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THE 1977 ECONOMIC REPORT OF THE PRESIDENT

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-FIFTH CONGRESS

FIRST SESSION

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THE 1977 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, JANUARY 19, 1977

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

The committee met, pursuant to notice, at 10 a.m., in room 2237, Rayburn House Office Building, Hon. Richard Bolling (chairman of the committee) presiding.

Present: Representatives Bolling, Reuss, Moorhead, Hamilton, and Brown of Ohio; and Senators Humphrey, Proxmire, and Javits.

Also present: John R. Stark, executive director; Louis C. Krauthoff II and Courtenay M. Slater, assistant directors; Richard F. Kaufman, general counsel; William R. Buechner, G. Thomas Cator, William A. Cox, Kent H. Hughes, Sarah Jackson, John R. Karlik, L. Douglas Lee, and Katie MacArthur, professional staff members; Michael J. Runde, administrative assistant; and Charles H. Bradford, Stephen J. Entin, George D. Krumbhaar, Jr., M. Catherine Miller, and Mark R. Policinski, minority professional staff members.

OPENING STATEMENT OF REPRESENTATIVE BOLLING, CHAIRMAN

Representative BOLLING. The committee will come to order.

This morning the Joint Economic Committee begins its annual hearings on the Economic Report of the President. We have as our first two witnesses Mr. Alan Greenspan, Chairman of the Council of Economic Advisers, and Mr. Burton Malkiel, a member of the Council, who will discuss President Ford's Economic Report with us.

This past year has presented us with a mixed bag of economic indicators. Real output increased 5 percent from the fourth quarter of 1975 to the fourth quarter of 1976, but the increase averaged only an anemic 3.8 percent over the last three quarters.

The rate of inflation slowed considerably in 1976, but unemployment remained unexpectedly and distressingly high at 7.8 percent, only 0.5 of a percent below what it was at the end of 1975.

For the information of the members of the committee, the discrepancy between that figure with the one we have been using, involves a new seasonal adjustment.

Industrial production increased fairly steadily through the first half of the year, sputtered late in the third quarter and early fourth quarter and has recently begun to increase again. In short, what we have witnessed has been a rather typical recovery from an unusually deep recession. The strength of the recovery has been far less than most of us hoped it would be. A vast array of resources remain idle as the economy continues to operate far below its full employment potential.

The economic outlook for 1977 as presented in President Ford's report offers some hope of improvement over the present situation. The President's proposal for a tax cut, for the maintenance of a current services level of spending in fiscal year 1977 and for only a slight reduction from that level in fiscal year 1978 seem to indicate that the President's economic advisers recognize a greater need for stimulative policy than their public statements have indicated.

Given the proposed stimulus, the Council expects real GNP to grow by about 5 to 5½ percent in 1977 which would still leave us with about a 7-percent rate of unemployment by the end of 1977. I hope and I am sure all of us hope we can do better than that. In addition, the Council expects that there will be little, if any, improvement on the inflation front for this year.

Mr. Greenspan and Mr. Malkiel, we are glad to have you testify before us and we welcome your comments on the economic situation and outlook.

You may proceed as you wish.

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

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

Before we begin the formal substance of these hearings, I should like to take a moment to indicate how much I have personally appreciated and profited from my relationship with this committee over the past 2½ years.

I am also certain I speak for my colleagues, past and present in this regard.

The questions that have been posed to us have been tough but fair, and I certainly trust that such hearings have helped to illuminate some of the more pressing economic problems that have confronted this nation.

Mr. Chairman, I would like to ask my colleague, Mr. Malkiel, to outline the contents of our report, specifically some of the areas where we think key issues have arisen and then we will try to respond to your questions.

Representative Bolling. Thank you for your remarks.

You may proceed, Mr. Malkiel.

STATEMENT OF HON. BURTON MALKIEL, MEMBER, COUNCIL OF ECONOMIC ADVISERS

Mr. Malkiel. Thank you.

Mr. Chairman, as you have indicated we are here to discuss the short-term forecast of the Council of Economic Advisers.

I would like to spend a few minutes highlighting some aspects of our report dealing with problems which are of a longer term nature.

One of the aspects of the recovery that has been particularly troublesome from a long-term perspective is the weakness in private investment.

Investment is weaker than usual at this stage of the cycle, if you compare the investment trends in this cycle with previous upturns, you will find that this is the weakest one.

Investment is also weaker than one would have expected given the improvement in corporate cash flow, given the substantial reductions we have had in excess capacity and given the strong sales gains we have had.

Indeed, I think it is just about a uniform statement that all the econometric models which use these variables such as excess capacity and sales and so forth are all predicting more investment than we are actually getting.

We suggest in the report that risk factors are a very important element now restraining investment, and in the report we give some reasons why we think this is so.

You will recall in last year's report we presented a capital needs study which indicated that investment was going to have to account for a larger share of the gross national product if we were to meet a number of important national goals.

Specifically, we suggested if we were to get to full employment by 1980 and if we were to meet our environmental and energy goals that investment would have to account for 12 percent of GNP during the last half of the 1970's.

Last year investment was just over 9 percent of GNP. Now, even if our investment requirements were overestimated, and it is possible they might have been because we had two ambitious energy goals, perhaps you would want to take a tenth or so off of our investment requirements because our energy goals were too optimistic.

Even so, it is possible the investment requirements are only 11.5 percent of GNP.

Even if you make that adjustment, it is very clear that considerably larger investment is going to be required over the years ahead and I might add every private study I know of agrees with that conclusion.

If we don't provide the economic climate conducive to increases in business fixed investment, we are not going to have a capital shortage in the sense that we now have a shortage of natural gas.

Rather, the failure to get sufficient investment is going to be reflected in capacity problems and bottlenecks, not in 1977 but long before we get down to an acceptable level of unemployment.

It will also be reflected in a failure to meet our environmental and other goals and, most importantly, by slow growth in productivity and living standards.

This is really the key. Continued low investment is going to be a problem because it is associated with low productivity growth and slow productivity growth is in turn associated with a slow growth in living standards.

In the report we present a detailed analysis of the really striking decline in productivity growth.

In the 1948 to 1966 period, private productivity increased at a 3.3 percent rate per year. In 1966 to 1973, that was cut to a 2.1 percent rate, and the trend rate apparently declined even further in the last 3 years.

To some extent our analysis indicates the changing composition of the labor force toward younger and less experienced workers helps explain the slowdown.

Fortunately, to the extent that one can consider youth and inexperience a problem, it is a problem that has an automatic solution, because if youth is a problem, the passage of time will automatically solve it.

But another major determinant of the productivity slowdown may not automatically be solved and that is the problem of inadequate investment.

Because of the very slow rates of investment in recent years, coupled with large increases in the labor force growth, the growth rate of the capital labor ratio by which we simply mean the productive capital—the machines and tools—each worker has to work with, this growth rate in the capital labor ratio has declined from 68 percent over 20 years to 33 percent in the 1966 to 1973 period and apparently has declined even further since 1973.

It is for this reason I stress the investment problem is intimately related to the productivity problem and the problem of a slow growth in living standards.

This sharp drop in productivity growth is also the major reason why the CEA revised downward its estimates of so-called potential GNP, by which we mean the gross national product we could have if we were operating at full utilization of our labor and capital resources.

Previous CEA estimates of potential GNP indicated the gap between actual output and potential output was 11 percent. In other words, the actual output was actually 11 percent lower than the potential output we could have if we were operating at our full potential.

The new estimates incorporating the effects of the slower productivity growth reduced this gap to about 7 percent and for a number of reasons mentioned in the report we believe that that gap may be even lower.

While these estimates indicate, as you did in your opening statement, Mr. Chairman, that a strong economic recovery is necessary to eliminate the waste currently created by the underutilization of labor and capital resources, they do provide a note of caution that we probably have a good deal less slack in the economy than has been commonly supposed.

In estimating this potential output, there are actually two elements that have entered into the calculation. The first and by far the most important is this growth in productivity that I have already discussed.

But another element is the growth in the potential labor force at full employment. This is associated with what has been called the full employment-unemployment rate.

In the mid 1950's, the Council of Economic Advisers used a 4 percent rate as an estimate of the so-called full employment-unemployment rate.

In other words, we said that when 96 percent of the labor force was employed that we considered this full utilization of our labor resources.

The point was there is always going to be some frictional unemployment from people moving from job to job and people first entering the labor force who will be unemployed for a period of time.

Since the 1950's, there has been a dramatic change in the composition of the labor force. In particular, the proportion of the labor force made up of youths has increased quite sharply and by the way we define unemployment in this country, a young person looking for a first job is counted as unemployed until he or she finds work.

Now, we always have higher reported unemployment rates per youths even at full employment, even in periods when we have been down to very low levels of unemployment since youths are more likely than older workers to be first entering the labor force and first looking for a job.

Therefore, if youths who normally have higher unemployment rates, no matter what the level of unemployment is, if youths now comprise a larger composition of the labor force, then we will tend to have higher unemployment rates now even at full employment.

It is also true now that youths are much more likely to combine school and work experience. In other words, they will tend now to be entering and reentering the labor force more often.

I think in prior years it used to be you did your schooling for a time and left and got a job. This is not the case now.

There is much more of a mixing of schooling and work experience. Thus, because of the compositional changes of the labor force and because of the increased tendency of youths and other workers to more frequently enter and reenter the labor force, the Council has now estimated that a 4 percent rate of unemployment in the mid 1950's corresponds to a 4.9 percent unemployment rate now, and we have used that latter figure, 4.9 percent, as our benchmark figure for full employment.

We present this figure not as some immutable number that represents the full employment-unemployment rate. I want to emphasize we don't present it in that sense.

Indeed, as the composition of the labor force changes in the future, so will this full employment-unemployment rate.

I might also add that most of the economic profession believes that a number of other factors besides these compositional changes that I have dwelt on have pushed the full employment-unemployment rate to a level somewhere between 5 and 6 percent.

I know most of my academic colleagues would put the rate somewhere in that range.

We in our estimates—and I assure you this is not an immutable figure—we have tried to err on the optimistic side.

We wanted to set our goals high for the potential in unemployment rates, but I think it is important that we warn the public if our estimates are inaccurate they are likely to be too low and signs of accelerating inflation could well occur before we get down to the 5 percent level.

Now, from this analysis of these longer run problems, it seems to us that there are several policy implications that seem apparent.

One is that we need cautious demand management policies in our return to full employment. Too rapid an expansion which would threaten to produce capacity problems and reignite inflationary expectations would certainly in the long run prove counterproductive.

Second, we believe that fiscal adjustments should be through tax reduction and not by increased Government spending because we think it is terribly important to stimulate the private economy and private initiatives.

As we see the problem, if we really want this kind of increase in living standards, which have to get the productivity moving again and we are only going to get the productivity moving again by stimulating the private economy.

Third, we believe that tax reduction will be more effective if it is permanent and not temporary, and I might just add there are several reasons for this in the report, but one in relation to the investment problem is that permanent reductions will create far more confidence in the future and thus help spur business investment.

Fourth, we would say tax reduction ought to be balanced between measures that stimulate consumption and those more likely to act directly on investment.

To be sure, we want measures to stimulate consumption which will to some extent stimulate investment as well. But for the reasons I mentioned earlier these so-called accelerator models that say investment is simply induced by the growth in consumer sales, as I mentioned earlier, these models are all over predicting the amount of investment we ought to have now.

I might also add that in the early 1960's, when we were faced with a similar problem, the Kennedy-Johnson administration responded to the same problems, recommending corporate tax cuts and the investment tax credit.

I do want to emphasize a too consumption oriented recovery poses very real long-run risks on the economy.

Finally, another implication of the analysis is that the so-called fiscal dividend that we calculate is probably not as large as previously thought.

By the fiscal dividend I mean the extra receipts you would get, tax receipts by getting the full employment. By our estimate, the Federal receipts we will get at, say, in the calendar year 1980, will be $30 billion lower than had previously been estimated at the former potential level of output.

That is to say, if we get to our potential level of output in 1980 because we have now lowered this potential level of output, it also implies that Federal tax receipts will be $30 billion lower and the fiscal dividend, therefore, will be much less than we have previously thought.

Let me just conclude with a few words about the recovery in the international economy which is now in its second year and at which there has been a good deal of concern recently.

I think one frequently finds at this stage of the recovery, we see a situation in the international economy where cyclical indicators are sufficiently mixed as to have raised a number of questions in people's minds whether the worldwide economy, the worldwide recovery is in some trouble.

There has, indeed, been a slowdown in the rate of growth for the industrialized economies. Nevertheless, I think it is important to put it in perspective and to indicate that there is no question of economic stagnation.

The growth that is forecast for the industrial economies this year may not be enough to reduce unemployment as much as we would like but it is near its long-term average, and there is not a question, I think, of stagnation.

It has been very popular recently to talk about synchronization of the world economies, that we are all moving up and down together, but in fact recent developments have shown considerable divergencies.

In the big three economies: The United States, Germany, and Japan, the main policy aim has been to assure a broadening out of the recovery without a reacceleration of inflation.

In contrast, though, in the major European economies and also in Canada, policy has swung to contain inflationary pressures in part because only insufficient policy actions of this sort have been instituted earlier.

As a result, the authorities in these countries as well as those in the developing world have looked to the so-called strong economies to help them achieve export recovery.

To be sure, the United States, Germany, and Japan do need to enjoy a healthy recovery to help the rest of the world.

It is important for us to have a healthy recovery and it is equally important for the world economy. We certainly do live in an interdependent world.

I think it is also important to note that an additional growth of 1 to 1½ percentage points above the 5½- to 6-percent quarterly path that we see for the U.S. economy next year would not make a crucial difference to the economic conditions in the rest of the world.

We have done large world scale econometric models and one finds the kind of extra 1 percent, 1½ percent is simply not going to make a major difference.

The most important contribution the three major economies can make to the international community is to achieve a steady, noninflationary growth.

It would certainly be counterproductive if the big countries were to institute excessively expansionary problems that then heightened inflation and then policy shifted abruptly to restraint.

I emphasize, though, that we do need steady growth. We need steady noninflationary growth, and this is particularly important as long as the OPEC member countries continue to accumulate large current account surpluses, because these current account surpluses imply unavoidable increases in the external debt of the oil importing countries and, therefore, increased financial needs for those countries.

So, in that sense, the need for international cooperation is, if anything, greater than ever. We think the two things we have to be very wary about in the years ahead are, first, that individual countries do not adopt divisive policies such as trade restrictions because of external problems and, secondly, it is equally important that the countries that have adopted satisfactory adjustment measures to deal with their external disequilibria and high debt positions to the extent they are doing the right things, we have to insure that they have sufficient access to international financial resources to carry them through and help them through the adjustment period.

Thank you, Mr. Chairman.

Representative BOLLING. Thank you.

Normally, I like to avoid the use of the 10-minute rule, but I think we are going to have enough people present this morning so that we will need to use it.

Normally, I operate on the principle that if I can get away with it I recognize the members of the committee in order of their first arrival, but my friend from Wisconsin, Mr. Reuss, recommends to me that in the interest of comity between the houses, I recognize my friend from Wisconsin, Mr. Proxmire.

Senator PROXMIRE. I am deeply flattered.

I approve highly of this system of recognizing people in order of their arrival so, therefore, I decline.

Representative BOLLING. Henry, you have the floor for 10 minutes.

Representative REUSS. Thank you.

This may be a farewell performance for both of you gentlemen and I want to tell you for all of us how much we have enjoyed working with you and what a patriotic and dedicated job you have done.

Many thanks.

I will now proceed to exercise my right to disagree with you.

Mr. GREENSPAN. Before you do so, let me just say thank you.

Representative REUSS. I am concerned at the new look that has been introduced here today in which the Council of Economic Advisers formally, as I see it, throws in the sponge, what has been the target for many years, namely, it has been our view that four percent unemployment was about right as that level of unemployment which could be reached by overall fiscal and monetary methods and then leave the job after that to more structural methods to get it lower than 4 percent.

You have changed that 4 percent to about 5 percent. Mr. Malkiel suggests it may be even a little higher, and reading your report, particularly pages 48 through 51, most of the blame for this horrible sponge throwing in you lay on women and young people on the ground that they seem to be moving in and out of the labor force with greater rapidity than before. The report argues that this leads us to put up with a higher unemployment level of tolerance.

Mr. Malkiel, you and the report go on to say that you strongly favor tax reductions rather than expenditure increases as a method of lowering unemployment.

I would think if there is something awry with the high number of young people and women in the labor force and also with the number of unemployed, that an excellent way to remedy that would be better women power, youth power and manpower methods ranging from specific on-the-job manpower training to reform of our educational system.

Let the central city schools beef up their teaching of the three R's, for instance, and you would find more minority kids can get jobs in the downtown service industries, in the banks, insurance companies, and so on.

So, I put it to you if your analysis is right that part of the trouble is caused by the high percentage of young people and women in the force, then your remedy is 100 percent wrong.

How do you get out of that one?

Mr. GREENSPAN. First, Mr. Reuss, in one respect we have not changed the four percent goal at all. What we have done is translated the particular concept to which the four percent referred in the earlier period to its current statistical equivalent.

The issue is not a basic abandonment or throwing in of the sponge as you put it with respect to trying to reach a particular level, but trying to indicate that the aggregate of unemployment statistics is an extremely complex number. This is largely because of the nature of initial job search, which I think is a major problem, I might add, with respect to teenage unemployment.

The point is that this is largely due to the changing composition of the labor force. The same qualitative conditions of the labor force in today's terms is represented by a higher aggregate statistic than it did in the 1950's.

To that extent there is no abandonment of trying to reach the same qualitative level of unemployment in the earlier period.

Second, on the issue of training programs which, in principle we think are a very sensible idea, they are already in the budget—very large programs, very substantial commitments to this.

We should recognize we are already doing substantial amounts of these types of activities and the issue is not whether or not they are being done, but whether small changes in these programs so far as expenditures are concerned will materially improve their effectiveness.

In our view, having looked at the very intractable nature of certain types of unemployment over recent years, we conclude that it is quite important to examine and reexamine the underlying structural reasons for these unemployment levels.

We must in all honesty say that a lot of them have not done what they initially proposed to do when passed by the Congress.

It is more important, I think, to review what we have already done and try to improve upon them rather than to merely add new ones.

So, in that respect, we do not feel that more spending in this area per se will effectively resolve these particular issues.

Our underlying preference with respect to macroeconomic policies for tax cuts rather than more spending largely arises because of the impact of the levels of inflation on tax rates. Inflation generates a fairly marked increase in money incomes and with our graduated income tax structure even at the current five percent inflation rate creates a fairly pronounced increase in the average taxes paid per family.

One of the reasons why President Ford has argued for tax cuts year in and year out is an attempt to offset this particular phenomenon—in other words, to reduce the drag on the economy from ever increasing taxes.

In that respect, we think that that is a far more preferable approach to restoring full employment to this country than increased government spending.

Representative REUSS. I don't see how a young black person from a central city who can't get a job in a downtown insurance company or bank or educational institutional or hospital administration office because of reading and writing deficiencies suddenly is going to get that job if you give everyone large-scale tax cuts and move the economy faster.

It seems to me he would still be without a job and your tax reduction program, however joyous it may be for those persons whose taxes are cut, does nothing for the people who are in a structural bind.

That, at any rate, is my difficulty. If I can read the English language what you are saying on pages 48 to 51 is that the former four percent level of unemployment, that if attacked—and I quote from you—". . . will not result in accelerated inflation," is now raised to 4.9 percent.

That is too bad as far as I am concerned. I think it is a poor time to be lowering goals in our perception of what we can do.

Mr. GREENSPAN. I don't think we are lowering our goals at all. We are statistically adjusting the same goal to its equivalent figure today.

Let me say with respect to the tax questions, much of what anyone would attempt to do in attacking the type of problem you are referring to, can easily be done on the tax side. There are obviously a number of other instruments which do not require in any way increases in spending.

There are a number of tax incentive programs that could be devised. Some of them would work and certainly some of them in a marginal way would do more than an expenditure program directed in that area in our view.

Representative REUSS. Thank you.

Representative BOLLING. I announced earlier, Senator Humphrey, I was going to recognize people in the order of their arrival.

Senator HUMPHREY. You should have told me that yesterday. It would not have made any difference but it would have been nice.

Representative BOLLING. I am sure everyone would want to get you on.

Representative MOORHEAD. Thank you, Mr. Chairman, and to members of the other body let me say that I am willing to defer my time to Senator Humphrey.

Senator HUMPHREY. It is a good rule. It will get us here on time.

Representative MOORHEAD. First, let me echo the sentiments expressed by my friend, the chairman of the banking committee, about the good relations between the Council and the Joint Economic Committee over the years.

I have enjoyed it and it has been very instructive to me. I think the level of cooperation given the political partisan differences has been kept to a minimum and I think that has been extremely helpful.

I congratulate you and I hope we can look forward to hearing from both of you in the future.

The Consumer Price Index figure was supposed to come out this morning. Do you know what that is?

Can you tell us?

Mr. GREENSPAN. I presume it has been released. The increase in prices is 0.4 seasonally adjusted for the month of December, which brings the increase from December 1975 to 4.8 percent, which is the lowest in 4 years, as I recall.

Representative MOORHEAD. What you are saying is that you are encouraged because there had been reports that the Consumer Price Index in view of the Wholesale Price Index increase of last month would be disturbingly high.

You were not discouraged but encouraged?

Mr. GREENSPAN. Yes, sir.

Representative MOORHEAD. One think that comes out of the report is the emphasis on permanent tax cuts as opposed to temporary rebates.

Let's say in the best of all possible worlds I might agree with you, but we live in a political world.

It may be that in the future we decide we have cut too much permanently and we need more revenues to control inflation. Putting the political factors into it, would you not consider that temporary tax cuts or rebates, however you want to call it, which, if we were wrong or needed additional revenue to control inflation, with the political input, would you not then agree that we should move on a temporary basis rather than a permanent basis, the permanent basis being harder to reverse?

Mr. GREENSPAN. We have enough trouble trying to make economic calculations without getting into differing political views and desirability.

Representative MOORHEAD. Your recommendation is based as nearly as possible on economic criteria rather than economic plus political?

Mr. GREENSPAN. There is also the other question with respect to the maintenance of revenues for various different purposes.

In our views, as we have stipulated on a number of occasions, a substantial part of a fiscal dividend that arises from a general rise in economic activity should be restored in tax cuts.

That is not a political evaluation, although I would certainly grant you that the various parties are divided on this question.

That is our economic judgment.

Representative MOORHEAD. When I said political, I did not mean partisan political.

I was saying the unpopularity of whichever party you belong to to vote to raise taxes. That is why I was using the term political on that basis.

Mr. GREENSPAN. Then I misunderstood you.

Mr. MALKIEL. If I could add one note to this, if you do nothing, our progressive tax system guarantees that you will have a tax increase each year.

I think this is a very interesting point, if you do nothing.

Representative MOORHEAD. And assume inflation.

Mr. MALKIEL. And assume there will be some level of inflation, people will be pushed into higher and higher brackets.

There is a very excellent report done for the Joint Economic Committee which indicated you will have a tax increase each year

We make the mistake of thinking if we have a permanent tax cut you have lost revenues completely and there will be no revenue base support for the future.

I think the opposite is true. If you don't from time to time have permanent tax cuts, you will have taxes becoming an ever increasing share of people's income and you are in effect getting tax increases year by year, so I think that is important to keep in mind, that in effect it is automatically being reversed.

As an example of that, were we not to have a permanent tax cut now, inflation has put us back into the same place we were in 1974.

In other words, all the permanent tax reduction we have had since then has really been negated by this combination of inflation and the progessivity of the income tax, so I think it is an important point to keep in mind.

Representative MOORHEAD. I would not disagree with that.

I would say only a portion should be permanent and some should be temporary to give a chance for error, and the report stresses only the permanent.

Let me shift to another subject, energy policy. I gather from the report that you are not recommending a total, immediate decontrol of oil and gas prices but rather a phased-in decontrol.

Is that correct, sir?

There were rumors we were going to have the President announce total and immediate decontrol. Apparently, if that possibility existed, it no longer exists; is that correct?

Mr. GREENSPAN. I can't comment on that further.

Representative MOORHEAD. No but you can talk about the report. Page 35 of this report talks about a phase-in.

Mr. GREENSPAN. There are very important differences, with respect to crude oil pricing controls and product price controls.

The major impact of the OPEC price change and the tremendous lurch in the price structure which has occurred is caused almost wholly by the rise in crude oil prices. The markup and processing costs from crude to petroleum products, that is gasoline, fuel oils and so forth, is not a factor of significance.

The President supports the bill which he signed into law which phased-in price decontrol for crude oil over a period of years.

The issue which has been raised with respect to product decontrol is one which tries to unwind the extremely complex and, in our view, distorting types of regulations which effect the margins from crude oil through to products. These margins are quite small and do not vary in any great or considerable way.

So, it is important to make the very major distinction between crude oil price decontrol which has whatever real big price impact may occur, and product price decontrol, which really has very little effect.

Our view, and as we also state in the report, is that product price decontrol would scarcely have any significant effect, as in fact previous pricing product decontrols have shown.

So, our view is that gasoline decontrol on the product level would not have a significant effect on gasoline prices.

Representative MOORHEAD. Shifting to the President's statement accompanying the report for my final question. His statement emphasizes regulatory reform. I firmly believe we have seen a massive increase in regulations issued by various departments, agencies, and commissions of the Government.

One of the ways of controlling that, it seems to me, and to limit their adverse economic effect, is to enact into law and expand in the President's Executive order which, as extended, requires the Council on Wage and Price Stability to do an economic impact statement, but only for executive branch agencies of the Government and not for the independent regulatory commissions.

I intend today to introduce legislation which would first, put the Executive order into law, and second, expand it to regulatory commissions.

Granted, I have not submitted this legislation to you but does that approach seem to have some appeal to you?

Mr. GREENSPAN. Without having seen codes themselves? But I would obviously support the thrust of your thoughts.

Representative BOLLING. Mr. Hamilton.

Representative HAMILTON. Thank you, Mr. Chairman.

Mr. Greenspan, I would like you to comment as elaborately as possible on the Carter economic package. You cannot help but be impressed by the many differences between President Ford's package and that of the President-Elect.

There is a large component of spending in the Carter package. You talk about a permanent tax reduction. He suggests a rebate. You emphasize incentives for business.

Mr. Carter has many incentives for the consumer, I suppose. Mr. Ford, however, has the following in his economic message: "Although the course of faster expansion seems attractive, it is clearly risky."

In your judgment, is the package that Mr. Carter has set forth a risky one because it is excessively expansionary?

Mr. GREENSPAN. First let me say it is certainly true that our preferences with respect to the type of package differs with respect to, one, its composition and, two, the nature of the tax cuts which they are proposing.

A more fundamental question truly should be answered first and that is the size of the package, because although there are obvious differences with respect to how we view the impact of temporary versus permanent cuts it is not a major issue.

As you may recall, we ourselves recommended a temporary one-time tax cut in 1975. It is a technical question with respect to the impact that that type of tax cut has and there is disagreement among some on this question.

In our view, we think a permanent tax cut is far superior to a temporary one, especially in the current period.

We do think that the emphasis on capital investment is going to have to be quite considerably more, perhaps more than even we are recommending at this particular stage.

As we point out in our economic report, should the incentives prove inadequate, further actions, specifically in the investment tax credit area, should definitely be considered.

There are unquestionably differences, but I think what is more important perhaps is the fact that they have chosen, and I think quite wisely, to introduce what many have termed a moderate level of total activities, distinguishing that from the question of its internal composition.

My successor, whom I have maintained on numerous occasions is one of the best economists in the country, has very wisely stated that the actions with respect to various fiscal stimuli are far easier to change on the expansionary side than on the contractionary side.

As we have testified before this committee on numerous occasions, it certainly has been our experience, and I am certain it has been yours, that additional stimulative measures are very easy to implement.

Stimulative measures which turn out to have been too much are very difficult to reverse.

Representative HAMILTON. As I interpret your position, then, you are in accord, at least roughly, with the total amount of stimulus being recommended.

Mr. GREENSPAN. Our view is the particular package President Ford recommended is the appropriate one. I wanted to point out there is not a huge difference.

Representative HAMILTON. I want to shift to another matter which Mr. Malkiel mentioned in his remarks.

There is much concern about coordinated economic expansion in West Germany, Japan, and the United States, the countries with the strongest economies.

How important do you think such coordinated economic expansion is, and do you think that West Germany and Japan are now taking the steps—the appropriate steps—to stimulate their economies so that we may revive the world economy and come out of the recession?

Mr. GREENSPAN. Mr. Hamilton, I think the issue of definitions requires a moment. We have, unfortunately, linked the term stimulative with economic or monetary policy in the hope that they will succeed in what they are supposed to do.

If we want to say do we want to stimulate our economy most clearly we always want to. Clearly, the reverse is not something anybody should support.

The question, however, is what do you really mean by those terms. In our view, the current maximum stimulis to the American economy would occur through some means to enhance the confidence of the business community to invest in the long-lived investment projects where we believe there is a significant shortfall and a shortfall which, if it continues, could be very significantly detrimental to the growth and standards of living in this country.

Now, that does not mean, or should not be definitionally equivalent to, more spending or more tax cuts, necessarily. There is a tendency for us to assume that if our economy is not running at an *x* percent growth rate we need more stimulus.

The implication is that that large increased expenditures or tax cuts, will actually achieve the goal.

In our view, at this stage in the United States, for example, I would have no doubt that a very large increase in the deficit might, in the short run. create some short-term increases in real GNP, but I think they would be short-lived. If one takes the full timeframe in which the policy initiatives should be evaluated—say, 2 years, I would say that the level of employment will be lower than it would otherwise have been, and unemployment would be higher.

In that sense, that type of stimulation, so to speak, is really counterproductive and would not achieve the goals which the President proposed to achieve.

Much the same sort of evaluation, much the same sort of promise exists as far as we can judge both in Germany and in Japan.

In our discussions which have been virtually continuous with our major trading partners throughout the world, we have exchanged points of views, exchanged data, exchanged evaluations and we find a remarkale similarity in the problem that confront this country and the other countries throughout the world, that is an abnormally suppressed level of private investment, and a concern over a much higher level of the so-called risk premiums, which creates a much more difficult climate for private expansion than we believe is tolerable.

Therefore, when we talk in terms of a joint venture to coordinate stimulative policies to lift ourselves by our bootstraps, so to speak, I would say that the purpose and the policy is certainly a laudatory one, but the tools of implementation, I think, have got to be looked upon very carefully, because what may appear to be very enticing in the short run could turn out to be a very unfavorable set of circumstances a year or two down the track.

So, in that light, what we have observed in the last several years in these types of meetings, whether it be meetings of the OECD, which meets quite often for the 24 industrial nations, or whether at the two major economic summits that we have had, these issues have surfaced and I think very sensibly.

There is a general awareness of what the constraints are and what the opportunities are. While we are groping with inadequate knowledge in too many areas, we are beginning to grasp some of the basic principles which do cut across national boundaries on economic problems. I trust that the next administration will make further progress in this area. We have made considerable progress in unwinding some of the extraordinary instabilities that have confronted the world as a whole, but we have an awfully long way to go.

Representative HAMILTON. My time has expired. Thank you very much.

Representative BOLLING. Senator Proxmire.

Senator PROXMIRE. Mr. Chairman, you were certainly here before the rest of us. You are the most self-effacing chairman I know.

Representative BOLLING. Don't worry about it. Go ahead.

Senator PROXMIRE. Mr. Greenspan, as you know, I opposed your nomination and spoke against your nomination on the floor of the Senate.

I have been very impressed by your great intelligence, your remarkable ability as an economist, although I persist in my disagreement with your philosophical convictions, and in spite of my great respect for you, I would like to ask you the question: Why has the economic policy of this administration failed?

It is true you just pointed out to us we have one good economic statistic this morning and that is that inflation has moderated.

However, I don't think that has had anything to do with our economic policy. I think that has to do with the fact that energy prices have not increased, since the quadrupling that produced the Ford-Greenspan turn.

Food prices have dropped and the farmer has been taking a beating. We have a very serious unemployment situation, a very sluggish recovery.

As you indicate in your report there is poor productivity, and inadequate growth of our economy.

It is true we have a Congress that does one thing and the President has done something else. The veto has been very effective.

We have had to follow the policies of the Ford administration and the Nixon administration. Why have these policies served this economy so badly?

Mr. GREENSPAN. I have for 2½ years respectfully disagreed with many of your conclusions and at this time I would like to do so again.

Let me say, first, I do not feel that our policies have failed. Frankly, they have been a great deal better than I thought they would turn out.

Let me see if I can document that.

It may well be true there are a number of factors in the inflation improvement which are not immediately related to specific policies. I don't think we should appropriately take full credit for the decline in the inflation rate from 12.2 percent in 1974 to 4.8 percent in 1976—not all of it—but for a very substantial amount of it, I think we should.

More importantly, what occurred during this period——

Senator PROXMIRE. Let me be specific.

The industrial prices have been going up, particularly since May.

It seems to me this is one area that might be affected by our policies whereas food and energy prices have performed rather well, not in the last month but over the past 6 months.

Mr. GREENSPAN. The last report on industrial prices was quite good. The two previous reports were very significantly affected by the way we price natural gas in the index.

As you will recall, in July the Federal Power Commission initiated a change in natural gas prices which caused a very sharp increase. As a consequence of the delay in getting official natural gas prices, there happens to be a 2-month lag in the index. As a consequence the price increases of August and September show up in our indexes in October and November.

If you adjust for that, the industrial prices of the last several months have not been mad at all.

Certainly it is true that the unemployment level has proved to be intractable, more so than we had expected, but it is important to recognize that economic policy does impact to a very substantial effect on employment.

As you know, Senator, during the last year, December to December, employment is up approximately 3 million and from the low in 1975, March, it is up well over 4 million.

The problems of excessive labor force growth, which was clearly way beyond our expectations, statistically is a major reason for this.

It will not continue at anywhere near this rate in the next year and we would expect accordingly the unemployment rate to move down.

More fundamentally, the major element in this administration's economic policy was to bring down the state of frenetic uncertainty which characterizes late 1974.

Bringing down the rate of inflation is a precondition of bringing down the rate of uncertainty. As we said before, we still think that uncertainties remain much too high and that is one of the major reasons why capital investment is not back to the levels which we believe necessary.

Nonetheless, if you go back and compare the sense of instability, and the degree of risks and uncertainties, of say, late 1974, with where we stand today, I would say we have made very substantial progress.

I would not by any means subscribe to your statement that our policies have been a failure. On the contrary, I think they have been quite successful, and that the full effects of those policies will carry over in the years immediately ahead.

So, while undoubtedly there are a number of things we would have liked to have done differently, I would say in restrospect we have very little to apologize for.

Senator PROXMIRE. The difference between your proposal and that of the Carter administration on tax reduction and economic stimulus seems to be in part that you are advocating a reduction in taxes, a permanent reduction including a significant component for business.

The administration, the new administration is proposing a tax cut which would be broader, would assist the people with modest incomes somewhat more and, therefore, it would be more likely, it seems to me, to increase demand which seems to me to be the fundamental economic problem now.

I can't understand how we can continue to expect business to expand investment in equipment, no matter what incentives we provide if the market is not there.

If they are operating at 80 percent or less why should they invest? Why is not the Carter policy, which is more progressive also sounder economically?

Mr. GREENSPAN. There are larger theoretical differences between the forthcoming administration's proposals and ours. I would describe them as follows:

Yes, we do agree that expanding markets, consumer markets specifically, are a necessary condition to restore a higher level of capital investment. But they are not a sufficient condition.

First of all, such induced capital investment relates only to capacity expansion which, as you well know, Senator, is roughly only half of the expenditures that take place. The other half reflects attempts at modernization, replacement, and the like.

But, there is this very interesting question which we really don't know the answer to as well as we would like: to what extent granted short-term increases in consumer markets, would business react by committing funds over the very longer term.

As Mr. Malkiel pointed out in his remarks, this is the underlying theory which stipulates that higher consumer spending or higher effective demand will, of necessity, generate higher outlays.

That particular theory, as embodied in our econometric models, has failed, I should point out to actually explain the levels of capital investment at this point. At current and past levels of consumer demand, and the levels of capacity utilization, and the like our models, based on the past, would say today that we should already be having a significantly higher level of investment.

What this means to us is that there are other elements involved in the investment equation over and above the question of increasing consumer demand. We certainly acknowledge that it is a necessary, but what we are saying is not a sufficient, initiative.

In that respect, we believe that very specific things must be done more directly to enhance the incentives to put in the new plant and equipment over and above the secondary so-called derived demand for capital goods which comes through what economists call the accelerator principle.

In that respect, I think we do that.

It may turn out that the current shortfalls of capital investment will be redressed. It could very well be that increased consumer outlays, may even in themselves dissipate some of the lack of confidence with respect to the future.

We think not.

We believe that this a phenomenon which has been observed not only in the United States but in every other industrial country, where expansionary policies to implement greater effective demand, have not created inducements to capital investment.

Much of the same type of phenomenon exists in this country although admittedly to a lesser extent. That is the reason why we believe that there should be considerably greater emphasis on a tax cut to back investment.

Senator PROXMIRE. My time is up.

Representative BOLLING. I will recognize Senator Humphrey.

Senator HUMPHREY. Thank you very much.

As the former chairman of this committee, I want to express my appreciation for your excellent cooperation, you and the Council of Economic Advisers.

You were always available, you always came at our request, and I want you to know that I am most appreciative of it and I know I speak for the members of the committee.

We have our differences at times on policy but your cooperation was exemplary and that is what I think is necessary in the two branches of government, so I thank you.

My feelings about this report, which I have only had the chance to partially read but which I intend to read in full, is that it is one of the better reports that has been published. Its emphasis on the international economic situation and outlook is commendable.

This report goes far beyond other reports on that area, and chapter four on the policies to stimulate labor supply and material supply I think requires our very thoughtful and serious consideration.

This is a very provocative report which is exactly what it ought to be. It will challenge us to evaluate and to analyze your comments on the unemployment compensation system which I think—and may I say most respectfully to the chairman and the members of the committee—has some problems, because unemployment compensation which was supposed to be a short-term insurance system has become a long-term welfare system, and that is not its purpose.

Your commentary on public service employment and the problems that have been inherent in that program, I think, are very useful to us.

The tendency in the past to hire people who are more likely to get private employment because of their education and their skills and the apparent lack of interest in hiring people who are more of the long-term unemployed group, I think, necessitates the Congress's very good analysis.

I am going to suggest that the staff, Mr. Chairman, with your concurrence, of course, take those parts of the report and see that they are readily made available to the legislative committees, because I think there is a lot of thought that has gone into this report.

It is not a question of whether we all agreed with what is there, but it should trigger our minds to educate what we should be doing.

What we have been doing is not enough. I am not saying that it is all bad, but it is not enough.

In the international section I think it should be noted, despite the fact that Germany and Japan have made demands for capital investment, that there is very little of it and that goes to what Senator Proxmire said.

When people see uncertainty in the market, if they are worried about the lack of continuity of Government policies, if they are concerned about prices such as energy prices, if they are concerned about the stop and go aspects of the economy then the interest in or the willingness to make long-term capital investments is very limited. The interest in making the long-term investment is reduced.

I found this committee to be like a graduate school in economics. I guess one of the problems is the more you learn the less you know. I was much more certain of my position 25 years ago than today.

Representative BROWN of Ohio. It was much more correct 25 years ago.

Senator HUMPHREY. That is when I was supporting Harry Truman.

Thank you very much.

Speaking of the current situation and the Carter package, I am impressed, might I say, somewhat as a maverick here this morning, on the matter of permanent tax reductions.

I think Mr. Malkiel makes a good point, that we have had a rising tax rate without ever adjusting the rates with respect to inflation.

The rebate has the very immediate impact. I have never been too hot for rebates. You remember, Mr. Greenspan, that this is not a partisan view.

I have not forgotten it when Mr. Ford had them and I understand the new administrations ideas about rebates, I see there can be some advantage to them. A man has to be openminded, but most of the rebates will go to pay for the increased costs of fuel—no doubt about it.

In my part of the country it wouldn't be enough to take care of the increased costs of fuel. There won't be any real new purchases.

I can assure you that the cost of fuel, not because the unit cost has gone up. but because of the cold winter which has necessitated a high expenditure on the part of people for fuel.

Might I say it might be a good idea for some committee to take a look at what is happening to old people who are living on fixed incomes because of the cost of fuel.

We are always worrying about the cost of food. I want to tell you when you start to freeze, it is as bad as when you start to starve.

The people on social security and on a fixed income in this country are suffering today; every time that thermometer goes down, their income goes down.

I think that is one of the great social problems we have right now.

I think it is an immediate problem of disastrous proportions. That is something the Council of Economic Advisers doesn't have to address themselves to in terms of long-term policies but it is something the Government should look at.

My State is down to 1 week's reserve supply of fuel. Yesterday, the Governor ordered the thermostats in State buildings to be turned down from 65 to 60 degrees. We are laying off workers by the thousands and our fuel supply in our part of the country is drying up.

I am sure it is true in other areas.

Cincinnati has had the lowest temperatures in its history and with the frozen conditions of our waterways, we are in trouble.

Having said that—and you know my philosophy and you have had to put up with me, I'd like to say that I am a job man and I don't buy a lot of this bunk that I have been hearing, not from you, but from a lot of other folks.

I certainly know that tax reductions are very important. For the long term, again, I want to go back.

In the meantime, what do we do about the 2 million youth? Some people say, "Write them off, start anew," but they are here. The real truth is we have an overwhelming number of young people who have never had work experience and even the job training programs and CETA and other programs have only gotten to a minimum number of them.

They are sitting out there. They can't draw unemployment compensation because they have never had a job and they don't qualify. They are on welfare, food stamps, or they are in the shadow of the public economy in the private economy that causes high-crime rates.

How in the name of God and Heaven can governments stand around and ignore this and pretend there is nothing we can do about it? I read your report. What do you advocate?

You advocate lowering the minimum wage because there are some 800,000 exemptions last year and I realize the administrative problems. If I thought lowering the minimum wage for youth would be the answer, I would vote for it this afternoon.

We can give the problem all the titles we want, but the simple fact is 40 percent or more of our black youth in the center cities are unemployed.

Ask the Urban League, a very responsible group, 50 percent of the unemployment rate is accounted for by youth unemployment. It is not getting better. It is getting worse.

I notice in your report you point out under the unemployment system people kind of go along with it because the benefits are tax free. It it true. But in a public works job program or a youth conservation program working out in parks and forests, et cetera, any of these work programs, the income that is earned is taxable, and it is income and you do work for it.

I am fed up with the Government having policies that just hand out money for people who do nothing to get it. I am perfectly willing to see people get unemployment compensation for 26 weeks or 40 weeks as a temporary, but once we get beyond that, we ought to have something for them to do.

I see where Amtrak fell off the tracks down here in Alabama. Amtrak fell off the tracks in Minnesota. Amtrak is falling off the tracks all over the place. Let me tell you why.

The track beds are old, obsolete. Do you mean we can't find a way to put people to work so we pay them $5 or $6 an hour? So what? It is better than paying them unemployment compensation or giving them food stamps.

You are kind of for it a little bit, and this is where we kind of disagree. The incoming administration is kind of for it in a little larger bit, but I want to let them know, loyal partisan that I am, it it not enough.

Jobs are what are needed. I saw what Ray Marshall had to say the other day. I want tax reductions. I will buy tax rebates. That is the frosting on the cake, but you can't live on sugar. You have to have some protein and the protein is public service jobs.

Somebody said they don't do much. They do a heck of a lot more than doing nothing. There will be some slippage. So what? There will be more slippages in the food stamp area than in a good jobs program.

What is the hue and cry? I will shoot it down in my 10 minutes.

Let me tell you what I hear not only from this report but from Charlie Schultze and other people whom I greatly respect, just as I do you. I think he is a very able man, but what do I hear?

Public works jobs take too long for startup. That is nonsense.

Let me tell you something. There are $25 billion worth of public works projects right down here in Washington on the line, approved by State planning commissions, county commissioners, city councils, regional offices, and the Statistical Office of EDA. I don't care where you go. You couldn't get more approvals than that.

The $25 billion is not a pie in the sky. It is $25 billion that has been approved by the very people that the President says ought to approve things out there, local folk, good smart citizens, approved by regional commissions, planning commissions, EDA, county commissioners, and we sit down here and say that takes too much startup time.

What do you do, you get a little money in there. We will start projects in Minnesota at 35° below zero. The startup problem is down here. We can't get these people off their lead britches to figure out how to get that money out there. It ought not take much time to write a check.

If you get the startup money out there, they will use it and I do not buy this argument that we can't put people to work. That is Hubert Humphrey's difference with any administration, and I serve warning on the new one or the previous one. I did not come down here just to study. I came down here for action. I think the President's report is scholarly and it is maybe the best report the Council of Economic Advisers put out for years, and I compliment you, but it does not get at youth unemployment. It really does not get at youth unemployment.

You say there will be about a 7 percent unemployment rate at the end of the year and now you redefine full employment to the 4.9 percent. That is like saying with a flu epidemic the normal temperature is 100. It is ridiculous.

Germany today is in an economic crisis and what does it have for an unemployment rate—about 5 percent. And we want to call full employment 4.9—why? Because we have more kids and more women.

I am not going to let the Council of Economic Advisers brainwash me into believing that 4.9 is full employment.

That is my summary for the day. I will come back to you later. You ponder this and we will come back for questions.

Mr. GREENSPAN. My only response for the moment is like always it is Humphrey 1–Greenspan 0. It has not changed.

Senator HUMPHREY. I seldom win.

Representative BOLLING. It is a pleasure to hear you in the same form that you were in in 1947.

Congressman Brown.

Representative BROWN of Ohio. Thank you very much, Mr. Chairman.

I am pleased to have yielded my time to Senator Humphrey for that question.

Mr. Greenspan, I have not had the opportunity to ask you what you are going to do, whether it is back to the investment world where you came from or maybe the broadcast industry where I understand you have some good connections.

Senator HUMPHREY. Would you like to expand on that?

Representative BROWN of Ohio. I want to say also that I wish you well, because I think your service has been exemplary and also has been provocative and this report is provocative, as the Senator has pointed out, and something we have a good 2 years to work on.

I am sorry you are not going to be here so we can work on you for those 2 years, but I hope you will give us the opportunity by coming back and sharing your thoughts with us and the same goes for you, too, Mr. Malkiel. Mr. Malkiel, we hope we will have your views in the future.

I am more concerned about an immediate crisis, which I think deserves our immediate action. I am not sure we will get it. But since the oil embargo we have had three mild winters and I might say since the beginning of the natural gas shortage, we had 3 years to straighten out our energy policies. We did not do anything, at least we in the Congress did not do anything of any very impressive degree except to continue the freeze on prices until after this election, the recent election, and now they will go up gradually.

Now you have the worst winter in decades. As Senator Humphrey pointed out, in my hometown the other morning it was 22° below zero. I cannot remember ever having a colder winter in States like Georgia, Ohio, California, and others.

We have had 100-percent curtailment in factories. No school is doing anything over the last 2 or 3 days because people are asked to stay home and not use that energy. In Missouri people were asked to go to public buildings because they didn't have enough gas to heat the homes.

The Federal Power Commission is now being sued for the sale of emergency gas by a group which I think has the unmitigated gall to call themselves the Consumer Federation of America. Consumers are without gas and that organization, so called, is suing to see that they don't get gas.

With all due respect, some of my liberal colleagues on the Democratic side in the Congress several years ago sued the Federal Power

Commission, to deny them the opportunity to extend emergency gas provisions for 180 days.

Now the FPC has its hands tied in this situation.

My question to you is, how much unemployment do you and the Council expect from the current cold wave natural gas shortage situation, unemployment which is an economic cost? How much tax revenue will the Government lose? How much additional unemployment compensation will the Government have to pay out, and economic cost to the taxpayer and the consumer, and who is going to bear the cost of the fact that these factories were closed and nonproductive during this period of time?

Never mind the schools that will have to go on into the summer months to meet their requirements under the law in Ohio for 180 days or whatever it is for school sessions. To me there is a great problem with gas shortages that have made it impossible for us to operate industries in this country, public institutions in this country, and the Congress sits there and says, "We will continue to regulate the price so that consumer does not have to pay any more."

He is not paying any more—he is just sitting at home not working, huddling around whatever sources of heat he has. I think that is a canard. What is the cost of our economic failure to do something to stimulate the production of natural gas in this country, to bring more natural gas into the interstate system?

Mr. GREENSPAN. Mr. Brown, you are raising a very important issue. As you well know, it has been an issue that has been discussed for the last several winters and concerns have been expressed about the dwindling supply and the possible shutdowns in various sectors of the country.

As it turns out, we were lulled into a sense of inaction in recent years but the most recent events have brought home, in a very startling way the true nature of the problem that exists. The whole question of natural gas price regulations and, similarly, the effects of price controls of oil products supply has also been a relevant question here.

So far as the answer to your specific question is concerned, the actual calculations will depend to a very substantial extent on the length of the time frame in which these extraordinary conditions exist. I need not say should they continue, the cumulative costs could be considerable.

Representative BROWN of Ohio. As you are no doubt aware, the Ohio River is now frozen, and we have barges that can't get up the river at the present time. The railroads are not operating. I came down on Amtrack last night from Wilmington, Del. It was about 40° in that train and half the trains were running 2-hours late and the other half were not running at all, so that is how it is going to accumulate.

We are not going to get the resources to send out electric heat either.

Mr. GREENSPAN. We have inadequate information with respect to the effect on industrial activity, and unemployment. It is too early to tell. I think however that this is an issue which should be confronted very quickly.

In the waning days of this administration there has been very considerable discussion on this question. It will surface in an accelerating way unless there is a break in the cold wave.

This happens to be one issue which I think has to be closely watched. Hopefully the new administration will confront this problem in a coherent way.

We have every reason to believe that that will be so.

Representative BROWN of Ohio. Two things will surface very shortly in this Congress and neither one will do a lot of good—typical bureaucratic issues.

Let's take the supplies. We have to ration them around the country and, therefore, schools and industries throughout the country will be working 1 or 2 days a week rather than deal with the problem of supply, and that simply does not address the shortage. It merely spreads the shortage around thoroughly.

The other is short term deregulation, which says let's look at it and pass legislation that will enable us to buy gas at the prices that they are selling in the intrastate market, uncontrolled prices. But if I were in the intrastate market, I think with the wave of cold weather being nationwide, I would not assume we would get much out of the intrastate market at this time, would you?

Mr. GREENSPAN. Probably not.

Representative BROWN of Ohio. They are experiencing shortages and turnoff of gas and industry in Texas, Louisiana, some of the producing States, as I understand. So that is no answer.

It seems to me the only answer is for us to stimulate production of the product that we need in some kind of price way.

I would like to address one other question, if I may. Can you relate the decline in private investment you mentioned a minute ago and private spending to any other statistic in particular, that is, the inflation rate, percentage of public spending, the percentage of public deficit? Is there some kind of a corollary there?

Mr. GREENSPAN. In our evaluation of the slowdown in investment, what we have attempted to do is try to find specific statistical measures other than what my colleague likes to call "casual empiricism" on this point. We think we have in that sense centered on the statistical problem, namely, a measure of the degree of confidence. It will be useful if my colleague explores for you one of the types of measures we think tell us the degree of confidence that exists for business investment.

Representative BROWN of Ohio. Before you address it, let me expand the question. Over the past couple of years from you we have heard a great deal about the threat of crowding out in private credit markets with too much Government spending. We have had a great deal of Government spending, but the crowding out literally does not seem to have occurred because of the low private credit demands for investment.

Should we create or should we decrease such crowding out or is there a flash point where the need for private investment is being responded to by private resources and yet the Federal Government has taken too much of its borrowing from that private market? Is there still a threat then of crowding out and the consequent problems of inflation that flow from that?

Mr. GREENSPAN. Unquestionably, the issue of crowding out is statistically demonstrable when you get a significant increase in private credit demands in the context of the very large Federal deficit.

As you point out, to date, that has not existed because the level of private demand for funds has been rather low, in part because private investment capital requirements have been below expectation. We would find a crowding-out impact when the aggregate demands of funds, both in the public and private sectors, begin to exceed the available new savings flows which are generated in our economy.

That has not happened yet because of the low level of private credit requirements. There is almost no way to avoid crowding out should we get into a situation in which a significant increase in private investment and private demands occur.

Representative BROWN. of Ohio. That seems to me to bring us to the conculsion—and I always hate to differ with my very elegant colleague, Senator Humphrey—but if we discourage private investment by overspending and if we run the risk of crowding out by overborrowing, which seems to be the problem, and if we spend it, we wouldn't generate it in new taxes.

Then we run the risk of doing further damage to the economy. The effort to cure may be worse than the illness in the first instance, but if we reduce taxes on individuals—and here I am with him, because I want to stimulate everybody, to spend on what they would like to spend it on, not what the Federal Government in some infinite wisdom we seem to have would like to spend it on. At that point you stimulate the economy by having those private sources of whatever it is they are going to buy suddenly realizing that that 80 percent of factory utilization that Senator Proxmire thinks is way too low—and I think is way too high, but seems not to have stimulated—it seems to be high enough, in previous recoveries, to have stimulated some investment factors—that at that point if we reduce the taxes and get that private individual consumer spending decision, you get an encouragement of the capital expansion that you need to further go ahead and enhance the economy.

Are we likely to get a better answer that way than we are from expanding deficit borrowings?

Mr. GREENSPAN. Yes, sir.

Representative BROWN of Ohio. By God, I have done a Hubert on you.

Senator HUMPHREY. It is contagious.

Representative BROWN of Ohio. I did not mean to stop you altogether. Let me ask one other question related to this business of youth unemployment, which the Senator and I are very much interested in, and I think perhaps share a great deal of common ground on.

Can an unemployment tax credit be designed to counter the impact, has been some impact by the minimum wage on that question of youth unemployment. How do you feel about a subsidy? And here I am willing to spend a little Federal money for training expenses to a private firm when that firm hires new workers, provided that there is real training involved. I am all for the vocational training programs that train a youngster to do a job that exists out there rather than training for something that does not exist.

But assuming we have that and there is still a need to link up that individual with the job that needs that skill and the firm may not be quite encouraged to make the hire to actually bring that youngster on, could we through a Federal program that would share the expense of hiring that person into an on-the-job training situation stimulate some reduction in the youth unemployment problem that depresses both of us so much?

Mr. GREENSPAN. Mr. Brown, we looked at that issue in some detail approximately a year ago. There is the possibility of constructing a program which will work in part. I say "in part" because there are considerable difficulties with respect to trying to write the regulations in a manner in which what you do is merely create payments for hiring, which would occur in any event.

It is a tradeoff question. There is no way that we could see to avoid that particular problem. Nonetheless, there is no way to construct a program which, in any event, will always be administratively the way you want it. It is an area we gave some serious thought to, but had not at least, in the judgment of this administration, constructed a program that had yet quite met the very many technical problems that go into writing the legislation.

It is easier, in effect, to adjust the minimum wage than subsidizing it in a different way.

Representative BROWN of Ohio. I don't think all of these unemployed youngsters are minimum-wage types. Some of them are youngsters that have a skill that might be utilized at the current beginning wage, maybe even journeymen wage, considering the type of vocational education and training they have had in college or school, but the stimulant for the industry to hire that kid or that woman or that ghetto black, a 40-year-old man who has not been able to find a job, just is not quite there because they don't feel like they want to add that full-pay person onto the payroll for the first time.

If you encourage them by a subsidy which might, in effect, reduce the employment of a partially trained person to a minimum wage, but give you a partially trained person nonetheless, perhaps that would be enough of a catalyst, like the investment tax credit itself, which is to encourage them to reduce the cost by purchasing equipment to get the industry to make that move.

Isn't that possible?

Mr. GREENSPAN. At our current state of knowledge, it is very difficult to construct a plan that would not have a number of leakages that will turn out to be what amounts to very large tax credits for minimal increases in employment.

In principle, it can be done. It is certainly far superior than going on the expenditure side. My colleague would like to comment.

Mr. MALKIEL. If I might add a comment to that, as an example, a plan to take as a tax credit 5 percent of the social security taxes paid, if you look at the arithmetic of that and look at what that would cost and then look at perhaps the one-quarter of 1 percent reduction that it really nets out for the firm, for the money you spend, it does not appear that that is the kind of program that is going to give you any kind of effect.

I think the point about the minimum wage and this really gets back to something Senator Humphrey and Mr. Reuss talked about with respect to schooling and training, some of the best schooling and training is on the job. You learn to do by doing.

The reason we come back to the teenage differential on the minimum wage is that it would in and of itself encourage firms to take youths on for this important on-the-job training and we think would have a very beneficial effect.

Indeed, we have estimates in the report that it would have very substantial employment-creating effects.

On this point, Senator Humphrey brought out some of the problems we have with public service employment. One of the difficulties we have seen in the programs is that the people getting the jobs are not the disadvantaged people. They are not the people who are handicapped by lack of training. These don't seem to be the people who are employed in the programs. As the administration recommended earlier in the year and as we recommended in the report, to the extent you do this, you should at least try to target it better, and the particular proposal that was made to the extent you have public service employment, you target it to people who in fact are having difficulties finding employment, in particular, for example, to the long-term unemployed.

I think these kinds of programs would have a far more substantial effect in creating jobs.

Representative Brown of Ohio. Mr. Chairman, my time is up. I apologize for running overtime.

Representative Bolling. Thank you.

Senator Javits.

Senator Javits. Mr. Greenspan, I came here especially and hurriedly, since this will be your last appearance in your capacity as CEA chairman, to express my appreciation for the enormous service you have rendered this country. We have not always agreed but the amount of work, expertise and the character and your own integrity and your own professional skill have been unreservedly placed at the service of the committee. I want to record myself as a friend and public servant, and while I don't know your work as well, Mr. Malkiel, I would like to say the same thing to you. I am sure you two have diligently and unreservedly given to the people of the United States every bit of your talent and expertise.

I had this question I wanted to ask you both, and either of you can answer it, but I would hope Mr. Greenspan would lead off.

We are faced with a grave dilemma. In a sense, it relates to our party, the Republican Party. We have not been able to crack the dilemma. As you leave, I think it would be very good if you could give us a summation of your view even if it is philosophical. The dilemma is this: We must do what is necessary to absorb new people in the work force, some 4 million in the last 2 years which would, if they had not appeared on the scene, had our unemployment rate down to under 4 percent today. That rate is, of course, now well over 7 percent, and that is completely unacceptable to the American people.

You and Congressman Brown can talk all you want to about reducing the minimum wage for youth. My answer to you is, "forget it." You are just barking up the wrong tree. It will never happen, at least in my time or yours. So, the question is, what do we do? You cannot do it by the theory of encouraging business investment. It is something structural we have not settled yet in this economy. Hubert Humphrey spoke of it, whether it is ghastly slums of Bedford-Stuyvesant and Brownsville or Bronx, duplicated in every city.

We have not cracked that nut, young people unemployed to the extent of 60 percent in some big cities who have given up and undertaken a life of crime or shiftlessness.

Now, one alternative I gather you do not like is that the government be the employer of last resort. I think it has to be and not because I like it but I know of nothing better; we have a social festering sore in this country. Remember, half of the unemployed are under 20 years of age. This is not an economic problem. It is a fantastic social problem. Now, you have women who now want to work. The number has increased greatly. There is nothing wrong with that. It is great. It should act to the productivity of our country.

You know the statistics and necessarily you know better than we do. We are here looking for suggestions and options. What should we do? We cannot accept the idea that more business investment will result in more employment because in the meantime people are thrown on the scrap heap.

Hundreds of thousands of working people will disappear or live God-knows-how and our Governor in New York, and he has to, is cutting the relief for those able to work. They will get no relief. They won't starve, I don't think, because there are many other social facilities outside the government, but they could starve as far as the government is concerned. You know me too well to know I say this adversely or invidiously. I really would take all the time I have to have you tell me your thinking before you leave.

Mr. GREENSPAN. First of all, let me say I believe, too, that the marked increase in the willingness of women to work, is very productive. It is clearly something that will enhance the productivity of the American economy and it is nothing that we should in any respect try to construct barriers against. I fully agree with the idea that we need to put more of the unemployed back to work, for vast numbers of obvious reasons which I do not need to recite here.

The issue on youth employment is a very difficult one which we have looked at in great detail. I think we can come to certain conclusions.

One is a good deal of the conventional wisdom has not proved to be accurate. There have been, as you know, Senator, programs directed at this problem for many, many years. It is not as though there are not currently already large programs in the budget. It is not as though there have not been increasingly new initiatives year in and year out.

It is very important that we somehow come to grips with the underlying problem. Our evaluations to date clearly indicate it is not strictly an economic problem. A large part of the difficulty exists in the transition between the school and work. Teenage unemployment was never a problem decades ago. In fact, many kids just had to go out and work. Fortunately the gap there between education and work was not as difficult a barrier as I think it is today. There seemed to be less difficulty of moving into the work force. When this problem is confronted, it should not be confronted solely as an economic problem, but I think much greater interface between education and work is required in the analysis. We need to reduce the time it takes a youth from the time he leaves school to the time he gets a job. That is where a big chunk of this unemployment is.

There are a lot of difficulties associated with that first job.

I do find it unfortunate that the teenage minimum wage issue is merely dismissed out of hand. There are a number of solutions to problems and you say this is not the solution. I find that distressing.

While clearly the minimum wage is not the major factor, it is clearly a factor.

Senator JAVITS. Allow me to interrupt you at that point. Hubert will testify, Dick will, Henry will, you are not going to change the minimum wage. If you don't like the subsidy, you leave us barren.

Mr. GREENSPAN. It is not the fact that I dislike the subsidy. It is another way of coming at the problem. The subsidy in one form or another will create much the same condition as having a teenage differential. But, it is quite costly on the budgetary side because there is an awful lot of slippage that is implicit in that type of program. Obviously it is clearly a fallback position. But, I tell you as far as we can judge analytically, it is an inferior fallback position.

With respect to the overall question of direct employment programs, I will simply agree that black teenage unemployment is an extremely difficult problem.

I can conceive of situations that would be far worse. I can conceive of situations where this problem, and similar problems, continue to deteriorate and get far worse than they are now. We have to recognize that there are problems which we can initiate, on the Government spending side which could make the problem worse. Should we run into a situation in which inflation reignites in this country and that creates a new period of stagnation and a new upturn in unemployment rates, I submit, sir, that the problems we now have, as severe as they are, will get worse.

As a consequence, any responsible policy that is directed at these issues must clearly keep in mind that they have secondary consequences. In all instances, it is absolutely necessary that we focus on the costs in the longer term, not only in money, but in economic growth, productivity, standards of living, and indirectly, on the social ills of the country.

Senator JAVITS. I would like to ask one more question and I would like to address this question to Mr. Malkiel. You opened the door to the possibility that we ought to turn over to education agencies both the education which they do now and the first job. In other words, seeing the youngster through from the education into and through the first job. That would be a budgetary thing, but it would be a totally different concept in respect to how we deal with youth unemployment. By the way, I mentioned women. We have not dealt with that but my time will not allow it. Please answer that one. Then, we will go to Mr. Malkiel and then we are through.

Mr. GREENSPAN. We have looked at this particular problem for quite a long time. We view the key problem as structural.

This is an issue that has been very closely studied. I can probably give you 20 ways to come at it which are wrong. I wish I could give you one way which I could say is a really good way. However that is not to say we should not continue to reexamine our analyses of the causes of the problem because unless you confront where the problem is, you are not going to solve it.

Senator JAVITS. Thank you very much.

Mr. Malkiel.

Mr. MALKIEL. Senator Javits, in answer to your question, I do think the first emphasis ought to be on stimulating the private economy; 85 percent of the economy is in the private economy. I think it is very clear as the recovery proceeds, this problem will to some extent take care of itself.

For example, let's take the problem of black unemployment which is a terribly serious problem. We know in previous cycles black unemployment rises far more in a recession than unemployment for whites. This has to do with the occupational mix and the training mix of blacks relative to white. They tend to be in more cyclically sensitive occupations and it has always happened that their unemployment rates always rise more than whites in a recession.

As the initial recovery begins, the decline in employment rates has been more gradual for blacks. The experience we had before, eventually their unemployment rates start to recede faster. I know no reason why that wouldn't be the pattern again so I do think the first line of attack has to be on macroeconomic policies that assure that we keep up with a good expansion.

On the structural level, I wouldn't say much about it. I think it may be politically infeasible. I think teenage minimum wage might be helpful. On training, there I would agree with some of the thoughts Mr. Reuss mentioned earlier but I think we ought to admit—we have to be honest about it, we don't know that much about how to do it. I think small-scale experimental programs might be very helpful but we should not fool ourselves. It is a very difficult problem.

We have not learned how to solve it yet. I would hope we would get some experience and know-how to do the job better but we don't know how.

Now, with respect to public service employment and having the Government the employer of last resort, I must say that I have some sympathy for the plan that Arthur Burns has proposed on several occasions, that the Government at a low wage does take on the function of being the employer of last resort. In a sense, that is what I was saying earlier when I said public service employment in fact ought to be targeted to those people who really cannot get jobs in the private sector. We have the programs now.

We are spending a lot of money on them but they are not being targeted to the right groups and I do think that is something we can do much better on in the future.

Senator JAVITS. Thank you, gentlemen. You don't leave me very happy, but thank you very much.

Representative BOLLING. Thank you.

Congressman Reuss.

Representative REUSS. You say that generally there was a healthy downward movement of interest rates this year. Short-term rates, Federal funds, Treasury bills, commercial paper, all went down appreciably.

You also say that corporate bonds and municipal bonds, both highly rated and not so highly rated, have gone down. But there is one glaring exception and that is, though you point out on page 63 that plenty of savings were flowing into the thrift institutions and that this has "made funds for home mortgages readily available," nevertheless, the long-term interest rate on home mortgages, instead of going down like everything else, actually went up in 1976. This is made clear in your tables on pages 260 and 261 where, for example, in the last year, U.S. Government bonds' interest rate went down from 7.17 to 6.39. Corporate bonds, Moody's AAA went down from 8.79 to 7.98, December to December.

Moody's B's went down from 10.56 to 9.12, but new home mortgages went up from 9 to 9.10. You point out on page 82, and you are quite right that with a lessened expectation of inflation and a lower rate of inflation, long-term rates should have been expected to go down, and down they went except for the one that the four of us here at this table would want to go down the most, namely, home mortgages. This is the big problem. Working people are priced out of a home. Sure, the starts in the last couple of months are better, but we are still way, way below the 2.6 million goal we set way back in 1968.

So what is going on here? Could it be that the lenders of mortgage money are not competing in that fashion which Adam Smith and you would have recommended? If so, what can we do about it, starting today?

Mr. GREENSPAN. First of all, the mortgage market is a somewhat different type of market that does compete obviously in the market for corporate bond issues and a variety of other instruments of similar nature.

Representative REUSS. Mortgage banks and mutual savings banks. They are the lenders. What is the trouble here?

Mr. GREENSPAN. The trouble is unlike these corporate markets, you don't have as much open secondary market capacity to move in and out with these instruments to get full competitive effect.

Representative REUSS. There is a secondary market and the interest rates there went down.

Mr. GREENSPAN. What I am saying basically is this: I don't think anyone who has observed the phenomenon would say that there are institutions that do not compete. They compete with each other and they compete with banks. The difference is because of the localized nature of a good deal of this type of borrowing, you don't get the immediate reactions.

Eventually you do, and if you look over the long history you find that mortgage rates will move very closely in their major movements with various competitive instruments.

Representative REUSS. This is encouraging. Are you sure you do not have the immediate reaction? It has gone up.

Mr. GREENSPAN. That is correct.

Representative REUSS. Would you join us today in a call to the lenders of mortgage money to start reacting to lessen inflation and ready the availability of incoming funds?

Mr. GREENSPAN. Not knowing the specifics of the individual areas, I would reserve comment because at this particular stage, Mr. Reuss, I don't know enough why specifically in the last couple of months these rates have gone up as much as they have.

Representative REUSS. It is a whole year, not just the last couple of months.

Mr. GREENSPAN. I would have thought the lag in the adjustment would have been less than in fact it has been. Why, I do not know at this stage and until I do and have a much better understanding, I would hesitate to make any comments with respect to that.

Representative REUSS. Just look at your tables. In 1965 the new home mortgage yield was 5.81 percent. In 1966, 1967, 1968, mortgage interest rates were below 7 percent and then for the next 5 years they get into the 7 percent range, and 1974 into the 8 percent range, and in the last couple of years they have been around 9 percent, and despite the market easing off of inflation and despite the inflow of funds into the institutions, it is about as bad now as it has ever been; 9.10 last month, the most recent month for which we have figures. There were only 3 months in the history of the world where it has been higher, and those 3 months in 1974 were months of hyperinflation.

You still can't join in a wispful hope that they are going to lower the price of their commodity?

Mr. GREENSPAN. If you asking me do I expect mortgage rates to come down, yes, I do.

Representative REUSS. That is a help.

Would you hope that your prediction comes true? Don't you think it would be good for the economy, the homebuilding industry and the construction workers and the 80 percent of Americans who can't afford to buy homes?

Mr. GREENSPAN. I have always said mortgage rates are a critical factor and I have not changed my viewpoint on that.

Mr. MALKIEL. If I could add one note. I too hope they would come down. But it is important to note that mortgage rates are and have been notoriously sticky in the past. I think one of the problems is, if you look at these tables in the hyperinflation period in 1974, mortgage rates did not rise as much as one would have expected in view of the inflationary expectations of the time, and in view of the increases in other long-term interest rates.

As a consequence, what you are seeing in part is a consequence of the fact that they did not react on the "up" side either. There was much more of a question of money not being available——

Representative REUSS. You are putting it exquisitely delicate, but aren't you saying they are trying to make a killing now to make up for some lean years?

Mr. MALKIEL. No, what I am saying is partly because of usury laws and the fact that rationing was done by simply not allowing people to have mortgage money. You did not get the rate in 1974 that was in effect a freely determined open market rate and, therefore, you don't see the decline from that level that you see in other freely determined open market rates.

Representative REUSS. The vendors want to make up for lost opportunities.

Mr. MALKIEL. Many of them were not making loans at those posted rates in 1974.

Mr. GREENSPAN. If I might point out as far as the numbers are concerned, in January of 1974, just to pick a number, corporate BAA's, probably the closest in quality to these instruments, were virtually equal to the new mortgage yields in that month, and observe that in December of 1976, again, they were approximately the same, so that in that sense, what Mr. Malkiel is pointing out is that in 1974 the rates in the BAA category moved up relative to mortgages.

For example, during 1974 and 1975 BAA's rose approximately 2 percentage points whereas the gain in mortgages was half of a percentage point. What he is pointing out is that the adjustment process takes quite a long time.

If you go back historically, the current spread that exists now is not that different. I do expect, however, that rates will come down, but it is not that extraordinary a difference at this point.

Representative REUSS. I am not looking for a devil here. What I am trying to inquire about is wouldn't the country have been better off at a time of hyperinflation had mortgage rates been a shade higher and, thus, had the monetary effect on legislators, the Council of Economic Advisers and homebuyers of showing a true reflection of tight money economics?

I don't see much value for the country in telling a young working family they can't have a home because mortgage interest rates are still 9.10 percent.

I think if you would apply the rationale of your excellent section on international money where you said, "Let's not intervene and let's not try to rig the rate," and I subscribe to that, if you apply that rationale here, we would be better off had we not intervened with usury laws back in times of tight money so that this generation of homebuyers would be given a break?

Mr. GREENSPAN. I believe you would find virtually every economist I know would agree with that point.

Senator HUMPHREY. I want to point to the Joint Economic Committee's 1976 report, which really called to my attention what was a remarkably close forecast. The report said, "In our judgment, real output may be expected to grow 6 percent in 1976."

"Although the sharp drop in unemployment to 8 percent in January was welcome, it was so large that there may be a tendency in succeeding months for the rate to remain at this level or even rise slightly." Not bad for a prediction, but not good news.

"It is possible the drop in unemployment in January may be the major improvement we will see this year." Well, that is exactly what happened. A recovery path that increases output by only 5 to 6 percent is unlikely to reduce the unemployment rate below 7.5 percent by year's end.

The 1975 unemployment rate averaged 8.5 and 1976 the rate is down, fortunately. I mention this because I have been reading some columns in which writers have said practically everybody's forecasts were wrong.

I said to Courtenay Slater and her team that put this report together that their analysis of the administration's program as well as what we thought was necessary stimulus was extraordinarily good. Of course, we used very much the same data as other forecasters. We used the same models, data resources, the Wharton School and Chase Econometrics. But we drew different conclusions.

What has bothered me about governmental policy and when I say "governmental" I mean the OMB and CEA. Economic policy is not made by CEA. It recommends policy and analyzes it. We had a meeting on emergency public works about a year ago where I got quite upset because every member of CEA said it would not work. It was too costly. I know there are problems. I have been sick. But I will tell you what is a worse one—dying. I decided to live. I don't live as well as I would like to. I am not as active as I once was, but I am not about to settle for an alternative. Do you see my analogy?

We always have problems. If you are looking for a utopian answer, there aren't any around here except in campaigns. When you get down to the real business of government or the real business of business, you know, business is a risk, a big risk.

Modern business makes mistakes, but thank God they do because it shows they have the adventure of trying new changes.

This Government including the Congress, has to bear its share of this responsibility because we ultimately make the law and the appropriations. We have been timid.

People talk about crowding out but as a matter of fact, there is so much money in the banks that bankers don't know what to do with it. Here is a country with the following conditions: more money in the banks than ever before in our history; more than 7 million unemployed, some of the finest skilled workers the world has ever known are unemployed; building trade workers are unemployed, but materials are in abundance.

The issue is the economy. What we are doing presently is a social disaster, absolute disaster. The only thing we are building a lot of today is more jails and we are asking for more jails and we are asking for more police to round up the criminals. Who are the criminals?

Of all crime 80 percent is created by youths between the ages of 14 and 20. That is what is clogging up the jails. We are holding hearings now on how many more jails and police we need, and the biggest public works of this country outside of the highway program is jail building. That is a poor objective for our country to have, and I resent it. We have top people in government who have a better goal than that. We don't go around talking about it, we are either expanding jails, remodeling them or building new ones so youth unemployment has to be attacked.

Senator Javits and I have introduced a bill. I don't know if it provides the best answer but it is a good start. One section would provide community service employment. I live in a little town called Waverly, Minn.; 600 people—youth unemployment is rampant. Vandalism is a characteristic of the day. We took some of those kids, got a few of them on the job, and we are building a lakeside park with their youth. You know what has happened to the vandalism? It stopped. Do you know what has happened to the youth crime in the area? It cut in half, and we only had a few thousand dollars—$40,000 is about all the money they had to put a few kids to work, and give them a chance to work.

Before that they were stealing cars, ripping off hubcaps, ripping out radios, robbing the local grocery stores. It isn't in New York and they were not blacks.

I don't have to go to college to learn about unemployment and its disastrous effects. I told EDA, you don't need a computer. You need

Hubert Humphrey out there. I found out through empirical evidence, not theoretical analysis. I found that when you put people to work, and didn't get much minimum wage, they stopped the crime. They built something for the community.

We have two illuminated tennis courts. We have campsites. We have a beach. We got a dock. Who built it? Kids, 16 and 17 years old under supervision. They can do it. We have people who are overeducated down here. They said it would take too long. I can tell you, Mortimer Snerd can figure things out faster than that.

This administration coming in is going to hear from independent Hubert Humphrey just as the Republicans have. They are going to hear from me. You know I will shake them up, don't you, Allen?

Mr. GREENSPAN. Yes, sir.

Senator HUMPHREY. Why can't we have a 6 percent interest rate for housing? I handle the foreign trade program. You don't believe in market rates for foreign aid. I handle $8 billion worth of foreign aid every year as a Senate subcommittee chairman and there isn't a dollar of it that is under current rates.

If you could just live in Afghanistan, we could get you a house. Why is it, Mr. Greenspan, that our Government policy can help people all around the world who need development, and can get them low interest rate loans, but can't do the same for Americans? It is a governmental policy that interferes with the market. The Government appropriates billions and billions of dollars, asking for a safety net to save somebody else. We have more problems coming in to save somebody else and I have to handle all of them.

Every time I handle them I wish I could attach a note saying "This applies to the 50 States of the United States."

Why economize? How come we can do that, but we can't have a policy back here to say it is in our national interest just like it is in our national interest to say we have an interstate policy to have institute health? And homeownership, which is important; I don't want to interfere with the banking structure if they want to charge 8 percent, but we should have a policy that interest rates the consumer pays are no more than 6 percent. If you need a subsidy to make up the differential, I will vote for it every day of the week. I think it is important to have it, and I want to know why the Government and why these economists are all opposed to it?

Is it because we live in good houses? I remember the day I bought my first house and if I had to pay 8 or 9 percent when I first bought it. Mom and I would still be living in a teepee. We paid 4 percent. We financed World War II on 2 percent money. Didn't we? You bet. I remember when good old George Humphrey came down here and wanted to get 4 percent loans, and we thought he was a rascal. Now that is only a few years ago.

How come these interest rates always seem alike? How is it one bank says the prime rate will be 6¼ and they get in line like sheep. I believe in competition.

Why don't bankers act like that? How come they have to have that Federal Reserve System up there that protects them all the time and how come they don't have any competition? I am not being facetious. I want to know why the prime priorities of free enterprise don't believe in free enterprise and money. How come the rates are the same?

Mr. GREENSPAN. I was not aware the prime rate was so significant. When you get a bank that wants to expand its loans and reduces the prime rate, everybody follows and that is the way the market should function which is in effect saying the interest rate is too high. If some particular bank decides it does not like the existing prime rate everybody is following—they change it.

Senator HUMPHREY. My friends who are going to be starving with no crops out there are not going to get loans at the prime rate.

Mr. GREENSPAN. With the differentials representing different risks all bank loan rates move very closely to the prime rate.

Senator HUMPHREY. I noticed the bank profit sheets this morning were very, very good. I looked at the New York Times financial section this morning. Bank profits are really right up there, good, doing fine. I like profit. I have had enough losses politically and economically so I like victories and profits, but how come they do so well and the housing industry does so poorly? Contractors are going broke, 15 percent of construction workers are laid off. The Government sits here paralyzed.

Mr. GREENSPAN. We have had a rather significant increase in housing starts in the last 6 months. Obviously, while everyone would still like it to be higher, it is not a bad number. It has come up considerably.

Senator HUMPHREY. What is your present rate?

Mr. GREENSPAN. 1.8 and that is double what is was in late 1974.

Senator HUMPHREY. They weren't building anything then; 1.8 is still below the normal of over 2 million.

Mr. GREENSPAN. Not for that particular period. On the basis of the growth in households and at the structure of the housing market, normal demand is roughly 1.8 to 2.0 million units. I certainly share a good deal of your concern about that, and housing costs are exceptionally high and we agree mortgage rates are too high. Nonetheless, the level of housing construction is not all that bad. While it is always important to try to do better, it is absolutely just as important to recognize where you are.

Senator HUMPHREY. But you are way behind. You begin to think this is pretty good. I am telling you something. You are losing the race. If you had any major recovery from the low starts of 900,000 in the year 1974, you ought to be way up now. The cities of America, the need for housing, and I am not talking just middle-income housing, I am talking about housing for our people. You let people live in a pigsty, and they act that way. I have watched the committees here in Congress do the same thing.

We have failed to come up with any answers of any consequences. Senator Proxmire had a bill that passed that was a good bill. It was vetoed. We couldn't do anything to override the veto.

My complaint is we don't try hard enough.

Representative BOLLING. I would not want you to believe you were alone in your attitude on youth employment, and I know your attitude on full employment.

I wholly agree that we are too timid and too unwilling to look at the very near total destruction of a large part of the generation of American citizens. I think it is the urgent problem of the day, and I think we will have to figure out a solution for it.

Frankly, I think some very drastic things will happen otherwise. I think we may lose our form of government along the way. I don't believe a generation will put up with what is happening to them in the cities and in some of the rural areas that I also know.

I think that is the fundamental dilemma that affects the country. I hope we will be able in the years and months ahead to do something in this committee about analyzing and coming up with viable solutions that will result in full employment and without inflation and will result in the elimination of the kind of situation that exists all over the country with regard to the young.

You have been very patient. The questions I have fill in gaps that I would like to fill.

The persistent decline in the birth rates which began some 20 years ago implies that the expansion of the labor force, the formation of new households and such demographic variables closely related to the economy's applicable requirements will decline after 1980. This could turn what is now perceived as a capital shortage into a persistent decline in capital needs and the need to stimulate consumption to sustain the economy.

This would require reversal of the policies that you propose to boost savings.

Don't you agree that the demographic factors will tend to reduce capital needs materially as a fraction of GNP by the mid-1980's?

Mr. GREENSPAN. Certainly the numbers you cite are pretty much indisputable. It is almost certain we will get a slowing down.

To translate population into direct requirements for capital investment requires a long series of assumptions. The problems that we have with respect to capital investment are of such a nature that they are unlikely to be resolved by 1980 and likely to continue on quite considerably beyond that. So, while it may well be that in certain areas related directly to the population flow, some minor diminution in the demand for equipment, structures, and the like may occur, I would doubt very much that it would significantly alter the basic dimensions of our requirements. The vast portion of our capital requirements relate to energy needs which will be larger rather than smaller.

They refer to the sustaining of productivity in our economy, and this will require more rather than less investment, so that we are going to need vast amounts of basic infrastructure and new investment over and above that type of investment which is tied to the demographic trends to which you allude.

I would agree, that part of the problem does get ameliorated by these particular trends. It is not in any way a reason to alter our view with respect to the nature of the difficulties we see out there.

Representative BOLLING. Thank you.

Now on an entirely different subject. The Council's report discusses in some detail the factors which may influence changes in the velocity of money in the coming year. You conclude that if the velocity of money increases quite rapidly as it did last year, the money supply targets established by the Federal Reserve will be adequate to accommodate the GNP growth you are forecasting. However, you also say "Some reduction in velocity growth normally occurs in the advanced state of economic recoveries and the "financial developments must be closely monitored."

Should we take this as a hint that velocity growth may well slow down and the money growth at the upper end of the Federal target range, may well be necessary.

Mr. MALKIEL. I think the answer to that is we really don't know. The target ranges will, in fact, be appropriate if we get a continued shift downward in what we call the demand shift for language, which means in plainer language, if the structural shifts that are going on will allow the economy to get along with less money than it was normally used to, these structural changes have to do with increased use of NOW accounts, increasing use of overdraft facilities, being able to transfer from your savings account to your checking account by telephone, allowing small corporations to have savings accounts and in effect with the telephonic transfer use, this in lieu of the savings account. In other words, there have been a number of structural changes that have tended to allow the economy to get along with reduced money growth.

The target ranges are based on an assumption that this is going to continue. It is very difficult for any of us to know for sure whether or not these structural changes will continue.

I think all we were saying was we do have to monitor the situation closely. The changes may well continue, but they may not.

But as Chairman Burns has said, "These target ranges are not fixed in concrete," and if, in fact, we find out next year they are not appropriate they would then have to be revised accordingly.

I think it would be impossible for me or, frankly, anybody else to say at this stage whether or not they will, in fact, prove to be appropriate.

Representative BOLLING. We have kept you so long, I hesitate to proceed, but I have a couple of questions I would like to get answers for, at least in the record, and I know you are departing your job relatively soon. I want to do whatever is most convenient for you. They are not very lengthy questions, but if you have an engagement you would like to make, I can submit to you a couple of questions for you to answer in writing and I will bring the matter to a close.

Mr. GREENSPAN. I have a commitment.

Representative BOLLING. Would you mind if I gave you a couple of questions to answer at your convenience?

Mr. GREENSPAN. I would be delighted to.

Representative BOLLING. The report provides revised estimates of potential GNP for past years. Do you have projections on a similar basis for future years? If so, could these be provided for our record, together with appropriate documentations explaining how the estimates were made?

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

A New Estimate of Potential GNP

(By Peter K. Clark—Council of Economic Advisers, Jan. 27, 1977)

I. INTRODUCTION

The concept of the output attainable by the economy if resources were fully utilized has interested economists for many years. This measure of maximum sustainable output, usually called "potential GNP," has been a useful tool for analyzing policies designed to bring about the full utilization of labor and capital resources.

The potential GNP measure that has gained the widest recognition was first proposed by the Council of Economic Advisers in 1962.[1] After making a number of calculations relating unemployment to constant-dollar GNP, it was determined that a reasonable estimate of the GNP attainable at 4 percent unemployment equaled actual GNP in mid-1955 and grew at a 3.5-percent annual rate thereafter. In a technical paper discussing the 1962 estimates, Arthur Okun noted that there were many intervening links between the unemployment rate and output, and stated:

"Still, I shall feel much more satisfied with the estimation of potential output when our data and our analysis have advanced to the point where the estimation can take place step-by-step, and where the capital factor can be taken explicitly into account."[2]

The new estimates of potential GNP reported here were made in the spirit of Okun's remark.

Over the years since 1962, the Council's estimates have been extended and modified. The August 1976 issue of *Business Conditions Digest* gives the following description of potential GNP:

"Potential GNP is not something ordinarily observable. In practice, the Council in 1962 made the judgment that the economy was operating at 100 percent of potential in mid-1955. Since that time potential GNP has been estimated to grow at differing annual rates, as follows: 3.5 percent from the first quarter of 1952 to the fourth quarter of 1962, 3.75 percent from the fourth quarter of 1962 to the fourth quarter of 1968, 4 percent from the fourth quarter of 1968 to the fourth quarter of 1975."[3]

Little documentation is available for the methodology behind the shifts from CEA's original 3.5 percent rate of growth to 3.75 percent and then 4 percent, but probably these shifts were made because the rate of growth of labor force increased steadily in the late 1960's and in the 1970's.

By 1974, however, the higher 4 percent growth rate became suspect. In 1973, widespread inflation indicated that the economy was much closer to potential output than the Council's potential GNP estimates indicated. Although special circumstances, such as the relaxation of price controls, devaluation, and some extraordinary food and other commodity price increases couold be blamed for the 1973 price bulge, the economy still might have been overheated, instead of below potential by 30 billion 1972 dollars as the existing estimates suggested.

The crucial determinant of the difference between any two historical potential GNP estimates is the rate of growth of productivity. The main question is then: *How much has the rate of productivity growth slowed down?* If the slowdown is very significant, then estimates of potential GNP should be lowered, because the current potential GNP estimates assume only a slight decline in productivity growth. There are a number of reasons for suspecting that the current low figures for productivity are the result of a lower basic productivity growth rate and not just due to the current recession. These include:

Slower growth in the nonresidential fixed capital stock relative to the growth of the labor force;

A shift in the composition of the work force toward younger and less experienced workers;

An end to the shift of workers out of agriculture, and the consequent end to increases in average productivity from this source; and

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[1] *Annual Report of the Council of Economic Advisers*, January, 1962.

[2] Arthur M. Okun, "Potential GNP: Its Measurement and Significance," in American Statistical Association, *Proceedings of the Business and Economic Statistics Section* (1962), p. 104.

[3] This is part of a note to the potential GNP series provided by the Council of Economic Advisers, *Business Conditions Digest*, August 1976, p. 95.

A reduction in the fraction of output denoted to research and development.[4] However, instead of discussing the various factors that stimulate or retard productivity growth, this paper presents estimates of the productivity slowdown, and incorporates them in a new potential GNP series.

II. DISAGGREGATION OF GNP

The first step in estimating the trend in productivity growth was the division of GNP into four components: (1) Gross Output Originating in the Rest of the World; (2) Compensation of Government Employees; (3) Gross Housing Output; and (4) Private Nonresidential Output. Gross output originating in the rest of the world, or GNP minus GDP, was an obvious candidate for exclusion from the productivity estimates because this contribution to GNP is generated by investments outside the U.S., and should not respond to domestic inputs of labor or capital.

Compensation of government employees is the only measure of government output in the national income and product accounts. This component is deflated by an index of salaries of government workers, which implies that real output of the government sector is a weighted average of government employment. Therefore, productivity for the government sector is weighted employment divided by employment, and productivity growth is defined as zero in the National Income and Product Accounts. When measuring productivity growth, it is reasonable to exclude government output so that varitions in the ratio of government to total employment do not affect the productivity calculations.

Segregation of housing output into a separate category was based on the possibility that the real return from residential capital and nonresidential capital might be different. In theory, such a disparity should be only temporary, but in the actual analysis, it was thought that the fixed nonresidential capital stock measured by the Commerce Department was only a proxy for nonlabor inputs to private production. Since housing was easy to exclude, it seemed worthwhile to do so.

Another important reason for excluding these three sectors is that their output is not related to the domestic business cycle. If unemployment is high and capacity utilization low, government output, the imputation to the residential capital stock, and gross product originating in the rest of the world are not necessarily low. Therefore, potential and actual output can be assumed equal in these sectors.

Private nonresidential output, the residual in GNP after (GNP–GDP), compensation of government employees, and output imputation to the residential capital stock have been subtracted, corresponds closely to many economists' preconception of private sector output, produced by factories and workers. It is this output which is most closely studied, and for which productivity estimates will be made.[5]

III. LABOR AND CAPITAL INPUTS TO THE PRIVATE NONRESIDENTIAL SECTOR

In order to estimate the level and growth of potential output in the private nonresidential sector, quantities of actual capital and labor input must be estimated. Capital input was taken to be an estimate of the effective private fixed nonresidential capital stock multiplied by an estimate of capacity utilization. The effective capital stock measure used is the B.E.A. gross stock of private nonresidential capital, adjusted for investment in pollution abatement equipment.[6] Quarterly data were linearly interpolated from annual data; projections of capital stock were derived from an investment forecast in which the ratio of nonresidential fixed investment to GNP rises to ten percent by 1980. Six percent of fixed investment was assumed to be for pollution abatement throughout the forecast period.

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[4] A discussion of these factors is given in Chapter 1 of the 1977 *Annual Report of the Council of Economic Advisers.*

[5] This concept of the private sector is close to what Denison calls the "nonresidential business sector." See Edward F. Denison, *Accounting for United States Growth, 1929–1969*, (Brookings; Washington, D.C.), 1974, p. 21ff.

[6] See John A. Musgrave, "Fixed Nonresidential Business and Residential Capital in the United States, 1925–1975," *Survey of Current Business*, April 1976. And (for example) Frank W. Segel and Gary L. Rutledge "Capital Expenditures by Business for Air, Water, and Solid Waste Pollution Abatement, 1975 and Planned 1976," *Survey of Current Business*, July 1976.

The B.E.A. manufacturing capacity utilization index was considered the most reliable index for capacity utilization, and this index was taken as a proxy for capital utilization in the private sector. Since manufacturing output is more cyclically variable than total private output, using a manufacturing utilization index probably overstates variation in total capacity utilization; this bias may be partially eliminated by the cyclical adjustment to productivity growth. The B.E.A. manufacturing capacity utilization index is not available before 1965, but the Federal Reserve Board manufacturing capacity utilization index is relatively well behaved before then, so the two series are spliced in 1965. with an adjustment for the wider variability of the FRB index. Changes in the extended B.E.A. index are taken to be equal to changes in the FRB index multiplied by the ratio of the sample variance of the two series. Annual values of the index used are given in Table A-4 in the data appendix.

The labor input measure that was constructed tried to adjust for the productivity of different groups of workers by dividing the labor force into four age categories (16–19, 20–24, 25–64, 65+) and also disaggregating by sex. Private employment in each of these 8 categories was obtained by subtracting an estimate of civilian government employment from total civilian employment. Private employment for each group was then weighted by mean weekly earnings for that group in May 1973.[7] Use of the weekly earnings weights approximates the contribution to production of an employee in each demographic group, including both average hourly earnings and average weekly hours. It would be better to have weights that vary over time rather than one fixed set of weights, but data are not available to construct variable weights. Therefore, the effect of changes in the age-sex weights representing changes in average weekly hours and average hourly earnings is included in the estimated trend terms described later. Rates of growth of weighted and unweighted labor input are shown in Table 1. Although the growth rate of weighted employment is less than the growth rate of unweighted employment, it is only the change in this difference that explains part of the productivity slowdown since 1966.

IV. ESTIMATION OF TREND AND CYCLE IN TOTAL FACTOR PRODUCTIVITY

Output in the private nonresidential sector is assumed to be related to capital and labor inputs by a Cobb-Douglas production function with labor's share equal to 2/3:

$$(1) \qquad Y_{PNR}=CK^{1/3}E^{2/3}e^{a\,(\text{trend, cycle})}$$

where:

Y=private nonresidential output in 1972 dollars as defined above.
E=private nonresidential labor input=private employment by 8 age-sex groups, weighted by mean average weekly earnings.
K=utilized effective fixed nonresidential capital=[total effective fixed nonresidential capital]×[B.E.A. manufacturing utilization rate]. (Effective capital=total capital minus pollution abatement capital.)

TABLE 1.—RATES OF GROWTH OF WEIGHTED AND UNWEIGHTED PRIVATE EMPLOYMENT, 1948-76

Time period	Private employment [1]	Private employment (weighted by 1973 earnings) [2]
1948 to 1955	0.58	0.61
1955 to 1966	1.13	.75
1966 to 1973	1.78	1.38

[1] Civilian employment minus civilian government employment from the "Current Population Survey."
[2] Civilian employment minus civilian government employment by eight age-sex groups (16 to 19, 20 to 24, 25 to 64, 65 plus; M, F) weighted by May 1973 mean weekly earnings, all from "Current Population Survey."

In a Cobb-Douglas production function with constant returns to scale such as equation (1), the exponent of a factor of production is also its share of output,

[7] Data are available by age and sex for May of the years 1973-1976. 1973 was chosen because it is closest to a cyclical peak. Such an adjustment is sometimes called "Perry-weighting" since a similar weighting scheme was used by George Perry in adjusting the unemployment rate: "Changing Labor Markets and Inflation," *Brookings Papers on Economic Activity* (1:1971), pp. 105–58.

assuming the factor is paid its marginal product. Some studies indicate that labor's share is lower than 67%, depending on the treatment of income from self employment. However, the estimates of total output are insensitive to the assumed exponents of K and E in (1), since variations in output that are not represented by $K^{1/3} E^{2/3}$ are allocated to Φ (time, cycle) instead. Elimination of capital from the production function (the assumption that there is enough capital for any labor that is employed) gives similar results in terms of potential output. It is not possible to directly estimate the shares of labor and capital in output, due to problems with simultaneous determination of output and labor input, as well as leads and lags inherent in these variables.

Equation (1) leads to a definition of total factor productivity P, a measure of real output per unit of weighted capital plus labor input:

$$\log P = \log \left(\frac{Y_{PNR}}{K^{1/3} E^{2/3}}\right) = C + \alpha \text{ (trend, cycle)}$$

Since the shares of capital and labor have been assumed, rather than estimated, only trend and cycle in total factor productivity must be estimated to obtain an estimate of output at any given level of factori nput. The particular functional form chosen for ϕ (trend, cycle) is:

(2) ϕ (trend, cycle) $= a^* U_t + b^* DU_t + C^* T + d^* T1 + e^* T2$:

U_t = unemployment rate of men 25–54, adjusted for the change in sampling methodology in 1967.

$DU_t = U_t - U_t - 1$.

T = Time trend = 1,2,3, * * * starting in 1947 : 1.

$T1$ = productivity growth shift variable = 0, * * * 0 through 1966 : 4, then 1,2,3,4.

$T2$ = productivity level shift variable = 0, * * * 0, through 1973 : 4, then .25, .5, .75, 1 in 1974, and 1, * * * 1 in 1975 and 1976.

Equation (2), when estimated using a correction for serial correlation of residuals, gives the following result:

$$\text{(3)}\quad \log P = \underset{(.008)}{-2.163} \underset{(.0016)}{-.0063^* U} \underset{(.0020)}{-.0042^* DU} \underset{(.001)}{+.0048^* T} \underset{(.004)}{-.0012^* T1} \underset{(.011)}{-.042^* T2}$$

$$\bar{R}^2 = .997 \quad d-w = 1.95 = .67$$

NOTE.—Standard errors in parentheses. Interval of Estimation: 1948: 3 to 1976 : 2.

U_t and DU_t are cyclical variables. U_t is used to adjust for the observed phenomenon that the level of productivity is lower when resources are not fully utilized; DU_t adjusts for lower productivity relative to trend during recession and higher productivity during recovery. Both of these effects are usually explained in terms of incomplete or slow adjustment of labor input to new levels output: During recession, output falls, but many production workers are kept working at less than full speed to avoid the adjustment costs of layoffs and rehiring, while the number of whitecollar workers adjusts only very slowly. During recovery, the reverse is true, with both production and nonproduction workers working at full speed to meet a higher production schedule. The prime-age male unemployment rate was used because its value was judged to remain constant relative to the business cycle. As is discussed more fully in a later section, the use of the unemployment rate for all adults 25–54 would give very similar results. The use of the unemployment rate for all adults 25–54 would have the advantage of being a broader-based measure of the cycle but the disadvantage of possible random changes due to changes in the labor-force participation rate of women which are not related to the business cycle. The overall unemployment rate (ages 16+) could also be used, if it were expressed as a deviation from a variable benchmark [8] representing constant labor resource utilization. Further experiments with other cyclical variables, such as capital utilization rates and the Conference Board's "Help-Wanted" index yielded results which were nearly identical to those reported above.

The coefficient on $T1$ measures the change in the trend of total factor productivity after 1966. Comparison of this coefficient with the coefficient of the time

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[8] Such a benchmark is calculated in the next section of this paper.

trend indicates that growth in total factor productivity was reduced by about 25% after 1965. This shift (in terms of labor productivity) was discussed by Norsworthy and Fulco in 1974.[9] The $T2$ level shift variable was included to remove the influence of very atypical productivity behavior that started in 1973. Productivity started to fall earlier and fell much farther in 1974–75 than in any other postwar recession. Unless a variable similar to $T2$ is entered in the equation, the coefficient of $T1$ is significantly increased in absolute value. Forecasts of potential output growth generated by an equation not continuing a "$T2$" type variable are probably biased downward.[10]

The question raised by the significance of $T2$ is whether or not there has been a downward shift in the level of trend in private total factor productivity since 1974. Although the statistical results indicate a downward shift, the more cautious approach taken in the potential GNP estimates is to not include the effect of $T2$ except in an alternative estimate. There is some theoretical justification for expecting such a downward shift: the large change in the relative price of energy may have made some energy-intensive processes unprofitable, and some capital stock obsolete. Such obsolescence would not appear in the B.E.A. capital stock series, and would make the impact of energy price increases much larger than indicated by an estimate of reductions in energy input only. On the other hand, it is possible that productivity will reattain its 1966–73 trend. As recovery continues and the economy moves closer to capacity, the magnitude of a level shift will be more evident.

V. FULL EMPLOYMENT LEVELS OF CAPITAL AND LABOR UTILIZATION

Once the trend in total factor productivity is estimated in equation (1), it only remains to estimate "full employment" or "benchmark" labor and capital inputs, which then may be entered in (1) to determine potential private nonresidential output. The determination of benchmark capital input is relatively easy, because the capital stock is not cyclically sensitive, and there is no discernible trend in the utilization rate at high employment. The full employment benchmark assumed for capital input is 86% of the effective private capital stock, because this was the approximate level reached by the B.E.A. manufacturing utilization rate (and its spliced extension) during periods in which output is generally thought to be near capacity.

More data allow for a more precise determination of full employment labor input. First, the potential labor force must be determined, and then translated into potential employment using a benchmark unemployment rate. Since labor input is a weighted sum of employment from eight age-sex groups, levels for potential labor force and the full employment unemployment rate must be determined for each group. Full-employment labor input is then potential employment for each age-sex group, weighted by mean average weekly earnings in 1973.

Potential Labor Force

Potential labor force for each age-sex group is calculated by estimating a cyclical adjustment to labor force participation for that group, and then adjusting actual labor force to full employment labor force using the adjustment. The general form of the labor force participation equations is:

$$\frac{L_i}{POP_i}=\alpha_i+\beta_i U+f_i(t) \tag{4}$$

where:

L_i =labor force in group i;
POP_i=population in group i;
U =unemployment rate of men 25–54, as above;
$f_i(t)$ =time trend, fit to particular group.

The t-statistic for βi was statistically significant for men 16–19, men 65+, women 16–19, and women 20–24. The t-statistic for men 20–24 was greater than one, however, so this group was also cyclically adjusted. This cyclical adjustment to the labor force is smaller than is generally thought; however, it is in agreement

[9] J. R. Norsworthy and L. J. Fulco, "Productivity and Costs in the Private Economy, 1973," *Monthly Labor Review*, June 1974, p. 5.

[10] Many other possibilities for "ad hoc" adjustment since 1973 exist besides the particular shift variable, $T2$, that was chosen. The important point is that the shift is still significant in 1976, after a year of economic recovery. Thus, a shift variable that goes to 0 in 1976 would increase the absolute value of the "growth shift" coefficient on $T1$.

with results obtained using regressions of total labor force participation on cyclical variables. Projections of labor force by group necessary for projections of potential GNP were made with the estimated labor force participation equations. Since they include a cyclical adjustment, the projections are slightly higher than those made recently by BLS. Annual totals for potential labor force are given in Table A-2.

Full Employment Unemployment Rates

The establishment of a benchmark unemployment rate for use in estimating potential output is a difficult problem. If there were a good statistical relationship between unemployment rates and the inflation rate, the vector of unemployment rates by age and sex that yields a constant rate of inflation could be determined directly. Unfortunately, there seems to be no unique relationship between unemployment and inflation, so this simple "Phillips curve" method of estimating an appropriate unemployment benchmark is not available. The picture is further complicated by increases in the proportion of the labor force comprised of young people (aged 16–24) and of adult (aged 25–64) women, which seems to have changed the relationship between the unemployment rates of different age-sex groups. The significant change in the household survey in 1967 also tends to make the determination of an unemployment benchmark which is consistent over time somewhat arbitrary.

The procedure actually used makes the assumption that a 4.0% overall unemployment rate represented full employment in 1955. By looking at the relationship of unemployment rates between age and sex groups in 1955, the eight age-sex unemployment rates that would have yielded a 4.0% overall unemployment rate in 1955 may be determined. It is further assumed (as was the case with the estimation of the cyclical component of growth in total factor productivity) that the unemployment rate for men aged 25–54 has remained a stationary indicator of the state of the labor market. The increase or decrease in each group's unemployment rate is estimated using an equation of the form:

$$U_i = \alpha_i + \beta_i{}^* U + \gamma_i{}^* \left(\frac{\widehat{LP}_i}{\widehat{LP}}\right), \tag{5}$$

where:

U_i =unemployment rate of age-sex group i;
U =unemployment rate of men 25–54 as before;

$\widehat{LP}_i = \left(\frac{\widehat{L_i}}{\text{Pop}_i}\right)$ from equation (4) times Pop_i;

$\widehat{LP} = \sum_i \left(\frac{\widehat{L_i}}{\text{Pop}_i}\right) (\text{Pop}_i).$

The inclusion of the $\left(\frac{\widehat{LP}_i}{\widehat{LP}}\right)$ term, the relative proportion of group i in the labor force (purged of short-term variations) was based on the idea of partial segregation of labor markets. A relatively high proportion of the labor force in a particular group may make it difficult for members of that group to find satisfactory employment. The coefficient ϕ_i estimates the change in relationship between the unemployment rate of group i and the unemployment rate of men 25–64. The data used in estimation of (5) have been adjusted for the change in sampling procedure starting in 1967 by multplying employment and labor force by ratios obtained in 1966 by BLS using both sampling techniques.[11] While this adjustment is reasonable for high-employment years, there is no evidence on its accuracy during periods of low economic activity.

Estimation results for equation (5) are given in Table 2 for all eight demographic groups. The unemployment rates for women 25–64, women 65+, and, of course, men 25–64, did not exhibit any change relative to the rate for men

[11] See Robert L. Stein, "New Definitions for Employment and Unemployment," *Monthly Labor Review*, February 1967, pp. 3–27. Since the parallel surveys in 1966 used for this adjustment are only half the size of the CPS, these ratios are subject to considerable sampling variability.

25–64.[12] The sign of γ_i was negative for men 65+ indicating the operation of other forces such as Social Security in the labor market for these workers. However, a downward trend was evident, so the equation was re-estimated with a time trend, as shown.

Since it is by no means clear that (5) represents a correct sturctural specification of the relationship of group unemployment rates over the business cycle, and because of the small sample used by BLS to estimate the effects of the survey change in 1967, it is reasonable to adjust the regression results in Table 2 to coincide more closely with unemployment rates actually observed in 1956 and 1973. After such adjustments to the equations for young persons (16–24), the overall benchmark unemployment rate equivalent to 4.0% in 1955 is 4.9% in 1976, as shown in Table 3. This is slightly less than the 5.1% obtained when the equations in Table 2 are used without adjustment to calculate the unemployment benchmarks.

4.0 percent in 1955 and 4.9 percent in 1976 are in no sense estimates of the lowest overall unemployment rate that does not cause inflation to accelerate. Rather, the time series of unemployment rates generated by the equations in Table 2 is a consistent set of unemployment rates over time generated by the assumption that the unemployment rate of men aged 25–64 is a stationary measure of labor market tightness.

TABLE 2.—ESTIMATES OF THE RELATIONSHIP OF AGE-SEX UNEMPLOYMENT RATES TO THE UNEMPLOYMENT RATE OF MEN 25-54 (EQUATION 2), ESTIMATION INTERVAL 1948:2—1975:4 (STANDARD ERRORS IN PARENTHESIS) [1]

Group	α_i	β_i	γ_i	Time trend	β	$\bar{R}^2$
Men 16 to 19	0.92	1.77	208.8		0.81	0.928
	(2.83)	(.165)	(64.2)			
Women 16 to 19	−8.16	1.26	499.9		.82	.929
	(3.04)	(.205)	(87.8)			
Men 20 to 24	−.99	1.95	41.5		.70	.944
	(1.30)	(.115)	(20.1)			
Women 20 to 24	.71	1.94	85.3		.79	.095
	(1.28)	(.115)	(25.9)			
Men 25 to 64	−.97	.96	2.3		.44	.995
	(.18)	(.01)	(.36)			
Women 25 to 64	2.59	.76	−.81		.65	.924
	(1.05)	(.05)	(4.1)			
Men 65-plus	2.83	.58		−.0095	.70	.779
	(.43)	(.09)		(.0048)		
Women 65-plus	−2.83	.51	339.8		.59	.553
	(2.15)	(.10)	(178.6)			

[1] Data adjusted for 1967 CPS survey change.

TABLE 3.—HIGH EMPLOYMENT BENCHMARK UNEMPLOYMENT RATES 1955 AND 1976 (PERCENT)

Demographic group	1955	1976
Women 16 to 19	10.0	15.0
Women 20 to 24	5.8	7.8
Women 25 to 64	3.8	4.2
Women 65-plus	2.8	2.4
Men 16 to 19	10.5	13.3
Men 20 to 24	6.4	6.8
Men 25 to 64	3.0	2.6
Men 65-plus	3.5	3.0
Total (both sexes, 16-plus	4.0	4.9

Note.—Unemployment rates assume the survey technique actually used in that year.

[12] As mentioned earlier, this result indicates that the unemployment rate for all persons 25–64 could be used as a cyclical indicator in place of the unemployment rate for men 25–64. Observations of the adult womens' unemployment rate relative to that of adult men shows a .5 point increase in the differential between them from 1962–1966, a .7 point increase in 1967 (as predicted by the BLS partial samples) and then a .6 point decrease from 1967 to 1968. This strange behavior of the women's unemployment rate influenced the decision to use the rate for adult men, although results using either rate are virtually identical.

The high employment level of labor input is calculated in three steps. First, employment in each age-sex group is estimated by multiplying the potential labor force by one minus the benchmark unemployment rate. Second, civilian government employment is subtracted from these potential employment estimates to obtain potential employment in the private nonresidential sector. Third, potential private nonresidential employment in each age-sex group is weighted by mean average earnings in May 1973 and aggregated to obtain weighted potential labor input.

VI. CALCULATION OF POTENTIAL

Potential weighted employment and potential fixed capital, when substituted into equation (1) yield an estimate of potential output in the private nonresidential sector:

(6) log (private nonresidential potential output):

$$= \tfrac{1}{3} \log [KP] + \tfrac{2}{3} \log [LP] - 2.163$$
$$- .0063[2.5] + .0048 * T - .0012 * T1$$

where

KP = potential fixed capital input; and
LP = weighted private potential employment.

Note that the benchmark unemployment rate for men aged 25–64 is a constant 2.5% (on the post-1966 sampling basis) and the coefficient of T2 is set equal to zero, as discussed earlier.

Since there is no significant cyclical movement in any of the other four components of GNP which make up the difference between private nonresidential output and total GNP, these components may be added directly to the output estimates from (4) to obtain estimates of potential GNP. These unsmoothed estimates of private nonresidential GNP and total GNP are given in Table 4 below.

TABLE 4.—POTENTIAL GNP ESTIMATES (UNSMOOTHED IN BILLIONS OF 1972 DOLLARS)

	Private nonresidential GNP	Total GNP	Growth rate of total GNP from previous year
Year:			
1948	411.4	495.3	
	426.9	517.0	4.4
1950	442.2	536.8	3.8
	451.5	562.2	4.7
	465.6	585.2	4.1
	485.7	607.3	3.8
	504.2	627.3	3.3
1955	523.2	649.0	3.5
	542.2	672.2	3.6
	561.7	696.8	3.7
	582.1	721.5	3.6
	601.1	744.9	3.3
1960	622.8	772.6	3.8
	644.2	801.1	3.7
	663.3	828.2	3.4
	688.0	858.6	3.7
	713.0	891.0	3.8
1965	738.7	924.9	3.8
	760.7	957.8	3.6
	786.8	994.9	3.9
	816.0	1031.8	3.7
	846.8	1069.2	3.6
1970	880.5	1106.0	3.4
	914.3	1145.4	3.6
	952.2	1188.9	3.8
	989.7	1232.4	3.7
	1028.7	1277.5	3.7
1975	1063.7	1318.6	3.2
	1100.3	1362.2	3.3
	1138.5	1408.1	3.4
	1179.3	1457.1	3.5
	1223.2	1509.4	3.6
1980	1268.7	1563.5	3.6

The growth rate of potential GNP varies from year to year for a number of reasons. First, potential labor force is taken as actual labor force plus a cyclical adjustment, so that an erratically growing labor force creates an erratic path for potential. Second, movements of workers in and out of civilian government employment creates changes in the growth rate of potential. For example, draftees in the Vietnam war were probably paid more than the average earnings for teenagers (16–19), but less than the average for young adults (20–24), so that movements out of civilian employment in 1965–68 and movement back to civilian employment in 1970–72 probably caused some changes in potential GNP growth.

Projections of potential GNP were made using projections of compensation of government employees, the output imputation to the residential capital stock, gross product originating in the rest of the world, labor force by age and sex group, and capital stock, as shown in the data appendix. Real compensation of State and local government employees was projected to grow at the constant rate observed since 1970, which is lower than in earlier periods. Compensation of Federal employees was projected to grow arithmetically at the very slow rate observed over the past 20 years.

Capital stock growth was estimated from a projection of business fixed investment that grows to about 10% as a percent of projected actual GNP in 1980. More optimistic projections of fixed investment would increase the rate of growth of potential moderately; the assumed capital share of ⅓ implies that an increase of the investment ratio to 11% from 10% would increase potential output growth from 3.5% to 3.7% per year.

Aside from uncertainty about the growth of total factor productivity in the future, the most uncertainty about future potential growth is generated by lack of knowledge about growth in the labor force. In 1976, particularly, growth in the labor force participation rates for women were higher than predicted by estimates of equation (4). If these large increases continue, and are not offset by reductions in productivity growth, potential output would grow at a faster rate than projected.

The wide range of possible values for future productivity and labor force growth (or equivalently, the lack of structural models that explain these factors) make projections of potential output very uncertain relative to calculations of potential for past years.

VII. SMOOTHING THE POTENTIAL SERIES AND CONSTRUCTION OF A RANGE OF UNCERTAINTY

The susceptibility of the potential estimates in Table 4 to disturbances in labor force and movements of workers in and out of the military makes the year-to-year growth rates of potential GNP vary substantially over short intervals. In order not to create the false impression that these changes in the growth of potential are significant, it is generally agreed that such estimates should be smoothed. A number of techniques are available for doing this. Strictly mechanical smoothing procedures (such as double exponential smoothing or least squares extraction of signal from noise) all share the common problem that they assume stationarity of the series to be smoothed, and therefore delay sustained changes in the growth of potential such as the ones that occurred after 1952 and 1962. Smoothing the second differences in the quarterly potential estimates would avoid this delay problem, and might be good from a statistical point of view, but this procedure would result in growth rates of potential that continuously change over time, conflicting with the usual view that potential output should grow at a constant rate over relatively long periods of time.

The smoothing procedure actually used was an OLS regression of the unsmoothed potential estimates on an exponential trend that was allowed to change when there seemed to be a significant change in the growth rate of potential in 1952, 1962, and 1966. These smoothed estimates are given in Table 5. Clearly, many other smoothing procedures could have been used. However, any smoothing procedure would tell the same basic story about the long-run output growth for the economy: High rates of labor force growth have been offset by low productivity growth since the mid-1960s, yielding growth in potential output of about 3.5% a year.

Also shown in Table 5 are estimates of a 95% confidence interval around potential output generated by the standard error of estimate of equation (3), which indicates that the standard error in estimating private nonresidential output is about .6%. Measurement errors in capital and labor input are not considered in the calculation of the standard error.

The third column of Table 5 gives the smoothed potential series that results when the regression coefficient of $T2$ in equation (3) is used in the estimation of potential output rather than set equal to zero on the assumption that all of the extraordinary productivity decrease in 1973 and 1974 was temporary in nature. A comparison of this series with the smoothed potential estimates in column 1 of Table 5 indicates that the shift in the level of productivity may have been substantial in 1973–74, reducing potential output by as much as 3.6% in 1976. Experiments with labor productivity measures instead of total factor productivity measures indicate that the regression coefficient of $T2$ may overstate the productivity reduction; an estimate of a 2% reduction in potential may be closer to the truth than the 3.6% reduction indicated by equation (3).

TABLE 5.—SMOOTHED ESTIMATES OF POTENTIAL GNP

	(1) Smoothed potential GNP	(2) 95 pct confidence interval for estimates in col. (1)	(3) Smoothed potential with estimated level shift	(4) Old potential GNP
Year:				
1948	492.8	488–498	492.8	
	514.4	509–520	514.4	
1950	537.0	531–543	537.0	
	560.5	555–567	560.5	
	584.9	579–591	584.9	592.2
	608.2	602–615	608.2	613.0
	629.7	623–636	629.7	634.4
1955	651.4	644–658	651.4	656.6
	673.9	667–681	673.9	679.6
	697.2	690–705	697.2	703.4
	721.3	714–729	721.3	728.0
	746.2	738–754	746.2	753.5
1960	771.9	764–780	771.9	779.9
	798.6	790–807	798.6	807.1
	826.4	818–835	826.4	835.4
	857.1	848–866	857.1	865.9
	890.3	881–900	890.3	898.4
1965	925.0	915–935	925.0	932.1
	960.8	951–971	960.8	967.0
	996.3	986–1007	996.3	1003.3
	1031.7	1021–1043	1031.7	1040.9
	1068.3	1057–1080	1068.3	1081.6
1970	1106.2	1094–1118	1106.2	1124.9
	1145.5	1133–1158	1145.5	1169.9
	1186.1	1173–1199	1186.1	1216.7
	1228.2	1215–1241	1228.2	1265.4
	1271.7	1258–1285	1258.0	1315.9
1975	1316.9	1303–1331	1279.7	1368.6
	1363.6	1349–1378	1314.5	1421.2
	1412.0	1397–1427	1361.2	1474.5
	1462.1	1446–1478	1410.2	1529.8
	1513.9	1498–1530	1461.1	1587.2
1980	1567.7	1551–1585	1513.8	1646.7

Even a 2% reduction in potential output has serious implications for the gap between potential and actual GNP. Such a reduction would reduce potential GNP from 1363.6 billion to about 1335 billion 1972 dollars, thereby reducing the estimated gap from \$96 billion to \$68 billion. Although such a reduction would not imply a constraint on the growth of output in 1977, steady 6% growth in real GNP starting in the fourth quarterly of 1976 would imply elimination of the gap sometime in 1978. Productivity performance in 1977 and 1978 should indicate whether or not a change in the level occurred in 1973–74: Private labor productivity growth above 3% will indicate that the downward shift was temporary, while figures closer to 2% accompanying significant increases in employment will indicate that potential output is lower than the estimates in the first column of Table 5.

It is also worth noting that the estimates of potential output do not confirm the judgment implicit in the old official estimates that actual and potential output were equal in mid-1955. Although the unemployment rate is slightly above 4.0% in the second and third quarters of 1955, indicating that output is below potential, this is more than offset by productivity that is estimated to be well above its trend level at that time. Since potential GNP is calculated using average productivity relative to trend at periods of high capacity utilization, potential GNP should be below actual GNP when labor and capital are at their benchmark levels, but productivity is atypically high. Thus, the new potential is below actual in the last three quarters of 1955.

FURTHER EVIDENCE ON THE LEVEL AND GROWTH OF POTENTIAL OUTPUT

Another model which yields estimates of potential output is one that relates labor input to output.

Define:

$Y_t{}^P$ = potential output $= Ce^{rt}$;
Y_t = actual output;
$L_t{}^P$ = potential labor input;
L_t = actual labor input.

The short-run increasing returns to labor that are observed over the business cycle can be modeled by using the assumption that the percentage difference between actual and potential labor input is a fraction of the percentage difference between actual and potential output:

$$\frac{L_t}{L_t{}^P} = \left(\frac{Y_t}{Y_t{}^P}\right)^{\alpha}, \ \alpha < 1. \tag{7}$$

This constant-elasticity relationship implies that an x percent output gap will be associated with an αx percent gap in labor utilization. This constant-elasticity model was one used by Okun to estimate potential output in 1962.[13] Note that equation (7) approximates an equation relating the unemployment rate to the percentage GNP gap.

Let:

$Y_G = Y_P - Y$ = GNP gap;
$L_G = L_P - L$ = Employment gap;
UR_f = the full employment unemployment benchmark (expressed as a fraction);
UR = unemployment rate (also a fraction)

Then

$$UR \approx UR_f + \frac{L_G}{L_P},$$

an approximation due to cyclical variation in the labor force.

Equation (7) states that:

$$\log\left(1 - \frac{L_G}{L_P}\right) = \log\left(1 - \frac{Y_G}{Y_P}\right),$$

or, using the approximation $\log(1+x) = x$ for small x,

$$\frac{L_G}{L_P} \approx \alpha \frac{Y_G}{Y_P},$$

or

$$UR = UR_f + \alpha \frac{Y_G}{Y_P}. \tag{8}$$

Thus (7) is essentially "Okum's Law" (8) with the effect of cyclical variation in the labor force removed by the use of L_p, a cyclically adjusted labor forec measure.

The constant-elasticity model is equivalent to estimating a trend and cycle in labor productivity, with the cycle term a function of the output gap.

[13] See Okun "Potential GNP * * *."

$$\frac{L_t}{L_t^P}=\left(\frac{Y_t}{Y_t^P}\right)^{\alpha} \Longrightarrow \frac{Y_t}{L_t}=\left(\frac{Y_t^P}{L_t^P}\right)\cdot\left(\frac{Y_t}{Y_t^P}\right)^{1-\alpha}$$

or

$$\log\frac{Y_t}{L_t}=\underset{\text{trend}}{\log\left(\frac{Y_t^P}{L_t^P}\right)}+\underset{\text{cycle}}{(1-\alpha)\log\left(\frac{Y_t^P}{Y_t}\right)}$$

Thus, Okum's formulation is very similar to the method to derive new estimates of potential GNP.

Substituting the constant-growth relationship $Y_t^P=Ce^{rt}$ into (7) yields:

(9) $$\log(L_t)-\log(L_t^P)=\alpha\log Y_t-\alpha\log C-\alpha rt.$$

Given data for L_t, L_t^P, and Y_t, generalized least squares estimates of ($\alpha\log C$) and (α r) yield estimates of C and r, and therefore of potential output. Entering a lagged output term to (9) yields superior statistical results, possibly because the reaction of labor input to output is not completely described by the constant-elasticity assumption (7).

Modifying the constant-elasticity assumption above appropriately:

(10) $$\left(\frac{L_t}{L_t^P}\right)=\left(\frac{Y_t}{Y_t^P}\right)^{\alpha_1}\cdot\left(\frac{Y_{t-1}}{Y_{t-1}^P}\right)^{\alpha_2}$$

and $Y_t^P=Ce^{rt}$ as before,

(11)

$$\log L_t-\log L_t^P=\alpha_1\log Y_t+\alpha_2\log Y_{t-1}-(\alpha_1+\alpha_2)\log C-\alpha_1 rt-\alpha_2 r(t-1)$$

$$=\alpha_1\log Y_t+\alpha_2\log Y_{t-1}-[(\alpha_1+\alpha_2)\log C-\alpha_2 r]-(\alpha_1+\alpha_2)rt.$$

Generalized least squares estimates of the coefficients of Y^t, Y_{t-1}, trend, and the constant term again give estimates of r and C. Equation (11) can be estimated using a number of different sets of data. Labor input can be employment, hours, or earnings-weighted employment. The entire economy or just the private sector can also be used.

Estimates of equation (11) are given in Table 6. Rows 1 and 2 use data on total GNP and unweighted employment. Potential employment was assumed to be 96% of the potential labor force discussed earlier. With the lower full-employment unemployment benchmark, it was expected that potential output would be higher than the estimates given in Table 5. The 1975 potential GNP estimate in row 1 using data from 1952–76 would be lower than $1316.9 if a 4.8% unemployment rate were used, but the row 2 estimate would be slightly higher on a 4.8% basis.

TABLE 6.—REGRESSION ESTIMATES OF EQUATION (11) AND ASSOCIATED ESTIMATES OF POTENTIAL GNP (STANDARD ERRORS IN PARENTHESES (BILLIONS OF 1972 DOLLARS)

Equation	$-[(\phi_1+\phi_2 \log C]+\phi_3 r$	ϕ_1	ϕ_2	$-\phi_r$	R^2	β	Potential d—w	Potential GNP 1955	Potential GNP 1975	Growth rate of potential 1955–75
Total, 52:–76:2 (2)	2.81 (.25)	0.226 (.042)	0.230 (.042)	0.0041 (.0004)	0.95	0.87	1.62	646.1	1,320.7	3.64
Total, 62:1–76:2 (2)	2.60 (.32)	.226 (.053)	.194 (.053)	.0037 (.0004)	.96	.85	1.51	662.6	1,334.4	3.56
Private, 52:2–76:2 (2)	2.48 (.14)	.225 (.024)	.191 (.024)	.0035 (.0002)	.97	.85	1.44	649.4	1,289.4	3.49
Private, 62:1–76:2 (2)	2.12 (.19)	.203 (.032)	.154 (.032)	.0035 (.0003)	.97	.84	1.42	633.5	1,303.2	3.67
New potential GNP estimate								651.4	1,316.9	3.58

In rows 3 and 4, private nonresidential output was estimated using potential and actual weighted employment, the same data that were used in the new potential estimates. Potential GNP was calculated by adding the actual output of the government, residential housing, and foreign sectors. The estimates of potential output in 1975 are lower than $1316.9. It is difficult to explain why calculations using the private sector and weighted employment give lower answers. The assumed unemployed persons at 4.8% include many young workers with low earnings weights, so that the "Perry-weighted" unemployment rate increases more slowly than the unweighted increase from 4.0 to 4.8 indicates.

In regressions such as this it is easy to confuse trends with increasing returns to scale, and the estimates r and $\log c$ have no variance, because they are the ratios of normally distributed coefficients. Nevertheless, the evidence from this model, which implicitly uses the output gap rather than the employment gap as a cyclical variable, indicates that previously published estimates are too high, and that the magnitude of the downward revision may be, if anything, understated.

These additional estimates indicate that the estimate of potential output is relatively insensitive to the method used to estimate it. In both models, a trend rate of growth is estimated, and changes in productivity growth not explained by factors like growth in the capital/labor ratio or the age-sex composition of the labor force are aggregated in a residual term. Thus, it can be expected that calculations using growth in labor productivity, reductions in average workweeks, and growth in the potential labor force will yield the same results. For example, an examination of these three factors for the period 1968–1973 also yields the conclusion that potential output has been growing at only about 3.5% per year in the late 1960s and early 1970s, even though labor force growth rates were much higher than in earlier years. (Table 7.) The 3.5% growth rate also agrees remarkably well with projections made by William Nordhaus in 1972.[14] Nordhaus attributed much of the pronounced slowdown in productivity growth to shifts in employment and hours between sectors of the economy.

CONCLUSION

The new estimates of potential GNP presented in Tables 4 and 5 represent an improvement over earlier estimates that used measures of total GNP, employment, and labor force only, but are by no means a definitive model of aggregate supply. The inclusion of a fixed capital stock measure and an adjustment for the age-sex composition of the labor force separate out effects that would have otherwise been included in a trend term along with total factor productivity growth. The relative success of disaggregation into sectors in explaining the productivity slowdown since 1966[15] indicates that the next logical step in estimating productivity trends and their relationship to long-term economic growth is disaggregation of the private sector into smaller subsectors for analysis.

TABLE 7.—GROWTH OF TOTAL LABOR FORCE, AVERAGE WEEKLY HOURS, AND PRODUCTIVITY

[Annual rates in percent for U.S. economy]

	(1) Total labor force growth [1]	(2) Growth in average weekly hours [2]	(3) Growth in output per labor-hour [3]	(1)+(2)+(3)
1952 to 1956	1.4	−0.2	2.0	3.2
1956 to 1968	1.4	−.2	2.6	3.8
1968 to 1973	2.0	−.3	1.8	3.5

[1] Total labor force is defined as civilian labor force plus militry employment.
[2] Average weekly hours decline estimated from "Current Population Survey" data.
[3] Total hours of labor input including government workers and military.

[14] William D. Nordhaus, "The Recent Productivity Slowdown," *Brookings Papers on Economic Activity*, (3:1972), p. 493–548.
[15] See Norsworthy and Fulco, "Productivity and Costs . . ." and Nordhaus, "The Recent Productivity Slowdown."

Still, the concept of potential GNP falls short of satisfying our need for a description of the supply side of the economy because it is essentially a static concept, based on the notion of a static production function. One of the problems of applying a static analysis is illustrated by the method used here to project potential growth through 1980. Such a projection requires an estimate of capital stock growth, which in turn requires a projection of fixed investment expenditure. The investment forecast assumed that the economy grows at about 5 percent per year until 1980, and is therefore below potential throughout the entire period. Thus, potential output is not independent of the path that is taken to reach it. While such a consideration is less important for calculation of historical values for potential output, it is most important if potential GNP is used as a target or limit on growth for the future. A sector-by-sector description of how the economy could grow over time from where it actually is now would be much more informative than a potential GNP forecast. The estimate of what output would be if resources were fully utilized may be less important in most situations than good descriptions of the cyclical reaction of productivity and the labor force as output changes.

TABLE A–1.—*Fixed nonresidential capital stock at 1972 prices excluding pollution abatement capital*

[Billions of 1972 dollars]

1948	632.8, 658.0
1950	681.1, 707.5, 734.2, 761.1, 787.9
1955	815.4, 845.7, 876.3, 902.2, 925.0
1960	950.5, 976.4, 1,003.6, 1,003.5, 1,067.2
1965	1,110.4
1966	1,164.2, 1,219.3, 1,273.3, 1,331.1
1970	1,387.6, 1,437.2, 1,486.1, 1,541.7, 1,600.6
1975	1,649.0, 1,687.1, 1,729.9, 1,783.5, 1,845.6
1980	1,913.2

Note.—Figures are average values of capital stock during the given year.

TABLE A–2.—*Potential civilian labor force 1948–80*

[Millions of persons]

1948	60.6, 61.5
1950	62.4, 62.0, 62.1, 62.9, 63.8
1955	65.0, 66.5, 67.0, 68.0, 68.6
1960	69.8, 70.8, 70.8, 72.0, 73.2
1965	74.4
1966	75.6, 77.2, 78.6, 80.5
1970	82.7, 84.3, 86.7, 88.7, 91.1
1975	93.3, 95.9, 98.0, 99.7, 101.4
1980	103.3

TABLE A–3.—*Private employment, 1948–75*

[Millions of persons]

1948	53.1, 52.3
1950	53.1, 53.9, 53.8, 54.7, 53.5
1955	55.3, 56.9, 56.9, 55.6, 56.9
1960	57.8, 57.6, 58.0, 58.7, 60.0
1965	61.5
1966	62.6, 63.2, 64.3, 65.9
1970	66.2, 66.3, 68.4, 70.8, 71.9
1975	70.3

TABLE A-4.—*Manufacturing capacity utilization rate 1948–75* [1]

[Percent]

1948	87.8, 82.2
1950	87.4, 89.2, 87.9, 89.3, 93.0
1955	86.3, 85.3, 83.2, 78.0, 81.5
1960	80.8
1961	79.4, 81.5, 82.4, 83.8
1965	85.7, 87.3, 85.1, 84.8, 84.5
1970	80.8, 80.3, 83.0, 85.5, 82.5
1975	77.0

[1] Annual average rate. After 1967, series is Department of Commerce manufacturing utilization rate. Before 1967, an estimate consistent with the Commerce series is calculated using the Federal Reserve Board manufacturing utilization index.

TABLE A-5.—*Full employment unemployment benchmark equivalent to 4.0 pct unemployment in 1955*

[Percent]

1948	4.3, 4.2
1950	4.2, 4.1, 4.0, 4.0, 4.0
1955	4.0, 4.0, 4.0, 4.0, 4.1
1960	4.1, 4.1, 4.1, 4.2, 4.3
1965	4.4
1966	4.5, 4.4, 4.4, 4.4
1970	4.5, 4.6, 4.7, 4.8, 4.8
1975	4.8, 4.9, 4.9, 4.9, 4.9
1980	4.8

NOTE.—Unemployment rates are computed relative to the sampling procedure actually used in a given time period. The CPS survey change in 1967 causes the shift in the benchmark unemployment rate from 1966 to 1967.

TABLE A-6.—PROJECTIONS OF NONCYCLICAL GNP COMPONENTS 1976-80

[Billions of 1972 dollars]

	Compnesation of Federal employees	Compensation of State and local government employees
Year:		
1975 [1]	47.8	97.3
1976	47.6	100.4
1977	47.7	103.6
1978	47.7	106.9
1979	47.8	110.3
1980	47.8	113.8

	Gross output attributed to residential housing stock	Gross output originating in rest of world (GNP-GDP)
Year:		
1975 [1]	105.0	4.8
1976	107.8	6.1
1977	110.5	7.8
1978	114.1	9.2
1979	117.9	10.3
1980	121.9	11.3

[1] 1975 figures are actual, included for comparison.

Senator HUMPHREY. I just want to thank Mr. Greenspan. You are a delightful human being and I appreciated the chance to work with you.

While I have not known Mr. Malkiel as well, I know the CEA has tried to be of great help to this committee and to the country.

Mr. GREENSPAN. As I said personally before you arrived, it has been a very extraordinary and fruitful experience for me and I appreciate both your and other committee members' cooperation with us, specifically the tough questions. That is the way in which we can illuminate the very difficut problems of which we are all conscious.

Mr. BOLLING. As the new chairman, I would like to completely endorse what Senator Humphrey has said. You have been cooperative, a good witness and a good-humored one. You have made a great contribution, and we will expect to see you back here on other occasions.

We thank you both very much.

[Whereupon, at 12:55 p.m., the committee recessed, to reconvene at 10 a.m., Wednesday, February 2, 1977.]

THE 1977 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 2, 1977

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

The committee met, pursuant to recess, at 10:02 a.m., in room 5302, Dirksen Senate Office Building, Hon. Richard Bolling (chairman of the committee) presiding.

Present: Representatives Bolling, Reuss, Moorhead, and Hamilton; and Senators Humphrey, Proxmire, Bentsen, and Kennedy.

Also present: John R. Stark, executive director; Louis C. Krauthoff II and Courtenay M. Slater, assistant directors; Richard F. Kaufman, general counsel; Richard Boltuck, William R. Beuchner, G. Thomas Cator, William A. Cox, Bret Fromson, Robert D. Hamrin, Kent H. Hughes, Sarah Jackson, John R. Karlik, L. Douglas Lee, and Katie MacArthur, professional staff members; Michael J. Runde, administrative assistant; and Charles H. Bradford, George D. Krumbhaar, Jr., M. Catherine Miller, and Mark R. Policinski, minority professional staff members.

OPENING STATEMENT OF REPRESENTATIVE BOLLING, CHAIRMAN

Representative BOLLING. The committee will be in order. It is a great pleasure to welcome before this committee for the first time in his official capacity an old friend, Mr. Charles Schultze, the new Chairman of the Council of Economic Advisers. He probably is as much in demand as anybody in Washington. I think the committees of Congress are all trying to have him on the same day. The Joint Economic Committee began its 1977 annual hearings on January 19th with testimony from Alan Greenspan, the outgoing Chairman of the CEA. We will be continuing tomorrow afternoon at 2 p.m. in room 2172 of the Rayburn House Office Building with the Secretary of the Treasury, W. Michael Blumenthal. Additional hearings are scheduled throughout the remainder of this month, and a schedule is available on the press table.

This year's hearings are unusual in several ways. First, we must evaluate the policy proposals of two different administrations. Second, we must carry out our responsibilities under what is still the relatively new congressional budget process. This means that we must evaluate not only the 1977 economic outlook and the two rather different sets of prescriptions for dealing with it, but we must also attempt to evaluate the outlook for 1978 and formulate recommendations for budget totals for fiscal year 1978 which will serve to carry forward the Employment Act mandate to "promote maximum employment, production and purchasing power."

This puts all of us in the situation of dealing with several questions at once. I testified before the House Budget Committee last week on the Third Concurrent Resolution on the fiscal year 1977 budget, and I know that Mr. Schultze did, too. This committee must report formally to the Budget Committees by mid-March on the fiscal year 1978 budget, even though we may or may not know at that point what all the decisions on the fiscal year 1977 budget will be.

So I hope you will bear with us, Mr. Schultze, when we ask you questions about a number of different aspects of the economic situation and when we press you to give us your judgments about 1978 as well as 1977. We recognize that forecasting a year in advance is a hazardous business, but the congressional timetable imposes on us the necessity to attempt to do just that.

The administration has done a remarkable job in being prepared to present major economic proposals within a week of taking office. We will ask you many questions this morning about the details of the economic proposals, and we will make some criticisms. This is a natural and healthy process and should not be allowed to detract from the basic fact that we welcome the prompt and intensive way in which the new administration is approaching the urgent challenge of bringing down unemployment. We think you have presented a good program; we want to see if we can make it even better.

Mr. Schultze, as we requested, you have provided us with a very complete and rather lengthy prepared statement, which we are very glad to have for inclusion in the hearing record.

Perhaps in your oral statement you would like to highlight for us some of its main points. Please proceed.

STATEMENT OF HON. CHARLES L. SCHULTZE, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. SCHULTZE. Thank you, Mr. Chairman, members of the committee.

I welcome, given my time schedule this week, yes, I welcome the invitation to appear before you. This committee is an old friend under a number of different hats.

I think what I would lik to do is read exerpts from my prepared statement, liberally excising in order to give the committee a chance to have more questions. There are some things I would like to concentrate upon. In particular, the economic strategy behind the particular economic measures the President is asking the Congress to approve.

I don't have to tell this committee that the recovery from the worst recession of the past 40 years has, to date, and on balance, been disappointing. And, without vigorous action, it shows signs of continuing disappointment.

I don't think I need to read the record. You know it, and it is summarized in the first few pages of my statement. Taking off from that past record, forecasts of economic activity for 1977, the year ahead, the fourth quarter of 1976 to the fourth quarter of 1977, both those we have made ourselves in the short time we have had and those of most other economic observers point to growth in the real GNP during those four quarters in the range of 3 and a half to 5 percent, in the absence of any Federal actions to provide conomic stimulus. Most of the forecasts are clustered in the neighborhood of $4\frac{1}{2}$ to $4\frac{3}{4}$ percent; and this isn't enough.

With the labor force growing very rapidly now and with productivity moving up, a rise of output and income of around $4\frac{1}{4}$ to $4\frac{3}{4}$ percent in real GNP this year would probably have the unemployment rate only modestly down from its current high level.

The basic problem is that the current recovery has not yet proceeded far enough or rapidly enough to set off a self-sustaining economic expansion. Consumers are already spending a very high fraction of their income; the highest fraction since 1972. Only as consumer income grows will consumption expand further. We cannot count on consumers as an independent force to speed up the recovery in the year ahead.

Similarly, while inventory accumulation by business firms will continue this year, we cannot count on it to be the major factor keeping the expansion going during the year ahead. In fact, under current circumstances a sharply accelerated accumulation of inventories by businessmen would be unhealthy. So we must look to other areas, and particularly to spending by business firms for plant and equipment investment.

The expansion of investment spending has been much less vigorous in this recovery than in other recoveries. And it continues to be sluggish. In fact, indicators of business capital outlays—such as contracts and orders for plant and equipment—rose less in the latter half of 1976 than they had in the first 6 months, and surveys of anticipated expenditures by the Commerce Department indicate only a weak advance of these outlays during the first half of 1977. The major reason for this continued sluggishness is clear—sales, income and use of productive capacity have not recovered enough to give businessmen strong enough incentives to expand their capacity for the future.

At this point in other post-war recoveries, real output and real consumer income had expanded well beyond the high point reached before the recession began.

In other words, they went well up beyond the prior peak. The rebound this time has been much weaker. In the final quarter of 1976, real GNP was only 3.1 percent above its prior peak in 1973, compared to an average of almost 8 percent in other recoveries. Similarly, consumer income, adjusted for inflation, was only 4.4 percent above its prior peak, versus an average of 8 percent in earlier recoveries. Sales and output have expanded so little compared to 3 years ago that business incentives to invest in new capacity are still quite weak. We need additional economic stimulus that expands markets, in order both to reduce unemployment directly and to set in motion a self-sustaining, long-lasting economic recovery, led by strong increases in business investment. There are other reasons for the sluggishness of investment and I shall return to these briefly at a later point in my testimony.

Let me turn to the page where I summarize the basic elements of the President's economic proposals.

There are seven essential components of those proposals. First, a one-time rebate on 1976 taxes and social security payments of 11.4 billion dollars, paid out in April or May of this year.

Second, a permanent simplification and reform of the taxes levied on individuals through changes in the standard deduction that will mean a tax savings of $4 billion a year once fully in effect.

Third, businesses will save $2.5 billion in taxes by choosing either a 2 percentage point increase in the investment tax credit or a credit against income taxes equal to 4 percent of their payroll tax payments.

Fourth, the number of federally funded public service jobs will be raised from 310,000 now to 600,000 by the end of fiscal year 1977, and to 725,000 during 1978.

Fifth, an additional 346,000 positions will be added to the various training and employment programs under the Comprehensive Employment and Training Act.

The appropriation request for this should be approximately 50 percent over the current levels.

Six, a $4 billion authorization (on top of the $2 billion already available) for additional emergency public work jobs will be requested; $2 billion of the new moneys would be requested in a supplemental appropriation for 1977 and the other $2 billion in the 1978 budget.

Finally, the countercyclical revenue sharing program, which will pay out $1.25 billion in fiscal year 1977 will be revised so that, when the unemployment rate equals 7.5 percent a total of $2.25 billion will be paid out. The funds for this program would be gradually increased as the unemployment rate exceeded 7.5 percent, and gradually decreased as it fell below 7.5 percent.

This package does not provide a one-shot "hypo" for the housing market, one that might carry the risk of instability in that vital industry in years ahead. But Secretary Harris is urgently preparing a program to increase federally assisted low- and moderate-income housing on a sustained basis. This program too will have a direct impact on the recovery.

Let's look at the rationale for this particular recovery program, why this set of elements.

The various components of President Carter's economic stimulus package were designed to meet several objectives and to satisfy several conditions.

First, the stimulus should begin to take effect quickly—hence the one-time $11.4 billion rebate to be paid out in April or May. This will immediately add to the consumer income and, on the basis of experience with the 1975 rebate, will shortly begin boosting sales of consumer goods. A further enlargement of public service employment or accelerated public works would not meet this objective of acting quickly. Neither can be expanded faster than the President has proposed without running into very serious management problems.

Second, the stimulus should extend over a sufficient period of time to create expectations of a sustained rise in economic activity. That, we believe, will elicit a response in the form of increased business willingness to invest in plant and equipment. So the proposed stimulus package thus injects about $15.5 billion in fiscal year 1977 and another $15.7 billion in fiscal year 1978.

Third, the permanent additions to spending or reductions in receipts should be small, to avoid mortgaging future revenues or endangering the ultimate goal of balancing the Federal budget. For that reason, all but $6.5 billion in permanent tax cuts should begin to fade away as the economy improves. Specifically:

The public works component is a temporary injection. While the actual construction work that results will extend over several years, the program itself is not a permanent addition to the Federal budget.

For amounts spent under the special program for public service employment and special aids to State and local governments will also be reduced as the employment rate falls to more reasonable levels.

Finally, the rebate is, by definition, a one-time affair.

What results do we expect? We don't pretend to be able to forecast with precision the impact this program will have on the U.S. economy. In broad terms, however, we would expect the following:

The growth of the real gross national product from the fourth quarter of 1976 to the fourth quarter of 1977 should be in the range of 5¾ percent to 6 percent. Without added stimulus, that growth rate would probably be only 4½ to 4¾ percent.

Beyond 1977, forecasting becomes particularly hazardous. We believe that the speedup in economic growth in 1977, together with renewed confidence in the sustainability of recovery, will lead to a continued healthy expansion in the year 1978. The prospects for a sustained rise in sales and output should elicit a strong response from business firms in the form of increased investment. Consumer confidence, which has recently improved, should remain at the higher level.

Given these economic developments, the unemployment rate, by the fourth quarter of 1977, should decline to the neighborhood of 6.7 to 6.9 percent, and should fall still further in 1978 toward 6 percent by the end of the year.

The rate of inflation during the coming year should be affected only minimally by the stimulus package as I noted earlier. We must be prepared, however, for the possibility that some increase in the rate of inflation may occur in 1977 for reasons that have nothing to do with the stimulus package. In particular, food prices at the retail level rose relatively little during 1976, and during a good part of the year fell, and thus exerted a moderating influence on the overall level of consumer prices. The outlook for food prices at this juncture is uncertain, but it is less favorable than a year ago. Cold weather has destroyed a portion of the citrus fruit crop in Florida; drought and cold in the Midwest have done some damage to the winter wheat crop, and beef prices are now rising again. Food prices this year are not likely to show anything resembling the increases we saw in earlier years, but some acceleration in the advance of food prices may be forthcoming.

Let's look at long-term effects on investment, because as I said earlier, if we want to get to a situation where we are not injecting stimulus every year, in order to get a self-sustaining rise in the

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economy, we have to set off a healthy and steady rise in business investment.

As I pointed out earlier, a principal reason the recovery slowed down in 1976 was the failure of business investment to pick up in the wake of improvements in other sectors of the economy. Investment, adjusted for inflation, is now 12 percent below the prior 1973 peak, while at the same stage in earlier postwar recoveries it averaged 5 percent above the prior peak.

In order for this expansion to become self-sustaining, not dependent upon continuous injections of stimulus, business investment, as I said, will have to begin expanding steadily and rapidly.

While the disappointing recovery in sales and consumer purchases is a major reason for the sluggishness of investment spending, there are other problems. The risk that investments will not yield a satisfactory return is perceived by businessmen to be larger now than it was a decade or two ago. To many business firms the economic outlook has become more uncertain, and planning for the future more difficult. Double-digit inflation is only a year or two behind us and the current inflation rate is 5 to 6 percent. What are prices and costs likely to be over the life of a new investment? Will energy shortages or sharp rises in energy prices make plants inefficient or, worse, force them to become obsolete and close? Could future changes in environmental, safety and other regulations render today's investments obsolete tomorrow? These are specific issues that bother business planners. There is also a more general worry. The recession of 1974–75 did more than reduce business sales and profits. It seemed to shake the confidence of the business community in the ability of our Government to maintain a reasonably stable economic and financial environment that will provide growing markets in the future for the output of the plants and machines they buy today.

Some of the most important of these problems are addressed by the President's current fiscal proposals. These proposals are designed to generate a steady recovery in sales and income—markets to count on. But they will not continue to provide large conomic stimulus indefinitely into the future, when it may no longer be needed and could become inflationary.

The investment credit component of the President's proposals is also designed to increase investment. No one can argue obviously that the addition of 2-percentage points to the credit will revolutionize investment behavior. Of course, it won't. By itself, and without an expansion in sales and capacity utilization, the additional investment credit would not elicit much extra investment. But in the context of a steady expansion in sales, and growing confidence in the sustainability of the recovery, a modest increase in the investment credit should add its contribution to the set of factors generating an expansion in investment.

On the other hand, not all of the factors leading to increased investment risk are addressed in this immediate stimulus package. But they will be addressed. The President is determined to move ahead with proposals for long-range tax reform, that will deal comprehensively both with problems of inequity and unfairness and with elements in the tax code that may be unnecessary obstacles to investment.

In the area of Government regulation, I believe that it is not the objectives or the basic standards set by regulation which are the main problem. Rather it is the combined uncertainty of our future requirements and unnecessarily complex and time-consuming regulations that add to risks and discourage investment. Here also, without sacrificing the highly important goals which the Congress had in mind in enacting various regulatory statutes, the President intends to try to create a regulatory climate of greater certainty and simplicity.

Let me finally look at the balance of uncertainties. We are not dealing in a certain world and we have to deal with the possibility of being wrong.

As is the case with any economic policy, there are uncertainties in the outlook that could make a stimulative policy too weak or, conversely, too large.

We tried to design this package to tread prudently between the twin risks of over and understimulation.

Suppose, for instance, that the rate of economic growth in the absence of stimulus turns out to be larger than the 4½ to 4¾ percent rate forecast earlier. Would the addition of the economic stimulus package then produce an excessive rate of growth and lead to inflation? The answer is no. The reason lies in the nature of the inflation we are now experiencing.

The 5 to 6 percent rate of inflation with which we are now living is not the result of an excessively buoyant economy, or of tight labor markets, or of shortages and bottlenecks. Quite the reverse. There are millions of experienced workers looking for jobs; there is ample industrial capacity standing idle.

We are suffering, rather, from what might be called "momentum inflation." Prices are rising today because they were rising yesterday. Workers whose living standards were eroded by the sharp price increases of 1974 and 1975 are asking and getting increases in wages and fringe benefits that average about 7½ to 8 percent a year. Business firms are then passing the higher costs along in higher prices. Prices are chasing wages, and wages, prices.

This kind of inflation has not been and will not be cured by a policy of sluggish recovery, by high unemployment and by idle plant capacity. Equally important, it will not be accelerated by a prudent policy of economic stimulus that restores a steady and sustainable rate of economic recovery.

We have sought to put together a set of economic recovery measures that are sufficient to provide a sorely needed increase in the rate of growth, but which are scaled in their magnitude and their timing so as to avoid any danger of igniting a new inflationary surge. Even if the growth rate in 1977 turned out, with stimulus, to be 6½ to 6¾ percent, rather than the 5¾ to 6 percent we expect, the existing slack in the economy is sufficient to accommodate it.

If business investment and exports pick up nicely in late 1977 and in 1978, the decline in the stimulus now planned after mid-1978 will be quite appropriate in order to avoid excessive prodding of a healthy economy.

On the other hand, if private demand does not respond sharply enough to the stimulus package, and the self-sustaining expansion we envisage does not come up to expectations, additional measures can be taken. It is far more easier to add more stimulus later in 1978, should that be needed, than to retract excessive stimulus once committed.

I think, Mr. Chairman, this constitutes the major parts of my testimony. I will be glad to answer your questions.

[The prepared statement of Mr. Schultze follows:]

Prepared Statement of Hon. Charles L. Schultze

Mr. Chairman and members of the committee, I welcome the invitation to appear before you. I would like to concentrate on the economic reasons why the President is proposing a program of fiscal stimulus and the economic strategy behind the particular combination of measures he is asking Congress to approve.

ECONOMIC BACKGROUND

The recovery from the worst recession of the past forty years has, to date, been disappointing. And, without vigorous action, it shows signs of continuing disappointment.

Look, for a moment, at the record of the economy since the recovery began:

By December 1976, almost two years into recovery, the unemployment rate had fallen from a peak of 9 percent to only 7.8 percent—there were still 7.5 million Americans out of work.

Consumers' incomes, adjusted for inflation, have risen at a dishearteningly slow rate.

Total industrial production has barely recovered its previous peak in the summer of 1974. The production of durable goods, in fact, is still below its previous high and has yet to show the vigorous cyclical rise we normally associate with the recovery from a deep recession.

The retarded recovery of durable goods manufacturing has caused special hardship to regions of our country where economic prosperity hangs heavily on durable goods production. Those regions have fallen behind the growth of income and employment that other sections of the nation have enjoyed. For example, during the year that ended in September 1976, total payroll employment in the Northeastern United States rose only ½ of one percent, compared with an almost 3 percent increase for the nation as a whole.

In large measure the weakness of durable goods output since the spring of 1975 reflects a shortfall of business spending for new plant and equipment. During earlier postwar business cycles, business fixed capital outlays— in real terms—usually surpassed their previous peak during the first year of recovery. But in the last quarter of 1976—with the current recovery nearly two years old—real business fixed investment was still 12 percent below its previous high at the beginning of 1974.

So far, this economic recovery has gone through three phases. Initially, from the first quarter of 1976 through the first quarter of 1976, the recovery proceeded briskly, spurred by the tax cut which Congress enacted in 1975 and by the sharp turnaround of business inventory investment from deep liquidation to substantial accumulation. During that first year, the Gross National Product rose by 7.3 percent, unemployment fell from 9 to 7.3 percent, and the strength of recovery exceeded most expectations.

But then, from early 1976 until about October, the rate of growth of economic activity fell steadily. Unemployment began to rise again. By early winter, fears were expressed that the recovery was running out of steam completely.

Since October, however, most of the statistics indicate that the recovery is proceeding once again. But they also point to a pace of growth during 1977 that will be unsatisfactory, and would bring forth only a very modest reduction in unemployment in the year ahead.

Forecasts of economic activity in 1977, both those which we have made ourselves and those of most other economic observers, point to real GNP growth during 1977 in the range of 3½ to 5 percent, in the absence of federal actions to provide economic stimulus. Most of the forecasts are clustered in the 4½ to 4¾ percent range. This is not enough. With the labor force growing very rapidly now, and with productivity also moving up, a rise of income of from 4½ to

4¾ percent in real GNP this year would probably leave the unemployment rate down only modestly from its present high level.

The basic problem is that the current recovery has not yet proceeded far enough or rapidly enough to set off a self-sustaining economic expansion. Consumers are already spending a very high fraction of their income; the highest fraction since 1972. Only as consumer income grows will consumption expand further. We cannot count on consumers as an independent force to speed up the recovery in the year ahead.

Similarly, while inventory accumulation by business firms will continue this year, we cannot count on it to be the major factor keeping the expansion going during the year ahead. In fact, under current circumstances a sharply accelerated accumulation of inventories by businessmen would be unhealthy. So we must look to other areas, and particularly to spending by business firms for plant and equipment investment.

The expansion of investment spending has been much less vigorous in this recovery than in other recoveries. And it continues to be sluggish. In fact, indicators of business capital outlays—such as contracts and orders for plant and equipment—rose less in the latter half of 1976 than they had in the first six months, and surveys of anticipated expenditures by the Commerce Department indicate only a weak advance of these outlays during the first half of 1977. The major reason for this continued sluggishness is clear—sales, income and use of productive capacity have not recovered enough to give businessmen strong enough incentives to expand their capacity for the future. The table below tells the basic story.

TABLE 1.—MAJOR ECONOMIC INDICATORS—7 QUARTERS AFTER TROUGH OF RECESSION COMPARED WITH PRIOR PEAK

[Percent change]

	Average, prior postwar recoveries	1975–76 recovery
GNP	+7.7	+3.1
Consumer income	+8.0	+4.4
Industrial production	+7.7	+0
Business Investment	+5.3	−11.8

Note.—All data adjusted for inflation.

At this point in other post-war recoveries, real output and real consumer income had expanded well beyond the high point reached before the recession began. The rebound this time has been much weaker. In the final quarter of 1976, real GNP was only 3.1 percent above its prior peak in 1973, compared to an average of almost 8 percent in other recoveries. Similarly, consumer income, adjusted for inflation, was only 4.4 percent above its prior peak, versus an average of 8 percent in earlier recoveries. Sales and output have expanded so little compared to three years ago that business incentives to invest in new capacity are still quite weak. We need additional economic stimulus that expands markets, in order both to reduce unemployment directly and to set in motion a self-sustaining, long-lasting economic recovery, led by strong increases in business investment. There are other reasons for the sluggishness of investment and I shall return to these briefly at a later point in my testimony.

REDUCING UNEMPLOYMENT

There are two different kinds of problems with which we can and must deal now in getting the rate of unemployment down.

At the present time we are faced with substantial cyclical unemployment. This unemployment is brought about principally because businessmen do not have strong enough markets in which to sell the goods and services which additional workers would produce. Consequently, they won't hire them. In December 1976 there were 3.2 million more people unemployed than in 1973, when the economy was reasonably prosperous and the overall unemployment rate was 5 percent. These extra 3.2 million unemployed are the cyclically unemployed. They are not principally those people who have a hard time finding decent jobs, even in good times.

TABLE 2.—*Cyclical unemployment (increase in unemployment between 1973 and December 1976)*

[Millions of persons]

Total increase	3.2
Of which:	
Age 20 and over	2.7
Teenagers (16 to 19)	0.5
Experienced workers	2.9
Job losers	2.1

Of the additional 3.2 million unemployed, 2.7 million were adults; 2.9 million were experienced wage and salary workers; 2.1 million were people who were unemployed because they had lost their prior jobs. In other words, these extra 3.2 million unemployed persons are not mainly composed of the disadvantaged, or of teenagers or other groups that we normally think of as the structurally unemployed.

The long-term answer to the problem of cyclical unemployed is a general economic expansion, creating market outlets for the broad range of business firms who then can be expected to increase their employment and hiring.

In addition, there is the problem of structural unemployment. Even in good time, when the overall unemployment rate is well below what we now have, there are many people who have a hard time finding a job.

TABLE 3.—THE COMPOSITION OF UNEMPLOYMENT BY GROUP, IN 1973

Group	Percent of labor force	Percent of unemployment
Teenagers (16 to 19)	9.5	28.5
Young adults (20 to 24)	14.3	22.9
Nonwhite	11.3	20.8
Nonwhite teenagers	1.0	6.4

In 1973, for example, teenagers, who comprised about 10 percent of the labor force, made up almost 30 percent of the unemployed. Young adults from 20–40 years old made up 14 percent of the labor force, but 23 percent of the unemployed. Blacks and other minority groups who comprised only 11 percent of the labor force accounted for 21 percent of the unemployed. To deal with these structural problems we need pinpointed measures which provide skills, training and other assistance to particular groups of workers in order to get them into productive, well paying jobs.

There is no reason, of course, that we should not attack both problems simultaneously. As we pursue general economic expansion, we can also provide additional training and skill improvement measures. We can provide some temporary public service employment for both the cyclically and the structurally unemployed while at the same time expanding the private economy to take up the slack of the cyclically unemployed.

I would like, at this stage, to outline in broad terms the principal elements of the economic recovery program.

BASIC ELEMENTS OF THE STIMULUS PACKAGE

There are seven essential components of the stimulus plan.

First, a one-time rebate on 1976 taxes and social security payments of $11.4 billion, paid out in April or May of this year.

Second, a permanent simplification and reform of the taxes levied on individuals through changes in the standard deduction that will mean a tax savings of $4 billion a year once fully in effect.

Third, businesses will save $2.5 billion in taxes by choosing either a 2 percentage point increase in the investment tax credit or a credit against income taxes equal to 4 percent of their payroll tax payments.

Fourth, the number of federally-funded public service jobs will be raised from 310,000 now to 600,000 by the end of fiscal year 1977, and to 725,000 during 1978.

Fifth, an additional 346,000 positions will be added to the various training and employment programs under the Comprehensive Employment and Training Act.

Sixth, a $4 billion authorization (on top of the $2 billion already available) for additional emergency public work jobs will be requested; $2 billion of the new moneys would be requested in a supplemental appropriation for 1977 and the other $2 billion in the 1978 budget.

Finally, the counter-cyclical revenue sharing program, which will pay out $1.25 billion in Fiscal Year 1977 will be revised so that, when the unemployment rate equals 7.5 percent a total of $2.25 billion will be paid out. The funds for this program would be gradually increased as the unemployment rate exceeded 7.5 percent, and gradually decreased as it fell below 7.5 percent.

This package does not provide a one-shot "hypo" for the housing market, one that might carry the risk of instability in that vital industry in years ahead. But Secretary Harris is urgently preparing a program to increase federally assisted low and moderate income housing on a sustained basis. This program, to, will have a direct impact on the recovery.

RATIONALE FOR THIS RECOVERY PROGRAM

The various components of President Carter's economic stimulus package were designed to meet several objectives and to satisfy several conditions.

First, the stimulus should begin to take effect quickly—hence the one-time $11.4 billion rebate to be paid out in April or May. This will immediately add to consumer income and, on the basis of experience with the 1975 rebate, will shortly begin boosting sales of consumer goods. A further enlargement of public service employment or accelerated public works would not meet this objective of acting quickly. Neither can be expanded faster than the President has proposed without running into very serious management problems.

Second, the stimulus should extend over a sufficient period of time to create expectations of a sustained rise in economic activity. That, we believe, will elicit a response in the form of increased business willingness to invest in plant and equipment. So the proposed stimulus package thus injects about $15.5 billion in FY 1977 and another $15.7 billion in FY 1978.

Third, the permanent additions to spending or reductions in receipts should be small, to avoid mortgaging future revenues or endangering the ultimate goal of balancing the Federal budget. For that reason, all but $6.5 billion in permanent tax cuts should begin to fade away as the economy improves. Specifically:

The public works component is a temporary injection. While the actual construction work that results will extend over several years, the program itself is not a permanent addition to the Federal budget.

The amounts spent under the special program for public service employment and special aids to State and local governments will also be reduced as the unemployment rate falls to more reasonable levels.

Finally, the rebate is, by definition, a one-time affair.

EXPECTED RESULTS

We do not pretend to be able to forecast with precision the impact this program will have on the U.S. economy. In broad terms, however, we would expect the following:

The growth of the real gross national product from the fourth quarter of 1976 to the fourth quarter of 1977 should be in the range of 5¾ percent to 6 percent. Without added stimulus, that growth rate would probably be only 4½–4¾ percent.

Beyond 1977, forecasting becomes particularly hazardous. We believe that the speedup in economic growth in 1977, together with renewed confidence in the sustainability of recovery, will lead to a continued healthy expansion in the year 1978. The prospects for a sustained rise in sales and output should elicit a strong response from business firms in the form of increased investment. Consumer confidence, which has recently improved, should remain at the higher level.

Given these economic developments the unemployment rate, by the fourth quarter of 1977, should decline to the neighborhood of 6.7 to 6.9 percent, and should fall still further in 1978 toward 6 percent by the end of the year.

The rate of inflation during the coming year should be affected only minimally by the stimulus package as I noted earlier. We must be prepared, however, for the possibility that some increase in the rate of inflation may occur in 1977 for reasons that have nothing to do with the stimulus package. In particular, food prices at the retail level rose relatively little during 1976, and thus exerted a moderating influence on the overall level of consumer prices. The outlook for food prices at this juncture is uncertain, but it is less favorable than a year ago. Cold weather has destroyed a portion of the citrus fruit crop in Florida; drought and cold in the Midwest have done some damage to the winter wheat crop, and beef prices are now rising again. Food prices this year are not likely to show anything resembling the increases we saw in earlier years but some acceleration in the advance of food prices may be forthcoming.

LONG-TERM EFFECTS ON INVESTMENT

As I pointed out earlier, a principal reason the recovery slowed down in 1976 was the failure of business investment to pick up in the wake of improvements in other sectors of the economy. Investment, adjusted for inflation, is now 12 percent below the prior 1973 peak, while at the same stage in earlier postwar recoveries it averaged 5 percent above the prior peak.

In order for this expansion to become self-sustaining, not dependent upon continuous injections of stimulus, business investment as I said will have to begin expanding steadily and rapidly.

While the disappointing recovery in sales and consumer purchases is a major reason for the sluggishness of investment spending, there are other problems. The risk that investments will not yield a satisfactory return is perceived by businessmen to be larger now that it was a decade or two ago. To many business firms the economic outlook has become more uncertain, and planning for the future more difficult. Double-digit inflation is only a year or two behind us, and the current inflation rate is 5 to 6 percent. What are prices and costs likely to be over the life of a new investment? Will energy shortages or sharp rises in energy prices make plants inefficient or, worse, force them to become obsolete and close? Could future changes in environmental, safety and other regulations render today's investments obsolete tomorrow? These are specific issues that bother business planners. There is also a more general worry. The recession of 1974–75 did more than reduce business sales and profits. It seemed to shake the confidence of the business community in the ability of our government to maintain a reasonably stable economic and financial environment that will provide growing markets in the future for the output of the plants and machines they buy today.

Some of the most important of these problems are addressed by the President's current fiscal proposals. These proposals are designed to generate a steady recovery in sales and income—markets to count on. But they will not continue to provide large economic stimulus indefinitely into the future, when it may no longer be needed and could become inflationary.

The investment credit component of the President's proposals is also designed to increase investment. No one can argue obviously that the addition of 2 percentage points to the credit will revolutionize investment behavior. Of course, it won't. By itself, and without an expansion in sales and capacity utilization, the additional investment credit would not elicit much extra investment. But in the context of a steady expansion in sales, and growing confidence in the sustainability of the recovery, a modest increase in the investment credit should add its contribution to the set of factors generating an expansion in investment.

On the other hand, not all of the factors leading to increased investment risk are addressed in this immediate stimulus package. But they will be addressed. The President is determined to move ahead with proposals for long range tax reform, that will deal comprehensively both with problems of inequity and unfairness and with elements in the tax code that may be unnecessary obstacles to investment. In the area of government regulation, I believe that it is not the objectives or the basic standards set by regulation which are the main problem. Rather it is the combined uncertainty of our future requirements and unnecessarily complex and time consuming regulations that add to risks and discourage investment. Here also, without sacrificing the highly important goals which the Congress had in mind in enacting various regulatory statutes, the President intends to try to create a regulatory climate of greater certainty and simplicity.

THE BALANCE OF UNCERTAINTIES

As is the case with any economic policy, there are uncertainties in the outlook that could make a stimulative policy too weak or, conversely, too large.

We tried to design this package to tread prudently between the twin risks of over and under-stimulation.

Suppose, for instance, that the rate of economic growth in the absence of stimulus turns out to be larger than the 4½ to 4¾ percent rate forecast earlier. Would the addition of the economic stimulus package then produce an excessive rate of growth and lead to inflation? The answer is no. The reason lies in the nature of the inflation we are now experiencing.

The 5 to 6 percent rate of inflation with which we are now living is not the result of an excessively buoyant economy, or of tight labor markets, or of shortages and bottlenecks. Quite the reverse. There are millions of experienced workers looking for jobs; there is ample industrial capacity standing idle.

We are suffering, rather, from what might be called "momentum inflation". Prices are rising today because they were rising yesterday. Workers whose living standards were eroded by the sharp price increases of 1974 and 1975 are asking and getting increases in wages and fringe benefits that average about 7½ to 8 percent a year. Business firms are then passing the higher costs along in higher prices. Prices are chasing wages, and wages, prices.

This kind of inflation has not been and will not be cured by a policy of sluggish recovery, by high unemployment and by idle plant capacity. Equally important, it will not be accelerated by a prudent policy of economic stimulus that restores a steady and sustainable rate of economic recovery.

We have sought to put together a set of economic recovery measures that are sufficient to provide a sorely needed increase in the rate of growth, but which are scaled in their magnitude and their timing so as to avoid any danger of igniting a new inflationary surge. Even if the growth rate in 1977 turned out, with stimulus, to be 6½ to 6¾ percent, rather than the 5¾ to 6 percent we expect, the existing slack in the economy is sufficient to accommodate it.

If business investment and exports pick up nicely in late 1977 and in 1978, the decline in the stimulus now planned after mid-1978 will be quite appropriate in order to avoid excessive prodding of a healthy economy.

On the other hand, if private demand does not respond sharply enough to the stimulus package, and the self-sustaining expansion we envisage does not come up to expectations, additional measures can be taken. It is far more easier to add more stimulus later in 1978, should that be needed, than to retract exececssive stimulus once committed.

In addition to making sure that our economic recovery program does not reignite new inflation, we can also undertake some specific measures both to prevent new inflation and to try to edge down the current persistent rate of price increases.

The President plans to upgrade the current Cabinet level Council on Wage and Price Stability in several ways. It will work with labor and management to secure voluntary pre-notification of major wage and price increases. We believe voluntary cooperation will be forthcoming, but will re-assess the need for other measures if it is not. In order to give the Council the capability to monitor supply and demand of critical materials, and to spot supply bottlenecks before inflationary-causing shortages emerge, the staff of the Council will be strengthened.

The economic recovery program itself already contains additional funds to strengthen the skill training and employment programs with the Department of Labor. In addition the Secretary of Labor will be developing longer term measures for the same purpose. As we find ways to put disadvantaged workers into productive jobs, we will improve the efficiency of the labor market, and thereby reduce inflationary pressures. As an additional measure, the Secretary of HEW is developing, on a priority basis, measures to hold down the rapidly escalating costs of hospital care.

We have also started to think through and develop a set of procedures whereby the federal government can enlist the advice and participation of business, labor, and other groups in the development of voluntary principles of responsible wage and price behavior.

Nobody gains from the "momentum" inflation we are experiencing today. And it will not be easy to reduce that spiral. But if we can secure the cooperation of business and labor, if everybody will give just a little bit, then everybody will end up gaining. We cannot guarantee that such an approach will work.

I am very hopeful it will. In any event, I believe we have no option but to give it a try.

Representative BOLLING. Thank you, Mr. Schultze. The 10-minute rule will apply in questioning. The Chair will recognize members in the order they arrived. Mr. Reuss.

Representative REUSS. Thank you, Mr. Chairman.

I want to congratulate you, Chairman Schultze, on a really superb analysis of the problem that confronts us. I want to talk about fiscal 1977 because, as you say, it is a bold man indeed who can get down to brass tacks on fiscal 1978. We have most of fiscal 1977 before us. While I think that your rough estimate of $16 billion of additional tax expnditures is about right—any less wouldn't be enough and any more would justify the Fed in raising interest rates—the mix, as you probably know, bothers me.

You have in there some $14 billion for fiscal 1977 of tax reductions, and less than $2 billion of direct job-creating programs, public works, public service employment, and countercyclical grants.

You have been quoted in the last day or two as saying that if the cold weather requires greater immediate stimulus, you would still recommend keeping the direct job-creating programs at $1.8 billion, whatever they are now, and go for a larger tax increase. My own view is that we could do much better with all three of those employment-creating programs. When the ice recedes from the city streets, enough chuckholes will appear to keep an army busy repairing them. During the FDR administration public service jobs employed 3 million young men in the CCC's.

We aren't talking about a program that is historically very large. You have $24 billion worth of immediate quick acting public works on the spindle and only $2 billion or so dished out and another two or so down the road.

On countercyclical aid, you testified very ably before this committee in 1971 advocating that the Nixon administration put in $4 billion worth. Six years of inflation and travail for the cities have since occurred. The package only contains, if I am not mistaken, about $2 million today. All of this restraint on the job-creating side, is justified in your statement and in the administration's position, as being due to the difficulties of management.

Here is my question: If the President tomorrow were to appoint a livewire—just because he isn't here at the moment, I will suggest Senator Humphrey as one who would meet my description—and told him that his job was to do something better prior to next October, the end of the fiscal year, with respect to direct job-creating programs, don't you think that consistent with policies of good management we could eke out a couple of billion more so that the gross imbalance, something like 7 to 1 for tax reductions compared to direct job-making programs, could be to a degree redressed?

Mr. SCHULTZE. All right.

Representative REUSS. Is management all that impossible?

Mr. SCHULTZE. Let me respond in several ways.

I don't know whether you met Ray Marshall. I consider Marshall quite a livewire. In effect, the President told Ray, "You give me your judgment from somebody who is really an enthusiast in these kind of programs."

Speaking now of the various employment, training, Youth Corps, Job Corps programs, as to how rapidly they can be expanded and still remain good programs, Secretary Marshall came up with a program, and that is what you have. It was not cut back. That is No. 1.

Representative REUSS. Could I interrupt you?

Just before we leave Mr. Marshall, whom I haven't met but he sounds great to me—didn't I read in the paper that he testified that he was disappointed with the direct job creating aspect of the current program, and didn't he then later do a modest Joan of Arc on that?

Mr. SCHULTZE. Not as I understand it. He said he was disappointed but he was disappointed that in his best judgment he couldn't do more.

Representative REUSS. So, Marshall says you can't do it.

Anybody else?

Mr. SCHULTZE. Let me make a distinction between what we are going to put in by way of new budget authority and our estimates of how rapidly it can get done.

I think they are good estimates, what you have in front of you with the $16 billion each year is our estimate within that first year's $16 billion of how much can be spent.

However, the amount of appropriations which will be asked for, for those programs, is substantially more than that. If it turns out that the spending can responsibly be increased faster than that, we are not going to hold them up.

For example, again on the public works, we are asking for an immediate $4 billion authorization. Two billion of that is to be appropriated immediately but we are making a conservative estimate that the actual construction drawdowns in the remaining 5 to 6 months of the fiscal year would only be $200 million.

We are not going to hold those drawdowns up.

In any event, we are not going to control them in that sense. What we really have is a $2 billion public works program addition to start immediately.

If it turns out the communities can get the construction going, then the money will be put out as rapidly as is managerially feasible.

If the communities can get the construction work under way and draw down the expenditures, fine.

Hence, I think a better way to measure what we are trying to do is not to look at our expenditure estimates, particularly on the public works side, but to look at the size of that program.

It is a fairly substantial program, and reasonable people can differ; but, after a pretty careful look at it, we thought that this is precisely why we needed the rebate to fill in that gap until those programs could be moved up.

Representative REUSS. On the subject you are discussing—and I am glad to hear that the administration does have an open mind on what I call redressing the imbalance—I think you have too much revenue lost and too little job creation. You say that if additional stimulus is needed in 1978, it is far easier to add it later in 1978 than to retract excessive stimulus once committed.

Well, without arguing that one, the congressional budget process does have a timetable; and we will be having to pass the first budget resolution for fiscal 1978 this May and then the second one this September.

What would you think of the idea—and I am trying to respond directly to what you said—of putting in that first budget resolution for 1978, next May, an unallocated sum for the general subject of jobs, in addition to what you have proposed at this time, so that it could be allocated if needed in the second resolution.

It may well be that we won't have enough experience by May on whether Marshall is right or whether Humphrey could do better. I don't know.

But I would hate to miss this opportunity. Therefore, wouldn't a beachhead, an enclave, and hand hold, a jobs fund be a good idea?

Mr. SCHULTZE. Well——

Representative REUSS. Then if it isn't needed, you withdraw it.

Mr. SCHULTZE. On the other hand, it seems to me it makes more sense to review the situation in September when you have a second concurrent resolution coming up.

To put in a lump sum unallocated fund seems almost like setting out a bit of meat and waiting for people to grab it.

I am not sure it would stay that way. My judgment is that we do need flexibility, but the congressional budget process has that by the fact of having a second concurrent budget resolution.

Mr. REUSS. I will leave the subject by reminding you that the congressional budget process does put a lot of emphasis on that first resolution; and once you commit yourself on that, it is not easy to change. So it really depends upon one's point of view whether it is more likely to be needed than not.

So, I hope you will keep an open mind until, say, May on that.

Thank you.

Representative BOLLING. Senator Proxmire.

Senator PROXMIRE. Mr. Schultze, I notice that in your statement you say pretty much the same thing that President Carter said in his economic statement on January 31 when he talked about the package with respect to housing.

He said a healthy housing industry is also critical to economic recovery, but they don't want a one-shot operation, they want a healthy long-range program.

I think that the administration is just missing the boat badly on this. I think it is a serious mistake. I think there are many, many jobs you can provide. I think housing needs it right now.

The fact is that our analysis in the housing subcommittee of the Senate indicates that we have needed for the last 3 years about 2.5 million housing units a year in order to keep pace with new households, lost houses, vancancies, and so forth.

Instead of getting 2.5 million houses a year, we have 1.3 million units in 1974, 1.16 in 1975, and 1.5 last year.

So, we are about 2.3 million housing units short of where we should be. We have a backlog to move on. Now, a great deal of that is publicly assisted housing in which the Government policies can make them effective if we act on them.

We have calculated that simply using the Brooke-Cranston program, the tandem plan, that we could provide with two jobs a unit, 170,000 units at $544 million in outlays, over 2 years, over the coming 2 years, or 340,000 jobs.

That is on Brooke-Cranston alone.

That's authorized, available, ready to go, and it doesn't take any significant action except some adjustment of the law which we can—I am sure we can get through the Congress in a matter of weeks, if not days.

Then, section 235 is available. There we calculate that we can get another 240,000 units, or 480,000 jobs, at a cost of about $4,000 a job.

Both of these programs are a great deal cheaper than either the tax cut route or the public jobs route that we have been talking about.

It is almost all in the private sector. The industry, construction industry as you know, is way underutilized, heavy unemployment, a great deal of vacant capacity, ideal area to move in.

Yet the administration for some reason has just turned its back on this. It is hard for me to understand. It is good to say you can come along with a program eventually.

As the chairman said at the beginning, you have done a marvelous job of coming up with any kind of program in the 10 or 12 days you have had in office.

I do think this is something you should look at and something you can move on right now and will in no way handicap housing in the future.

In fact, I think it will help it.

Mr. SCHULTZE. Senator, as I understand it, we are not talking about a delay of 2 months, 6 months, or a year. We are talking about the 1978 budget revisions which the Carter administration will submit to the Congress, I think, on February 15.

Mrs. Harris is currently having discussions with OMB on presenting a program in the assistance to housing areas. We are not talking about waiting until next year.

Senator PROXMIRE. The banking committee is going to meet—and this is the Senate banking committee—tomorrow to recommend to the budget committee what we can do with what is left of this year, this fiscal year that we are operating in now in terms of housing, and housing authority.

In talking with the staff last night, we concluded we can do a great deal of this this year. Much of it will be next year, it is true, in 1978. I think you are overlooking the opportunity for a great deal of stimulus at a low cost in the area where we badly need the houses.

I hope you will take another hard look at it.

Mr. SCHULTZE. All I can say is we are.

Senator PROXMIRE. Yes. Well, see what gives me pause is that you talk about whether this is about the right balance in terms of inflation, in terms of moving too fast, expanding the economy too much.

I calculate by the right kind of action in the housing area you will get as many jobs as in the entire package we talked about so far.

In other words, you get about 850,000 jobs on the basis of what is available now and what we can easily move on over the next 2 years; and you, as I understand it, would plan about 850,000 jobs in the $31 billion package, tax cut, and jobs program.

Mr. SCHULTZE. Those 850,000 jobs are the positions in public service employment and CETA training programs. That is where that 850 comes from.

Not all of those will be net new jobs. There is always some substitution. There is always—it won't be all additional reductions on unemployment, because you increase jobs, additional people come into the labor force.

If you look at the number of public service job slots—I don't like the term "slots" but that's the only one I can think of—and training, it comes to approximately 800,000.

I don't have the exact number.

Senator PROXMIRE. The reason I am bringing this up now is I fear there is a feeling on the part of some people who look at the superficial figures, that in the last 4 months of 1976 that they were good for housing over all.

On a macro basis, you average 1.8, 1.9 housing starts on an annual rate for the last 4 months. If you go beyond those figures you find they are heavily concentrated in a relatively few States, in the South or the West.

No. 2, you find these are very expensive houses. They average about $50,000 apiece. Seventy-five percent of Americans are pretty much priced out of the new housing market.

This is the area where with a relatively modest action in these various programs I have mentioned here, 235 as well as 236, tandem plan, and so forth, we can get results, we can get houses built, make them available to people who otherwise wouldn't buy them.

Mr. SCHULTZE. The administration came in on January 20 with a host of alternative assisted housing possibilities open to it; sections 235 and 236, tandem, section 8, et cetera.

Again, Mrs. Harris is reviewing that. There will be proposals in the budget amendments coming up on February 15. That's essentially what I have said.

Senator PROXMIRE. This is so timely, because as I say we do meet tomorrow. Recommendations have to be made. I am talking about the 1977 fiscal year that we are in right now.

We meet a little later, a few weeks from now, for the 1978 fiscal year. Will you ask for the $5 billion tandem money to be appropriated?

It is authorized. Will you ask for that?

Mr. SCHULTZE. I don't know the answer.

Senator PROXMIRE. It would make it easier for us if you did. There might be a question of whether the Congress would do it. It is so logical if you do.

As I say, we need the houses. It is an efficient program. It is worthwhile.

Mr. SCHULTZE. I think it does have to be carefully evaluated as to which particular instrument one uses and how you have to change those instruments.

For example, there is now $2 billion worth of tandem money out which hasn't been claimed.

Senator PROXMIRE. Yes. We have to make changes in that. We also have to provide that HUD gives a deadline, use it or lose it.

They will claim it. If you say if you don't get this, you will lose it.

Mr. SCHULTZE. That also poses problems. You are quite right, sir, but that poses in turn some problems. My only point is there is no use coming up here and submitting flat another $5 billion in the tandem plan when you have $2 billion sitting there.

You have to look at it: How good is that compared to other measures?

What changes will have to be made in it if you do want to use it? It is not something you can do in 7 days. I don't want to prejudge what the response is going to be.

All I am saying is that is the kind of thing that has to be evaluated.

Senator PROXMIRE. I have additional questions.

I will get to those later.

Representative BOLLING. Congressman Moorhead.

Representative MOORHEAD. Thank you, Mr. Chairman.

I also want to welcome Mr. Schultze back here in an official capacity.

Nothing could please me more than to see you part of another administration team. I have such high regard for what you have done in the past administrations. I am very hopeful and confident that you will continue to do that in the future.

Second, I want to say that I agree entirely with your overall trust that we better not lock stimulus into an economy because while I think in point of priority, stimulating the economy is No. 1, in the long range I think inflation is something we—we and all particularly democratic countries—have got to look out for.

So, I agree with your thrust.

I am, however, concerned with whether you have enough stimulus in the short run, whether you have taken into account the economic effect of this dreadful winter that we have had, where people have been laid off because they can't get fuel at a much higher rate than I think was anticipated just a few weeks ago and where even without price increases in fuel, people have had to spend more money just to stay warm.

I wonder if this tax rebate won't go, A, just to pay off back bills, and, B, to rebuild savings that have been depleted because of these unusual expenses. That we are actually going to end up with, because of circumstances really beyond our control, no real stimulus at all?

Mr. SCHULTZE. Well, in the first place, we have a team—I guess the best I can say is crashing in terms of trying to figure out the longer term impact of the cold weather.

Representative MOORHEAD. I think you should do the shorter term impact first.

Mr. SCHULTZE. When I say "longer term" I mean over 6 to 8 months.

Let me look at two or three different impacts and what you have to do to evaluate them.

I think you do have to distinguish between the very short-term distress and what you do about that distress. From those changes in the longer term economic outlook—and by longer term I mean by the end of the year—which have relevance for making overall economic policy.

It is to the latter I am turning. What are the lasting—6 to 8 months—lasting effects of the cold weather.

It seems to me you have to look at three things, none of which we have a firm fix on.

We are trying to get it and keep up with it.

First, your point that consumers will be spending more simply to keep warm, both by way of burning more fuel and in the case of emergency gas sales, paying out more for the fuel they get.

The first stab at an estimate we made said that might range between $2 to $5 billion, depending upon whether the cold is over quickly or extends.

I might have to widen that range. That is our first stab.

Second, what are the longer lasting effects of plant closings?

Obviously, you have a large number of plant closings. If they do not last too long, there will principally be a rundown in stocks so that workers will lose income, being laid off, make up some of it with unemployment compensation, and then make up by way of overtime as those stocks are built up so that if it is a short plant close-down—and I don't want to underrate the distress at all, but from a longer term economic effect, if it is short-lived, you make up in the stock building what you lost when stocks ran down.

We are trying to get a fix on that.

Finally—and again it is hard to get a fix on this—what will this do to the fruit and vegetable crops, particularly in Florida; what will this do to consumer prices, and therefore what impact will it have on the consumer?

You are quite right, we need to take this into account.

It is far too early for us to make a fix on it and say we need to change this package. You have to put that into the context also that in the last 2 months of 1976 personal income was increasing at a faster rate than anybody expected.

You are starting at a higher base.

How all of that finally comes out, I can't tell you. We are obviously alert to it, trying to sort these things out.

Representative MOORHEAD. I merely note that your stimulus seems to be $15.5 billion for fiscal 1977, $15.7 billion for 1978.

We know we are in dreadful shape economically in fiscal 1977 because of this winter. We don't know about 1978.

If anything, I would suggest that even though we have a shorter period of time to deal with, that the figures should be proportionately larger in fiscal 1977 to counteract these desperate situations, desperate economic situations.

Mr. SCHULTZE. As I say, Mr. Moorhead, we are clearly aware of that possibility, but we are also aware of the fact that what is relevant is for a measure which will pass and become effective and get out into the economy in April and May and into June, what's the impact of this weather on the second half of the year; and that isn't as easy as counting the number of layoffs we now have.

Representative MOORHEAD. One of the most significant tables that I have seen is table 1 in your prepared statement where you show that in all areas the recovery of 1975–76 is less than previous recoveries. But the most striking difference is business investment which is normally plus 5.3 and which now is minus 11.8; and it seems to me that we hear from business people that it is the inflation that is causing them to be uncertain about their investments and that $2.5 billion tax incentive for business is really minor as compared to if we could convince people that we have terminated what you very aptly phrased "momentum inflation."

Would you agree with that, sir?

Mr. SCHULTZE. I agree that would be very useful.

I think there are other problems, but that would be very useful.

On the other hand, terminating inflation is a thing much to be desired and hard to do, precisely because it is momentum inflation.

It is something we really have to work at. Quite frankly, it is something that if we don't get voluntary cooperation on, we are not going to lick it. It is not the kind of thing that overall economic policy can sit on.

In my judgment it is not the kind of thing that wage and price controls will handle. It is one of those areas where if American people want to get rid of momentum inflation, the American people are going to have to cooperate in getting rid of momentum inflation. It is going to require voluntary cooperation. It is going to be very difficult. I agree with you, but it is very, very difficult to lick.

Representative MOORHEAD. It seemed to me that in your testimony, in your prepared statement, you directed most of your attention to starting at the beginning; and, you eliminated it from your oral testimony.

I know the committee appreciates the fact that you didn't complete all of it, but I would hope that that does not mean that you downgraded in importance the various steps that you have taken to inspire voluntary cooperation on the part of American business and working people.

Mr. SCHULTZE. As a matter of fact, the thought that ran through my mind as I decided to cut off at that point, I hope the committee doesn't think I didn't consider this important.

Representative MOORHEAD. In the matter of the hardships that are connected with the—particularly with the plant closures because of the cold, as I understand it, the unemployment compensation extended program terminates March 31. In view of these changed circumstances, do you believe that we should extend that date?

Mr. SCHULTZE. This is again another one of those areas where the administration is in the process of coming up with a very immediate recommendation to the Congress. I would presume—I guess I have to use the word "presume" correctly at the moment there would be some extension, although precisely in what form, what kind, what modifications, I don't know.

Representative MOORHEAD. The other thing that I would suggest to you, sir, that is along the lines Mr. Reuss said about the public works programs, from personal experience I can tell you that the city of Pittsburgh has plenty of public works programs ready to get started immediately; and under the previous public works programs, as allocated by the previous administration's Economic Development Administration, the city of Pittsburgh and a number of other larger cities. with a far-above average unemployment, received nothing in the way of benefits under public works. I would hope that any new program—and I might say neighboring suburbs that are considered wealthy and well to do, with a higher income, did receive public works. I would hope that the new administration would either recruit, as I think it is perfectly permissible to do under the past law, or would come up with new formulas for the Congress so that we won't have this absolutely ridiculous situation of public works money not going to the needy areas and going to the not so needy areas.

Mr. SCHULTZE. One of the problems is the so-called 70–30 formula in that law. Mrs. Kreps is working with the relevant committees to try to get that changed in the right direction. There is in the law a formula which to some extent is responsible for that.

Representative MOORHEAD. I realize that, but I think within the 70 there was plenty of leeway and discretion—to where the law said you can consider employment—unemployment in neighboring areas. Well, you can consider it, but you don't have to give it as much weight as they did. I hope we could, (A) change the law; and (B) change the administration thereof.

Thank you, Mr. Chairman.

Representative BOLLING. Mr. Hamilton.

Representative HAMILTON. Thank you very much, Mr. Chairman.

Mr. Schultze, we are pleased to have you before the committee. I read in the morning press that the chairman of Ways and Means Committee and the ranking member of the committee have agreed on a particular program. As you can appreciate that doesn't happen every day in economic policy. They have agreed to put forward an employment tax credit proposal.

The stimulus package that you have put forward, as I understand it, has a proposal to give business a choice between two tax cuts, but I would like to get your reaction to this employment tax credit proposal. It seems as if this proposal that Chairman Ullman has made may have some momentum behind it in the Ways and Means Committe and that you may at some time be faced with a decision as to how you would respond to it.

Can you give me your reaction to it?

Mr. SCHULTZE. Yes, sir. I think a Treasury spokesman summed it up well as kind of "friendly doubt."

While I don't know the details of the proposal, basically it would provide something like a credit of 5 percent of the first $5,000.

Representative HAMILTON. I think it is the first $4,200. That's the way the press reports it.

Mr. SCHULTZE. In which case, for the kind of economic recovery we are thinking of over the next year that would then, in that case, if it's $4,200, would be something like $2½ billion in costs.

I think there are several problems with it. In the first place, businessmen hire workers for one of two reasons: Because they can sell the output that these workers produce in which case subsidizing part of the wage won't get you another employee hired. You are not going to get a loss of the remaining part of the wage if you can't sell the output. So this program would do nothing on that end.

The other reason that you might hire additional workers is to have more workers per unit of output. More workers per unit of output lowers productivity. In the long run, if this is put in as a long-run program, it becomes a subsidy in effect for reducing the rate at which you adapt technological change, which over time in general increases output per worker.

This would tend to reduce output per worker. It is a negative incentive for development over the long run.

Representative HAMILTON. I think the proposal is perhaps to limit it to 1 year, perhaps 2 years; and as soon as you no longer need extra stimulation, it would be phased out.

Mr. SCHULTZE. Then in effect what this says to an employer, as I understand it, is—this is why I don't think even in the short run it would do much good—it doesn't increase sales and he is not going to hire somebody who can't sell the output. Only then if in the short run he could find ways of producing which would save him on capital costs, and pick up labor costs, would this work. I just don't think in the short run there is that much flexibility in business methods.

So with a subsidy to hire additional workers, unless your sales are going up, you aren't going to hire them.

Representative HAMILTON. I would like to get from you your general thoughts on an incomes policy.

You have seen some reports that the administration is interested in strengthening the Council on Price and Wage Stability. I would be interested in your thoughts as to how it might be strengthened. I know you have rejected, and the President has rejected, formal price and wage controls.

You have talked in interviews about the rejection of those controls and the necessity of being fairly flexible in whatever you do. I wonder if you could give us your thinking as to the Council and then also what your thinking is with regard to the development of an incomes policy.

Mr. SCHULTZE. Yes, sir. I think there are several things the Council can do more effectively.

First—and this really goes to a little bit longer term—to develop the capability, to look carefully at the demand and supply situation in very critical areas, particularly materials areas, so that we won't be running blind in the bottlenecks, that is, monitoring the whole supply-demand side in those critical areas, which is something the Council really doesn't do and is very critical, and we think can be done at a relatively modest cost.

The second thing that the Council or more generally the administration can do, I believe—I say I believe—and this we are now in the process of trying to work through, is to develop procedures whereby we can enlist the support of business and labor themselves in drawing up principles for voluntary moderation of wage and price increases.

One of the problems in the past has been the tendency to impose this sort of thing. Query: Is there a way, simply, without inviting a lot of rhetoric, that one can in the framework of a very specific set of price targets, a very specific set of principles, enlist business and labor in modifying those and suggesting them so that if, say, a business group suggests a given set of principles on price behavior, that they can see what its consequences would be so you can't make suggestions irresponsibly.

Or if labor suggests a given set of a broad criteria for wage behavior, they can see what the consequences are.

Query: Can we develop a framework within which to enlist cooperation in a way where everybody is kind of pinned down a little bit in terms of being consistent in their answers? That is not going to happen overnight. We are working on it very rapidly to try to develop procedures to do that.

Representative HAMILTON. Are you considering seriously any of the proposals to use the tax power as an incentive to keep prices or wages down?

Mr. SCHULTZE. Without wanting to say we have a closed mind on anything, we are not at this stage.

Representative HAMILTON. Can we expect a lot more jawboning from this administration than we had in the last?

Mr. SCHULTZE. We already had one instance of it reported in the Wall Street Journal this morning. We did have conversations with the chairman of the board of U.S. Steel with respect—in advance—with respect to his tin plate prices. Those prices came in significantly lower than recent steel price increases.

According to the Wall Street Journal, at least, they may be enough to cause—through competition—a rollback of aluminum prices.

Representative HAMILTON. I heard you talk before about the necessity of coordinated economic expansion in the Western economies and Japan. I wonder if as a result of the Vice President's trip you have any more of a feel of that situation and how it might develop?

Mr. SCHULTZE. I have not yet had a chance either directly or indirectly to talk to the Vice President with respect to the results of his conversations. As is clear, one of the top items on his agenda, particularly in Japan and Germany, was the discussion of their own stimulus package and urging cooperation, particularly among the three big powers in the economic area. The results of those, I don't know.

Representative HAMILTON. Do you expect there to be much decline in unemployment in 1978? In your statement you forecast unemployment as moving toward 6 percent. Can you be more precise on that?

Mr. SCHULTZE. Between six and six-and-a-quarter. I am trying deliberately to be reasonable and conservative in making targets and forecasts. In effect, it is our belief that this stimulus package when it percolates through the economy, given the kind of confidence we think it will engender, will set off both a sharper rise in business expansion and investment and will maintain consumer confidence; and if both of those happen, then a continuation of pretty healthy rates of growth into 1978 is possible. In all honesty, I cannot sit here and forecast with 100-percent accuracy that will work. That's our strategy. We think it will work.

Representative HAMILTON. You describe the present inflation as momentum inflation or inertia. When would you expect inflationary pressures to reassert themselves in 1978?

Mr. SCHULTZE. Barring—which is a very big qualification—currently unforseeable developments in the petroleum and food prices, we would not expect that the rate of expansion envisaged in this program would get us into the area where there are dangers of reigniting the old classical excess demand inflation. We would not envisage that at all.

Representative MOORHEAD. Would the gentlemen yield to me for a unanimous consent request? Mr. Chairman, I believe to make the record clear, that the article on the tin increase in the New York Times, which I have just read, should be included.

Representative BOLLING. Without objection, so ordered.

[The article referred to follows:]

[From the New York Times, Wednesday, Feb. 2, 1977]

U.S. STEEL TO INCREASE TIN MILL PRODUCTS PRICES BY 4.8 PERCENT

(By Gene Smith)

The United States Steel Corporation yesterday tested the Carter Administration's new policy of taking an active role in curbing wage and price increases.

The nation's largest steel maker, having conferred with Carter advisers, said it planned to raise its prices for tin mill products by 4.8 percent, effective March 13. The White House apparently had no objections.

The products are used to make beer, soft drink and other containers.

The White House acknowledged in late afternoon that United States Steel had discussed its pricing action in advance with top economic advisers and said that President Carter "is aware" that the increase was "lower than recent steel-price increases and is significantly below the 6½ percent rate at which industrial prices rose in 1976."

The White House statement added:

"The President realizes that the large rise in prices and cost over the past three years makes it impossible to reduce inflation to zero overnight."

COUNCIL DECLINES COMMENT

The Council on Wage and Price Stability declined formal comment on U.S. Steel's move. But a member of the council did say that "we thought they'd try for 10 percent."

Representative Robert H. Mollohan, Democrat of West Virginia, said the increase was "not unexpected in view of the rapid rise in the price of tin over the last year." He pointed out that high grade tin pricing has gone up nearly 55 percent since last January.

Mr. Mollohan, introduced on Monday a bill providing for the release of tin from the national stockpile as a method of restoring more stability in the domestic price situation.

In announcing its move, U. S. Steel said that over the past two-and-a-half years the costs of producing tin mill products has increased more than has been recovered by price action."

It added that the company was moderating its cost recovery "to demonstrate clearly that it shares the Administration's objective of reducing the rate of inflation."

NEGLIGIBLE EFFECT SEEN

U. S. Steel also reported that the price increase affected only one-half of one percent of its total steel product line and added that according to the weighting given to tin mill products by the Bureau of Labor Statistics, the effect on the Wholesale Price Index would be "an almost immeasurable one-hundredth of one percent."

Two of U. S. Steel's major competitors in this product, the National Steel Corporation and the Jones & Laughlin Steel Corporation, said they were studying the pricing move, while the nation's second largest steelmaker, the Bethlehem Steel Corporation, had no comment.

The increase in tin mill product lines had been long expected. In an appearance before the New York Society of Security Analysts on Dec. 3, Edgar B. Speer, chairman of U. S. Steel, had forecast price moves in tinplate "probably within the next 30 days," but he added that he did "not know what to do about tinplate."

The steel industry, led by National Steel and Jones & Laughlin, put into effect in early December an increase of 6 percent in the price of sheet and strip steel that accounts for almost 40 percent of the domestic steel industry's production."

Yesterday's announcement by U.S. Steel covered increases in the price base and base weight extras, while heavier tin coating extras were adjusted to recover "only part of the rapidly escalating cost of tin."

The increase was lower than generally expected by security analysts who had been forecasting increases in the range of 6 to 8 or 9 percent.

ALCOA INCREASED PRICES

Major steel companies last announced a price increase on tin can stock in November 1975 to become effective January 1976.

The increase averaged 8½ percent but was less on light weight plate, which competes directly with aluminum can stock.

When the aluminum companies did not take similar pricing action, the steel companies offer price allowances for quantity purchases. This reduced the price for beer and soft-drink cans below the pre-January 1976 level.

The Aluminum Company of America, the world's largest producer of aluminum, announced on Nov. 29, 1975 price increase of as much as 11.2 percent on the aluminum it produces for use in beer and carbonated beverage cans and specialty containers.

Representative HAMILTON. Thank you, Mr. Chairman.

Representative BOLLING. Senator Bentsen.

Senator BENTSEN. Thank you, Mr. Chairman.

Mr. Schultze, we are pleased to have you with us this morning. I would like to get into questions raised by Congressman Hamilton. That is the question of employment tax credit again.

I noted the administration's proposal is for a 4-percent credit against payroll taxes and that that could be a part of the stimulus package. Now, it works out, I think, to about a $24 credit per worker.

Frankly, I don't think that is going to call for industry to expand the number of workers or to hold onto workers.

Now, I introduced last year, and some time ago I started working on it, something somewhat similar to what Chairman Ullman has introduced, unemployment tax credit. I believe it would be an incentive to keep workers on a payroll. When times start getting bad, businessmen generally try to hold onto workers for a while because they are concerned about losing them and having to retrain new ones. They like to keep a working pool. I think this would be a carrot that would help.

When I read the Godkin series of lectures of yours, I was much impressed by it because you talked about incentives in the system to try to make the Nation's objectives the private objectives, in effect, to hold a carrot out there.

I think that does some of that. If you have a public service job that might cost $10,000 a year, often a dead-end job, often not adding much to productivity. The big problem we usually have in trying to fight inflation and unemployment at the same time is that they are counterproductive, they work against each other; but it would seem that with an employment tax credit that you have lowered the cost of production and in a competitive society that gets passed on to the consumer. It's a much cheaper way from a taxpayer's standpoint if you had either my proposal which was about $500 a worker or you had Chairman Ullman's proposal; but I think you ought to have a bearable base in there, where that incentive gets stronger as unemployment gets higher.

One of the big problems we have in this Congress is by the time we react, and we arrive at a consensus, and get through all the politics of it, the economic situation is changed and what we do is too late.

If we had a variable base in that thing, where it would take effect and the credit would get higher based on higher unemployment and lower and finally phase out as we got closer to whatever might be considered full employment, I think you would have an automatic control there in government that might be of assistance.

Mr. SCHULTZE. Senator, it is conceivable that during a period in which the economy was actually going down, and employment was actually falling sharply, that it might be possible to design some kind of subsidy to get businessmen to hold onto those workers temporarily until sales picked up. That is conceivable. What I was saying was in a period of expansion, which is what we are after, to boost recovery, that what is critical is getting those sales up and that businessmen are not going to hire additional workers and put them on their rolls if they can't sell their output.

Giving them a subsidy to put an additional worker on where they are paying him from 50 to 100 percent of the bill, you are not going to take the loss if you can't sell the output. I can conceive on the down side, when employment is actually declining, there might be a way to pay people to hold them on until sales came back up again. Once you have sales going back up, it seems to me you can't use that kind of an incentive to have that much of an impact.

Senator BENTSEN. Traditionally we have seen businessmen hold workers longer than they might, because they want to keep a trained worker.

Mr. SCHULTZE. That is one of the things that happens in a deep recession. In the earlier, mild recession they could count on sales snapping back quickly. It didn't happen this time. That has made it a lot worse.

My point would be with respect to that particular kind of incentive, it is not likely to work on the up side.

Senator BENTSEN. Let me touch on another point that was made earlier here concerning the public works division. As I recall the present counter-cyclical allocation, it is 70 percent based on those areas that are above the national average and 30 percent on those from 6 to whatever the national average of unemployment is.

This new bill that is proposed is supposed to meet some of these problems that were referred to by going to a formula of 85 percent and 15 percent. I think you get a very strong inequity in that kind of a situation, because when we are talking about public works jobs, and we get varying figures on this, we talk about $25,000 per year, and you have benefits that last far beyond the current problem of unemployment to that specific area. You can be building public works that may last 30, 40, or 50 years as in Buffalo, N.Y., looking at swimming pools that they had built back during the depression. You look at the Chicago waterfront, which was built back during the depression.

Now, to say that we are going to give those areas all of these funds with the long-term benefits, I think for taxpayers in other parts of the country you have a gross inequity. I can understand the counter-cyclical reasons when you are talking about public service jobs to strongly support that. You have an immediate problem and are trying to take care of the areas of high unemployment. To turn around and say you will spend $25,000 per employee and make a capital investment to last 40 or 50 years, and funnel all the taxpayers' money into those areas, I think you have inequities that ought to be corrected.

Mr. SCHULTZE. I realize that no matter how you do it, you can't do it perfectly. The counter to that is that what is also happening is that in communities whose unemployment has not risen very much, their revenues have stayed up and they are more able to go ahead with these projects on their own. Because of national economic unemployment, a lot of local areas with high unemployment have lower revenues so they can't put in the public works they would have put in themselves anyway. So kind of pushing as much as is feasible into the areas of high unemployment is also a way of correcting for those revenue declines that have been very sharp and very serious in such areas. It's not a perfect way of doing it, I realize.

There are bound to be some inequities, I also realize. If one is trying to strike a balance, it seems to me, putting more of it into the high unemployment areas does make some sense. Maybe not 100 percent, but moving it up from the current 70 does seem to make sense, realizing no matter how you cut it, it won't come up perfectly.

Senator BENTSEN. Well, I feel the inequities so strongly in that, that I am going to try to resist that percentage of long-term investment in those areas to the detriment of other parts of the country where the taxpayers who have to carry their own burden insofar as those public works.

Mr. Schultze, on your Godkin series of lectures, I was very much impressed with the fact that you, too, were concerned with the problems of overregulation and trying to answer all of these inequities and problems just by regulation, and that more incentives ought to be built in the system, or penalties built in the system such as a tax on pollution, for example.

I do hope that this administration will pursue that line of thought.

Mr. SCHULTZE. I hope so, too, sir.

Senator BENTSEN. Thank you very much.

Representative BOLLING. Senator Humphrey.

Senator HUMPHREY. Thank you, Mr. Chairman.

I am sure that a number of the questions have been asked. If I am redundant, you just cut me off.

I want to get on the energy——

Senator KENNEDY. What did you say, Senator? [Laughter.]

Senator HUMPHREY. Was that word beyond you, Ted? [Laughter.]

I want to discuss the natural gas shortage and its impact on the economy and the stimulus package. The reason I do is that there is so much conflicting information about its impact. For example, estimates of the number of unemployed varies, the Federal Power Commission estimates 549,000 people out of work; the "Today" show this morning estimates 2 million; the UPI figure is 1.6 million to 2 million; and, the duration of the unemployment is also a matter of uncertainty.

I hope we will be able to get the Bureau of Labor Statistics to give us some more positive information because this will have a very important bearing on what the economic stimulus package can do or will not be able to do.

Let me just discuss the weather situation and its relationship to the effectiveness of the economic package. The Congressional Research Service of the Library of Congress has made a study. I asked them to do so. They gave me a preliminary report on January 21, which I placed in the Congressional Record. Their preliminary estimate given at that time was that the increase in fuel costs because of cold weather will be approximately $5.1 billion. I see that today you have testified that you feel that the increased costs will be around $5 billion.

Mr. SCHULTZE. What I said is it would range from $2½ to $5 billion depending on how long the cold weather lasted.

Senator HUMPHREY. The CRS, in the final draft of their study of January 21, which I want to present to you so you can give it your own analysis, and for your own consideration, estimates that the increase in the total residential heating bill for the winter of 1976–77 from the winter of 1975–76 will be approximately $8 billion; and if you add to that the factory shutdowns that may stretch as far as into April in some instances, due to fuel shortages, another $1.6 billion in wages will be lost as well.

So they say that the impact of the bitter weather that we have had will be approximately $10 billion on the economy. Now, if they are anywhere near right, $10 billion is an awful blow.

It seems to me then that the administration has a very serious matter on their hands because you have to give us some solid figures very soon because of the budget resolution. We don't have very much time. The Budget Committee has to make its report on a third resolution next week.

I would suggest that there's a matter of some urgency here. Otherwise the Congress will find itself in a very difficult situation. Once the Budget Committee has set these figures by concurrent resolution, we are more or less locked in. Our timetable doesn't permit us the flexibility that we used to have.

Mr. SCHULTZE. I understand the problem, Senator. As I indicated earlier in a colloquy, I think, with Mr. Moorhead, there are two parts to this. One is the additional amount consumers are paying out on account of higher fuel bills.

Senator HUMPHREY. Right.

Mr. SCHULTZE. That would depend on how long the weather lasts. As I say, our numbers are between $2½ and $5 billion.

The second one is more difficult. What we are after is the longer term impact of this. That is in terms of economic policy we are looking for the impact as it hits you in the third and fourth quarters of this year. In turn, depending upon the length of the shutdowns, if the shutdowns are short, businessmen will draw their inventories; when plants go back to work, they will build up their inventories. The working time lost on the down side will be made up on the up side as those inventories are put in; and the net loss, for a short shutdown, the net loss over the period, turns out not to be large.

If, on the other hand, the shutdowns are longer and inventories run out, you can't run them down any further; you get a different answer. I am not waffling. I am simply saying it turns out when you dig into this, it gets very difficult not only to say how many people are unemployed at the moment. As you indicated, there are all kinds of estimates floating around.

More importantly, for the purposes of making economic policy, what is the cumulative impact of the shutdown and the buildup. That is what we are trying to figure as fast as we can.

Senator HUMPHREY. On the rebate, if the CRS study is anywhere near accurate, it will be about 70 percent of the proposed tax cut and more than 50 percent of the entire fiscal stimulus package for this calendar—for this year.

Mr. SCHULTZE. Yes.

Senator HUMPHREY. Of course, the weather conditions may reduce the effectiveness of the economic package. Now that package was conceived in the months of November, December, and early January when the conditions were considerably different than they are now.

For example, the tax rebate will have no economic effect of any consequence in my State. We have had the coldest winter on record. And the heating bills will consume—the increased costs of fuel in the State of Minnesota will consume all of the tax rebate. There isn't going to be any stimulus there. That is just a matter of paying for propane, gas, oil, coal; that's it.

There has been incredibly bad weather in Minnesota. Of course, that is true of many other parts of the country. Therefore, I do think it is important that the administration take an immediate look at whether or not this package is going to do its job.

I will tell you why: There are so many hopes involved in it. If the package is not big enough, and does not achieve its goals it destroys the credibility of those who recommend these economic packages. I just came from the Public Works Committee. I happen to believe—and you know this—that there should be more job creation—more money in the job-creating type of activities. I have always looked upon public works as someone said here a moment ago as an investment, not as a boondoggle, or pork barrel, which is a cheap shot.

In the little town in which I live, the best things that we have were built by WPA. The roads, the village hall, the fire hall, the dams that made it possible for us to have two fine lakes as recreation areas, were built by WPA. They were all called boondoggles at that time, I remember. The local editors always used to raise Cain about those WPA'ers. But we are not talking about WPA now.

We are talking about public works, with 20,000 projects right here in Washington cleared at the local levels of government; all have the seal of approval by city councils, water and sewer districts, school boards, et cetera. They are ready to go—not in 90 days, but actually in 30 days.

The EDA people tell me they can get $2 billion worth of projects underway within a month, and another $2 billion dollars worth of projects in another month, over and above what has been recommended.

The administration recommends a $4 billion package for 2 years?

Mr. SCHULTZE. Two and then two.

Senator HUMPHREY. Two and two?

My own judgment is that there is not enough in that package for job creation. It has, of course, other funds for public service jobs which is a temporary measure. It is inadequate in terms of youth unemployment. You know my feeling about that. I would be derelict if I didn't express them again. About half of the unemployment in this country is youth unemployment; and I think that this administration should be able to come up with a program to put these young men and women to work in this country.

Mr. SCHULTZE. Senator, let me call to your attention the fact that in the first week of this administration's being in office the recommendations in this program in the area of the CETA training programs boosts that budget by 50 percent.

Senator HUMPHREY. For youth?

Mr. SCHULTZE. It is 50 percent in the total, a very large part of it devoted to youth. My hunch would be the percentage increase for youth is much higher than that. The total is up 50, with different components. There are moneys in for migrants, Indians, veterans. That is a very substantial increase. Of course, it's not the be-all and end-all of this administration's programs in the manpower and youth training area. It is our initial crack at it. It's a very large amount.

Senator HUMPHREY. I want to give you the copy of the CRS study. I will see that the staff presents it to you. I will come back and discuss with you some other studies that we have had done.

Representative BOLLING. Senator Kennedy.

Senator KENNEDY. Thank you, Mr. Chairman.

I know Mr. Schultze has been warmly welcomed but I, too, want to extend congratulations to him for his new responsibilities, and to welcome him back to this committee. I have been in the U.S. Senate for 14 years and have been there at a time when he was the counselor to Presidents and distinguished scholar at Brookings and I think all of us on this committee and other committees have benefited tremendously from his information and advice, and I think the country has benefited from his public service.

We are delighted with President Carter's selection. I just want to join in welcoming you here to the committee.

Before going into some other areas, I would like to continue the point that Senator Humphrey mentioned about the public works program. All of us received the recent announcement by EDA on the grants to various States—my own State received about $5 million, which makes it about the 11th State in terms of monies received for the amount we pay in. We have $643 million requested by mayors and communities all over that State. We had $20 billion requested nationwide, when only $2 billion was available. I cannot underscore strongly enough the feeling of the mayors in these local communities about their need for those resources. These projects are good programs. We know the President's recommendation will be $2 billion as I understand it in this fiscal year, and then $2 billion in fiscal 1978.

Now, I know this was debated within the administration in terms of the proper mix of programs. Mr. Marshall was asked about this extensively during the course of his confirmation hearings. Let me just read this—when asked about this question, he said, "The point I want to make is that in my judgment, in public works, we do not face the administrative constraints we face with training for public service employment. Therefore, I would have opted for a much larger package of public works than we got in the package and for a smaller tax cut."

That is the relevant testimony. He was queried about this at considerable length. Given what we have seen in terms of our regional needs, we know the value and the benefit of these programs desired by Mr. Marshall. Given the burdens on the economy, it seems to me this ought to be an aspect which is reviewed again, in the hope of making an increase.

Mr. SCHULTZE. Well, let me point out that the reasons for picking what we picked are thus: the total program now, counting the $2 billion that has just been gone out from the early part, plus $2 billion more, you have $4 billion going out now and $2 billion in 1978, total State and local construction, even after the decline which has occurred is $30 billion a year.

I venture that any smart State and local finance officer—if he has a list of projects and has a hundred percent Federal grant, is going to put some of his own projects in first and tag the new one on the back of the line. That won't happen very much if you have moderate—moderate, not huge and not small—but moderate additions. If you go to very large additions, what you will find is you are basically adding the construction in the years 1978, 1979, and 1980 at a time when the economic situation is likely to be substantially different. We do think public works are a good idea. Altogether, counting the $2 billion the Congress approved last year, we are dealing with a $6 billion public works program.

My point is if you push it up too far and too fast, no matter what the accounting statistics are going to show, you are going to find a substantial point and what you are really getting is projects that are going ahead anyway $30 billion a year.

Senator KENNEDY. Mr. Schultze, if you review the situation in Massachusetts, we didn't have one project grant west of Worcester. In Bedford, I don't think they got a single grant. They would have been next on the list. If you had gone to $60 million they would have had funding. We are not talking about communities receiving their top three or four priority grants filled. We are not talking about marginal grants.

There are important needs for communities and towns in the States that are not being met. We aren't talking about the second level or the third level in terms of the quality of the programs or their importance.

Now, if I could move into another area, one of the things President Carter mentioned during the first debate and during the course of the campaign was the issue of tax reform. In the first debate, he talked about the repeal of DISC and tax deferral. That would mean $1.5 billion in increased revenues. We came within one vote in the Senate of repealing deferral. We had substantial support for repealing DISC. Why not add those two elements to the package?

Mr. SCHULTZE. Well, the judgment that was made—I think correctly—again people can obviously quarrel with it—that what you wanted for an economic stimulus package was something that would be immediate, would not involve the hairy questions of tax reform; and what we ought to do—not as to weight. Secretary Blumenthal has already gotten his people working. He will be prepared to start talking with the Congress in the not too distant future on this, but to separate out—and I think rightly, the question of tax reform from what we need to get this economy moving again.

Senator KENNEDY. I agree with the general point. We debated tax reform for 7 weeks last spring here. You are very familiar with the complexities of general tax reform. But it seems on these two matters, where the President has stated his views strongly, and where Congress has already been active, we could move now.

Mr. SCHULTZE. I don't want to pose as an expert on DISC. I also don't want to give the impression I like it either. I also don't want to pose as an expert on what can get through the Congress in a hurry. I am the last one to pose as an expert on this. I had not thought this was so uncontroversial that it won't complicate the package.

Senator KENNEDY. In a third area, I would like to have your own assessment of 1975 experience on the stimulus provided by the rebate. How much was saved? I read your excellent article in the Outlook section a week or so ago, and you talked about this just briefly.

That is a matter of significant controversy. I wonder if you can just elaborate a bit on your own conclusions?

Mr. SCHULTZE. Yes, sir, let me start with two facts—three facts. The rebate part of that tax package in 1975 was, I think, about $7 billion in a consumer spending pattern of a trillion. So, it is very difficult to try to say, disentangle the effects and say I can prove to you conclusively what happened.

However, there have been several fairly careful studies using econometric techniques which in effect treated the rebate like any other form of income and tried to predict what would happen to consumer spending. Then, you observe what actually did happen—lo and behold—consumer spending behaved very closely to what would have been predicted if you assumed in these models that the rebate was like any other form of income, of which a very large fraction is spent. That is what happened. There is no conclusive proof. None of these econometric models are that precise.

But it is an indication. People do spend the money. If people lose $3 or $4 thousand of their income, or get a $3 or $4 thousand huge windfall, they do treat it differently. A couple of hundred bucks, they don't.

The second point, the first year of this recovery was actually quite good. Consumer spending rose quite rapidly in the first year. The economy rose quite rapidly in the first year compared to other recoveries. Our problem was not that the first year recovery was bad or that the rebate didn't work. The problem was too much one-shot. It wasn't enough. That is the reason we are back in now with an additional stimulus extending over two years. I can't tell you in all honesty I know precisely what happened to that rebate, but the thing is it was heavily spent.

Representative BOLLING. Congressman Reuss.

Representative REUSS. I just have one question about international economics. Last year in 1976, we had a trade deficit of $6 billion or more and the prospects are for a continued trade deficit this year. Are these deficits good or bad for the United States and for the rest of the world? That is to say, should American policymakers be concerned about the trade deficit and should we do anything in particular to try to diminish them?

Mr. SCHULTZE. At the level at which it now exists, I do not think we should be concerned about it. For the world as a whole, for the world as a whole—I am sorry, the oil-importing world as a whole, the very fact of the OPEC surplus of $40 billion a year means there must, by arithmetic, sheer arithmetic, be a deficit in the rest of the world.

If the strong countries like the United States, Japan, and Germany do not bear their share of it, in a sense, it puts both an unfair and unbearable burden on the rest. Therefore, within limits, I don't want to be tied down today in the sense I know what those limits exactly ought to be. I would not consider that a matter of great concern.

Representative REUSS. I am glad to hear you say that. Couldn't you also add to what you said that if you have a trade deficit, that means you are importing more than you are exporting?

Mr. SCHULTZE. That is correct.

Representative REUSS. And if you have indemic inflation since as we seem to have, it isn't a bad idea to have a few extra goods around to sop up purchasing power?

Mr. SCHULTZE. No. And it is also true that even with our disappointing recovery, we were ahead of many other countries which automatically tends to push imports up somewhat more than exports.

Representative BOLLING. Senator Proxmire.

Senator PROXMIRE. I am sure you know my great respect for you so I am sure you will understand it if I say I am somewhat disappointed in what you say this morning. I am disappointed in that this is not a complete economic report. It is an explanation of the stimulus package. I understand, of course, how difficult it is when you come in with only a few days in office. But it contains no discussion of the international sector, no forecasts for fiscal year 1978, does not address the attempt to revise the full employment estimate from 4 to 4.9 percent which the administration decided to do about the last day they were in office.

I would like to know when you expect to make a full economic report of the kind that we usually get from the Council when we have these meetings. As you know, you are our principal expert from the administration; and we have to make this—file a report for the guidance of the Budget Committee, among others; and they have to go to work within a short time after that on what they expect to do for fiscal year 1978. We don't have much in your statement to guide us on that.

Mr. SCHULTZE. No, sir, you don't. At least in some areas. I can respond to some of those areas.

First, let me note that we thought it was more important—and I think we are right—to have before the Congress—whether you agree with all its details—an actual explicit economic stimulus package rather than an economic report. I think this first will do more good for the country than the second.

Second, we do plan to review—I just read last night for the first time carefully the working papers behind it, the old Council's new estimate of potential gross national product, full employment GNP. It has two elements in it. One—on the basis I think of some fairly careful work, it comes to the conclusion—which I think is correct—that as we see it in the immediate period, the long-range rate of growth of productivity in the American economy has slowed down somewhat. It doesn't mean it is inevitable, but it has. I think that has to be recognized without wanting to buy onto the particular estimate made by the outgoing Council.

The second element of that reduction in the full employment GNP was an increase in the unemployment rate at which you calculated it. That is a separate matter that we would want to look at carefully. I can't say that we have come to the point where I can tell you now that that estimate ought to be changed by X or Y. We do intend to look at it very carefully.

With respect to turning out a minieconomic report, in effect, in all honesty I think we will have to make a judgment as to where our limited resources can best be turned in the several weeks ahead.

In my own judgment—and I have a lot of my people working on it now— a good up-to-date and accurate estimate of the economic impact of the cold weather is so terribly important it ought to come ahead of anything else. I must admit it does take manpower to do that.

Senator PROXMIRE. Let me ask you just a couple of general questions, then. On the basis of the proposals you made, would you say that 1978 will be a year of strong growth and declining unemployment? You said the unemployment rate should fall toward 6 percent in 1978. Could you be more precise than that?

Mr. SCHULTZE. I think I said in answer to a prior question, we would say somewhere in the 6 to 6.25 percent range. Our best way to phrase the outlook for 1978 is the following: We believe that the economic strategy behind the stimulus package will work. That is that we can set in motion a self-sustaining recovery. We don't have to keep coming back year after year with a stimulus. If you look at the numbers and the U.S. economy, you can't avoid saying that is going to happen if and only if—if and only if—two things— there are a lot of things, but two big things—business investment picks up strongly—it has been very weak, and consumer confidence remains fairly high.

We believe there is a very good chance that that will happen. If it does happen, then we ought to be able to sustain a good rate of growth through 1978. I can't guarantee you it is going to happen. We will be prepared to come back and recommend action if it doesn't. I think we have to proceed on that reasonable set of assumptions, and we are.

If you are asking me if I can give you a point forecast with 100 percent, or 80 percent accuracy, no. That is the strategy, and I think it will work.

Senator PROXMIRE. I heard you say you do not think demand pressures will exert an inflationary impact on the economy in 1977. How about 1978?

Mr. SCHULTZE. Same answer, sir.

Senator PROXMIRE. Let me ask you this: I know the details of your 1978 budget proposals are not available. Once they have become available, can you supply for our records estimates by quarter, if possible, of the full employment budget to the end of fiscal year 1978?

Mr. SCHULTZE. We can give you an estimate of the full employment budget based on the old and on the new calculations, but I don't want to say within a week or two——

Senator PROXMIRE. Can you get them by the end of the month?

Mr. SCHULTZE. That isn't my point. We can give them to you on either of the two, in fact, both of the two. The old and the new. I don't want to be forced to make a judgment as to whether that new one is right or not in that period of time. We need a little more time to review it. In terms of two ways, the old one and the new one, I think we can get it to you fairly quickly, as soon as the budget estimates are made.

Senator PROXMIRE. We want it primarily on the old one.

Mr. SCHULTZE. I think we can do that, sir.

Senator PROXMIRE. You told us at your confirmation hearing before the Banking Committee that the way the CEA would primarily differ from its predecessors is that you would meld foreign economic policy and domestic economic policy and be concerned with the interplay between both and work on both. I asked you at the time as I recall whether this would mean that you would have an expert on foreign economic policy as one of your colleagues on the Council. Now, you have made two recommendations of two able people, Lyle Gramley of the Federal Reserve who is a monetary expert, that has been his total experience in the Federal Reserve Board, and William Nordhaus, who is an expert on almost everything except economic policy in international economics. What happened?

Mr. SCHULTZE. Nothing happened. In the first place, Mr. Nordhaus, in the area of international energy policy, has done a lot of work. He did a lot of work. In the area of international monetary policy, no.

Mr. Nordhaus is one of the most outstanding young economists in the country. His background across the board is very good, and his ability to pick this up quickly is incredible. With the background he already has in the area, those he does not have he will pick up quickly. I assure you, be an outstanding Council--make an outstanding Council contribution in this area.

Senator PROXMIRE. Well, I hope so. I do think that that is a problem in view of the fact that you yourself said that would be the principal distinguishing element.

Mr. SCHULTZE. I hope I am remembering what I said correctly. I think what I said—and certainly what is most important—is not even primarily that the Council per se makes more contributions in this area, but that administration, economic policymaking, will in all its aspects try to join the other domestic and international. This is not just the Council. It is the administration's overall policymaking apparatus. If you look at the people who are coming on board in this area, they are about as strong as you can get.

Senator PROXMIRE. Prior to taking office, President Carter said his goal was to get unemployment down to 6.5 percent, 6.5 percent by the end of the year. Now, you are fudging that. You are making it 6.7 or 6.9 percent. Why has the President retreated from this goal so quickly?

Mr. SCHULTZE. What we have done is make an estimate of what we think is, on a conservative, careful estimating process, the path that we think we can achieve, and those are the numbers we have given you.

Senator PROXMIRE. I just have one more point. Again, I want to go back to housing. I do think this is something that is a serious omission from the economic package that you have put together. Let me say that the $5 billion in budget authority needed for the tandem plan translates into only $400 million in outlay. That is because, of course, there is a long-range element here. That $400 million could create a 125,000 to 140,000 new homes and 250,000 jobs that would cost about $1,600 a job. Doesn't that seem to be a far less costly program than almost any other that you could suggest?

Mr. SCHULTZE. I don't know, sir. It depends upon how many of those houses are additional to what would otherwise have been built and how many are simply people using the cheap money for the higher money.

Senator PROXMIRE. Exactly. That is why the way this program is handled is so important. That is why it is important to insist upon income limits. The tandem plan today, the average income of people buying houses under that, is something like $21,000. Those people buy houses anyway. I am talking about people with an average around $14,000, $15,000, or $16,000.

You are right. You have to provide other elements here.

Mr. SCHULTZE. That is why you need to put it together in a carefully conceived package. Exactly right, sir.

Senator PROXMIRE. My time is up.

Senator HUMPHREY [presiding]. Congressman Moorhead.

Mr. MOORHEAD. Mr. Chairman, I will limit myself to one question. I want to distinguish between the Public Works program and its formula where Senator Bentsen has asked you questions, I have another side. On the countercyclical program, which is different, which doesn't have the long-range effect, are you satisfied with the distribution formula; funds can go to areas with unemployment rates as low as 4.5 percent. As the overall unemployment rate comes down, won't this mean that more and more of the money is going where it is least needed; and have you given any consideration to recommending revisions in the formula?

Mr. SCHULTZE. We seriously considered it until we looked at the numbers. It turns out cumulatively to date of the money that has been distributed, of areas with unemployment rates under 5 percent, they got zero percent of the money. Areas under 6 percent got 5 percent of the money; 95 percent of the money went out to areas above 6 percent. This cumulative distribution may be a month old by now, but fundamentally we then said the game isn't worth the candle. Logically, it probably does make sense to push that up. But when you look at the way the formula is written, that business of being able to get it over 4.5 percent really put very little money into areas with low unemployment.

Representative MOORHEAD. I would agree with you that that is the result of when unemployment is high. As it declines down toward the point where, of course, the total funds will decline, you still think that we won't end up with more money going to areas where there is less need?

Mr. SCHULTZE. You will have some of that, sir. This program is one that phases out at 6 percent. It isn't as if you were pushing the whole thing down to 4.5. I can't deny there would be some share. It should not be large. We have to make a judgment as to whether to try to get a reauthorization of the additional moneys certainly and quickly or to take on a big fight. In looking at these numbers, it suggests that it wasn't worth it, even though the logic of your position is, I think, right.

Representative MOORHEAD. Thank you, Mr. Chairman. I have no further questions.

Representative BOLLING [presiding]. Senator Humphrey.

Senator HUMPHREY. I want to come back again, Mr. Schultze, to the figures relating to the energy problem in the country. I think this is a prospective Achilles heel in the economic stimulus package unless it is watched very, very carefully.

Recently, one of the aides at the White House indicated that they would have to have a couple of months to evaluate the impact of the weather on the economy and make whatever adjustments in the stimulus package as are necessary; but the fact is as I was indicating a little earlier that the Budget Committee will be reporting out the third concurrent resolution on fiscal 1977 in just a few days; and, therefore, I think it is imperative that there be something done by the CEA and by other offices, Treasury and OMB, on what, if anything, needs to be done in the tax rebate sector or other parts of the economic stimulus package. I don't think that it is going to be possible to just depend on a couple of extra months.

Mr. SCHULTZE. Not a couple of months, that is right, sir. We won't know enough about the weather and the plant close-downs to be able to come back in a couple of days. That is clear, sir.

Senator HUMPHREY. I wonder if there ought not to be some caveat at least on what you say to the Budget Committee so there is sort of a forewarning? If we don't have that, we really get locked in. The power of the Budget Committee is something that we have never dealt with before until the last 2 years, although I am glad that we have it.

Mr. SCHULTZE. I think that is worth considering, sir.

Senator HUMPHREY. I would hope that you would do that.

The other note that I have is on the countercyclical to which Congressman Moorhead was referring; and I only bring this up because of your previous commentary on it. I noted in 1971 when you testified before this committee on Mr. Nixon's economic package, and you recall 1971 surely wasn't a year comparable to this in terms of recession or unemployment or inflation, you then advocated a $4 billion program of countercyclical aid and made it clear that this should not be confused with revenue sharing. You also noted that as the economy would pick up, revenues would improve at the local levels and therefore, the countercyclical amounts could be reduced.

Now we have that law on the books. This committee actually made that original recommendation, and it was picked up by Senator Muskie and others. I joined with him. I believe Senator Kennedy did so also. There were several of us that got together and pushed that bill through.

But, you now proposed only $2 billion. So, my questions are, have you made any estimates of how much revenue, State and local government, will lose in 1977 and 1978 because of high unemployment? Have you estimated the extra costs that they will incur because of the incredibly bad weather? And, if you have done this, could you make such estimates and supply them to us?

I think that the rapid changes that took place recently are such that they necessitate not only very close monitoring but revised expenditure and revenue estimates on a rather current basis.

Mr. SCHULTZE. One thing I can note, Senator, there is a reason for the lower number which is that when you take the total package together, in 1978, there is about $7 billion additional flowing through State and local governments by way of public works, public service, CETA, and the countercyclical revenue sharing.

Second, for reasons I must admit I don't fully understand, I am trying to look the numbers up in a hurry. But in the fourth quarter, the surplus of State and local governments took a very large increase. We want to be careful not to push so much money into that area that, instead of flowing out into the economy, some of it gets stuck and takes a while to go through. You have to be careful.

Senator HUMPHREY. I just put a little note of caution here that most of the States that I have looked at in terms of their budgets are now going to have to either advocate tax increases or sharp cutbacks because their budget surpluses have been eroded through the inflation and by increased governmental costs. This is very characteristic of most State governments.

Mr. SCHULTZE. No, sir. It is a statistic I want to look at more closely. It did surprise me that the surpluses of State and local governments in the National Council have been building up.

Senator HUMPHREY. Some of that is pension funds.

Mr. SCHULTZE. Even excluding that.

Senator HUMPHREY. It would be good to do. I am one that has basically supported your 2-year program and I think it is important for us to note that the administration hasn't come here with just a package for 1 year, but has come with some continuity over a period of 2 years; and, there, the package will have, I think, psychologically as well as economically, a more positive impact.

Yet there are so many eminent organizations and economists that are worried about the size of the package. I noticed a story in the Sunday Post in which a University of Michigan forecast predicts few improvements in 1977, even with a $13 billion income tax cut.

That forecast projects an average unemployment rate will be about 7.1 percent for the year; that is an unacceptable level of unemployment.

Chase Econometrics has recently done an analysis which attempts to take into account the current energy crisis.

They say that events have moved so rapidly on the cold weather front that our standard forecasts distributed only a few days ago may be out of date.

Then they indicate all of the elements of what they call the worst-case scenario.

I do underscore the phrase "worst-case scenario", but under that scenario they forecast a reduction in 1977 first quarter employment of 600,000, an increase in fuel bills of $8 billion, which is just about on target with the CRS report.

Again, it is all on the basis of projections of what people think the weather will be. They forecast that natural gas prices at the wholesale level will be up 52 percent instead of 34 percent during 1977; there will be a reduction of 200,000 housing starts, a $3 billion reduction in nonresidential construction in the first quarter of 1977; an inventory reduction of $15 billion, and offsetting reductions in other consumption areas of $1 billion in the first quarter and $4 billion in the second quarter of 1977.

There are a whole series of projections here by Chase Econometrics, which is a pretty good outfit. They indicate that the stimulus package may very well need to be changed and strengthened.

You know what Walter Heller has said. He is one of your old associates. He supported a $20 billion package for 1 year.

Mr. SCHULTZE. Although the package we have in effect comes out to $20 billion if you count it the way most people count it when they were talking 20—that is, we have what people were doing, saying we need a certain tax cut, a certain spending program.

You put our spending program and tax program together and it comes out to over $20 billion except by the time you build the spending up, you don't get it as quick as you get the taxes.

Senator HUMPHREY. That is the point. It is the jolt effect we were talking about. Paul McCracken supports a $24 billion package.

Reginald Jones came out calling for $15 billion tax cut for individuals, a permanent $3 billion increase investment tax credit, and $5 billion for Federal spending to reduce structural unemployment.

That is a $23 billion program. Of course, the AFL-CIO has made strong testimony and endorsed a $30 billion program.

Now, all of those were based upon conditions existing prior to this winter. I don't want to get all hung up on the basis of weather, but the projections from the meteorologists that we need to take seriously tell us that we are due for 5 to 6 or 7 more weeks of severe weather depending upon whether you are a pessimist or an optimist.

My point is that I think that the administration owes it to itself and to the Congress and the public to really evaluate—to re-examine these figures promptly and try to get more solid information on the unemployment figures, and better information on what is happening to State and local government finances.

Mr. SCHULTZE. That is what we are trying to do. What I say we are trying to do is translate that into its impact not just in the quarter it happens, but in the third and fourth quarter which is relevant to economic policy.

Senator HUMPHREY. Let me conclude by saying, Mr. Schultze, I think one of the finest appointments the President has made is yours.

My comments should not be taken out of context. I think what we are all trying to do here is to find the facts as best we can ascertain them and then make our proposals accordingly.

Representative BOLLING. Senator Kennedy.

Senator KENNEDY. If you are going to review the package, and given your own statement about a week ago that energy costs would be anywhere from $3 to $5 billion higher for consumers, is it going to be appropriate for us to assume that there will be an increase in the level of the stimulus?

Mr. SCHULTZE. No, sir.

At this stage I can't tell you. You have to remember that we have to put this together with all the other information we have.

For example, as I said earlier, the November and December personal income numbers were coming in significantly higher than had been anticipated.

We have to put all of this together. I don't know what it would lead to. We are going to stay flexible but I can't tell you what is going to come out of this.

Senator KENNEDY. Would it be correct for us to assume the stimulus would increase, if other things were consistent?

Would we expect the administration to make that recommendation?

Mr. SCHULTZE. The only problem is you have the other variables. They have already happened.

I can't tell you what is going to happen when we sit down and put this all together and see what is appropriate.

Senator KENNEDY. When is that? The House starts hearings on the President's package in a few days.

Mr. SCHULTZE. They are starting today over in the Ways and Means Committee.

Senator KENNEDY. They are supposed to take 10 days to 2 weeks?

Mr. SCHULTZE. Something like that.

I don't know the timetable.

Senator KENNEDY. We will have something, though, at least the basis——

Mr. SCHULTZE. I hope we will have a basis to give you a definitive answer as quickly as we can get it together.

Senator KENNEDY. One point in your earlier response to Senator Humphrey about the surplus and the number of communities, municipalities, if you look through those charts you will find most of those areas are areas with significant petroleum capacity.

Mr. SCHULTZE. That may very well be.

Senator KENNEDY. The obvious focus of the countercyclical assistance was in the higher unemployment areas, which were the petroleum consuming areas.

Let me mention a very important point in terms of the unemployment figures, which I am sure you are very much aware of.

In Massachusetts, unemployment has been going down significantly over the period of the last year. It isn't because of economic recovery, it is because people are going off the unemployment lists.

That has been a dramatic factor. We have gone from about 11.6 percent unemployment down to about 7.6. In the formulation of the stimulus as it relates to the unemployment figures, I would hope that you would work very closely with Mr. Marshall, who is sensitive to this point, to find out what the real unemployment figures are, so that the areas of the country which have had the most prolonged and persistent unemployment are not discriminated against.

A commission has been established to try to help us devise a formula to deal with this problem.

Mr. SCHULTZE. In my testimony I note that the particular way this recession has worked has particularly hit the Northeastern States.

Senator KENNEDY. On a few other items, on the problems of inflation, I think all of us have been very much impressed with what President Carter has indicated in trying to meet the problems of inflation and utilize the full offices of the executive branch.

The story in the Wall Street Journal reports that you, Burt Lance, the Secretary of the Treasury Blumenthal, and others, were in touch with United States Steel, with regard to the prices of tin products.

I wonder if you could tell us in that case, did you contact United States Steel or did they contact you?

Mr. SCHULTZE. They did first.

Senator KENNEDY Could you tell us how much they reduced their planned increase?

Mr. SCHULTZE. No, sir, except to indicate that I think the discussion made a big difference. At this stage, the last way to deal, it seems to me, with getting voluntary cooperation is to kind of give everything away about private conversations.

Let me simply say in my judgment it was a success.

Senator KENNEDY. Have you tried to do anything with the 11 percent aluminum industry increase?

Mr. SCHULTZE. Well, that's already been announced. The Wall Street Journal story today indicated that this United States Steel move may put pressure on the aluminum side because of the competitive situation.

Competition is great—the 11 percent in aluminum was an increase that had taken place some time ago.

Senator KENNEDY. Was there any jawboning on that?

Mr. SCHULTZE. No.

Senator KENNEDY. Can you give us any indication from your conversation with the President about his willingness to be involved in this process?

I know he's very much involved in talking with you and working with your group.

Mr. SCHULTZE. No, sir. He's clearly willing to do what he decides on the basis of advice in terms of what is necessary for him to do and desirable for him to do as opposed in turn to what it is appropriate for Lance, Blumenthal, and Schultze to do.

That becomes a matter of judgment in each case.

Senator KENNEDY. In terms of his own involvement, there doesn't appear to be any reluctance, where he feels it is necessary?

Mr. SCHULTZE. No, sir.

Senator KENNEDY. On another issue, the taxable bonds option proposal—I have written to you about this idea.

President Ford had indicated support for a 30-percent interest subsidy. and the Ways and Means Committee recommended 35 percent.

Many experts believe it would be essential to set the level at 40 percent in order to make the option work.

Mr. SCHULTZE. I will have to bring myself up to speed on that.

Senator KENNEDY. That's fine.

I would like to talk to you about it.

Representative BOLLING. Senator Proxmire.

Senator PROXMIRE. Come on, Mr. Chairman. You have to go ahead. This will be my third turn.

Representative BOLLING. No. I already explained to you what I do.

Senator PROXMIRE. I will be very, very brief. I really will be.

Senator HUMPHREY. You are getting as bad as I am, Bill.

Senator PROXMIRE. On the tandem plan you said they have something like $1.8 billion.

They had that experience before. HUD said we will close the window next week. Whammo, it was gone within 2 or 3 days.

The developers wait as long as they can, as long as they think it will be available. If HUD tells them they have to take that money—once they get it, then they have to start work.

It is a very effective way to get stimulus.

Mr. SCHULTZE. The question is I have——

Senator PROXMIRE. I understand.

Mr. SCHULTZE. There is a problem of cutting the gate off too soon and chopping some off.

I don't know enough about it to know what the optimum timing is.

Senator PROXMIRE. It is something at a time when we have very heavy unemployment. It might be something worth considering.

Now, I have a letter from the EPA based on an article that Mr. Roger Strelow wrote in the Washington Post with regard to trying to solve this tough problem we have in the automobile industry where because of the concern about the Clean Air Act, they say they may not be able to produce cars at all in the coming year.

Mr. Strelow pointed out that the law permits a fine to be imposed; and he suggested that this is a course of action.

That makes all the sense in the world to me. That fits into your philosophy of imposing fees. It would mean that it could be a modest amount, something like $150 that he argued would do the trick.

That means that you have cars produced, that you have conformity with the law, in all likelihood, because that is a cost of technology on the basis of their estimate.

That seems to be something that I hope the administration would pursue.

Mr. SCHULTZE. I think it is worth looking at, yes.

Senator PROXMIRE. One final point. You stressed the importance of—the great importance of business investment picking up.

I might point out to you that business reluctance to invest might have been to some extent because of the recent cold weather and the effect that might have upon the availability of fuel.

It is hard to estimate these things, but it is something that I think we have to give some thought to, maybe some kind of Government program that would provide some sore of better assurance in future years.

I think a businessman who has now had to lay people off, and seen perhaps the loss of his market and so forth because of this weather, anticipating he might have experiences like that in the coming years, forecasts of three consecutive winters of cold weather——

Mr. SCHULTZE. The real point is if the fuel isn't there, we can't guarantee it. It is an energy problem.

Senator PROXMIRE. It is something that might be cranked into this notion of what we do to restore business confidence so you get the kind of investment you need.

Mr. SCHULTZE. I think to make one comment, I think that underlines the need for a long-term energy policy quickly.

I hadn't thought of the investment connection. It is obviously there.

Senator PROXMIRE. Thank you very much.

Representative BOLLING. Senator Humphrey.

Senator HUMPHREY. No, thank you, Mr. Chairman.

Representative BOLLING. Mr. Schultze, I have been sitting here wondering whether I should say this on the record or off the record. This is not going to be a question.

I was the House manager of the budget bill when it passed; and I worked very closely with the chairman and the House leadership and the chairman and members of the Budget Committee in its first 2 years with desperate anxiety that it survive, because I think it is a terribly important process.

I have been a true believer about acting quickly on its deadlines. As I listened to this conversation, a number of different questions and your answers, I came to the conclusion that made me a little nervous about the current situation.

I am not sure that the dynamics of the Budget Committee in the House and the different dynamics of the Budget Committee in the Senate are in perspective perhaps for even as acute an observer as you.

I didn't know whether I should put this on the record or mention it to you casually.

I think it needs to be on the record.

There is a very real danger on this third one that affects fiscal 1977, and I know there isn't much of fiscal 1977 left in a budgetary sense.

What happens next week is going to be a lock-in, which we woun't be able to get out of in the House.

There isn't that much flexibility in terms of the real dynamics.

It may look like there is flexibility because we wrote it into the law, but I am very much concerned that we may get locked in one place or another; I don't want the administration to miscalculate the difficulty of enlarging the stimulus package at a later time; decreasing it would probably be easier.

Members of both the House and the Senate would like to see it decreased if there is a legitimate reason for it to go down. Pushing it up is going to be very tough even in these circumstances where we have a Democratic administration and very large Democratic majorities in the House and Senate.

I think the administration ought to give a lot of thought to what is going to happen next week or very shortly thereafter and look at the danger of our getting locked in and the administration misunderstanding its loss of flexibility.

I am not suggesting an increase or anything at the moment.

I am just suggesting that that be looked at pretty carefully.

Mr. SCHULTZE. I think I receive the message.

Representative BOLLING. I am glad I still can articulate something. I have no questions.

I do know that you have another meeting, at which you will be asked a great many questions in a very short period of time.

If there are not further questions, I am merely going to say what I would like to say, that as far as I am concerned they could not have picked a better Chairman of the Council of Economic Advisers than you.

I am delighted with what you have been able to do up to this point; and I think that you have as difficult a job as a human being can have in a transition period.

I know you are going to do it just exactly as well as you can. That is going to be superbly. We look forward in this committee to working with you; not always agreeing with you, but having a good time in both cases. We thank you so much.

Mr. SCHULTZE. Thank you, Mr. Chairman.

[Whereupon, at 12:20 p.m., the committee recessed, to reconvene at 2 p.m., Thursday, February 3, 1977.]

THE 1977 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 3, 1977

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

The committee met, pursuant to recess, at 2:05 p.m., in room 2172, Rayburn House Office Building, Hon. Richard Bolling (chairman of the committee) presiding.

Present: Representatives Bolling, Moorhead, Hamilton, Brown of Michigan, and Heckler; and Senator Javits.

Also present: John R. Stark, executive director; Louis C. Krauthoff II and Courtenay M. Slater, assistant directors; Richard F. Kaufman, general counsel; G. Thomas Cator, William A. Cox, Kent H. Hughes, Sarah Jackson, John R. Karlik, L. Douglas Lee, and Katie MacArthur, professional staff members; Michael J. Runde, administrative assistant; and Charles H. Bradford, Stephen J. Entin, George D. Krumbhaar, Jr., M. Catherine Miller, and Mark R. Policinski, minority professional staff members.

OPENING STATEMENT OF REPRESENTATIVE BOLLING, CHAIRMAN

Representative BOLLING. The committee will be in order.

Mr. Secretary, I am going to start, because I know you have lots of things to do. We have a number of members who have indicated they are going to turn up, and I hope they will be along shortly.

We are particularly pleased to welcome you, because you are one of those rare people who are three things: an economist, a man with an outstanding career in business and in the academy, and 10 years of distinguished Government service.

Everybody knows about your ability in business and your success there. I am not going to go through the usual rather lengthy introduction. I am going to raise one point which came out in the hearing yesterday; and I haven't had an opportunity to examine all of your statement, and I am not sure that it deals with this point.

In our various colloquies with the Chairman of the Council, it became clear that one of the things that some of us on the Hill were not sure that the administration was enough aware of was some of the time frames built into the Budget Act. I had a great deal to do with writing that, and it wasn't written to be rigid, but to include the dynamics of the Hill in relation to the Budget Act, and the dynamics, as I understand them, are different in the House than they are in the Senate.

One of the things that worried us a good deal, and this is not an attempt to do any levering up of the administration package, but the dynamics of the Hill are such that I think Senator Humphrey and a number of others and I were really very worried that the administration might overlook some of the legislative aspects of the budget.

It is much more difficult for us to increase the level of stimulus than it is for us to decrease it. This might surprise some people because of the reputation that the Congress has for being liberal in spending, but it is a fact.

I wanted to mention that, not to intrude on your statement, or not in any way to modify anything you are about to say, but just as an honest concern that a great many of us have. We hope that in the next few hours and days the administration will look at that dilemma and not be caught unaware if we suddenly find we have not appropriated sufficient funds and if the weather caused it to be too low, there would be difficulty in raising the level of stimulus.

We can pass an emergency energy bill, but the second time around it gets to be tougher.

I am very glad to have you here, and I stated my concerns at the beginning, because I wanted to ask questions about it down the line.

please proceed as you wish. We will be glad to listen to your whole statement or a summary.

STATEMENT OF HON. W. MICHAEL BLUMENTHAL, SECRETARY OF THE TREASURY, ACCOMPANIED BY LAURENCE WOODWORTH, ASSISTANT SECRETARY FOR TAX POLICY

Secretary BLUMENTHAL. Thank you, Mr. Chairman. I am very glad to be here today and make my first appearance before your committee.

I have a prepared statement which has been submitted to you. I will not read it. It, of course, is basically a summary of the stimulus package with which you are already well acquainted, particularly after yesterday's testimony by Mr. Schultze.

I would perhaps just make a few comments relating to my statement and to the package, and deal with the first point that you have already raised.

I suppose the first thing to say about this package is that it is not perfect, and that we recognize that there is really no way in which we could have devised a set of proposals that met our goals and that would at the same time either solve all of the problems that we face within the economy, or satisfactorily meet all of the particular concerns that various individuals and people on either side of the House or the Senate might have.

Our concern was first to have a balanced program which would have its impact both in 1977 and 1978, fiscal 1977 and 1978. Second, to have a program that would have a rapid impact in 1977, which immediately caused us to select the tax rebate as one of the very few devices which could be quickly implemented. Third, a program which would not immediately force us into decisions where there would be a massive, permanent loss of revenue.

We wanted a program that would be a proper mix between stimulating the economy generally on the one hand, and beginning to address some of the questions of structural unemployment on the other. That is why we thought of a balanced approach, why we have a balance of measures, no one of which, taken alone makes perfect sense, but which, taken together, can be implemented quickly and make sense in achieving the first limited objective—to get the economy going at a faster rate in order to eat into cyclical unemployment; and second, to target particular forms of structural unemployment, and third, to do so in a careful way so that the budget deficit does not become any bigger than it already is. We already regret that it is so large.

We also recognize that the stimulus will take place in the context of a rather slack economy but we don't want to stimulate so much that we reignite the flame of inflation.

Clearly, at the time this program was developed, none of us could predict the weather. That is a new factor that we were not in position to take into account, and which should be taken into account.

On the other hand, we have had, since the program has been introduced, some indications that at least up to the point when the weather turned against us some of the economic indicators really were performing a little better than we had anticipated.

So you have some kind of an offset there, and I can tell you that we are going to meet late this afternoon, as a matter of fact, within the administration to review the numbers and the assumptions in terms of the impact of the weather and what we have learned. We are, bearing in mind particularly the new situation here—the Budget Committee and the congressional budget process—which seems to make the dynamics of decisionmaking somewhat different than it used to be.

I am impressed by the fact that in discussing this with some of your colleagues, they don't seem to understand fully how the process works and who has authority to make which decisions. I suspect that as we contemplate later this afternoon what we must do and when; we will be perhaps as puzzled as you and some of your colleagues are as to how things will proceed.

I would hope we don't get locked into a very rigid situation today or tomorrow. Again, we need a fluid background against which we can assess the weather situation in the next few days.

We have it in mind, and Mr. Schultze received a very clear admonition from the top yesterday. I can assure you that he was also on the telephone with me and with others saying, "You had better talk about it."

So with that as a general introduction, and without going into the details of the program, I would be happy to deal, to the best of my ability, with whatever questions you may wish to put to me.

[The prepared statement of Secretary Blumenthal follows:]

Prepared Statement of Hon. W. Michael Blumenthal

Mr. Chairman and members of this distinguished committee: It is an honor to appear before you in support of the President's program for economic recovery.

Economic Setting

We are slowly emerging from the worst recession of the last 40 years.

The recovery began reasonably well. From the first quarter of 1975 through the first quarter of 1976, the real gross national product rose by over 7 percent. Between May 1975 and May 1976 unemployment fell from 9 percent to 7.3 percent. This performance was due largely to the tax cut which Congress enacted in 1975 and to an intentional increase in inventory accumulation.

Beginning with the second quarter of 1976, however, the pace of the recovery slackened. The rate of growth in real output fell from 9.2 percent in the first quarter of the year to 3.0 percent in the fourth quarter. Unemployment rose and, since July, has fluctuated between 7.8 and 8 percent; between May and December 1976, the number of unemployed workers rose from 6.9 million to 7.5 million.

Since October, the pace of recovery appears to have improved somewhat. But the rate of growth and the level of unemployment are still plainly unsatisfactory, without stimulus, the economy will grow in calendar year 1977 at only 4½ to 4¾ percent, and unemployment may remain significantly above 7 percent.

The current recovery does not appear to be self-sustaining. Relative to earlier recoveries, this one lacks a strong rebound in private investment. Investment will not be adequate until businessmen see a reasonable prospect of a sustained growth in consumer demand. In turn, the course of demand depends mainly on the state of consumer income; we cannot reasonably expect consumers to increase their rate of spending from current income levels.

The President's economic stimulus package has both tax cuts and expenditure increases to boost spendable income. Let me explain the strategy behind this program. First, it is a 2 year program. We wish to enable consumers and businesses to plan ahead. Second, the program contains a good deal of flexibility. It allows us either to add additional stimulus, or to cut back, to meet varying economic conditions. Third, the program promises only what can be realistically undertaken. We are proposing major increases in existing programs within a short period of time. To force more stimulus into our system, or to force it faster, would strain our ability to administer the programs in a responsible manner. Fourth, the tax rebate and the expenditure programs are temporary and will end as the economy recovers. This will permit us to fulfill our commitment to a balanced Federal budget for fiscal year 1981.

INTERNATIONAL ECONOMIC CONSIDERATIONS

Let me now discuss the international economic considerations associated with this program. First, we must recognize that we are now in a global economy. American economic health is importantly affected by our export markets, and other industrialized countries are just as dependent on our economy. In turn, the developing nations are critically dependent on demand for their products from the industrialized world.

Second, just as we recently experienced a pronounced economic pause at home, a slowing of growth among the industrial countries has recently been evident. Japan and Germany are expected to grow at only a silghtly lower rate than in 1976. But several of the other major economies—such as the United Kingdom, France, Italy, and Mexico—may be facing considerably slower growth in the period immediately ahead. There is only one industrial country—Switzerland—which is not experiencing near record unemployment. In addition, inflation continues at levels which would be unacceptable even at full employment. Only in Germany and Switzerland is the current inflation rate below 4 percent.

In addition to these twin problems of unemployment and inflation, both industrial and developing nations are becoming concerned about their ability to finance balance of payments deficits. Their external debts have risen dramatically. For some governments, it will be very difficult to maintain economic expansion, reduce unemployment, and control inflation.

It is important that those countries which have greater economic and financial resources expand as rapidly as is consistent with sustained growth and the control of inflation. Expansion in those countries will provide stimulus for other industrialized countries and for developing countries. The United States is now encouraging the stronger countries abroad to follow our lead on stimulating their economies. This was an important theme of the Vice President's trip.

THE STIMULUS PROGRAM

Let me turn now to the stimulus program itself.

The tax features of the program have a two-fold purpose: to provide a quick injection of spending into the national economy and to take the first step toward a program of tax simplification and tax reform.

In broad terms, stimulus to the economy will be provided by a payment of $50 per capita to almost everyone through a general refundable rebate on 1976 taxes of $50 for each taxpayer and each dependent. For those who have no dependents or no earned income, this rebate will not exceed the amount of 1976 tax liability. Also, a payment of $50 per beneficiary will be made to Social Security beneficiaries, those receiving supplemental security income payments (SSI), and those receiving Railroad Retirement payments.

The $50 per person rebate and Social Security payment will amount to about $11.4 billion. The payments will largely be made this spring and the total rebate payments should fall entirely in fiscal year 1977.

The second tax feature in the program is a simplification measure, designed to streamline the tax laws for those presently using the standard deduction. The program substitutes for the present complex set of standard deduction provisions a flat deduction of $2,400 for single people and $2,800 for married couples, thus enlarging the standard deduction for joint returns with incomes of $17,500 or less and single returns with incomes of $15,000 or less.

This increase in the standard deduction will apply for the entire calendar year 1977 as well as subsequent years. However, the tax reduction cannot be reflected in lower withholding until approximately a month after the date of the enactment of the bill. We are assuming that the required withholding changes can become effective as of the first of May. Since the lower withholding will not be in effect for the first 4 months of 1977, there will be either smaller tax payments or larger refunds when the individuals involved file their tax returns by April 15 of next year.

In terms of revenue loss, this simplification measure will cost $1.5 billion in fiscal year 1977 and $5.4 billion in fiscal year 1978. At current income levels, the full year effect is $4 billion.

The third tax feature is a business tax reduction. We are proposing that business be given a choice between a 2 percentage point increase in the present 10 percent investment credit or a refundable 4 percent tax credit for payroll taxes paid for Social Security (FICA) tax purposes. Businesses will have a choice but cannot take both. They will be required to stay with their choice for 5 years.

The full year effect of this business tax cut at current income levels is $2.6 billion. In fiscal year 1977 this will cost $0.9 billion and, in fiscal year 1978, $2.7 billion.

To summarize, the tax features of the proposal have a budget cost of $13.7 billion in fiscal year 1977. Most of this represents the cost of the tax rebate. In fiscal year 1978 the tax budget cost is expected to be about $8 billion. This decrease is, of course, attributable to the fact that the rebate is for the year 1977 only.

Let me now discuss with you the criteria by which we chose the spending components of the program.

First, and most important, the programs had to create jobs. Second, the programs had to be effective, and subject to a well administered expansion. We were not interested in creating waste, confusion, or corruption. Third, the programs had to phase out as the economy improved. We did not wish to mortgage large amounts of future tax revenues in the first few days of the Administration.

Within these limits, our spending program is an aggressive one.

For local public works, we recommend an increased authorization of $4 billion, to be spent over 2 years as quickly as good management will allow. We are asking increased appropriations of $2.0 billion in both fiscal year 1977 and fiscal year 1978. We estimate that only $0.2 billion of this can be spent in what remains of fiscal year 1977, but this estimate is an informed guess, not a ceiling. In fiscal year 1978, we expect a full $2.0 billion increase in outlays.

For the public service and training programs, we are aiming for $1.0 billion in increased outlays this fiscal year, and $5.0 billion in fiscal year 1978. Once these programs get underway, their job creating impact will be considerable. We project, by fiscal year 1978, an increase of 415,000 jobs in public service employment, and an additional 346,000 training and youth slots under other provisions of the Comprehensive Employment and Training Act. We think it doubtful that the Labor Department can efficiently manage any larger expansion in so short a time.

Finally, we propose an expansion and reform of countercyclical revenue sharing—changes designed to distribute, at current unemployment rates, $1 billion a year more than does the present system. These funds will combat unemployment by saving hard-pressed State and local governments from having to contract their payrolls.

Because countercyclical revenue sharing is administered by the Treasury Department, allow me to say a word more about this element of the stimulus package.

Existing law provides for the expenditure of $1.25 billion for countercyclical revenue sharing. Under this program, funds are allocated on a quarterly basis of $125 million plus $62.5 million for each half percentage of national unemployment over 6 percent. When national unemployment falls to 6 percent, this latter part of the program turns off. At the current national unemployment rate, about 8 percent, all funds appropriated by Congress for this program will be exhausted by April of 1977.

The President's economic stimulus package both expands and reforms the program. The program would be given a 4 year authorization with annual appropriations, as compared to the current authority, which covers only five quarters. Thus, the "trigger" would remain in place over the whole business cycle, a sound precaution against any sudden downturn in the years ahead. An additional $1 billion would be made available for distribution, beginning in July of 1977. Finally, the funding would be made more sensitive to changes in the unemployment rate. Instead of the current increase of $62.5 million for every half percentage point of unemployment over 6 percent, each change of one tenth of a percentage point in unemployment would result in an additional $30 million in funding.

For this program, we currently estimate an increase in spending in fiscal year 1977 of $500 million and in fiscal year 1978 of $600 million. If unemployment is higher than anticipated, the expenditures in fiscal 1977 might be larger than indicated.

EFFECTS OF THE STIMULUS PROGRAM ON THE OVERALL ECONOMY

Let me outline what we believe will be the effect of this stimulus program on our economy.

The tax rebate will almost immediately put funds into the hands of consumers, and thereby increase their spending and encourage higher levels of overall economic activity. Such an immediate stimulus must be provided through a rebate because public service employment or accelerated public works cannot be expanded fast enough to achieve this objective in the few remaining months of fiscal year 1977.

In fiscal 1978 the spending programs will come into their own and strike directly at unemployment, particularly among construction workers, veterans, and minorities.

We hope that the unemployment rate will fall below 7 percent by the fourth quarter of 1977. This decline in the unemployment rate, along with normal growth in the labor force, means an increase of over 3 million jobs during 1977, up to one million of which may be attributable—directly and indirectly—to the stimulus program. We hope the unemployment rate will decline toward 6 percent by the end of 1978.

With this program, the real gross national product should increase during calendar year 1977 by about 5¾ to 6 percent, as contrasted to only 4½ or 4¾ percent in the absence of the program. This would mean an increase in the nation's output of about $14 to $18 billion per year by the end of 1977 and $25 to $35 billion per year by the end of 1978.

While this program will provide the needed economic stimulus, we do not expect it to cause any significant increase in the rate of inflation. The present high unemployment rate and the substantial unused industrial capacity—still approaching 20 percent—indicate that inflationary pressures are subdued now and will not be affected appreciably by the stimulus program we are presenting.

Price measures that do occur will primarily reflect past price increases which have not yet worked their way through the economic system.

IMPACT OF PROGRAM ON FEDERAL BUDGET DEFICITS AND CREDIT MARKETS

I turn now to the effect of the economic stimulus program on the reviewed by Federal budget deficits and, in turn, the effect of these on the capital markets. The entire Federal budget is currently being reviewed by the Administration and, as a result, it is impossible for us at this time to provide a precise deficit figure for the fiscal year 1977. However, we believe that the fiscal year 1977 deficit will be in the range of $67 billion to $69 billion, including the effect of the President's stimulus proposal.

A deficit in this range, together with about $10 billion of off-budget financing, will mean that the Treasury will raise $77 billion to $79 billion of net new cash in fiscal year 1977. Questions have been raised as to whether this prospective Treasury financing will "crowd out" private borrowers from the credit markets.

First, let me point out that in 1976 the Treasury also raised a large amount of net new cash—roughly $62 billion--and did so rather easily. Notwithstanding this financing task, interest rates declined throughout much of the year and credit-worthy private borrowers had ready access to loans. In fact, markets were so slack last year that Treasury wisely emphasized coupon (longer term) issues in its financing program, thus successfully raising a large amount and extending the maturity of our national debt at the same time. I think that 1976 demostrated that a large Federal borrowing program does not necessarily result in strained credit markets and rising interest rates.

One reason for this, of course, is that borrowing demand from the private sector has a much greater influence on our credit markets than does government borrowing. The President's commitment to achieving a balanced budget should reduce Federal borrowing and thus ensure that private credit demands have an even greater effect on our markets in the future.

Concerning 1977, we do face a slightly less favorable overall borrowing climate than we did last year. Specifically, the 1977 deficit will be financed in a period when private credit demands are rising. The continuing housing recovery signals eventual increases in mortgage demands. Business is also expected to borrow somewhat more in 1977, as plant and equipment expenditures rise and inventories are accumulated. Consumers, too, probably will increase their credit demands, reflecting higher automobile and other durable goods sales.

We have been carefully reviewing the resultant outlook for the credit and capital markets in 1977. Our latest estimate is that total funds raised, including Federal, State and local government, corporate and other business, mortgage, consumer credit, security credit, foreign and other credits, are likely to reach nearly $300 billion in 1977. This compares with an estimated $268 billion in 1976 and $228 billion in 1975.

The funds available to meet this enlarged financing seem adequate. We believe that consumer savings will expand further and that the inflows of new savings funds to institutional investors—already running at record rates—will expand further. We estimate that, altogether, the supply of funds from financial institutions *other than banks*—savings and loans, mutual savings banks, credit unions, insurance companies, pension funds, mutual funds, foundations and trust funds—will total some $150 billion in 1977, compared with an estimated $137 billion in 1976 and $108 billion in 1975.

The other half of the $300 billion required will come from two sources. First, the banking system—which supplied $57 billion in the recovery year of 1976 and $38 billion in the recession year of 1975. In 1974, however, a healthier year for economic growth, the banking system furnished $68 billion. Our current estimate suggests that in 1977 the banking system will provide some $70 billion.

The balance will be met from a variety of traditional sources, including businesses and State and local governments, Federal government agencies, foreign investors, and households. All told, some $70–75 billion of funds should be supplied to the credit markets from these sources.

This outlook reflects our expectation that inflation rates will not rise and, therefore, that the Federal Reserve System will be able to be accomodative throughout 1977 and 1978. This, in turn, will enable commercial banks to have the resources to acquire net large amounts of credit market instruments.

My judgment is, therefore, that the large amount of financing in prospect for 1977 can be accomplished without "crowding out" and that any rise in interest rates will be quite modest. Even with the economic initiatives I have outlined, the economy will only gradually return to higher rates of capacity utilization, and thus the real rate of growth will not reach an unsustainable level. I do not believe, therefore, Federal borrowing will be unduly competitive with the private sector's loan demands.

I thank you.

TABLE 1.—ESTIMATED EFFECTS OF THE ADMINISTRATION'S FLAT STANDARD DEDUCTION PROPOSAL, DISTRIBUTED BY ADJUSTED GROSS INCOME CLASS

[Calendar year 1976 levels of income]

Adjusted gross income class (thousands of dollars)	Tax change resulting from the $2,400/$2,800 standard deduction [1]		
	Amount (millions of dollars)	Percentage distribution (percent)	Cumlative percentage distribution (percent)
Less than 5	−616	15.6	15.6
5 to 10	−1,953	49.4	65.0
10 to 15	−1,245	31.5	96.5
15 to 20	−137	3.5	100.0
20 to 30	−1	*	100.0
30 to 50	−*	*	100.0
50 to 100	−*	*	100.0
100 or more	−*	*	100.0
Total	−3,951	100.0	

*Less then $500,000 or 0.05 pct.

[1] Includes the effect of extending the $35 general tax credit to exemptions for age and blindness.

Note.—Details may not add to totals due to rounding.

Source: Office of the Secretary of the Treasury; Office of Tax Analysis Jan. 26, 1977.

TABLE 2.—ESTIMATED EFFECTS OF THE ADMINISTRATION'S TAX REBATE PROGRAM, DISTRIBUTED BY ADJUSTED GROSS INCOME CLASS

[Calendar year 1976 levels of income]

Adjusted gross income class (thousands of dollars)	Tax change resulting from the $50 per capita rebate		
	Amount (millions of dollars)	Percentage distribution (percent)	Cumulative percentage distribution (percent)
Less than 5	−984	10.3	10.3
5 to 10	−2,010	21.0	31.2
10 to 15	−2,223	23.2	54.4
15 to 20	−1,904	19.9	74.3
20 to 30	−1,695	17.7	92.0
30 to 50	−564	5.9	97.9
50 to 100	−169	1.8	99.6
100 or more	−36	0.4	100.0
Total	−9,585	100.0	

Note.—Details may not add to totals due to rounding.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Jan. 26, 1977.

TABLE 3.—THE FLAT STANDARD DEDUCTION PROPOSAL FOR 1977: TAX CHANGES FOR REPRESENTATIVE TAXPAYERS

Filing status	Adjusted gross income	1976 law tax	Proposed 1977 tax [1]	Tax change
Single	$3,000	$42.50	0	$−42.50
	5,000	363.50	$247.50	−116.00
	7,000	714.50	584.50	−130.00
	10,000	1,331.00	1,177.00	−154.00
Joint return	5,000	130.00	28.00	−102.00
	7,000	448.00	332.00	−116.00
	10,000	948.00	829.00	−119.00
	15,000	1,882.00	1,794.00	−88.00
Family of four	7,000	[2] 35.00	[2] −70.00	−105.00
	10,000	651.00	518.00	−133.00
	15,000	1,552.00	1,464.00	−88.00

[1] The proposal would increase the minimum standard deduction to $2,400, or, for joint returns, $2,800.
[2] Assumes use of the earned income credit.

Note.—Tax calculations are based on the tax rate schedules and assume the standard deduction, both for present law and under the proposal.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Jan. 26, 1977.

TABLE 4.—TAX-FREE LEVELS AND PROJECTED POVERTY LEVELS

	Tax-free levels		Projected poverty levels [1]	
	1976 law	Proposed for 1977 and thereafter	1977	1979
Single person	$2,700	$3,400	$3,107	$3,439
Couple without dependents	4,100	4,800	4,018	4,448
Family of four	6,100	6,800	6,110	6,763

[1] Applicable to nonfarm families. Projections assume Consumer Price Indexes of 179.11 in 1977 and 198.26 in 1979

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Jan. 26, 1977.

TABLE 5.—BUDGET COSTS OF THE ADMINISTRATION'S STIMULUS AND TAX SIMPLIFICATION AND REFORM PROPOSALS

[In billions of dollars]

	Fiscal years	
	1977	1978
Rebate and social security payment program:		
$50 per capita rebate:		
Reduction of tax	8.2	
Refunds of excess of liability	1.4	
Total	9.6	
$50 payment to social security and railroad retirement beneficiaries	1.8	
Total rebate program	11.4	
Simplification and reform program:		
Replace the current law standard deduction with a flat deduction of $2,400 for single returns and $2,800 for joint returns [1]	1.5	5.5
Business tax reduction program:		
Optional increase in the investment tax credit from 10 pct to 12 pct or an income tax credit equal to 4 pct of employers' social security tax payments	0.9	2.7
Other expenditures program:		
Increased countercyclical revenue sharing	0.5	0.6
Public service employment	0.7	3.4
Public works	0.2	2.0
Expanded training and youth programs	0.3	1.6
Total other expenditures programs	1.7	7.6
Total administration proposals	15.5	15.7

[1] Includes extension of the $35 general tax credit to exemptions for age and blindness.

Note.—Details may not add to totals due to rounding.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Jan. 26, 1977.

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Representative BOLLING. We thank you very much, and I am going to make one comment before I yield to Mr. Hamilton, who has some questions. I especially hope Mr. Schultze and your other colleagues will be as flexible as you are.

Your awareness that some of us on the Hill have not absorbed the implications of the Budget Act would be even greater if you had been here 2-years ago. That act passed 400-something to virtually nothing in the House, and when the then-Speaker Albert had the first meeting of the new budget chairmen with the various chairmen of the House committees and their chiefs of staff, it was very clear that a high percentage had never heard of the act of which some had voted. The process by which we absorb our new procedures is not terribly quick, as you are obviously aware, but in this particular area, the authors of the act, the final authors of the act, really hadn't thought very deeply about what it was going to be like when a third budget resolution came up at the moment of transition between an old Republican administration and a new Democratic administration, and as one of those authors, I will freely admit it.

Thank you for your comment.

Congressman Hamilton.

Representative HAMILTON. Thank you very much, Mr. Chairman.

We are very pleased to have the Secretary with us today.

Mr. Secretary, I come from Indiana, and one of the articles of faith in Indiana is that big deficits cause inflation.

Now, you project in your prepared statement, I see, as I read very quickly, a range of the deficit from $67 to $69 billion, and the Treasury is going to be raising between $77 and $78 billion.

You come from a business background. What do you say to businessmen in Indiana when they get shook up after seeing those kinds of figures in the deficit column?

Secretary BLUMENTHAL. If I may begin by indicating, sir, that I have taken off my businessmen's hat only a few days ago. It is perhaps worthy of note that some of the most important installations of the company with which I was associated were in the State of Indiana, so in a way I was an Indiana businessman, at least until a very few days ago.

I would say that I share the view that large deficits are not a good thing, and that they are one of the factors that cause inflation in many situations. I hate to use this awful phrase that economists use, which is "other things being equal," but I think it is appropriate, in the absence of other factors. Clearly, budget deficits can cause inflation, but quite apart from that, I don't like the idea of spending more than you are taking in. I think that is wrong. I think it is wrong for governments as it is for companies and individuals.

I would begin my commenting on this present situation by saying that, unfortunately, the economists and others are learning that the situation is more complicated than one of recognizing simple relationships. For example, why would we have had huge deficits over the last couple of years and a falling rate of inflation? Clearly that in itself indicates that the situation is more complicated. But this is not going to negate that a deficit, other things being equal, causes inflation and is bad.

Representative HAMILTON. With the deficits you are projecting, do you think you can continue to have a falling rate of inflation?

Secretary BLUMENTHAL. Yes. I think it is quite possible that the rate of inflation could continue to fall. In fact, we should work and will work toward that end. If our expectations are correct, which are that the pace of growth will accelerate—but not at a rapid and sudden rate which a much larger stimulus package such as some people suggested to us might well have produced—so that the economy starts moving at a higher level of growth, would work to reduce the deficit. Certainly in fiscal year 1978, we expect it to be less than fiscal year 1977 and fiscal year 1979 substantially less as the economy moves toward higher levels of utilization. I think we can continue to work and bring the rate of inflation down.

I want to say one more thing. I don't want to be too lengthy in my replies, but this is a fundamental question, and I want to deal with it. I think we are learning that the relationship between deficits and inflation is not that direct, but also that inflation in this country—and in most advanced economies—is caused by some very, very tough structural rigidities, and those we have to work on. On the supply side of the equation, for example, we need to get away from stimulating business to produce more things that only create bottlenecks, to get away from an inflationary psychology, from business and management expecting the inflation rate to increase, to an attitude where they will be satisfied with smaller increases. It is really things of this sort that I hope the administration will do that will allow us, in my judgment, or give us a good chance to bring inflation under better control.

Representative HAMILTON. Let me pursue that with you a little bit. You are beginning to talk about an incomes policy, and you suggested one or two things that you have on your mind.

What other things do you have on your mind? At some point, the inflationary pressures are going to reassert themselves if your stimulative program works as we hope it does.

What are your thoughts about an incomes policy? The President has rejected, of course, direct controls on prices and wages, and I have seen statements by Mr. Schultze and some of his thoughts on it.

Are you interested in any of these proposals to use the taxing policy to discourage excessive wage settlements? Are you interested in the proposals for an industry-by-industry approach to work out stabilization targets? How active are we going to see you folks jawboning over there?

What are you going to do with the Council of Wage and Price Stability?

Secretary BLUMENTHAL. We are just beginning to focus specifically on what does and does not make sense. So I have to speak somewhat informally, and essentially express my own views on this.

I think that we certainly do need a Council on Wage and Price Stability that has some good people on it, that can provide good information to those responsible for making decisions within the administration. A strong Council in the sense, in terms of having good people, is something that I would strongly recommend that we seek to develop and associate closely with the economic policy group that we are setting up as a means for coordinating decisionmaking within the administration on economic matters.

Second, I think that, and I would hope that, in time the President and his senior advisers would be in a position to talk about the kinds of targets that we have in terms of growth of the economy, in terms of working on a steady reduction of inflation, and in terms of the kinds of wage and price decisions that we feel would be supportive of achieving those targets and those which clearly would not.

If we could have a few successes in that area, with people recognizing this and acting accordingly, I think we can go some distance in that regard.

You may have seen in the newspapers, for example, within the last few days an announcement on the price increase for tinplate by United States Steel. There was reference to the fact that there had been some discussions, that the chairman of United States Steel had been in to see us and had told us about what he had in mind, and we talked about it, and out of that came a decision which we thought was not too bad. I think it involved an increase of 4.8 percent in that particular instance.

If we can begin to see some of that, and the labor unions recognizing that we are ratcheting inflation down, we might be able to be successful in bringing inflation under better control.

Finally, what about taxes as a tool in that regard? I do not believe in any kind of coercive measures in a free market economy on either collective bargaining or on the setting of prices and production. I do believe that in the course of tax reform, which is something that we will be looking at and will be presenting proposals on, that in the context we should consider what kind of reform would be most helpful to increase productivity in the country, to perhaps moderate some of the marginal higher rates, and to create incentives for individuals and businesses to produce more and more efficiently. Using tax reform could be another way of working on the inflation problem.

Representative HAMILTON. We had a $6-billion trade deficit this year after a pretty good surplus in 1975. How do you look at that? Is it good, or bad, to have that kind of a deficit?

We are probably going to have a pretty big deficit in 1977.

How do you assess it? How concerned should we be with it?

Secretary BLUMENTHAL. I would be concerned if it lasted indefinitely. I think that the deficit that we have had, the $6 billion to which you refer, seen in the context of the previous large surplus in 1975, is not in itself alarming. I think to a large extent it is merely reflective of the fact that our recovery, albeit halting, has been a little bit ahead of and a little bit greater than those of other countries.

Representative HAMILTON. Rubbing out that deficit is not going to be one of your major economic goals in 1977, then? Aren't there a lot of other things that would take priority over that?

Secretary BLUMENTHAL. I would think so, but I certainly think that as we go along here, the growth of trade and of exports, which are very important to us, clearly has to be an important goal that I would want to see us pursue very actively.

You know, going back to a previous incarnation, the last time I was here I was involved with the Kennedy round. I think it is in the

U.S. interest to pursue actively these MTN efforts in Geneva, because over time that kind of work on getting rid of barriers on a reciprocal basis does tend to favor all nations, including ours. So, I would want to support that.

Representative HAMILTON. Thank you, Mr. Chairman.

Thank you, Mr. Secretary.

Representative BOLLING. Mr. Moorhead.

Representative MOORHEAD. Mr. Secretary, I will be briefer than usual, because as chairman pro tempore of another committee, I was forced to keep Mr. Blumenthal here on the Hill until 5:30 yesterday.

There is one question that has disturbed me, and that is the economic stimulus package was put together before we had this dreadful weather that we have had. Before this committee, Mr. Schultze identified the problems of increased heating costs, which are almost like a tax on people, and increased layoffs due to plant closures, and higher food prices resulting from, particularly, citrus and vegetables in Florida being frozen.

I would want to add to this that when warm weather comes, we are going to have floods which will equally have economic damage if we can't find out some way of trying to minimize them.

But my first question is, in view of these circumstances should the economic stimulus plan be reviewed and possibly reviewed upward, and I also remind you of the chairman's remarks about the time constraints under our new Budget Control Act.

Secretary BLUMENTHAL. Well, it is clear that the package was not developed at a time when we could have anticipated that very serious weather situation. The problem is that it really is still too early for us to estimate what the full effects of that will be.

Much depends on how long this weather situation lasts.

As I indicated in the other committee, Mr. Moorhead, we have had some offsetting factors. We should take another look at it, and we will. I just think that one really ought to deal with the emergency created by the weather as something apart from the basic economic stimulus.

If the decisionmaking processes of the Congress preclude us from doing that, no doubt we should take that into account. I was indicating to the chairman earlier that we are going to have a discussion of that later this afternoon amongst ourselves to see where we stand in terms of what the various committees are doing, when they make their decisions, and what the weather impact is.

The trouble is, we really don't know yet. I see in the paper today that the Library of Congress estimates that the impact could be such as to wipe out $10 billion of the stimulus. Well, I would like to look at that study. We really haven't been able to come up with such a figure yet. Mr. Schultze, I think, has mentioned a lower figure to you, somewhere between $2 to $5 billion.

Representative MOORHEAD. $2 to $5 billion, I believe he said.

Secretary BLUMENTHAL. And that represented our judgment as of that time. But we will take another look at it, and we may have to consider it.

Clearly we thought $30 billion was right. If the $30 billion turned out to be $20 billion, and it would be on the low side. We should take another look.

Representative MOORHEAD. It appears to me that one possible solution would be to increase the rebate, but that goes across the country and doesn't take into account that some areas have been more severely damaged than others, because of the weather, and if there is increased stimulus because of the weather factor, the stimulus should be targeted toward those areas which have suffered or will suffer the most, as best one can determine.

Secretary BLUMENTHAL. I would say, Mr. Moorhead, that we were very much concerned with having a set of proposals that would be simple, and which could be enacted quickly and uniformly. The consequences of a natural disaster that strikes unevenly at certain parts of the country really requires different measures, and I would strongly urge that the Congress and the administration work together to see what particular measures could be taken to deal with a very particular and very unevenly distributed natural disaster.

Representative MOORHEAD. The only other final concluding thought is that I think most of the economic damage will be in fiscal 1977, and that we shouldn't increase because of this unusual phenomenon the stimulus in fiscal 1978 until we see we have another bad weather situation.

Thank you, Mr. Chairman.

Representative BOLLING. Mr. Hamilton, do you have more questions?

Representative HAMILTON. No, go ahead, Mr. Chairman.

Representative BOLLING. Mr. Secretary, I have a variety of questions. One of them is not really a question of policy, and it certainly has nothing to do with the current stimulus package, but in past years, the Treasury has supplied what is referred to as "the sources and uses of funds." That is a table showing projections of amounts expected to be lent or borrowed in the U.S. credit markets by the main groups in the economy, the business section, government, household and so forth.

We would like you to supply those for our record again this year, and we would like to have estimates for both 1977 and 1978, and we would like it to be based on the Carter administration budget proposals for 1977 and 1978, and we would like to receive them by the end of this month.

Is that a reasonable request, and can that be continued?

Secretary BLUMENTHAL. We will certainly supply them as soon as we can. We are not totally sure how quickly we will have them. We will try to have them by the end of the month but it may be a little later than that.

Representative BOLLING. We just want to be sure we continue the general thrust. I have a whole series of questions I would like to ask or get into the record at your leisure on international economic matters. We are at the beginning of a cycle. It would seem to me it makes better sense to give you an opportunity to comment in writing and I will have them handed to you or one of your assistants.

The first job I had on this committee was serving as the first subcommittee chairman on economic statistics. I also spent time as chairman of the International Subcommittee. I believe there has been a great change in our economy in relationship to things in the last 30 years and the greatest of all changes has been its relationship to other nations. In other circumstances, I would be wanting a greater change on that subject but at this time, I don't think it is a particularly good idea because you have other preoccupations and you don't have an indefinite amount of time, but I want to give an indication that I think the committee and certainly as chairman I will spend more time on international economics than I have heretofore for some time.

I am curious to find out about your comment on unemployment. I am sure you are asked this everywhere you go, but I have always said that no level of unemployment was satisfactory to me except frictional. That is my kind of statement, or does it have another meaning?

Secretary BLUMENTHAL. I have been amused by this notoriety. I have said if I am going to be misquoted, and I am sure I will be many times, I could not be more happy than to be misquoted on this issue. I was asked what is an acceptable level of unemployment. My answer, as best I can recall, was that I am tempted to say zero unemployment is an acceptable level of unemployment but, of course, that is impossible. We will always have some frictional unemployment, some people moving from one job into another. However, as long as there are people who are willing and able to work but who can't find work in this country—one of the richest in the world though on a per capita basis there are some countries richer than ours—it should be possible for all people who want to work to find employment. Therefore, I can't accept any level of unemployment as long as that is not yet the case. I think that statement in a sense speaks for itself and I would stand on it.

I do recognize from the present level of 7.8 percent or whatever it is, to get to that ideal state will take a long time, and I certainly don't think that one should make an effort to get there helter skelter. I do believe that it is an important target and that we have to work at it at the same time we make sure that we don't get back into an inflationary situation.

I think that there are three types of people who tend to make up, in a broad sense, those who appear in the unemployment statistics. The first group is made up of those that are unemployed strictly because of cyclical factors. They are laid off, skilled people who have a job, who have work experience, and who would be working if the economy was operating closer to capacity.

It is a job of the economic policymakers and of private industry working together to create enough jobs to put those people back to work. I certainly would not be satisfied if any of those are off very long, and the longer they are, the worse it is.

The second group is very difficult and important for us to deal with. Anyone who lives near a big city is well aware of the problem. They are high school students, the unskilled, the minority groups who are unemployed, even when the economy is operating at a high level of capacity. They seem to be the last to be employed, and don't seem to be able to find any work before then.

I served for a number of years on the Board of Directors of New Detroit, in the city of Detroit, where we dealt with this sort of problem. I have seen it at first hand there and certainly heard about it in other places. It clearly needs to be dealt with regardless of where we are in the cycle. It seems to me that has to be dealt with through some of the specific programs we included in this package, those that involve training, that involve youth employment of various kinds.

The third type of unemployed that appear in the statistics are what are called frictional—one of the papers quoted me as saying "frictional" unemployment. Those are the people that have quit a job and may be collecting unemployment benefits as they move or as they go on to another job. There will always be a number of those.

I don't know exactly what that group would amount to in terms of a percentage of unemployed. But, I would think just as there is no target for inflation that is satisfactory enough that we should be stuck with it, so there is no level of unemployment. I would be dissatisfied to say 4 or 5 percent is OK. I think we ought to work it down.

We are saying we will get to 6.7 to 6.9 percent by the end of this year and that we should get to 6 percent next year. We should continue to go on from there to get the figure to 5 percent and lower. At the same time, we should work at the inflation problem. I don't believe there is a clear trade-off between these two variables. I think it would be terrible if there were and I don't think that is by any means totally true.

Representative BOLLING. Since I have said some relatively extravagant things about one of your assistants when we were talking in private, and I am a relatively extravagant person, on the basis of that one comment that you made I want to say you are a Secretary of the Treasury well worth waiting for all the 29 years I have been in Congress.

I am absolutely delighted with your statement, in particular because of your mentioned background, your very practical experience as well as your academic experience. I happen to believe what this country wants are the people and what it needs as a country is full employment without inflation very much in the terms that you stated it and it is possible, although no other developed nation and certainly not this one has achieved that. That is the responsibility that this administration takes on when it comes to power.

I think full employment without inflation is achievable and enormously difficult, and one step further, I think our ability to achieve it is going to answer whether or not the democratic representative process can survive. I think it is the most important collection of issues that is before us and I really and truly believe it is good for the country. I am perfectly delighted with your comment and that I should hear it from the Secretary of the Treasury. It is wonderful.

Congressman Hamilton.

Representative HAMILTON. Mr. Secretary, have you had an opportunity to talk to Vice President Mondale since he came back?

Secretary BLUMENTHAL. Only very briefly on the telephone. I have been so busy testifying up here we have not been able to get together except on the telephone.

Representative HAMILTON. We ought to allow you time to do that.

I am interested in the reaction the Vice President got from Germany and Japan with regard to stimulative policies and whether or not you think those countries are doing enough as two of the three major economies along with our own to bring the economic world out of its doldrums.

Secretary BLUMENTHAL. I have not talked to him personally about it. I did see some reports of his conversations. Let me say that I believe that there is a clear recognition on the part of both the Japanese and the Germans that there is a responsibility for them as well as for us to work together. The relatively stronger economies of the world need to stimulate their economies as part of their contribution toward world recovery.

So, as a principle, that is accepted.

My impression is that the program that the Germans have proposed is quite a modest one. That is a view that has been expressed to them and there is some hope they might do more than they initially indicated.

The Japanese have indicated they will go somewhat further. I think in both instances there is a case to be made for additional effort.

Representative HAMILTON. Will it be the policy of the administration to put quite a bit of pressure on those two countries to be more stimulative? I have the general impression that they are really very reluctant to move out with a real stimulative program, and that we are disappointed, really, in what they are doing so far. Is that an accurate impression?

Secretary BLUMENTHAL. We have been somewhat disappointed. I think we have conveyed to them our views that they ought to do more—as much as possible—and I am not too pessimistic about our ability to show some leadership in this area. We need to convince them to move along a little bit more rapidly, and I think we may do so. I would not express that in terms of pressure particularly, but I think the kinds of discussions that the Vice President has begun will prove very helpful in that regard.

Representative HAMILTON. I would like to ask you to comment on the proposal that is being advocated by Chairman Ullman of the Ways and Means Committee for an employment tax credit. Your stimulative program, does, of course, include some provisions with regard to business, the investment tax credit or the social security tax credit. Mr. Schultze yesterday, I might say to you, was somewhat negative with regard to the employment tax credit. Do you share your view on this proposal?

Secretary BLUMENTHAL. I share it very definitely and I must say again going back to my experience as a business executive, frankly I do not believe it would have any impact on the level of employment. I think it has serious problems. I think it is a tax on efficiency. That is really what it is. I think it would be capricious the way in which funds would be distributed. If you happened to be starting up a plant this year rather than last year based on investments you made sometime ago, you would get government payment and the fellow who started it up the year before would not. Big and growing companies would get it and the little ones that are struggling would not. It would be a discouragement for investment because you are in fact saying to people, "Don't make your factory more efficient with automation and labor-saving devices which create unemployment, but which also make us more productive."

There are quite a number of problems in the way you would administer it in technical sense.

Representative HAMILTON. Do you think the payroll tax proposal will spur investment and help employment at all?

Secretary BLUMENTHAL. I don't think any one of these schemes by itself would do everything. I would be hard pressed to argue that in an economy of our size, a $2.5 billion option, or if you take the payroll tax option, which we estimate will be chosen to the tune of $1.1 billion, that that is going to have a significant employment-creating effect by itself. As part of an overall program, I think it makes some sense—at least it goes in the right direction. I would say an employment subsidy goes in the wrong direction.

I would like to say one more thing about that. It would be a terribly dangerous precedent in my view for the Federal Government to subsidize private wages and particularly if you start picking out the kinds of people you are going to subsidize. Pretty soon you will be subsidizing people in a particular race or industry. Once you do that you begin to make changes in the way an economy functions in a free enterprise system, which, I would think, has some rather serious implications. So I hope the Congress will take a close look at that.

Representative HAMILTON. You object to the sum of the approaches being taken now in some of the European countries to subsidize in the private sector to create additional jobs as well as any use of the tax power to directly create jobs in the private sector?

Secretary BLUMENTHAL. If you put it that way, I am going to have to be a little careful on how I respond because this is a very broad statement. I do see opportunity in the course of tax reform to make some changes in the tax system which would provide an economically sound incentive to create private sector jobs and this is what we have to do. Five out of six jobs we have are private. So, I would reject that.

What I do reject, or at least have great difficulty with, is the notion that you can reward people, or certain groups of people, employed irrespective of the basic underlying economic rationale for employing them.

Representative HAMILTON. One argument is that it is cheaper for the Government to spend maybe with a direct subsidy to a private corporation of several thousand dollars to create an additional job in the private sector than it is to pay $7,000 or $8,000 or $9,000, whatever it is per job for the creation of a public service job.

Secretary BLUMENTHAL. Mr. Hamilton, you certainly have in your State some General Motors plants. I don't believe you have any American Motors plants, but let us assume you do. Under this proposal, General Motors, which is a strong and growing company, would collect some money from Uncle Sam. American Motors, which is struggling to hold its own in terms of employment, would not for reasons that have nothing to do with the purposes that you had in mind in enacting such legislation. I just don't think it makes a lot of sense.

Representative HAMILTON. I don't mean to be argumentative. Obviously, it will receive serious consideration up here and obviously you gentlemen will be faced with a decision on it some point down the road and I appreciate your comments on it.

Thank you.

Representative BOLLING. Senator Javits.

Senator JAVITS. Thank you, Mr. Chairman. This is the first time I have had a chance to ask you some questions since you took on this job.

Secretary BLUMENTHAL. Not the first time, however.

Senator JAVITS. I welcome you here and I know you will do an excellent job in what you are doing.

I have listened carefully to what you have said about the additional employment credit and the impact problems in it. That is the problem as you see it, that you do not think a system can be devised which will be a fair one.

Secretary BLUMENTHAL. Yes.

Senator JAVITS. Isn't it a fact you don't expect everyone to get the additional employment credit any more than you expect everyone to get a public service job, everybody to get youth employment who is connected with educational training? With regard to your own bill—isn't this a question of intelligence and where you are going to apply it in order that you use it wisely and in a nondiscriminatory way? Maybe they should not give it to General Motors. Just because it is on the statute books does not mean it has to. Neither Al Ullman or I or anyone else would write such a bill.

Secretary BLUMENTHAL. As I understand it, Senator, I know two variations on the theme. One of them is the proposal where you simply take a base period and you say any increase over that base period by any employer commands a certain subsidy. I believe that is the most recent proposal Chairman Ullman has made.

A second one I have heard described is that you target it for those additional people who are employed in a particular area. In the inner city, for example, the hard-core unemployed, and you give an increase to employment if those types of people are chosen.

In either of those two proposals I would have some practical objections.

Senator JAVITS. But it is universally true you don't have to apply any of these. You have some selective ones. You did not give to everybody for public works. They are screaming bloody murder because you didn't.

Secretary BLUMENTHAL. I think in the tax proposals we have, Senator, we are attempting to make suggestions for programs that are quick, across the board, and can be implemented without great administrative difficulty.

Senator JAVITS. All I wanted to say was we are dealing within the ingenuity of man. Maybe you are right. Maybe it is impossible to do this. There is no law which says you are wrong and this is right.

I would like to pursue with you the question of rebates versus permanent tax cuts. That is the essence of it. We could hassle around whether the administration's idea of reducing the standard deduction or the Senate Republicans' idea of rebates being bad or good, but the real question is what will the rebate do? I think that is a very serious question and I say that for this reason. CEA Chairman Schultze has analyzed our problem saying the major reason for this continued sluggishness is clear, and I quote, "sales, income, productive capacity have not given businessmen strong incentives to expand their capacity for the future."

Isn't it a fact it is a very arguable theory whether the shot-in-the-arm theory of $9 to $11 billion now will simply be a shot in the arm, you get euphoric, what I call the pep pill, you will be pepped up for 6 or 8 months and then you are dead again and perhaps the income tax cut will tend to give the people confidence in the fact that the inventive, more productive and they will really do a job.

I ask you this as a citizen and not as Secretary or partisan, but shouldn't we take a chance on that theory on the grounds that that is its history? You have analyzed Treasury's figures. When you cut the tax rates, you took in more money than you did before you cut them. That is almost a pattern since the end of World War II. That is one big question that appeals to me.

I tell you, frankly, I hope in the debate we can arrive at some conclusion on that, and I do not believe the American people want us to do it on the basis of who is going to crow if he is right or wrong.

So I suggest this to you. Give us your views. I know you are for the other idea but give us your views so that we can debate it.

Secretary BLUMENTHAL. Senator, I have a great deal of sympathy for your view. I believe that a tax cut, particularly one which will stimulate inventiveness, efficiency, and production, and create more incentives for individuals in business is the right way to go. And I would do that on a permanent basis. I am fully in favor of that.

I argued very strongly within the administration for the inclusion of as much permanency as possible within that package. There are some elements which are permanent. We do want to take another crack or get another crack at really more fundamental tax reform which I am sure you would agree is very necessary.

There was a tax reform bill passed a year or so ago in the Congress which I am told resulted in—there is some debate about how many additional pages were added as a result of it—about 700 or 800 more pages in the tax code.

I think the goal which the President has talked about— of attempting to simplify that along with changing the tax structure more fundamentally—is a very good one.

We have begun with Mr. Woodworth who has left this part of town and joined us in another part of town——

Senator JAVITS. He is still my expert. I am not relinquishing him.

Secretary BLUMENTHAL. With your help, we really have some hopes for help there. I think it really makes sense to keep some of our resources for that effort because it is going to take something to grease the skids, so to speak, to get that done.

So at this early stage, 11 days after the administration takes office, when you face the problem of getting the economy going a little faster, to commit yourself to the loss of revenue for an indefinite period of time without having the 6 months or so needed to focus on the reform effort, is, I really think, not wise.

Senator JAVITS. Is it a timing problem? You want to go the way we want to go but you feel you can't go right now and as fast?

Secretary BLUMENTHAL. Yes.

Senator JAVITS. I think you are being fair and honest. If we stimulate consumer demand as our main thrust, consumer demand may be in imports. I believe American business is falling behind in terms of the obsolescence of our plants and I am hoping one day soon, our committee will dig into that. We are no longer numero uno as we were so many decades ago.

The other thing I wanted to come to was unemployment compensation. We have an enormously bad situation with 1.3 million unemployed for more than 26 weeks. It does not look any better this year. I happen to be very interested in all kinds of compensation systems by which you might use unemployment compensation for purposes of wages and salaries but again like your problem with the rebate, that is my problem because you can't convert a system that fast.

Yet we face it right away because March 31, this year, Federal extended unemployment benefits will expire. Does the administration have any policy on that?

Secretary BLUMENTHAL. I turned around to look at Mr. Woodworth because I was not aware of the fact that we got involved in that. I have not been involved in such discussions.

Senator JAVITS. The time is extremely short and I would respectfully request, Mr. Secretary, that the administration tell us what its policy will be.

The last thing I would like to ask you, sir, is whether or not it is intended by this economic stimulus package to reach the issue of productivity or whether the administration considers that, again, to be an issue it simply cannot grapple with here and now but will come to? We have a commission now that is very badly underfinanced, ridiculous in what we do with such enormous enterprises, underutilizing facilities 20 percent and we are not nearly as automated and up-to-date as we ought to be and yet I think we are spending $5 million and maybe just 2.5 on the question of productivity and working and living values.

Is it fair to say you are not quite ready to come to grips with that?

Secretary BLUMENTHAL. I think it is fair to say this package does not address itself to what I agree with you is a critical problem.

Senator JAVITS. Thank you.

Representative BOLLING. Mrs. Heckler.

Representative HECKLER. Thank you, Mr. Secretary. I am delighted to receive your testimony. I did not hear you give it. I am delighted to have you before the committee and I welcome you and I wish you well. I think it is helpful for the country to have your views.

I am concerned with your views on unemployment and I am alarmed over the inadequacy of unemployment data. The recent public works grants under the Public Works Employment Act of 1976, the most needy communities in my district in Massachusetts in a place called Fall River, Mass., both of which had a long history of unemployment, in so-called maturing economies of Massachusetts, we found that they did not receive one thin dime from the Federal Government under the formula—under the most recent act, and part of the reason for lack of funding is our later discovery that the unemployment statistics did not really reflect the degree of unemployment in those communities.

Now, what has happened is the Federal Government has started to disburse considerable funds, in billions of dollars, in the CETA program and through the Public Employment Works Act and the countercyclical revenue-sharing program. They have begun funding largely on the basis of unemployment in the communities so that the unemployment figure attributable to a specific community is very central to the question of whether or not that community will receive the grants under the affected programs.

Now we learn from the Bureau of Labor Statistics, and I had a very long session with them yesterday, that they feel that their methodology is not up to providing really accurate figures on a local level and that the Congress is requiring this before the Bureau has been really geared up to meeting this challenge in a manner consistent with their usual accuracy, so that a very substantial change in the funding and size and scope of the BLS is going to have—and also the Census Bureau—to be brought about in order to provide really accurate statistics. I think it is going to be imperative that the Congress take cognizance of this.

We know now that in Massachusetts with the new procedures for benchmarking, there is an updating of our figures about 2 percent, they are saying now, and this comes too late for the communities affected to receive funding under the Public Works Act. Some of these communities lost out by tenths of a point, and now we find the inaccuracy is in the range of more than one point, possibly two, so that bringing the BLS into par with what the Congress is requiring, and what you want, is again going to have to be a priority of both you and the administration.

But in terms of unemployment, one of the most difficult problems is the question of youth unemployment, the high percentage in many cities of young people who don't have jobs. I wonder what your feeling is about the increase in the minimum wage which is being considered by the Education and Labor Committee of the Congress now and is going to be considered in this session of Congress and how this particular change, an increase to $3 an hour, would affect, say, the unemployed young people of our communities.

Secretary BLUMENTHAL. I agree with you that unemployment amongst the young is a very serious problem. I have always felt in recent years as a society we have tended to take care of older people much better than the younger people because the younger people are less organized and the least politically influential. They don't vote as much as older people do and for a variety of other reasons. So, clearly, it is a very important problem, and particularly in the city.

At least this program does begin to deal, not adequately or fully, but begins to make some effort to deal with this problem. It does so through the creation of, and through putting as much as we can into, training and youth corps employment. Also, some of these measures will bring some of these younger people onto a payroll and take them out of the unemployed status—to develop them, hopefully so they can go on to more productive jobs.

I have not really studied, Mrs. Heckler, the various ways in which a raising of the minimum wage would impact the problems. I tend to be a believer in the minimum wage concept. I am, generally speaking, dubious when I hear people argue against the minimum wage on the ostensible grounds that it tends to inhibit employment of certain types of people. Frequently, I find that that is being used as an argument for not having some kind of minimum standard. I think one is very necessary.

I don't think that $3 an hour is an excessive rate of pay if a person has to support himself or herself. A $100 a week, or $120 a week, is not a great deal. So, I would think that the minimum wage needs to be reviewed from time to time in the light of developments and inflation. Whether or not this particular amount of $3 is right or not and what its impact on the unemployment rate would be, I do not know since I just have not had a chance to look at it.

Representative HECKLER. Would it be possible for you to consider this and review the studies of the Department and respond to the committee.

Secretary BLUMENTHAL. Yes.

Representative HECKLER. I would ask permission for that, Mr. Chairman.

Representative BOLLING. Without objection, it is so ordered.

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

Staff economists at the Treasury Department have reviewed the available literature on the impact of the minimum wage on youth unemployment as requested. The most comprehensive study in the area was done by the Bureau of Labor Statistics in 1970, but several more recent private studies have been published as well. In general, the results appear to be drifting toward the conclusion that the minimum wage does increase unemployment rates among teenagers, particularly as they expand their job searches into sectors subject to the minimum wage requirement (or coverage of the program is expanded), and the level of the requirement becomes higher relative to average hourly wage rates.

The question remains essentially unresolved, however, because of numerous analytical difficulties and problems associated with the overall policy environment. The analytical difficulties center around separating the impact of the minimum wage from the influences of other factors such as population and school enrollment changes, or even secular changes in the behavior of the economy. Consideration of the overall policy environment confuses the issue still further. The minimum wage is only one facet of the larger area of manpower policies, which is in turn only part of the still larger area of domestic economic policies. If minimum wage requirements are imposed in conjunction with other policies aimed at achieving full employment, the empirical evidence could suggest a rise in employment resulting from a higher minimum. The reverse is also true, i.e., in a poor employment policy environment minimum wage increases could appear quite damaging.

For these reasons it appears perfectly acceptable to judge the matter on the basis of other considerations. The need for a "living wage" which will support a socially acceptable minimum standard of living is an example of an alternative frame of reference. In short, even if conclusive empirical evidence establishing a negative impact were available, support of minimum wage requirements for young people might still be appropriate.

Representative HECKLER. How do you feel about a subsidy for training when a firm hires new workers provided some real training is involved?

Secretary BLUMENTHAL. I think there are some real possibilities there. This particular package does include quite a bit of money for training programs and we hope that this training will indeed be carried out by private organizations to the largest extent possible. I think this is an approach that has a lot of merit and can work well as long as it does not merely fund efforts that private industry would do anyway. You always have to worry about how funding and additional training would have to be very carefully administered in order that companies don't just pocket the money for what they would be doing anyway.

Representative HECKLER. Can you think of any safeguards that could be written into law to prevent that?

Secretary BLUMENTHAL. To go back to a comment of Senator Javits, with particular targeting—and I say this with some sense of caution because I have also been impressed by the great proclivity to write regulations and to multiply the amounts of rules and regulations and the difficulty that industry has with living with this ever-increasing set of rules and regulations—you have inspectors that must check up on it and you drown in paper. You would want to be careful not to overdo it.

Representative HECKLER. Following one of the questions Senator Javits raised, you indicated that you do favor some permanent decrease in the tax rate. Isn't that your statement?

Secretary BLUMENTHAL. Right.

Representative HECKLER. Do you have any idea now in what area that would occur or what outline or form it would take, or the possible scope of the reductions?

Secretary BLUMENTHAL. Mrs. Heckler, I think it is really a little too early for me to discourse on this because we have just begun to think about it, let alone talk about it. We need a little time in order to come up with more specific ideas which we should then discuss with you and your colleagues. I am not really ready to talk about that.

Representative HECKLER. In view of the fact that events seem to have almost overtaken the impact of the package you proposed two or three weeks ago, in view of the energy crisis itself, how much real stimulus will the rebates provide when the energy costs are increasing so rapidly that people will probably just use the rebates to pay their new fuel bills?

Secretary BLUMENTHAL. I think it is still a little too early to tell what the energy costs and employment costs and state of the economy in general will be. If it is indeed true, as I saw in the paper today, that the Library of Congress indicated the cost would be $10 billion, you could argue that would wipe out the impact of the rebate itself. Mr. Schultze testified yesterday and I agree with him, that it is a little too early to tell but our preliminary indications showed that it might be somewhere in the range of $2.5 to $5 billion. We really don't know. We will have to watch it day by day and reevaluate our situation.

Representative HECKLER. But it might well be Congress could pass a package that would be totally inadequate in providing a stimulus?

Secretary BLUMENTHAL. I would say the weather and the consequences for the economy is an emergency situation that should be dealt with in those terms when the dimensions are known because it is a shifting thing.

Representative BOLLING. Senator Javits.

Senator JAVITS. I have just two questions and feel free to tell us you will give us the answers. I notice one big criticism, there is no housing component. The Senate included one on housing rehabilitation. Chairman Schultze said that he thought that the new Secretary of HUD was going to produce one in about 10 days.

Could we agree there should be a housing component?

Secretary BLUMENTHAL. There should be a housing program. We agreed that Secretary Harris would develop one which we would present to you. But we did not include it in this package and will do it as a separate matter to come forward shortly.

Senator JAVITS. But we agree there should be a housing component to our effort?

Secretary BLUMENTHAL. Yes.

Senator JAVITS. If capital and capital formation, et cetera, is a desirable thing, should we not also consider these various ideas about increasing the $100 exclusion for dividends, doing something about small-saver interest, et cetera?

Secretary BLUMENTHAL. I tried to duck the question a while ago as to exactly where we would look at it. I suspect we will look at those things very closely in terms of our review.

Senator JAVITS. I guess I chaired the committee that got up this package, and I just want you to know that my attitude, and I really think it is the atttitude of most of our members, that we want to make our contribution, but we also want to wed that to the expertise of the departments. So, you are not insulting us if you say this is wrong and why. We may struggle with you and have different views, but I hope President Carter's feelings which he so often expressed will be that, one, debate will produce the better result; two, nothing will shake the country if something the opposition puts up is included and, third; that we have all tried to be objective.

Thank you.

Representative BOLLING. Mr. Secretary, I would like to make a comment on tax reform.

I have been sitting here thinking about the attempts at tax reform over the years. In this case, I do not want to overstate it at all or even risk it. But I think this is perhaps the best opportunity that any administration has had in the post-World War II period to get a major tax reform through Congress. Your associates will know if that is correct better than I and I would take your judgment. But my memory of the time I have been around here is there has been some component that was missing, that is not missing at this time, on every other occasion. Either the President was not very sophisticated about the Congress or the Congress and some of its components were not very friendly. There are always difficulties in Congress regardless of the circumstances. But I think this may be a good opportunity in modern history. And I think it is worth saying here that there is absolutely no possibility of an administration alone getting a tax program through a Congress.

Also there is absolutely no possibility of the Congress alone passing its own tax program, but there is a possibility of a coordinated effort by an administration and by various elements in the Congress to pass a tax reform package. Now, that is not a leverage statement. I think that is a statement of fact, but unless the administration's program is devised in relation to the realities that exist in the two Tax Committees in the two bodies, unless the various power centers in each of the two bodies on the Hill, and this includes both parties, outside of the Tax Committee, the leadership and people in other committees are all included in the process, there is not going to be a result.

I have believed in one or another type of relatively mild tax reform for quite a long time and I have not seen anything consummated cleanly because somebody has left out a piece or another piece. I would have preferred to have talked to one man before I made this statement, but I think it is accurate. If you really have a unique opportunity and unique problem then I think for the first time you have all of the component parts in one place and it will be interesting to see whether it can be done.

I think that is an accurate statement.

Secretary BLUMENTHAL. Thank you very much. I will be very grateful for your help and comments in the future on how we can best achieve that goal and who all the interested parties are who need to be brought into the process. I have in the last 12 to 30 days, perhaps, occasionally asked myself at night what am I doing here. I felt maybe because of one of the goals. I think there will be more, but even if it were the only one achieved, if I could make a contribution to help bring it about, to take advantage of the opportunity to which you refer, to bring about some fundamental reforms, it would be worth it.

Mr. Woodworth has chosen to jump into the fray, I think, roughly for the same reason. We will work hard at it. I will certainly do my very best to do it on a cooperative basis, to involve those members of Congress who have an interest and a responsibility in this area and who need to be consulted.

Representative BOLLING. I think it would be worth the trip if we had real tax reform. I really agree with that.

Thank you, sir.

I have a few cleanup questions. If Mrs. Heckler has further questions, you can ask them now or later.

Representative HECKLER. Thank you, Mr. Chairman. I have no further questions at this time.

Representative BOLLING. This is not a technical question but it is a question of how we do a better job of looking at the economy.

One of the significant contributors to the economy's regrettable pause in the latter part of 1976 was the fact that Federal purchases ran at a slower rate than was budgeted. Thus, we found to our surprise toward the end of the year that the Government had spent some $15 billion less than had been determined to be needed to support the economy.

What assurance do we have that a similar shortfall in Federal fiscal support to the economy—or even a surge in outlays above what is expected—will not happen in the future? Do we need new procedures to monitor the actual execution of Federal spending policy?

Secretary BLUMENTHAL. Can I take some time to reflect on that and provide the answer for the record?

Representative BOLLING. We would be delighted if you did.

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

The simple answer to the first question is: "None with any certainty." The Office of Management and Budget (OMB) does not know yet whether there will be either a budget shortfall or a budget overrun in fiscal year 1977. OMB asked agencies to make a careful review of their outlay estimates in conjunction with the preparation of the 1978 budget. Then, OMB made a thorough review of the estimates that were submitted. This emphasis did result in some reductions from the initial agency estimates.

As each month passes, OMB will review actual spending relative to estimated outlays for the year and make a judgment as to whether spending is proceeding approximately on target. For example, cumulative outlays through December amounted to $99 billion. While that total for the quarter does not seem high in comparison to a total of $411 billion to $413 billion for the year, much less to the $418 billion that is being considered by the Congressional Budget Committees, a shortfall is not necessarily forecast. Not only is it quite possible that spending rates will pick up considerably; the stimulus proposals of both the President and the Congressional Committees are designed to produce an acceleration of spending throughout the remainder of the year.

OMB is committed to following outlays closely as the year passes. The Congress will be informed if the Administration concludes that outlays are going to be either less than or more than those estimated in the latest official estimate.

With respect to the second question, we doubt the advisability of instituting the control system that it recommends because we doubt the practicability of such a system. To a large extent, the difficulty of explaining differences between estimated and actual outlays has its roots in the nature of the control mechanisms in the Federal budgetary system and in the very loose connection between this control mechanism and budget outlays. Consistent with the Antideficiency Act (Section 3679 of the Revised Statutes, as amended) the Federal budget system is designed to control obligations (i.e., commitments to spend), not outlays. Indeed, the marginal notation for section 3679(a) describes the control mechanism very well in a few words: "Obligations not to exceed authority."

The emphasis on obligations is heightened by the fact that penalties are provided in the Act for obligating funds in excess of those that are authorized. The budgetary process, the control mechanism, and these penalties for over-obligating funds produce two biases: First, there is a natural bias toward optimism by agencies in estimating their ability to obligate authorized funds in any given period, since authorized amounts are often justified on the basis of expected obligations. Second, there is also some natural bias toward conservatism in obligating funds once they are authorized for fear of violating the Antideficiency Act. Independently of these biases, there are numerous difficulties in estimating future obligations with accuracy.

Clearly, the ability of agencies to obligate funds in the 15-month period encompassing fiscal year 1976 and the transition quarter was overestimated. Even if obligations had been estimated accurately, actual outlays might have differed significantly from estimated outlays, however, since the linkage between obligations and outlays is not direct. This is particularly true in areas where the translation of obligations into actual spending by the Federal Government depends upon the actions of others, such as States or contractors. Moreover, even where the linkage between obligations and outlays is close and direct, as in the case of most Federal payments to individuals and other programs in which the Government has little or no discretion about the spending, the accuracy of outlay estimates depends on such difficult-to-estimate causal factors as the participation rates of beneficiary populations, unemployment rates, prices and earnings. Some of these factors were significant in the 1976 and transition quarter underrun. For example, interest rates were lower than anticipated, more was received for offshore oilland leases than predicted, and the requirements of income maintenance programs were less than expected.

Generally, agencies lack incentives to estimate outlays for discretionary programs with accuracy. As is noted above, the Federal budget system controls obligations, not outlays, and, in fact, the laws that establish the system place very little direct responsibility on the agencies to make accurate outlay estimates. That responsibility and the necessary discipline in the system must be imposed by OMB (as the President's agent) and by the Congress.

In most years, the discipline has been effective. When the President's original budget outlay estimates are adjusted to reflect congressional action, later Presidential initiatives, the effect of major changes in economic conditions, and revisions based upon experience within the budget year, the record shows that there is a small bias toward overestimating outlays—less than 1 percent (net) over the last 5 fiscal years. It is doubtful that this record could be improved on by the control mechanism suggested by the question.

Representative BOLLING. Yesterday, Senator Proxmire raised the question whether this winter's production stoppages caused by natural gas shortages may have an adverse effect on business investment psychology.

You are very familiar with investment decisionmaking in the business community. Do you think that the demonstration that we currently are witnessing of the vulnerability of our energy supplies will give businessmen pause about expanding capacity, especially in industries in which natural gas is essential at some point in the process? How important are such industries in the overall economy?

Looking at the matter from a slightly different angle, to what extent may this winter's critical gas shortages result in a diversion of funds from capacity expansion projects to efforts to convert facilities from dependence on gas to dependence on coal and oil? Does this kind of diversion have any major implications for the future of productive capacity?

Secretary BLUMENTHAL. The natural reaction of most businessmen to that kind of situation would be how can we protect ourselves in our own particular enterprise against that kind of vulnerability. It probably might lead businessmen to invest more in ultimate ways of providing energy for their enterprises so that they can switch from one to the other. I know we did that in my company in a number of instances so that we were not relying totally either on natural gas or oil. We had the opportunity to alternate somewhat between the two.

In this sense, it might lead to more investment, and importantly I think, it will perhaps do something that has been needed for a long time. I think the President referred to it last night in a way in his statement. It is to bring home to those businessmen and other Americans who may have forgotten that we really need an energy policy. Our general vulnerability to forces beyond our control in the absence of such a policy is greatly increased.

I would hope that that, therefore, would increase the support not only in the Congress, but throughout the country the efforts I know that the President, Mr. Schlesinger on his behalf, and all of us will be undertaking to finally come up with an energy program for the country is not going to be pleasant or easy.

Representative BOLLING. I have a couple of questions, and I think I know your answers in advance because of what you have already said.

But quite precisely, as you know, there is a lot of controversy on the Hill about the components of a tax cut, rebate and also the business tax cuts, and I have some specific questions about that.

Statements have been made to the effect that almost everyone will receive a rebate or social security bonus. In fact, there are quite a few left out, including, if I am correctly informed, virtually all "nonaids", single individuals and families without children whose income is too low to incur a tax liability, many welfare recipients, et cetera, will all be left out. Do we have any figures on that or is that something you would rather deal with at another time?

Secretary BLUMENTHAL. I hope I have this right. I have this every time and then Larry whispers I left something out.

The only people who are left out and let me underline first of all, more people are included in this proposal than the last package—96 against 89, the only people left out are single people or married people without dependents who had no income of any kind and who are not on social security, SSI, or railroad retirement.

Representative BOLLING. My staff tells me it includes those whose income is too low to have tax liability.

Secretary BLUMENTHAL. No, because they are then eligible for an earned income credit.

I will let Mr. Woodworth debate that.

Representative BOLLING. I would like it to be a discussion between those who know what they are talking about.

Mr. WOODWORTH. If you are talking about dependents in the family, they are covered if they have one dependent and file for an earned income credit. The only ones who are not covered are those who are married and have no children or are single and have no tax liability, and then only if they are not on social security, SSI, or railroad retirement.

Representative BOLLING. Do we have figures on how many people had no income? I guess that is the sticker.

Mr. WOODWORTH. It is very difficult to make an analysis here——

Representative BOLLING. Do you think it is 96 percent as opposed to 89 percent and the 4 percent are all you think are involved in not getting it?

Mr. WOODWORTH. That is correct.

Representative BOLLING. How good are those figures?

Mr. WOODWORTH. They are not too good because you can't get clean series here because of the fact that some individuals get in more than once.

Representative BOLLING. What is the plus or minus? Roughly 1, 2, 3, or what? I am not trying to hold you to anything.

Mr. WOODWORTH. I guess it could be off by as much as twice that figure——

Representative BOLLING. Twice four?

Mr. WOODWORTH. Yes, it could be eight.

Representative BOLLING. That is enough for me. I have spent too much time playing with statistics to get excited beyond that point although it may mean a significant number have been left out.

What are the advantages of a flat payment per person as opposed to a scale payment to low income family—simplicity—flat payment as opposed to a scale?

Mr. WOODWORTH. It is simplicity but relative to income it is better for low income than high income persons. This takes into account dependents and you tend to have more dependents at the lower income levels—substantially more.

Representative BOLLING. Considering the proportions of the tax rebate, what proportions do you think will be spent, and what proportions will be saved?

This is not Christmas in July—just July.

Mr. WOODWORTH. Based on past experience, it is felt there is initially some saving, but over a short period of time the saving rate reverts to pretty much the normal rate. In fact, it seems to go down.

We think there are circumstances this time which may be even more beneficial than last because when the rebate was paid out last time, unemployment was increasing and there was a feeling that they had to save for the rainy day that might face them in the future. We think generally the confidence of the consumer is somewhat on the increase now, they are less inclined to feel that they must save it for the rainy day and are more inclined to spend it as a result.

Representative BOLLING. I have one that bothers me because it is part of a package. Precisely, what economic benefits are going to come from the two alternative business tax reductions that the administration has proposed? Is either one really going to have any short-term effect on employment? Then I have some followups to that?

Secretary BLUMENTHAL. We do not know the precise impact of this part of the package. In terms of the immediate impact on employment, I think they would be marginal in both instances. I think the employment tax may be somewhat greater initially than the investment tax credit, although the investment tax credit may have a more lasting impact over the long run. But in both instances, they would be marginal because they are quite small.

Representative BOLLING. Mr. Garry Brown of Michigan just arrived.

Representative BROWN of Michigan. We had occasion before to meet back in Michigan. It is wonderful to have you onboard here. We also had an opportunity to meet yesterday before the Banking and Currency Committee.

I don't want you to feel that you are getting a double wammy, and I trust I am not being duplicative, but there are two or three things I would like to ask you. I don't know to what extent you got into the employment tax credit. Your counterpart was before us last year and we discussed the extent that the investment tax credit is an incentive for improvement of plant and modernization of equipment, and so on, that is all fine, if the modernization of equipment does not go to replace or to eliminate jobs because in high unemployment times, it seems we don't want incentives for things which will eliminate jobs even though we may get some increased productivity.

So, I, at that time, suggested the idea as Mr. Ullman has, why not have an investment tax credit for employment, in effect. It seems to me that that has kind of an offsetting effect on the minimum wage and a lot of other things that are basically, I think, disincentives in the labor market, especially if you are talking about youth, marginal employees, et cetera.

Would you care to comment further on the employment investment tax credit?

Secretary BLUMENTHAL. Mr. Brown, I, too, am glad to be sitting here and was glad to meet you yesterday. I learned about a different kind of double dipping yesterday and I think this kind is very pleasant.

Representative BROWN of Michigan. I have looked at your schedule and between the different committees where you have to be on the Hill, you are going to find probably the greatest demands on your time will be the Congress and all of its committees, et cetera, that have jurisdiction over some part of your activities. You will be called up here constantly. I have often said I don't understand how anybody runs a department because you are on the Hill all the time.

Excuse me. Let me let you proceed.

Secretary BLUMENTHAL. The question of the investment tax credit being utilized for increases in productivity which replace labor, I think, needs to be seen in somewhat broader context, Mr. Brown.

My former company happens to be a Michigan company, as you know. Our total employment was 85,000 people in that company, I would say two-thirds of which were engaged in the production of equipment which, when somebody buys it, involves an investment tax credit. All of the machine tools that company produces, all of the electronic test equipment that company produces, the numerical controls, all of the things that make American industry great, are the sorts of things for which you get investment tax credit.

The point I am making therefore, is that there is not only the initial effect of putting in a numerical control and substituting it for the 12 people that measured and controlled a particular production process before—and less accurately, probably—that you have to take into account, but also the people who make the equipment, the people who have to service it, the software people, all sorts of things that go with it.

It also makes us much more productive so we can compete effectively abroad. A significant portion of the business of that company is exported. When you take it all together, you don't lose by being more productive. You gain in employment by being more productive and you have to go beyond looking——

Representative BROWN of Michigan. You have to look beyond the site where the credit applies?

Secretary BLUMENTHAL. You have to look at the economy as a whole. The employment tax credit—I had the occasion to comment on that earlier this afternoon before you joined us, sir—I would say is a tax on efficiency. It is in fact a tax which says if you do not make yourselves more productive, you get a payment. If you happen to grow for whatever reason—probably decisions you made 2 or 3 years ago, you get it.

To use a Michigan example which is better than in the case of Indiana, General Motors—the biggest and strongest company—is growing, but American Motors, who is not going along that well and may be declining, wouldn't get it. You get into the kind of complications that are very hard to work out.

If you say why don't you just give it for more employment of people in the innercity in Lansing, Detroit, Grand Rapids, or whatever—people unemployed for 26 weeks or more—then you run into the problem of how do you identify it, what kind of paperwork is involved, and what does the employer do who wants to maneuver the system. He lays off certain people and hires some who have been 28 weeks out of work. You get a churning in order to collect more of a subsidy. I guess what I am saying is it presents innumerable obstacles to efficient administration and it raises basic questions that give me great trouble.

Representative BROWN of Michigan. The point which I think is very valid is the cost effectiveness of it. I remember the Russel Long home purchase credit—Larry, I am sure you remember this—the credit for the purchase of a new home. What were the figures?

Mr. WOODWORTH. $2,000.

Representative BROWN of Michigan. For every new home that that provided the incentive for purchase, 3.4 would have been purchased anyway—maybe I am not quite right but something like that—and as a consequence, the cost to Government of the incentive for that one additional purchase, since they all got the credit, was something like $6,800 or something like that—I have forgotten.

Secretary BLUMENTHAL. To give you a specific Michigan example, my former employer decided some months ago to close a factory in Ann Arbor and to transfer it to Mount Clemens for various complicated reasons. Because that decision was made within a time period that might benefit under this particular scheme—since they will be laying off some people in one place and then hiring some people in another in a bigger facility where they can have more people—they get some kind of a payment.

It has no impact on the number of people they employ because they are going through with something they planned to do anyway. That would not make a great deal of sense in terms of stimulating additional employment. It is those sort of situations that would be just rampant throughout the economy.

Representative BROWN of Michigan. On a little different subject, I know that you are getting a lot of pressure to advocate additional stimulus because of the unemployment created by cold weather and the energy shortage. I hope that you will continue to do that which I perceive you are doing and that is oppose additional stimulus because I think it is quite misdirected. The problem today of unemployment is not the lack of demand and the lack of jobs because of the stimulus involved. The problem is that we don't have the energy, et cetera to run the plants where people would be employed if we had it. It seems to me we would exacerbate a situation rather than helping it if you succumb to the pressures that I know will be applied.

I am introducing legislation that I discussed before. One I have already mentioned to you and I hope you will look at the supplemental Community Development Assistance Act of 1976 which, as I say, passed the House and was killed in the conference with the Senate.

But another one is in connection with the revitalization of the cities which I know you are interested in. I would like to have you give some consideration and I would like to have your input on providing an investment tax credit for residential capital improvements.

HUD has, of course, identified in every city the declining, deteriorating neighborhoods. These you can identify. They have been identified for a kind of positive affirmative assistance, for the spending side.

It seems to me that such an investment tax credit would provide an incentive for improvements in these areas which now there are disincentives due to the fact that under every practical taxing system I know of, when you improve the property, you get an increased assessment and your taxes go up, and there is no incentive for a landlord or individual to improve his property. I think the tax credit is a different way of providing assistance, and I think it could be of some value. I don't know what the figures should be. I have some figures. We will be trying to get a revenue estimate from your office one of these days.

The propsal also contemplates that all older and declining neighborhoods would be eligible for assistance, but mayors could establish priorities for areas, and they would certify that the areas qualify and then the administrative task would be lessened by having the building department, the code enforcement people merely certify that improvements have been made. They would not certify as to the value because it is the taxpayer's responsibility to prove the value to get a credit.

So, I don't think there would be an absolute quagmire, but I am introducing it at least to get a discussion on it. I think it has some merit. I think everyone in the tax area is reluctant to tack on more and more special little gimmicks for tax credits and things of that nature. It does not help to simplify your tax return, I agree, but so long as we have decided to go this route, until we do a complete turnabout, I think maybe one more would not hurt.

Did you discuss at all indexing insofar as tax rates are concerned, the argument being, with inflation, you are taking a lot more revenue than you really should for the amount of purchasing power that a person actually has by virtue of his income?

Secretary BLUMENTHAL. The question has been raised a number of times in the course of the week as I have appeared before different committees. I would say, as we now begin to look at fundamental tax reform, that is one of the issues we ought to look at. We should do so but we have not done so in the context of this package.

Representative BROWN of Michigan. Thank you, Mr. Secretary, and Mr. Chairman. I have no further questions.

Representative BOLLING. Mr. Secretary, we thank you very much for your patience and your presence.

The committee is now recessed.

[Whereupon, at 3:45 p.m., the committee recessed, to reconvene at 10 a.m., Monday, February 7, 1977.]

[The following questions and answers were subsequently supplied for the record:]

RESPONSE OF HON. W. MICHAEL BLUMENTHAL TO ADDITIONAL WRITTEN QUESTIONS POSED BY REPRESENTATIVE BOLLING

Question 1. During the fall, President Carter seemed hopeful that the U.S. might engage or join in the negotiation of some commodity agreements. Since, when you were in the State Department, you negotiated our first international Textile Agreement and also had a hand in the Coffee Agreement in 1962, what advice would you give Mr. Carter on the desirability of commodity agreements in general, and are there any commodity agreements in which you think we should take the lead? What are your views on the Integrated Commodity Program proposed at last May's UNCTAD meeting?

Answer. I believe commodity agreements can play an important role in reducing extreme price fluctuations. Each commodity has certain unique characteristics, however, so we will have to examine each case separately and judge whether it is in the interest of the United States to participate in a specific agreement. This Administration will not be doctrinaire in its approach to commodities and we do expect to be constructive in addressing commodity issues. Our overall commodity policy is under review at this time, but I do not expect a large change in our traditional case-by-case approach.

From a U.S. view, there are no commodities for which there is an urgent need for an agreement so we do not expect to take the lead in getting a specific agreement. It seems to me that with the adoption of the Integrated Program at UNCTAD IV in Nairobi last May and the consequent scheduling of Preparatory Conferences on 18 commodities, it is not necessary for any country to take the lead at this time on any of these commodities.

The Integrated Program for Commodities was adopted last May, but the United States made several specific reservations. We are currently participating in the conferences called for in the Integrated Program without prejudice to our case-by-case approach. We also are examining closely the issue of common funding for buffer stocks. Our study so far has made us very skeptical of the Common Fund proposed by UNCTAD in the Integrated Program.

Question 2. Are the two other leading industrial nations—Japan and Germany—doing enough to insure that global recovery from the 1974–75 recession and economic expansion will continue in 1977 and 1978? In addition, it is generally agreed that the industrial countries should do what they can to help redistribute global payments deficits so that financing burdens of non-oil producing developing countries are reduced and wealthy nations assume a growing proportion of such deficits. Are Japan and Germany also doing enough to assist in the global redistribution of payments deficits?

Answer. What is needed to insure that global expansion will continue in 1977 and 1978 is to maximize the number of countries experiencing strong, sustainable expansion. During the 1960s—a period of solid, non-inflationary growth in the world economy—the key factor was that a sizeable group of countries maintained steady real growth year after year. The composition of the group changed over time but the nucleus remained of sufficient mass to pull along "weak" countries by providing export markets throughout the world economy. We need, not a single leader—or even 2 or 3—on the expansion path, but a sizeable group of leaders.

In this vein, we have been urging other nations—in particular those in the strongest economic position, such as the U.S., Japan, and Germany—to keep their international responsibilities in mind when designing domestic macroeconomic policies. In particular, the sluggish growth and persistent high unemployment which are common to most if not all national economies point to a need for additional stimulus wherever such action is consistent with the control of inflation and the preservation of a sustainable external financial position. The U.S., Japan, and Germany have all proposed packages to add stimulus to their economies. The U.S. and Japanese packages look to be roughly equal in magnitudes, while the German proposal is less ambitious. Since virtually all of these proposals still require legislative approval, it would be appropriate for me to comment further on what the end result may be.

The most appropriate policies for "strong" countries to follow at the present center on providing growing export markets for those weaker countries facing balance of payments difficulties. By pursuing non-inflationary expansionary policies, by encouraging the free movement of trade and capital, and by allowing exchange rates to respond to market pressures, strong countries provide the necessary climate for the redistribution of current account balances among the oil importers. There are no quantitative yardsticks by which one can measure "doing enough", but one can look at expected trends in the external balances of strong countries to gain an impression of the accommodation being made. We would hope to see reduction in the current account surpluses of both Japan and Germany during 1977.

Question 3. The Amendments to the IMF's Articles of Agreement that are currently being approved charge the Fund with the responsibility of exercising "firm surveillance over the exchange rate policies of members". What preparations is the IMF making to carry out this responsibility? What assurance do we have that the United States will not be injured by other countries' efforts to manipulate the value of their currencies with respect to the dollar?

Answer. Under amended Article IV, the Fund is directed to exercise firm surveillance over members' exchange rate policies and to establish principles for the guidance of members with respect to those policies. The new surveillance function is explicitly directed toward ensuring that countries do not manipulate exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain unfair competitive advantage over other members. The IMF Executive Board has just completed a second discussion of surveillance, with a view toward reporting to the IMF's Interim Committee of the Board of Governors in April on the broad approach to be taken by the Fund, as the Committee requested at its last meeting in October. The IMF's new responsibilities for surveillance will be extremely important under the amended Articles and it is essential that the approach which is ultimately adopted obtain the widespread support of the IMF's membership.

The Administration is currently giving major attention to the surveillance issue. We feel, though, that present arrangements are working well and we are more concerned that the approach to surveillance be developed correctly then it be developed quickly. We will be looking toward arrangements that are equitable and consistent with U.S. views that exchange rates must play their proper role in bringing about international adjustment.

Question 4. Projections for 1977 indicate that the payments deficits of non-oil producing developing countries will at best be only slightly reduced from 1976. In addition, several industrial countries are struggling with difficult external payments problems. In the light of these circumstances, are the resources of the International Monetary Fund and the World Bank adequate? Should we anticipate the need for further expansion of the resources of either or both of these institutions in the foreseeable future?

Answer. We expect the aggregate current account deficits of both the non-OPEC developing countries and the industrial countries to remain roughly unchanged from 1976 to 1977.

As to the adequacy of the resources of the World Bank and the International Monetary Fund (IMF), different considerations and criteria are relevant due to the fundamental differences between the two institutions and the purpose for which their respective resources are used. The World Bank finances development projects in developing countries, and the adequacy of its resources is more directly related to long-term developmental needs rather than to the problem of financing balance of payments deficits. Legislation authorizing U.S. participation in a selective increase in the Bank's capital and capital replenishments of the International Finance Corporation (IFC) and International Development Association (IDA) is now being considered by Congress.

The resources of the IMF are used to provide temporary balance of payments financing to members in need during a transitional period while corrective adjustment policies take effect. The question of their adequacy is an extremely important one and we are currently conducting a thorough review of the situation. Use of Fund resources has increased greatly during the last few years and current availability of usable resources is relatively low by his historic standards. These resources are now being increased through the IMF's gold sales program, and an increase in Fund quotas is expected to become effective during 1977 which will expand quotas from SDR 29 billion to SDR 39 billion (approximately $45 billion) and add significantly to the Fund's available resources.

Question 5. Since oil prices were quadrupled in 1973, commercial banks and other private financial intermediaries have assumed a much larger portion of the burden of financing the payments deficits of developing countries than these institutions had in previous years. In the light of the growing debt burdens of the developing countries that do not produce oil and of certain weaker industrial nations, apprehensions have arisen about the willingness and ability of private financial intermediaries to continue extending a similar level of financing as that they have provided recently. The activities of these intermediaries have expanded to the point that they have been providing nearly half of the balance of payments financing required by non-oil developing countries. What are the prospects for continued private financing in 1977 and 1978? Should the U.S. Government take any specific action to either bolster the debt carrying capability of developing countries or backstop commercial banks and other private lenders?

Answer. By providing the overwhelming share of the required balance of payments financing over the past several years, private financial markets—especially commercial banks—have demonstrated considerable confidence that the related problems of international payments imbalance and the increase in external indebtedness of many deficit countries are manageable. While certain financial intermediaries may be approaching their self-imposed exposure limits in some countries, the overall ability of private markets to continue to meet the financing needs of creditworthy borrowers appears quite adequate.

The willingness of private lenders to provide additional financing will depend critically on the types of policies pursued by individual countries and their confidence in the ability of heavily indebted countries to manage their affairs. For a number of deficit countries, effective adjustment actions will be required to preserve their creditworthiness in the eyes of private lenders.

We recognize that provision for adequate official financing will have an important role to play—both in supporting required adjustment actions and in giving private institutions the confidence needed to continue their necessary financing role. The Administration is currently reviewing the adequacy of official arrangements.

Question 6. At the Rambouillet Summit Conference of November 1975, the goal was announced of completing the current Tokyo Round of GATT negotiations by the end of 1977. This goal was reconfirmed at the Puerto Rico Summit of June, 1976. Limited progress has been achieved in these negotiations to date. Should not this deadline be set aside in order to achieve more substantial benefits from these negotiations?

Answer. This Administration places great importance on the Ministerial Trade Negotiations now in session in Geneva. In our first contacts with our major trading partners, we have stressed the urgency of accelerating the work in the MTN and of attaining the goals originally envisioned in the Tokyo Declaration which launched this round of trade talks. We hope for major reductions in both tariffs and nontariff barriers. As Secretary of the Treasury, I am particularly concerned that MTN successfully deal with the problem of subsidies and countervailing duties. While we hope for rapid progress, obviously we place a higher value on substantive results than we do on adhering to a timetable. We will soon hold a series of intense bilateral discussions on the MTN with our trading partners, and I imagine that the question of substance and timing of negotiations will be dealt with at the economic summit.

RESPONSE OF HON. W. MICHAEL BLUMENTHAL TO AN ADDITIONAL WRITTEN QUESTION POSED BY REPRESENTATIVE BROWN OF MICHIGAN

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., February 8, 1977.

HON. W. MICHAEL BLUMENTHAL,
Secretary of the Treasury,
Department of the Treasury,
Washington, D.C.

DEAR MR. SECRETARY: Representative Garry Brown has requested that the following question be submitted to you. The question, along with your answer, will be included in the record of the hearings on the President's Economic Report which were held on February 3, 1977.

"In the last year or so, the Treasury Department, has twice sold notes at a fixed coupon of 8 percent, instead of at auction. Each time, the issues were grossly over-subscribed, because market interest rates were below 8 percent. The Treasury Department would have saved over $200 million by using the usual auction method. Would you be willing to review these note sales to see if the Treasury should stick to the auction method, and give us your conclusions?"

We would appreciate your reply as soon as possible in order to insert the answer in the final transcript.

Thank you for your attention to this matter.

Sincerely,

JOHN R. STARK,
Executive Director.

DEPARTMENT OF THE TREASURY,
Washington, D.C., April 11, 1977.

MR. JOHN R. STARK,
Executive Director, Joint Economic Committee, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STARK: On behalf of Secretary Blumenthal, I regret the delay in responding to your letter of February 8 and to the request by Representative Brown that the Treasury review the fixed-price subscription technique used by the previous Administration in offerings of certain Treasury marketable notes in 1976.

I am enclosing a copy of a January 19, 1977, letter to Chairman Reuss from former Assistant Secretary Gerard, which sets forth in detail the reasons why fixed-price securities were issued in 1976.[1] As indicated in Mr. Gerard's letter, the purpose of the fixed-price technique was to sell larger amounts of long-term notes than could be sold efficiently by the auction technique. Large issues of longer-term securities were essential to achieve the Treasury's objective of a better balance in the maturity structure of the public debt.

The fixed-price technique was the traditional method of selling Treasury coupon securities prior to November 1970. Since that date the Treasury has sold all coupon (notes and bonds) securities by the auction technique except for advanced refundings, exchange-rights offerings, and the three fixed-price offerings in 1976. The Treasury has experimented with price auctions, Dutch auctions, and yield auctions in recent years, and with auctions to private syndicates in the early 1960's.

All Treasury coupon offerings since August 1976 have been sold by the yield auction technique, except for price auctions in the case of reopenings of existing issues. It is our intention to continue to utilize the auction technique of sale. However, we are currently studying the full range of financing techniques in connection with our overall review of debt management policies and strategies. A decision on whether to deviate from the auction technique will depend upon the results of our studies and upon broader debt management objectives, which in turn will depend upon overall conditions in financial markets. At this time we feel that it is essential that the Treasury study the question of sales technique closely and retain the flexibility to adapt its financing techniques to changing market conditions.

Please let me know if I can be of any further assistance.

Sincerely yours,

GENE E. GODLEY,
Assistant Secretary-Designate,
Legislative Affairs.

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[1] The enclosed copy of a Jan. 19, 1977, letter to Chairman Reuss from former Assistant Secretary Gerard may be found in the committee room files.

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