credit permanent at a high percent. This removes the unfavorable discretionary aspects which have caused many businessmen to dismiss the ITC as a tool used

by government and as unreliable. Making the change proposed by the Minority would make the ITC a tool which would be useful to business. 9/ 10/

9/ S.2814, introduced by Senators Javits and Danforth, which makes the investment tax credit permanent at a 12 percent rate, addresses this issue.

10/ Representative Clarence J. Brown states, "Corporate tax rate reducation and real cost depreciation are both preferable to the ITC, as a method of encouraging business expansion on both equity and efficiency grounds."

VI. PRODUCTIVITY AND CAPITAL FORMATION

Productivity of the private business sector in America is in a sorry state. Measured in output per labor hour, productivity has risen by only 1.0 percent per year in the 1970's, and at an annual rate of only 0.8 percent in the second quarter of 1978, compared to a growth rate of 3.0 percent per year in the 1960's. The prospects for improvement are not bright, without major revamping of tax policy, increased savings, and improved attitudes of workers, business leaders, and the government.

While the causes of the productivity slowdown are not always agreed upon, three causes stand out:

1. The decline in the amount of physical capital per worker (measured here as business capital spending as a ratio to GNP).

2. The heavy hand of Federal regulation.

3. Labor demographic changes -- increased women and youth in the labor force in less productive occupations.

Each of these deserves elaboration.

Investment Ratio

The ratio of business fixed investment to GNP has fallen from peaks of nearly 11 percent in the mid 1960's and early 1970's to about 9-1/2 percent the last few years. If we consider only productive investment, excluding government-mandated capital expenditures which do not increase output, the ratio drops to an even less impressive 8.7 percent. To keep up with obsolescence, to create new jobs, to achieve full employment and to meet environmental objectives, the ratio must rise to a level of at least 12 percent.

Compared to other industrial countries, the U.S. is at the bottom of the investment pile. Over the period 1970-1976, U.S. fixed capital formation (including residential investment) as a percent of GNP has averaged 17.4 percent, far below West Germany's 23.7 percent and Japan's 33.4 percent.

Declines in this investment ratio and productivity growth are not coincidental. In fact, there is a close correlation between the investment ratio and productivity growth for all major industrial nations. Comparisons of these measures for the three major industrial nations are shown in the following two charts:

33-958 O - 78 - 19

CHART 1

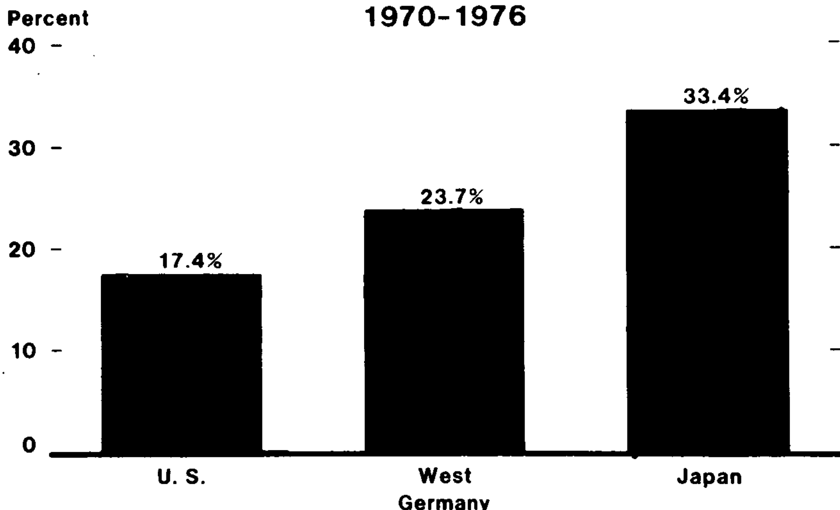
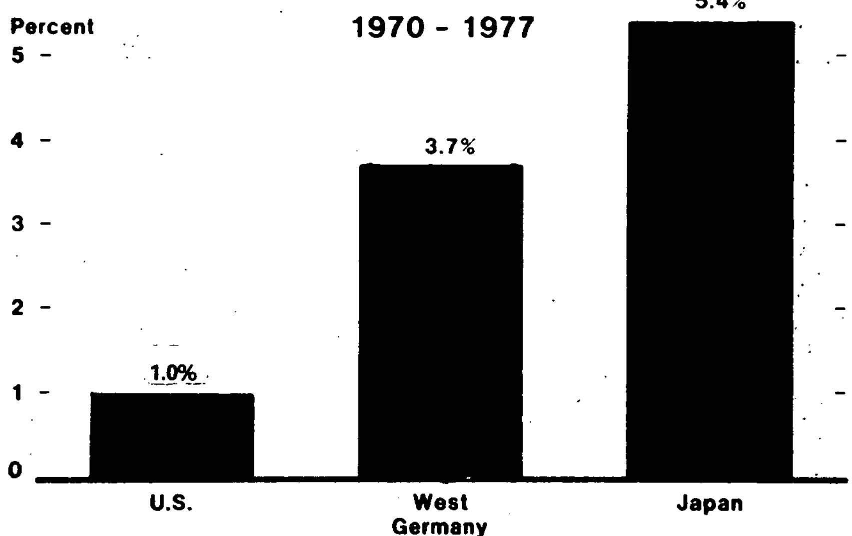


CHART 2



Source: U.S. Dept. Of Labor, Bureau Of Labor Statistics

These international comparisons should leave little doubt concerning the vital role of investment as a determinant of productivity growth.

The question is, what steps do we take to increase effective business capital spending? The answer is simply to increase after-tax returns by reducing the effective rate of taxation on capital income, either directly or through liberalized depreciation allowances, or through integration of personal and corporate taxes or other means. Some of the alternatives are discussed in the foregoing corporate tax section.

One point should be made clear here, however. The U.S. has had three investment booms in the post-World War II period: 1955-56, 1964-66, and 1972-73. In each case, the boom was preceded in the previous year by a major change in the tax code which was favorable to investment. The first boom was preceded by a 1954 end to the excess profits tax and the first liberalization of depreciation allowances. In 1962, the investment tax credit was introduced and accounting tax lives were reduced by 20 percent; and, also in 1964, corporate income tax rates were reduced from 52 percent to 48 percent. Needless to say, corporate spending increased by a record 20 percent in 1965. Finally, in 1972, the investment tax credit was reinstated at 7 percent and accounting lives were reduced an additional 20 percent and, hence, the capital spending boom of 1972-73.

On the other side of the coin, in 1969, the imposition of the 10 percent income surtax and the suspension of the investment tax credit caused a decline in investment in 1970, even though the economy was operating at very high utilization rates at that time.

While there are some exceptions to the above pattern, and while stockmarket responses to outside influences are hard to forecast, the primary determinant of investment is not the level of output as such, but the expected future rate of after-tax return, and tax provisions are crucial to this. Appropriate policies to achieve the desired goals were discussed earlier.

Government Regulation

The burden of Federal regulation is a cause of lowered productivity in three ways: (1) the direct impact on business costs and, therefore, on the profitability of capital investments; (2) uncertainties as to the ability to proceed with investment plans; and (3) diversion from productive pursuits in order to satisfy Federal regulations.

The direct costs of compliance with regulations were discussed earlier. The bill is enormous -- about $100 billion -- and has a direct negative effect on profit margins which entice investment.

Second, government regulation, particularly changes in regulation, can cause uncertainties in making long-run cost and

profit calculations and, due to increased risks in building a plant, can have a negative psychological influence on long-range investment commitments far out of proportion to the actual costs imposed.

One of many examples of this deterring influence is cited in the report of a task force of the U.S. Energy Resources Council dealing with the possibility of developing a new synthetic fuel industry. The task force reported that, in evaluating the impact of the Federal Water Pollution Control Act Amendments of 1972, "It would be next to impossible at this time to predict the impact of these requirements on synthetic fuels production." Further, in assessing the National Environmental Policy Act of 1969, this same task force reported that a major uncertainty was not whether a project would be allowed to proceed, but rather the length of time that it would be delayed pending the issuance of an environmental impact statement that would stand up in court. In assessing the overall impact of government regulatory activity, the task force concluded, "In summary, some of these requirements could easily hold up or permanently postpone any attempt to build and operate a synthetic fuels plant."

Needless to say, investment is hurt by such regulatory impacts, and with it productivity is dealt another damaging blow.

Third, government paperwork and other regulatory requirements divert trained professionals from productive pursuits to filling out forms and making adjustments in modus operandi in order to satisfy the government.

It should be noted that small business is especially harmed by regulation. Many small firms live a marginal existence and the time and money burden of wading through regulatory red tape pushes many of them to the brink of closing their doors.

Edward Dennison of the Brookings Institution has estimated substantial losses in productivity from government regulation. He said the loss results both from diversion of capital investment as well as from current expenses in meeting regulatory requirements. His study shows that, in 1975, output per unit of input in the nonresidential business sector of the economy was 1.4 percent smaller than it would have been if business had operated under the regulatory conditions of 1967.

Demographic Composition Of The Labor Force

A third factor causing a slowdown in labor productivity, and one which will be reversed in the 1980's, is demographic changes in the composition of the labor force. There has been a sharp growth in "secondary" workers in the work force, namely women and teenagers. In 1967, males aged 25 to 54 accounted for 40.4 percent of the total labor force; today (1977), their ratio is 36.7 percent, while

the ratios of women (aged 25 to 54) and teenagers have risen from 21.6 percent and 8.4 percent, respectively, to 24.3 percent and 9.5 percent, respectively, over the same period.

Many of these "secondary" workers have had less education, vocational training, or on-the-job experience than the primary workers, when first hired. Thus, they are initially less productive. But this lower level of productivity will not continue.

During the 1980's, the teenage share of the population will shrink and, by then, women 25 to 54 will have had extensive on-the-job training, more education, and more vocational training. Thus, this influence on lower productivity from these labor demographic changes will ease in the 1980's.

A corollary to the foregoing is the considerably lower productivity in services and trade than in manufacturing. These are the employment areas to which women and teenagers gravitate and employment is rising relatively faster in those areas.

Policies To Stimulate Productivity Growth

Unless we achieve and maintain a higher rate of productivity growth, we will be faced with the politically impossible task of lowering the expectations of all Americans for a higher standard of living.

Unfortunately, there is no single key that, by itself, will speed up productivity growth, and would, therefore, simplify the solution.

Productivity depends on: (1) increases in the amount of physical capital per worker; (2) technological innovation that brings more output from each unit of resources, capital, or labor; (3) qualitative improvements in the labor force through better education and manpower training; (4) improved mobility of labor and capital, permitting resources to shift from low productivity sectors to high productivity sectors; and (5) management innovation to improve the way labor and capital are used.

Of the factors listed, increased and improved capital per worker is the essential ingredient for productivity.

And the course for improved capital-to-labor ratios is quite clear; enlightened tax policies designed to provide incentives for investment; namely, a reduction in capital gains taxes, reduced corporate tax rates, depreciation placed on a replacement cost basis, integration of corporate and personal income taxes to eliminate the double taxation of corporate income, and a permanent and expanded investment tax credit. These proposals are discussed further in another section of this report.

While the foregoing are the hardball solutions to our productivity problems, enabling us to increase the tangible factor inputs, there are other important policies that deserve attention.

Once an adequate stock of capital investment is in place, expanded research and development -- of all types -- is probably the fountainhead of advancing technological knowledge, and a most important source of productivity growth. 1/

1/ Representative Clarence J. Brown observes: "There has been a decline in the number of patents applied for and granted in the United States in recent years, both in absolute terms and relative to those granted to individuals in other nations. This reflects a decline in valuable research and development. Two of the major reasons for this decline are: (1) the heavy hand of Federal regulation; and (2) inadequate tax incentives for the encouragement of research and development.

Dr. John Kendrick, who testified before the Joint Economic Committee's Special Study on Economic Change, said:

> The advances in knowledge resulting from R&D projects are embodied in new capital goods and diffused through investment, and the associated know-how is embodied in the current or future labor force through education and training outlays. With regard to the former, tangible capital outlays are not only important as a carrier of technological progress, but also, if the rate of capital formation is strong enough to reduce the average age of plants and equipment, the rate of technological advance is speeded up.

In view of the valuable social contribution of research and development, the Minority recommends a tax credit or other subsidy for privately financed R&D, and a large increase in government R&D outlays in selected areas, including basic research.

There are other important aids to productivity. Manpower training programs can increase the skills of workers, particularly new workers.

Joint labor/management cooperative committees can identify opportunties for enhancing productivity and can improve worker morale by enlarging the common interests of labor and management without undermining the traditional role of labor unions or the prerogatives of management. Individual

interests are subordinated to an overall goal of a healthy, competitive industry with secure employment and profits.

And finally, the stifling effects of government regulation must be removed by a deliberate national policy to develop cost/benefit analyses of regulations; to reduce compliance costs; and to eliminate overlapping and contradicting regulations.

VII. URBAN INITIATIVES

In the 1978 Joint Economic Report, the Minority said:

> Most of the problems of society, from ancient times on, have been the problems of cities. "Congestion" is really urban congestion; air and water pollution is usually urban pollution; crime rates in urban areas are higher than in rural ones. Ironically, the rising expectations of our affluent society have generated accelerating demand for services which many cities, given their relatively fixed tax base, cannot afford. Cleaner air, better education, modern medical care, efficient transportation systems, and effective police departments able to cope with modern society's problems are typical of the expensive demands we place on government; yet, each of these examples is also typical of the items with which mayors must deal in making up their own budgets.

The Minority also noted evidence from Census Bureau reports on the differences in relative demographic changes between central cities, particularly in the older urban areas, and the surrounding suburban areas. These demographic changes have, over time, led to the present concentration of employment gains in the suburban portions of metropolitan areas, rather than in the core cities. On the other hand, unemployment is

concentrated in central city areas, rather than in suburbs, and incomes are lower in the central cities than in the suburbs.

The pressures for tighter local government budgets, which have recently been dramatized in California, have been with the older core cities of the Northeast for some time, as demands for additional services by the poor, the minorities, and the unemployed have pressed upon tax bases already weakened by the demographic changes of recent decades.

The Minority believes that the nation lacks a comprehensive urban policy. De facto, however, there is an urban policy which creates disincentives and distortions, preventing the efficient delivery of services and the efficient management of urban areas.

One major element in such a policy is the shortsighted programs of the Federal Government through Federal activities which create incentives to favor suburbs over central cities. Examples of such programs, in which distortions have been or could have been created by Federal action, include grants for sewage and water treatment facilities, the investment tax credit, the national highway program, and airport subsidies.

So far in this report, the Minority has argued that one major theme of the first nine months of 1978 has been the role of inflation and taxes in creating middle income unrest with government programs and activities which previously such groups were willing to

tolerate. That unrest comes about, it has been argued, because of the distortions inflation and taxes create in choicemaking.

In both large and small cities, there has been continued deterioration of public infrastructure, by which the Minority means bridges, highways, mass transit facilities, water and sewer facilities, and waste treatment facilities. There is an excellent chance that the otherwise desirable spin-offs from the passage of California's Proposition 13 may create distortions in local government decisionmaking, which will favor construction of new facilities over repair and maintenance of older facilities. The Minority believes the latter is a priority item for local government attention.

Distortions adverse to proper repair, deferred maintenance, and rehabilitation already exist affecting local government decisionmaking. Testimony taken by the Committee in the Midyear Hearings leads us to lieve that, as Lyle Fitch, of the Institute of Public Administration put it:

> All expenditures that can possibly be deferred will be deferred, particularly maintenance expenditures and capital outlays. Hardpressed city and county governments have already been doing this for years; consequently, vast amounts of deferred maintenance are accumulating, with water and sewer mains falling apart, streets filled with potholes, and deterioration of highways and bridges to the point where they have to be closed.

As the local government tax-cutting movement goes forward, the Minority fears that institutional realities of local government decisionmaking may ensure that the expenditures which are cut may, in the long-run, prove to be serious errors. The Minority believes that local government repair, deferred maintenance, and rehabilitation activities are likely to be cut. The effects of such cuts would be particularly undesirable.

The local government tax cutting movement will operate to reduce expenditures through the local political process. This will mean that spending proposals utilizing general obligation bonds, which often require taxpayer approval, will be turned down.

Revenue bonds, however, most often do not require voter approval. Such projects will probably go forward. Yet, if given the opportunity to vote on them, the citizens would probably vote down these extravagent projects as they do general obligation bonds. The result will be distortions in local government decisionmaking with projects financed with revenue bonds going forward in an environment in which the taxpayer message is that government be prudent and careful in its expenditures, while eliminating waste.

The Minority believes that this distortion should be eliminated to ensure that local governments make reasonable and balanced choices among maintenance and new construction activities. There are, fundamentally, three different ways to do this:

1. A National Bank for Capital Conservation might be created by the Federal Government to make loans to local governments, both large and small, for infrastructure development. Because it would be available for infrastructure development, it would help eliminate distortions in local government decisionmaking which prevents adequate maintenance and repair of local government infrastructure. Because infrastructure would be assisted by the bank, local government loan recipients would be encouraged to pass along as a heritage a local government capital stock in sound physical condition, able to deliver high quality physical services well into the 21st century.

2. Those conditions in state constitutions and local government decisionmaking structure which cause choices to be distorted could be eliminated by state and local government action over time. This would mean constitutional amendments in many states, probably tightening up requirements for revenue bond financing.

3. Those Federal programs which help create the bias in local government choicemaking in favor of new construction and against maintenance, repair, and

33-958 O - 78 - 20

> rehabilitation might be reworked to eliminate the distortions in them against Federal financing to help local government with repair, rehabilitation, and maintenance of their local government infrastructure. For example, the investment tax credit might be modified to assist the rehabilitation of urban buildings.

An increasing share of total resources is taken up by government activities year-by-year, so the productivity of government activities becomes more and more important. This is particularly true because there is evidence that State and local government productivity has declined in recent years. As Lyle Fitch said in testimony before the Midyear Hearings:

> The average citizen of many states and localities is not wrong in thinking he is getting less from his tax dollars.

The 207 percent increase in the unit cost of State/local government between 1955 and 1977 is to be compared with the 126 percent increase in the price of goods and services purchased by consumers over the same period. The major reason for this differential is relative costs is the increase in the average wage paid State and local government employees over those years. After adjusting for inflation and population increases, per capita real expenditures on State/local government services approximately doubled in that time frame. Yet, the Minority is

convinced that State/local government output in the form of service delivered has not doubled over the 1955-77 period. Indeed, in the 1978 Joint Economic Report, the Minority discussed in some detail the causes of the decline in the livability of urban areas, drawing the conclusion that in many cases such areas are noticeably worse off than they were only a decade ago.

What causes this productivity decline? There are six major reasons why productivity in State and local government continues to decline:

- More manpower is required to make up for improvements in working conditions in recent years (resulting from decreased work weeks, etc.);

- Deterioration of the positions in State and local government of technical, professional, and managerial personnel who are not elected officials or are not protected by unions or an adequate civil service structure;

- Continued degeneration of civil service merit systems into instruments for "protecting mediocrity and defying administrative control;"

- Opportunities are ignored for improving productivity through capital investment (the capacities of computers in paper processing are not well exploited by local governments, to list only one example);

- Despite improvements over the last decade, states and localities still do not have good organization, management, and accountability; and

- Local elected officials are still more interested in inputs to local government production (dollars of inputs, contracts, laws affecting hours at work and wages, etc.) than in outputs from that production (services delivered).

When State and local governments try to deal with taxpayer difficulties by direct budget-cutting activities, they use techniques such as position freezes, controls over executive prerequisites, across-the-board reductions in force, budgetary tricks and gimmicks, and deferral of capital outlays. Each of these approaches may cause local government productivity to decline by more than the amount of the budgetary savings they appear to generate. Generally, these are not the techniques local government should use to obtain budgetary savings. Some of the reasons why are:

- Position freezes. Generally, the wrong people get discouraged and resign. So a position freeze gradually reduces the quality of work force.

- Controls over executive prerequisites. These prerequisites, however indefensible they appear to be, are often justified by the time they save senior executives -- whose time is usually relatively productive.

- Across-the-board reductions in force. Again, these distort resource allocation and fundamentally may cost more than they are worth.

- Budgetary tricks and gimmicks. These just postpone the inevitable, and ensure that budget reductions are more severe and arbitrary when they come.

- Deferral of needed capital outlays. This can be a very shortsighted policy as was just discussed above.

The ultimate cure for this problem at the local level is: (1) budget reductions, section by section, in the local budget, with attention to selecting the cuts to minimize (rather than as usual to maximize) the response of public opinion; (2) an effort to

strengthen local government administrative capacity and management, possibly through the use of science and technology, which is not utilized to its potential by the state and local sectors; and (3) the realization that local government budget cutting will be somewhat painful because some activities -- however wasteful they appear -- are important to certain constituent groups.

In sum, local governments need help to ensure that the combination of the high and rising Carter Administration inflation and the resultant local government efforts for increased and responsible budget control do not continue to create unacceptable damage to the needed physical plant of the local public sector.

VIII. TAXPAYER REVOLT

The dramatic landslide victory of Proposition 13 is a most important development in our domestic economy this year. The California vote is an affirmation of the tax cutting policies that this Committee's Minority has put forth for almost two years.

It is important to note that Proposition 13 and other expressions of the taxpayer revolt are not simply dissatisfactions with taxes. The reasons for the taxpayer revolt are specific, easily identifiable, and, in the opinion of the Minority, completely justifiable.

Polls taken in California after the June 6 vote show that voters there viewed Proposition 13 as a vote against high taxes, as a vote against government spending, and as a vote against what is felt to be the politician's general misuse of the public trust.

As was reported in the Los Angeles Times of July 9:

> There are no nagging doubts, regrets or guilt pangs among Californians about having voted for Proposition 13. If anything people who voted against it are starting to come around.

> Further, they do not want the measure tinkered with. Groups pushing to limit its tax cuts solely to residential property face a tough selling job...

> "It's time the politicians learned they can't do anything they want to," was a statement frequently concurred in by 1,072 people interviewed in a Los Angeles Times poll.

However, the revolt is not limited to California. Tennessee has passed a statute placing a limit on state spending. Poll after poll shows all-time peaks in taxpayer resentment. "Proposition-13" type initiatives will probably appear on the November ballot in four states -- Michigan, Oregon, Nevada, and Idaho. Twenty-two states have passed resolutions calling for a constitutional convention to write a balanced budget amendment. The evidence is clear that the revolt is nationwide.

Why do we have a taxpayers' revolt in 1978? What change has occurred to turn usual taxpayer disenchantment into something more. The Minority believes that the reasons are not complex or hidden.

First, taxpayers are most interested in their spendable income. Two factors work to reduce spendable income: taxes and inflation. A significant feature of our economy is that taxpayers are being pushed into higher and higher tax brackets by inflation. As a person's income increases, he pays a higher tax which reduces the

spendable portion of the pay increase. In addition, inflation reduces the real value of any pay increase. Consequently, a pay increase may not automatically mean an increase in real spendable income.

If we examine the course of real spendable income, we see very clearly why tax-reducing initiatives are winning at the polls. According to the Bureau of Labor Statistics, in June, 1978, the real spendable income index 1/ was 92.69. This is approximately where the index stood in December, 1965. In other words, the typical person earning the average wage has not experienced any increase in real spendable earnings during the past 13 years! More discouraging is the fact that the Bureau's figures adjust for inflation and only Federal income taxes and social security taxes -- State and local taxes are not included. And because State and local taxes have approximately tripled since 1965, the real spendable income of the average taxpayer today may be much less than the average taxpayer's real spendable income in 1965.

1/ For a married worker with three dependents who earned the average weekly earning.

Thus, the basic taxpayer problem is that real spendable income that has not increased in 13 years.

Inflation and taxes are at the heart of the taxpayers' dilemma. The Minority finds it more than coincidental that the revolt has started as the economy is once again at double-digit inflation and the Congress has passed a $227 billion tax increase in the form of social security taxes.

A second reason for the taxpayer revolt is the taxpayer belief that the Federal Government is part of the problem rather than the solution. 2/ While the suffering taxpayer is not exactly aware of the details of the spending being carried out in his name, a sense of profound disquiet must exist as the taxpayer looks at a Federal Government that generates noncomprehendable spending levels and large deficits yearly. 3/ The taxpayer who must continually adjust his habits to maintain a certain standard of living does not believe the claims of government that it is holding down its spending. The efforts to cut Federal spending that have occurred this year have not by and large eased the taxpayer's suspicion.

2/ Senator Javits believes that a national requirement for budgetary balance -- one potential national fallout of California's Proposition 13 -- could jeopardize the borrowing ability of the United States. See also Senator Javits' Additional Views.

3/ Senator Javits believes that the suffering taxpayer has more on his mind than just taxes and the overall size of Federal spending programs. While the taxpayer wants his money spent efficiently, he is also sympathetic to the human needs being met. See also Senator Javits' Additional Views.

Indeed, the tax revolt would dissappear if taxpayers believed that their tax dollars were necessary to provide aid and protect the general public. But there is doubt among Americans that the level of Federal spending is necessary. Unfortunately, 1978 has provided many examples of waste in the spending of tax dollars.

The Inspector General's report on waste in the Department of Health, Education, and Welfare, the growing criticism of CETA, fraud and waste in the General Services Administration, and the billions of dollars lost to inefficiencies created by government overregulation all diminish the government's standing in the public eye. A government that draws its political support directly and solely from the people runs a dangerous course if it abuses the trust of those that elected the government. Because of high inflation and high taxes, the government needs to take corrective action immediately by mitigating the cause of the taxpayer revolt.

The Minority makes the following recommendations to create a government that is responsive to the needs of the taxpayers.

First, as the Minority has proposed for almost two years, taxes must be cut substantially. As is mentioned in other sections of the Minority report, this includes large cuts in the marginal income tax brackets, adjustment of tax brackets for inflation, reduction of the capital gains tax, reduction in the corporate tax rate,

adoption of replacement cost depreciation, and to make permanent the investment tax credit.

The Minority also recommends an ambitious program to increase productivity in our work sector. Though we believe that the tax cuts we have outlined will improve national productivity, a separate innovative program that would place productivity high on the list of national priorities is needed because of the magnitude and dimensions of the problem.

The Minority has persistently pointed out that substantial theoretical and empirical evidence exists that changes in aggregate demand are not the whole story with respect to tax cuts. The real level of income in the economy is set not only by the demand for goods and services, but also by the techniques used to supply them. And tax changes can significantly affect those supply channels.

The Minority believes that this emphasis on tax cuts and productivity, besides relieving the tax burden, will stimulate the supply side of our economy and work to reduce inflation. These measures will help boost the real spendable earnings of workers and improve the economic power of the American worker.

The second recommendation of the Minority deals with federal spending levels. Any reduction in spending levels presents acute political problems. The reduction of

spending levels leads to the difficult and complex question of which areas should be cut.

The Minority recommends that Congress should reduce spending levels by first making a genuine effort to eliminate waste in Federal Government programs.

To do this:

The Minority recommends that Inspectors General be placed in all government agencies to monitor and identify waste and inefficient operations. 4/

4/ The Minority recommends H.R. 8588, introduced by Representative L. H. Fountain and Representative Clarence J. Brown, that would establish an Inspector General's position in many departments and agencies.

The Minority recommends that before any new regulations are promulgated, an economic impact statement shall be issued so that the regulated and regulators will be aware of the costs of new regulations. Lyle Fitch in testimony before this Committee on July 25 noted that the National Governor's Conference, in its 1977 report stated:

> Congress continues to legislate more narrow and special purpose programs which, added to hundreds of existing programs, lead directly to an unmanageable maze of conflicting regulations and requirements. These impediments unnecessarily divert state and federal resources to paperwork and other overhead which should be used for services. Programs are often poorly drafted and passed without a clear understanding of their impact on state and local budgets or administrative structures. Federal, state and local program administrators cannot make rational budgetary or administrative decisions, recipients cannot understand what is expected of them, and the public is irate over government's inability to be responsible.

The Minority believes the present economic costs of regulation must be cut back substantially over time through programs that eliminate those activities which are not justified in economic or human terms.

The Minority recommends that each regulatory agency should be reviewed by Congress periodically to determine if it should continue.

The Minority recommends that each year the President shall publically disclose those federal programs and regulations that have been judged duplicative of other programs, inefficient or working in opposition to other federal programs. The President shall state what his Administration will do to end these wasteful programs.

The Minority believes that the aforementioned examples of waste and fraud are only the "tip of the iceberg." The billions of dollars that could be saved through a concerted effort by the Legislative and Executive Branches to eliminate waste would reduce the spending of government and yet not reduce the amount of federal services.

Those politicians and commentators who see the taxpayer revolt as having only an economic consequence are missing its most dramatic impact -- that is, the public's continuing lack of faith in their government. It would benefit the nation, both economically and politically, if the Congress and the President actively moved to eliminate the causes of the revolt.

IX. CONCLUSION

The Minority is concerned by the economy's steady drift toward a slowdown or recession in 1979 or 1980, a slowdown predicted by more and more forecasters. We attribute this drift to inflation and rising tax rates.

A lack of Federal fiscal responsibility and excessive money creation have produced rapid inflation, which has eroded confidence in the dollar, and destroyed its value at home and abroad. The decline of the dollar in turn reinforces the inflation.

Inflation produces rising tax rates by pushing individual taxpayers into higher tax brackets, thus reducing disposable income, lowering the rate of return to saving and investing, and encouraging the use of tax shelters. Inflation sharply increases business taxes and lowers the rate of return to business investment by leading to the understatement of depreciation and inventory costs. Inflation boosts taxes on real capital gains to levels which can exceed 100 percent, further discouraging saving and investment, and particularly the funding of small, innovative firms.

None of these problems has been squarely faced by the Administration. The President has tried to handle these problems with symbolic gestures and stopgap measures.

Instead of fighting the causes of inflation with curbs on Federal spending and a less expansive monetary policy, the

33-958 O - 78 - 21

Administration has tried to shift the blame to labor and business. It has relied on jawboning, and now seems to be moving toward large-scale disruption of the economy through policies which are ever closer approximations to wage and price controls.

Instead of facing up to the severity of the dollar crisis and addressing the inflation which has brought it about, the Administration blames the Congress for not raising energy taxes, the public for not abandoning the automobile, business for not promoting exports, and foreigners for lack of faith in the dollar and for failure to reduce trade barriers.

Instead of recognizing that an increasing tax burden threatens us with recession and makes our products uncompetitive abroad, the Administration proposes to allow sharp tax increases on labor, income, and energy. These taxes will simultaneously increase the cost of production and decrease the reward from production in the United States, both in absolute terms and relative to conditions abroad.

The Administration is displaying a pattern of failing to address the monetary and budgetary fundamentals underlying our major problems, and of avoiding hard choices. In addition, the Administration neglects consideration of how motivation, incentive, and real after-tax reward affect economic behavior. Policies which neglect these factors will not produce real growth, real productivity gains, or real solutions to inflation and the declining dollar.

ADDITIONAL VIEWS OF SENATOR JACOB K. JAVITS

The focus of my separate views is on the international economy and on inflation, two interrelated problems; and on budget and governmental expenditures.

International Economy

It is critical that we check the fall of the dollar, because any continued decline could be catastrophic, and will reinforce the already strong inflationary pressures on the U.S. economy -- which may lead to a sharp recession.

The last month has seen several steps taken which may mark the end of the Administration's policy of "benign neglect" of the fall in the dollar:

> An announcement by the President that he had requested Secretary of the Treasury Blumenthal and Federal Reserve Chairman Miller to recommend to him any future actions he might take to deal with the sharp decline in the dollar and the recent disorders in the foreign exchange markets;

- Step increases in short-term interest rates by the Federal Reserve Board; and the removal of the 4 percent reserve requirement on borrowing abroad by U.S. commercial banks; and

- Increased gold sales by the Treasury.

These limited measures represent short-run steps that will contribute to the stability of the dollar, only if other medium- and long-term measures are taken simultaneously to deal with the fundamental and structural causes of the problem.

A failure to deal with the problem of the dollar, which has declined beyond the level dictated by trade flows, cyclical, or inflation differentials, threatens the very existence of foreign exchange markets at a time when it is necessary that a properly functioning international monetary system be in place.

The falling dollar contributes to inflation in the United States. Recent estimates that the depreciation of the dollar adds 1/2 to 1 percent to the inflation rate are too low. If we take into account the price rise of domestically produced goods that occur because of the protection afforded to domestic industries from higher import prices, we may find that the falling dollar has actually contributed close to two percentage points to the U.S. inflation, or an estimated 25 to 30 percent of the 1978 inflation rate.

Other adverse political and economic effects of the falling dollar are discussed in the Minority Report.

As I have noted, tentative steps must be supplemented by other measures if buyers of dollars are to be brought back into the market.

At the same time, we must deal with the medium-term problem facing the dollar, to wit, the basic economic "fundamentals," by turning our trade account around through a vigorous export promotion program, cutting our dependence on energy imports, and monitoring prices and wages and salaries.

It is for this reason that I have supported the Conference Committee Report on the energy bill, largely because I believe that failure to pass the energy legislation would provide a negative and adverse signal to the foreign exchange markets that the U.S. is unable to take decisive and required steps in its own self-interest.

Finally, we must also deal with the basic structural problem facing the world monetary system, that is, the massive dollar overhang, by convening a meeting of the world's finance ministers in order to begin serious discussions on a monetary plan that would supplement the reserve role of the dollar with that of the other major currencies and the SDR.

U.S. Policies To Deal With Inflation

To deal with inflation, we must move to a more restrained fiscal policy. Any consideration of possible tax reductions must be considered within the revenue estimates of the Conference Report on the Second Budget Resolution, which allows for a tax reduction of up to $19.4 billion for fiscal year 1979.

Such a tax reduction should seek to provide a partial offset to the anticipated increases in the social security taxes (about $14 billion, including past scheduled and 1977 amendment increases); and the effects of an expected 8 percent inflation on tax bracket creep and loss in value of depreciation reserves for individuals and businesses (about $16 billion).

While fiscal restraint is the correct policy at the present time, it does not imply a need for privation for the old, the very young, the lame, the halt, the blind, and the truly disadvantaged. Neither does the need for some movement toward restraint in fiscal policy imply any need for delay in the scheduled increase in the minimum wage.

During extensive hearings in the Human Resources Committee last year on the Fair Labor Standards Act Amendments of 1977, considerable testimony was received on the possible inflationary impact of minimum wage increases. There appears to be no persuasive evidence to support the contention that modest increases for the small proportion of the U.S. labor force at the bottom of the wage scale have significant inflationary

impact. Coupled with the need to help these workers catch up with at least a portion of the enormous increase in the cost of living since the minimum wage levels were set in 1974, I believe that the 1977 amendments struck a fair balance between the needs of these workers and the needs of the U.S. economy as a whole.

It has been suggested that, if large individual income tax cuts are made, thereby reducing upper income tax brackets, investors would be encouraged to leave tax shelters, which would increase their total savings available for real investment.

Such large upper bracket personal income tax reductions are not the proper approach for increasing investment, for the resulting increases will not be large enough to have a significant effect in this direction.

This approach involving large upper income individual tax cuts has been recommended as a first step in a program to reduce overall outlays in the Federal budget. I seriously doubt that the nation can take the risk of a further large spurt in inflation which would result from such large tax reductions without having Federal budgetary spending cuts as part of the same package, particularly in the present environment with inflation already high and rising and inflationary expectations laying around like tinder.

Instead, as is pointed out in the Minority report, the present inflationary situation calls for increased capital formation and incentives that will encourage significantly

increased productivity and modernization of the U.S. industrial plant. To this end, I believe that the proper tax reduction approach should focus on corporate tax reductions, as embodied in the Danforth-Javits tax bill. Rather than massively cutting individual taxes, it would be preferable to have rate reductions in the corporate income tax, a widening of the Asset Depreciation Range to 40 percent and a permanent investment tax credit pegged at 12 percent per year.

In the present economic environment, some commentators have begun to discuss wage and price controls again. I am opposed to such controls, except in wartime or extreme national economic emergencies.

The use of tax-based incomes policies (TIP) as a method of fighting inflation has been proposed. Both variants, the carrot approach, which would reward firms that hold wage and salary increases within Federally designated guidelines by giving tax subsidies graduated to the amount that the wage increases were below the guidepost, and the stick approach, which would impose a special tax on firms if wage increases exceeded the government-imposed guidepost, are, in effect, similar efforts to convince corporations to stand firm against wage and salary increases.

While each of the approaches raises substantive as well as administrative questions, TIP, as a novel approach to dealing with inflation, must be considered carefully and weighed against other anti-inflationary approaches.

As compared with business-directed tax cuts embodied in the Danforth-Javits approach or even a straight corporate income tax reduction, TIP would probably yield less of an investment response, but would have a more substantial impact on fighting inflation.

To defend the dollar, the Federal Reserve has recently and quite appropriately increased significantly the Federal funds rate. Concern has been raised about the availability of funds to the housing sector as a consequence of that policy. It is not too soon to begin to be concerned about liquidity in the housing markets, although there is still estimated to be some margin available for moderate Federal funds rate increases.

While it is appropriate to consider the benefits and costs of Federal regulations, this must be done in an environment in which regulations needed to protect health, human needs, or human rights are not unduly deferred through endless cost-benefit studies. Similar care must be taken with respect to some proposals to universalize "sunset" legislation.

Voters across the nation have been sending us a message with respect to the use of their tax dollars. At the Federal level, a fixed requirement for budgetary balance could conceivably jeopardize the borrowing ability of the United States and the ability of any bond rating group to give the United States a clean bill of health for the issuance of U.S. securities.

In addition, a balanced budget may be counterproductive at times; for example, during periods of recession or in times of national emergency, such as when there is a need for new and expanded military expenditures.

I have sought to highlight these two broad issues -- the international economy and inflation -- in my additional views because they are the two critical economic issues facing the U.S. and the world today. It is imperative that the U.S. and world economy be moved in the direction of a stable dollar, structural reform of the world economy and the international monetary system, reduced inflation, and economic growth both here and abroad.

ADDITIONAL VIEWS OF REPRESENTATIVES CLARENCE J. BROWN AND JOHN H. ROUSSELOT

The U.S. continues to struggle with the highest unemployment rate and the worst trade deficit in the developed world. It also has the worst record on wage and fringe benefit increases and productivity growth. This situation can be summed up by repeating the point made in the Minority Views: the average American worker has had no increase in real take-home pay in 13 years, after taxes and inflation.

The cause of this poor performance is the low rate of saving and investing in the U.S. The U.S. consistently turns in the lowest rate of saving and investing in the developed world. Compounding the problem is the fact that the Federal budget deficit has been absorbing about $50 billion a year out of annual private personal and business saving, totaling about $160 billion.

If the U.S. is to solve its growth, income, trade, and unemployment problems, it must increase saving to fund the modernization and expansion of plant and equipment, and to pay for research and development and manpower training.

Toward that end, we have introduced a bill entitled the Savings Act of 1978. It is designed to encourage and to assist Americans to save and invest -- activities which many of our citizens find next to impossible in an inflationary period.

The bill allows individuals a tax credit of 50 percent for additions to all types of bank and savings accounts, stock and taxable bond holdings, insurance, and their share of assets of small businesses. It will sharply increase the reward to saving, and will, for the first time in years, allow many of our citizens to have a real return after taxes and inflation on their savings. It will enable many people to set aside sufficient funds for the purchase of a home, payment of tuition or medical expenses, a secure retirement, and the many other goals our citizens have worked so hard to reach, only to be cheated out of them by taxes and inflation.

While helping savers to reach these goals, this bill will help the country reach its goals of full employment and price stability. By adding to the supply of savings, the bill makes possible the funding of far more investment in plant and equipment, the modernization of thousands more factories, and the creation of hundreds of thousands of additional jobs each year. By increasing productivity and the demand for labor, this will make American industry more competitive with foreign firms even while providing real wage increases for American workers. By funding the investment out of saving, instead of through money creation by the Federal Reserve, and by increasing efficiency and the supply of goods, the bill will reduce inflation.

Last year, before the Joint Economic Committee, a panel of experts on growth and capital formation zeroed in on the bias in the tax code against saving. Income is taxed when earned. If it is consumed, it purchases

a service or a product with little added tax. If it is saved, the service (interest or dividends) is taxed a second time at higher tax rates. The experts recommended removing saving from taxable income as the best way to return the tax code to neutrality between consumption and saving. Taxes would remain on the earnings of saving, but we would no longer be double-taxing both saving and its earnings. This bill is a major step in that direction.

The bill recognizes the difficulty lower income taxpayers have in saving by providing a tax credit rather than an exemption. Lower income taxpayers would receive a credit on all eligible savings.

Middle and upper bracket taxpayers have historically saved higher percentages of their incomes than lower bracket taxpayers. To sharply reduce revenue losses to the Federal Government from this bill, these taxpayers would receive a credit only on eligible savings done in excess of the normal percent of income saved by people in their income brackets.

This savings credit will restore the attractiveness of straightforward saving in basic U.S. industry, small business, and homebuilding, as compared to inefficient but tax-sheltered projects. A 50 percent credit doubles the reward to such taxable investment and saving for any given interest rate or dividend. Thus, this credit will produce a reallocation of saving into projects of the greatest value in terms of economic growth and modernization of American plant and equipment.

Other nations actively encourage saving. For example, Canada permits tax exempt deposits in special savings accounts. Germany subsidizes interest rates in a similar program. Japan, as part of its new budget package to promote more rapid growth, will allow a tax deduction for stock purchases of up to $5,000. The nationwide benefits from such programs appear to be high. There is no reason why the U.S. should not enjoy the same gains.

Saving is the key to noninflationary economic growth. Growth is the key to full employment, rising living standards, and a sound social security system. We hope this savings proposal will spur the Congress to get right to the heart of our economic problems and to produce a substantial increase in the U.S. growth rate for years to come.

SUPPLEMENTAL VIEWS OF REPRESENTATIVE CLARENCE J. BROWN

I would like to address two other points -- structural unemployment and government regulation.

Structural unemployment is a national tragedy.

Unemployment has remained around the 6.0 percent rate for much of this year. However, hidden in the unemployed is a group that has little chance of ever finding a permanent job. These people have few skills; skills so few that they face a life of unemployment. These people have gained nothing from the scandal-ridden CETA or other bungled jobs programs. It is because of government's failure to really help these people that they are losing hope.

To correct this situation, I have introduced H.R.14100, a bill to help the structurally unemployed. This legislation would subsidize a private sector employer for hiring and training a structurally unemployed person. The subsidy, which starts at 50 percent of the wage is gradually reduced in six-month intervals until, after two years, it is ended. I must emphasize that the employer subsidy would only be paid if the employer trained, as well as employed, the low-skilled person. Training is the key solution to the problem of structural unemployment.

This subsidy would be provided under a set of priorities. Priority is given to high unemployment areas, to small business employers who wish to participate in the program, and to employers who use intermediate organizations.

Intermediate organizations are local, nonprofit organizations that bring together representatives of labor, business, schools, clergy, civic groups, and other community groups in an effort to match the structurally unemployed with jobs available in that community. Intermediate organizations have proven much more successful than any government job training program. Priority is given to these organizations because they not only aid in finding jobs for the structurally unemployed, but also provide very essential support services to the newly hired low-skill employee. Because of their outstanding record, intermediate organizations act as a guarantor of successful job placement of the structurally unemployed.

A minimum paperwork provision is included in the bill to prevent it from being an administrative and paperwork burden on the employer. No state will receive any subsidy money until it has convinced the Secretary of Labor that its *modus operandi* places a minimum of paperwork and administrative burden on the employer.

We must solve structural unemployment because, under current conditions, millions of people have little chance of employment.

We must solve this problem because our slumping economy needs the input of these citizens.

But, most crucially, we must solve this problem to help millions of people who find their lives robbed of security, opportunity, and, most of all, hope. Government regulation is another area demanding action.

There has been an astronomical growth in government regulation and its costs over the past few years. The Code of Federal Regulations now fills 65,000 pages in 38 volumes, filling a shelf 15 feet long. Thousands of new regulations are added each year.

The costs are unbelievable. Murray Weidenbaum, Director for the Study of American Business, at Washington University, in a recent study for the Joint Economic Committee, showed a regulatory cost of $4.8 billion for administration and $97.9 billion for private sector compliance costs in fiscal 1979. That is almost $500 for every many, woman, and child in the country.

Much of the regulatory activity represented by this huge $103 billion burden is well intentioned. Concerns over safety, the environment, and consumer protection are legitimate concerns.

But it is high time we turn our attention to the high cost of these regulations, and analyze them to determine the areas in which the costs are exceeding the benefits.

33-958 O - 78 - 22

I have introduced two bills to begin work on lifting these burdens. Senator Bentsen has introduced the same legislation in the Senate. These bills will stem the tide of stifling government regulation. One of the bills deals with the broad scope of regulatory costs. The other bill would remove individual regulations that are contradictory and duplicative.

Under the first bill, H.R.14165, beginning with fiscal year 1979 and for the four following years, the President is required to submit recommendations to Congress for reducing by up to 5 percent each year the cost imposed on society by Federal regulations. Any government agency failing to achieve a 5 percent compliance cost reduction during any year is required to provide a full explanation of its failure and to cite all provisions of law which may have prevented it from achieving the goal.

Under the second bill, H.R.14166, the Office of Management and Budget will annually report to Congress and the President on Federal agency rules or regulations which duplicate or conflict with rules or regulations promulgated by other Federal agencies or by State and local governments. At the start of each fiscal year, the President will submit his recommendations for resolving or eliminating duplication or conflicts among rules or regulations at the Federal, State, and local levels.

It is senseless for a businessman to be put squarely between a rock and a hard place where complying with one regulation requires

violating another. My legislation is designed to eliminate that impossible situation.

The bills that Senator Bentsen and I have introduced are not aimed at the legitimate efforts of government to clean up our environment and to improve worker health and safety. We all want that. Actually, enactment of this legislation will make the entire regulatory process more efficient and hence more effective in carrying out the work of improving the quality of life for all citizens.

Human effort, our richest resource, is at its best in an economic environment in which personal liberty and security are in optimum balance, with liberty at its maximum and regulation at its minimum safe level. This is the regulatory philosophy we should pursue.

ADDITIONAL VIEWS OF SENATOR WILLIAM V. ROTH

The single most outrageous fact of economic life today is that American workers have had no increase in real take-home pay in 13 years. All pay raises received by the average worker since 1975 have gone to inflation and taxes. The Minority Report states, in Chapter VII, "According to the Bureau of Labor Statistics, in June, 1978, the real spendable income index was 92.69. This is approximately where the index stood in December, 1965."

Why is the Administration silent on this point? This one fact should be proof positive that the tax and spending policies of the Administration and their Keynesian advisers are bankrupt. Yet, these same officials and advisers refuse to accept alternative policies, such as the Roth-Kemp bill, which would put middle-income Americans ahead of the game for the first time in 13 years.

There are other signs of trouble. Real economic profits, fully adjusted for inflation, are lower today than they were in 1967. Even worse, more and more economic forecasters are predicting an economic slowdown in the months ahead. Some even forecast a full-blown recession for 1979.

The stagnation of earnings, and the continued dismal performance of profits, are due to the inflation and the higher taxes which the inflation produces. The higher taxes cut disposable income directly by

reducing take-home pay. Indirectly, higher taxes reduce the growth of the economy, restrain hiring, and retard the growth of wages.

It is time for this country to develop a new economic theory which will enable us to fight inflation and unemployment at the same time. It should be obvious by now that we cannot fight inflation by reducing production and creating shortages. In fact, since 1969, we have had higher inflation every time production has slowed down, and lower inflation every time production has speeded up. This is just the opposite of what the Administration's theories predict should be happening. We need a theory which will enable us to increase production, employment, and real take-home pay without having to call upon the Federal Reserve to run the printing presses to flood the country with easy money and additional inflation.

There is such a theory, one which analyzes tax cuts in terms of incentives to produce. Higher production creates jobs and lowers inflation at the same time. We need to examine tax proposals in these terms.

The Roth-Kemp tax proposal is not designed to work by injecting spending power into the economy. It is designed to work by increasing incentives for the supply of goods and services and to encourage the saving needed to supply investment funds. It does this by reducing marginal tax rates.

The Administration and the Treasury analyze a tax cut only in terms of its size, the number of dollars it dumps into the economy. This is supposed to stimulate "demand" and purchasing power and be spent about twice over to increase GNP by a multiple (two) of the tax cut. Hence, the term "multiplier." This whole line of reasoning is badly out of date. But, for the moment, let us work in terms of the theory the Administration is using.

The Administration brazenly overstates the size of Roth-Kemp. They then claim that Roth-Kemp is too large, that the increased spending it would generate would greatly exceed our unused capacity, currently about $50 billion. But, in addition to overstating its size, the Administration has conveniently forgotten to adjust Roth-Kemp for the offsetting increases in taxes which will be produced by pending social security tax hikes and inflation. These amount to $23 billion in 1979, $42 billion in 1980, $74 billion in 1981, $94 billion in 1982, and $103 billion in 1983. The Administration should subtract these numbers from the Roth-Kemp figures. It is the net tax cut which must be used in a multiplier analysis.

Net of these other tax increases, the tax cuts in Roth-Kemp are only $2 billion in 1979, $8 billion in 1980, and $5 billion in 1981, as social security and inflation-induced tax increases continue. If the Administration multiplied these numbers by two, they would still have no cause to worry about capacity ceilings and inflation. On the contrary, they would have to advocate

further tax cuts by 1982. Clearly, Roth-Kemp is needed just to prevent tax increases over the next three years.

The case for Roth-Kemp does not rely on demand stimulation and an instant reflow of revenue from an expanded economy. It is based on the same microeconomic foundations as capital gains tax reduction -- if you lower marginal tax rates on an activity, you get more of it, and if the activity is a growth activity, you get more growth. Roth-Kemp reduces marginal tax rates on income. In particular, it lowers the tax rates on the last few dollars of wages, interest, and dividends in every tax bracket. It makes work effort, saving, and investment more profitable. It tilts the tax structure, reducing the current bias produced by double taxation of savings and investment income. It favors labor over leisure and saving and investment over consumption.

The Administration and the Treasury dispute this approach. They have tried to tell the Senate Finance Committee that all tax cuts are pretty much alike in their effect on GNP and in the revenue feedback they would produce. They refuse to analyze the net effect of various tax proposals after all their differential economic repercussions. To their criticism of Roth-Kemp, Dr. Norman Ture, President of Norman Ture Associates, replied:

> The criticism, for the most part, derives from antique, obsolete notions about how fiscal changes affect the economy. They are the same Keynesian notions which

> disregard the effects of tax changes on the conditions of supply of factors of production, which look only to the effects on disposable incomes and on aggregate demand, and which in practice have proved to be so consistently, harmfully wrong.

Michael Evans, President of Chase Econometric Associates, said:

> As far as the Treasury goes, I have heard that argument. It is a common argument, one they always trot out. It doesn't improve with age.

The Administration goes astray primarily because they look at the tax cut out of context, and judge it by size alone. However, the day is past when tax cuts should be thought of only in terms of their size.

Many tax cuts work because of their shape, not their size. The Minority Report uses an example from the economics of international trade. Suppose a prohibitive tariff, one so high that it chokes off all imports, is placed on French wine. Since no French wine is imported after the tariff, no revenue is raised. Now, suppose the tariff is removed. No revenue is lost, but importation of French wine resumes. Thus, a tax cut of zero dollars results in an infinite percent jump in activity, some positive number of bottles imported divided by zero bottles in the year of the tariff.

As another example, consider the recent studies which show a small tax cut on capital gains to be so stimulative of asset trading and GNP that the Federal deficit is reduced. Compare this to the general consensus that tax rebates, even fairly substantial ones, have so little impact on GNP as to be massive revenue losers. Obviously, the type of tax cut matters a great deal.

Roth-Kemp works by redirecting demand toward, and expanding the supply of, capital goods, labor, research and development, structures, and saving. It is not an attempt to boost spending through the roof. It works on incentives to produce.

The incentive to an activity is the after-tax payment received for it. That payment rises when the tax rate falls.

The "price" of an hour of leisure is the after-tax wage given up by not working. The "price" of a dollar of current spending is the lost dollar plus after-tax interest which could have been spent next year. Lowering tax rates makes leisure and spending more expensive in terms of lost income. As people respond to this "price" change, they shift into work effort and saving. These are both growth-oriented activities. They increase investment, hiring, capacity, and production. They lower interest rates and prices.

The tax rate in question is the rate on the last few dollars of wages, interest, and dividends, because these marginal rates are what will be paid if work effort, saving, and investing are increased. Thus, cuts in tax

rates in every bracket encourage more work, saving, and investing, as opposed to leisure and consumption. Tax rate reduction increases the available supply of the labor and capital inputs needed for production of goods for current consumption and production of capital goods to expand future economic capacity. Tax rate reduction changes behavior, just as any other price changes do.

As Norman Ture has explained:

> It is in the supply side context, I believe, that one should evaluate the estimates of the Roth-Kemp tax reductions.
>
> The proposed tax reductions would materially reduce the cost of market-directed effort relative to leisure. Certainly, the labor force data of the last few years argue strongly for the plausibility of the employment increases we have projected.
>
> Similarly, Roth-Kemp would dramatically reduce the cost of saving and investing relative to the cost of consumption. To assert less is, in effect, to argue that people's saving and investing behavior is irrational, that people are indifferent to the after-tax return they may obtain in deciding how much of their income to save and how much to consume.

The estimated increases in the supplies of labor and capital services argue forcefully against the criticism that Roth-Kemp would accentuate inflation. The contention that enactment of these tax reductions would sharply boost inflation derives from the mistaken Keynesian views which ignore conditions of supply and look only at alleged effects of tax changes on demand, principally consumption spending.

The real effect of a tax change is that it changes the cost any one of us confronts in doing this versus that .... You can in effect examine why the economy is going to do what it is going to do if you take account of what happens to relative prices. And tax changes are in fact primarily to be interpreted as changes in the relative prices and costs confronting taxpayers.

Roth-Kemp is not inflationary precisely because it does affect behavior, increases growth, and encourages saving.

In order to judge a tax cut's impact on growth and inflation, we have to know what the cut will do to GNP and saving. To finance itself without causing inflation, a tax cut can do four things:

1. It can increase GNP, which is the tax base, and recover revenues to offset part or all of the initial reduction.

2. If it reduces marginal tax rates, it can cause existing savings and investment funds to switch out of tax shelters and nontaxable uses into taxable uses, raising the tax base and revenue. (This also makes saving and investment more efficient, raising GNP by shifting saving and investment from low-yield, but sheltered projects into straightforward, high-yield activities.)

3. If it reduces marginal tax rates, the tax cut makes saving more rewarding after taxes and raises the total amount of saving being done.

4. By fostering growth and employment, the right kind of tax cut reduces unemployment and welfare spending.

As long as revenues rise to offset the tax cut, or as long as savings rise by enough to cover any added debt, the Federal Reserve does not have to buy even one additional Treasury bill, and does not have to add one cent to the money supply.

In fact, Chase Econometrics estimates that saving will rise enough from the tax rate reductions found in the Roth-Kemp bill to cover any added deficit, with enough saving left over to increase net investment substantially, delivering an enormous boost to real growth and productivity.

Furthermore, that saving will be used more efficiently than at present as lower marginal tax rates shift savings out of tax shelters into straightforward investment. The importance of this effect is demonstrated in the Minority Views. There we point out that the percent of personal saving being done by taxpayers in the "tax shelter brackets," saving which might potentially be lured into tax shelters, has risen from 10 percent in 1965 to 30 percent today, and may rise to 80 percent by 1985, if marginal tax rates are not reduced. Where will ordinary industries raise money for expansion under those conditions? How will they modernize to compete with imports?

There are those who downplay the importance of saving, and who would prefer to direct more tax relief to business. However, we cannot modernize American industry simply by cutting taxes for business without doing anything to encourage saving. The various business tax reductions now being proposed are important. Business will be strongly encouraged to expand. However, business will have to run to the credit market, because only a fraction of its need for funds can be met out of retained earnings or the investment tax credit. The ITC only covers 10 percent of the purchase cost of a machine, and expansion programs generally take several years of a firm's income. So business will

run to the credit market. And what will it find there? The government, trying to borrow back the tax cut it just granted. Interest rates will soar. The Federal Reserve will see this as crowding out. It will step in to buy Treasury bills, printing money right and left, guaranteeing inflation. The only way to avoid this outcome is to slash Federal spending. I certainly support reductions in Federal spending. However, a sudden drop of the size needed to meet this demand for credit is most unlikely.

Now look at Roth-Kemp. The firms reach the credit market and find a large surge in saving, providing funds for both the firms and the government. Roth-Kemp prevents the increase in interest rates, the crowding out, the printing of money, and the inflation. Why? Because Roth-Kemp cuts the tax rates on individuals, and they save more. Roth-Kemp is balanced. The House bill and other proposals which do not reduce marginal tax rates do nothing for ordinary saving. They are unbalanced and inflationary.

Only Roth-Kemp reduces marginal tax rates, the rates that affect behavior. Only Roth-Kemp addresses this basic question of savings, economic growth, and protection of American jobs.

Thus, Roth-Kemp is not inflationary. It is self-financing in four ways. The Administration doubts this primarily because, in their frame of reference, they have no way to distinguish between a tax cut which alters incentives, reduces the use of tax shelters, and stimulates savings and investment, and

one which simply cuts Federal revenue and forces the Federal Reserve to create money to buy Treasury debt.

What has happened to the Administration's advisers is very simple. They are macroeconomists used to looking at tax cuts according to their size. Roth-Kemp is a very small net tax cut which operates by restructuring tax rates and affecting incentives. Thus, its effects fall within the study of individual behavior -- microeconomics. The advisers are out of their element.

The Administration and the Treasury have totally neglected the fact that saving will be encouraged by lower tax rates. They have given no thought to the efficiency gains (and tax revenues) that will result as people shift from tax shelters into ordinary investment. They ignore production gains from a greater acceptance of overtime, or the more intense work effort and seeking after promotions brought on by lower rates. They neglect the benefits from increases in research and development as profitability is restored. These microeconomic effects come from lowering the tax barriers between effort and reward. These barriers, which the Kennedy tax cut reduced, have been gradually resurrected by 15 years of inflation. They are powerful. They are not in the Keynesian short-run world view.

In the Kennedy years, the labor supply rose sharply, productivity rose sharply, saving surged, and capacity increased much faster than in the previous decade. The Administration says capacity and productivity

will not rise fast enough for Roth-Kemp to repay Washington in three years in terms of higher Federal revenue. Maybe not. But any delay in repayment will be thoroughly covered by higher saving, not by inflationary money creation. And the tax cut will repay the country as a whole in terms of full employment, higher real income, higher state and local tax receipts, fewer lives wasted on welfare, and a rekindling of the work ethic and entrepreneurial incentives. People will be working for themselves and their families once again, and upward mobility will again be part of American life.

ADDITIONAL VIEWS OF REPRESENTATIVE GARRY BROWN

The Federal Government is probably the largest barrier to full employment today. Its overspending has increased tax rates and retarded growth. Its deficits have preempted almost one-third of the country's private saving, taking over $50 billion this year which could have gone for new factories, modern machinery, job training, and permanent hiring.

The solution to this problem is to bring the Federal budget under control by requiring the Federal Government to bring down its spending from 28 percent of personal income today to 25 percent of personal income by 1983. This is equivalent to a drop in spending from the current 22 percent of GNP to just over 20 percent of GNP, the historical peacetime norm.

Many states are considering the enactment of formal tax limitations with no explicit cap on state spending. This works at the state level, because most states have limited borrowing power. With taxes restricted and borrowing limited, the state budget is under control.

I strongly support tax reduction at the Federal level. However, since there is no Constitutional restriction or referendum procedure on Federal borrowing, a formal spending cap is needed to guarantee control of the Federal budget and a reduction in Federal spending as a percent of personal income and GNP.

33-958 O - 78 - 23

This return to normal spending cannot be done in a rigid fashion, however. Allowances must be made for adjustment in spending over the business cycle. This would require reductions in spending as a share of GNP in good years to provide funds which could be used to permit unemployment compensation and countercyclical spending to vary in years of recession or slowdown (which today's high taxes and inflation may bring on).

Therefore, I favor the adoption of a Constitutional Amendment, plus accommodating amendments to the Budget Act, to provide a "variable cap" spending limitation. This limitation would vary inversely with the rate of growth of the economy. It would curb spending to allow for specified amounts of funds to be set aside in years of rapid growth, and would permit countercyclical transfer payments and spending in years of downturn, while still providing for a gradual transition of permanent, full employment levels of Federal spending to normal postwar levels.

The gradual reduction of Federal spending, coupled with substantial across-the-board reductions in personal and corporate tax rates, will sharply retard inflation and encourage saving, low interest rates, investment, and permanent hiring. It will help to modernize America's factories and lower the cost of producing in the U.S., safeguarding our jobs from foreign competition and strengthening the purchasing power of the dollar. Most importantly, lower taxes, lower prices, higher production, and higher wages will improve living standards for everyone.

Restraining taxes and inflation, and promoting productivity are the only ways to produce real growth in spendable earnings for American workers. Since 1965, the typical working American has seen all of his pay increases disappear due to taxes and inflation. Real take-home pay is no higher today than in 1965. Tax reduction and a Constitutional Amendment to curb Federal spending growth will put a swift end to this disgraceful and unnecessary situation.

ADDITIONAL VIEWS OF
REPRESENTATIVE MARGARET M. HECKLER

New England should have a special interest in the October 1978 Review of the Economy, Minority Views on the falling dollar and energy prices. The Minority Views point out that, after inflation and taxes, the average worker has had no real increase in take-home pay in 13 years. I believe that, over the next few years, we may see actual reductions in take-home pay.

The Administration is pursuing policies in several areas which, taken separately, are unsatisfactory; in combination, they comprise disaster for New England. These policies involve taxes, inflation, energy, and the falling dollar.

Workers all over the country are going to have their real take-home pay reduced because the tax cuts likely to be enacted are all too small to offset the pending social security tax increase and the effect of inflation in pushing everyone into higher tax brackets.

All Americans will face a drop in real purchasing power because inflation is going to be kept high by the rapid growth of Federal spending and pressure on the Federal Reserve to pay for it with new money.

The energy bill creates new problems for New England. It will quickly raise energy prices to consumers and employers, with few compensating benefits Because the bill is not expected to generate immediately higher

domestic energy supplies, it will be of no real help for the falling value of the dollar. The U.S., and New England in particular, will become even more dependent on high-cost foreign energy.

The decline of the U.S. dollar further reduces the purchasing power of U.S. consumers. The falling dollar helps to raise the price of all traded goods, particularly oil. It makes inflation worse throughout the U.S. economy by leading to price increases on competing domestic products too. But the oil price increase will be a special problem for New England.

New England is more dependent on foreign oil than any other region. New England pays energy prices 2-1/2 times the national average, costing us more to heat our homes, and costing us jobs and wage increases by making it harder for New England businesses to compete with firms in the rest of the country. For years, those manufacturing companies which need a lot of energy to make their particular products have been moving out of the Northeast. Without some relief, this trend will continue.

I would like to see the Administration proceed with greater awareness of the relationships among its tax policy and balance of payments policy, as well as energy and inflation policies. Each policy is inadequate by itself, and even worse when its effect on the other problems are considered. As usual, it is the people who bear the burden, and New England in particular.

ADDITIONAL VIEWS OF SENATORS JAMES A. MCCLURE AND ORRIN G. HATCH

The gentlemanly language of the Minority Views should not be allowed to mask the fact that we are making some serious charges against the Administration. We doubt the basic competence of the Administration to understand what is happening to the economy. And without understanding, there can be no rational policy decisions, except by accident. Thus, we see the Administration adopt policy after policy, each one an empty gesture, all symbol and no substance.

The Administration does not understand why the dollar is falling, what the fall means for the U.S. economy, or how to stop the fall.

Administration officials do not realize that a falling dollar raises prices throughout the economy, not just on imports and a few closely related items. Thus, they were surprised by the burst of inflation we have had so far this year. The relationship between the falling dollar and domestic inflation is a mystery to Administration policymakers. That is one reason why the collapse of the dollar did not disturb them for nearly a year.

The Administration seems to feel that the dollar's collapse is due to oil imports and adverse market psychology. It believes the energy bill and other psychological measures like currency swaps and gold sales will stem the tide. But the exchange markets do not

accept the substitution of psychology for substance. Anne Mills of the Irving Trust Company's foreign exchange desk has written:

> Since the mid-August White House announcement of a dollar-defense plan (specifics to be revealed over time), the market's bearish dollar bias has been held at bay by fears of U.S. moves. But bears can't be fended off indefinitely with unsubstantiated threats, and the impact of "intervention by intimidation" eroded in the absence of firm Administrative action.

The dollar is falling because people all over the world are afraid to hold onto their dollar assets. They are convinced that U.S. inflation will worsen. It will worsen because the Administration does not know what causes inflation. It blames everyone except itself. It offers symbolic gestures such as jawboning and guidelines. It studies special taxes on labor and camouflages them by calling them "tax-based incomes policies." It does everything except say, "Overspending by the Federal Government leads to a Federal deficit. The deficit puts pressure on the Federal Reserve to monetize the debt that is issued to cover the deficit. The excess money creates inflation. Let us stop the excess spending and the excess money creation." Thus, Administration officials really believe that currency swap arrangements, which do nothing to reduce the number of dollars in circulation, are a real cure for the dollar's weakness. Therefore, these officials do nothing to stop the flood of dollars being created to fund the Federal

deficit. They make a symbolic gesture and avoid the policy of substance.

The Administration does not understand that the Federal deficit has direct spillover effects on the trade balance and the balance of payments. It does not realize that the payments deficit is due to total U.S. spending in excess of total U.S. output and earnings, rather than to spending on any one product, such as oil. Thus, an energy bill which will produce no additional oil or gas for five to seven years (if ever) is touted as a psychological cure for the trade deficit and the falling dollar. Meanwhile, other necessary long-run sources of energy, such as coal, nuclear, and solar, are given far too little support, and the substantive policy which could help the dollar quickly -- reduced Federal spending and slower money creation to curb inflation -- is ignored.

This is not to say that the Administration is ignoring inflation. On the contrary, it is preparing an inflation program for domestic reasons. It is a program that will be a disaster for both domestic and foreign economic policy.

As this goes to press, the Administration is moving to strengthen its "voluntary" wage and price guidelines by adding sanctions. As we should have learned from the last experiment with wage and price controls from 1971 to 1974, these controls will hold down real rates of return to labor and business, restricting output by holding down incentives. With real domestic output down, and the price per unit restrained, and the Administration busily creating more money, we

will see an explosion of imports. And when controls are removed, there will be an explosion of prices. The Administration has forgotten this lesson.

Picture a simple island economy producing and consuming 100 bushels of apples a year. Assume the money supply is $100, with each dollar being spent once a year (velocity of circulation equals 1). Thus, apples sell for $1 per bushel. Now impose price controls. Assume that apples are required to sell for $.80 a bushel, and that only 90 bushels can be produced at that price. Meanwhile, the government raises the money supply to $125. Domestic sales of apples are only $72. Either the public simply sits on the extra money (velocity falls drastically) or it spends it on $53 of imports from the next island. The currency falls in value as the people on neighboring islands get tired of acquiring it, and when controls are removed, domestic prices soar to at least $1.25 per bushel.

Does the Administration really think that controls will reduce inflation as output falls and the money supply keeps growing? Does the Administration think the balance of payments will improve with shortages of domestic products springing up everywhere? Lowering prices by decree on U.S. goods will not boost exports if there is no output to export. Lowering domestic output will reduce exports and raise imports.

The way to bring domestic inflation under control, and to solve the dollar's problems, is to curtail Federal spending and money creation. The way to make U.S. products more

competitive is to reassure U.S. producers by firmly rejecting wage and price controls, so that producers can proceed with modernization and expansion plans. The government can help to lower prices by cutting taxes and regulatory red tape. This will boost output and exports. Unfortunately, the Administration cannot seem to relate these domestic and international problems.

Administration tax policy is a shambles. Its proposals have been ripped apart by the Congress, and for good reason. The Administration is operating with the most primitive Keynesian theories. They claim that tax cuts work by dumping purchasing power into the economy, and the more that is spent and the less that is saved, the better. Therefore, it doesn't matter how you hand out the money. All that matters is how much.

In the Keynesian textbook, the theory assumes fixed prices, excess capacity, and a perfectly responsive labor supply and business sector ever ready to increase output. But higher output involves higher costs. In the real world, tax cuts fall completely flat if they do not affect people's attitudes toward work and production by improving the after tax rewards to those activities.

The Administration does not understand that tax cuts will not produce growth by raising "demand." In the first place, unless spending is cut, the government will simply borrow back whatever tax cut it grants, eliminating any surge in demand. But even if the government did not take the money back, demand policies are not the answer. Demand

does nothing but raise prices unless there is more supply. There will not be more supply unless the tax cut takes a form that raises rates of return to suppliers, and that means labor, business, savers, and investors.

The "demand only" approach raises rates of return to business only if it raises prices relative to wages, tricking labor out of its anticipated real wages. But this is not only immoral, it is ineffective, because wages are soon adjusted upward by new contracts or cost-of-living adjustments. Otherwise, labor would be withdrawn from the market and output would fall.

However, the government can generate higher after-tax wages and higher after-tax returns on output and investment if it reduces tax rates. By this we mean the tax rates on additional units of output and hours of work. Thus, the tax cut will fail unless it cuts tax rates on extra effort, on added earnings, on greater output. That means cutting tax rates in all brackets for individuals, and cutting corporate tax rates for business.

Increasing exemptions or the standard deduction by a few dollars leaves most people in the same tax brackets as before. But if tax rates are reduced, people find themselves changing their behavior.

An investor in the 70 percent bracket who is put back into the 50 percent bracket may switch his money out of tax shelters and into expansion of his business.

The taxpayer who reached the 50 percent Federal tax bracket may reduce his saving because, after tax, his interest receipts fall below worthwhile levels. He may resume saving if the rate in his Federal tax bracket falls to 38 percent.

The worker in the 22 percent bracket, facing a 6 percent state income tax and a 6 percent social security tax, may decide that a 34 percent tax bite out of each dollar earned in overtime makes going fishing with the kids a better deal. He may resume working if his Federal tax rate falls to 15 percent.

The wife who wants to return to work may stay home because her earnings will be added to her husband's for tax purposes. If her husband's earnings reach the 28 percent tax bracket, her earnings might fall into the 28 to 36 percent tax brackets, before state and social security taxes. She may take the job if her husband's bracket falls to 19 percent, putting her income into the 19 to 25 percent brackets.

A firm might not risk borrowing at 9 percent to expand an operation which might return only 10 percent after tax. That firm would find that operation yielding 12 percent if corporate tax rates fell to 40 percent from 48 percent, and it might expand.

Each of these tax rate reductions also lowers the cost of production in the U.S. compared to overseas, reducing inflation at home, improving the balance of payments, and strengthening the dollar abroad.

The Administration ignores these effects. It ignores the fact that tax cuts really come in two shapes -- those that change the rate of return after tax to growth activities, and those that do not. In its ignornace, the Administration designed a tax cut which, although permanent, acted just like a rebate. It did little to make added earnings, interest, sales, or investment more attractive, and it handed out money in a fashion mostly unrelated to productive activity.

The Administration badly needs new ideas which take into account the real relationship between the domestic economy and the rest of the world, and the real relationship between taxes and output. It must consider the world to be made up of rational individuals responding to real rewards and real market signals in deciding whether to hold dollars or deutschemarks, and whether to save or consume, produce or disinvest, work or take leisure.

At the moment, the Administration has no theory of cause and effect to predict how people will respond to policy. They rely on psychological explanations of no predictive value. It is high time it abandoned the "eye of newt and toe of frog, wool of bat and tongue of dog" approach to policymaking. Let them return to the fundamentals, and develop policy on the basis of the real variables and motivations which are at the heart of real economics.

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